



Uttarakhand Open University, Haldwani

BBA(N)-606

School of Management Studies and Commerce



Income Tax

BBA(N)-606

Income Tax



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Syllabus

Course Name **Income Tax**

Course Credits: **4**

Course Code: **BBAN-606**

Level: **300**

Course Objective: The course aims to provide basic knowledge and equip students with application of principles and provisions in Income-tax Act, 1961.

Block-I Income Tax Concept and Income from Salary

Unit-I	Introduction and Basic Concepts
Unit-II	Residential Status and Incidence of Tax
Unit-III	Exempted Incomes
Unit-IV	Income from Salary

Block-II Income from House Property and Income from Business or Profession

Unit-V	Income from House Property
Unit-VI	Depreciation
Unit-VII	Income from Business or Profession
Unit-VIII	Income from Capital Gains
Unit-IX	Income from Other Sources

Block-III Deductions from Gross Total Income and Aggregation of Income

Unit-X	Deductions from Gross Total Income
Unit-XI	Set-off and Carry Forward,
Unit-XII	Clubbing and Aggregation of Income
Unit-XIII	Assessment of Individuals
Unit-XIV	Assessment of Firms

Suggested Readings:

1. Lal, B.B., (2009), Income Tax and Central Sales tax Law and Practice, 30th edition, Pearson Education.
2. Vinod K. Singhania and Monica Singhania, *Students' Guide to Income Tax*, Taxmann Publications Pvt. Ltd., New Delhi.
3. Mahesh Chandra, S.P. Goyal and D.C. Shukla, *Income Tax Law and Practice*, Pragati Prakashan, Delhi.
4. Dinkar Pagare, *Law and Practice of Income Tax*, Sultan Chand and sons, New Delhi.

Index

S. No.	Name of Unit	Page No.
Block-I	Income Tax Concept and Income from Salary	
Unit-I	Introduction and Basic Concepts	1-13
Unit-II	Residential Status and Incidence of Tax	14-28
Unit-III	Exempted Incomes	29-42
Unit-IV	Income from Salary	43-62
Block-II	Income from House Property and Income from Business or Profession	
Unit-V	Income from House Property	63-77
Unit-VI	Depreciation	78-94
Unit-VII	Income from Business or Profession	95-113
Unit-VIII	Income from Capital Gains	114-129
Unit-IX	Income from Other Sources	130-144
Block-III	Deductions from Gross Total Income and Aggregation of Income	
Unit-X	Deductions from Gross Total Income	145-162
Unit-XI	Set-off and Carry Forward,	163-173
Unit-XII	Clubbing and Aggregation of Income	174-188
Unit-XIII	Assessment of Individuals	189-203
Unit-XIV	Assessment of Firms	204-218

Block 1

UNIT 1: INTRODUCTION AND BASIC CONCEPTS OF INCOME TAX

1.1 Introduction to taxes

1.2 Learning Objectives

1.3 Types of taxes and difference between it.

1.4 Income tax concept

1.5 Features and history of income tax in India

1.6 Important sections under Income Tax Act, 1961

1.7 Concept of casual income under income tax act, 1961

1.8 Summary of the Unit

1.9 Glossary

1.10 Check Your Progress (Multiple Choice/Objective Type Questions)

1.11 Reference Books

1.12 Suggested Readings

1.13 Terminal Questions

1.1 INTRODUCTION TO TAXES

1. Taxes are the most significant source of revenue for the government. The act of levying taxes is known as taxation. A tax is a mandatory levy or fee levied by the government on persons or companies. Taxpayers must pay the tax regardless of whether the government receives a proportional return on goods and services. Taxes may be levied on the income and wealth of individuals or businesses, and the rates may vary. A tax is an obligatory monetary contribution to the state's revenue assessed and imposed by the government on the acts, enjoyment, spending, income, occupation, privilege, and property of individuals and organizations. A tax is a financial charge or other levy levied on a taxpayer by the state or its functional equivalent.

Some of the definitions of the tax are given below:-

According to **Dr. Dalton** : “Tax is mandatory liability and it does not resemble any reciprocal or proportionate benefit”.

View of the Seligman is that: “Tax means a compulsorily collected donation from public which is used for the benefit of all. Tax does not cater to individual needs”.

Taylor has said that : “Tax means a compulsory donation by public without any direct benefit for such donation”.

1.2 LEARNING OBJECTIVES

After reading this unit, the learners will be able to understand:-

1. Learn the concept of the tax.
2. Learner will understand the basic concept of income tax which exist in India.

1.3 TYPES OF TAXES

In India, taxes are classified into two types: (a) Direct taxes. (a) Indirect taxes. (a) Direct Taxes: A direct tax is a government-imposed fee on an individual or entity that must be paid directly to the government body levying it. The basic aspect is that the tax burden cannot be passed to another person or firm; the individual or organization responsible for paying the tax bears the financial consequences. A direct tax is one that is paid by the person against whom it is legally imposed and cannot be transferred to another person. Direct taxes include income tax, corporation tax, and property tax, among others. Direct taxes are usually progressive in design, so persons with a

Prof. Bullock is having view that the “Tax levied on **production of goods** is an indirect tax. Similarly tax levied on income is direct tax”.

According to **Dr. Dalton** : “When tax is levied on one person and the same is paid by that person then it is said to be direct tax”.

Indirect Taxes : An indirect tax is one imposed on products and services rather than on an individual's income or earnings. The fundamental element is that the tax burden is moved from the entity that collects the tax (such as a manufacturer or retailer) to the ultimate customer by including the tax in the product's final price. Indirect taxes are those that shift the burden to a third party. Examples include excise duty, Goods and Services tax (GST), Customs duty etc.

According to **Prof. J.S. Gill** : “When tax levied on one person could be transferred on some other person and when the Government does not expect some specific person to pay such tax, then it is an indirect tax”.

Prof. Bullock is having view that the “Tax levied on consumers and tax levied on expenditure could be defined as indirect tax”.

Difference between Direct Tax and Indirect Tax

Sr. No.	Direct Tax	Indirect Tax
1.	A direct tax is a tax assessed on a person, and that person is responsible for paying the tax.	The tax is levied on one individual, while the duty for paying the tax to the

		government falls on someone else.
2.	Individuals face direct taxes.	Indirect taxes are placed on products and services.
3.	The burden of paying the direct tax cannot be transferred to other person.	The burden of indirect tax can be transferred to the end users or consumers.
4.	Direct tax is often considered a progressive tax, although it can also be regressive.	Indirect taxes are often regarded as regressive.
5.	The goal of direct taxation is to disperse a nation's resources in an equitable manner among the people .	Indirect taxes cause a rise in the price of products or services.
6.	Income Tax, Gift tax, Corporate tax etc.	Excise Duty, Customs Duty, GST etc.

1.4 CONCEPT OF INCOME TAX

Income tax is a tax imposed on an individual's earnings. Income tax is an important topic under the Indian Constitution. Income tax is among the most significant direct taxes. It is the government's main source of income. The government need funding to preserve peace and order in the nation and protect it from external aggressions, and promote the wellbeing of its citizens. It is the government's primary responsibility to implement welfare and development projects that would close the gap between the wealthy and the poor. This necessitates the mobilization of funds from many sources. These sources may be direct or indirect. Income tax is a government-imposed tax on the money generated by individuals and businesses within a specific fiscal year. Governments use this money to fund public services including schools, hospitals, roads, defense, and social programs. In India, income tax is a direct tax levied by the government on the income earned by individuals, businesses, and other organizations within a certain fiscal year. It is governed by the Income Tax Act of 1961 and administered by the Central Board of Direct Taxes (CBDT), which reports to the Ministry of Finance.

Tax liability is based on total taxable income and is computed using specified tax slabs with a progressive structure—greater income results in higher tax rates. The tax structure of India is basically progressive in nature as with the increase in individual personal income, the corresponding income tax on individual income is also get increased. In India, the fiscal year runs from April 1 to March 31, and tax is assessed in the assessment year, which comes after the fiscal year. Taxpayers can minimize their tax burden by taking advantage of the Act's deductions and exemptions, which include savings plans, insurance premiums, and certain costs. Filing an Income Tax Return (ITR) is required for all qualifying taxpayers, and taxes are collected via techniques such as Tax Deducted at Source (TDS), advance tax, and self-assessment. Income tax is critical to supporting public services and national development in India.

Objectives of income tax:-

1. Income taxes aim to reduce income and wealth inequality in the society.
2. It is a means to ensure fairness among different kinds of taxpayers.
3. It promotes economic growth and development by funding government programs and initiatives.
4. It finances the country's economic development.
5. Encourages investment in new capital assets, which is crucial for the country's economic progress.
6. It prioritizes investment in industries that drive economic growth.

Who is required to pay income taxes:

If a person's income exceeds the basic exemption level established by a country's income tax legislation (such as in India), they must pay income tax. Every individual whose taxable income for the previous fiscal year above the minimum taxable limit must pay income tax to the Central Government at the rates in place for the current fiscal year.

In India, the following individuals are required to pay income taxes:

1. Individuals include salaried employees, self-employed individuals, and professionals.
2. Hindu Undivided Families (HUF)
3. Firms and Partnership Firms
4. Companies
5. Foreign companies (on income earned in India)
6. Association of Persons (AOP)
7. Body of Individuals (BOI)
8. Local Authorities
9. Artificial Juridical Persons (Entities recognized by law but not falling into the above categories)

A taxpayer's responsibility relies on:

- (a) Residential status
- (b) Type and quantity of income
- (c) The applicable tax slab or rate

Income tax is not due if your income is less than the exemption level, although you may still need to file a return in some instances.

1.5 FEATURES OF INCOME TAX

1. Income tax is imposed on the preceding year's income at a rate determined by the Finance Act for the relevant assessment year.

2. The Finance Act, sometimes known as the 'budget', is passed by parliament annually. The Income Tax Act of 1961 governs income tax in India, ensuring that all regulations and procedures are followed consistently.
3. Income tax is calculated based on a person's prior year's income.
4. The tax payer's liability is determined by their resident status from the previous year or accounting year.
5. Income tax is levied when total income exceeds the maximum tax-free amount set by the Finance Act for the year.
6. Income tax rates are progressive, increasing as income rises.
7. The tax must be deducted at the source and paid to the government.
8. Payment of income tax is mandatory and enforceable by law.
9. Taxpayers can reduce their tax liability through deductions and exemptions provided under the law.
10. Income tax is one of the main sources of revenue for the government to fund public welfare and development programs.

History of Income Tax in India:

1. Sir James Wilson, the first British-Indian Finance Minister, implemented income tax in 1860 to cover expenditures and losses caused by the 1857 Military Mutiny (Freedom Movement). It was implemented as a temporary revenue measure for just five years.
2. The separate Income Tax Act was passed in 1886 and was in force until 1917, with occasional amendments.
3. In 1918, the new Income Tax Act was passed.
4. In 1922, another act was adopted that supplanted the 1918 Income Tax act. The 1922 Act remained in effect until the assessment year 1961-62, with many changes.
5. The Income Tax Act of 1922 had become very complicated as a result of multiple changes. In 1956, the Indian government suggested it to the Law Commission in order to simplify and combat tax evasion. The law panel issued its conclusions in September 1958.
6. Finally, the Income Tax Act came into effect on April 1, 1962. It covers all of India and Sikkim (including Jammu and Kashmir).
7. The Income Tax Act of 1961 comprises 298 sections and XIV (14) schedules.

1.6 IMPORTANT SECTIONS UNDER INCOME TAX ACT, 1961

Short Title, Extent and Commencement (Sec 1) :

1. **Short Title** : This may be called the **Income Tax Act, 1961**,
2. **Extent** : It extends to **whole of India**. (It also means people of **Jammu and Kashmir** earning income is required to pay income tax to Government of India).
3. **Commencement** : This act comes into force on **1st day of April, 1962**.

Finance Bill:- A Finance measure is a measure released yearly to implement the Government of India's financial goals for the following fiscal year, which may include new suggestions at any moment. A Financial Bill is a money bill, as defined in Article 110 of the Constitution. This law comprises the government's suggestions for collecting additional taxes, modifying

the existing tax system, or extending the current tax structure beyond the time limit set by parliament. The Finance Bill can be introduced only in the Lok Sabha. The Bill is amendable by the Rajya Sabha. The legislation must be passed by Parliament within 75 days.

Procedure for passing Money Bill in the Parliament:-

1. Money bills may only be introduced or originated in the Lok Sabha.
2. A money bill can only be introduced based on the President's previous recommendations.
3. The Lok Sabha Speaker will decide whether it is a monetary bill or not. No one is doubting his judgment.
4. There can only be one money bill issued by the government.
5. Once a money bill is passed by the Lok Sabha, it is referred to the Rajya Sabha for consideration. The money bill cannot be rejected or altered by the Rajya Sabha. It can simply provide ideas and must return the measure to the Lok Sabha within 14 days, regardless of whether it is recommended.
6. The Lok Sabha may or may not approve the Rajya Sabha's recommendations. Thus, both houses treat the returning measure as passed. If the Rajya Sabha does not return the bill within 14 days, it is considered passed by both houses.
7. The legislation must be passed by Parliament within 75 days after its presentation.

Important Definitions under Income Tax Act, 1961

Under Sec. 2 and 3 of the Income Tax Act, 1961, definitions of important sections and their explanation have been given which is as follows:-

1. Gross Total Income (Sec. 14) :

Individual income is calculated using five categories:

1. Salaries.
2. Income from residential property.
3. Profits and benefits from business or vocation.
4. Capital gain.
5. Income from other sources.

The aggregate revenue from the aforementioned categories is referred to as '**Gross Total revenue**'. In other words, gross total income is the entire income earned from the five sources listed above before to any deduction under sections 80C to 80U.

2. **Total income** refers to the remaining income after subtracting deductions under sections 80C-80U from gross total income. The value so calculated is rounded to the nearest multiple of 10 rupees.

Difference between Gross Total Income and Total Income

Ser No.	Gross Total Income	Total Income
1.	It is an aggregate of various heads of income.	After deduction of income under section 80C to 80U, the remaining balance is called Total Income.
2.	Gross Total Income is not rounded	Total Income is rounded off to the nearest

	off.	multiple of ten rupees.
3.	Tax is not levied on Gross Total Income.	Tax is levied on the Total Income at the prescribed rates or slabs of income tax prevailing at the time of deduction.
4.	Gross Total Income is not less than the Total Income.	Total Income can be equal to Gross Total Income or less than Gross Total Income.
5.	Agricultural income is not included in Gross Total Income.	If an agricultural income exceeds Rs. 5,000/-, it is included in the total income of an individual or HUF to determine the tax payable by the assessee.

2. **Section 2(7):** It defines an assessee as a person who is required to pay taxes.

An assessee means a person –

- i) Who is liable to pay any tax; or
- ii) Who is liable to pay any other sum of money under this Act (e.g., interest, penalty, etc.); or
- iii) In respect of whom any proceeding under this Act has been taken for the assessment of his income; or
- iv) In respect of whom any proceeding under this Act has been taken for the assessment of the income of any other person in respect of which he is assessable; or
- v) In respect of whom any proceeding under this Act has been taken for the assessment of the loss sustained by him; or
- vi) In respect of whom any proceeding under this Act has been taken for the amount of refund due to him; or
- vii) Who is deemed to be an assessee under any provision of this Act; or
- viii) Who is deemed to be an assessee in default under any provision of this Act.

3. **Deemed Assessee:** A person or individual, who is deemed to be an assessee for some other person, is called 'Deemed Assessee'. Example are:-

- (a) After a person dies, his legal representative is recognized as an assessee for the deceased's income on which tax was not paid prior to death.
- (b) A person who represents a foreigner, a minor, or a lunatic is considered as an assessee for that person's income.

4. **Assessee in Default:** When a person is accountable for performing any job under the Act but fails to do so, he is referred to as a 'Assessee in Default'. For example, if a person is required to deduct income tax at the source on a payment to another person, does not deduct it, or if he deducts it but does not deposit it in the Government Treasury, he will be classified as an Assessee in Default for that income tax.

5. **Section 2(31)** This section of Income Tax Act, 1961 defines the term “person” for income tax purposes in India.

Importance of Section 2(31).

- (a) It specifies who may be taxed under the Income Tax Act.
- (b) Only entities falling under this criteria are required to pay income taxes.
- (c) It offers broad coverage for both natural individuals and legal entities.

6. **The term 'person' includes:**

- (i) An individual: The term 'person' refers to a natural human being, whether male, female, young child, or mentally ill.
- (ii) A Hindu undivided family is one in which all members, including spouses and unmarried daughters, are lineally descended from the same progenitor.
- (iii) A company is defined as a legal body with perpetual succession, a common seal, and shares with restricted liability.
- (iv) Firm: A firm is a partnership firm as defined in the Partnership Act. A partnership firm must meet two requirements: (i) a registered partnership deed, and (ii) a profit-sharing ratio stipulated in the deed.
- v) **An association of persons (AOP) or a body of individuals (BOI), whether or not incorporated:** An association of humans is defined as two or more people who join together for a shared aim, such as making money. It may be made up of two or more persons or any other person, such as an individual and a firm or two or more companies.
- vi) **A local authority:** This comprises municipalities, municipal corporations, district boards, and other such entities.
- vii) **Every artificial legal person that does not fit into any of the preceding categories:** An idol or deity can be assessed as an artificial legal person, but only by those who manage them. Similarly, all other artificial individuals possessing a legal existence, such as universities, are also artificial.

7. **Assessment Year [Section 2(9)] :** The assessment year is a twelve-month period that begins on April 1 of each year and finishes on March 31 of the following year. An assessee is expected to pay tax on the previous year's income during the next assessment year. For example, during the assessment year 2025-26, tax must be paid for the previous year 2024-25.

8. **Previous Year (section 3):** Previous year refers to the fiscal year before the assessment year. In other words, the year in which revenue is created is referred to as the prior year, and the year in which this income becomes taxable is known as the assessment year.

9. Financial Year: The fiscal year runs from April 1 to March 31 of the following year. A financial year includes both the preceding and assessment years. It is the previous year for revenue earned within that fiscal year, and the assessment year for income created in the fiscal year before it. For example, the fiscal year 2024-25 is the assessment year for income earned during fiscal year 2023-24.

1.7 CASUAL INCOME

Casual income is defined as revenue that is irregular, non-recurring, and earned by chance rather than from a regular source of income. Casual income is defined as any receipt that is both casual and non-recurring. In other terms, casual income is revenue that is received unexpectedly and without any conditions. It is akin to an unexpected windfall or monetary gains. Casual earnings include winnings from lotteries, crossword puzzles, card games, and other activities, as well as any form of gambling or betting. Even earnings from regular betting are non-recurring and can be reported as casual income.

The casual income does **not include** –

- (a) Casual income excludes capital gains, company receipts, and profession or vocation earnings.
- (b) Receipts in addition to an employee's compensation, such as bonuses, gratuities, and perquisites.
- (c) Gifts from relatives do not qualify as income. A gift from a relative is not deemed income just because it is received year after year. A recurrent allowance given year after year as a voluntary gift, such as by a husband to his wife or a father to his child, is just a new gift each time; it is paid and does not represent income.
- (d) Maintenance allowances paid by a spouse to his wife under a separation agreement are not considered personal gifts or casual income. Consequently, it is taxed.

An assessee's total income is determined depending on their residence status and is grouped into the following five categories of income:

- (i) Income from Salary : Wages, pensions, bonuses, allowances, and perquisites are examples of employer-provided income.
- (ii) Income from House Property : Income from owning property, such as a house, building, or land belonging to a building, is taxed under this category.
- (iii) Profits and Gains from Business or Profession : This covers earnings from any company or profession, such as trading, manufacturing, or providing professional services.
- (iv) Capital gains are taxed on income earned from the transfer or sale of capital assets such as land, buildings, stocks, or securities.
- (v) Income from Other Sources: Interest, dividends, and casual income are taxed as they do not fall under any other category.

11. Residential Status of an Individual Assessee are divided into three groups based on their residency status. The Income Tax Act divides people and Hindu undivided families into two categories: resident and ordinarily resident.

- (i) Resident and Ordinarily Resident; or
- (ii) Resident but not Ordinarily Resident; or
- (iii) Non-Resident

To be considered a resident or ordinarily resident in India for a preceding year, an individual must meet both basic and supplementary standards.

Basic conditions are as follows:

- a) Spending at least 182 days in India in the previous year, or
- b) Spending at least 60 days in India in the previous year and 365 days in the previous four years.

Exceptions to the above-stated conditions for a 60-day stay in India:

To depart India for employment or as a crew member on an Indian ship, a citizen must have spent at least 182 days in India in the previous year, not just 60 days.

(a) If an Indian citizen or person of Indian origin living outside India visited India in the previous year, they must have spent at least 182 days there, not just 60.

A person is deemed to be 'Indian origin'.

- (a) If the individual, their parents, or grandparents were born in undivided India. Grandparents include both maternal and paternal grandparents.
- (b) It's not necessary for him to stay for the whole 182 days. His total stay of at least 182 days may include interruptions.
- (c) When determining the number of days spent in India, include the days of arrival and exit.

1.8 SUMMARY

Income tax is a direct tax imposed by the government on the income produced by people and other companies throughout a fiscal year. It is controlled by India's Income Tax Act of 1961. Tax burden is determined by residence status, kind of income, and relevant tax slabs. Income is classified into five categories: wage or salary, house or property ownership, company or profession, capital gains, and other sources. Taxpayers can reduce their taxes by claiming deductions and exemptions, and eligible individuals must file an income tax return every year. Income tax generates important cash for the government and encourages national development.

1.9 GLOSSARY

Income tax- Income tax is a government-imposed tax on the income of people, corporations, and other entities.

Assessee - A person or company required to pay income tax under the Income Tax Act.

Person - As defined in Section 2(31) of the Income Tax Act, this term comprises people, Hindu Undivided Families (HUF), businesses, firms, associations of persons (AOP), bodies of individuals (BOI), municipal governments, and artificial juridical persons.

Residential Status - Determines how much a person's income is taxable in India; might be Resident, Non-Resident, or Resident but Not Ordinarily Resident.

Financial Year (FY) - The 12-month period during which revenue is earned, typically 1 April to 31 March in India.

Assessment Year (AY) is the year after the fiscal year in which income is assessed and taxed.

Total Income - The sum of income under all headings, after exemptions and deductions, on which tax is calculated.

Exemptions- It refers to income or allowances that are not taxable under the Income Tax Act.

Deductions- They are specific sums authorized by law to lower taxable income (for example, investments, insurance, education).

Tax Slab - An income range having a specific tax rate; used in a progressive tax system.

Income Tax Return (ITR) - A form used by taxpayers to record income, claim deductions, and calculate their tax bill or refund.

Finance Bill- A Finance Bill is a legislative document presented to Parliament that proposes tax adjustments and budget implementation methods.

1.10 CHECK YOUR PROGRESS (MULTIPLE CHOICE QUESTIONS)

1. **What is the primary aim of income tax?**
 - (A) To increase business profits
 - (B) To generate revenue for the government
 - (C) To reduce personal savings
 - (D) To encourage borrowing

2. **Under Section 2(31) of the Income Tax Act, which of the under mentioned term that includes “person”:**
 - A) Only individuals
 - B) Only companies
 - C) Individuals, HUF, companies, firms, AOP, BOI, local authorities, and artificial

- juridical persons
D) Only residents of India
3. **Income from lottery win or by indulging in gambling is classified under:**
 (A) Income from Salary
 (B) Income from House Property
 (C) Capital Gains
 (D) Casual Income
 4. **The period from 1 April to 31 March in India is generally referred as:**
 (A) Assessment Year
 (B) Calendar Year
 (C) Financial Year
 (D) Tax Year
 5. **Which of the following is NOT a head of income under the Income Tax Act, 1961 of India?**
 (A) Income from Salary
 (B) Income from Agriculture
 (C) Capital Gains
 (D) Income from Other Sources

1.11 REFERENCE BOOKS

- **Students' Guide to Income Tax & GST — Vinod K. Singhania & Monica Singhania**
 – A simplified book covering fundamental concepts of income tax along with examples.
lawmart.in
- **Handbook on Income Tax — CA Raj K. Agrawal**
 – Practical and concise reference covering basic concepts, residential status, exemptions, and heads of income. bharatlaws.com
- **A Textbook of Income Tax — Raman Anita & Mary A. Lydia Arockia**
 – A clear introduction to core income tax topics suitable for commerce students. [Sultan Chand & Sons](http://SultanChand&Sons)
- **Fundamentals of Income Tax — Preeti Rani Mittal & Anshika Bansal**
 Focuses on basics with problems and solutions, good for class study.

1.12 SUGGESTED READINGS

- **Systematic Approach to Income Tax (Containing Income Tax & GST) — Dr. Girish Ahuja & Dr. Ravi Gupta**
 Detailed and structured, good for systematic learning from basics to advanced topics.
[Commercial Law Publishers](http://CommercialLawPublishers)
- **A Textbook of Income Tax — Raman Anita & Mary A. Lydia Arockia**
 Covers core concepts and basic provisions with clear language and examples suitable for commerce students. [Sultan Chand & Sons](http://SultanChand&Sons)

□ **Income Tax Law and Practice — R.K. Jain** (older edition available free online)
A traditional reference that explains core definitions, computation methods, and heads of income.

Key to Check your progress:

1. B 2. C 3. D 4. C 5. B

1.13 TERMINAL QUESTIONS

1. Define Income Tax.

2. Who is considered a **person** under Section 2(31) of the Income Tax Act, 1961?

3. What is the purpose of a **Finance Bill** in India?

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UNIT-2

RESIDENTIAL STATUS AND INCIDENCE OF TAX

Contents

2.1 Introduction

2.2 Preliminary Concepts

2.3 Residential Status of an Individual (Section 6(1))

2.4 Classification of Resident Individuals: ROR and RNOR (Section 6(6))

2.5 Concept of Deemed Resident (Section 6(1A))

2.6 Residential Status of Non-Individual Assesseees

2.7 The Place of Effective Management (POEM) Rule

2.8 Incidence of Tax: Scope of Total Income (Section 5)

2.9 Illustrative Examples / Applications

2.10 Summary

2.11 Glossary

2.12 References/ Bibliography

2.13 Suggested Readings

2.14 Terminal Questions

Learning Objectives

Upon successful completion of this unit, the learner will be able to:

- Explain the fundamental distinction between residential status, citizenship, and domicile under the Income Tax Act.
- Describe the basic and additional conditions for determining the residential status of an individual assessee under Section 6(1) and 6(6).
- Differentiate the specialized residency rules applicable to Indian citizens/PIOs based on their purpose of visit and their non-foreign source income level (specifically the ₹15 Lakh threshold).
- Analyze the concept of a "Deemed Resident" (Section 6(1A)) and its mandatory classification as Resident but Not Ordinarily Resident (RNOR).
- Determine the residential status for non-individual assesseees, including Hindu Undivided Families (HUF), Firms, and Companies, and define the Place of Effective Management (POEM) rule.
- Apply Section 5 of the Income Tax Act to determine the scope of total income (incidence of tax) for Resident and Ordinarily Resident (ROR), RNOR, and Non-Resident (NR)

categories.

- Evaluate the tax implications of various streams of income—specifically income received, income accrued, and foreign income controlled from India—for different resident types.
- Solve numerical problems related to the calculation of days of stay and the final taxable income.

2.1 INTRODUCTION

The calculation of income tax liability in India hinges entirely upon the assessee's residential status for the specific Financial Year (FY). This status acts as the foundation upon which the entire tax structure is built, determining the extent of income that is subject to Indian taxation under the Income Tax Act, 1961. Unlike citizenship or domicile, which are permanent legal concepts, residential status is dynamic and must be reassessed annually based on physical presence or control within India during the relevant Previous Year (PY). For undergraduate students studying business administration and commerce, understanding residential status (governed by Section 6) is crucial because it directly impacts strategic managerial and financial decision-making, particularly in the context of global business operations and Non-Resident Indian (NRI) investments. An incorrect determination of status can lead to either significant tax non-compliance or unnecessary overpayment of tax.

Recent legislative changes, notably those introduced by the Finance Act, 2020, have strengthened India's tax framework to prevent misuse. These amendments introduced stricter rules for high-net-worth individuals (HNIs) of Indian origin and formalized the Place of Effective Management (POEM) concept for foreign companies. These provisions underscore a modern legislative objective: ensuring that economic connections to India translate into appropriate tax liability. This unit will follow a systematic approach. First, it defines the necessary foundational terms. Second, it elaborates on the precise rules and exceptions governing the residential status determination for all types of assesseees (individuals, HUFs, firms, and companies). Finally, it connects this status to Section 5, which determines the exact scope of income taxable in India—the incidence of tax.

2.2 PRELIMINARY CONCEPTS

2.2.1 Preliminary Concepts (Section 4, 5, 6)

The Income Tax Act, 1961, operates using several key definitions that are specific to the tax domain and must be understood before determining residential status.

2.2.2 Previous Year (PY) and Assessment Year (AY)

Residential status must be determined every year. The income earned during the Previous Year (PY), which is the financial year immediately preceding the assessment year, commencing on April 1st, is assessed for tax in the immediately following year, known as the Assessment Year (AY). The residential status during the PY determines the total taxable income for the AY.

2.2.3 Residence vs. Citizenship vs. Domicile

It is imperative to distinguish residential status under the Income Tax Act from other legal concepts.

- 1) **Citizenship:** This relates to nationality and legal allegiance to a country. A person can be an Indian citizen yet be a Non-Resident (NR) for tax purposes.
- 2) **Domicile:** This refers to a person's permanent home.
- 3) **Residential Status:** This is purely based on the length of physical stay in India or the location of effective control over business affairs during the PY. A crucial implication of this distinction is that an individual may be considered a tax resident in more than one country simultaneously, depending on the tax laws of those countries.

2.2.4 Person of Indian Origin (PIO)

Many special rules apply to Indian citizens and Persons of Indian Origin (PIOs) who visit India. An individual is deemed to be of Indian origin if they, or either of their parents, or any of their grandparents, were born in undivided India.

2.2.5 Foreign Sources Income

In the context of recent amendments, "income from foreign sources" holds a precise legal meaning. It refers to income which accrues or arises outside India, but specifically excludes income derived from a business controlled in India or a profession set up in India. This legal distinction is vital for determining the application of the ₹15 Lakh income threshold, as discussed below.

2.3 RESIDENTIAL STATUS OF AN INDIVIDUAL (SECTION 6(1))

The residential status of an individual is primarily determined by the duration of their physical stay in India during the PY. An individual is classified as a Resident if they satisfy at least one of the two basic conditions specified in Section 6(1). If neither condition is satisfied, the individual is a Non-Resident (NR).

The physical stay includes the stay within the territorial waters of India (12 nautical miles into the sea from the Indian coastline). Both the date of arrival and the date of departure from India are included while counting the number of days stayed.

2.3.1 Basic Condition 1 (BC1)

The individual has been in India for a total period of 182 days or more during the relevant Previous Year.

2.3.2 Basic Condition 2 (BC2)

The individual has been in India for a period of 60 days or more during the relevant Previous

Year AND has been in India for 365 days or more during the four years immediately preceding the relevant Previous Year. It must be noted that satisfying even one of these basic conditions is sufficient to be classified as a Resident.

2.3.3 Exceptions to the 60-Day Rule

The government has recognized that certain individuals maintain strong ties to India but must travel abroad frequently or for long periods. Thus, the 60-day limit in Basic Condition 2 is relaxed in specific cases by replacing it with a minimum requirement of 182 days, effectively making BC1 the sole relevant condition for residency for these individuals, unless special amendments apply.

Case A: Indian Citizen Leaving India

The 60 days limit is substituted by 182 days for an Indian citizen who leaves India during the PY:

- 1) As a member of the crew of an Indian ship; or
- 2) For the purpose of employment outside India.

This exception provides a large safe harbor, allowing these professionals to stay in India for up to 181 days and still retain Non-Resident status, ensuring that their global income remains untaxed in India.

Case B: Indian Citizen or PIO Visiting India (Low Income)

The 60 days limit is substituted by 182 days for an Indian citizen or a Person of Indian Origin (PIO) who comes on a visit to India during the PY, provided their total income (other than income from foreign sources) does not exceed ₹15 Lakhs during the PY.

2.3.4 The Amended 120-Day Rule (High-Income Visitors)

A significant amendment, introduced by the Finance Act, 2020, addresses high-net-worth Indian citizens or PIOs who maintain substantial economic interests in India while managing their physical stay to technically remain Non-Residents under the previous 182-day exception.

Conditions for the 120-Day Rule:

This rule applies to an Indian citizen or a Person of Indian Origin (PIO) visiting India whose total income (other than income from foreign sources) exceeds ₹15 Lakhs during the Previous Year.

The Rule: For this specific category of high-income visitors, the 60 days limit in Basic Condition 2 is substituted by 120 days.

Impact: If an individual in this category stays in India for 120 days or more (but less than 182 days) AND satisfies the 365 days or more in the preceding four years, they will be classified as a Resident. This amendment ensures that individuals with substantial economic connections to India cannot achieve Non-Resident status by merely restricting their stay to between 120 and 181 days. The legislative intent here is to curb aggressive tax planning by requiring a greater physical disconnect from India to avoid residency. Table A summarizes the Basic Conditions and the critical exceptions affecting Indian citizens and PIOs.

Table A: Individual Residency Conditions Summary

Category of Individual	Condition A (Stay in PY)	Condition B (Stay in PY AND 4 Preceding Years)	Status
General Individual (Any other case)	182 days or more	60 days or more (in PY) + 365 days or more (in 4 preceding PYs)	Resident (if A or B is met)
Indian Citizen leaving for employment/crew	182 days or more	182 days or more (in PY) + 365 days or more (in 4 preceding PYs)	Resident (if A or B is met)
PIO/Citizen visiting India (Non-foreign income Rs. ₹15 Lakhs)	182 days or more	182 days or more (in PY) + 365 days or more (in 4 preceding PYs)	Resident (if A or B is met)
PIO/Citizen visiting India (Non-foreign income > ₹15 Lakhs)	182 days or more	120 days or more (in PY) + 365 days or more (in 4 preceding PYs)	Resident (if A or B is met)

2.4 CLASSIFICATION OF RESIDENT INDIVIDUALS: ROR AND RNOR (SECTION 6(6))

Once an individual is classified as a Resident by satisfying at least one of the basic conditions (Section 6(1)), their status must be further classified into either Resident and Ordinarily Resident (ROR) or Resident but Not Ordinarily Resident (RNOR). This sub-classification is vital because it significantly alters the scope of their taxable income.

A Resident is classified as ROR if they satisfy both of the following two Additional Conditions (ACs):

2.4.1 Additional Condition 1 (AC1)

The individual has been a Resident in India in at least 2 out of the 10 Previous Years immediately preceding the relevant Previous Year.

2.4.2 Additional Condition 2 (AC2)

The individual has been in India for a total period of 730 days or more during the 7 Previous Years immediately preceding the relevant Previous Year.

2.4.3 Classification Result

- 1) **Resident and Ordinarily Resident (ROR):** An individual is ROR if they satisfy a Basic Condition AND satisfy both AC1 and AC2.
- 2) **Resident but Not Ordinarily Resident (RNOR):** An individual is RNOR if they satisfy a Basic Condition AND fail one or both of AC1 or AC2.

The RNOR status serves an important function, often acting as a tax transition status for

individuals returning to India after a long stay abroad.⁹ Since an NRI would typically fail AC1 (being Non-Resident in 9 out of 10 preceding years) and likely fail AC2 (not meeting the 730-day stay requirement), this classification offers them tax relief by exempting their pure foreign income, thereby facilitating their financial repatriation to India.

2.5 CONCEPT OF DEEMED RESIDENT (SECTION 6(1A))

Section 6(1A) introduces the concept of a "Deemed Resident" (DR), applicable from Assessment Year 2021-22 onwards. This provision is a strong anti-abuse measure designed to prevent Indian citizens from claiming to be "tax stateless" in any jurisdiction globally.

2.5.1 Conditions for Deemed Residency

An individual shall be deemed to be a Resident in India if they satisfy all three of the following conditions:

- 1) The individual is a Citizen of India.
- 2) The individual's total income (excluding income from foreign sources) exceeds ₹15 Lakhs during the Previous Year.
- 3) The individual is not liable to tax in any other country or jurisdiction by reason of their domicile, residence, or any other similar criteria.

This provision ensures that if a high-income Indian citizen is found to have no tax liability elsewhere, India claims them as a tax resident. This eliminates the loophole where an individual restricts their stay in India to avoid residency while also avoiding being classified as a resident in a lower-tax country.

2.5.2 Mandated Status for Deemed Resident

Crucially, the law specifies the sub-classification for a Deemed Resident. If an individual is deemed to be a resident under Section 6(1A), they are always classified as Resident but Not Ordinarily Resident (RNOR). This mandatory RNOR classification means that the Deemed Resident is taxed in India on all their India-sourced income and income derived from a business controlled in or profession set up in India, but their pure foreign income remains exempt. The objective is to ensure that India can tax all economic connections related to the country while providing transitional relief on income that is genuinely passive and foreign-sourced.

2.6 RESIDENTIAL STATUS OF NON-INDIVIDUAL ASSESSEES

The determination of residential status for entities other than individuals (corporates, families, and partnerships) is based on the location of control and management of their affairs. These entities are classified simply as Resident or Non-Resident; only Individuals and Hindu Undivided Families (HUF) are further sub-classified into ROR and RNOR.

2.6.1 Hindu Undivided Family (HUF)

A Hindu Undivided Family (HUF) is a Resident in India in every case, except where the control

and management of its affairs is situated wholly outside India during the Previous Year. If the control and management of the HUF's affairs are situated even partly in India (e.g., key decisions are made in India), the HUF becomes a Resident.

ROR/RNOR Classification for HUF (Section 6(6)): Once an HUF is determined to be a Resident, its further classification depends entirely on the residential status of the Karta (the manager of the family). The HUF will be:

- **ROR:** If the Karta satisfies both Additional Conditions (AC1: Resident in 2/10 preceding years, AND AC2: Stayed 730/7 preceding years).
- **RNOR:** If the Karta fails one or both of the Additional Conditions.

This illustrates a two-step approach: the location of management determines if the HUF is a Resident, but the Karta's past physical presence determines its ordinal residency status.

2.6.2 Firms, Associations of Persons (AOPs), and Bodies of Individuals (BOIs)

Like an HUF, a Firm, AOP, or BOI is considered a Resident in India unless the control and management of its affairs are situated wholly outside India during the relevant Previous Year. Control is considered to be where the partners or members meet to decide the entity's critical affairs. If even a fraction of the control or management is exercised from India, the entity is resident. These entities are not sub-classified as ROR or RNOR.

2.6.3 Companies

The rules for company residency are structured based on their place of incorporation:

- 1) **Indian Company:** An Indian company (one incorporated in India) is always treated as a Resident in India for tax purposes, regardless of where its management decisions are made.
- 2) **Foreign Company:** A foreign company (one incorporated outside India) is treated as a Resident in India if its Place of Effective Management (POEM), during that year, is situated in India.

2.7 THE PLACE OF EFFECTIVE MANAGEMENT (POEM) RULE

The POEM rule, an internationally recognized criterion, was introduced to address instances where companies are incorporated abroad (to be formally Non-Resident) but are managed and controlled entirely from India.

2.7.1 Concept of POEM

POEM is defined as the place where the key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made. The concept emphasizes "substance over form," meaning the actual location of critical strategic decision-making overrides the formal place of incorporation. The objective of POEM is to prevent tax evasion and ensure that companies with significant management and operational control within India fulfill their tax obligations, leading to the taxation of their worldwide

income if POEM is found to be in India.

2.7.2 Administrative Guidelines and Exemption

Due to the complexity involved in determining POEM, the Indian Revenue Department has issued guidelines. These guidelines clarify that the POEM determination process is divided into two categories: companies engaged in active business outside India and other companies.

A significant aspect of the POEM rule is the exemption threshold: The POEM provisions will not apply to a foreign company if it has a turnover or gross receipts of ₹500 million (₹50 Crore) or less in a tax year. This threshold is a pragmatic measure implemented to reduce administrative burden. It ensures that complex, subjective rules like POEM are primarily aimed at larger entities where the risk of base erosion and profit shifting is substantial, thereby providing relief and simplicity for smaller foreign companies (SMEs) controlled from India.

2.8 INCIDENCE OF TAX: SCOPE OF TOTAL INCOME (SECTION 5)

Section 5 of the Income Tax Act defines the scope of total income based on the residential status determined under Section 6. The taxability of any income depends on three key factors: where the income is received, where it accrues or arises, and where the related business or profession is controlled or set up.

2.8.1 The Three Taxable Bases

Total income, for a Resident, includes all income derived from whatever source which:

- 1) Is received or deemed to be received in India during the previous year.
- 2) Accrues or arises or is deemed to accrue or arise in India during the previous year.
- 3) Accrues or arises outside India (taxable only for ROR, with exceptions for RNOR and NR).

Note on Deemed Income: Income can be considered "deemed to accrue or arise in India" even if the actual physical transaction occurs outside India. For example, salary paid by the Government of India to an Indian citizen for services rendered outside India is treated as income deemed to accrue in India.

2.8.2 Detailed Scope of Taxability (The Matrix)

The scope of total income differs significantly among the three classifications—ROR, RNOR, and NR.

(1) **Resident and Ordinarily Resident (ROR):** An ROR is subject to tax in India on their worldwide income, regardless of where it is earned, received, or accrued.¹⁰ This is the broadest scope of taxation.

(2) **Non-Resident (NR):** An NR is taxed in India only on income that has an Indian nexus. Specifically, income that is received or deemed to be received in India, or which accrues or is

deemed to accrue or arise in India. Income earned and received entirely outside India is generally exempt.

(3) Resident but Not Ordinarily Resident (RNOR): The RNOR status represents a hybrid tax position, benefiting from a narrower scope of taxation than ROR but a wider scope than NR. An RNOR is taxed in India on:

- Income received or deemed to be received in India.
- Income that accrues or is deemed to accrue or arise in India.
- Income that accrues or arises outside India only if it is derived from a business controlled in or a profession set up in India.

All other income accruing or arising outside India, which is not received in or deemed to accrue in India, is exempt for an RNOR. The relationship between residential status and the taxability of various income streams is summarized in Table B.

Table B: Incidence of Tax (Scope of Total Income) based on Residential Status

Type of Income	ROR (Resident & Ordinarily Resident)	RNOR (Resident but Not Ordinarily Resident)	NR (Non-Resident)
Income received in India (Source Location irrelevant)	Taxable (T)	Taxable (T)	Taxable (T)
Income accrued/ arisen in India (Received Location irrelevant)	Taxable (T)	Taxable (T)	Taxable (T)
Income accrued/ arisen outside India, derived from business controlled in India/profession set up in India	Taxable (T)	Taxable (T)	Not Taxable (NT)
Income accrued/ arisen outside India, derived from business controlled outside India (Pure Foreign Income)	Taxable (T)	Not Taxable (NT)	Not Taxable (NT)

2.8.3 Crucial Distinction between RNOR and NR

The critical difference between an RNOR and an NR lies in the taxability of foreign business income controlled from India. For an RNOR, this specific category of foreign income is taxable in India, whereas for an NR, it is exempt. This rule emphasizes that if an individual maintains operational control over their foreign business from India, the income generated from that control is subject to Indian tax, even if the actual receipts remain abroad.

2.9 ILLUSTRATIVE EXAMPLES / APPLICATIONS

The following examples demonstrate the practical application of the residency rules and the incidence of tax.

2.9.1 Numerical Example 1: Determining Residential Status for a High-Income PIO Visitor

Mr. Rajesh, an Indian citizen, lives in the USA but visited India during the Financial Year 2024-25. His total income, excluding foreign sources, is ₹22 Lakhs (exceeds ₹15 Lakhs). His stay in India during the PY 2024-25 was 130 days. He was in India for 400 days during the four preceding PYs (2020-21 to 2023-24). Determine his residential status for AY 2025-26.

Step-by-Step Solution:

Step 1: Determine Applicable Rule.

Since Mr. Rajesh is an Indian citizen visiting India and his non-foreign income (₹22 Lakhs) exceeds ₹15 Lakhs, the special amended rule applies. The 60-day limit in BC2 is replaced by 120 days.

Step 2: Check Basic Condition 1 (BC1).

Stay in PY 2024-25: 130 days.

Requirement: 182 days or more.

Result: BC1 is Not Satisfied.

Step 3: Check Basic Condition 2 (BC2 - Amended Rule).

- Part 1 (Stay in PY): Stay is 130 days. Requirement is 120 days or more. Satisfied.
- Part 2 (Stay in 4 preceding PYs): Stay is 400 days. Requirement is 365 days or more. Satisfied.

Result: BC2 is Satisfied.

Since he satisfies one Basic Condition, Mr. Rajesh is a Resident.

Step 4: Check Additional Conditions (ACs) for ROR/RNOR.

We must assume Mr. Rajesh was a Non-Resident during the four preceding PYs because he lives in the USA.

- **AC1:** Resident in 2 out of 10 preceding PYs. Since he was likely NR in 9 out of 10 years, AC1 is Not Satisfied.
- **AC2:** Stay of 730 days or more in the 7 preceding PYs. Given his frequent absences, AC2 is likely Not Satisfied.

Final Status: Mr. Rajesh is a Resident but fails the additional conditions; therefore, he is a **Resident but Not Ordinarily Resident (RNOR)**.

2.9.2 Numerical Example 2: Comparative Taxable Income Calculation

Mr. C earns the following incomes during the PY 2024-25. Compute his Gross Total Income (GTI) assuming he is an ROR, an RNOR, or an NR.

Sr. No.	Income Description	Amount (₹)
1.	Rent from house property in Mumbai (received in India)	1,50,000
2.	Interest on bonds of a French company (accrued and received in France)	40,000

3.	Profit from a business in Thailand, the control and management of which is wholly in India (received in Thailand)	90,000
4.	Professional fees earned and received in Delhi	2,00,000
5.	Interest on bank account in Nigeria (wholly outside India)	30,000

Computation of Gross Total Income (GTI) for PY 2024-25

Income Description	ROR (Taxable)	RNOR (Taxable)	NR (Taxable)	Basis for Inclusion
1. Rent from house property in Mumbai	1,50,000	1,50,000	1,50,000	Accrued in India (T for all)
2. Interest on French bonds (Pure Foreign Income)	40,000	Nil	Nil	Accrued and received outside India. T for ROR only
3. Profit from Thailand business (Controlled from India)	90,000	90,000	Nil	Foreign income controlled from India. T for ROR and RNOR
4. Professional fees in Delhi	2,00,000	2,00,000	2,00,000	Accrued and received in India (T for all)
5. Interest in Nigeria (Pure Foreign Income)	30,000	Nil	Nil	Accrued and received outside India. T for ROR only
Gross Total Income (GTI)	5,10,000	4,40,000	3,50,000	

2.9.3 Application Case Study: POEM and the ₹50 Crore Threshold

Foreign Co. X, incorporated in Singapore, operates a manufacturing unit in Malaysia. All key strategic and commercial decisions for Co. X are made by its Board of Directors during quarterly meetings held in Delhi, India.

Scenario A: Turnover ₹480 Million (₹48 Crore)

- **Determination:** Since the turnover is ₹48 Crore, which is less than the statutory threshold of ₹500 million (₹50 Crore), the POEM provisions do not apply.
- **Status:** Foreign Co. X is a Non-Resident (NR).
- **Tax Liability:** The company is taxed only on income that accrues or arises in India. Its global manufacturing profits are exempt.

Scenario B: Turnover ₹550 Million (₹55 Crore)

- **Determination:** The turnover exceeds the ₹500 million threshold. Since the key management and commercial decisions (POEM) are made in Delhi, India.
- **Status:** Foreign Co. X is a Resident in India.
- **Tax Liability:** Since Co. X is now a tax resident, it is liable to pay tax in India on its

worldwide income, including all profits earned from its Malaysian manufacturing operations.

This case clearly demonstrates the regulatory mechanism designed to focus the complexity of POEM determination only on large foreign entities (above ₹50 Crore turnover), ensuring administrative efficiency while protecting the Indian tax base from large-scale profit diversion.



Check Your Progress – A

1. What is meant by residential status under the Income Tax Act, 1961?

2. What is meant by income from foreign sources?

3. Explain the term incidence of tax.

2.10 SUMMARY

Residential status is the foundation for determining income tax liability in India under the Income Tax Act, 1961. It is assessed every financial year based on physical presence or control and management, and it is distinct from citizenship or domicile. Section 6 lays down the rules for determining residential status, while Section 5 defines the scope (incidence) of taxable income. An individual is treated as a Resident if they satisfy either of the two basic conditions: (i) stay in India for 182 days or more during the Previous Year, or (ii) stay for 60 days or more in the Previous Year along with 365 days or more during the four preceding years. Special relaxations apply to Indian citizens and Persons of Indian Origin (PIOs). For low-income visitors, the 60-day limit is replaced by 182 days, while for high-income visitors (income exceeding ₹15 lakh), a stricter 120-day rule applies. The concept of Deemed Resident ensures that high-income Indian citizens who are not liable to tax in any other country are taxed in India and classified as RNOR. Residents are further classified as Resident and Ordinarily Resident (ROR) or Resident but Not Ordinarily Resident (RNOR) based on additional conditions relating to past residency and duration of stay. Non-individual assesseees are classified using the control and management test, while foreign companies are governed by the Place of Effective Management (POEM) rule. The incidence of tax varies by status: RORs are taxed on

worldwide income, RNORs on limited foreign income, and Non-Residents only on India-sourced income.



2.11 GLOSSARY

- **Assessee:** A person liable to pay any tax or any other sum of money under the Income Tax Act.
- **Previous Year (PY):** The financial year (April 1 to March 31) in which income is earned.
- **Assessment Year (AY):** The financial year immediately following the PY, in which the income of the PY is taxed.
- **Resident and Ordinarily Resident (ROR):** A resident who satisfies both additional conditions under Section 6(6).
- **Resident but Not Ordinarily Resident (RNOR):** A resident who fails one or both additional conditions under Section 6(6).
- **Non-Resident (NR):** An individual or entity who does not satisfy any of the basic conditions for residency.
- **Person of Indian Origin (PIO):** An individual or their parent/grandparent was born in undivided India.
- **Deemed Resident:** An Indian citizen whose non-foreign income exceeds ₹15 Lakhs and is not liable to tax in any other country due to residence or domicile.
- **Control and Management (C&M):** The head and brain which directs the affairs of a non-individual entity (HUF/Firm).
- **Place of Effective Management (POEM):** The place where key management and commercial decisions are, in substance, made for a company.
- **Foreign Sources Income:** Income accruing or arising outside India, excluding income from a business controlled in or profession set up in India.
- **Incidence of Tax:** The extent or scope of income that is subject to taxation in India, dependent on the residential status.
- **Accrue or Arise:** Income becomes due, whether or not it is actually received.
- **Received in India:** Income is first taken possession of by the assessee or their agent in India.



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2.14 TERMINAL QUESTIONS

- 1) Determine the residential status of an individual under Section 6 of the Income Tax Act and explain how it affects the incidence of tax.
- 2) Explain the basic conditions and additional conditions prescribed for determining the residential status of an individual assessee.
- 3) Discuss the special provisions applicable to Indian citizens and Persons of Indian Origin (PIOs) visiting India, including the 120-day rule and the ₹15 lakh income threshold.
- 4) Examine the concept of Resident but Not Ordinarily Resident (RNOR) and explain its significance in the Indian income tax system.
- 5) Analyze the provisions relating to Deemed Resident under Section 6(1A) and justify why such assesseees are mandatorily treated as RNOR.
- 6) Explain the rules for determining the residential status of a Hindu Undivided Family (HUF) and the role of the Karta in its classification as ROR or RNOR.
- 7) Describe the criteria for determining the residential status of firms, AOPs, BOIs, and companies under the Income Tax Act.

- 8) Critically examine the concept of Place of Effective Management (POEM) and its relevance in determining the residential status of foreign companies.
 - 9) Discuss the scope of total income under Section 5 and explain how the incidence of tax differs for ROR, RNOR, and Non-Resident assesseees.
 - 10) With the help of suitable examples, explain the taxability of income received in India, income accrued in India, and income accruing outside India for different categories of residential status.
 - 11) Mr. Anand, an Indian citizen, left India on 15.10.2023 for employment in Dubai. He had never been outside India before this date. Determine his residential status for the AY 2024-25. (The previous year is 2023-24). (*Hint*: Calculate days stayed. Apply the employment exception (182 days rule).)
 - 12) Ms. Geeta, a PIO, visits India every year. Her non-foreign income is ₹17 Lakhs. She stayed in India for 145 days during the PY 2024-25, and for 380 days during the four preceding PYs. Determine her residential status for AY 2025-26. (*Hint*: Apply the 120-day rule. Determine ROR/RNOR based on ACs.)
 - 13) Compute the Gross Total Income for Mr. Q for the PY 2024-25 if he is: (A) ROR, (B) RNOR, and (C) NR, based on the following income data:
 - i. Salary earned and received in Delhi: ₹3,00,000.
 - ii. Profit from business in Singapore, controlled from Mumbai: ₹1,50,000.
 - iii. Interest on personal bank deposit in Switzerland (received there): ₹50,000.
 - iv. Rent from house property in Chennai (received in London): ₹1,00,000.
 - v. Past untaxed foreign income brought into India during the PY: ₹75,000.
- (*Hint*: Past untaxed income brought to India in the current year is not taxable. Item ii is taxable for ROR and RNOR. Item iii is pure foreign income.)

UNIT-3

EXEMPTED INCOMES

Contents

- 3.1 Introduction**
- 3.2. Statutory Exemptions**
- 3.3 Fully Exempt Incomes (Selected Key Clauses)**
- 3.4 Partially Exempt Salary Components**
- 3.5 Other Key Exemptions**
- 3.6. Illustrative Examples / Applications**
- 3.7 Summary**
- 3.8 Glossary**
- 3.9 References/ Bibliography**
- 3.10 Suggested Readings**
- 3.11 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, the learner will be able to:

- Explain the concept of 'Exempt Income' and identify its statutory basis under Section 10 of the Income Tax Act, 1961.
- Differentiate clearly between Tax Exemptions, Tax Deductions (Chapter VI-A), and Tax Rebates (Sec 87A) based on their impact and application stage in the tax computation process.
- Describe the definition and conditions for claiming full exemption on Agricultural Income and analyze the mechanism of partial integration for non-corporate assesseees.
- Apply the specific step-by-step statutory calculation rules for partial salary-based exemptions, including House Rent Allowance (HRA).
- Evaluate the tax exempt limits for terminal benefits like Gratuity and analyze the calculation distinction between employees covered and not covered under the Payment of Gratuity Act (POGA).
- Identify and discuss key exemptions related to entities and specific income streams, such as Partner's Profit Share and the recent statutory limits on Life Insurance Proceeds.
- Analyze the critical documentation and mandatory disclosure requirements for claiming major exemptions while filing the Income Tax Return (ITR).

3.1 INTRODUCTION

The study of Income Tax involves understanding not only which incomes are taxable but also which incomes are intentionally excluded from the tax framework by the Government of India. This exclusion is governed primarily by Section 10 of the Income Tax Act, 1961, which lists specific incomes that "do not form part of total income". These are legally termed exempted incomes. The relevance of understanding tax exemptions extends beyond mere compliance; it forms a critical component of individual and managerial financial strategy. Exemptions serve multiple purposes: social welfare (e.g., scholarships), economic stimulus (e.g., agricultural income), and providing relief for necessary expenses (e.g., House Rent Allowance or HRA). For undergraduate learners in Business Administration or Commerce, this unit is foundational because the proper identification and calculation of exempted income is the first step in accurately determining the individual's taxable income.

In the realm of managerial decision-making, experts utilize these statutory provisions to structure employee compensation packages (often referred to as Cost-to-Company or CTC). By maximizing the legitimate utilization of exempt components, such as HRA and Leave Travel Allowance (LTA), employers can significantly increase the employee's net take-home salary without incurring additional proportional cost for the company. This strategic classification of income sources is essential for financial optimization and effective tax planning. Therefore, mastering the nuances, conditions, and calculation rules of Section 10 is indispensable for any future business analyst or finance professional. This unit guides the learner through the statutory definitions and computational steps necessary for independent analysis.

3.2. STATUTORY EXEMPTIONS

3.2.1 Conceptual Framework: Exempt Income, Deduction, and Rebate

Understanding tax relief requires precise definitions of the mechanisms used to reduce tax liability. The Income Tax Act, 1961, provides three distinct methods: exemption, deduction, and rebate.

3.2.2 Definition and Statutory Basis of Exempt Income

Exempt income refers to specific earnings that are entirely non-taxable and are legally excluded from the process of calculating a person's total income. The legal foundation for such exclusion rests squarely on Section 10 of the Income Tax Act, 1961.

Crucially, because these incomes do not form part of the total income, they are generally not considered when calculating the tax base. However, compliance with Indian tax law mandates that taxpayers must disclose all exempt income in their Income Tax Return (ITR), typically under Schedule EI. This disclosure ensures transparency and allows the tax authorities to verify that the claimed income sources meet the statutory conditions for exemption.

3.2.3 The Critical Distinction: Exemption vs. Deduction vs. Rebate

Tax students frequently confuse exemptions and deductions because both lead to lower tax liability. However, their mechanism and stage of application are fundamentally different.

Tax Exemption: An exemption excludes a specific type of income (like agricultural income or a portion of HRA) from being taxed at all. It is applied at the very beginning of the tax calculation process, effectively reducing the Gross Income before any further computations are made. Exemptions directly impact the Total Income before deductions are considered.

Tax Deduction: A deduction is an amount permitted to be subtracted from the Gross Total Income (GTI). Deductions are generally based on qualifying expenses or investments made by the taxpayer, such as contributions to the Public Provident Fund (PPF), life insurance premiums, or certain health insurance expenses claimed under Chapter VI-A (e.g., Section 80C or 80D). Deductions operate post-calculation of the GTI, lowering the final taxable amount.

Tax Rebate: A tax rebate is a direct reduction of the computed tax liability, not the income itself. It is available only to resident individuals whose total taxable income does not exceed a statutory limit. For example, Section 87A grants a tax rebate up to a specified amount for resident individuals meeting the income criteria. Rebates are applied after the tax has been calculated on the taxable income.

The sequencing of these provisions—Exemption first, followed by Deduction, and finally Rebate—underscores their strategic value. Exemptions are arguably the most effective form of tax relief because they reduce the income base used for all subsequent calculations, including the determination of which tax slabs apply.

3.3 FULLY EXEMPT INCOMES (SELECTED KEY CLAUSES)

Certain categories of income are fully exempt from tax, meaning the entire amount received under that head is excluded from total income, provided all statutory conditions are met.

3.3.1 Agricultural Income

Agricultural income holds a unique position in Indian tax law. The Central Government cannot levy income tax on agricultural income; this power is explicitly reserved for State Governments under the Constitution of India. Hence, Section 10(1) grants a complete exemption.

Definition of Agricultural Income

To qualify for the exemption, the income must meet the following criteria:

- 1) **Rent or Revenue from Land:** Any rent or revenue derived from land that is situated in India and is used for agricultural purposes.
- 2) **Operations:** Any income derived from such land by agricultural operations, including processing the produce to render it fit for the market, or the actual sale of such produce.
- 3) **Farm Building Income:** Any income attributable to a farmhouse, provided the farmhouse meets specific conditions, such as being situated on or in the immediate vicinity of the agricultural land and used as a dwelling house or storehouse by the cultivator or receiver of rent.

- 4) **Nursery Income:** Income derived from saplings or seedlings grown in a nursery is deemed to be agricultural income.

Treatment of Partly Agricultural Income

When a business integrates agricultural activities with subsequent commercial or manufacturing processes, the resulting total income is categorized as 'partly agricultural'. For instance, a tea company that grows tea leaves on its own estate and then processes them into finished tea products earns income that is partly agricultural and partly business income.

Specific rules govern the apportionment of this income to prevent tax leakage:

- **Tea Cultivation and Manufacturing (Rule 8):** 60% of the income derived from the sale of manufactured tea in India is deemed agricultural (exempt), and the remaining 40% is treated as business income (taxable).
- Similar rules apply to coffee and rubber processing.

The Concept of Partial Integration

Although agricultural income is fully exempt, it is used for the limited purpose of determining the tax rate applicable to the non-agricultural income of individuals, Hindu Undivided Families (HUFs), Association of Persons (AOPs), and other non-corporate assesseees. This is called Partial Integration of Agricultural Income. The mechanism ensures that a resident individual with substantial agricultural income does not benefit unfairly from the lower marginal tax rates on their non-agricultural income. If the assessee's net agricultural income exceeds ₹5,000, and their non-agricultural income exceeds the basic exemption limit, the integration scheme applies. This acts as an equity mechanism, pushing the individual's non-agricultural income into higher tax brackets, thereby leading to a greater effective tax rate on the taxable income.

3.3.2 Partner's Share in Firm's Profit

The share of profit received by a partner from a Partnership Firm or a Limited Liability Partnership (LLP) is fully exempt from tax in the hands of the partner. The underlying legislative intent is to prevent double taxation. Since the firm or LLP is itself taxed as a separate entity on its total income at the prescribed rates, taxing the residual profits again when distributed to the partners would constitute double taxation. It is essential for the learner to note a critical nuance: this exemption applies only to the share of profit. Any remuneration, such as salary, bonus, commission, or interest on capital, received by the partner, if allowed as a deduction to the firm in calculating its taxable income, remains fully taxable in the partner's hands under the head 'Profits and Gains of Business or Profession'.

3.3.3 Life Insurance Policy Proceeds

Section 10(10D) provides a crucial exemption on amounts received from a life insurance policy (LIP), including the death benefit, maturity proceeds, or surrender value, plus any accrued bonus. This exemption generally promotes long-term savings and financial security.

Statutory Conditions (Premium Limits)

The exemption is subject to strict conditions relating to the annual premium paid relative to the Sum Assured (SA):

- 1) **Policies issued on or after April 1, 2012:** The annual premium payable must not exceed 10% of the actual capital sum assured.
- 2) **Policies issued between April 1, 2003, and March 31, 2012:** The annual premium payable must not exceed 20% of the actual capital sum assured.

Recent Legislative Changes (Post-2021)

Recent legislative amendments have significantly limited this exemption, particularly for high-value policies, converting many investment-oriented insurance products into taxable assets:

- **Unit-Linked Insurance Plans (ULIPs) (Post-February 1, 2021):** The maturity proceeds of a ULIP become taxable if the aggregate annual premium across all ULIPs held by the individual exceeds ₹2,50,000 in any previous year during the policy term.
- **Non-ULIP Life Insurance Policies (Post-April 1, 2023):** For non-linked policies issued on or after April 1, 2023, the maturity proceeds will be taxable if the aggregate annual premium payable across all such policies exceeds ₹5,00,000 in any previous year. The exemption is only available to policies where the annual premium remains below the ₹5 lakh cap.

3.3.4 Educational Scholarships and Awards

Any scholarship granted to an individual to meet the cost of education is fully exempt from tax. There is no monetary limit prescribed, provided the scholarship is genuinely intended to cover educational expenses. Similarly, certain awards instituted by the government are also exempt.

3.3.5 Provident Fund Income

Maturity payments, including interest and employer contributions, from a Recognized Provident Fund (RPF) and the Public Provident Fund (PPF) are generally tax-free, maintaining their Exempt-Exempt-Exempt (EEE) status.

However, a crucial restriction was introduced for high-value contributions. Interest accruing on an employee's contribution to a Recognized Provident Fund (RPF) is now taxable to the extent the annual contribution exceeds ₹2,50,000 in a financial year (beginning FY 2021-22). If the RPF maintains a separate account for the taxable contribution, the interest earned on the excess contribution becomes taxable. This limit is extended to ₹5,00,000 if the fund does not receive any contribution from the employer.

3.4 PARTIALLY EXEMPT SALARY COMPONENTS

Certain components of an employee's salary are exempt only up to prescribed limits, which typically depend on specific conditions, actual expenditure, or statutory formulas.

3.4.1 House Rent Allowance (HRA)

HRA is a common allowance granted by an employer to a salaried employee for the cost of residential accommodation. The exemption under Section 10(13A) is available only if the employee actually lives in rented accommodation and pays rent for it. The exempt portion of the HRA is calculated as the least (minimum) of the following three amounts:

Table 3.1: HRA Exemption Calculation (Section 10(13A))

Condition	Description
1. Actual HRA Received	The total amount of HRA received from the employer during the financial year.
2. Statutory Percentage of Salary	50% of Salary, if the accommodation is situated in a metro city (Delhi, Mumbai, Kolkata, Chennai). OR 40% of Salary, if the accommodation is situated in any other (non-metro) city.
3. Rent Paid Excess	Actual Rent Paid minus 10% of Salary.

Definition of Salary for HRA:

For the purpose of HRA calculation, the term 'Salary' means: Basic Pay + Dearness Allowance (DA), provided the DA forms part of the retirement benefits (i.e., included in the terms of employment) + Commission, provided it is based upon a fixed percentage of turnover achieved by the employee.

Taxability: The amount of HRA received that exceeds the calculated minimum exempt amount is chargeable to tax under the head 'Income from Salary' Documentation: Employees paying annual rent exceeding ₹1,00,000 must mandatorily furnish the Permanent Account Number (PAN) of their landlord to claim the exemption.

3.4.2 Gratuity

Gratuity is a lump-sum payment provided by the employer to an employee, usually upon termination of service (retirement, resignation, or death), typically after completing at least five years of service Taxability based on Employee Status:

- 1) **Government Employees:** Gratuity received by a Central or State Government employee is fully exempt from tax.
- 2) **Other Employees:** For employees in the private sector or statutory corporations, the exemption is limited and capped by specific rules, depending on whether they are covered under the Payment of Gratuity Act, 1972 (POGA).

The Statutory Cap: The maximum statutory limit for the exemption of gratuity (for non-government employees) is currently fixed at ₹20,00,000. This limit is applied on an aggregate basis across all employers.

The exempt amount is determined as the **least** (minimum) of the following three conditions:

Table 3.2: Gratuity Exemption Calculation (Non-Government Employees)

Category	Condition 1	Condition 2	Condition 3	Nuance
POGA Covered	Actual Gratuity received.	Statutory Limit: ₹20,00,000.	15 days' salary x Completed years of service.	Service period exceeding 6 months is rounded up to the next completed year. 15 days' salary is calculated as (Last Drawn Monthly Salary x 15 / 26).
Non-POGA Covered	Actual Gratuity received.	Statutory Limit: ₹20,00,000.	Half month's average salary x Completed years of service.	Only completed years of service are considered (no rounding up). Average Salary is calculated based on the average salary of the 10 months immediately preceding the retirement month

This difference in calculation methodology—particularly the method of calculating service years and the definition of salary—provides an incentive for employers to comply with POGA, as it offers a slightly more favorable tax treatment to the employee.

3.3.3 Leave Travel Concession (LTC/LTA)

LTA is an allowance given by the employer to cover an employee's travel expenses during leave. The exemption under Section 10(5) is subject to the following strict conditions:

- 1) **Purpose and Limit:** The exemption is limited to the actual amount spent by the employee on domestic travel fare (air, rail, or bus) for themselves and their family. Expenses for accommodation, food, or local transport are not exempt.
- 2) **Frequency:** The exemption is available for a maximum of two journeys undertaken in a specified block of four calendar years. The current block period is 2022–2025.
- 3) **Family Definition:** The family typically includes the employee's spouse, dependent children, parents, and siblings. There is a restriction on children: the exemption is limited to two children born after October 1, 1998, though this restriction does not apply to children born before that date or in the case of multiple births after the first child.

3.4.4 Commutation of Pension

Commutation refers to receiving a lump sum payment in lieu of a portion of the future periodic pension. The tax exemption depends on the employment status and whether the employee also receives gratuity.

- **Government Employees:** The commuted value of the pension is fully exempt.
- **Other Employees:**
 - If the employee receives Gratuity: 1/3 of the commuted value of the total pension that

the employee is entitled to receive is exempt.

- If the employee does not receive Gratuity: 1/2 of the commuted value of the total pension that the employee is entitled to receive is exempt.

3.5 OTHER KEY EXEMPTIONS

Beyond salary and terminal benefits, Section 10 covers various other income streams that are exempt for specific socio-economic reasons.

- **Receipts from Hindu Undivided Family (HUF):** Any sum received by a member of an HUF out of the income of the HUF, or the income of an impartible estate belonging to the HUF, is fully exempt. This prevents double taxation, as the HUF is already taxed on its total income.
- **Compensation on Transfer of Urban Agricultural Land:** Capital gains arising from the compulsory acquisition of urban agricultural land by the government or other specified authorities are exempt, provided the land was used for agricultural purposes by the individual or their parents for the two years immediately preceding the date of transfer.
- **Income of International Institutions/Staff:** Income earned by staff or employees of specific consultants or entities working under the Cooperative Technical Assistance Programme is exempt, often governed by international agreements to facilitate global cooperation.

3.6. ILLUSTRATIVE EXAMPLES / APPLICATIONS

To solidify the understanding of these statutory rules, practical application through numerical examples is essential.

Numerical Example 1: HRA Calculation (Metro City)

Ms. Priya works in a large marketing firm in Chennai (a Metro City). Her annual salary components for the Financial Year are:

Particulars	Annual Amount (₹)
Basic Salary	6,00,000
Dearness Allowance (forming part of retirement benefits)	1,20,000
House Rent Allowance (HRA) Received	2,88,000
Actual Annual Rent Paid	3,00,000

Step 1: Calculate Salary for HRA Purpose

$$\text{Salary} = \text{Basic Salary} + \text{DA (forming part)} = ₹6,00,000 + ₹1,20,000 = ₹7,20,000$$

Step 2: Determine the Three Statutory Conditions (Least of which is Exempt)

Condition	Calculation	Amount (₹)
1. Actual HRA Received	Given in data	2,88,000
2. Statutory Percentage (Metro City)	50% of Salary (₹7,20,000)	3,60,000
3. Rent Paid Excess	Rent Paid (₹3,00,000) – 10% of Salary (10% of ₹7,20,000)	₹3,00,000 - ₹72,000 = 2,28,000

Step 3: Determine the Exempt and Taxable HRA

The minimum of the three amounts is ₹2,28,000.

- **HRA Exempted:** ₹2,28,000
- **HRA Taxable:** Actual HRA Received minus HRA Exempted
 - ₹2,88,000 - ₹2,28,000 = ₹60,000

Thus, only ₹60,000 of the HRA received will be added to Ms. Priya's taxable income under the head 'Salaries'.

Numerical Example 2: Gratuity Calculation (POGA vs. Non-POGA)

Mr. Sharma, a private sector employee, retires after 18 years and 7 months of continuous service. His last drawn salary (Basic + DA) was ₹60,000 per month. He receives a lump-sum gratuity of ₹15,00,000.

Assumption 1: Mr. Sharma is Covered under POGA

Condition	Calculation	Amount (₹)
1. Actual Gratuity Received	Given in data	15,00,000
2. Statutory Limit	Maximum limit	20,00,000
3. 15 days' salary x Completed years of service	Service period (18 years 7 months) is rounded up to 19 years. Salary for 15 days = (₹60,000 x 15 / 26) = ₹34,615.38. Exemption: ₹34,615.38 x 19 years	6,57,692

- **Gratuity Exempted (POGA):** The least of the three is ₹6,57,692.
- **Gratuity Taxable (POGA):** ₹15,00,000 - ₹6,57,692 = **₹8,42,308**

Assumption 2: Mr. Sharma is NOT Covered under POGA

Condition	Calculation	Amount (₹)
1. Actual Gratuity Received	Given in data	15,00,000
2. Statutory Limit	Maximum limit	20,00,000
3. Half month's average salary x Completed years of service	Only completed years (18 years) are considered. Half month's salary (last 10 months average) = ₹60,000 / 2 = ₹30,000. Exemption: ₹30,000 x 18 years	5,40,000

- **Gratuity Exempted (Non-POGA):** The least of the three is ₹5,40,000.
- **Gratuity Taxable (Non-POGA):** ₹15,00,000 - ₹5,40,000 = **₹9,60,000**

Conclusion: The comparative calculation shows that POGA coverage provides a significantly larger tax exemption (₹6,57,692 vs. ₹5,40,000), resulting in lower taxable income for the employee, primarily due to the ability to round up the service period.

Application Example 3: Managerial Implication of Exemptions (Compensation Strategy)

A manager structuring the Cost-to-Company (CTC) package for a new employee earning an annual CTC of ₹12,00,000 must decide how to allocate the components. The employee resides in a non-metro city and pays ₹20,000 per month in rent.

Component	Scenario A (Sub-optimal)	Scenario B (Optimized)
Basic Pay	₹9,60,000	₹6,00,000
HRA Received	₹48,000 (₹4,000/ month)	₹1,92,000 (₹16,000/ month)
Conveyance/ Other Allowances	₹1,92,000	₹4,08,000
Total CTC	₹12,00,000	₹12,00,000

Tax Impact Analysis (Focusing on HRA Exemption):

Scenario A (Sub-optimal):

- 1) HRA Received: ₹48,000.
- 2) 40% of Salary: 40% of ₹9,60,000 = ₹3,84,000.
- 3) Rent Paid – 10% of Salary: (₹2,40,000 rent paid) - (10% of ₹9,60,000) = ₹1,44,000.
Exempt HRA (Least of 1, 2, 3): ₹48,000.

Scenario B (Optimized):

- 1) HRA Received: ₹1,92,000.
- 2) 40% of Salary: 40% of ₹6,00,000 = ₹2,40,000.
- 3) Rent Paid – 10% of Salary: (₹2,40,000 rent paid) - (10% of ₹6,00,000) = ₹1,80,000.
Exempt HRA (Least of 1, 2, 3): ₹1,80,000.

By allocating a higher portion of the CTC to HRA (Scenario B), the manager maximizes the exemption amount (₹1,80,000) compared to Scenario A (₹48,000). This strategic use of Section 10(13A) reduces the employee's overall taxable income by an additional ₹1,32,000 (₹1,80,000 - ₹48,000), leading to a significantly higher net take-home salary for the employee, even though the total cost to the company remains identical. This demonstrates the direct financial benefit of effective managerial tax planning.



Check Your Progress – A

1. What is meant by “Exempt Income” under Section 10 of the Income Tax Act, 1961.

2. What is the maximum statutory limit of gratuity exemption for non-government employees?

3. Why is a partner’s share in the profit of a firm or LLP exempt from tax under Section 10(2A), while partner’s salary is taxable?

3.7 SUMMARY

This unit explains the concept, scope, and application of Exempted Incomes under Section 10 of the Income Tax Act, 1961, which specifies incomes that do not form part of total taxable income. The unit begins by clarifying the conceptual distinction between tax exemptions, deductions, and rebates, emphasizing that exemptions operate at the initial stage of income computation by excluding specific incomes altogether. A major focus is placed on fully exempt incomes, particularly agricultural income, which is exempt under Section 10(1) due to constitutional provisions reserving its taxation to State Governments. The unit also explains the concept of partial integration of agricultural income, ensuring tax equity for non-corporate assesseees. Other fully exempt incomes discussed include partner’s share of profit from a firm, educational scholarships, certain provident fund receipts, and eligible life insurance proceeds under Section 10(10D), subject to premium limits and recent legislative amendments.

The unit further covers partially exempt salary components such as House Rent Allowance (HRA), Gratuity, Leave Travel Allowance (LTA), and Commuted Pension, explaining statutory formulas, monetary caps, and conditions for exemption. Differences in gratuity calculation for employees covered and not covered under the Payment of Gratuity Act, 1972 are highlighted. Illustrative numerical examples strengthen practical understanding, while managerial applications demonstrate how exemptions can be strategically used in compensation planning. The unit concludes by stressing the importance of mandatory disclosure of exempt income in the ITR for transparency and compliance.



3.8 GLOSSARY

- **Exempt Income:** Income specified under Section 10 of the IT Act that is not included in the total income for tax calculation.
- **Tax Deduction:** An amount subtracted from the Gross Total Income (GTI) based on investments or expenses (e.g., Sec 80C).
- **Tax Rebate:** A reduction in the calculated tax liability, usually restricted by income limits (e.g., Sec 87A).
- **Agricultural Income:** Revenue derived from land situated in India and used for agricultural purposes, fully exempt under Sec 10(1).
- **Partial Integration:** The mechanism used to calculate the tax rate on non-agricultural income by referencing the taxpayer's exempt agricultural income.
- **Gross Total Income (GTI):** The sum of income computed under the five heads of income *after* applying all exemptions under Section 10, but *before* applying deductions under Chapter VI-A.
- **House Rent Allowance (HRA):** An allowance received by an employee to cover rental costs, partially exempt under Section 10(13A).
- **Gratuity:** A lump-sum terminal benefit paid by an employer to an employee upon retirement, resignation, or death.
- **POGA:** Acronym for the Payment of Gratuity Act, 1972, which governs gratuity calculation rules for covered employees.
- **Leave Travel Concession (LTC/LTA):** An allowance covering domestic travel fare during leave, partially exempt under Section 10(5).
- **Commuted Pension:** The lump sum amount received in exchange for giving up a portion of the future periodic pension.
- **Section 10(10D):** The statutory provision governing the exemption of maturity proceeds from life insurance policies.
- **Statutory Limit:** A maximum monetary cap specified by the Income Tax Act for certain exemptions (e.g., ₹20,00,000 for Gratuity).
- **Metro Cities (HRA):** For HRA calculation purposes, typically defined as Delhi, Mumbai, Kolkata, and Chennai.
- **ULIP:** Unit-Linked Insurance Plan, a specific type of investment-cum-insurance policy now subject to special tax restrictions under Section 10(10D).



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3.10 SUGGESTED READINGS

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3.11 TERMINAL QUESTIONS

- 1) Define exempt income and explain its statutory basis under Section 10 of the Income Tax Act, 1961.
- 2) Distinguish clearly between tax exemption, tax deduction, and tax rebate with reference to their stage of application.
- 3) Explain the concept of agricultural income and justify why it is fully exempt from central income tax.
- 4) What is partial integration of agricultural income? Explain its purpose and applicability.

- 5) Discuss the tax treatment of a partner's share of profit and partner's remuneration received from a firm.
- 6) Explain the conditions and premium limits for exemption of life insurance policy proceeds under Section 10(10D).
- 7) Describe the calculation mechanism and statutory conditions for exemption of House Rent Allowance (HRA).
- 8) Analyze the exemption rules for gratuity received by (a) government employees and (b) non-government employees.
- 9) Explain the difference in gratuity exemption calculation for employees covered and not covered under the Payment of Gratuity Act, 1972.
- 10) State the conditions, limits, and frequency applicable to Leave Travel Allowance (LTA) exemption.
- 11) Explain the tax treatment of commuted pension with and without receipt of gratuity.
- 12) Why is disclosure of exempt income in the Income Tax Return mandatory despite such income being non-taxable?
- 13) Mr. Rahul, residing in Pune (Non-Metro), provides the following annual salary details:
Basic Salary: ₹8,00,000; Dearness Allowance (part of retirement benefit): ₹1,00,000; HRA Received: ₹1,50,000; Actual Rent Paid: ₹1,80,000. Calculate the amount of HRA exempt under Section 10(13A) and the taxable HRA.
- 14) Ms. Deepika, not covered under POGA, retired after 25 years and 3 months of service. Her average salary for the 10 months preceding retirement was ₹95,000 per month. She received a total gratuity of ₹25,00,000. Calculate the amount of gratuity exempt under Section 10(10).
- 15) Mr. Anand, covered under POGA, retired after 20 years and 8 months of service. His last drawn monthly salary was ₹75,000. He received a gratuity of ₹14,00,000. Calculate the taxable amount of gratuity.

UNIT-4

INCOME FROM SALARY

Contents

- 4.1 Introduction**
- 4.2 Foundational Concepts: Chargeability and Definition of Salary (Sections 15 and 17)**
- 4.3 Tax Treatment of Allowances**
- 4.4 Tax Treatment and Valuation of Perquisites (Section 17(2) and Rule 3)**
- 4.5 Tax Treatment of Retirement Benefits**
- 4.6 Deductions from Gross Salary (Section 16)**
- 4.7 Illustrative Examples / Applications**
- 4.8. Summary**
- 4.9 Glossary**
- 4.10 References/ Bibliography**
- 4.11 Suggested Readings / References**
- 4.12 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, you should be able to:

- Explain the statutory condition of the employer-employee relationship and the charging mechanism of salary income under Section 15.
- Describe the definition of ‘Salary’ as an inclusive concept under Section 17(1), covering wages, annuity, and advance salary.
- Differentiate between fully taxable, partially exempt, and fully exempt allowances, focusing on House Rent Allowance (HRA), Children Education Allowance (CEA), and specialized transport allowances.
- Apply the complex rules and formula prescribed under Section 10(13A) to calculate the maximum permissible House Rent Allowance (HRA) exemption.
- Evaluate the statutory valuation methods (Rule 3) for key non-monetary perquisites, specifically Rent-Free Accommodation (RFA) and Motor Car provided by the employer.
- Analyze the tax treatment of common retirement benefits, including Gratuity, Pension (commuted versus uncommuted), and the comparative taxability of different types of

Provident Funds (Recognized versus Unrecognized).

- Determine the mandatory deductions available from Gross Salary under Section 16, encompassing the Standard Deduction, Entertainment Allowance, and Professional Tax.
- Compute the final taxable income under the head 'Salaries' for an individual using the prescribed step-by-step format.

4.1 INTRODUCTION

The 'Income from Salary' is categorized as the first and most common head of income under the Income Tax Act, 1961. This unit is dedicated to providing a deep, systematic understanding of the provisions governing income generated from an employment relationship. For a vast majority of Indian taxpayers, including salaried professionals and executives, the accurate computation of income under this head is foundational to tax compliance and filing returns. Understanding the taxability of salary is not just a regulatory necessity; it forms a critical aspect of managerial decision-making. When designing Cost-to-Company (CTC) compensation packages, employers must strategically allocate funds across various components—Basic Salary, Allowances, and Perquisites—to maximize tax efficiency for the employee while adhering to statutory limits. This unit will analyze the mandatory condition for taxing income under this head—the existence of an employer-employee relationship—and the fundamental principle of taxation based on 'due or receipt basis'. We will systematically break down the three primary components of salary: Allowances (monetary payments), Perquisites (non-monetary benefits), and Retirement Benefits. Crucially, we will study the statutory exemptions and valuation rules provided for these components. Finally, we will apply the essential statutory deductions available exclusively to salaried individuals under Section 16. By the conclusion of this unit, learners will be proficient in calculating the Net Taxable Income under the head Salaries, a core skill required for accurate income tax reporting.

4.2 FOUNDATIONAL CONCEPTS: CHARGEABILITY AND DEFINITION OF SALARY (SECTIONS 15 AND 17)

4.2.1 The Crucial Condition: Employer-Employee Relationship

The foundational requirement for taxing any income under the head 'Salaries' is the definitive existence of an employer-employee relationship between the payer and the payee. If this relationship is absent, the income must be taxed under a different head, such as 'Profits and Gains of Business or Profession' or 'Income from Other Sources'.

The key criterion used to identify this relationship is the master-servant dynamic. An employer not only dictates *what* work is to be done but, crucially, reserves the right to control the manner in which the work is executed. For instance, a Managing Director who is also an employee drawing

a salary is covered under this head. Conversely, fees received by professional consultants, such as independent auditors or legal advisors, are generally excluded because they are typically hired to achieve a result, but the control over the execution process remains with them.

This condition also implies that payments received by partners from their firm are typically not taxed as salary, even if labelled as such in the partnership deed, because a partner cannot technically be an employee of the firm.² Similarly, salary paid by a foreign government to its employee serving in India is taxable under the head Salaries.

4.2.2 Basis of Charge: Due or Receipt, Whichever is Earlier (Section 15)

Section 15 stipulates that salary income is charged to tax in the previous year in which it is due or in which it is received, depending on which event occurs first. This principle, known as the 'due or receipt basis,' serves two critical functions. First, it ensures that income is never taxed in two different assessment years (e.g., once when it becomes due, and again when it is physically received). Second, it prevents taxpayers from deferring their tax liability simply by delaying the actual receipt of income that has already become legally due.

For instance, if an employee receives an advance salary (i.e., payment before it is due), it is taxed in the year of receipt. Conversely, if salary is due on March 31st but paid on April 5th of the next financial year, it is taxed in the year it became due. In the case of salary arrears (salary pertaining to an earlier year but received later), it is taxed in the year of receipt. However, the Act provides a mechanism, under Section 89, for the assessee to claim relief to mitigate the higher tax burden that might result from receiving multiple years' income in one go.

4.2.3 Definition and Inclusions in Salary (Section 17(1))

Section 17(1) provides an inclusive definition of salary, meaning the list provided is not exhaustive, and other payments derived from the employment relationship may also be covered based on the facts and circumstances of the case. The definition explicitly includes ¹:

- 1) Basic Pay and Wages.
- 2) Any Annuity or Pension.
- 3) Any Gratuity.
- 4) Any fees, commissions, perquisites, or profits in lieu of salary.
- 5) Any Advance Salary or Arrears of salary paid or allowed to the employee.
- 6) The taxable value of any perquisites provided to the employee, which are benefits received in terms of kind like accommodation, commute expenses, or subsidized meals.
- 7) Leave Encashment, which is the consideration received for leave days worked or accumulated.
- 8) The taxable portion of the employer's contribution to a recognized provident fund.

The first step in calculating taxable salary is always to aggregate these components to determine the Gross Salary.

Table 4.1: Key Components of Gross Salary Income

Category	Nature of Inclusion	Taxability Status	Relevant Section
Basic Salary/ Wages	Fixed remuneration for services rendered	Fully Taxable (Always)	Section 17(1)(i)
Allowances	Fixed monetary component (e.g., HRA, DA, CCA)	Fully, Partially, or Fully Exempt	Section 10 read with Rule 2BB
Perquisites	Non-monetary benefits in kind (e.g., RFA, Motor Car)	Taxable based on Rule 3 valuation	Section 17(2)
Retirement Benefits	Payments like Gratuity, Pension, PF Withdrawal	Fully, Partially, or Fully Exempt	Section 10(10), 10(10A)

4.3 TAX TREATMENT OF ALLOWANCES

Allowances are specific, regular cash payments provided by the employer to the employee, typically intended to cover expenditure for a particular purpose, such as housing, travel, or education. They are generally fixed amounts, irrespective of the actual expenditure incurred by the employee, and are assumed to be fully taxable unless the Income Tax Act specifically grants a full or partial exemption.

4.3.1 Fully Taxable Allowances

The following are examples of allowances that are fully included in the Gross Salary without any exemption:

- 1) **Dearness Allowance (DA):** Provided to compensate the employee for the effects of inflation and rising prices.
- 2) **City Compensatory Allowance (CCA):** Paid to employees to compensate them for the higher cost of living prevalent in large metropolitan areas.
- 3) **Overtime Allowance:** Compensation given to employees for working beyond their stipulated working hours.
- 4) **Transport Allowance (Commuting):** Allowance granted to employees to meet the cost of commuting between their residence and their place of duty. This allowance is fully taxable for employees other than those who are blind, deaf and dumb, or orthopedically handicapped.

4.3.2 Partially Exempt Allowances

These allowances are taxable only to the extent they exceed a statutory exemption limit or the

actual expenditure incurred.

A. House Rent Allowance (HRA)

HRA is provided to enable employees to meet the cost of renting residential accommodation. The exemption under Section 10(13A) is available only if the employee actually lives in rented accommodation and pays rent. If an employee receives HRA but lives in their own house or does not pay rent, the entire HRA received is fully taxable.

It is important to note the conditions for claiming this exemption. The employee must furnish valid proof of rent payment, such as receipts. If the monthly rent exceeds ₹3,000, submitting rent receipts is mandatory. Furthermore, if the total annual rent paid exceeds ₹1 Lakh, the employee must provide the Permanent Account Number (PAN) of the landlord. The statutory mechanism for determining the maximum HRA exemption ensures that the benefit is strictly proportional to the actual need for rented accommodation.

Exemption Formula for HRA: The amount exempt from tax is the least of the following three amounts 8:

- 1) Actual HRA received by the employee.
- 2) Rent Paid *minus* 10% of Salary.
- 3) 50% of Salary (if residing in Metro cities: Delhi, Mumbai, Kolkata, or Chennai).
- 4) 40% of Salary (if residing in any Non-Metro city).

Note: For HRA calculation purposes, the term 'Salary' means: Basic Salary + Dearness Allowance (DA) that forms part of retirement benefits + Commission based on a fixed percentage of turnover achieved by the employee. A critical point for managerial strategy and employee compensation design relates to the tax regimes. The HRA exemption is not available to salaried individuals who opt for the New Tax Regime (Section 115BAC). This fact necessitates a careful evaluation, especially for employees paying high rent in major metropolitan areas, as the tax savings offered by the HRA exemption under the Old Tax Regime may outweigh the benefits of the lower slab rates under the New Regime.

B. Fixed Limit Allowances (Section 10(14)(ii) read with Rule 2BB)

These allowances are exempt up to a specific, fixed monthly limit set by the Act, regardless of the employee's actual expenditure, provided the allowance is received for the stipulated purpose.

- **Children Education Allowance (CEA):** Granted to meet the tuition fees of a maximum of two children. The exemption is limited to ₹100 per month per child, for a maximum of two children.
- **Hostel Expenditure Allowance (HEA):** Granted to meet the hostel expenditure of a maximum of two children. The exemption is limited to ₹300 per month per child, for a maximum of two children.

- **Transport Allowance (Disabled/Handicapped):** Granted to meet the expenditure for commuting between residence and duty place for employees who are blind, deaf and dumb, or orthopedically handicapped. The exemption is limited to ₹3,200 per month.

C. Official Duty Allowances (Section 10(14)(i))

These allowances are designed to reimburse expenses incurred wholly and necessarily in the performance of official duties. The exemption is allowed only up to the lower of the actual allowance received or the amount actually spent by the employee for that specific official purpose. Any surplus amount received beyond the expenditure incurred is fully taxable.

Examples include:

- **Uniform Allowance:** Granted to meet the expenditure on the purchase or maintenance of an office uniform.
- **Daily Allowance:** Granted to meet ordinary daily charges incurred by an employee during a tour or transfer, when away from the normal place of duty.
- **Conveyance Allowance:** Granted to meet the expenditure on conveyance incurred for official duties, excluding the regular home-to-work commute (which is covered by Transport Allowance).
- **Travel Allowance:** Covers travel costs during tours or transfers, including moving personal belongings.

Table 4.3: Exemption Limits for Key Specific Allowances

Allowance	Exemption Limit Criterion	Maximum Statutory Amount	Applicable Rule
Children Education Allowance (CEA)	Lower of amount received or amount spent	₹100 per child per month (Max. 2 children)	Rule 2BB
Hostel Expenditure Allowance (HEA)	Lower of amount received or amount spent	₹300 per child per month (Max. 2 children)	Rule 2BB
Transport Allowance (Disabled/Handicapped)	Fixed Exemption	₹3,200 per month	Rule 2BB
Uniform Allowance	Lower of amount received or actual expenses incurred	Amount actually spent	Rule 2BB

4.4 TAX TREATMENT AND VALUATION OF PERQUISITES (SECTION 17(2) AND RULE 3)

Perquisites, often abbreviated as 'perks,' are defined as any casual emolument or benefit attached to an office or position, provided by the employer to the employee in addition to salary or wages. These benefits are typically received in kind, such as free housing or the use of a company car, rather than in cash. Since these are benefits enjoyed by the employee, their monetary value must be computed and included in the taxable Gross Salary as stipulated by Section 17(2) and subsequently valued according to Rule 3 of the Income Tax Rules.

4.4.1 Valuation of Rent-Free Accommodation (RFA)

When an employer provides residential accommodation free of cost or at a reduced rate (concessional rate) to an employee, the value of this benefit is considered a taxable perquisite.

The valuation method depends on whether the employer is a government entity or a non-government entity. For non-government employees, the valuation of an unfurnished Rent-Free Accommodation is systematically determined based on the population of the city where the accommodation is located, using the figures from the 2001 Census.

- **Valuation Based on Population:** The value of the perquisite is calculated as a specific percentage of the employee's salary (salary defined here is broader than for HRA, usually meaning all monetary taxable components, excluding RFA itself).

The continued reliance on the 2001 Census for RFA valuation carries a significant implication for compensation strategy. Since the actual market rental values in major urban areas have increased dramatically since 2001, the statutory valuation often results in a perquisite value that is substantially lower than the true economic cost of the accommodation. This disparity means that allocating funds toward providing RFA is often a far more tax-efficient mechanism for an employer to compensate an employee, compared to increasing the fully taxable Basic Salary component. Table 4.4 details the valuation norms for unfurnished RFA provided by a non-government employer:

Table 4.4: Valuation of Unfurnished RFA for Non-Government Employees

City Population (as per 2001 Census)	Value of Perquisite (% of Salary)
More than 25 lakh	15% of Salary
Exceeding 10 lakh but not exceeding 25 lakh	10% of Salary
10 lakh or below	7.5% of Salary

In a situation where the employer does not own the accommodation but takes it on lease or rent, the value of the perquisite is determined as the lower of the actual rent paid/payable by the

employer or 15% of the employee's salary. In all cases, the perquisite value is reduced by any amount of rent actually recovered from the employee.

Note: If the accommodation is provided for less than 15 days, such as a short-term stay in a hotel during a transfer, it is generally not taxable. However, if hotel accommodation is provided for 15 days or more, the perquisite value is calculated as the lower of 24% of salary or the actual charges paid to the hotel.

4.4.2 Valuation of Motor Car Perquisite (Rule 3)

The provision of a motor car by the employer to the employee is a common perquisite, usually reserved for senior or top-level employees. The taxable value depends heavily on the car's usage and its engine capacity (cubic capacity or CC).

- 1) **Wholly Official Use:** If the motor car is used entirely and exclusively for the performance of official duties, the value of the perquisite is NIL (not taxable), provided the employer maintains complete records of such official use.
- 2) **Partly Official and Partly Private Use:** This is the most common scenario. Here, a fixed monthly amount is added to the employee's salary, reflecting the estimated cost of private use. This calculation is based on the engine capacity and who bears the running and maintenance expenses.

Case 1: Employer owns/hires the car and meets all running expenses:

Table 4.5: Fixed Monthly Taxable Value of Motor Car Perquisite (Employer Bears Expenses)

Engine Capacity (CC)	Fixed Taxable Amount (Per Month)	If Chauffeur is Provided (Add)
Up to 1.6 litres (1600 cc)	₹1,800	₹900
Above 1.6 litres (1600 cc)	₹2,400	₹900

Case 2: Employee owns the car, but the running and maintenance expenses are met or reimbursed by the employer:

The value of the perquisite is the actual expenditure incurred by the employer, reduced by a fixed statutory amount, which represents the estimated official use.

- Engine Capacity Up to 1.6 litres: Actual Expenditure minus ₹1,800 per month (plus ₹900 if a chauffeur is provided).
- Engine Capacity Above 1.6 litres: Actual Expenditure minus ₹2,400 per month (plus ₹900 if a chauffeur is provided).

4.4.3 Valuation of Other Key Perquisites

- **Supply of Gas, Electricity, or Water:** If supplied from an external agency, the value is the amount paid by the employer to that agency. If supplied from the employer's own resources,

the value is determined by the manufacturing cost per unit incurred by the employer. Any amount recovered from the employee must be reduced from the determined value.

- **Use of Movable Assets:** The valuation varies by asset type:
 - For the use of Laptops and Computers, the taxable value is NIL. This provision encourages the use of modern technology without imposing a tax burden.
 - For other movable assets (excluding motor cars), the value is 10% per annum of the original cost of the asset (if owned by the employer) or the actual hire charges (if taken on rent), reduced by any amount recovered from the employee.
- **Transfer of Movable Assets (Sale to Employee):** If the employer transfers an asset to the employee (e.g., sells an old company car), the taxable value is the actual cost of the asset reduced by depreciation calculated for each completed year of usage. The depreciation rates differ: 50% on the reducing balance method for computers/laptops; 20% on the reducing balance method for motor cars; and 10% on the Straight Line Method (SLM) for other assets.

4.5 TAX TREATMENT OF RETIREMENT BENEFITS

Payments received by an employee at the time of retirement or separation are considered salary income, as they represent compensation for past services. However, these benefits are often granted significant exemptions under Section 10 of the Act.

4.5.1 Gratuity (Section 10(10))

Gratuity is a lump-sum payment given by an employer to an employee upon termination, resignation, or retirement, provided the employee has completed a minimum specified period of service.

- **Government Employees:** Gratuity received by a government employee (Central or State) is **fully exempt** from tax.
- **Non-Government Employees:** The tax exemption for non-government employees is subject to the provisions of the Payment of Gratuity Act, 1972, or other specific rules. In all cases, the maximum lifetime exemption limit for gratuity is ₹20,00,000.

The exempt amount is the **least** of the following three:

- 1) Actual gratuity received.
- 2) The maximum statutory limit (currently ₹20,00,000).
- 3) Half month's average salary multiplied by the number of completed years of service.

4.5.2 Pension (Section 10(10A))

Pension is typically paid monthly (uncommuted) or received as a lump sum (commuted).

- **Uncommuted Pension:** Any periodical payment of pension (monthly pension) is fully taxable as salary for all categories of employees—government or non-government.
- **Commuted Pension (Lump-sum):** This refers to receiving a part or the entire pension in a

lump sum instead of monthly payments.

- **Government Employees:** Commuted pension received by government employees is **fully exempt** from tax.
- **Non-Government Employees:** The exemption is partial and depends on whether the employee also receives gratuity:
 - **If Gratuity is received:** 1/3 of the total pension amount that could have been commuted is exempt. The remaining amount is taxable.
 - **If Gratuity is NOT received:** 1/2 (half) of the total pension amount that could have been commuted is exempt. The remaining amount is taxable.

The statutory linkage between the receipt of gratuity and the quantum of pension exemption requires meticulous attention during retirement planning and settlement. If an employee receives gratuity, their tax-free portion of the commuted pension is reduced, reflecting the legislative intent to balance the total tax-exempt retirement benefits received.

Note: Pension received by a family member after the employee's death is taxed under the head 'Income from Other Sources.' A partial exemption is allowed: the least of ₹15,000 (recently increased to ₹25,000, referring to specific provisions of the latest Finance Act) or 1/3 of the uncommuted pension received.

4.5.3 Provident Funds (PF)

Provident funds are mandatory savings schemes designed for employees' long-term financial security. Their tax treatment is critically dependent on whether the fund is 'Recognized' or 'Unrecognized.'

A. Recognized Provident Fund (RPF)

An RPF is a scheme established by the employer and employee that is approved by the Commissioner of Income Tax. These funds offer significant tax incentives.

- **During Employment:**
 - Employee contributions are eligible for deduction under Section 80C (up to the overall limit of ₹1.5 lakh).
 - Employer contributions are tax-free up to 12% of the employee's salary.
 - Interest credited is tax-free up to 9.5% per annum. However, a recent amendment (effective April 1, 2021) dictates that interest earned on employee contributions exceeding ₹2.5 lakh annually will be taxable upon withdrawal.
- **At Withdrawal:** Withdrawals are entirely tax-free if the employee has completed 5 years of continuous service or if termination is due to specified conditions (e.g., health issues or business closure). If continuous service is less than 5 years, the employer's contributions and accrued interest become taxable.

B. Unrecognized Provident Fund (URPF)

An URPF is a scheme established by the employer and employee but not approved by the Commissioner of Income Tax. These schemes lack the typical tax benefits associated with recognized funds.

- **During Employment:**
 - Neither employer nor employee contributions are eligible for tax deductions.
 - Interest earned is not taxed annually but is fully taxable at the time of withdrawal.
- **At Withdrawal:** The entire accumulated balance is not taxed uniformly. The employer's contribution and the interest accrued on both the employer's and employee's contributions are taxed as 'Salary Income.' Only the employee's contribution is generally tax-free (as it was made from taxed income), but the interest on the employee's contribution is taxed under 'Income from Other Sources'.

The fundamental difference in tax treatment between RPF and URPF highlights the crucial importance of statutory approval. Companies offering URPF schemes severely disadvantage their employees from a tax perspective, as tax relief on contributions is denied and the final withdrawal is heavily taxed, making the scheme inherently tax-inefficient.

Table 4.5: Comparative Tax Treatment of Provident Funds

Criteria	Recognized Provident Fund (RPF)	Unrecognized Provident Fund (URPF)
Employee Contribution (During Employment)	Deductible u/s 80C	Not Eligible for Deduction
Employer Contribution (During Employment)	Tax-free up to 12% of salary	Not taxed annually
Interest Earned (During Employment)	Tax-free up to 9.5% p.a. (subject to contribution limits)	Not taxed annually
Withdrawal (After 5 years continuous service)	Tax-free	Employer's contribution + Interest on both shares is taxable as Salary

4.6 DEDUCTIONS FROM GROSS SALARY (SECTION 16)

After calculating the Gross Salary (Salary components + Taxable Allowances + Taxable Perquisites + Taxable Retirement Benefits), the next step is to subtract certain mandatory deductions stipulated under Section 16 to arrive at the Net Taxable Salary.

4.6.1 Standard Deduction (Section 16(ia))

The standard deduction is a flat, fixed deduction allowed to all salaried employees, regardless of

their actual expenditure.

- **Amount:** The deduction allowed is the lower of ₹50,000 or the total amount of salary received.
- **Policy Evolution:** Historically, the standard deduction was eliminated, then reintroduced to replace the exemptions for medical reimbursement and transport allowance. A key development is the extension of the ₹50,000 standard deduction to those opting for the New Tax Regime (Section 115BAC), ensuring this benefit is universally available to all salaried taxpayers. This development simplifies tax calculation and provides guaranteed relief across regimes.

4.6.2 Entertainment Allowance (Section 16(ii))

While entertainment allowance is initially included as fully taxable income in Gross Salary, a deduction under Section 16(ii) is subsequently available, but only under specific circumstances.

- **Eligibility Restriction:** The deduction for Entertainment Allowance is available only in the case of Government employees. Private sector employees, even if they receive the allowance, are not eligible for this deduction.
- **Deduction Limit:** For eligible (Government) employees, the amount of deduction allowed is the **least** of the following three amounts:
 - 1) One-fifth (1/5) of the employee's Basic Salary.
 - 2) A fixed statutory amount of ₹5,000.
 - 3) Actual entertainment allowance received during the year.

The statutory disparity, which allows this deduction exclusively for government employees while denying it to private sector employees who might perform similar official duties requiring entertainment expenditure, reflects a deliberate policy choice to provide an exclusive, tax-sheltered benefit within the public service compensation structure. Furthermore, this deduction is only available if the taxpayer opts for the Old Tax Regime.

4.6.3 Professional Tax (Section 16(iii))

Professional tax (or tax on employment) is a levy imposed by state governments in India.

- **Deduction:** The deduction allowed is the amount of professional tax actually paid by the employee during the financial year.
- **Maximum Limit:** The deduction is capped at ₹2,500 per annum.
- **Payment by Employer:** If the professional tax is paid by the employer on behalf of the employee, this amount is first treated as a taxable perquisite and added to the Gross Salary. Subsequently, the same amount (up to ₹2,500) is allowed as a deduction under Section 16(iii).
- **Regime Note:** This deduction is available only under the Old Tax Regime.

Table 4.6: Summary of Deductions under Section 16

Deduction Type	Eligibility	Maximum Limit / Calculation Rule	Regime Availability
Standard Deduction (16(ia))	All Salaried Employees	Lower of ₹50,000 or Total Salary	Both Old and New Regimes
Entertainment Allowance (16(ii))	Government Employees Only	Least of (1) 1/5 Basic Salary, (2) ₹5,000, or (3) Actual Allowance Received	Old Regime Only
Professional Tax (16(iii))	All Salaried Employees (where applicable state levy exists)	Actual amount paid, capped at ₹2,500 per annum	Old Regime Only

4.7 ILLUSTRATIVE EXAMPLES / APPLICATIONS

To solidify the understanding of complex calculations, two specific numerical examples are provided, focusing on the calculation of HRA exemption and the overall computation of taxable salary.

Illustration 1: Computation of House Rent Allowance (HRA) Exemption

Mr. Rohan works for a private company and is employed in Mumbai (a metro city). His annual salary components for the Financial Year (FY) 2025-26 are as follows:

Particulars	Annual Amount (₹)
Basic Salary (BS)	7,20,000
Dearness Allowance (DA) (40% forms part of retirement benefits)	1,80,000
House Rent Allowance (HRA) received	1,20,000
Rent paid per month	12,000

Step-by-step Solution:

Step 1: Determine 'Salary' for HRA calculation.

Salary = Basic Salary + DA forming part of retirement benefits.

DA forming part of salary = 40% of ₹1,80,000 = ₹72,000.

HRA Salary = ₹7,20,000 + ₹72,000 = ₹7,92,000.

Step 2: Calculate 10% of HRA Salary.

10% of Salary = 10% of ₹7,92,000 = ₹79,200.

Step 3: Calculate the maximum statutory percentage of Salary.

Since Mumbai is a metro city, the limit is 50% of Salary.

50% of Salary = 50% of ₹7,92,000 = ₹3,96,000.

Step 4: Calculate the three exemption amounts (Least of the following):

- 1) Actual HRA received: ₹1,20,000
- 2) Rent paid less 10% of Salary: (₹12,000 x 12) minus ₹79,200
= ₹1,44,000 minus ₹79,200 = ₹64,800
- 3) 50% of HRA Salary: ₹3,96,000

Step 5: Determine the HRA Exemption.

The least of the three amounts is ₹64,800.

HRA Exempted = ₹64,800.

Step 6: Determine Taxable HRA.

Taxable HRA = HRA Received minus HRA Exempted

Taxable HRA = ₹1,20,000 minus ₹64,800 = ₹55,200.

Illustration 2: Comprehensive Computation of Income from Salary (Old Tax Regime)

Mr. Suresh is a non-government employee working in Pune (Non-Metro city, Population > 25 Lakh as per 2001 Census). Compute his taxable salary for the FY 2025-26.

Particulars	Annual Amount (₹)	Notes
Basic Salary	10,00,000	-
Dearness Allowance (DA)	1,20,000	Entirely forms part of retirement benefits.
House Rent Allowance (HRA) received	1,00,000	Rent paid: ₹1,20,000 (i.e., ₹10,000 per month).
Children Education Allowance (CEA)	18,000	For two children. Actual expense incurred: ₹15,000.
Professional Tax paid by Suresh	2,500	-
RFA provided by employer (City population > 25L)	NIL	Employer owned, unfurnished.

Step 1: Computation of Gross Salary

Particulars	Amount (₹)	Details
1. Basic Salary	10,00,000	Fully Taxable
2. Dearness Allowance (DA)	1,20,000	Fully Taxable

3. House Rent Allowance (HRA)	1,00,000	(To be adjusted in exemption below)
4. Children Education Allowance (CEA)	18,000	(To be adjusted in exemption below)
Gross Total (A)	12,38,000	-

Step 2: Less: Exemptions under Section 10

Particulars	Calculation	Exempt Amount (₹)
HRA Exemption		
Salary for HRA (BS + DA)	₹10,00,000 + ₹1,20,000 = ₹11,20,000	-
(i) Actual HRA received	₹1,00,000	-
(ii) Rent paid less 10% Salary	₹1,20,000 minus ₹1,12,000 = ₹8,000	-
(iii) 40% of Salary (Non-Metro)	40% of ₹11,20,000 = ₹4,48,000	-
HRA Exempt (Least of i, ii, iii)	-	8,000
CEA Exemption	(₹100/month x 12 months x 2 children)	2,400
Total Exemptions (B)	-	10,400

Step 3: Add: Taxable Value of Perquisites (RFA)

Particulars	Calculation	Taxable Amount (₹)
RFA Value	15% of Salary (since Pune population > 25L, and DA forms part of salary)	15% of ₹11,20,000
Taxable Perquisite (C)	-	1,68,000

Note: For RFA valuation, the definition of salary is broader than HRA and includes DA forming part of retirement benefits.

Step 4: Calculation of Gross Taxable Salary

Particulars	Amount (₹)
Gross Total (A)	12,38,000
Less: Total Exemptions (B)	10,400

Add: Taxable Perquisites (C)	1,68,000
Gross Taxable Salary (GTS)	13,95,600

Step 5: Less: Deductions under Section 16

Particulars	Calculation	Deductible Amount (₹)
Standard Deduction (16(ia))	Flat deduction	50,000
Professional Tax (16(iii))	Actual amount paid, max ₹2,500	2,500
Entertainment Allowance (Not a Govt. Employee)	Nil	Nil
Total Deductions (D)	-	52,500

Step 6: Computation of Income Chargeable to Tax under the head 'Salaries'

Particulars	Amount (₹)
Gross Taxable Salary (GTS)	13,95,600
Less: Deductions under Section 16 (D)	52,500
Income from Salary	13,43,100

**Check Your Progress – A**

1. What is the necessary condition required for an income receipt to be taxed under the head 'Salaries'?

2. List three allowances that are fully taxable under the head Salaries.

3. A private sector manager receives an Entertainment Allowance of ₹1,000 per month. How much of this is deductible under Section 16(ii)?

4.8. SUMMARY

This unit deals comprehensively with Income from Salary under Sections 15, 16, and 17 of the Income Tax Act, 1961. Salary is chargeable to tax only when a clear employer–employee relationship exists, and it is taxed on a due or receipt basis, whichever is earlier, ensuring income is not taxed twice or deferred. Section 17 provides an inclusive definition of salary, covering basic pay, wages, allowances, perquisites, and certain retirement benefits. The unit explains the tax treatment of allowances, classifying them as fully taxable, partially exempt, or exempt within statutory limits. Special emphasis is laid on House Rent Allowance (HRA), whose exemption is calculated as the least of three prescribed amounts under Section 10(13A). Fixed-limit exemptions such as Children Education Allowance and Hostel Expenditure Allowance are also discussed. A detailed analysis of perquisites under Section 17(2) and Rule 3 is provided, including valuation of Rent-Free Accommodation and motor car facilities, highlighting the continued use of 2001 Census data. The unit further examines retirement benefits like gratuity, pension, and provident funds, distinguishing between recognized and unrecognized schemes. Finally, mandatory deductions under Section 16—standard deduction, entertainment allowance, and professional tax—are explained, leading to a structured, step-by-step computation of taxable salary.



4.9 GLOSSARY

- **Salary:** Defined inclusively under Section 17(1) to include wages, annuity, fees, commission, and advance salary.
- **Due or Receipt Basis:** The rule determining the year of chargeability for salary income, whichever event occurs earlier.
- **Allowances:** Fixed monetary sums paid to an employee to meet specific expenditures (e.g., HRA, DA).
- **Perquisites:** Non-monetary benefits or amenities attached to an office or position, taxed based on prescribed valuation rules (Rule 3).
- **House Rent Allowance (HRA):** Allowance paid for rented accommodation, partially exempt under Section 10(13A).
- **Rent-Free Accommodation (RFA):** Housing provided free or at a concessional rate, a taxable perquisite valued based on the city's population.
- **Standard Deduction:** A fixed deduction of ₹50,000 available to all salaried employees under Section 16(ia).
- **Entertainment Allowance:** Allowance for entertaining clients; deduction under Section 16(ii) is limited only to government employees.

- **Professional Tax:** A state-level tax on employment, deductible under Section 16(iii) up to ₹2,500.
- **Gratuity:** A lump-sum payment upon retirement/separation, partially exempt under Section 10(10), with a lifetime limit of ₹20 lakh.
- **Uncommuted Pension:** Periodic (e.g., monthly) pension payments, fully taxable as salary.
- **Commuted Pension:** Lump-sum payment received in lieu of monthly pension, fully or partially exempt depending on employee type and gratuity receipt.
- **Recognized Provident Fund (RPF):** A scheme approved by the Commissioner of Income Tax, offering significant tax benefits on contributions, interest, and withdrawal.
- **Unrecognized Provident Fund (URPF):** A non-approved PF scheme where the employer's contribution and interest are fully taxable upon withdrawal.
- **Children Education Allowance (CEA):** Allowance for a child's education, exempt up to ₹100 per month per child (max 2 children).



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4.11 SUGGESTED READINGS

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- ✚ Singhania, Vinod K., & Singhania, Kapil. (Latest Edition). *Direct Taxes Law & Practice*. Taxmann Publications. (Highly regarded professional edition covering rules and case law).¹⁹
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- ✚ Mehrotra, H. C., & Goyal, S. P. (Latest Edition). *Income Tax Law and Practice*. Sahitya Bhawan Publications.
- ✚ Indian Income Tax Act, 1961 (as amended by the latest Finance Act). Official Publication, Ministry of Finance, Government of India.¹⁹
- ✚ Rule 3 of the Income Tax Rules, 1962 (For Perquisite Valuation) and Rule 2BB (For Allowance Exemptions).



4.12 TERMINAL QUESTIONS

1. Explain the concept of 'Income from Salary' and discuss the statutory conditions required for its chargeability under Section 15.
2. Define 'Salary' as per Section 17(1) of the Income Tax Act, 1961, and explain its inclusive nature with suitable illustrations.
3. Classify allowances based on their tax treatment and explain the exemption rules applicable to House Rent Allowance (HRA).
4. Discuss the tax treatment and valuation of perquisites under Section 17(2) and Rule 3, with special reference to Rent-Free Accommodation and Motor Car perquisite.
5. Explain the tax treatment of retirement benefits, covering Gratuity, Pension, and Provident Funds, highlighting differences between government and non-government employees.
6. Describe the deductions available from Gross Salary under Section 16 and explain their relevance in computing taxable salary income.
7. Explain the step-by-step procedure for computing income chargeable to tax under the head 'Salaries'.
8. Distinguish between Recognized Provident Fund (RPF) and Unrecognized Provident Fund (URPF) with reference to their tax implications.
9. Discuss the significance of the employer–employee relationship in determining the head under which income is taxable.
10. Critically analyze the role of allowances and perquisites in tax-efficient salary structuring.
11. Mr. A resides in Chennai. His annual salary details are: Basic Salary ₹9,00,000; DA (forming part of retirement benefits) ₹1,50,000; HRA received ₹1,60,000. He pays rent of ₹15,000 per month. Calculate the taxable HRA.
12. Mr. B, a non-government employee in Hyderabad (Non-Metro), receives a Gross Salary of ₹12,00,000, including ₹10,000/month as HRA, ₹1,200/month as CEA (for one child), and ₹800/month as Transport Allowance. He pays rent of ₹10,000/month. His Basic Salary is

₹8,00,000 (DA forms no part of salary). Compute the Net Taxable Salary, assuming only the Standard Deduction is claimed.

13. Mr. C is provided with an RFA in Delhi. His salary is ₹15,00,000. The accommodation is owned by the employer (non-government). He is also provided with a motor car (engine capacity 1.8 litres) where the employer bears all expenses, for partly official and partly private use. Calculate the total taxable value of RFA and Motor Car perquisite annually.

Block 2

UNIT-5

INCOME FROM HOUSE PROPERTY

Contents

5.1 Introduction

5.2 Basis of Charge: Section 22

5.3 Ownership and Deemed Ownership: Section 27

5.4 Computation of Gross Annual Value (GAV): Section 23

5.5 Treatment of Different Property Categories and NAV Computation

5.6 Deductions from Net Annual Value (NAV): Section 24

5.7 Arrears of Rent and Unrealized Rent Received Subsequently: Section 25A

5.8. Illustrative Examples / Applications

5.9. Summary

5.10. Glossary

5.11 References / Bibliography

5.12 Suggested Readings

5.13 Terminal & Model Questions

Learning Objectives

Upon successful completion of this unit, the learner will be able to:

- Explain the three fundamental conditions necessary for charging income under the head "Income from House Property" (Section 22), focusing on the distinction between residential and business use.
- Describe and distinguish the criteria for 'owner' and 'deemed owner' under Section 27, analyzing how the law assigns tax liability regardless of the legal title in specific transfer scenarios.
- Differentiate between the key notional rent concepts—Municipal Value, Fair Rent, and Standard Rent—and analyze their sequential comparison for determining Expected Rent.
- Compute the Gross Annual Value (GAV) of a let-out property, incorporating the complex adjustments required for vacancy loss and unrealized rent.
- Analyze and apply the distinct rules for calculating the Net Annual Value (NAV) and final taxable income/loss for Self-Occupied, Let-Out, and Deemed Let-Out properties, including the special treatment of time-share and area-share letting.

- Apply the statutory rules for deductions under Section 24, specifically the calculation of interest on borrowed capital, detailing the treatment and five-year amortization of pre-construction interest.
- Evaluate the tax treatment of arrears of rent and subsequently realized unrealized rent (Section 25A) and the simplified 30% deduction permitted on such past receipts.
- Calculate the final taxable income or loss from house property for individual assesseees in various scenarios following the prescribed format.

5.1 INTRODUCTION

Welcome to Unit V of the Income Tax course, where the focus shifts from active earnings (like salary) to passive income derived from capital assets, specifically immovable property. This unit, governed primarily by Sections 22 to 27 of the Income Tax Act, 1961, introduces the statutory framework for taxing rental income or the potential rental value of buildings and the land attached to them. Understanding this head of income is crucial for every taxpayer in India who owns residential or commercial property, as it dictates how one of the most substantial assets in a portfolio is treated for taxation.

A key distinction in this area of tax law is the concept of Annual Value (AV). The law defines taxability not merely based on the actual rent received, but on the capacity of the property to generate income. This means the property is considered a capital asset capable of earning a notional income. If an owner keeps a property vacant or lets it out at a rent lower than the market rate, the tax authorities might still levy tax based on an estimated, reasonable benchmark of income, rather than just the actual receipt. This method ensures that the minimum potential earning capacity of the asset is brought under the tax net, promoting fairness in fiscal administration.

Relevance in Managerial Decision-Making

For business and commerce graduates, comprehending the intricacies of 'Income from House Property' is essential for sound financial and investment strategy.

- 1) **Optimizing Real Estate Investment:** Knowledge of Section 24, particularly the rules concerning the deduction of interest on borrowed capital, directly influences the effective cost of owning a house. Financial decisions regarding whether to utilize a property for self-occupation (SOP) or rental income (LOP) depend heavily on the associated tax benefits, such as the ₹2,00,000 limit for SOP interest versus the unlimited interest deduction for LOPs. Accurate computation allows for maximizing tax efficiency within legal structures.
- 2) **Corporate and Individual Portfolio Management:** Real estate is a fundamental component of wealth accumulation. By correctly calculating the taxable income or loss derived from properties, managers can accurately predict their Gross Total Income and corresponding tax liability. This includes managing multiple properties where some may be deemed let-out (DLOP). Furthermore, understanding the limitations on setting off

losses (restricted to ₹2,00,000 against other income heads) is vital for liquidity planning and minimizing immediate tax outflows.

- 3) **Financial Accounting for Developers:** For individuals or entities involved in real estate development, the specific rules regarding pre-construction interest (PCI) and stock-in-trade properties are critical. The PCI, which is deductible in five equal annual installments starting from the year of completion, must be accounted for correctly to ensure the project costs and subsequent tax relief are appropriately managed over time.

This unit provides the systematic methodology necessary to move from property valuation metrics (Municipal Value, Fair Rent, Standard Rent) to the final calculation of taxable income, step by logical step.

5.2 BASIS OF CHARGE: SECTION 22

Section 22 of the Income Tax Act, 1961, defines the scope of this head of income. It stipulates that the annual value of any property consisting of buildings or lands appurtenant thereto, of which the assessee is the owner, is chargeable to income tax under this head.

5.2.1 Essential Conditions for Chargeability

For income to be successfully categorized and charged under this specific head, three conditions must be satisfied:

- 1) **Existence of Property (Building and Land Appurtenant):** The property must be a building or part of a building. This covers any structure, whether residential (like a house) or commercial (like an office or shop). The provision also includes 'land appurtenant thereto,' referring to land immediately attached to the building, necessary for its enjoyment, such as a garden, courtyard, or car park. Income derived solely from letting out vacant land without any structure is excluded and is generally taxed under 'Income from Other Sources.'
- 2) **Ownership by the Assessee:** The taxpayer must be the owner of the property. The tax is levied on the owner, who may be the legal title holder or a deemed owner under Section 27. If a person receives rent but is merely a tenant (e.g., in a sub-letting arrangement), that income is not taxed under this head because the condition of ownership is not met. Such sub-letting income is instead classified under 'Income from Other Sources' or 'Profits and Gains from Business or Profession (PGBP).'
- 3) **Non-Use for Own Business or Profession:** The property must not be used by the owner for the purpose of carrying on any business or profession, the profits of which are chargeable to income tax.¹ If the property is used as the owner's factory, hotel, or retail showroom, the income derived from its use is computed under the PGBP head.

5.2.2 The Logic of the Business Exclusion

The exclusion of property used for the owner's own business or profession is a critical classifying mechanism based on the owner's operational intent. If a property generates passive, predictable rental income, it falls under the House Property head, subject to rigid, fixed deductions (like the 30% standard deduction). Conversely, if the property is actively used as

an instrument for commercial trade (e.g., a hotel where revenue is generated by offering services alongside accommodation), the income is treated as business income.

This classification is essential because the PGBP head allows the owner to deduct all actual, necessary expenses incurred to run the business, such as specialized repairs or higher maintenance costs. If such a property were taxed under the House Property head, the owner would be restricted to the statutory 30% standard deduction, which might fall far short of the actual business operational expenditure, resulting in an inflated taxable income and an inaccurate assessment of commercial profit. Therefore, the law ensures consistency by classifying income based on the owner's active commercial engagement versus passive property ownership.

5.3 OWNERSHIP AND DEEMED OWNERSHIP: SECTION 27

While tax is generally levied on the legal owner, Section 27 expands the scope of ownership to include specific scenarios where an individual, though not the legal owner, holds effective economic control or benefit, or has transferred the asset merely to reduce tax liability. These individuals are classified as deemed owners.

5.3.1 Statutory Cases of Deemed Ownership

A person is considered a deemed owner in the following circumstances:

- 1) **Transfer to Spouse or Minor Child:** If an individual transfers a house property to their spouse (excluding transfers related to an agreement to live apart) or to a minor child (except a minor married daughter) without receiving adequate consideration (i.e., less than market value or as a gift), the transferor remains the deemed owner. This provision is designed to counter tax planning attempts where income is shifted to family members who might be non-taxable or in lower tax brackets, ensuring that the income is aggregated (clubbed) with the transferor's income.
- 2) **Holder of Impartible Estate:** In cases where an estate (a large property or title) cannot be legally partitioned among its legal heirs, the individual who is entitled to the possession and enjoyment of that estate is deemed to be the owner for tax purposes.
- 3) **Allottee under Co-operative Housing Schemes:** A member of a cooperative society, company, or association who is allotted a house under a house construction scheme is treated as the deemed owner, even if the final legal title rests temporarily with the society or company.
- 4) **Possession under Section 53A of Transfer of Property Act:** If a person enters into a contract for the transfer of immovable property and is allowed to take possession under the doctrine of part performance (Section 53A of the Transfer of Property Act), that possessor is treated as the deemed owner, even if the formal conveyance deed is pending. This prioritizes economic control and enjoyment over legal formalities.
- 5) **Long-Term Lease Holder:** A person holding property under a lease agreement for a term exceeding twelve years (other than yearly or monthly tenancies) is classified as the deemed owner. This acknowledges that a long-term lease grants the lessee rights substantially similar to ownership.

The purpose of these deemed ownership provisions is to prevent fragmentation of income and ensure that tax liability remains with the person who exercised the financial decision-making authority or enjoyed the substantive benefits of the asset.

5.4 COMPUTATION OF GROSS ANNUAL VALUE (GAV): SECTION 23

The computation of taxable house property income begins with determining the Gross Annual Value (GAV) for Let-Out Properties (LOPs) and Deemed Let-Out Properties (DLOPs). GAV represents the benchmark used by the tax authority.

5.4.1 Components of Rental Valuation

GAV is determined through a detailed comparison of four value components :

- 1) **Municipal Value (MV):** The value assigned to the property by the local municipal corporation or authority to calculate local property taxes. This assessment is based on factors such as property size, location, and structural features.
- 2) **Fair Rent (FR):** The estimated rent that a similar, equally situated property in the same or an adjacent locality could reasonably fetch if placed on the open market. It is essentially a market valuation of the property's earning potential.
- 3) **Standard Rent (SR):** The maximum rent legally fixed under the relevant Rent Control Act (if applicable to the property). This value is statutory and acts as a cap on the rent an owner can legally demand from a tenant, reflecting a social policy intervention to protect tenants.
- 4) **Actual Rent Received or Receivable (ARR):** The total rent for the year less any unrealized rent that satisfies the prescribed conditions (Rule 4).

5.4.2 Step-by-Step Determination of GAV

The calculation follows a mandated three-step hierarchical process:

Step 1: Determine Expected Rent (ER)

The Expected Rent is the higher of the statutory/market valuation, subject to the legal ceiling.

- 1) **Compare MV and FR:** Calculate the Higher of the Municipal Value (MV) or the Fair Rent (FR).
- 2) **Apply Standard Rent Constraint:** Compare the result from (1) with the Standard Rent (SR). The Expected Rent (ER) is the Lower of the two figures.

The application of the Standard Rent limit ensures that the tax base (ER) does not exceed the amount the owner can legally charge, thus integrating regulatory limitations into fiscal calculation. If the property is not subject to rent control laws, SR is ignored.

Step 2: Compare ER and ARR (Interim GAV)

The Interim GAV is calculated as the Higher of the Expected Rent (ER) or the Actual Rent Received/Receivable (ARR).

Step 3: Adjustment for Vacancy Loss (Final GAV)

The final GAV is determined after accounting for losses caused by property vacancy.

- **Vacancy Rule:** If the Actual Rent Received/Receivable (ARR) is lower than the Expected Rent (ER), the taxpayer must ascertain the reason for the shortfall.
 - If the shortfall is attributable solely to the property remaining vacant for a part of the year, the GAV is limited to the ARR, which is the lower figure. This rule accepts that real-world market factors (vacancy) can suppress the income below its notional potential (ER).
 - If ARR is lower than ER for any other reason (e.g., owner charging low rent, or unrecovered rent not yet meeting the unrealized rent criteria), the GAV must remain at the higher Expected Rent figure.

Table 5.1: GAV Calculation Hierarchy

Step	Comparison	Result	Rationale
1A	Higher of MV or FR	Result A	Market/Municipal Valuation
1B	Lower of Result A or SR	Expected Rent (ER)	Statutory ceiling limitation
2	Higher of ER or ARR	Interim GAV	Maximize tax base
3	If $ARR < ER$, and shortfall due ONLY to vacancy	Final GAV = ARR	Concession for genuine market loss

5.5 TREATMENT OF DIFFERENT PROPERTY CATEGORIES AND NAV COMPUTATION

5.5.1 Self-Occupied Property (SOP)

A property utilized by the owner for their own residence, or which cannot be occupied due to employment in another city, is treated as Self-Occupied Property.

- **Annual Value:** The GAV and consequently the Net Annual Value (NAV) of an SOP is taken as NIL (Section 23(2)).
- **Multiple SOPs:** A taxpayer is allowed to claim NIL Annual Value for up to two house properties chosen by them. This is a recent amendment recognizing the need for mobility across the country.
- **Deductions:** Since the NAV is NIL, the 30% standard deduction (Section 24(a)) is not applicable. The only possible deduction is the interest on borrowed capital (Section 24(b)), which often leads to a tax loss.

5.5.2 Deemed Let-Out Property (DLOP)

If an individual owns more than two houses, all of which are self-occupied, the properties exceeding the two-house limit must be treated as Deemed Let-Out Properties (DLOPs).

- **Computation:** The taxpayer selects two properties as SOPs (NIL AV), and the remaining properties are treated as DLOPs. For DLOPs, the GAV is mandatorily taken as the Expected Rent (ER), since no actual rent is received.
- **DLOP Income:** DLOPs are computed exactly like regular LOPs, allowing deductions for municipal taxes paid, the 30% standard deduction, and interest on borrowed capital. The requirement to treat excess self-occupied properties as DLOPs ensures that individuals with substantial non-income generating property assets contribute tax based on the notional earning capacity of those assets.

5.5.3 Net Annual Value (NAV)

The NAV is calculated for LOPs and DLOPs by deducting municipal taxes paid by the owner from the GAV.

$$\text{NAV} = \text{GAV} - \text{Municipal Taxes Paid}$$

Municipal Tax Deduction: This is the only expenditure allowed as a direct deduction from GAV. Importantly, it is allowed only on a payment basis (i.e., actually paid during the previous year) and only if the taxes were paid by the owner.

5.5.4 Special Cases

- 1) **Time-wise Partial Letting:** If a single house unit is self-occupied for part of the year and let out for the remaining period, it is statutorily treated as a Let-Out Property for the entire year. Its GAV is calculated by comparing the Expected Rent for the full year with the Actual Rent Received for the let-out period.
- 2) **Area-wise Partial Letting:** If a property has independent units, and one unit is SOP while others are LOP, each unit is treated as a separate, independent property for computation purposes.

5.6 DEDUCTIONS FROM NET ANNUAL VALUE (NAV): SECTION 24

Only three specific deductions are permitted from the NAV (or against a loss in the case of SOP) to arrive at the final taxable income from house property. These deductions are exhaustive.

5.6.1 Standard Deduction (Section 24(a))

- **Rule:** A mandatory deduction equal to 30% of the Net Annual Value (NAV) is allowed.
- **Applicability:** This deduction is available only for LOPs and DLOPs. It is a fixed, statutory allowance intended to cover repairs, maintenance, insurance, and other miscellaneous costs, regardless of the actual amount spent. Since this deduction is fixed, taxpayers cannot claim actual repair expenses. It is not available for SOPs as their NAV is NIL.

5.6.2 Interest on Borrowed Capital (Section 24(b))

This deduction applies to interest payable on capital borrowed for the purpose of acquisition, construction, reconstruction, repair, or renewal of the property.

A. Let-Out / Deemed Let-Out Property (LOP/DLOP):

- **Limit:** The entire amount of interest paid or payable during the previous year is deductible. **There is no ceiling limit** on the amount of interest claimed for LOPs/DLOPs.
- **Loss Treatment:** If the large interest deduction results in a loss under the head "Income from House Property," the amount of that loss which can be set off against income from *other heads* (like Salary or Business) in the same year is capped at ₹2,00,000. Any remaining loss must be carried forward for up to eight subsequent assessment years for set-off against future house property income. This set-off limit is a measure to limit the utilization of real estate losses as a short-term tax shelter.

B. Self-Occupied Property (SOP):

The interest deduction is subject to strict monetary limits.

- 1) **₹2,00,000 Limit:** Applicable if the loan was taken on or after April 1, 1999, specifically for the acquisition or construction of the property, and the construction/acquisition is completed within five years from the end of the financial year in which the capital was borrowed.
- 2) **₹30,000 Limit:** Applicable in all other cases, including loans taken before April 1, 1999, or loans used for repairs, renewal, or reconstruction (regardless of the loan date).

5.6.3 Pre-Construction Interest (PCI)

Interest paid during the period prior to the completion of construction is treated separately.

- **PCI Period:** This period starts from the date of borrowing and ends on March 31 immediately preceding the financial year in which the construction is completed.
- **Deduction Rule:** The accumulated interest paid during this period is allowed as a deduction in **five equal annual installments**, commencing from the financial year in which the construction or acquisition is completed.
- **Constraint:** For SOPs, the 1/5th PCI installment, when added to the current year's interest, must remain within the overall ₹2,00,000 or ₹30,000 limit.⁹ The taxpayer cannot claim the full amount in one go.

5.6.4 Tax Regime Implications

A crucial factor influencing this deduction is the choice of tax regime. Under the new tax regime (Section 115BAC):

- Deduction for interest on loans for Self-Occupied Property is not allowed.
- Deduction for interest on loans for Let-Out Property remains allowed (unlimited deduction), though the set-off of the resulting loss against other income is still limited to ₹2,00,000.

5.7 ARREARS OF RENT AND UNREALIZED RENT RECEIVED SUBSEQUENTLY: SECTION 25A

This section deals with rent related to a previous year which is finally recovered or received in the current financial year.

5.7.1 Taxability Rule

The entire amount of arrears of rent or previously unrealized rent received subsequently is treated as deemed income under the head "Income from house property" in the financial year of receipt. This tax liability applies even if the assessee has ceased to be the owner of the property in the year of receipt.

5.7.2 Fixed Deduction

The Act allows a mandatory deduction equal to 30% of the amount received under Section 25A. The remaining 70% is taxable income. This provision simplifies taxation, as it avoids the complexity of recalculating deductions and expenses that might have applied in the original past year to which the rent pertains.

5.8. ILLUSTRATIVE EXAMPLES / APPLICATIONS

These quantitative examples demonstrate the application of the computational rules for various property types.

5.8.1 Numerical Example 1: Full LOP Computation with Calculation of Income

Scenario: Mr. Ramesh owns an apartment in Delhi, let out throughout FY 2024-25.

- Municipal Value (MV): ₹3,50,000; Fair Rent (FR): ₹3,80,000; Standard Rent (SR): ₹3,60,000.
- Actual Rent Received (ARR): ₹35,000 per month (₹4,20,000 annually).
- Municipal Taxes Paid (by Ramesh): ₹30,000.
- Interest Paid on Housing Loan: ₹1,00,000.

Objective: Compute the Income from House Property for AY 2025-26.

Computation of Taxable Income from House Property

Particulars	Calculation Details	Amount (₹)
A. Gross Annual Value (GAV)		
1. Expected Rent (ER)	Higher of MV (3.5 L) or FR (3.8 L) = 3.8 L. Lower of 3.8 L or SR (3.6 L)	3,60,000
2. Actual Rent Received (ARR)	₹35,000 x 12 months	4,20,000
3. GAV	Higher of ER (3.6 L) or ARR (4.2 L)	4,20,000
B. Net Annual Value (NAV)		

Less: Municipal Taxes Paid	Paid by owner	(30,000)
NAV	GAV - Municipal Taxes	3,90,000
C. Deductions under Section 24		
1. Standard Deduction (30% of NAV)	30% of ₹3,90,000	(1,17,000)
2. Interest on Borrowed Capital	Full amount (No limit for LOP)	(1,00,000)
D. Taxable Income from House Property	NAV - Deductions	1,73,000

5.8.2 Numerical Example 2: SOP Loss and Pre-Construction Interest Application

Scenario: Ms. Kavita took a loan on 01/01/2021 for the construction of her SOP. Construction completed 30/06/2024.

- Interest paid during FY 2024-25 (Current Interest): ₹1,70,000.
- Total Interest paid from 01/01/2021 up to 31/03/2024 (Pre-construction): ₹3,00,000.

Objective: Compute the loss from House Property for AY 2025-26.

Step 1: Determine Pre-Construction Interest (PCI) Installment:

- PCI period ends: March 31, 2024 (immediately preceding completion FY 2024-25).
- Total PCI: ₹3,00,000.
- Annual Installment (1/5th): $\text{₹3,00,000} / 5 = \text{₹60,000}$. (Claimed starting FY 2024-25)

Step 2: Calculate Total Deductible Interest for FY 2024-25:

- Current Year Interest: ₹1,70,000.
- Add: PCI Installment: ₹60,000.
- Total Interest (before limit): ₹2,30,000.

Step 3: Apply SOP Limit:

- Loan is for construction, taken post-1999, and construction completed within 5 years. Limit = ₹2,00,000.
- Deduction Allowed: Restricted to **₹2,00,000**.

Step 4: Compute Final Loss:

- GAV and NAV of SOP are NIL.
- Income/(Loss) from House Property = (₹2,00,000).

5.8.3 Application Example: Unrealized Rent Received Subsequently (Section 25A)

Scenario: Mr. Jain had ₹1,50,000 in rent related to FY 2021-22 which was previously treated as unrealized rent (deducted from ARR in 2021-22). In the current FY 2024-25, Mr. Jain successfully recovers ₹1,00,000 of this previously unrealized rent from the tenant. Mr. Jain has since sold the property.

Objective: Calculate the taxable income for FY 2024-25 under Section 25A.

Computation of Taxable Income under Section 25A

Particulars	Calculation Details	Amount (₹)
Amount of Unrealized Rent Received	(Taxable in year of receipt, regardless of current ownership)	1,00,000
Less: Statutory Deduction (30%)	30% of ₹1,00,000	(30,000)
Taxable Income under House Property		70,000

The ₹70,000 is added to Mr. Jain's Gross Total Income for AY 2025-26.



Check Your Progress – A

1. What is the charging section for Income from House Property?

2. What is meant by "Fair Rent"?

3. How is Gross Annual Value (GAV) determined for a let-out property?

5.9. SUMMARY

This unit explains the statutory framework for taxing income under the head “Income from House Property” as per Sections 22 to 27 of the Income Tax Act, 1961. The charge is based on the annual value of buildings and land appurtenant thereto, provided the assessee is the owner (legal or deemed) and the property is not used for the owner’s own business or profession. Section 27 widens ownership through the concept of deemed ownership to prevent tax avoidance in cases such as transfers to spouse/minor child, long-term leases, possession under part performance, and cooperative housing allotments. The unit details the computation mechanism beginning with Gross Annual Value (GAV) under Section 23, derived by comparing Municipal Value, Fair Rent, Standard Rent, and Actual Rent, with relief for genuine vacancy loss. From GAV, Net Annual Value (NAV) is computed after deducting municipal taxes actually paid by the owner. Different treatments apply to Self-Occupied Properties (SOP) (NIL annual value for up to two houses), Let-Out Properties (LOP), and Deemed Let-Out Properties (DLOP). Section 24 allows limited deductions: a standard deduction of 30% of NAV

and interest on borrowed capital, with specific caps for SOPs and unlimited interest for LOPs/DLOPs (subject to loss set-off limits). The unit also clarifies pre-construction interest, allowed in five equal installments, and the taxation of arrears and unrealized rent received subsequently under Section 25A with a flat 30% deduction. Thus, the unit provides a systematic, application-oriented approach to accurate computation and compliance.



5.10. GLOSSARY

- **Annual Value (AV):** The notional income capability of a property used as the base for taxation.
- **Gross Annual Value (GAV):** The starting point for computation for let-out and deemed let-out properties.
- **Net Annual Value (NAV):** GAV less municipal taxes paid by the owner.
- **Expected Rent (ER):** The reasonably expected rent, constrained by Standard Rent.
- **Standard Rent (SR):** The maximum legal rent permissible under Rent Control legislation.
- **Deemed Owner:** A person treated as the property owner for tax purposes under Section 27, despite lacking legal title.
- **Land Appurtenant:** Land attached to a building, such as a garden or courtyard.
- **Unrealized Rent:** Rent that was receivable but determined to be unrecoverable, subject to statutory conditions.
- **Arrears of Rent:** Rent due from past years that is received in the current year.
- **Self-Occupied Property (SOP):** Property used for the owner's residence, for which AV is NIL.
- **Deemed Let-Out Property (DLOP):** A property treated as let-out (using notional rent) when an individual owns more than two SOPs.
- **Pre-Construction Interest (PCI):** Interest paid on a housing loan before the date of completion.
- **Section 24(a) Deduction:** The mandatory 30% deduction on NAV.
- **Municipal Taxes:** Property taxes paid to the local authority, deductible from GAV if paid by the owner.



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- ✚ The Income Tax Act, 1961 (as amended by the latest Finance Act).



5.13 TERMINAL QUESTIONS

1. Explain the basis of charge for income from house property under Section 22 and discuss its essential conditions.

2. Define the concept of “Annual Value” and explain why income from house property is taxed on a notional basis.
3. Distinguish between legal ownership and deemed ownership with reference to Section 27.
4. Discuss the situations in which a person is treated as a deemed owner of house property.
5. Explain the concepts of Municipal Value, Fair Rent, and Standard Rent and their relevance in determining Expected Rent.
6. Describe the step-by-step procedure for computing Gross Annual Value (GAV) of a let-out property.
7. Explain the treatment of vacancy allowance while determining GAV under Section 23.
8. Discuss the tax treatment of Self-Occupied Property (SOP) and explain why its annual value is taken as NIL.
9. Explain the concept of Deemed Let-Out Property (DLOP) and its tax implications.
10. Describe how Net Annual Value (NAV) is computed and state the conditions for deducting municipal taxes.
11. Explain the deductions allowed under Section 24, highlighting the rationale of the 30% standard deduction.
12. Discuss the rules relating to deduction of interest on borrowed capital for self-occupied and let-out properties.
13. Explain the concept of pre-construction interest and its method of allowance under the Income Tax Act.
14. Discuss the provisions relating to set-off and carry forward of loss from house property.
15. Explain the tax treatment of arrears of rent and unrealized rent received subsequently under Section 25A.
16. Analyze how partial letting of a property (time-wise or area-wise) affects computation of income from house property.
17. Compare the tax treatment of house property income under the old tax regime and the new tax regime (Section 115BAC).
18. Illustrate, with reasons, why income from sub-letting is not taxed under the head “Income from House Property.”
19. Explain the importance of correct classification of property (SOP, LOP, DLOP) for accurate tax computation.
20. GAV Calculation with SR and Vacancy: MV: ₹7,00,000, FR: ₹8,00,000, SR: ₹7,50,000. Property was let out for ₹65,000/month for 11 months (1 month vacancy). Calculate GAV. (Hint: ER = ₹7,50,000. Notional ARR for 12 months = ₹7,80,000. ARR for 11 months = ₹7,15,000. Since notional ARR > ER, the reduction is due to vacancy. GAV = ₹7,15,000.)
21. Full LOP Computation: GAV: ₹6,00,000. Municipal Taxes paid: ₹40,000. Interest paid on loan: ₹2,80,000. Compute taxable income/loss. (Hint: NAV = ₹5,60,000. SD = ₹1,68,000. Income/(Loss) = ₹1,12,000.)
22. SOP Interest Calculation: Mr. Z borrowed ₹40 lakhs for construction on 1/7/2017, completed 1/9/2021. PCI amount (paid up to 31/03/2021): ₹3,00,000. Current year interest (2024-25): ₹1,80,000. Calculate the total interest deduction allowed for FY

2024-25. (Hint: PCI Installment = ₹60,000. Total claim = ₹2,40,000. Allowed deduction = ₹2,00,000)

23. DLOP Assessment: Ms. X owns four SOPs (H1, H2, H3, H4). She chooses H1 and H2 as SOP. H3 (ER: ₹4,00,000, Taxes: ₹30,000, Interest: ₹1,50,000) and H4 (ER: ₹5,00,000, Taxes: ₹40,000, Interest: ₹2,00,000) are DLOPs. Calculate the total Income from House Property (Loss is limited to ₹2,00,000 set-off). (Hint: H1/H2 Loss: Interest (₹1,50,000 + ₹2,00,000) restricted to ₹4,00,000 but limited to ₹2,00,000 deduction on SOPs = (₹2,00,000). H3 Income = ₹1,00,000. H4 Income = ₹1,10,000. Total Income = ₹10,000.)

UNIT-6

DEPRECIATION

Contents

- 6.1. Introduction**
- 6.2. Statutory Framework and Eligibility for Deduction (Section 32)**
- 6.3. Basis of Calculation: Actual Cost and Written Down Value (WDV)**
- 6.4 The Block of Assets Concept and Computation**
- 6.5. Prescribed Depreciation Rates and the 180-Day Rule**
- 6.6. Special Tax Allowance: Additional Depreciation (Section 32(1)(ia))**
- 6.7. Treatment of Unabsorbed Depreciation (UAD)**
- 6.8. Sale of Depreciable Assets and Capital Gains (Section 50)**
- 6.9. Distinction between Tax Depreciation and Accounting Depreciation**
- 6.10. Illustrative Examples / Applications**
- 6.11. Summary**
- 6.12. Glossary**
- 6.13 References / Bibliography**
- 6.14 Suggested Readings**
- 6.15 Terminal Questions**

Learning Objectives

Upon completing this unit, the learner will be able to:

- Explain the essential statutory conditions and eligibility criteria for claiming depreciation under Section 32.
- Describe the concepts of 'Actual Cost' (Section 43(1)) and 'Written Down Value' (WDV) and compute them accurately.
- Analyze the 'Block of Assets' structure and classify tangible and intangible assets based on prescribed rates.
- Apply the crucial '180-Day Rule' for computing half-rate depreciation in the year of acquisition for both normal and additional allowances.

- Calculate the quantum of Normal Depreciation and Additional Depreciation (Section 32(1)(iia)) for eligible plant and machinery.
- Differentiate between tax depreciation (WDV on Block of Assets) and accounting depreciation (useful life/SLM under Companies Act).
- Evaluate the tax implications, specifically determining Short-Term Capital Gains/Losses (Terminal Depreciation) upon the transfer of depreciable assets (Section 50).
- Discuss the managerial significance of depreciation in generating post-tax cash flows and influencing capital investment timing.

6.1. INTRODUCTION

The Income Tax Act, 1961, recognizes that assets used to generate business or professional income—such as machinery, buildings, and specialized technology—do not last forever. These assets suffer wear and tear, eventually requiring replacement due to physical deterioration or technological obsolescence. If a business were forced to deduct the entire cost of a major asset in the year of purchase, its profits in that year would be severely understated, and profits in subsequent years would be overstated. Depreciation, therefore, is an accounting mechanism that systematically allocates the cost of a tangible or intangible asset over its estimated useful life. Under the Income Tax Act, this concept transforms into a crucial statutory deduction permitted under Section 32. This deduction is mandatory and serves as a vital component in calculating the taxable income under the head "Profits and Gains of Business or Profession."

Understanding tax depreciation is essential for students of commerce, particularly in the context of corporate finance and managerial decision-making. Depreciation is a non-cash expense, meaning that while it reduces reported accounting profit, it does not involve an outflow of funds. Because it is deductible from taxable income, it generates a tax shield—a reduction in tax liability proportional to the depreciation amount and the applicable tax rate. This immediate cash flow advantage is critically important when evaluating long-term investment proposals through capital budgeting. The rules governing depreciation, especially the incentives like Additional Depreciation and the unique Indian 'Block of Assets' system, strongly influence whether and when a company chooses to invest in new fixed assets. This unit provides a step-by-step guide to calculating tax depreciation, explaining the core definitions, rates, special timing rules, and the profound tax implications that arise when these assets are eventually sold.

6.2. STATUTORY FRAMEWORK AND ELIGIBILITY FOR DEDUCTION (SECTION 32)

Section 32 of the Income Tax Act, 1961, specifies the rules and prerequisites for allowing depreciation as a deduction against business income.

6.2.1. Essential Conditions for Claim

To successfully claim depreciation, an assessee (the taxpayer) must fulfill the following mandatory criteria :

- 1) **Ownership Requirement:** The asset must be owned, either wholly or partly, by the assessee.¹ If the asset is jointly owned (co-ownership), each owner is permitted to claim depreciation corresponding to their specific share in the asset.¹ Legal ownership, as opposed to mere possession, is essential.
- 2) **Usage for Business or Profession:** The asset must be actively used for the purposes of the assessee's business or profession. Assets lying idle, kept in reserve, or used solely for personal purposes are not eligible for this deduction.
- 3) **Mandatory Nature of Deduction:** Depreciation is not an optional claim. According to legislative changes effective from Assessment Year (AY) 2002-03, depreciation is "allowed or deemed allowed". This provision means that even if an assessee chooses not to record the depreciation in their books of account (perhaps due to low profitability in a given year), the Written Down Value (WDV) of the asset block must still be reduced by the amount of depreciation that was legally allowable under the Act. This rule prevents taxpayers from delaying the reduction of the asset's cost base simply to inflate future capital gains, thus ensuring that the basis for cost recovery is correctly tracked for tax purposes.

6.2.2. Types of Assets Eligible for Depreciation

Depreciation is allowed on two primary categories of assets used in the business:

- 1) **Tangible Assets:** These include physical assets such as buildings, machinery, plant, and furniture.
- 2) **Intangible Assets:** These are non-physical assets, provided they were acquired on or after April 1, 1998. The list includes know-how, patents, copyrights, trademarks, licenses, franchises, and any other commercial or business rights of a similar nature.

6.2.3. Assets Excluded from Depreciation

Not all long-term assets qualify for depreciation under Section 32:

- **Land:** Land is generally not subject to wear and tear or obsolescence and is, therefore, not a depreciable asset.
- **Goodwill:** Under the Finance Act, 2021, 'goodwill of a business or profession' has been specifically excluded from the definition of a block of assets. Consequently, it is no longer considered a depreciable asset for tax purposes.

6.3. BASIS OF CALCULATION: ACTUAL COST AND WRITTEN DOWN VALUE (WDV)

The deduction under Section 32 is primarily calculated using the WDV method, based on the

asset's Actual Cost.

6.3.1. Defining Actual Cost (Section 43(1))

The Actual Cost is the cost for which the asset was acquired by the assessee. Section 43(1) mandates specific inclusions and exclusions to arrive at this figure.

Components of Actual Cost:

- **Direct Costs:** The purchase price of the asset.
- **Installation Costs:** All expenses required to bring the asset to the site and prepare it for its intended use. This includes carriage inwards, costs related to loading and unloading, installation charges, and expenses incurred for constructing necessary supporting structures.

Exclusion of Subsidies and Grants:

A critical adjustment specified in Section 43(1) relates to external funding. If the assessee receives a grant, subsidy, or reimbursement from the government or any other authority towards the acquisition of the asset, that portion must be excluded from the Actual Cost used for calculating depreciation. For instance, if a machinery worth ₹10,00,000 is purchased, and a government grant of ₹3,00,000 is received, the Actual Cost for tax depreciation purposes is ₹7,00,000 only. This rule prevents the assessee from claiming a tax deduction (depreciation) on a cost that was effectively borne by a third party.

Actual Cost for Previously Used Assets:

If an asset (like a residential building) was initially used for personal purposes and later converted for business use, the Actual Cost for tax purposes is adjusted. It is calculated as the original cost of the asset reduced by the notional depreciation that would have been allowable had the asset been used for business since its acquisition date. For other assets, such as general plant or machinery, previously used for personal purposes, the cost of acquisition is simply treated as the Actual Cost for Section 43(1) purposes.

6.3.2. The Written Down Value (WDV) Method

The WDV method is the mandated basis for calculating depreciation on a block of assets.¹ Under this method, the prescribed depreciation rate is applied to the carrying value of the asset block remaining at the end of the previous year.

- **Mechanism:** Depreciation is highest in the first year of the asset's life and progressively decreases over time, as the base (WDV) reduces annually. This approach provides an accelerated tax benefit in the initial years, significantly enhancing cash flows early in the investment period.
- **Calculation for New Assets:** If an asset is acquired in the current previous year, its initial WDV is simply its Actual Cost.
- **Calculation for Old Assets:** If the asset was acquired in an earlier year, its WDV is its Actual

Cost minus the aggregate depreciation *actually allowed* under the Act in all preceding years.

6.3.3. The Exceptional Straight Line Method (SLM)

While WDV is mandatory for most businesses, undertakings engaged in the generation or the generation and distribution of power have a special statutory option to choose the Straight Line Method (SLM). Under SLM, depreciation is calculated as a uniform amount each year based on the prescribed percentage of the original actual cost. Once this option is exercised, it is final and applies to all subsequent assessment years.

6.4 THE BLOCK OF ASSETS CONCEPT AND COMPUTATION

The Indian Income Tax system employs a unique 'Block of Assets' approach, significantly different from individual asset accounting common in other regulatory frameworks.

6.4.1. Definition of Block of Assets

A 'block of assets' is defined as a group of assets falling within the same class—whether tangible (buildings, machinery, plant, furniture) or intangible—and subject to the same prescribed rate of depreciation.

- Classification:** Assets are grouped based on their nature (e.g., Buildings, Plant & Machinery) and the common rate applied to them. For example, all machinery subject to a 15% rate forms one block, and all computers subject to a 40% rate form a separate block. Depreciation is calculated on the aggregate WDV of this collective block, not on individual assets.

6.4.2. Computation of WDV for a Block

The WDV of a block on the last day of the previous year, before charging depreciation, is calculated systematically:

Table 6.1: Computation of Written Down Value (WDV) of a Block

Particulars	Details
1. WDV of the Block at the beginning of the Previous Year	This value is carried forward from the preceding year.
2. <i>Add:</i> Actual Cost of any new asset falling within that block, acquired during the previous year.	This includes all eligible acquisitions made during the year.
3. Total Value (WDV plus Acquisitions)	This represents the maximum potential base for depreciation.
4. <i>Less:</i> Moneys payable (full value of consideration received from sale, insurance compensation for destroyed assets, or scrap value) in respect of any asset falling within that block	The deduction is the realization from the asset disposal.

which is sold, discarded, demolished, or destroyed during the year.	
5. WDV of the Block before charging Depreciation	This is the final value upon which the prescribed depreciation rate is applied, subject to the 180-Day Rule.

6.5. PRESCRIBED DEPRECIATION RATES AND THE 180-DAY RULE

The depreciation rates are specified in the Income Tax Rules and are applied to the WDV of the corresponding block.

6.5.1. Key Depreciation Rates (Percentage of WDV)

Table 3.2 provides a summary of major depreciation rates applicable to common blocks of assets:

Table 6.2: Selected Prescribed Depreciation Rates (WDV Method)

Block of Assets	Prescribed Rate (% of WDV)
I. Buildings	
Residential Buildings (excluding hotels/boardings houses)	5%
Non-Residential Buildings (General commercial/office use)	10%
Purely Temporary Erections (e.g., wooden structures)	40%
II. Furniture and Fittings	
Furniture and Fittings (including electrical fittings)	10%
III. Machinery and Plant	
General Plant and Machinery (Default Rate)	15%
Motor Cars (General use, not for hire)	15%
Computers and Computer Software	40%
Life-Saving Medical Equipment, Pollution Control Equipment	40%
IV. Intangible Assets	
Know-how, Patents, Copyrights, Trademarks, Licenses, Franchises	25%

6.5.2. The 180-Day Rule for Usage

The timing of the asset acquisition and "put to use" date during the previous year significantly impacts the depreciation claimed. This is known as the 180-Day Rule.

- 1) **Full Depreciation:** If an asset, which is acquired during the previous year, is put to use for the purposes of business or profession for a period of 180 days or more in that year, the

assessee is allowed to claim the full prescribed rate of depreciation.

- 2) **Half Depreciation:** If the asset is acquired and put to use for a period of less than 180 days in that previous year, the depreciation deduction allowed is restricted to 50% (half) of the amount calculated at the prescribed percentage.

This rule applies only to assets acquired during the previous year. Assets that were already part of the block at the beginning of the year receive the full rate, provided they were used at any time during the year. The implementation of the 180-day rule necessitates careful capital planning. Since the financial year runs from April 1st to March 31st, the cut-off date for 180 days of usage typically falls around the end of September. Managers often aim to put high-value assets into use before this date to maximize the immediate tax deduction. This acceleration of the tax shield improves current-year cash flows and, consequently, enhances the financial attractiveness (Net Present Value) of the investment project.

6.6. SPECIAL TAX ALLOWANCE: ADDITIONAL DEPRECIATION (SECTION 32(1)(IIA))

To encourage industrial growth and investment in capital assets, the Income Tax Act provides an incentive deduction known as Additional Depreciation.

6.6.1. Eligibility and Rate

- **Eligible Assessee:** This deduction is only available to assessee engaged in the business of manufacture or production of any article or thing, or engaged in the generation, transmission, or distribution of power.
- **Rate and Basis:** Additional Depreciation is calculated at a standard rate of 20% of the Actual Cost of the new plant and machinery acquired and installed.

6.6.2. Restrictions and Exclusions

This allowance is subject to strict restrictions, focusing solely on core manufacturing and power infrastructure. It is explicitly disallowed in respect of :

- 1) Any machinery or plant that was used previously by any other person in India or outside India (i.e., second-hand machinery).
- 2) Machinery or plant installed in office premises, residential accommodation, or a guest house.
- 3) Any office appliances or road transport vehicles (e.g., general-purpose motor cars).
- 4) Ships and aircraft.
- 5) Any asset whose whole actual cost is already allowed as a deduction in the computation of income in any one previous year.

6.6.3. Application of the 180-Day Rule to Additional Depreciation

The 180-Day Rule applies to Additional Depreciation exactly as it applies to Normal Depreciation.

- If the new machinery is put to use for 180 days or more, the full 20% Additional Depreciation on the Actual Cost is allowed.
- If the new machinery is put to use for less than 180 days, only half the rate (10%) of the Actual Cost is allowed in the year of acquisition. The remaining 10% is allowed as a deduction in the immediate succeeding previous year.

Table 6.3: Treatment of Normal and Additional Depreciation under the 180-Day Rule

Period of Use	Normal Depreciation (Base: WDV of Block)	Additional Depreciation (Base: Actual Cost)
180 Days	Full prescribed rate (e.g., 15% P&M)	Full 20% of Actual Cost
180 Days	Half the prescribed rate (e.g., 7.5% P&M)	Half 10% of Actual Cost, balance 10% carried to next year

6.7. TREATMENT OF UNABSORBED DEPRECIATION (UAD)

In some years, particularly during periods of high investment or low revenue, the total depreciation allowable might exceed the total income calculated under the head "Profits and Gains of Business or Profession." This excess amount is termed Unabsorbed Depreciation (UAD).

- 1) **Current Year Set-off:** UAD is first set off against any other income of the assessee in the current assessment year, provided that income is not "Income from Salary".
- 2) **Indefinite Carry Forward:** Any residual UAD that cannot be fully set off against other incomes in the current year is carried forward to the subsequent assessment years.
- 3) Crucially, there is no time limit for carrying forward UAD; it can be carried forward indefinitely.
- 4) **Future Set-off:** The carried forward UAD can be set off against *any* income (excluding salary) in those future years, even if the original business for which the depreciation was claimed has been discontinued. This broad flexibility and indefinite timeline make UAD a highly valuable future tax benefit.

The ability to carry forward UAD indefinitely creates an important implication for financial statements. When UAD is created, it means the current taxable income is lower than the accounting income (before tax), leading to a low immediate tax payment. This difference indicates that the tax paid today is lower than what it would have been had the deduction not been available. Since the UAD will reduce the tax liability in future periods, it must be recognized in the financial statements as a Deferred Tax Asset (DTA). The DTA represents the future economic benefit derived from the reduction of future taxes by utilizing the carried-forward UAD.

6.8. SALE OF DEPRECIABLE ASSETS AND CAPITAL GAINS (SECTION 50)

Section 50 of the Income Tax Act contains special provisions for calculating capital gains on depreciable assets, which supersede the normal provisions for calculating holding period and indexation.

6.8.1. Mandatory Short-Term Capital Gain (STCG)

The most important rule in Section 50 is that any capital gain arising from the transfer of an asset forming part of a block for which depreciation has been allowed is always deemed to be a Short-Term Capital Gain (STCG), regardless of the actual period for which the asset was held.

This classification exists because the asset's value has already been systematically reduced over time using the generous WDV method (often leading to higher early deductions). The law ensures that the resulting profit upon sale is taxed immediately at the standard slab rates applicable to STCG, effectively clawing back the accelerated tax benefit previously claimed through depreciation. Indexation benefits, which are typically available only for Long-Term Capital Gains, are thus explicitly denied for depreciable assets.

6.8.2. Case I: Partial Sale (Block Continues to Exist)

If an assessee sells one or more assets from a block, but the block retains a positive WDV and/or other assets at the end of the previous year, the calculation is as follows:

- 1) The sale proceeds (full value of consideration received) are reduced from the WDV of the block (Opening WDV + Acquisitions).
- 2) If the resulting balance is still positive, normal depreciation is calculated on this reduced balance.
- 3) **STCG/Block Wiped Out:** If the total sale consideration received (from the transfer of one or more assets) exceeds the aggregate of the Opening WDV and the Actual Cost of assets acquired during the year, the excess amount is deemed to be a Short-Term Capital Gain. In this situation, the block ceases to exist and its WDV becomes NIL.

6.8.3. Case II: Block Ceases to Exist (Full Sale or Zero WDV)

A block ceases to exist in two scenarios: (1) when all assets in that block are transferred during the previous year, or (2) when the WDV of the block is reduced to zero.

- **Short-Term Capital Gain (STCG):** If all assets in the block are sold, and the net sale consideration exceeds the WDV of the block (Opening WDV + Acquisitions – Transfer expenses), the excess is treated as STCG.
- **Terminal Depreciation (Short-Term Capital Loss):** If the entire block is sold, and the net sale consideration is less than the total value of the block (Opening WDV + Acquisitions –

Transfer expenses), the resulting deficiency (loss) is treated as Terminal Depreciation. Terminal depreciation is essentially a Short-Term Capital Loss arising from the business. This loss is fully deductible from the business income for that year.

6.9. DISTINCTION BETWEEN TAX DEPRECIATION AND ACCOUNTING DEPRECIATION

Due to different regulatory objectives, the depreciation calculated for income tax purposes (IT Act) often varies significantly from the depreciation calculated for financial reporting (Companies Act, 2013).

6.9.1. Difference in Governing Rules

Feature	Tax Depreciation (IT Act, 1961)	Accounting Depreciation (Companies Act, 2013)
Governing Law	Section 32 and Income Tax Rules.	Schedule II of the Companies Act, 2013, and AS/ Ind AS 10/16.
Calculation Basis	WDV method, applied to the Block of Assets.	Based on the useful life of the asset.
Methods Allowed	Primarily WDV (SLM only for power units).	SLM, WDV, or Units of Production (UOP) are permitted.
Rates	Fixed, prescribed statutory rates (e.g., 15%, 40%).	Determined by management based on usage patterns, subject to maximum useful lives specified in Schedule II.

Schedule II of the Companies Act mandates that depreciation must systematically allocate the depreciable amount (cost minus residual value, which should generally not exceed 5% of original cost) over the asset's useful life. This focus on economic useful life contrasts sharply with the tax law's focus on fixed percentages applied to asset blocks.

6.9.2. Resulting Timing Differences

The divergence between the two depreciation amounts creates a timing difference between the profit calculated for financial statements and the profit calculated for taxation.

- **Deferred Tax Liability (DTL):** In the early years of an asset's life, tax depreciation (using the accelerated WDV method) is often higher than accounting depreciation (often using SLM). This higher deduction reduces the current year's taxable income and tax payment. However, in later years, the reverse happens. This postponement of tax payment creates a future obligation, which is accounted for as a Deferred Tax Liability (DTL).
- **Deferred Tax Asset (DTA):** Conversely, if accounting depreciation is higher than tax depreciation, or if Unabsorbed Depreciation is carried forward, a Deferred Tax Asset (DTA)

is recognized, representing a reduction in future tax payments.

6.10. ILLUSTRATIVE EXAMPLES / APPLICATIONS

6.10.1. Real-Life Illustration: Capital Budgeting and Timing Decisions

A manufacturing firm, Global Spares Pvt. Ltd., is planning a major capacity expansion requiring ₹50 lakh worth of new specialized machinery (Plant & Machinery, 15% Normal Depreciation Rate). The firm operates under a 30% tax regime.

- 1) **Impact of Immediate Tax Shield:** If the machinery is put to use for over 180 days, the firm can claim a combined deduction of 15% Normal Depreciation and 20% Additional Depreciation on the Actual Cost of ₹50 lakhs.
 - Total Depreciation Deduction (Year 1) = (15% + 20%) of ₹50,00,000 = ₹17,50,000.
 - Tax Shield Generated (Cash Saving) = ₹17,50,000 x 30% = ₹5,25,000.
- 2) **Impact of Delayed Usage:** If the firm delays installation by one month and the usage period falls under 180 days, both depreciation allowances are halved.
 - Total Deduction (Year 1) = (7.5% + 10%) of ₹50,00,000 = ₹8,75,000.
 - Tax Shield Generated (Cash Saving) = ₹8,75,000 x 30% = ₹2,62,500.

Application: The difference in cash flow in the first year is ₹2,62,500 (₹5,25,000 minus ₹2,62,500). In capital budgeting, cash flows received earlier are more valuable (higher Net Present Value). Therefore, the 180-Day Rule acts as a significant incentive structure, compelling management to accelerate asset installation and deployment before the mid-fiscal year cutoff (typically September 30th) to maximize the immediate tax deduction and enhance the financial viability of the investment.

6.10.2. Numerical Example 1: Full Depreciation Computation (Normal and Additional)

A power transmission company, Surya Energy Ltd. (eligible for Additional Depreciation), provides the following data for the Previous Year 2023-24 for its general P&M block (Rate 15%):

- 1) Opening WDV (1.4.2023): ₹40,00,000.
- 2) New Machine X (Actual Cost ₹10,00,000) acquired and put to use on 15.08.2023 (Used 180 days).
- 3) New Machine Y (Actual Cost ₹5,00,000) acquired and put to use on 01.02.2024 (Used < 180 days).
- 4) No assets were sold during the year.

Step 1: Compute WDV of the Block before Depreciation

Particulars	Amount (₹)
WDV on 1.4.2023	40,00,000
Add: Actual Cost of Machine X	10,00,000

Add: Actual Cost of Machine Y	5,00,000
Total WDV before Depreciation	55,00,000

Step 2: Compute Normal Depreciation (15% rate)

Asset	Calculation	Amount (₹)
Opening WDV (₹40,00,000)	Full rate (15%)	6,00,000
Machine X (Full period)	Full rate (15% on ₹10,00,000)	1,50,000
Machine Y (Half period)	Half rate (7.5% on ₹5,00,000)	37,500
Total Normal Depreciation		7,87,500

Step 3: Compute Additional Depreciation (20% rate on Actual Cost)

Asset	Calculation (20% on Actual Cost)	Amount (₹)
Machine X (Full period)	Full rate (20% on ₹10,00,000)	2,00,000
Machine Y (Half period)	Half rate (10% on ₹5,00,000)	50,000
Total Additional Depreciation (Current Year)		2,50,000
Balance Additional Dep. on Y carried forward (10%)	10% on ₹5,00,000	50,000

Step 4: Compute Closing WDV

Particulars	Amount (₹)
Total WDV before Depreciation (from Step 1)	55,00,000
Less: Total Normal Depreciation (from Step 2)	(7,87,500)
WDV of the Block on 31.3.2024	47,12,500

(Note: Additional Depreciation does not reduce the WDV of the block; it is a separate deduction from income. The WDV is reduced only by Normal Depreciation.)

6.10.3. Numerical Example 2: Sale of Depreciable Assets and Section 50

A professional services firm has a block of office furniture (Rate 10%).

Scenario A: Partial Sale and Block Continues

- 1) Opening WDV (1.4.2023): ₹8,00,000.
- 2) Sale of old furniture during the year: ₹1,50,000.
- 3) New furniture acquired (Full period use): ₹1,00,000.

Computation:

Particulars	Amount (₹)
A. Opening WDV	8,00,000
B. Add: Acquisitions	1,00,000
C. Less: Sale Consideration	(1,50,000)
D. WDV before Depreciation (C)	7,50,000
E. Less: Normal Depreciation (10% on ₹7,50,000)	(75,000)
F. Closing WDV	6,75,000

Tax Implication: Since the sale proceeds were less than the total block value (₹1,50,000 < ₹9,00,000), the block continues to exist, and depreciation is claimed normally on the remaining WDV. No capital gain or loss arises.

Scenario B: Full Sale and Block Wiped Out (STCG)

Assume the Opening WDV is ₹8,00,000, and the entire block is sold for a net consideration of ₹9,50,000.

Computation:

Particulars	Amount (₹)
A. Opening WDV (Total Value of Block)	8,00,000
B. Less: Full Value of Consideration Received (Sale Price)	(9,50,000)
C. Resulting Difference (A - B)	(1,50,000)

Tax Implication: The sale consideration exceeds the total block value. The excess of ₹1,50,000 is deemed to be a Short-Term Capital Gain (STCG) under Section 50. The WDV of the block becomes NIL, and no depreciation is allowable for the year.

Scenario C: Full Sale and Terminal Depreciation

Assume the Opening WDV is ₹8,00,000, and the entire block is sold for a net consideration of ₹7,20,000.

Computation:

Particulars	Amount (₹)
A. Opening WDV (Total Value of Block)	8,00,000
B. Less: Full Value of Consideration Received (Sale Price)	(7,20,000)
C. Resulting Difference (A - B)	80,000

Tax Implication: Since the sale consideration is less than the total block value, and the block ceases to exist, the resulting deficiency of ₹80,000 is treated as Terminal Depreciation (Short-Term Capital Loss) and is fully deductible from the firm's business income.



Check Your Progress – A

1. State the two primary statutory conditions an assessee must meet to claim depreciation under Section 32.

2. Define 'Block of Assets' as per the Income Tax Act.

3. What is the depreciation rate for residential buildings, and what is the rate for computers?

6.11 SUMMARY

This unit explains the concept of depreciation under Section 32 of the Income Tax Act, 1961 and its computation through the Block of Assets system. Depreciation is a mandatory deduction allowed on tangible assets such as buildings, plant and machinery, furniture, and specified intangible assets like patents and trademarks, provided the assets are owned and used for business or profession. The calculation is based on the Written Down Value (WDV) method, where assets with the same depreciation rate are grouped into a block and depreciation is computed on the aggregate value rather than on individual assets. The unit elaborates on Actual Cost (Section 43(1)), emphasizing that government grants or subsidies must be deducted from the cost for depreciation purposes. A key operational rule is the 180-Day Rule, under which assets put to use for less than 180 days in the year of acquisition are eligible for only 50% of normal depreciation. Manufacturing and power-sector assesseees can also claim Additional Depreciation at 20% on new plant and machinery, subject to conditions. The treatment of Unabsorbed Depreciation is discussed, highlighting its indefinite carry forward and set-off against future income (except salary). The unit also covers Section 50, which mandates that gains on depreciable assets are always treated as Short-Term Capital Gains, and explains terminal depreciation when a block ceases to exist. Differences between tax depreciation and accounting depreciation and their

deferred tax implications are also outlined.



6.12. GLOSSARY

➤ **Depreciation (Tax):** The mandatory deduction allowed under Section 32 for the decline in the value of assets used for business.

- **Written Down Value (WDV):** The value of a single asset or a block of assets determined by subtracting depreciation allowed in previous years from the actual cost.
- **Actual Cost (Section 43(1)):** The cost of acquisition, adjusted for installation expenses and excluding grants/subsidies.
- **Block of Assets:** A statutory grouping of assets (tangible or intangible) that share the same prescribed rate of depreciation.
- **180-Day Rule:** The rule restricting depreciation to 50% of the prescribed rate if an asset is put to use for less than 180 days in the year of acquisition.
- **Additional Depreciation:** An extra 20% deduction on the actual cost of new plant and machinery for manufacturing/power units.
- **Short-Term Capital Gain (STCG):** The statutory classification under Section 50 for any profit realized from the sale of a depreciable asset.
- **Terminal Depreciation:** The business loss arising when the entire block of assets is sold for a consideration less than its WDV.
- **Unabsorbed Depreciation (UAD):** The portion of depreciation that cannot be set off against the current year's income.
- **Intangible Assets:** Non-physical assets such as patents, copyrights, and licenses that are eligible for a 25% depreciation rate.
- **Tax Shield:** The reduction in tax liability resulting from the deduction of a non-cash expense like depreciation.
- **Deferred Tax Liability (DTL):** A future obligation arising because accelerated tax depreciation resulted in lower current tax payment compared to accounting standards.
- **SLM (Straight Line Method):** The method available exclusively to power units, charging an equal amount of depreciation annually on original cost.
- **Transfer:** The sale, exchange, relinquishment, or compulsory acquisition of an asset.



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6.15. SUGGESTED READINGS

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6.16. TERMINAL QUESTIONS

1. Explain the statutory conditions required to claim depreciation under Section 32 of the Income Tax Act, 1961.
2. Define the term Actual Cost under Section 43(1). Discuss the treatment of government grants and subsidies while determining actual cost.
3. Explain the Written Down Value (WDV) method of depreciation. How is WDV calculated for new and existing assets?
4. What is meant by the Block of Assets concept? Explain its significance in the computation

- of depreciation and capital gains.
5. Discuss the 180-Day Rule and analyze its impact on the quantum of depreciation and managerial investment decisions.
 6. Enumerate the prescribed depreciation rates for major classes of assets under the Income Tax Rules.
 7. Explain the provisions relating to Additional Depreciation under Section 32(1)(ia). Who is eligible to claim it and on which assets?
 8. Discuss the treatment of Unabsorbed Depreciation (UAD). How is it carried forward and set off against future income?
 9. Explain the tax treatment of the sale of depreciable assets under Section 50. Why are such gains always treated as Short-Term Capital Gains?
 10. What is Terminal Depreciation? Under what circumstances does it arise, and how is it treated for tax purposes?
 11. Distinguish clearly between Tax Depreciation under the Income Tax Act and Accounting Depreciation under the Companies Act, 2013.
 12. "Depreciation is a non-cash expense but a powerful tax planning tool." Justify this statement with suitable reasoning.
 13. A firm provides the following details for the 'Building-Commercial Use' block (Rate 10%): Opening WDV: ₹12,00,000. New office floor acquired and put to use on 15.11.20XX for ₹4,00,000. Calculate the total depreciation and the closing WDV of the block. (Hint: Apply the 180-day rule to the new acquisition.)
 14. A manufacturing company has an Opening WDV of ₹60,00,000 for the 15% P&M block. New P&M worth ₹15,00,000 was installed on 10.09.20XX. Calculate Normal Depreciation, Additional Depreciation, and the WDV of the block at the year-end.
 15. The Plant and Machinery block (Rate 15%) has an opening WDV of ₹2,50,000. During the year, no new assets were acquired. The company sold the entire block for ₹3,00,000 (net). Calculate the capital gain/loss arising from this sale and state its nature.
 16. Compute the Actual Cost for depreciation purposes for a machine purchased for ₹25,00,000. Installation costs amounted to ₹2,00,000. A state government grant of ₹5,00,000 was received towards the purchase.

UNIT-7

INCOME FROM BUSINESS OR PROFESSION

Contents

- 7.1. Introduction**
- 7.2 Preliminary Concepts: Business, Profession, and Vocation**
- 7.3 Chargeability and Scope of Income (Section 28)**
- 7.4 Computation Method: Adjusting the Net Profit (Section 29)**
- 7.5. Specific Deductions for Business Assets and Operations (Sections 30-36)**
- 7.6. General Deduction (Section 37(1))**
- 7.7. Compliance-Driven Disallowances (Sections 40, 40A, 43B)**
- 7.8. Presumptive Taxation Schemes (Sections 44AD and 44ADA)**
- 7.9. Illustrative Examples / Applications**
- 7.10 Summary**
- 7.11 Glossary**
- 7.12 References / Bibliography**
- 7.13. Suggested Readings**
- 7.14 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, the learners will be able to:

- ✓ Explain the characteristics that distinguish 'Business,' 'Profession,' and 'Vocation' and their unified tax treatment under PGBP.
- ✓ Describe the scope of income chargeable under Section 28, listing examples of income deemed to be business income, such as Keyman Insurance proceeds and compensation payments.
- ✓ Differentiate between the specific allowances (Sections 30-36) and the general allowance governed by the 'wholly and exclusively' rule (Section 37(1)).
- ✓ Analyze the mechanism of depreciation (Section 32) based on the 'Block of Assets' concept and the Written Down Value (WDV) method.
- ✓ Evaluate the necessity of compliance provisions, such as the cash payment restriction (Section

- 40A(3)) and the actual payment requirement for statutory dues (Section 43B).
- ✓ Apply the computation rules of presumptive taxation schemes (Section 44AD for business and Section 44ADA for professionals) to determine minimum taxable income.
 - ✓ Prepare the computation of taxable PGBP by systematically adjusting the Net Profit/Loss reported in the financial accounts.

7.1 INTRODUCTION

This unit focuses on one of the five major heads of income under the Indian Income Tax Act, 1961: Profits and Gains of Business or Profession (PGBP). This head is governed primarily by Sections 28 to 44DB of the Act. For commerce and management students, understanding PGBP is essential because it encompasses nearly all entrepreneurial and commercial activities, from running a small retail shop to operating a large manufacturing enterprise or practicing law or medicine. The fundamental challenge in computing PGBP is reconciling commercial accounting practices with the specific rules laid down by the Income Tax Act. While a business prepares its Profit and Loss (P&L) Account based on general accounting standards, the tax department requires numerous adjustments to this figure to arrive at "Taxable PGBP." These adjustments ensure that only expenditures incurred *wholly and exclusively* for business purposes are deducted, and that income taxable under other heads (like dividends or house property) is excluded.

Relevance in Managerial Decision-Making

PGBP provisions extend far beyond mere compliance; they are pivotal tools for managerial and financial strategy. The manner in which the tax law treats certain costs directly dictates resource allocation and timing decisions. For instance, the tax treatment of depreciation under Section 32, specifically the 180-day rule, forces managers to align capital budgeting timelines with the financial year to maximize tax savings. A manager might strategically delay or accelerate a machinery purchase based on whether the asset can be put to use for at least 180 days, thereby optimizing the available tax deduction.

Furthermore, compliance requirements embedded within PGBP rules significantly impact operational logistics. Provisions like Section 40A(3), which restrict cash payments above ₹10,000, encourage the adoption of transparent, digital, and traceable banking methods, mitigating the risk of tax penalties and enforcing better financial discipline. Similarly, the rules concerning preliminary expenses (Sec 35D) and scientific research expenditure (Sec 35) offer direct tax incentives that encourage long-term strategic investments in growth and innovation. Understanding these rules allows a management professional to treat the tax code not just as a compliance burden, but as a framework for efficient financial planning and risk management. This unit will systematically cover the concepts of business and profession, the scope of chargeable income, the detailed rules for claiming deductions (Sec 30-37), the critical provisions for

disallowance (Sec 40A/43B), and the simplified schemes available for small businesses and professionals (Sec 44AD/44ADA).

7.2 PRELIMINARY CONCEPTS: BUSINESS, PROFESSION, AND VOCATION

The head "Profits and Gains of Business or Profession" covers income derived from three distinct, yet related, activities: Business, Profession, and Vocation.

7.2.1 Business (Section 2(13))

A business is statutorily defined in a very broad manner. Section 2(13) states that "Business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture". The key feature of a business is the pursuit of commercial activity, often involving the purchase and sale of goods, manufacturing, or providing services, with the general intention of making a profit. This activity must generally be carried on regularly, although even a single "adventure in the nature of trade" can sometimes be deemed a business for tax purposes.

7.2.2 Profession (Section 2(36))

A profession, unlike a broad commercial business, involves individuals offering specialized services based on intellectual or manual skill.⁷ A profession is an occupation requiring specialized knowledge, intellectual ability, and personal qualification. Examples include Doctors, Chartered Accountants, Lawyers, Engineers, and Architects. These activities usually require formal education, certification, or licensing to be practiced.

7.2.3 Vocation

A vocation is often defined as an activity that requires a special skill or calling, which is then used to earn income. While similar to a profession, a vocation is generally broader and less formalized, often stemming from an individual's talent or passion. Examples include a Painter, Singer, or Actor.

7.2.4 Unified Tax Treatment

A crucial point for tax computation is that for the purpose of the Income Tax Act, there is no difference between income derived from a business, a profession, or a vocation. Income from all three activities is computed under the single head, PGBP, using the same set of rules regarding allowable deductions and mandatory disallowances.

However, this distinction becomes relevant when considering certain tax schemes. For instance, the simplified presumptive taxation scheme under Section 44ADA is strictly reserved for specified *professionals*, while the scheme under Section 44AD is for *businesses*. Accurate classification is

thus vital for compliance and tax planning.

7.3 CHARGEABILITY AND SCOPE OF INCOME (SECTION 28)

Section 28 is the charging section that specifies which incomes must be computed and taxed under the PGBP head.

7.3.1. The General Charge

The primary charge is on "the profits and gains of any business or profession which was carried on by the assessee at any time during the previous year". This includes income from trade, manufacturing, freelancing, and service activities.

7.3.2. Deemed Business Income (Specific Inclusions)

The scope of PGBP is broadened by the Act to include specific receipts that may not arise from routine day-to-day trading but are clearly commercial gains. These are crucial additions that ensure the integrity of the tax base.

Table 7.1: Scope of Income Chargeable under PGBP (Section 28)

Source of Income (Section 28)	Simple Explanation
Profits from Business or Profession	Standard revenue generated from core trade or professional services during the year.
Compensation Payments	Amounts received by a person in connection with the termination or modification of a contract relating to their business (e.g., termination of a management or agency contract).
Income from Associations	Income derived by a trade, professional, or similar association from specific services performed for its members.
Export Incentives	Profits made on the sale of import licenses, or cash assistance received from the government against exports.
Partner Remuneration	Any salary, commission, bonus, or interest that is owed to or received by a partner from the partnership firm.
Keyman Insurance Policy Proceeds	Any amount received under a Keyman Insurance Policy, including the sum received on maturity or surrender, is treated as business income.

The inclusion of compensation payments and Keyman Insurance proceeds under Section 28 is significant. For instance, if a company takes out a Keyman Insurance Policy on a crucial employee (like the CEO) to safeguard its financial interests against the risk of that person's death or disability, the premiums paid by the company are considered deductible business expenditure.

Consequently, any payout received by the company from that policy is logically taxed as business income. This ensures that the tax treatment of the expense (deduction) is matched by the tax treatment of the receipt (taxable income).

Furthermore, including items like export incentives under PGBP ensures that while the primary economic incentive is provided by the government, the resulting commercial gain is still accounted for in the tax base, aligning with the principle of comprehensive taxation.

7.4 COMPUTATION METHOD: ADJUSTING THE NET PROFIT (SECTION 29)

Section 29 of the Income Tax Act dictates the method for computing PGBP. Unlike other heads of income, PGBP computation does not typically start with gross receipts. Instead, it begins with the financial results reported by the taxpayer, specifically the Net Profit or Loss shown in the Profit and Loss (P&L) Account. The result shown in the P&L Account reflects commercial accounting principles. To determine the income taxable under the IT Act, a systematic adjustment process must be followed, adding back items disallowed by law and deducting items permitted by law.

The computation process relies on two key categories of adjustments:

- 1) **Add Back Inadmissible Expenses:** Expenses that were debited to the P&L Account (reducing commercial profit) but are not permitted as deductions under the IT Act. Examples include personal expenses (like the assessee's life insurance premium or household expenses), capital expenditure (which should be treated separately via depreciation), and tax payments (like income tax or wealth tax). These amounts must be added back to the Net Profit.
- 2) **Deduct Non-Business Income/Allowable Deductions:**
 - **Non-Business Income:** Income credited to the P&L Account that is taxable under a different head (e.g., 'Income from Other Sources' like dividend income or interest on securities). These items must be deducted from the Net Profit as they will be taxed elsewhere.
 - **Allowable Deductions Not Debited:** Expenses specifically allowed by the IT Act (like Statutory Depreciation under Section 32) but which may not have been fully debited or debited at the wrong rate in the P&L Account. The correct statutory allowance must be deducted.

This structured approach ensures that the calculation is based on the specific legal framework established by the IT Act, overriding general accounting rules whenever a conflict arises.

7.5. SPECIFIC DEDUCTIONS FOR BUSINESS ASSETS AND OPERATIONS (SECTIONS 30-36)

The IT Act provides specific sections detailing deductions for common operational expenses. If an expense is covered in Sections 30 to 36, it is allowed based on the conditions specified in that particular section.

7.5.1. Rent, Repairs, and Insurance (Sections 30 & 31)

- **Section 30 (Premises):** This section allows deductions for rent, rates, taxes, current repairs, and insurance premium paid relating to the building used for business purposes.
- **Section 31 (Machinery, Plant, Furniture):** This allows deductions for current repairs and insurance premium paid relating to machinery, plant, or furniture used for the business.
- **Key Distinction:** It is vital to note that these sections cover only revenue expenditure. Any cost that is capital in nature (e.g., the cost of acquiring a new piece of machinery or making substantial improvements to a building) is explicitly excluded from these sections and must be dealt with under the provisions of depreciation (Section 32).

7.5.2. Depreciation (Section 32): The WDV and Block of Assets

Depreciation is a mandatory deduction for the wear and tear of assets used in a business or profession.

Conditions for Claiming Depreciation

Depreciation is allowed only if:

- 1) The asset is owned by the assessee (fully or partly).
- 2) The asset is used for the purpose of the business or profession.
- 3) The asset must have been used during the previous year.

Written Down Value (WDV) Method

The Income Tax Act mandates the use of the Written Down Value (WDV) method for calculating depreciation, in contrast to the Straight-Line Method (SLM) often used in corporate accounting. The WDV is defined as the actual cost of the asset if it was acquired in the current year. If the asset was acquired in an earlier year, the WDV is the actual cost incurred less the depreciation actually allowed under the Act in prior years.

Block of Assets Concept

A crucial difference between tax depreciation and accounting depreciation is the concept of the Block of Assets. Instead of calculating depreciation asset-by-asset, the IT Act groups assets into "blocks" based on two criteria:

- 1) The asset must belong to the same class (e.g., buildings, plant, machinery, furniture).
- 2) The assets must be subject to the same prescribed rate of depreciation.

Depreciation is calculated on the WDV of the entire block. If an asset is sold or discarded, the sale price is simply deducted from the WDV of the block. If the asset block ceases to exist (the closing WDV becomes zero), any remaining unabsorbed loss is treated as a short-term capital loss. This simplification minimizes the complexity of tracking profit or loss on the sale of individual assets within a block.

Illustrative Depreciation Rates (WDV Basis):

- **Computers and Software:** 40% (Reflecting high obsolescence).
- **General Plant and Machinery:** 15%.
- **General Buildings (Factory/Office):** 10%.
- **Intangible Assets (Patents, Trademarks):** 25%.

The 180-Day Rule

The timing of asset acquisition is critical. If a capital asset is acquired and put to use for less than 180 days during the previous year, the depreciation allowed in that year is restricted to 50% of the normal rate. This rule has a direct operational consequence. A financial manager, recognizing that the cut-off date for full depreciation benefit is generally six months into the financial year, will prioritize purchasing and installing assets quickly to ensure they are "put to use" for at least 180 days. If the asset cannot be used for 180 days, the manager may intentionally defer the acquisition until the next financial year to claim the full rate of depreciation then, thereby optimizing the tax timing benefit.

7.5.3. Expenditure on Scientific Research (Section 35)

The government encourages innovation through tax incentives provided under Section 35. This section allows specific deductions for scientific research related to the assessee's business.

Categories of Research Expenditure

- 1) **In-House Research:** If the business undertakes scientific research internally (e.g., salaries for research staff, consumption of materials), 100% deduction is allowed for both revenue expenditure and capital expenditure. The only exception is the cost of land acquisition, which does not qualify for this deduction.
- 2) **External Contribution:** Deduction is also available for payments made to approved external organizations :
 - 100% deduction for payments made to institutions/associations for scientific research or research in social sciences or statistics.
 - A weighted deduction was historically available for contributions to National Laboratories, IITs, or Universities. However, for most categories, the deduction has been

phased down to 100% of the actual expenditure paid, starting from Assessment Year 2021-22, in alignment with policy simplification.

This provision significantly reduces the effective cost of research and development (R&D), serving as a direct mechanism to promote technological advancement and self-reliance in the Indian economy.

7.5.4. Other Specific Deductions (Section 36)

Section 36 covers a diverse range of operational expenses that are specifically allowed:

- **Interest on Borrowed Capital:** The actual amount of interest paid or payable in respect of capital borrowed for the purposes of the business or profession is deductible. However, if the borrowed capital is used to acquire a new asset, the interest paid until the asset is first put to use must be capitalized (added to the asset cost) and is not allowed as a deduction.
- **Insurance Premiums:** Premiums paid for insurance on stock, cattle, employee healthcare, and Keyman insurance are deductible.
- **Bonus and Commission:** Actual bonus or commission paid to employees for services rendered.
- **Bad Debts:** Bad debts that are actually written off as irrecoverable in the books of account are deductible. Note that merely creating a provision for bad debts is generally disallowed, as the debt must be proven bad and written off.
- **Contributions to Employee Funds:** Employer's contribution to recognized provident funds, superannuation funds, and gratuity funds.

7.6. GENERAL DEDUCTION (SECTION 37(1))

Section 37(1) acts as the residual or "catch-all" provision, covering any expenditure that is not explicitly covered under Sections 30 to 36 but is necessary for running the business or profession.

7.6.1. The Four Essential Conditions

For an expense to be allowed under Section 37(1), it must strictly satisfy four simultaneous conditions:

- 1) **Not Covered by Sections 30 to 36:** It should not be an expense already covered under the specific allowance sections.
- 2) **Revenue Nature:** The expenditure must be of a revenue nature, meaning it relates to the ordinary running of the business and does not create an enduring benefit or asset of a capital nature.
- 3) **Incurred in the Previous Year:** The expense must have been incurred (or accrued) during the relevant financial year.
- 4) **Wholly and Exclusively for Business:** It must have been incurred wholly and exclusively for the purpose of the business or profession. This is a crucial test; while 'wholly' implies the

entire expense, 'exclusively' focuses on the motive. Even if a business incurs an expense that provides an incidental personal benefit, the primary and sole reason for incurring the cost must be business needs.

Examples of generally allowed expenses under Section 37(1) include general legal fees (for business matters), professional fees, advertisement expenses (excluding those promoting political parties), and employee welfare expenses.

7.6.2. Explicit Disallowances

Section 37(1) expressly prohibits the deduction of two major categories of expenditure:

- 1) **Capital Expenditure:** Costs incurred for acquiring or improving a capital asset (e.g., fees paid to increase authorized capital or costs for demolishing a building to acquire a fixed asset).
- 2) **Illegal Activities and Offenses:** Any expenditure incurred for an activity prohibited by law, or for an offense, is disallowed. This includes payments such as bribes, protection money, and penalties paid for infringing or violating laws or regulations.

The disallowance of illegal expenses upholds the principle that the government should not subsidize criminal or non-compliant behavior through tax deductions.

7.7. COMPLIANCE-DRIVEN DISALLOWANCES (SECTIONS 40, 40A, 43B)

While Sections 30-37 determine *what* expenses are allowable, Sections 40, 40A, and 43B dictate *how* and *when* those expenses must be incurred or paid to qualify for deduction. These are known as compliance-driven disallowances and are instrumental in enforcing fiscal discipline and promoting transparency.

7.7.1. Failure to Deduct TDS (Section 40(a)(ia))

The Tax Deducted at Source (TDS) mechanism requires specified persons to deduct tax when making certain payments (like rent, interest, or professional fees) to residents. Section 40(a)(ia) imposes a penalty for non-compliance.

If an assessee fails to deduct the required TDS, or having deducted it, fails to deposit it with the government on or before the due date specified for filing the return of income (Section 139(1)), **30% of that expenditure is disallowed**. This partial disallowance is severe and is designed to strongly incentivize timely compliance with the TDS provisions.

7.7.2. Restriction on Cash Payments (Section 40A(3))

Section 40A(3) is a vital provision aimed at discouraging unaccounted cash transactions and curbing tax evasion.

The Limit and Disallowance

The rule is straightforward: any expenditure amount exceeding ₹10,000 paid in cash (or by bearer cheque/draft, which is considered equivalent to cash) to a single person in a single day is 100% disallowed as a deduction. For example, if a business pays a supplier ₹15,000 in cash for materials on a particular day, the entire ₹15,000 is added back to the taxable income, even if the materials were genuinely received. This rule mandates the use of traceable banking channels, such as account payee cheques, bank drafts, or electronic clearing systems (ECS).

Deemed Income (Section 40A(3A))

There is a related provision for accrued liabilities. If an expense was claimed as a deduction in a previous year (based on the mercantile/accrual system), but the subsequent payment of that accrued liability is made in the current year in cash exceeding the ₹10,000 limit, that cash amount is deemed to be the PGBP income of the current year. This ensures that even delayed cash payments for past liabilities are penalized.

While the law is strict, judicial precedents recognize the concept of "business expediency." If an assessee can conclusively prove that a cash payment above the limit was made under unavoidable compulsion to prevent business disruption, and the genuineness and identity of the recipient are established, courts have sometimes allowed the deduction. However, relying on this exception is highly risky, and robust financial management dictates strict adherence to the ₹10,000 limit.

7.7.3. Deductions on Actual Payment Basis (Section 43B)

Normally, business income is computed on the mercantile or accrual basis (expenses are claimed when incurred, not necessarily when paid). Section 43B creates a significant exception by specifying that certain expenses are deductible only in the year in which the actual payment is made, irrespective of the method of accounting followed.

Key Expenses Covered

The primary expenses governed by the actual payment rule include:

- 1) Any sum payable by the assessee as tax, duty, cess, or fee under any law (e.g., GST or customs duty).
- 2) Interest payable on loans and advances taken from specified financial institutions.
- 3) Employer contributions to Provident Funds, Superannuation Funds, and Gratuity Funds.

This provision prevents businesses from claiming deductions for statutory dues or employee benefits simply by accruing the liability, while delaying the actual payment indefinitely, thereby distorting the true financial position and cash flow.

The MSME Payment Clause (Section 43B(h))

A major addition to Section 43B is Clause (h), specifically dealing with payments due to Micro and Small Enterprises (MSMEs). Under this provision, if a business owes money to a vendor registered as a Micro or Small Enterprise, the expense is deductible only if the payment is made within the time frame specified by the MSMED Act, 2006 (generally 15 days, or up to 45 days if a written agreement exists). If the payment is delayed beyond this limit, the deduction is allowed only in the year the actual payment is made, irrespective of the accrual year.

This mechanism represents an intentional use of the tax code as an economic governance tool. By linking the tax deduction directly to prompt payment, the government pressures larger buyers to settle dues with MSMEs quickly, improving the working capital and liquidity of small enterprises across the economy.

7.8. PRESUMPTIVE TAXATION SCHEMES (SECTIONS 44AD AND 44ADA)

For small taxpayers, the general method of computing PGBP—which involves maintaining detailed books of accounts (Section 44AA) and often subjecting them to a tax audit (Section 44AB)—can be complex and costly. To provide relief, the Income Tax Act offers presumptive taxation schemes that simplify compliance by allowing income to be declared at a fixed minimum percentage of turnover or gross receipts.

7.8.1. Presumptive Taxation for Business (Section 44AD)

This scheme is designed for small eligible businesses.

- **Eligibility:** Applicable to a Resident Individual, Hindu Undivided Family (HUF), or a Resident Partnership Firm (excluding Limited Liability Partnerships, LLPs). Businesses engaged in agency, commission, or brokerage are specifically excluded.
- **Turnover Limit:** The annual turnover or gross receipts must not exceed ₹2 Crore. This limit is extended to ₹3 Crore if the aggregate amount received in cash during the year does not exceed 5% of the total gross receipts.
- **Presumed Profit Rate:** The minimum taxable profit must be declared as :
 - 6% of gross receipts received via digital modes (bank transfer, ECS, credit/debit card, etc.).
 - 8% of gross receipts received via cash.

By opting for this scheme and declaring at least the minimum required profit, the assessee is deemed to have claimed all deductions (Sec 30 to 38) and is relieved from maintaining detailed books of account.

7.8.2. Presumptive Taxation for Professionals (Section 44ADA)

This scheme is designed for small, specified professionals.

- **Eligibility:** Applicable to a Resident Individual or a Resident Partnership Firm (not LLP) engaged in a specified profession (Legal, Medical, Engineering, Architectural, Accountancy, Technical Consultancy, Interior Decoration, etc.).
- **Gross Receipts Limit:** The gross receipts must not exceed ₹50 Lakh. This limit is increased to ₹75 Lakh if the amount of cash received is less than 5% of the total gross receipts.
- **Presumed Profit Rate:** The minimum profit must be declared as 50% of the total gross receipts.
- **Implication:** Similar to Section 44AD, professionals under 44ADA are deemed to have claimed all deductions, including depreciation. They are relieved from the requirement of maintaining detailed books.

The benefit of Section 44ADA is substantial. A professional earning ₹60 Lakh, all digitally, can declare ₹30 Lakh (50%) as profit and avoid the need for complex expense tracking and statutory audits, significantly simplifying tax compliance. If, however, the professional's actual net profit is lower than the 50% deemed profit, they must declare the lower actual profit but, in turn, are required to maintain detailed books of account and undergo a mandatory tax audit.

Table 7.8: Summary of Presumptive Taxation Schemes

Feature	Section 44AD (Eligible Business)	Section 44ADA (Specified Profession)
Applicable Assessee	Resident Individual, HUF, Partnership Firm (not LLP).	Resident Individual, Partnership Firm (not LLP).
Gross Receipts Limit (Base)	₹2 Crore (up to ₹3 Crore for digital focus).	₹50 Lakh (up to ₹75 Lakh for digital focus).
Presumed Profit Rate	6% (Digital) or 8% (Cash).	Minimum 50% of Gross Receipts.
Relief Granted	Relieved from mandatory book maintenance and audit (if minimum profit is declared).	Relieved from mandatory book maintenance and audit (if minimum profit is declared).

7.9. ILLUSTRATIVE EXAMPLES / APPLICATIONS

7.9.1. Real-Life Illustration: R&D Deduction Strategy (Section 35)

Scenario: BioPharma Ltd., an Indian pharmaceutical company, wishes to develop a new vaccine. During the financial year, the company incurs the following expenditures:

- 1) Capital expenditure: ₹80 lakh on new testing equipment for its in-house R&D lab (excluding land cost).
- 2) Revenue expenditure: ₹15 lakh on salaries for the research team and chemicals.
- 3) Contribution: ₹10 lakh paid to a National Laboratory for sponsored research related to the project.

Application of Section 35: The tax law aims to significantly reduce the net cost of innovation. Under Section 35, the company can claim a 100% deduction for all qualifying expenditures.

- Capital Expenditure (Equipment): ₹80 Lakh (100% deduction).
- Revenue Expenditure (Salaries/Chemicals): ₹15 Lakh (100% deduction).
- Contribution to National Lab: ₹10 Lakh (100% deduction, assuming it falls under the current phase-down rules).

Total Deduction Claimed: $80 + 15 + 10 = ₹105$ Lakh.

Managerial Consequence: This means that the entire ₹1.05 Crore spent on research is immediately deductible from the company's taxable PGBP. For a company in the 30% tax bracket, this deduction reduces the tax liability by ₹31.5 Lakh. This direct tax saving serves as a powerful incentive to invest heavily in scientific research, making R&D activities more financially viable compared to non-deductible capital acquisitions. This mechanism actively channels corporate funds towards innovation.

7.9.2. Numerical Example 1: PGBP Computation (Adjustment Method)

Mr. Suresh, a retail trader, reports the following figures from his Profit & Loss Account for the Previous Year. The computation required is the Taxable PGBP.

Particulars (Debits to P&L)	Amount (₹)	Particulars (Credits to P&L)	Amount (₹)
Salary to Staff	60,000	Gross Profit	4,20,000
Life Insurance Premium (Assessee)	15,000	Dividend Income (Taxable under IOS)	10,000
Income Tax Paid	5,000	Sundry Receipts (Business related)	5,000
Provision for Bad Debts	8,000		
Depreciation as per Books	17,000		
Net Profit	3,50,000		
Total	4,55,000	Total	4,55,000

Additional Information: Allowable Depreciation U/s 32 is ₹12,000.

Step-by-Step Solution: Computation of Taxable PGBP of Mr. Suresh

Particulars	Amount (₹)	Reason for Adjustment
Step 1: Net Profit as per P&L A/c	3,50,000	Starting point of computation.
Step 2: ADD Inadmissible Expenses (Already debited)		
Life Insurance Premium	15,000	Personal Expense (Disallowed).
Income Tax Paid	5,000	Tax on Income (Application of profit, Disallowed).
Provision for Bad Debts	8,000	Contingent liability/Reserve (Only actual bad debts are allowed).
Depreciation as per Books	17,000	Book depreciation must be added back; tax depreciation (Sec 32) is allowed separately.
Sub-Total (A)	3,95,000	
Step 3: LESS Inadmissible Income (Taxable elsewhere)		
Dividend Income	(10,000)	Taxable under Income from Other Sources (IOS).
Step 4: LESS Allowable Deductions (Not debited)		
Statutory Depreciation U/s 32	(12,000)	Allowable deduction under IT Act.
Step 5: Taxable Income from PGBP (A - Deductions)	3,73,000	

7.9.3. Numerical Example 2: Presumptive Taxation (Section 44ADA)

Ms. Geeta, a freelance architect (a specified professional), has total gross receipts of ₹70,00,000 for the financial year. Her cash receipts total ₹3,00,000. Her actual business expenses amount to ₹40,00,000.

Step-by-Step Solution: Evaluating Presumptive Taxation under Section 44ADA

Particulars	Details	Amount (₹)
1. Calculate Threshold Check	5% of Total Receipts: $70,00,000 \times 5\% = ₹3,50,000$.	₹3,50,000
2. Check Eligibility for Enhanced Limit	Cash Receipts (₹3,00,000) are less than the 5% threshold	Eligible. Ms. Geeta qualifies for the enhanced limit of ₹75

	(₹3,50,000).	Lakh.
3. Calculate Presumptive Income	Minimum declared profit: 50% of Gross Receipts (₹70 Lakhs).	₹35,00,000
4. Calculate Actual Income	Receipts (₹70 Lakh) - Actual Expenses (₹40 Lakh).	₹30,00,000

Ms. Geeta's actual net profit (₹30,00,000) is lower than the presumptive income (₹35,00,000).

- If Ms. Geeta chooses the Presumptive Scheme (44ADA), she must declare the minimum statutory profit of ₹35,00,000. She will not need to maintain detailed books of account or get an audit.
- If she chooses to declare her lower actual profit of ₹30,00,000, she must maintain detailed books of account and get them audited as per Section 44AB.

This analysis reveals that Section 44ADA is advantageous only if the actual expenses are low (i.e., actual profit is higher than 50%). When actual expenses are high (as in this case), the professional must weigh the cost and complexity of maintaining detailed accounts and undergoing an audit against the tax saved by declaring a lower income.

7.9.4 Application: Cash Payment Disallowance (Section 40A(3))

Scenario: ABC Services, a marketing consultancy, paid ₹60,000 in cash to a vendor for promotional services on a single day. The payment was not covered by any exception under Rule 6DD.

Application of Section 40A(3): Since the payment exceeded the limit of ₹10,000 and was made in cash to a single person on a single day, the entire ₹60,000 is disallowed as a deduction under Section 40A(3).

Tax Impact: The disallowed expense of ₹60,000 is added back to the net profit of ABC Services, increasing its taxable PGBP by that amount. If the company is taxed at 30%, this failure to comply results in an avoidable tax penalty of ₹18,000 (₹60,000 x 30%). This example emphasizes that the government is willing to penalize genuine business expenses if compliance regarding the mode of payment is violated, highlighting the goal of enforcing digital transactions and transparency.



Check Your Progress – I

1. What is the statutory basis for charging income under the PGBP head?

2. Explain the key difference between the WDV method used for Income Tax depreciation and the Straight-Line Method (SLM) often used in financial accounting.

3. Define 'Block of Assets' under Section 32 of the Income Tax Act, 1961.

7.10 SUMMARY

This unit explains the head Income from Profits and Gains of Business or Profession (PGBP) under the Income Tax Act, 1961, governed mainly by Sections 28 to 44DB. It covers income arising from business, profession, and vocation, all of which are taxed uniformly under PGBP. The unit clarifies the scope of chargeable income under Section 28, including normal business profits as well as deemed incomes such as compensation for termination of contracts, partner remuneration, export incentives, and proceeds from Keyman Insurance policies. The computation of PGBP is carried out as per Section 29 by adjusting the net profit shown in the Profit and Loss Account. This involves adding back inadmissible expenses (personal, capital, or disallowed items) and deducting allowable expenses and incomes taxable under other heads. Detailed provisions relating to specific deductions (Sections 30–36) are discussed, including rent, repairs, depreciation (Section 32), scientific research expenditure (Section 35), and other business expenses. The concept of depreciation based on the Written Down Value method and the Block of Assets, along with the 180-day rule, is emphasized. The unit also highlights general deductions under Section 37(1), compliance-based disallowances under Sections 40A and 43B, and simplified presumptive taxation schemes under Sections 44AD and 44ADA. Overall, the unit integrates legal provisions with practical computation and managerial relevance.



7.11 GLOSSARY

- **Written Down Value (WDV):** The actual cost of an asset less the depreciation already allowed under the Income Tax Act.
- **Block of Assets:** A group of tangible or intangible assets categorized by the same depreciation rate.
- **Revenue Expenditure:** Expenses incurred in the day-to-day running of the business, generally deductible.
- **Capital Expenditure:** Spending that creates an enduring asset, generally disallowed as an

expense but eligible for depreciation.

- **Wholly and Exclusively:** The stringent condition under Sec 37(1) that expenditure must be incurred solely for the business purpose.
- **Keyman Insurance Policy:** Insurance taken by the business on the life of an employee, the proceeds of which are treated as business income under Section 28.
- **Deemed Business Income:** Receipts specifically included in PGBP under Section 28, such as partner remuneration or compensation payments.
- **Actual Payment Basis:** The requirement under Section 43B that deduction for certain statutory dues and interest is allowed only when payment is actually settled, overriding the accrual method.
- **Presumptive Taxation:** A simplified scheme where income is computed at a fixed minimum percentage of turnover or gross receipts.
- **Section 44AD:** Presumptive scheme applicable to eligible small businesses.
- **Section 44ADA:** Presumptive scheme applicable to specified professionals.
- **Disallowance:** An expense claimed in the P&L Account that is disregarded for tax computation purposes (e.g., non-compliance with Section 40A(3)).
- **Vocation:** A special calling, skill, or talent used to earn a livelihood, taxed under PGBP.
- **Preliminary Expenses (Sec 35D):** Expenses incurred before the commencement of business or setting up a new unit, deductible in five equal annual installments.
- **TDS Failure:** Non-deduction or non-deposit of Tax Deducted at Source, leading to 30% disallowance under Section 40(a)(ia).



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7.14 TERMINAL QUESTIONS

1. Explain the scope and chargeability of income under the head Profits and Gains of Business or Profession as per Section 28 of the Income Tax Act, 1961.
2. Distinguish between business, profession, and vocation, and justify why income from all three is taxed under a single head, PGBP.
3. Describe the step-by-step procedure for computing taxable PGBP starting from the Net Profit as per the Profit and Loss Account.
4. Discuss the concept of deemed business income under Section 28 with suitable illustrations.
5. Explain the provisions relating to specific deductions under Sections 30 to 36, highlighting at least four important deductions.
6. Elaborate on the concept of depreciation under Section 32, explaining the Block of Assets, Written Down Value method, and the 180-day rule.
7. Examine the scope and conditions of general deductions under Section 37(1). Why are capital and illegal expenses disallowed?
8. Analyze the importance of compliance-based disallowances under Sections 40A(3) and 43B in promoting financial discipline and transparency.
9. Explain the provisions of Section 43B(h) relating to payments to Micro and Small Enterprises (MSMEs) and discuss its economic significance.

10. Discuss the presumptive taxation scheme under Section 44AD, including eligibility, turnover limits, and presumed profit rates.
11. Explain the presumptive taxation scheme for professionals under Section 44ADA, and state the circumstances in which it is beneficial to opt for this scheme.
12. Illustrate, with numerical examples, the computation of taxable income under PGBP using both the normal method and the presumptive taxation method.
13. Mr. Vijay, a trader, reports a Net Profit of ₹4,50,000 for the financial year. Compute his taxable PGBP based on the following adjustments:
 - Household expenses debited: ₹50,000.
 - Income Tax paid debited: ₹15,000.
 - Interest on Savings Bank A/c (credited): ₹5,000.
 - Depreciation as per books debited: ₹45,000.
 - Allowable depreciation U/s 32: ₹38,000.(Hint: Follow the five-step adjustment format).
14. Determine the minimum taxable income for the following resident individuals:
 - (a) A small manufacturer with ₹1.8 Crore turnover, where 100% of receipts were digital.
 - (b) A legal professional with ₹45 Lakh gross receipts, 90% digital.
 - (c) A commission agent whose turnover is ₹80 Lakh (all digital).(Hint: Check eligibility and applicable percentage rate).
15. A Block of Machinery (rate 15%) has an Opening Written Down Value (WDV) of ₹8,00,000. During the year, new machinery was purchased for ₹4,00,000 and put to use on January 1, 2024. Old machinery from the block was sold for ₹1,00,000. Calculate the depreciation for the year and the Closing WDV of the block. (Hint: Apply the 180-day rule).

UNIT-8

INCOME FROM CAPITAL GAINS

Contents

- 8.1. Introduction**
- 8.2 Definition and Scope of Capital Gains**
- 8.3 Classification of Capital Assets and Capital Gains (STCG Vs. LTCG)**
- 8.4. Mechanism for Computation of Capital Gains**
- 8.5 The Inflation Shield: Cost Indexation and The Base Year Rule**
- 8.6 Tax Treatment and Applicable Rates**
- 8.7. Capital Gains Exemptions and Tax Planning**
- 8.8. Illustrative Examples / Applications**
- 8.9 Summary**
- 8.10 Glossary**
- 8.11 References / Bibliography**
- 8.12 Suggested Readings**
- 8.13 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, the learner will be able to:

- ✓ Explain the statutory definitions of a 'Capital Asset' (Section 2(14)) and 'Transfer' (Section 2(47)) under the Income Tax Act, 1961.
- ✓ Differentiate between Short-Term Capital Assets (STCA) and Long-Term Capital Assets (LTCA) based on variable holding periods for different asset classes (equity, property, and general assets).
- ✓ Identify assets that are specifically excluded from the definition of a Capital Asset, understanding the rationale behind their exclusion (e.g., stock-in-trade and rural agricultural land).
- ✓ Calculate the taxable STCG and LTCG using the prescribed formulas, correctly determining the Indexed Cost of Acquisition and the strategic choice of Fair Market Value (FMV) as of 01.04.2001.
- ✓ Analyze the mechanism of the Cost Inflation Index (CII), its application in computing LTCG for pre-existing assets, and the implication of the recent discontinuation of indexation for assets acquired post-July 23, 2024.
- ✓ Apply the key tax-saving exemptions available under Sections 54, 54F, and 54EC, and

describe the necessity and procedure of the Capital Gains Account Scheme (CGAS) for compliance.

8.1. INTRODUCTION

The framework of income taxation in India organizes an assessee's total income into five major "Heads of Income." This unit focuses intensely on the fourth head: Income from Capital Gains. Capital Gains represent the profit or gain derived when a taxpayer sells, exchanges, or otherwise transfers an investment asset that they have held. Unlike recurring income streams such as salary or rent, capital gains result from the appreciation of asset values over time, making them fundamentally non-recurring in nature.

Understanding this head of income is crucial for students of business administration and commerce, as capital gains taxation directly impacts investment decisions, portfolio management, real estate dealings, and corporate restructuring activities such as mergers and divestitures. The taxability is triggered not by the accrual of profit over years, but in the specific financial year in which the asset is legally 'transferred'.

This unit will systematically guide the learner through the core legal concepts—defining what qualifies as a capital asset, distinguishing between short-term and long-term assets based on holding periods, and mastering the quantitative computation techniques. A critical focus will be placed on the mechanism of indexation, which protects long-term investors from inflation, and on key statutory exemptions (Sections 54, 54F, and 54EC) that allow for tax deferral through reinvestment. Given the dynamic nature of Indian tax law, particularly the recent legislative changes regarding indexation and preferential tax rates, a nuanced understanding of these provisions is essential for compliance and strategic tax planning.

8.2 DEFINITION AND SCOPE OF CAPITAL GAINS

The chargeability of tax under the head "Capital Gains" is founded on two fundamental prerequisites: the existence of a capital asset and the occurrence of a transfer.

8.2.1. What is a Capital Asset? (Section 2(14))

The term 'capital asset' is defined very broadly to include any property held by an assessee, regardless of whether that property is connected with their business or profession. This comprehensive inclusion covers a wide array of personal and business investments.

General Inclusions:

- 1) **Property of any kind:** This includes tangible assets like land, buildings, machinery, and vehicles, as well as intangible assets like patents, trademarks, leasehold rights, and intellectual property.
- 2) **Securities held by Foreign Institutional Investors (FIIs):** Securities invested by FIIs according to SEBI regulations are explicitly included.

- 3) **Unit Linked Insurance Policies (ULIPs):** Certain ULIPs are included if they fail to meet the exemption criteria under Section 10(10D) due to specific clauses.

Statutory Exclusions from Capital Asset:

The Income Tax Act specifically excludes certain items from the definition of capital asset, meaning any profit or loss arising from their transfer is not categorized as capital gain/loss.

- 1) **Stock-in-Trade (Inventory):** Any stock-in-trade, raw materials, or consumable stores held by the assessee for the purpose of their business or profession are excluded. The gains from selling these items are taxable under the head "Income from Business or Profession" (PGBP).
- 2) **Personal Effects (Movable Property):** Movable property held for the personal use of the assessee or any dependent family member (e.g., personal motor car, ordinary furniture, or electronic appliances). The rationale is that transferring these items is considered a personal transaction, not an investment activity intended to yield profit.
 - **Important Exception:** Certain movable assets are *always* treated as capital assets, even if held for personal use, due to their inherent investment value. These include jewellery, archaeological collections, drawings, paintings, sculptures, and any work of art.
- 3) **Rural Agricultural Land in India:** Land designated as agricultural land situated outside the specified limits of a municipality or cantonment board is excluded.⁸ The criteria for determining if land is rural depend on the population of the area and its shortest aerial distance from the local limits of the municipality.
- 4) **Specified Gold Bonds:** Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999, or the Gold Monetisation Scheme, 2015.

8.2.2. What Constitutes a 'Transfer'? (Section 2(47))

Capital gains are taxable in the year in which the asset is 'transferred'.¹ The term 'transfer' is defined inclusively and extends beyond a simple sale:

- **Sale, Exchange, or Relinquishment:** The most common forms of transfer.
- **Extinguishment of Rights:** This occurs when the assessee's rights in relation to the capital asset are terminated, such as a tenant surrendering leasehold rights for compensation.
- **Compulsory Acquisition:** Acquisition of the asset by the Government or any authority under a law.
- **Conversion into Stock-in-Trade:** When the owner converts a capital asset (e.g., a piece of land held for investment) into stock-in-trade (e.g., developed plots for sale) for the purpose of commencing a business, it is treated as a deemed transfer.
- **Part Performance of Contract:** Allowing the possession of immovable property to a buyer in part performance of a contract, even if the legal conveyance deed is not yet registered.

The concept of 'transfer' is critical because it establishes the year of tax liability. The tax event is crystallized on the date of transfer (e.g., the date possession is handed over or the date of

conversion), regardless of whether the consideration has been fully received by the assessee in that year. This can create compliance challenges, requiring the assessee to calculate and pay tax based on an income that may not yet be realized as cash flow.

8.3 CLASSIFICATION OF CAPITAL ASSETS AND CAPITAL GAINS (STCG VS. LTCG)

The tax treatment of a capital gain hinges entirely on the period for which the asset was held by the assessee, known as the holding period. This determines whether the gain is classified as Short-Term Capital Gain (STCG) or Long-Term Capital Gain (LTCG).

8.3.1 Variable Holding Periods

The standard holding period for long-term status varies significantly depending on the nature of the asset.

- 1) **12 Months (One Year) Threshold:** This shortest period applies to highly liquid and frequently traded financial instruments:
 - Listed equity or preference shares in a recognized stock exchange in India.
 - Units of equity-oriented mutual funds.
 - Listed debentures and Government securities.
 - Units of UTI and Zero Coupon Bonds.
 - *If held for more than 12 months, the asset is Long-Term.*
- 2) **24 Months (Two Years) Threshold:** This threshold applies to key non-equity assets and unlisted securities:
 - Immovable property (being land or building or both).
 - Unlisted shares in a company.
 - *If held for more than 24 months, the asset is Long-Term.*
- 3) **General Threshold and Recent Amendments:** Historically, the general threshold for all other assets (e.g., gold, jewellery, debt funds) was 36 months. However, recent amendments applicable to transfers occurring on or after July 23, 2024, generally classify an asset as Short-Term if held for not more than 24 months.

Table 8.1: Summary of Holding Periods for LTCA/ STCA Classification

Asset Category	Holding Period for LTCG Status	Short-Term (STCA)
Listed Shares, Equity MFs, Listed Securities	More than 12 months	Up to 12 months
Immovable Property (Land/Building), Unlisted Shares	More than 24 months	Up to 24 months
General Assets (Gold, Debt Funds, Art) <i>Prior to July 23, 2024</i>	More than 36 months	Up to 36 months
General Assets (Gold, Debt Funds, Art) <i>Post July 23, 2024</i>	More than 24 months	Up to 24 months

The ongoing legislative movement to standardize the general holding period toward 24 months simplifies analysis for new transactions. This shift means that for most common investment assets, a 24-month holding period now defines long-term capital appreciation, aligning the treatment of real estate and general investments more closely.

8.3.2. Significance of Classification

Classification determines two critical factors:

- 1) **Indexation Benefit:** Long-Term Capital Assets (LTCAs) generally qualify for the indexation benefit (adjusting cost for inflation), while Short-Term Capital Assets (STCAs) do not.
- 2) **Tax Rate:** LTCGs are taxed at special, beneficial, and often lower fixed rates (e.g., 12.5% or 20%), whereas STCGs are frequently taxed at the normal personal income tax slab rates of the assessee.

8.4. MECHANISM FOR COMPUTATION OF CAPITAL GAINS

The calculation of capital gains is defined by Section 48. The basic premise involves subtracting eligible deductions from the Full Value of Consideration received from the transfer.

8.4.1. General Computation Framework

The computation starts with the sale price and allows deductions for costs directly related to the acquisition and transfer of the asset.

- 1) **Full Value of Consideration (FVC):** This is the total amount received or receivable by the seller for the transfer of the asset.
- 2) **Deduct: Expenditure on Transfer:** Costs incurred wholly and exclusively in connection with the sale, such as brokerage, commission, stamp paper costs, or legal fees.
- 3) **Deduct: Cost of Acquisition (CoA):** The price paid by the assessee to acquire the asset.
- 4) **Deduct: Cost of Improvement (CoI):** Capital expenditure incurred for additions or alterations that increase the value of the asset (e.g., adding a floor to a house).

8.4.2. Computation of Short-Term Capital Gains (STCG)

The calculation for STCG is straightforward as it uses the actual, unadjusted costs :

$$\text{STCG} = \text{FVC} - \text{Expenditure on Transfer} - \text{Actual Cost of Acquisition} - \text{Actual Cost of Improvement}$$

8.4.3. Computation of Long-Term Capital Gains (LTCG)

LTCG computation introduces the concept of indexation to adjust the cost of acquisition and improvement for inflation.

$$\text{LTCG} = \text{FVC} - \text{Expenditure on Transfer} - \text{Indexed Cost of Acquisition (ICoA)} - \text{Indexed Cost of Improvement (ICoI)}$$

8.5 THE INFLATION SHIELD: COST INDEXATION AND THE BASE YEAR RULE

The primary advantage of LTCG over STCG is the ability to adjust the historical cost of the asset using the Cost Inflation Index (CII). This mechanism ensures that the taxpayer pays tax only on the 'real' gain, after accounting for the decrease in the purchasing power of money over the holding period.

8.5.1. Indexation Mechanism and Formulas

The CII is an index notified annually by the Central Board of Direct Taxes (CBDT). It is used to arrive at the indexed cost.

- 1) Indexed Cost of Acquisition (ICoA):

$$\text{ICoA} = \text{Cost of Acquisition} \times (\text{CII of the Year of Transfer} / \text{CII of the Year of Acquisition})$$

- 2) Indexed Cost of Improvement (ICoI):

$$\text{ICoI} = \text{Cost of Improvement} \times (\text{CII of the Year of Transfer} / \text{CII of the Year of Improvement})$$

It is important to note that any Cost of Improvement incurred before April 1, 2001, is never taken into consideration for calculation.

8.5.2. Treatment of Assets Acquired Before April 1, 2001 (Base Year Rule)

The base year for indexation is Financial Year 2001-02, for which the CII is set at 100. For assets acquired by the assessee before April 1, 2001, a specific rule is provided to protect the taxpayer from losing the benefit of appreciation that occurred prior to the base year.

The Cost of Acquisition (CoA) for indexing purposes shall be the higher of :

- 1) The actual cost incurred by the assessee, OR
 - 2) The Fair Market Value (FMV) of the asset as on April 1, 2001.
- **Strategic Implication:** This rule presents a crucial tax planning opportunity. If the asset (e.g., inherited property or land) was acquired at a very low cost decade ago, the FMV on 01.04.2001 is almost always significantly higher than the original purchase price. By adopting the higher FMV as the deemed cost of acquisition, and then applying the indexation factor from FY 2001-02 (CII 100), the assessee can maximize the Indexed Cost of Acquisition, substantially reducing the taxable long-term capital gain.

The CII values for reference are published annually:

Table 8.2: Cost Inflation Index (CII) Table (FY 2001-02 to 2025-26)

Financial Year (FY)	Cost Inflation Index (CII)	Financial Year (FY)	Cost Inflation Index (CII)
2001-02	100 (Base Year)	2014-15	240
2002-03	105	2015-16	254
2003-04	109	2016-17	264
2004-05	113	2017-18	272
2005-06	117	2018-19	280
2006-07	122	2019-20	289
2007-08	129	2020-21	301
2008-09	137	2021-22	317
2009-10	148	2022-23	331
2010-11	167	2023-24	348
2011-12	184	2024-25	363
2012-13	200	2025-26	376
2013-14	220		

8.5.3. The New Dual Tax Regime: Post-July 23, 2024 Amendments

A significant restructuring of capital gains taxation occurred with amendments effective from July 23, 2024. This has created a dual regime, particularly for non-equity assets like real estate and gold.

- 1) **For Assets Acquired Before July 23, 2024:** Indexation benefits remain available. The standard LTCG rate is 20% applied to the indexed gain.
- 2) **For Assets Acquired On or After July 23, 2024:** The benefit of indexation is generally **discontinued**. These gains are taxed at a lower, flat rate of **12.5%** on the unindexed gain (Full Value Consideration minus Actual Cost).
 - **Rationale for Choice (Pre-July 2024 Assets):** For immovable property acquired before the cut-off date, the assessee is generally provided an option to choose the most beneficial tax outcome: either calculate the tax at 20% using indexation, or calculate the tax at the new flat 12.5% rate without indexation. This provision acknowledges that for very long-held assets, the 20% indexed method often results in lower tax due to massive inflation adjustment, whereas for assets held for shorter long-term periods, the flat 12.5% rate might be preferable. This choice requires careful quantitative analysis to ensure compliance and optimization.

8.6 TAX TREATMENT AND APPLICABLE RATES

The tax rates applicable to capital gains depend on the holding period (STCG vs. LTCG) and the asset class (equity vs. non-equity).

8.6.1. Tax Rates on Short-Term Capital Gains (STCG)

- 1) **STCG on Non-STT Assets:** Gains from assets where Securities Transaction Tax (STT) is not applicable (e.g., real estate, gold, unlisted shares) are added to the assessee's total income. They are taxed at the individual's normal income tax slab rates. This can lead to a high tax rate, potentially exceeding 40% (including surcharge and cess), for high-income earners.
- 2) **STCG on STT-Paid Assets (Equity/Equity MFs):** For listed equity shares and equity-oriented mutual funds where STT is paid on sale, the STCG is taxed at a special flat rate of **20%** (for transfers post-July 23, 2024). This preferential flat rate is applied irrespective of the assessee's slab rate.

8.6.2. Tax Rates on Long-Term Capital Gains (LTCG)

- 1) **LTCG on Listed Equity/Equity MFs (Section 112A):**
 - **Exemption Limit:** LTCG up to ₹1.25 Lakh in a financial year is completely exempt from tax.
 - **Rate:** Gains exceeding the ₹1.25 Lakh threshold are taxed at a flat rate of 12.5%.
 - **Note:** Indexation benefit is not available for these assets.
- 2) **LTCG on Non-Equity Assets (Real Estate, Gold, etc.):**
 - **Assets Acquired Pre-July 23, 2024:** The assessee has the beneficial option to choose between (i) 20% tax on the indexed gain, or (ii) 12.5% tax on the actual (non-indexed) gain.
 - **Assets Acquired Post-July 23, 2024:** The mandatory tax rate is 12.5% on the actual (non-indexed) gain.
- 3) **LTCG on Debt Mutual Funds (Acquired Post April 1, 2023):** Due to recent legislative changes, capital gains arising from the transfer of debt mutual funds (acquired on or after April 1, 2023) are treated differently. Regardless of the holding period, the entire gain is considered short-term and taxed at the individual's normal slab rates. This eliminates the previous benefit of 20% indexed LTCG treatment for debt funds.

Table 8.3: Summary of Major Capital Gains Tax Rates (Individuals/HUF, Post-July 2024 Regime)

Asset Type & Gain Type	Tax Rate	Calculation Basis	Key Conditions/Exceptions
STCG (Non-STT Assets - Property, Gold)	Normal Slab Rate	Actual Cost	Added to total income.
STCG (STT-Paid Equity/MFs)	20% Flat Rate	Actual Cost	Requires STT payment on sale.
LTCG (Listed Equity/MFs, Sec 112A)	12.5% Flat Rate	Actual Cost	Exempt up to ₹1.25 Lakh.
LTCG (Property/Gold) - Old Assets (Pre-23/07/24)	20% Indexed OR 12.5% Non-Indexed	Indexed Cost or Actual Cost	Assessee must choose the beneficial option.

LTCG (Property/Gold) - New Assets (Post-23/07/24)	12.5% Flat Rate	Actual Cost	Indexation benefit is removed.
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8.7. CAPITAL GAINS EXEMPTIONS AND TAX PLANNING

The Income Tax Act provides several conditional exemptions (under Sections 54 to 54F) that allow an assessee to reduce or eliminate their tax liability by reinvesting the gain or sale proceeds into specified assets, typically within specified time frames.

8.7.1. Section 54: Exemption on LTCG from Sale of Residential House

Section 54 provides relief when a residential house property (LTCA) is transferred and the proceeds are reinvested in acquiring another residential house property.

- **Eligible Assessee:** Individual or Hindu Undivided Family (HUF).
- **Original Asset:** Must be a Long-Term Capital Asset, being a residential house property.
- **Investment Requirement:** The assessee must utilize the amount of the Capital Gain (not the entire sale consideration) to purchase or construct the new residential property.
- **Timeline for Reinvestment:**
 - Purchase: 1 year before or 2 years after the date of transfer of the original house.
 - Construction: Within 3 years after the date of transfer.
- **Quantum of Exemption:**
 - If the cost of the new house is greater than or equal to the capital gain, the entire gain is exempt.
 - If the cost of the new house is less than the capital gain, the exemption is limited to the actual cost of the new house.
- **Special Conditions:** The maximum amount of exemption is capped at ₹10 Crore. Furthermore, the exemption may be claimed for the purchase or construction of two residential houses, provided the capital gain does not exceed ₹2 Crore (This is a one-time lifetime option).
- **Lock-in and Revocation:** If the new property is sold within 3 years of acquisition or completion, the exemption granted earlier is revoked and the profit is taxed as STCG in the year of the new sale.

8.7.2. Section 54F: Exemption on LTCG from Sale of Any Asset (Other than House)

Section 54F grants exemption when an assessee transfers any Long-Term Capital Asset *other than* a residential house (e.g., gold, mutual funds, land) and invests the proceeds into a residential house.

- **Eligible Assessee:** Individual or HUF.
- **Original Asset:** Any Long-Term Capital Asset *excluding* a residential house.
- **Key Restriction:** On the date of transfer of the original asset, the assessee should not own more than one residential house (apart from the new house being purchased).
- **Investment Requirement:** The assessee must reinvest the entire Net Sale Consideration (FVC minus transfer expenses) to purchase or construct a new residential house in India.

- **Timeline and Cap:** Similar timelines (1/2/3 years) and a maximum exemption cap of ₹10 Crore apply, identical to Section 54.

Differentiating the Investment Base (Section 54 vs. 54F)

The crucial difference lies in the quantum that must be reinvested to secure full exemption:

- **Section 54:** Focuses on reinvesting the gain (profit). If the gain is ₹50 Lakh, only ₹50 Lakh must be invested in the new property.
- **Section 54F:** Focuses on reinvesting the Net Sale Consideration (NSC, or total value received). If the NSC is ₹1 Crore and the LTCG is ₹50 Lakh, the entire ₹1 Crore must be invested to claim the full exemption.

If the assessee fails to invest the entire NSC in Section 54F, the exemption is limited to a proportionate amount, calculated as follows:

$$\text{LTCG Exemption} = \text{LTCG} \times (\text{Cost of New House} / \text{Net Sale Consideration})$$

This strict requirement under Section 54F ensures that the taxpayer commits the entire sales corpus to the new house, reinforcing the legislative intent to promote housing investment rather than merely sheltering gains.

8.7.3. Section 54EC: Reinvestment in Specified Bonds

This section provides an alternative for taxpayers seeking exemption by investing in highly secure bonds issued by Public Sector Undertakings (PSUs).

- **Asset:** LTCG arising from the transfer of *any* long-term capital asset.
- **Investment:** Must be invested in specific bonds notified by the Central Government, such as bonds issued by REC, PFC, or IRFC. These are often referred to as Capital Gains Bonds.
- **Time Limit:** Investment must be made within 6 months from the date of the transfer.
- **Investment Cap:** The maximum amount of investment eligible for exemption is capped at ₹50 Lakh per financial year.
- **Lock-in:** The bonds carry a mandatory lock-in period of 5 years.

8.7.4. Capital Gains Account Scheme (CGAS)

Often, the statutory deadlines for purchasing (2 years) or constructing (3 years) a new residential house extend beyond the due date for filing the income tax return (ITR) for the year in which the asset was sold. If the assessee has not yet utilized the capital gains for the specified investment before the ITR deadline, the unutilized portion must be deposited into the Capital Gains Account Scheme (CGAS).

- **Purpose:** CGAS acts as a necessary deferral mechanism. By depositing the intended investment amount into this scheme before the ITR due date, the assessee legally secures the exemption claim for that assessment year, demonstrating their intent to invest.
- **Procedure:** The account must be opened in an authorized bank (excluding rural branches) by submitting an application in Form A.

- **Deposit Types:** Deposits can be made in two forms: Type A (Savings Deposit) or Type B (Term Deposit, maximum term of 3 years). The choice of Type B term should match the maximum investment period remaining (2 or 3 years).
- **Consequence of Non-Utilization:** If the amount deposited in the CGAS is not utilized for the purchase or construction of the specified asset within the statutory 2-year or 3-year period, the unutilized balance is treated as income (LTCG) and becomes taxable in the final year.

8.8. ILLUSTRATIVE EXAMPLES / APPLICATIONS

To solidify understanding, three numerical examples demonstrating the application of the computation rules and exemptions are provided below.

Numerical Example 1: Calculating STCG on Real Estate (Slab Rate Applicable)

Scenario: Mrs. Priya, a high-income earner falling in the 30% tax bracket, purchased a commercial plot of land on January 1, 2024, for ₹50,00,000. She sold the plot on December 15, 2025, for ₹75,00,000. She paid a brokerage fee of 1% on the sale price.

Analysis:

- **Holding Period:** The period of holding is 23.5 months. Since immovable property has a 24-month threshold for LTCG, this asset is a Short-Term Capital Asset (STCA).
- **Calculation:** Since it is STCG, no indexation is available.

Particulars	Amount (₹)
Full Value of Consideration (FVC)	75,00,000
Less: Expenditure on Transfer (1% of 75 Lakh)	75,000
Less: Cost of Acquisition (Actual)	50,00,000
Short-Term Capital Gain (STCG)	24,25,000

Tax Treatment: The STCG of ₹24,25,000 will be added to Mrs. Priya's total income and taxed at her normal income tax slab rate (30% plus surcharge/cess).

Numerical Example 2: Calculating LTCG on Gold (Indexing Pre-July 2024 Acquisition)

Scenario: Mr. Sameer sold gold jewellery on December 1, 2024, for ₹15,00,000. He purchased the gold in FY 2015-16 for ₹4,00,000. Transfer expenses were nil.

Data: CII FY 2015-16 = 254; CII FY 2024-25 = 363.

Analysis:

- 1) **Holding Period:** FY 2024-25 is the year of transfer. Gold is an asset that required a holding period of more than 36 months when acquired pre-July 2024. Since it was held for several years, it is a Long-Term Capital Asset (LTCA). Indexation is available.
- 2) ICoA Calculation:

$$\text{ICoA} = ₹4,00,000 \times (363/254) = ₹5,71,654 \text{ (approx.)s}$$

Particulars	Amount (₹)
Full Value of Consideration (FVC)	15,00,000
Less: Indexed Cost of Acquisition (ICoA)	5,71,654
Long-Term Capital Gain (LTCG)	9,28,346

Tax Treatment: The LTCG of ₹9,28,346 will be taxed at the fixed LTCG rate of 20% (as this is the indexed method).

$$\text{Tax Liability} = 20\% \text{ of } ₹9,28,346 = ₹1,85,669.20.$$

Numerical Example 3: Application of Section 54F (Proportional Exemption)

Scenario: Mr. Kishore sold a long-term investment asset (non-house) for a Net Sale Consideration (NSC) of ₹2,50,00,000. The calculated Long-Term Capital Gain (LTCG) was ₹1,00,00,000. Mr. Kishore purchased a new residential house for ₹1,50,00,000 within the stipulated time.

Analysis:

- 1) **Section 54F Requirement:** To claim full exemption under Section 54F, the entire Net Sale Consideration (₹2.5 Crore) must be invested.
- 2) **Investment Check:** Mr. Kishore invested ₹1.5 Crore, which is less than the required ₹2.5 Crore. Thus, the exemption must be calculated proportionally.

Calculation:

- Exemption = LTCG x (Cost of New House/ Net Sale Consideration)
- Exemption = ₹1,00,00,000 x (₹1,50,00,000/ ₹2,50,00,000)
- Exemption = ₹1,00,00,000 x 0.60 = ₹60,00,000

Result:

- Total LTCG: ₹1,00,00,000
- Exemption claimed: ₹60,00,000
- **Taxable LTCG: ₹40,00,000**

The taxable gain of ₹40,00,000 will be subject to the applicable LTCG tax rate (e.g., 20% indexed, or 12.5% if acquired post-July 2024 and beneficial).



Check Your Progress – A

1. Define 'Capital Asset' under the Income Tax Act, 1961, and list two assets that are specifically excluded from this definition.

2. Explain two events that qualify as a 'transfer' under Section 2(47) that are not simple sales.

3. If a business owner converts a piece of investment land into plots for sale, when is the transfer deemed to occur for capital gains purposes?

8.9 SUMMARY

Income from Capital Gains arises when a capital asset is transferred during a financial year and the resulting gain is taxed under Sections 45 to 55A of the Income Tax Act, 1961. A capital asset includes any kind of property held by an assessee, whether or not connected with business, but excludes items such as stock-in-trade, personal effects (with exceptions like jewellery and art), rural agricultural land, and specified gold bonds. Taxability depends on the occurrence of a “transfer,” which is broadly defined to include sale, exchange, relinquishment of rights, compulsory acquisition, conversion into stock-in-trade, and part performance of contracts. Capital assets are classified as short-term or long-term based on holding periods—12 months for listed equity and equity mutual funds, 24 months for immovable property and unlisted shares, and generally 24 months for other assets under the current regime. This classification is crucial as it determines tax rates and the availability of indexation. Short-term capital gains are usually taxed at normal slab rates (or special rates for STT-paid equity), while long-term capital gains enjoy concessional rates and, for older assets, indexation benefits through the Cost Inflation Index (CII). The unit also explains computation mechanisms, the base year rule of 01.04.2001, recent post-July 2024 amendments removing indexation for new non-equity assets, and key exemptions under Sections 54, 54F, and 54EC, along with the role of the Capital Gains Account Scheme for compliance and tax planning.



8.10 GLOSSARY

- **Capital Asset (Section 2(14)):** Property of any kind held by an assessee, excluding stock-in-trade and certain personal effects.
- **Transfer (Section 2(47)):** Includes sale, exchange, relinquishment, compulsory acquisition, and conversion of a capital asset into stock-in-trade.
- **Short-Term Capital Asset (STCA):** An asset held for a period not exceeding 12, 24, or 36 months, depending on the asset type.
- **Long-Term Capital Asset (LTCA):** An asset held for a period exceeding the prescribed threshold (12, 24, or 36 months).
- **Full Value of Consideration (FVC):** The entire sale price or gross amount received or

receivable from the transfer of the capital asset.

- **Cost of Acquisition (CoA):** The value for which the capital asset was originally purchased by the seller.
- **Cost of Improvement (CoI):** Expenditure of a capital nature incurred in additions or alterations to the capital asset.
- **Cost Inflation Index (CII):** An index notified by the CBDT used to adjust the historical cost of an LTCA for inflation, thereby reducing the taxable gain.
- **Indexed Cost of Acquisition (ICoA):** The cost of acquisition adjusted using the CII.
- **Base Year (2001-02):** The financial year used as the starting point for indexation calculations, with CII set at 100. For assets acquired earlier, the FMV on 01.04.2001 is used as the cost base.
- **Section 54:** Exemption on LTCG from house property, conditional upon reinvesting the gain into another residential house.
- **Section 54F:** Exemption on LTCG from assets other than house property, conditional upon reinvesting the entire net sale consideration into a residential house.
- **Section 54EC:** Exemption on LTCG from any asset by reinvesting the gain in specified bonds (capped at ₹50 Lakh).
- **Capital Gains Account Scheme (CGAS):** A deposit scheme allowing taxpayers to park unutilized capital gains to claim exemption before the ITR filing due date.



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8.12 SUGGESTED READINGS

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- ✚ Singhanian, V. K., & Singhanian, K. (Latest Edition). *Students' Guide to Income Tax*. Taxmann Publications.
- ✚ Mehrotra, H. C., & Goyal, S. P. (Latest Edition). *Income Tax Law and Practice*. Sahitya Bhawan Publications.
- ✚ Prasad, Bhagwati. (Latest Edition). *Income Tax Law & Practice*. Vishwa Prakashan.
- ✚ ClearTax. *Capital Gains Tax in India*. Online Resource.
- ✚ Government of India, Income Tax Department. *Official Notifications and Circulars*. Available at incometaxindia.gov.in.



8.13 TERMINAL QUESTIONS

1. Define the term Capital Asset under Section 2(14) of the Income Tax Act, 1961. State the statutory exclusions.
2. Explain the meaning of Transfer under Section 2(47). Why is its definition broader than a simple sale?
3. Distinguish between Short-Term Capital Asset (STCA) and Long-Term Capital Asset (LTCA) with reference to holding periods applicable to different assets.
4. Explain the mechanism of computation of capital gains as prescribed under Section 48.
5. Differentiate clearly between the computation of STCG and LTCG, highlighting the role of indexation.
6. What is the Cost Inflation Index (CII)? Explain how it protects taxpayers from inflationary gains.
7. Discuss the base year rule (01.04.2001) and explain the strategic importance of Fair Market Value (FMV) in capital gains computation.
8. Analyze the post-23 July 2024 amendments relating to indexation and tax rates on non-equity capital assets.
9. Explain the tax treatment of LTCG on listed equity shares and equity-oriented mutual funds under Section 112A.
10. Discuss the tax rates applicable to STCG on (a) STT-paid equity assets and (b) non-STT assets.
11. Explain the provisions of Section 54 relating to exemption on LTCG from the transfer of residential house property.
12. Compare Section 54 and Section 54F with respect to eligibility, investment requirement, and exemption calculation.
13. What is Section 54EC? Explain its conditions, limits, and lock-in period.
14. Explain the purpose and working of the Capital Gains Account Scheme (CGAS). What are the consequences of non-utilisation of deposits?

15. Critically evaluate the impact of recent changes in capital gains taxation on long-term investment and tax planning decisions.
16. Mr. A sold a piece of land in FY 2024-25 for ₹55,00,000. He purchased it in FY 2012-13 for ₹15,00,000. Transfer expenses were ₹50,000. (CII 2012-13 = 200; CII 2024-25 = 363). Calculate the Long-Term Capital Gain and the tax payable at 20% (excluding surcharge/cess). (Hint: Calculate ICoA)
17. Ms. B sold unlisted shares on June 10, 2025, for ₹10,00,000. She acquired them on August 1, 2023, for ₹7,50,000. Brokerage was ₹10,000. Calculate the taxable capital gain and the applicable tax rate if Ms. B falls in the 10% tax slab. (Hint: Determine STCG/LTCG status based on 24-month rule.)
18. A HUF sold long-term gold bars for a Net Sale Consideration (NSC) of ₹5,00,00,000, resulting in an LTCG of ₹2,00,00,000. The HUF purchased a new residential property for ₹3,00,00,000. Calculate the exempt capital gain under Section 54F. (Hint: Apply proportional exemption formula).
19. Mr. C purchased listed equity mutual fund units on November 15, 2023, for ₹4,00,000. He sold them on November 20, 2024, for ₹5,50,000. Calculate the taxable LTCG. (Hint: Use Sec 112A exemption limit of ₹1.25 Lakh).

UNIT-9

INCOME FROM OTHER SOURCES

Contents

- 9.1. Introduction**
- 9.2 Principle of Chargeability and Scope (Section 56)**
- 9.3 Key Incomes Specifically Taxable under IFOS**
- 9.4 Taxability of Gifts (Section 56(2)(x))**
- 9.5. Interest and Other Residual Incomes**
- 9.6. Other Incomes**
- 9.7. Deductions Allowed from IFOS (Section 57)**
- 9.8. Amounts Not Deductible (Section 58)**
- 9.9. Computation of Income from Other Sources**
- 9.10 Illustrative Examples / Applications**
- 9.11 Summary**
- 9.12. Glossary**
- 9.13 References/ Bibliography**
- 9.14 Suggested Readings**
- 9.15 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, the learner should be able to:

- ✓ Explain the concept of the 'Residuary Head' and the fundamental charging provisions of Income from Other Sources (Section 56).
- ✓ Differentiate between general income taxable under IFOS and specific incomes that are mandatorily charged under this head.
- ✓ Analyze the taxability of dividend income, including the crucial rules surrounding 'Deemed Dividends' (Section 2(22)) and the recent changes to share buy-back taxation.
- ✓ Describe the special tax rate, compliance requirements (TDS), and the calculation method (Grossing Up) applicable to casual income (Section 115BB and 194B/194BA).
- ✓ Apply the detailed rules governing the taxability and specific exemptions related to gifts of money and property received without consideration (Section 56(2)(x)).
- ✓ Determine the allowable deductions against IFOS (Section 57), paying special attention to the standard deduction for family pension and the deduction for interest on enhanced compensation.

- ✓ Identify expenditures expressly disallowed under the Act (Section 58), particularly those related to capital and casual income.
- ✓ Compute the net taxable income under the head 'Income from Other Sources' for an individual assessee using step-by-step methodology.

9.1. INTRODUCTION

The Indian Income Tax Act, 1961, follows a structured approach by classifying all taxable receipts into five distinct categories, or "Heads of Income." These heads are: Salaries, Income from House Property, Profits and Gains from Business or Profession (PGBP), Capital Gains, and finally, Income from Other Sources (IFOS). For income to be included in an assessee's Total Income, it must necessarily fall under one of these five heads.

This unit focuses entirely on the fifth and final category, Income from Other Sources, which is governed primarily by Sections 56, 57, and 58 of the Act. This head is crucially known as the residuary head. Its existence serves as a statutory safety net, ensuring that any income, profit, or gain that is not explicitly exempt from tax under other sections, and cannot logically or legally be categorized under the preceding four heads, is nonetheless brought within the ambit of taxation .

For BBA and B.Com learners, a comprehensive grasp of IFOS is essential because it captures a wide array of passive and non-routine income streams that are increasingly common in modern finance. These include income from passive investments (like interest on bank deposits and corporate dividends), extraordinary gains (like lottery winnings), and non-routine receipts (such as certain gifts and compensation payments).

The proper classification and computation of these receipts are fundamental to managerial decision-making, especially in tax planning. Misclassification of income for instance, treating a loan from a closely held company as a non-taxable receipt instead of a 'Deemed Dividend' can lead to significant tax liabilities and penalties. This unit provides a step-by-step guide to accurately identifying, classifying, and computing the net taxable income under this critical head, preparing learners to handle complex financial receipts and ensure robust tax compliance.

9.2 PRINCIPLE OF CHARGEABILITY AND SCOPE

9.2.1 The Residuary Principle

The legal basis for charging income under the head "Income from Other Sources" is established by Section 56 of the Income Tax Act, 1961. This head operates on the residuary principle. This means it functions as the category of last resort for taxation.

For any income to be categorized under IFOS, it must satisfy two fundamental conditions:

- 1) **Taxable Nature:** The income must not be explicitly exempt from taxation under any provision of the Income Tax Act (e.g., it must not be agricultural income or a gift received

from a relative).

- 2) **Exclusion from Primary Heads:** The income must not be chargeable to tax under any of the preceding four heads: Salaries, Income from House Property, Profits and Gains from Business or Profession, or Capital Gains.

The underlying purpose of the residuary head is to enforce the principle of universal chargeability. It ensures that any economic accretion or gain earned by an assessee, regardless of its unique nature or source, is brought under the tax net, thereby preventing potential gaps in the taxation structure. For example, if an individual receives director's fees that do not constitute salary (because there is no employer-employee relationship), such fees must be charged under IFOS.

9.2.2 General vs. Specific Charging Provisions

Section 56 details two pathways for income to be charged under IFOS:

- 1) **General Charge (Section 56(1)):** This sub-section is broad, covering residual income not explicitly covered elsewhere. Common examples include interest received on bank accounts or loans provided to others, and rent from letting out a vacant plot of land.
- 2) **Specific Charge (Section 56(2)):** This sub-section lists specific types of income that the law mandates must be taxed under IFOS, even if they might theoretically meet some criteria for another head (though typically they are clearly distinguished). These incomes are specifically enumerated to remove any doubt about their categorization. Key examples include dividends, family pension, casual income (winnings), gifts, and income from letting out machinery, plant, or furniture.

9.3 KEY INCOMES SPECIFICALLY TAXABLE UNDER IFOS

9.3.1 Dividend Income and Deemed Dividends

Taxability of Dividends

Prior to 2020, dividends distributed by a domestic company were generally exempt in the hands of the shareholders, as the company paid a Dividend Distribution Tax (DDT). However, the tax regime underwent a critical change. For dividends declared, distributed, or paid on or after April 1, 2020, the income is now fully taxable in the hands of the shareholder at their applicable slab rates under the head 'Income from Other Sources'.

If a shareholder incurs interest expenditure specifically for the purpose of earning this dividend income (e.g., interest paid on a loan taken to purchase the shares), a deduction is allowed under Section 57. However, this deduction is statutorily capped at 20% of the total dividend income received. This restriction prevents high-interest costs from entirely neutralizing the tax liability on dividend income.

Deemed Dividend (Section 2(22))

The concept of 'Deemed Dividend' is critical for tax compliance, especially concerning closely held (private) companies. This provision aims to prevent companies from distributing profits

to shareholders in the guise of non-dividend payments to avoid tax. Such transactions are "deemed" to be dividends to the extent of the company's accumulated profits.

Section 2(22) outlines several distributions that are treated as deemed dividends:

- **Distribution of assets:** Any distribution by a company entailing the release of its assets to shareholders.
- **Distribution on reduction of capital or liquidation:** Distributions made to shareholders on the reduction of share capital or liquidation, to the extent of accumulated profits.
- **Loans and advances to beneficial shareholders (Sec 2(22)(e)):** This is particularly important. If a closely held company grants a loan or advance to a shareholder who has a substantial interest in the company (holding 10% or more of the equity capital), this loan or advance is treated as a deemed dividend, up to the limit of the company's accumulated profits. This measure ensures that funds taken out of the company by controlling shareholders are properly taxed.
- **Buy-back of Shares (Sec 2(22)(f)):** The tax treatment of amounts received by a shareholder when a company buys back its own shares has seen a legislative shift.
 - **On or after October 1, 2024:** The amount received by the shareholder is treated as a **deemed dividend** and is taxed in the hands of the shareholder at their normal applicable slab rates. Under this new regime, the company is exempt from paying tax on the buy-back transaction. This change aligns the tax treatment of profit extraction through buy-backs with the taxation of regular dividends in the hands of the recipient.

9.3.2 Casual Income (Winnings) and Special Tax Rate (Section 115BB)

Definition and Tax Rate

Casual income refers to unexpected, non-recurring gains such as winnings from lotteries, card games, crossword puzzles, betting, gambling, and horse races. The Income Tax Act mandates a special taxation regime for casual income under Section 115BB. This income is taxed at a compulsory flat rate of 30%. After including the Health and Education Cess (currently 4%), the total effective tax rate is 31.2%. This high, flat rate is applied uniformly to all winners, regardless of their total income, basic exemption limit, or residential status. This provision reflects a governmental stance to maximize revenue from speculative activities while simultaneously discouraging tax planning related to such gains.

Restrictions on Casual Income

The tax law applies extremely strict conditions to casual income, reinforcing the high tax rate:

- 1) **No Deductions:** No expenses, allowances, or deductions whatsoever are permitted against casual income. For instance, the cost incurred to purchase a lottery ticket cannot be deducted from the prize money won. The gross winning amount is fully taxable.
- 2) **No Set-off of Losses:** Losses arising from casual activities (such as losing money in a card game or betting) cannot be adjusted or set off against any other income, including casual income from a different source.

TDS Provisions (Sec 194B and 194BA)

Tax Deducted at Source (TDS) is mandatory on casual income if the winning amount exceeds ₹10,000. The organization distributing the prize is responsible for deducting the tax at the rate of 30% (31.2% effective) before the payment is made. This applies whether the winnings are in cash or in kind. Section 194BA, introduced by the Finance Act 2023, specifically addresses TDS on winnings from online gaming, ensuring that these sources are also subject to the mandatory 31.2% deduction if they exceed the threshold.

9.3.3 Grossing Up of Casual Income

The concept of 'Grossing Up' is essential when the winnings are received wholly or partly in kind (i.e., non-cash prizes like a car, appliance, or property). The tax must be paid on the *full* market value of the prize. If the distributor of the prize ensures that the winner receives the prize free of tax—meaning the distributor pays the tax liability on behalf of the winner—that tax payment itself is considered an additional financial benefit to the winner, and thus constitutes part of the taxable winning amount. The process of grossing up determines the total taxable value, G, based on the net value of the prize received, N, assuming the tax rate, T, is 31.2%.

$$G = N \times [100 / (100 - T)]$$

If a winner receives a car worth ₹6,88,000 net, and the organizer paid the 31.2% tax, the ₹6,88,000 represents only 68.8% of the total taxable prize value. The total taxable winning (G) must be calculated such that 31.2% of G equals the tax paid by the organizer. This procedure ensures the government receives tax on the entire economic benefit provided to the winner, including the benefit of having the tax paid by the prize giver.

9.4 TAXABILITY OF GIFTS (SECTION 56(2)(X))

Section 56(2)(x) addresses the receipt of money, immovable property, or specified movable property without consideration, or for inadequate consideration. This measure was introduced to prevent tax avoidance by treating gifts, especially those involving high-value assets, as income if received from non-relatives. This section applies to individuals, Hindu Undivided Families (HUFs), and firms.

9.4.1 The ₹50,000 Threshold

Taxability is determined by an aggregate threshold limit of ₹50,000 received during a financial year from non-relatives:

- **Exemption:** If the total value or aggregate value of all such receipts during the financial year is **₹50,000 or less**, the receipt is entirely exempt from tax.
- **Taxation:** If the total value or aggregate value of all such receipts exceeds ₹50,000, the entire amount/value of the receipt is taxable as Income from Other Sources.

9.4.2 Types of Receipts Covered

The section specifically covers three categories of receipts received without consideration:

- 1) **Monetary Gifts:** If the aggregate sum of money (cash, cheque, or bank transfer) received without consideration exceeds ₹50,000, the entire aggregate amount is taxable.
- 2) **Immovable Property:** If immovable property (e.g., land or building) is received without consideration, and its Stamp Duty Value (SDV) exceeds ₹50,000, the entire SDV is taxable.
- 3) **Specified Movable Property:** This includes shares and securities, jewellery, archaeological collections, drawings, paintings, sculptures, or works of art. If such property is received without consideration and its Fair Market Value (FMV) exceeds ₹50,000, the entire FMV is taxable.

Table 9.1: Taxability of Gifts from Non-Relatives (Section 56(2)(x))

Type of Receipt	Valuation Method	Taxation Rule
Monetary Gifts (Cash/Bank Transfer)	Actual Amount	If aggregate exceeds ₹50,000, the entire amount is taxable.
Immovable Property (e.g., Land/Building)	Stamp Duty Value (SDV)	If SDV exceeds ₹50,000, the entire SDV is taxable.
Specified Movable Property (e.g., Shares, Jewellery)	Fair Market Value (FMV)	If FMV exceeds ₹50,000, the entire FMV is taxable.

9.4.3 Exempt Receipts (Exclusions)

Crucially, Section 56(2)(x) provides specific exemptions, meaning certain gifts are completely non-taxable, regardless of the value involved:

- 1) **Gifts from a Relative:** Any gift received from a person defined as a 'Relative' of the individual is fully exempt. This is the most common exemption.
- 2) **On the Occasion of Marriage:** Gifts received by an individual on the occasion of their own marriage are exempt.
- 3) **Inheritance:** Gifts received by way of inheritance or under a will.
- 4) **Death Contemplation:** Gifts received in contemplation of the death of the donor.
- 5) **HUF Member:** Gifts received by an HUF from any of its members.
- 6) **COVID-19 Relief:** Amounts received for COVID-19 medical treatment are tax-free. Furthermore, money received by family members upon the death of a breadwinner due to COVID-19 is exempt (up to ₹10 lakh if received from any person other than the employer).

The definition of a Relative is legally specific and includes the spouse, siblings (of the individual, the spouse, or either of the parents), lineal ascendants or descendants of the individual or the spouse, and the spouse of any of these specified siblings or lineal family members. Gifts received from friends, non-specified cousins, or unrelated colleagues fall outside this exempt category and are subject to the ₹50,000 threshold.

9.5. INTEREST AND OTHER RESIDUAL INCOMES

9.5.1 Interest Income

Interest represents passive earnings from various investments and instruments. Unless the income is classified as business income (e.g., a bank earning interest is PGBP), it is categorized under IFOS:

- **Interest on Securities and Deposits:** Interest earned from bank fixed deposits (FDs), recurring deposits, corporate bonds, debentures, loans advanced to others, and deposited insurance dividends are all taxable under IFOS.
- **Interest on Enhanced Compensation (Sec 56(2)(viii)):** Any interest received on delayed payment or enhanced compensation, often awarded by courts or tribunals for compulsory land acquisition, is specifically charged to tax under IFOS. This interest has a unique tax treatment regarding deductions.

9.5.2 Income from Letting of Assets (P&M, Furniture)

Income generated from leasing or renting out machinery, plant, or furniture is taxable under IFOS, provided that the activity is not carried on as a business or profession by the assessee. The distinction between IFOS and PGBP in this context hinges entirely on the assessee's intention and activity scale. If the assessee's intention is simply to derive passive rental income from assets not actively used in a regular business, it falls under IFOS. If the assessee establishes a systematic, organized, and sustained commercial activity of leasing assets, it would be PGBP.

9.5.3 Composite Rent and Separability

When a building is let out along with machinery, plant, or furniture (a composite letting), the tax treatment depends on whether the two lettings are separable:

- **Inseparable Letting:** If the letting of the building is so intrinsically linked with the letting of the assets that the building cannot be let out profitably without the assets, the entire composite rent (including the rent component for the building) is taxed wholly under IFOS. This approach is taken because the entire transaction is viewed as a unified commercial activity, residuary in nature.
- **Separable Letting:** If the assets and the building could be let out independently, the rent attributable to the building is taxed under the head 'Income from House Property', while the rent attributable to the machinery, plant, or furniture is taxed under IFOS (or PGBP, depending on the nature of the activity).

9.6. OTHER INCOMES

- **Family Pension:** When an employee dies, the regular pension received by their legal heir (spouse, dependent children, etc.) is termed a family pension. This is mandatorily taxable under IFOS. However, the law provides a specific standard deduction against this income (see Section 4.6.2).

- **Keyman Insurance Policy:** Any sum received under a Keyman Insurance Policy (including bonuses) is taxable under IFOS, unless the amount is already chargeable as 'Salaries' or 'PGBP'.
- **Un-deposited Employee Contributions:** If an employer receives contributions from employees towards welfare funds like the Provident Fund (PF), Employees' State Insurance (ESI), or Superannuation Fund, and fails to deposit these amounts into the relevant fund by the specified due date, the un-deposited amount becomes taxable as the employer's income under IFOS.

9.7. DEDUCTIONS ALLOWED FROM IFOS (SECTION 57)

Unlike the heads PGBP or Salaries, where deductions are broadly allowed for expenses incurred for earning the income, deductions under IFOS are highly specific and restricted. Section 57 permits deductions only for expenses that strictly adhere to statutory requirements.

9.7.1 General Principle (Section 57(iii))

This provision allows the deduction of any expenditure (not being capital or personal expenditure) if it is laid out or expended wholly and exclusively for the purpose of earning the income chargeable under IFOS. This means the expense must have a direct and immediate nexus with the income being generated. For example, commission paid to an agent for collecting interest or legal fees incurred solely to recover overdue interest income would generally qualify. For income derived from letting out machinery, plant, or furniture (taxed under IFOS), specific expenses are allowed, including current repairs, insurance premiums paid, and depreciation of the assets.

9.7.2 Standard Deduction on Family Pension

Family pension is a taxable item under IFOS, but the law provides significant relief through a standard deduction. This deduction is automatic and does not require the assessee to prove specific expenses. The deductible amount is the lower of the following two figures:

- 1) One-third ($\frac{1}{3}$) of the family pension received, OR
- 2) ₹15,000.

This fixed statutory deduction acknowledges the purpose of family pension as support for dependents, providing automatic financial relief. If an individual receives ₹1,80,000 annually as family pension, the deduction is limited to ₹15,000, making ₹1,65,000 the taxable amount.

9.7.3 Specific Deduction for Interest on Enhanced Compensation

Interest received on enhanced compensation is mandatorily taxed under IFOS. However, the Act provides a mandatory deduction of 50% of such interest received. This deduction is granted regardless of any actual expenses incurred by the assessee to secure the compensation or interest. Importantly, because this specific statutory deduction exists, no other expenses (like legal fees) incurred to earn this interest are permitted under Section 57(iii). This simplifies computation but strictly limits relief to the statutory 50%.

9.8. AMOUNTS NOT DEDUCTIBLE (SECTION 58)

Section 58 explicitly lists certain expenses that are strictly disallowed while computing income under this head, even if they appear to satisfy the general condition of being incurred for earning income.

- 1) **Expenses related to Casual Income:** No expense relating to winning lotteries, gambling, betting, or crosswords is ever deductible. This is the primary reason why the gross winning amount is taxed at the flat rate.
- 2) **Personal Expenses:** Any expense that is personal in nature to the assessee is disallowed.
- 3) **Capital Expenditure:** Expenditures of a capital nature are disallowed, as only revenue expenses are generally considered for deductions.
- 4) **Disallowed Interest/Salaries:** Payments made outside India on which tax has not been deducted or paid, such as interest or salary, are also disallowed.

9.9. COMPUTATION OF INCOME FROM OTHER SOURCES

The computation of net income under IFOS requires careful segregation of incomes subject to normal slab rates from those subject to the special flat rate (casual income).

Steps for Computation:

- 1) **Identify Gross IFOS:** List and aggregate all items of income chargeable under Section 56(1) and 56(2).
- 2) **Segregate Casual Income:** Separate all winnings from lotteries, races, etc. This income is always taxed on a gross basis at 31.2% and is not subject to the deductions listed below.
- 3) **Apply Specific Deductions (Sec 57):**
 - Subtract the standard deduction for family pension (Lower of 1/3 or ₹15,000).
 - Subtract the mandatory 50% deduction on interest on enhanced compensation.
 - Subtract interest expenditure on dividend income (limited to 20% of the dividend).
- 4) **Apply General Deductions (Sec 57(iii)):** Deduct other eligible expenses (like collection charges, repairs, insurance, or depreciation on assets let out) that satisfy the 'wholly and exclusively' condition.
- 5) **Calculate Net IFOS (Normal Rates):** The result is the net income from other sources (excluding casual income), which is added to the Gross Total Income (GTI) for taxation at slab rates.
- 6) **Tax Casual Income Separately:** The gross casual income amount is taxed at the flat rate of 31.2%.

9.10 ILLUSTRATIVE EXAMPLES / APPLICATIONS

To solidify the understanding of IFOS provisions, we analyze several practical scenarios, starting with taxation rules for passive income, gifts, and special income treatment.

9.10.1 Real-Life Illustration 1: Taxation of Gifts vs. Relatives

Mr. Vikram, an individual assessee, received the following amounts and properties during the financial year:

- 1) **Gift A:** ₹40,000 cash from his younger brother (A specified relative).
- 2) **Gift B:** ₹60,000 cash from his business partner (Not a relative).
- 3) **Gift C:** Shares valued at ₹30,000 from his wife's sister (A specified relative).
- 4) **Gift D:** A painting from a friend (Not a relative) with a Fair Market Value (FMV) of ₹25,000.

Analysis of Taxability under Section 56(2)(x):

Gift	Value (₹)	Donor Status	Threshold Check	Taxability under IFOS
A (Brother)	40,000	Relative	N/A	Exempt. Gifts from relatives are fully exempt regardless of value.
C (Wife's Sister)	30,000	Relative	N/A	Exempt. A spouse's sibling qualifies as a relative.
B (Partner)	60,000	Non-Relative	Aggregate non-relative gifts: ₹60,000 + ₹25,000 = ₹85,000	Taxable. Monetary gift exceeds ₹50,000 threshold. Entire ₹60,000 is taxed.
D (Friend)	25,000	Non-Relative	Aggregate non-relative gifts: ₹85,000	Taxable. Although this gift alone is below ₹50,000, the aggregate value of gifts from non-relatives (₹85,000) crosses the ₹50,000 limit. Entire ₹25,000 is taxed.

The total taxable income from gifts for Mr. Vikram is ₹60,000 + ₹25,000 = ₹85,000. The key rule is that once the ₹50,000 limit is crossed for non-relative gifts, the entire sum is brought under the tax net.

9.10.2 Real-Life Illustration 2: Taxability of Enhanced Compensation Interest

Ms. Kavita received ₹2,50,000 during the financial year as interest on enhanced compensation awarded for land acquired by the government. She spent ₹15,000 on legal fees and documentation required to secure this delayed payment.

Computation of Taxable IFOS from Enhanced Compensation:

Particulars	Amount (₹)	Notes
Gross Interest on Enhanced Compensation Received	2,50,000	(Taxable under IFOS)
Less: Statutory Deduction (Sec	1,25,000	Mandatory deduction of 50% of

57(iv))		the gross amount .
Less: Legal Fees Incurred (₹15,000)	Nil	Actual expenses are disallowed as the mandatory 50% deduction is statutory and exclusive.
Taxable Income under IFOS	1,25,000	(This net amount is taxed at slab rates)

9.10.3 Numerical Example 3: Comprehensive Computation of Net Taxable IFOS

Mr. Anil furnishes the following data for the financial year (Assessment Year relevant):

- 1) Interest on Fixed Deposits (FDs): ₹50,000.
- 2) Winnings from a card game (Net received after TDS): ₹34,400.
- 3) Family Pension: ₹1,08,000 per annum.
- 4) Commission paid to the bank for managing his FD accounts: ₹1,000.
- 5) Loss incurred on purchasing lottery tickets: ₹5,000.

Computation of Taxable IFOS for Mr. Anil:

Particulars	Calculation	Amount (₹)
I. Income Taxable at Normal Rates		
Interest on FDs (Gross)		50,000
Family Pension (Gross)		1,08,000
Less: Deductions (Section 57)		
1. Standard Deduction on Family Pension	Lower of: (1/3rd of 1,08,000 = 36,000) OR ₹15,000. Lower is ₹15,000.	(15,000)
2. Commission Paid (Sec 57(iii))	Wholly and exclusively incurred for earning FD interest	(1,000)
Net IFOS Taxable at Slab Rates (A)	$(50,000 + 1,08,000) - 16,000$	1,42,000
II. Income Taxable at Flat Rate (31.2%)		
Net Card Game Winnings (after 31.2% TDS)	34,400	
Gross Casual Income (B) (Taxable on gross amount)	Grossing Up: $34,400 \times [100 / (100 - 31.2)] = 50,000$	50,000
Less: Loss on Lottery Tickets	Disallowed under Section 58.	Nil
Total Income from Other Sources (A + B)	$1,42,000 + 50,000$	1,92,000

The computation correctly separates the income streams. The ₹1,42,000 is added to Mr. Anil's Gross Total Income and taxed at the progressive slab rates. The ₹50,000 of casual income is taxed separately at the fixed rate of 31.2%. This mandatory segregation is crucial for compliance.



Check Your Progress – A

1. What is the statutory charging section for Income from Other Sources (IFOS)?

2. State the effective tax rate applicable to lottery winnings in India.

3. Define 'Deemed Dividend' as per the Income Tax Act, 1961, and provide one example relating to closely held companies.

9.11 SUMMARY

Income from Other Sources (IFOS), governed mainly by Sections 56, 57, and 58 of the Income Tax Act, 1961, is the residuary head of income. It brings to tax all incomes that are not exempt and do not fall under the four specific heads—Salaries, House Property, Business/Profession, or Capital Gains. Section 56 establishes the principle of chargeability, covering both general residual incomes and specific incomes mandatorily taxable under this head. Key items taxable under IFOS include dividends, deemed dividends (especially loans or advances by closely held companies to substantial shareholders), casual incomes such as lottery and betting winnings (taxed at a flat 30% plus cess), family pension, interest income, Keyman insurance receipts, and income from letting out machinery, plant, or furniture where it is not a business activity. The unit also explains the revised taxation of share buy-backs and the concept of grossing up for prizes received in kind. Section 56(2)(x) governs the taxability of gifts, taxing gifts from non-relatives if their aggregate value exceeds ₹50,000, while providing clear exemptions for gifts from relatives, on marriage, inheritance, and specified COVID-19 reliefs. Deductions under IFOS are strictly limited under Section 57, such as the standard deduction for family pension and a capped deduction for interest on dividends, while Section 58 expressly disallows expenses related to casual income. The unit provides a structured method for accurate computation and compliance.



9.12 GLOSSARY

- **Residuary Head (IFOS):** The final head of income that captures all taxable receipts not chargeable under the first four heads.
- **Section 56:** The statutory charging section for Income from Other Sources.
- **Deemed Dividend (Section 2(22)):** Distributions by companies, particularly loans to major shareholders, treated as dividends for tax purposes.
- **Casual Income:** Unexpected, non-recurring gains from activities like lotteries, card games, or gambling.
- **Section 115BB:** The section prescribing the flat tax rate (30%) applicable to casual income.
- **Grossing Up:** The process of calculating the total taxable value of a prize (often in kind) when the tax liability is paid by the distributor, ensuring tax is paid on the full economic benefit.
- **Stamp Duty Value (SDV):** The official value assigned to immovable property by registration authorities, used for taxing gifts of property.
- **Fair Market Value (FMV):** The estimated price a movable asset would fetch in the open market, used for taxing gifts of movable property.
- **Relative (for Gift Tax):** A statutorily defined group of family members (including lineal ascendants/descendants and specific siblings) from whom gifts are exempt.
- **Family Pension:** Pension received by the legal heirs of a deceased employee, taxable under IFOS.
- **Wholly and Exclusively:** The condition for general deductions under Section 57(iii), meaning the expense must be incurred entirely for earning the IFOS income.
- **Composite Rent:** Rent received for letting out a building along with machinery or furniture.
- **Interest on Enhanced Compensation:** Interest received on delayed payments for compulsory land acquisition, 50% of which is deductible.
- **Section 57:** The section outlining the specific and general deductions allowable from IFOS.
- **Section 58:** The section detailing specific expenses that are disallowed from IFOS (e.g., expenses on casual income).
- **Section 194B/194BA:** Sections dealing with the mandatory Tax Deduction at Source (TDS) on casual winnings.



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9.15 SUGGESTED READINGS

- Singhania, V., & Singhania, M. (Current Edition). *Students Guide to Income Tax*. Taxmann Publications.
- Ahuja, G., & Gupta, R. (Current Edition). *Systematic Approach to Income Tax and GST*. Bharat Law House.
- Lal, B. B., & Vashisht, N. (Current Edition). *Direct Taxes*. Pearson Education.
- The Income Tax Act, 1961 and Income Tax Rules, 1962 (Specifically Sections 56, 57, 58, 2(22), 115BB, and relevant Finance Acts).
- ClearTax.in and Income Tax Department (Official Portal) for authoritative guidance and current circulars.



9.16 TERMINAL QUESTIONS

1. Explain the concept of *Income from Other Sources* as a residuary head under Section 56 of the Income Tax Act, 1961.
2. Distinguish between general income and specific income taxable under IFOS with suitable examples.
3. Discuss the taxability of dividend income after the abolition of Dividend Distribution Tax (DDT).
4. Explain the concept of Deemed Dividend under Section 2(22), highlighting loans and advances by closely held companies.
5. Describe the tax treatment of buy-back of shares in the hands of shareholders after 1 October 2024.
6. What is casual income? Explain its special rate of taxation under Section 115BB and related restrictions.
7. Explain the concept of grossing up of winnings received partly or wholly in kind, with an illustration.
8. Discuss the provisions of Section 56(2)(x) relating to taxability of gifts, including the ₹50,000 threshold.
9. Enumerate the categories of gifts that are fully exempt from tax under IFOS.
10. Explain the tax treatment of interest income, including interest on enhanced compensation.
11. Distinguish between separable and inseparable composite letting and their tax implications.
12. Discuss the taxability of family pension and the standard deduction available under

Section 57.

13. Explain the scope of deductions allowed under Section 57, stating the “wholly and exclusively” condition.
14. List and explain the expenses expressly disallowed under Section 58.
15. Describe the step-by-step procedure for computing Income from Other Sources for an individual assessee.
16. Mr. A received an annual family pension of ₹1,65,000. Calculate the taxable amount under IFOS.
 - *Hint:* Deduction is lower of ₹15,000 or $\frac{1}{3} \times ₹1,65,000 = ₹55,000$. Taxable amount: ₹1,65,000 - ₹15,000.
17. Ms. B received ₹80,000 as interest on enhanced compensation for her land. She spent ₹5,000 on legal fees to recover this amount. Compute her taxable income from this source.
 - *Hint:* 50% mandatory deduction (Sec 57(iv)). Legal fees are disallowed.
18. Mr. C, a businessman, received the following non-recurring receipts during the year:
(i) Cash gift from mother's brother (uncle): ₹75,000. (ii) Movable property (painting) from a colleague (FMV): ₹55,000. (iii) Cash prize from a government sports contest: ₹8,000. Compute the total income taxable under IFOS.
 - *Hint:* Uncle is a relative. Colleague gift exceeds ₹50,000. Cash prize is casual income.
19. Mr. D won a car in a quiz show contest. The fair market value of the car is ₹6,88,000. The show organizer pays the required TDS on behalf of Mr. D. Calculate the gross taxable winning amount under IFOS.
 - *Hint:* Gross Income = ₹6,88,000 x $\left[\frac{100}{100 - 31.2} \right]$.
20. Mrs. E has the following income: (i) Bank FD interest: ₹60,000. (ii) Dividend income: ₹1,50,000. (iii) Interest paid on loan taken to buy FD: ₹10,000. (iv) Commission paid to collect dividends: ₹5,000. Compute the net taxable income under IFOS.
 - *Hint:* Interest against dividends is limited to 20% of dividend. Commission is fully deductible if wholly and exclusively for earning income, but interest on loan for FD is fully deductible. Recalculate based on Section 57(iii) applicability. (Note: The ₹5,000 commission is likely deductible if it relates to earning the income, as it is a general expense, unlike interest on loan for shares which is specifically capped.) Net IFOS: ₹60,000 + ₹1,50,000 - ₹10,000 - ₹5,000 = ₹1,95,000. (Assuming ₹10,000 and ₹5,000 satisfy Sec 57(iii) and are not interest against dividend).

Block 3

UNIT-10

DEDUCTIONS FROM GROSS TOTAL INCOME

Contents

10.1 Introduction

10.2 The Foundation: From Gross Total Income (GTI) to Total Income (TI)

10.3 Encouraging Savings and Investment (80C, 80CCC, 80CCD)

10.4 Promoting Health and Welfare (80D, 80DD, 80DDB, 80U)

10.5 Education, Housing, and Green Incentives (80E, 80EEA, 80EEB)

10.6 Rent and Savings Interest Deductions (80GG, 80TTA, 80TTB)

10.7 Social Contributions: Donations (80G)

10.8 Illustrative Examples / Applications

10.9 Summary

10.10 Glossary

10.11 References/ Bibliography

10.12 Suggested Readings

10.13 Terminal Questions

Learning Objectives

Upon completing this unit, the learner should be able to:

- ✓ Define and differentiate precisely between Gross Total Income (GTI) and Total Income (Taxable Income) and list the general restrictions governing Chapter VI-A deductions.
- ✓ Analyze the synergistic and restrictive effects of Sections 80C, 80CCC, and 80CCD(1), and explain the separate, additive benefit provided by 80CCD(1B).
- ✓ Explain the tiered deduction framework for health insurance premiums (80D) and medical expenses related to disabilities (80DD, 80DDB, 80U) based on the age of the individual or the severity of the ailment.
- ✓ Apply the specific conditions, eligibility criteria, and maximum duration limits for claiming interest paid on education loans (80E).
- ✓ Calculate the deduction available for rent paid when House Rent Allowance (HRA) is not received, utilizing the statutory 'least of three' rule under Section 80GG.
- ✓ Evaluate the limits and categories, including the role of Adjusted Gross Total Income (AGTI), for claiming deductions on charitable donations under Section 80G.
- ✓ Differentiate between the tax benefits available for interest on bank deposits for regular

individuals (80TTA) versus senior citizens (80TTB) and justify the policy reasons for the difference.

- ✓ Synthesize deductions from multiple sections (80C, 80D, 80E, etc.) to correctly compute the final Total Income (Taxable Income).

10.1 INTRODUCTION

Previous units have focused on calculating *how much* income you earned under the various heads. This unit focuses on the critical next step: reducing your taxable liability. This reduction is achieved through legally permissible subtractions known as deductions, which are primarily contained in Chapter VI-A of the Income Tax Act, 1961. The income tax computation process begins by aggregating all five heads of income—Income from Salary, Income from House Property, Profits and Gains of Business or Profession, Capital Gains, and Income from Other Sources—to arrive at the Gross Total Income (GTI). Chapter VI-A deductions are then reduced from this GTI. The remaining figure is the Total Income (or Taxable Income), which is the final amount upon which your tax liability is calculated based on the prevailing tax slabs.

Relevance in Managerial and Financial Decision-Making

For learners, mastering these deductions is crucial because it transforms tax compliance into strategic financial planning. This knowledge enables future managers and financial professionals to optimize their own finances and those of their organizations.

- 1) **Investment Strategy:** Deductions like Section 80C are powerful tools that incentivize specific long-term savings instruments (such as Public Provident Fund or Equity-Linked Savings Schemes). A deep understanding of the deduction limits guides individuals in prioritizing investment vehicles that offer both financial growth and immediate tax benefits. Managers, especially in the context of Human Resources or Treasury, utilize this knowledge to channel surplus funds efficiently.
- 2) **Compensation Structuring (CTC):** Sections like 80CCD(2) allow employers to incorporate tax-efficient components into the Cost-to-Company (CTC) structure. By facilitating employer contributions to the National Pension System (NPS), companies can offer substantial retirement benefits that are tax-deductible for the employee, thereby maximizing the net-take-home salary and enhancing employee satisfaction and retention without raising the overall cost to the company.
- 3) **Policy Compliance and Capital Expenditure:** Recognizing time-bound, policy-driven incentives (such as deductions for affordable housing or electric vehicle loans under Sections 80EEA and 80EEB) allows individuals and businesses to make timely capital expenditure decisions. These sections demonstrate how the Income Tax Act is used as a fiscal instrument to drive investment in favored sectors, such as green energy adoption and infrastructure growth.

Crucial Context: The Tax Regime Choice: It is vital to note that the vast majority of deductions discussed in this unit are only available if the taxpayer opts for the Old Tax Regime.

If a taxpayer chooses the default New Tax Regime (introduced under Section 115BAC), they generally forego most of these benefits in exchange for potentially lower slab rates. Consequently, effective tax planning starts with evaluating the specific deductions available under Chapter VI-A against the lower rates of the New Tax Regime to determine the most beneficial option.

10.2 THE FOUNDATION: FROM GROSS TOTAL INCOME (GTI) TO TOTAL INCOME (TI)

10.2.1 Gross Total Income (GTI) Defined

Gross Total Income (GTI) represents the total aggregate earnings of an assessee (typically an individual or a Hindu Undivided Family) during the financial year, calculated by summing up the net income under all five mandated heads of income :

- 1) Income from Salaries
- 2) Income from House Property
- 3) Profits and Gains of Business or Profession
- 4) Capital Gains
- 5) Income from Other Sources

The computation of GTI includes specific adjustments, such as adding any income subject to the 'clubbing' provisions (where the income of another person is treated as the taxpayer's income) and subtracting any legally permissible set-off of losses. Importantly, GTI is the starting point for Chapter VI-A; it is calculated *before* any deductions under Sections 80C to 80U are applied.

10.2.2 Total Income (TI) and Chapter VI-A

Total Income (TI), often interchangeably referred to as Taxable Income, is the final figure on which the tax is calculated at the applicable slab rates. This amount is derived after reducing the eligible deductions claimed under Chapter VI-A from the GTI.

The mathematical relationship is defined as:

$$\text{Total Income} = \text{Gross Total Income} - \text{Deductions under Chapter VI-A}$$

While GTI shows the magnitude of total earnings, TI indicates the true tax base, highlighting the effectiveness of tax planning efforts through eligible investments and expenditures.⁴

Table 10.1: Comparison of Gross Total Income (GTI) and Total Income (TI)

Feature	Gross Total Income (GTI)	Total Income (TI) / Taxable Income
Calculation Base	Aggregate of income under all five heads, after set-off/ clubbing, but before Chapter VI-A deductions.	Income remaining after subtracting eligible Chapter VI-A deductions (80C to 80U) from GTI.

Deductions Applied	No deductions allowed under Sections 80C to 80U.	Tax is levied based on this final amount.
Purpose	Base figure for determining monetary limits for deductions (e.g., 80G, 80GG).	The ultimate taxable figure used for calculating income tax liability.

10.2.3 General Rules and Restrictions on Chapter VI-A Deductions

Before reviewing specific sections, it is crucial to understand the rules governing all deductions in this chapter:

- 1) **Restriction to Gross Total Income (GTI):** The total sum of deductions claimed under Chapter VI-A (80C to 80U) cannot, under any circumstances, exceed the Gross Total Income of the taxpayer. If the eligible deductions exceed the GTI, the deduction is limited to the GTI, resulting in a zero Total Income.
- 2) **Exclusion of Special Incomes:** Deductions under Chapter VI-A are generally not permitted against certain categories of income that are taxed at special, fixed rates. Key examples include Long-Term Capital Gains (LTCG), Short-Term Capital Gains taxed under Section 111A, and winnings from lotteries or games.
- 3) **Documentation Requirement:** Claiming deductions is subject to mandatory documentary proof. Taxpayers must maintain receipts for investments (PPF, ELSS), premium payments (80D), interest certificates (80E), and official donation receipts (80G) to substantiate their claims during scrutiny or verification.
- 4) **Old Regime Applicability:** It must be reiterated that most deductions under Chapter VI-A are available only if the taxpayer chooses the Old Tax Regime.

10.3 ENCOURAGING SAVINGS AND INVESTMENT (80C, 80CCC, 80CCD)

These interlinked sections form the cornerstone of personal tax planning, designed by the legislature to encourage disciplined savings and long-term financial planning, particularly for retirement.

10.3.1 Section 80C: Investments and Expenses

Section 80C is the most frequently claimed deduction, available exclusively to resident individuals and Hindu Undivided Families (HUFs).

- **Maximum Limit:** The ceiling for the deduction allowed under this section is ₹1,50,000.
- **Eligible Investments and Payments:** The scope of 80C is broad, covering investments that serve multiple life goals, including retirement, housing, and children's education. Key eligible items include :
 - 1) **Insurance:** Premium paid for life insurance policies covering the life of the taxpayer, their spouse, or dependent children.
 - 2) **Mandatory Savings:** Contributions to recognized funds such as Statutory Provident Fund (SPF), Recognized Provident Fund (RPF), or Public Provident Fund (PPF).
 - 3) **Government Schemes:** Investments in National Savings Certificates (NSC),

- Sukanya Samriddhi Yojana (SSY), and the Senior Citizen Savings Scheme (SCSS).
- 4) **Market-Linked Investments:** Contributions to Equity-Linked Savings Schemes (ELSS), which offer deduction alongside market returns.
 - 5) **Bank Deposits:** Contributions to 5-year tax-saver Fixed Deposits (FDs) with banks or post offices.
 - 6) **Housing:** Repayment of the principal amount of a housing loan.
 - 7) **Education:** Payment of tuition fees (excluding development fees or donation) for the full-time education of any two children.

10.3.2 Section 80CCC and 80CCD(1): Pension Schemes

These sections focus on specific retirement contributions, falling within the same aggregate limit as 80C:

- **Section 80CCC (Annuity Plans):** Allows deduction for contributions made towards certain pension or annuity funds offered by insurance companies.
- **Section 80CCD(1) (NPS - Employee):** Allows deduction for the individual's contribution (employee or self-employed) to the National Pension System (NPS). The deductible amount is limited to 10% of the salary (Basic + Dearness Allowance) for salaried individuals, or 20% of the Gross Total Income for self-employed individuals.

10.3.3 Section 80CCE: The Aggregate Cap

Section 80CCE acts as the controlling limit for the primary tax savings bucket. It specifies that the total combined deduction claimed under 80C + 80CCC + 80CCD(1) cannot exceed ₹1,50,000.

This interlocking limit forces taxpayers to prioritize their investments. For instance, if a taxpayer claims ₹1,00,000 under 80C and ₹75,000 under 80CCD(1) (totaling ₹1,75,000), the actual deduction allowed is capped at the maximum limit of ₹1,50,000. This mechanism ensures that government relief for general savings and basic retirement planning remains confined to a predefined ceiling, preventing excessive tax erosion from these common investment avenues.

10.3.4 The Extended NPS Benefits (80CCD(1B) and 80CCD(2))

The National Pension System (NPS) offers two additional avenues for deduction that extend beyond the standard ₹1.5 lakh ceiling, signaling a strong governmental push towards long-term retirement security.

- 1) **Section 80CCD(1B) – Additional Self Contribution:** This powerful provision permits an **additional deduction of up to ₹50,000** for voluntary contributions made by the individual (self-contribution) to their Tier I NPS account.
 - **Significance:** This deduction is claimed over and above the ₹1,50,000 limit set by 80CCE. By combining 80CCE and 80CCD(1B), a proactive taxpayer can potentially reduce their taxable income by up to ₹2,00,000 through savings for retirement and other investments. This benefit is available to both salaried and self-employed individuals.

- 2) **Section 80CCD(2) – Employer Contribution:** This section is particularly significant for salaried individuals and companies, as it deals with the deduction for contributions made by the employer to the employee's NPS account.
- **Limit:** The maximum deduction is limited to 10% of the employee's salary (Basic + DA) for non-government employees, and 14% of the salary for Central/State government employees.
 - **Strategic Advantage (CTC Structuring):** The employer contribution is initially included in the employee's salary income (either as a perquisite or salary component) and is then claimed as a deduction under 80CCD(2). Crucially, this deduction is not restricted by the ₹1,50,000 limit of 80CCE, offering an uncapped avenue for tax-free retirement corpus building, subject only to the percentage of salary rule. Furthermore, 80CCD(2) is one of the few deductions retained for employees who opt for the New Tax Regime, making it a universally applicable tax-saving tool for compensation design.

Table 10.2: Consolidated Limits for Sections 80C, 80CCC, and 80CCD

Section	Eligible Contribution	Maximum Deduction Limit	Combined Limit Restriction
80C / 80CCC / 80CCD(1)	Investments, Insurance, Annuity Plans, Employee NPS Contribution (Self)	₹1,50,000	Restricted to ₹1,50,000 in aggregate under Section 80CCE.
80CCD(1B)	<i>Additional</i> Voluntary NPS Contribution (Self)	₹50,000	Over and above the ₹1,50,000 limit of 80CCE.
80CCD(2)	Employer's contribution to Employee NPS	10% (or 14% for Govt. employees) of Salary	No Monetary Limit and Not restricted by 80CCE.

10.4 PROMOTING HEALTH AND WELFARE (80D, 80DD, 80DDB, 80U)

The following sections encourage individuals to secure health insurance and provide financial relief for expenses related to chronic illnesses and disabilities.

10.4.1 Section 80D: Health Insurance and Preventive Check-ups

Section 80D provides deductions for premiums paid towards health insurance policies and expenses incurred on preventive health check-ups. The objective is to encourage adequate health coverage. Premiums must be paid via non-cash methods (e.g., cheque, digital payment), though cash payment for preventive check-ups is permitted.

- **Tiered Deduction Limits:** The maximum deduction is determined by the age of the individual being covered.
 - 1) **Group 1: Self, Spouse, and Dependent Children:** The maximum deduction allowed

- is ₹25,000. If the taxpayer or their spouse is a senior citizen (60 years or more), the limit increases to ₹50,000.
- 2) **Group 2: Parents (Additional Deduction):** An additional, separate deduction is available for health insurance premiums paid for the parents (who may or may not be financially dependent). This limit is ₹25,000 (if parents are below 60) or ₹50,000 (if parents are senior citizens).
 - 3) **Preventive Health Check-up:** An expense of up to ₹5,000 incurred on preventive health checks is also deductible. This amount is always subsumed within the overall limit of ₹25,000 or ₹50,000 applicable to the specific group (self/family or parents).
- **Maximum Potential Claim:** The maximum total deduction an individual can claim under 80D is ₹1,00,000 (₹50,000 for self/family as senior citizens + ₹50,000 for parents as senior citizens).

Table 10.3: Maximum Deduction Limits under Section 80D (Health Insurance)

Insured Group	Age Below 60 Years (Non-Senior Citizen)	Age 60 Years or More (Senior Citizen)	Maximum Combined Deduction
Self, Spouse, Children	₹25,000	₹50,000	N/A
Parents (Additional Deduction)	₹25,000	₹50,000	Up to ₹1,00,000 (If taxpayer and parents are both senior citizens).

10.4.2 Section 80DD: Dependent Disability

This section grants a fixed deduction to a resident individual or HUF who incurs expenses on the medical treatment, training, or rehabilitation of a disabled dependent.

- **Dependent Eligibility:** For an individual, this includes a spouse, children, parents, or siblings. For an HUF, it includes any member of the HUF.
- **Fixed Deduction Amount:** The benefit is a flat amount, which is not dependent on the actual, documented expenditure incurred, as long as some expenditure or an insurance premium for the dependent's care was paid. This structure simplifies the claiming process for ongoing, chronic costs.
 - **Disability (40% to 79%):** Fixed deduction of ₹75,000.
 - **Severe Disability (80% or more):** Fixed deduction of ₹1,25,000.
- **Mutual Exclusivity:** The dependent individual must not have claimed any deduction for themselves under Section 80U for the same assessment year.

10.4.3 Section 80DDB: Treatment of Specified Diseases

Section 80DDB allows a deduction for actual medical expenses incurred by the taxpayer for the treatment of certain specified diseases or ailments (such as malignant cancers, AIDS, chronic neurological diseases, etc.) for themselves or their dependents.

- **Non-Senior Citizen Limit:** ₹40,000 or the actual expenses incurred, whichever is less.
- **Senior Citizen Limit (60 years or more):** ₹1,00,000 or the actual expenses incurred, whichever is less.
- **Adjustment for Reimbursement:** A critical condition here is that if the taxpayer receives any reimbursement for these medical expenses from an insurance company or employer, the deduction claimed under 80DDB must be reduced by the amount reimbursed.

10.4.4 Section 80U: Deduction for Self-Disability

This section is designed to provide direct financial relief to resident individuals who are themselves certified as disabled by a recognized medical authority.

- **Fixed Deduction Amount:** Similar to 80DD, this is a flat, fixed deduction claimed by the individual for their *own* disability, regardless of whether they incurred specific medical expenses or not.
 - **Disability (40% or more):** Fixed deduction of ₹75,000.
 - **Severe Disability (80% or more):** Fixed deduction of ₹1,25,000.

The governmental approach in structuring medical relief is evident in the distinction between sections 80DDB (actual expenses, subject to reimbursement) and 80DD/80U (fixed deduction, irrespective of expenses). This policy difference reflects the nature of the financial burden: 80DDB addresses acute, temporary, and easily documented high-cost treatments, while the fixed benefits of 80DD and 80U acknowledge the continuous, often unquantifiable, long-term costs associated with permanent conditions, providing an assured measure of support for lifetime care and potentially reduced earning capacity.

10.5 EDUCATION, HOUSING, AND GREEN INCENTIVES (80E, 80EEA, 80EEB)

These provisions represent specific, targeted governmental incentives aimed at promoting education, affordable home ownership, and environmentally friendly choices through tax relief.

10.5.1 Section 80E: Interest on Education Loan

Section 80E provides a significant deduction aimed at encouraging access to higher education by reducing the financial burden of loan interest payments.

- **Eligibility:** Only individual taxpayers can claim this deduction, for a loan taken for their own higher education, or that of their spouse, children, or a student for whom the individual is a legal guardian.
- **Loan Source:** The loan must be secured from an approved financial institution, bank, or an approved charitable institution, not from friends or relatives.
- **The Deduction Scope:** The deduction is permitted only on the interest component of the loan repayment; the principal repayment amount is not covered under 80E (though tuition fees may qualify under 80C).
- **Monetary Limit:** There is no maximum monetary limit on the amount of interest that can

be claimed as a deduction in a financial year. The entire amount of interest paid is deductible.

- **Duration Limit:** The deduction is available for a maximum of 8 consecutive years, starting from the financial year the repayment begins, or until the interest is fully repaid, whichever occurs earlier.

10.5.2 Section 80EEA: Affordable Housing Loan Interest

This was a time-specific measure introduced to boost the affordable housing sector by providing first-time homebuyers with an additional tax incentive.

- **Deduction:** An additional deduction of up to ₹1,50,000 on interest paid on a home loan.
- **Additive Benefit:** This ₹1,50,000 is available over and above the existing ₹2,00,000 deduction allowed under Section 24(b) (for interest paid on self-occupied house property).
- **Key Conditions:** To qualify, the taxpayer must be an individual who is not eligible to claim 80EE. Critically, the loan must have been sanctioned within a specific window: between April 1, 2019, and March 31, 2022. Additionally, the stamp duty value of the property must not exceed ₹45 Lakh.

10.5.3 Section 80EEB: Electric Vehicle Loan Interest

Section 80EEB was introduced as a fiscal intervention to promote green mobility and environmental conservation by making Electric Vehicles (EVs) more affordable for individuals.

- **Deduction:** A deduction of up to ₹1,50,000 is allowed on the interest paid for a loan taken to purchase an electric vehicle.
- **Current Status (Time Constraint):** This was a temporary incentive. The loan must have been sanctioned between April 1, 2019, and March 31, 2023. If the loan was sanctioned within this specified window, the deduction continues to be available until the loan is fully repaid.

The structure of Sections 80EEA and 80EEB, with their specific sanction deadlines, demonstrates how the Income Tax Act is used for fiscal intervention to drive specific social and economic policies. By providing a fixed, high deduction, the government temporarily shifts consumer purchasing power and capital investment toward affordable housing and electric mobility, rewarding environmentally responsible choices and stimulating targeted industrial sectors.

10.6 RENT AND SAVINGS INTEREST DEDUCTIONS (80GG, 80TTA, 80TTB)

10.6.1 Section 80GG: Deduction for Rent Paid (No HRA)

Section 80GG addresses the housing costs of individuals who do not receive House Rent Allowance (HRA) as part of their salary structure, or those who are self-employed.

- **Eligibility Condition:** The taxpayer must be an individual (salaried or self-employed) and

must not have received HRA from their employer. Furthermore, neither the taxpayer, their spouse, minor child, nor the HUF (if applicable) should own any residential accommodation in the city where they live or work.

- **Calculation: The Least-of-Three Rule:** The deductible amount is the lowest of the following three figures, calculated annually:
 1. Rent Paid minus 10% of Adjusted Total Income (AGTI).
 2. Fixed limit of ₹5,000 per month (i.e., ₹60,000 per annum).
 3. 25% of Adjusted Total Income (AGTI).
- **Adjusted Total Income (AGTI) for 80GG:** The AGTI used for this calculation is the GTI minus Long-Term Capital Gains, Short-Term Capital Gains (u/s 111A), exempted income, and all deductions under Chapter VI-A, *except* for the deduction under Section 80GG itself.

10.6.2 Section 80TTA vs. 80TTB: Interest on Bank Deposits

Interest income earned from savings and fixed deposits is taxable under the head 'Income from Other Sources.' Sections 80TTA and 80TTB offer specific relief on this passive income.

- **Section 80TTA (General):** This section is applicable to general individual taxpayers (below 60 years) and HUFs.
 - **Limit:** Maximum deduction of ₹10,000.
 - **Scope:** Applies strictly only to interest earned from Savings Accounts (held with banks, post offices, or cooperative banks). Interest from Fixed Deposits (FDs) or Recurring Deposits (RDs) is not covered.
- **Section 80TTB (Senior Citizens):** This section is explicitly designed for Senior Citizens (individuals aged 60 years or more).
 - **Limit:** Higher maximum deduction of ₹50,000.
 - **Scope:** Crucially, this benefit covers interest from Savings Accounts *and* Fixed Deposits (FDs) and Recurring Deposits (RDs).
- **Mutual Exclusion:** A taxpayer can only claim the deduction under either 80TTA or 80TTB, based on their eligibility. They cannot claim both in the same financial year.

The difference in scope between 80TTA and 80TTB—specifically the inclusion of FD and RD interest under 80TTB—is a deliberate policy distinction. Older individuals often rely heavily on secure, interest-bearing deposits (FDs/RDs) as a primary source of regular income during retirement. By raising the limit to ₹50,000 and broadening the scope to include fixed deposits, the government acknowledges this dependence on passive income for livelihood and provides substantial tax relief to the elderly, whose expenses are often higher due to health needs.

10.7 SOCIAL CONTRIBUTIONS: DONATIONS (80G)

Section 80G encourages philanthropic activity by allowing deductions for monetary donations made to approved charitable institutions and specified government relief funds.

10.7.1 Key Conditions and Payment Restrictions

- **Donor Eligibility:** Deductions can be claimed by individuals, Hindu Undivided Families (HUFs), and companies.
- **Payment Method:** Only cash donations up to a maximum of ₹2,000 are eligible for deduction. Any donation amount exceeding ₹2,000 must be paid through banking channels (cheque, demand draft, UPI, or other digital payments) to qualify.
- **In-Kind Exclusion:** Contributions made in kind (such as food, clothes, or materials) are not eligible for deduction.
- **Documentation:** The taxpayer must possess an official receipt from the institution, containing its name, PAN, and the specific 80G registration number.

10.7.2 The Four Categories of 80G Deductions

The deduction percentage (100% or 50%) and the application of a ceiling limit depend entirely on the nature of the recipient organization or fund.

Table 10.3: Deduction Categories under Section 80G

Category	Deduction Percentage	Limit Application	Examples
100% Without Limit	100% of the donated amount.	No upper cap on the amount claimable.	Prime Minister's CARES Fund, National Defence Fund, National Children's Fund, Prime Minister's National Relief Fund.
50% Without Limit	50% of the donated amount.	No upper cap on the amount claimable.	Jawaharlal Nehru Memorial Fund, Prime Minister's Drought Relief Fund.
100% With Qualifying Limit	100% of the donation.	Restricted to a maximum of 10% of the Adjusted Gross Total Income (AGTI).	Donations to the Government or any approved local authority for the promotion of family planning.
50% With Qualifying Limit	50% of the donation.	Restricted to a maximum of 10% of the Adjusted Gross Total Income (AGTI).	Donations to many recognized charitable institutions that do not fall into the 'Without Limit' categories.

Calculation of Adjusted Gross Total Income (AGTI) for 80G:

For categories that are subject to a 'Qualifying Limit,' the taxpayer must first calculate the AGTI to determine the 10% ceiling.

$$\text{AGTI} = \text{GTI} - (\text{LTCG} + \text{STCG under sec. 111A} + \text{All Chapter VI-A Deductions EXCEPT 80G})$$

The government imposes the 10% AGTI restriction on the 'With Limit' categories to balance the objective of encouraging private charity with the need to protect the tax base. This mechanism ensures that the deduction claimed is proportionate to the taxpayer's capacity and prevents the possibility of using high donations to non-statutory bodies to excessively reduce taxable income.

10.8 ILLUSTRATIVE EXAMPLES / APPLICATIONS

The following examples demonstrate the practical application of the most frequently used and complex Chapter VI-A sections, highlighting their impact on final tax liability.

Illustration 1: Comprehensive Total Income Calculation (Numerical)

Scenario: Mr. Ritesh (40, salaried, opted for Old Regime) has a Gross Total Income (GTI) of ₹12,50,000 (after adjusting for standard deduction). He incurred the following eligible expenses/investments during the year:

- 1) Contribution to Public Provident Fund (80C): ₹1,00,000
- 2) Tuition Fees for children (80C): ₹40,000
- 3) Life Insurance Premium (80C): ₹20,000
- 4) Voluntary NPS contribution (80CCD(1B)): ₹50,000
- 5) Health Insurance Premium for Self & Spouse (80D): ₹20,000
- 6) Interest paid on Education Loan (80E): ₹90,000

Step-by-Step Solution:

Section	Particulars	Actual Payment (₹)	Maximum Limit (₹)	Eligible Deduction (₹)	Remarks
80C	PPF + Tuition + LIC Premium (₹1,00,000 + ₹40,000 + ₹20,000)	1,60,000	1,50,000	1,50,000	Capped by 80CCE limit.
80CCD(1B)	NPS Voluntary Contribution	50,000	50,000	50,000	Additional benefit, over and above the 80CCE cap.
80D	Health Insurance Premium (Self/Family)	20,000	25,000	20,000	Within the limit of ₹25,000 for non-senior citizens.
80E	Education Loan Interest	90,000	No Limit	90,000	Fully allowed, as there is no monetary ceiling.
Total Deductions		3,20,000		3,10,000	Sum of all eligible amounts.

Final Calculation:

Description	Amount (₹)
Gross Total Income (GTI)	12,50,000
Less: Total Chapter VI-A Deductions	(3,10,000)
Total Income (Taxable Income)	9,40,000

By strategically utilizing these tax provisions, Mr. Ritesh reduces his taxable income from ₹12,50,000 to ₹9,40,000, leading to substantial tax savings.

Illustration 2: Managerial Application: Tax-Efficient CTC Structuring (80CCD(2))

Scenario: Ms. Geetha works for a large private firm. Her Basic Salary + Dearness Allowance (DA) is ₹15,00,000 per annum. Her employer (TechCorp) contributes 10% of her salary towards her NPS Tier I account.

Application of 80CCD(2):

- 1) **Maximum Deductible Employer Contribution:** 10% of ₹15,00,000 = ₹1,50,000.
- 2) **Tax Impact:** TechCorp contributes ₹1,50,000 to Ms. Geetha's NPS. This amount is first added to her salary income.
- 3) **Deduction Claim:** Ms. Geetha claims the entire ₹1,50,000 as a deduction under Section 80CCD(2), as it is within the 10% limit.

Resulting Benefit: The employer contribution is effectively tax-neutral for the employee (added as income, deducted immediately under 80CCD(2)). This means Ms. Geetha receives a retirement benefit of ₹1,50,000, which is outside the ₹1.5 lakh limit of 80CCE. This compensation structure allows her employer to enhance her retirement corpus significantly without imposing any immediate tax burden on her, showcasing a vital strategy in designing competitive Cost-to-Company packages.

Illustration 3: Rent Deduction Clarity (80GG) (Numerical)

Scenario: Mr. Sameer (42, self-employed, Old Regime) pays a monthly rent of ₹12,000 (Annual Rent: ₹1,44,000). He does not receive HRA. His Adjusted Total Income (AGTI) for 80GG purposes is ₹8,00,000.

Step-by-Step Solution (Least of Three):

The deduction under Section 80GG is the lowest of the following three amounts:

- 1) **Rent Paid minus 10% of AGTI:**
 - ₹1,44,000 – (10% of ₹8,00,000)
 - = ₹1,44,000 – ₹80,000 = **₹64,000**
- 2) **Fixed Limit (per annum):**
 - ₹5,000 per month x 12 months = **₹60,000**.
- 3) **25% of AGTI:**
 - 25% of ₹8,00,000 = **₹2,00,000**

Conclusion: The least of the three calculated amounts (₹64,000, ₹60,000, and ₹2,00,000) is **₹60,000**. Mr. Sameer can therefore claim ₹60,000 as a deduction under Section 80GG.

Illustration 4: Medical Expense Deduction (80DDB) (Numerical)

Scenario: Mr. David (55, non-senior citizen) incurred ₹85,000 on the treatment of a specified neurological disease for his dependent spouse in the current financial year. He received ₹30,000 as reimbursement from his family health insurance policy.

Step-by-Step Solution:

- 1) **Maximum Eligible Deduction (Non-Senior Citizen):** The maximum statutory limit under 80DDB for individuals below 60 years is ₹40,000.
- 2) **Actual Expense vs. Limit:** Actual expense incurred is ₹85,000, which is higher than the statutory limit of ₹40,000. Therefore, the eligible amount before reimbursement adjustment is ₹40,000.
- 3) **Less: Reimbursement Received:** ₹30,000.

Deduction Claimable under 80DDB:

$$\text{Deduction} = \text{Eligible Amount} - \text{Reimbursement}$$

$$\text{Deduction} = ₹40,000 - ₹30,000 = ₹10,000$$

If Mr. David were a senior citizen (60 years or more), the limit would be ₹1,00,000. In that case, the deduction would be calculated as: ₹85,000 (Actual Expense) - ₹30,000 (Reimbursement) = ₹55,000 (since this is less than the senior citizen limit of ₹1,00,000).



Check Your Progress – I

1. Differentiate Gross Total Income from Total Income.

2. What is the aggregate limit imposed by Section 80CCE?

3. If an individual has exhausted the 80C limit, which NPS section provides additional deduction? State the limit.

10.9 SUMMARY

This unit explains the concept and practical application of deductions from Gross Total Income (GTI) under Chapter VI-A of the Income Tax Act, 1961, which play a crucial role in reducing taxable income. The unit clarifies the distinction between Gross Total Income (GTI) and Total Income (Taxable Income), emphasizing that deductions under Sections 80C to 80U are subtracted from GTI to arrive at Total Income. The unit systematically covers major deduction groups. Sections 80C, 80CCC, and 80CCD(1) encourage savings and retirement planning, collectively capped at ₹1,50,000 under Section 80CCE, while 80CCD(1B) provides an additional ₹50,000 deduction for NPS contributions and 80CCD(2) allows employer contributions beyond this limit. Health-related deductions under Sections 80D, 80DD, 80DDB, and 80U offer tiered or fixed benefits based on age and disability severity. Education and policy-driven incentives include 80E (education loan interest), 80EEA (affordable housing), and 80EEB (electric vehicle loans). Relief for rent paid without HRA is available under 80GG, while savings interest deductions differ for individuals (80TTA) and senior citizens (80TTB). The unit also explains charitable donation deductions under 80G, highlighting qualifying limits and documentation. Overall, the unit integrates legal provisions with numerical illustrations to support effective tax planning.



10.10 GLOSSARY

- **Gross Total Income (GTI):** The aggregate income calculated under the five heads, prior to any deductions under Chapter VI-A.
- **Total Income (TI):** The final taxable amount derived by subtracting Chapter VI-A deductions from the GTI.
- **Chapter VI-A:** The part of the Income Tax Act, 1961 (Sections 80C to 80U) detailing eligible tax deductions.
- **Section 80CCE:** The statutory provision that imposes a collective ceiling of ₹1,50,000 on deductions claimed under 80C, 80CCC, and 80CCD(1).
- **National Pension System (NPS):** A defined contribution retirement scheme that offers tax benefits under various 80CCD subsections.
- **Senior Citizen:** An individual who is 60 years of age or more during the relevant financial year.
- **Preventive Health Check-up:** Expenses for routine medical check-ups, deductible up to ₹5,000 within the overall 80D limit.
- **Higher Education:** Any course of study pursued after completing the senior secondary examination (12th standard equivalent).
- **Adjusted Gross Total Income (AGTI):** The net income used as the base for calculating the 10% limit ceiling for certain 80G and 80GG deductions.
- **Disabled Dependent:** A specified family member (spouse, child, parent, sibling) relying on the taxpayer for support, certified with at least 40% disability.
- **Severe Disability:** Disability certified at 80% or more.
- **Tax Saver FD:** Fixed deposits that are locked in for five years and qualify for deduction

under Section 80C.

- **Old Tax Regime:** The traditional tax structure that allows taxpayers to claim deductions under Chapter VI-A.
- **Equity Linked Savings Scheme (ELSS):** Mutual fund investment scheme eligible for 80C deduction, subject to a three-year lock-in.
- **Specified Diseases:** Critical or chronic ailments listed in the Income Tax Rules for which treatment expenses qualify for deduction under Section 80DDB.
- **Section 80EEA:** A temporary provision offering an additional deduction on interest paid for affordable housing loans sanctioned between April 1, 2019, and March 31, 2022.



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10.12 SUGGESTED READINGS

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10.13 TERMINAL QUESTIONS

1. Define Gross Total Income (GTI) and explain how Total Income is computed.
2. Discuss the scope, eligibility, and aggregate limit of deductions under Sections 80C, 80CCC, and 80CCD(1).
3. Explain the significance of Section 80CCE in tax planning and investment prioritization.
4. Analyze the additional tax benefits available under Sections 80CCD(1B) and 80CCD(2) with suitable examples.
5. Describe the tiered deduction structure under Section 80D for health insurance premiums.
6. Differentiate between Sections 80DD, 80DDB, and 80U with reference to disability and medical treatment deductions.
7. Explain the conditions, duration, and tax impact of deduction under Section 80E for education loan interest.
8. Examine the policy intent and eligibility conditions of deductions under Sections 80EEA and 80EEB.
9. Explain the calculation mechanism of deduction under Section 80GG, highlighting the “least of three” rule.
10. Distinguish clearly between deductions under Sections 80TTA and 80TTB and justify the higher benefit for senior citizens.
11. Discuss the classification of donations under Section 80G and the role of Adjusted Gross Total Income (AGTI).
12. Explain why most Chapter VI-A deductions are available only under the Old Tax Regime.
13. Illustrate, with a comprehensive example, how multiple deductions reduce taxable

income.

14. Evaluate deductions as fiscal policy instruments for influencing savings, health security, education, and social welfare.
15. Mr. Harish (40) has a GTI of ₹11,00,000. He made the following investments/payments: ₹1,20,000 in PPF (80C), ₹50,000 in ELSS (80C), and ₹60,000 as self-contribution to NPS (80CCD(1B)). Calculate the total deduction available under the combined 80C/80CCE/80CCD(1B) sections. (Hint: 80CCE cap is ₹1,50,000. 80CCD(1B) has an additional cap of ₹50,000.)
16. Ms. Deepika (35) pays annual rent of ₹18,000 per month and does not receive HRA. Her Adjusted Total Income (AGTI) for 80GG purposes is ₹10,00,000. Calculate the deduction available to her under Section 80GG. (Hint: Use the least of the three calculation rules: Rent Paid minus 10% of AGTI; ₹60,000; 25% of AGTI)
17. Mr. Joshi (70, senior citizen) incurred ₹90,000 on the treatment of a specified disease (80DDB). He received ₹45,000 as reimbursement from his employer's medical scheme. Calculate the deduction available to him under Section 80DDB. (Hint: Senior citizen limit is ₹1,00,000. Deduction = Actual Expense or Limit, minus Reimbursement)

UNIT 11 SET -OFF AND CARRY FORWARD

- 11.1 Introduction**
- 11.2 Objectives**
- 11.3 Aggregation of income**
- 11.4 Inter Source Adjustment**
- 11.5 Inter Head Adjustment**
- 11.6 Set and Carry Forward from House Property**
- 11.7 Carry Forward and Set Off Business Losses**
- 11.8 Losses in Speculation Business [Section 73]**
- 11.9 Carry Forward and Set Off Losses by Specified Businesses [SECTION 73A]**
- 11.10 Losses Under the Head ‘Capital Gains’ [Section 74]**
- 11.11 Losses from the Activity of Owning and Maintaining Race Horses**
- 11.12 Order of Set of Losses**
- 11.13 Summary**
- 11.14 Glossary**
- 11.15 Answers to Check Your Progress**
- 11.16 References**
- 11.17 Suggested Readings**
- 11.18 Terminal Questions**

11.1 INTRODUCTION

As you have learned in the earlier sections, an assessee is typically taxed according to the income they get from the various heads. Nonetheless, there can be situations in which an assessee is required to pay taxes on other people's income. The provisions of the Income Tax Act guarantee that the assessee cannot lower their tax responsibility by transferring their income to family members or by setting up their sources of income so that others bear the tax burden. Therefore, sections 60 to 64 of the Income Tax Act contain the appropriate provisions to combat such tax avoidance practices. Additionally, the Income Tax Act offers assessee provisions to lessen losses

This section will teach you how, based on the Act's provisions, losses from one source can be deducted from both the source and other sources. Additionally, you will discover how losses can be carried forward to be deducted from income or profits in the following assessment year if they cannot be offset due to the profit's unavailability

11.2 OBJECTIVES

After studying this unit, you will be able to understand:

1. How to identify the various permissible inter-source and inter-head adjustments in income tax.
2. How to identify the restrictions to inter-source and inter-head set-off of losses in income tax
3. Comprehending the various conditions to be satisfied for carry forward and set-off of losses under different heads in income tax.
4. State the maximum period for which different losses can be carried forward in income tax.

11.3 AGGREGATION OF INCOME

Certain amounts are often considered to be income in the assessee's hands even though they are not. Sections 68, 69, 69A, 69B, 69C, and 69D comprise these cases. In certain situations, the Assessing Officer may demand an explanation from the assessee. The amounts mentioned in these sections would be considered the assessee's income if the assessee fails to provide an explanation or provides an explanation that is insufficient. These sums must be added to the assessee's income.

11.4 SET AND CARRY FORWARD OF LOSSES

The Income-tax Act of 1961 contains specific provisions for carryover and set-off of losses. To put it simply, "set-off" refers to the process of adjusting losses against profits from another source or source of income during the same assessment year. Losses are carried over to the following assessment year for adjustment against the eligible earnings of that year if they cannot be offset in the same year due to insufficient eligible profits. The Act specifies the maximum amount of time that various losses may be carried forward for set-off.

These sums must be added to the assessee's income such shares.

11.5 INTER SOURCE ADJUSTMENT

Losses under one income category may be offset or adjusted against income

1. Since the income under each head is to be calculated by grouping together the net result of the activities of all the sources covered by that head, losses incurred by the assessee with regard to one source will be offset against income from any other source under the same head of income under this section. To put it another way, losses from one source of income can be offset by income from another, provided that both sources fall under the same heading.

Example 1: The income from one home property can be deducted against the loss from another.

2. However, the following situations prohibit inter-source set-off:

(a) Long-term capital loss [Section 70(3)]

(1) If the net result for any short-term capital asset is a loss, that loss may be deducted from any income for that assessment year under the heading "capital gains" for any other capital asset.

(2) If the net result for any long-term capital asset is a loss, it may be deducted from any income for that assessment year under the heading "capital gains" for any other asset that isn't a short-term capital asset. As a result, both short-term and long-term capital gains may be deducted from short-term capital losses. However, only long-term capital gains—not short-term capital gains—can offset long-term capital losses.

(b) Loss from speculation [Section 73(1)]

Only the profits of another speculation business, not any other business or professional income, may be used to offset a loss in a speculation business. Nonetheless, income from the speculation company might be used to offset losses from other ventures.

(c) Loss resulting from the ownership and upkeep of race horses [Section 74A(3)]

Only the revenue from owning and keeping race horses may be used to offset such a loss.

(d) Losses from Particular Business [Section 73A(1)]

Only any other specified business may be used to offset a loss in any of the specified businesses mentioned in section 35AD. Nonetheless, profits from a particular firm might be used to offset losses from other ventures.

It is important to remember that earnings from a taxable source of income cannot be offset by losses from an exempt source. For instance, long-term capital gains on the sale of land cannot be offset against long-term capital losses on shares sold through a recognized stock exchange, when STT is paid both at the time of acquisition and on the sale of such shares.

11.5 INTER HEAD ADJUSTMENT

Losses under one income category may be offset or adjusted against income under another. Nonetheless, it is important to take into account the following:

- (i) The assessee may deduct a loss from his income assessable for that assessment year under any other head, including "Capital Gains," if the net outcome of the computation under any head of income (apart from "Capital Gains") is a loss.
- (ii) If the computation under the heading "Profits and gains of business or profession" results in a loss, that loss cannot be deducted from income under the heading "Salaries."
- (iii) A capital loss cannot be deducted from income under any other heading if the computation under the heading "Capital Gains" results in a loss.
- (iv) If the assessee has income assessable under any other head of income and the net outcome of the computation under the head "Income from house property" is a loss, the amount of that loss exceeding 2 lakhs cannot be set off against income under the other head. To put it another way, the greatest loss from home property that can be deducted from earnings from any other source is approximately two lakhs.
- (v) Losses from speculation, owning and caring for race horses, and certain businesses mentioned in section 35AD cannot be deducted from income under any other heading.

11.6 SET AND CARRY FORWARD FROM HOUSE PROPERTY

- (i) If there is a loss under the heading "Income from house property" in any assessment year, it will first be deducted from any other head's income up to a maximum of Rs. 2,000,000.
- (ii) The unabsorbed loss will be carried over to the subsequent assessment year and deducted from income under the "Income from house property" heading.
- (iii) The loss under this heading may be carried forward for up to eight assessment years following the assessment year in which the loss was initially calculated.
- (iv) For instance, in the same assessment year, the earnings from one home property may be compared against the losses from another. To the amount of Rs. 2,000,000 in the same assessment year, any loss under the heading "Income from house property" may be deducted from any income under any other heading. However, any loss under the heading "Income from house property" that remains after such a set-off will be carried over to the following year.
- (v) Keep in mind that once a specific loss is carried forward, it can only be deducted from the same head's income in the upcoming assessment years.

11.7 CARRY FORWARD AND SET-OFF OF BUSINESS

LOSSES [SECTIONS 72 & 80]

In situations when the loss from the business and profession cannot be set against because of the lack or insufficiency of revenue under any other head in the same year, the assessee is entitled to carry forward the loss under the Act. The revenues of later prior years may be used to offset the loss thus carried forward. The carryover and set-off of losses resulting from a business or profession are covered by Section 72.

Conditions

However, the following restrictions apply to the assessee's ability to carry forward business losses under this section:

- (i) The loss ought to have come from a business, career, or vocation.
- (ii) The loss shouldn't resemble a loss in the speculation business.
- (iii) Although not always against the gains and profits of the same business or profession where the loss occurred, the loss may be carried forward and deducted from income from the business or profession. However, under no circumstances can a loss carried forward be deducted from income from any head other than "Profits and gains of business or profession."
- (iv) The loss can only be carried forward and deducted from the assessee's profits. In other words, the only individual who can carry forward or set off a loss is the one who actually experienced it. As a result, unless succession is via inheritance, a business's successor cannot carry on or offset the losses of his predecessor.
- (v) Following the assessment year in which the loss occurred, a business loss may be carried forward for a maximum of eight assessment years.
- (vi) To carry forward and set off a loss under section 80, the assessee must have submitted a return of loss under section 139(3). To put it another way, the assessee is not allowed to carry forward the loss he has experienced if a return of loss is not filed. Such a return must be submitted within the time frame specified in section 139(1). Nevertheless, unabsorbed depreciation carried forward under section 32(2) and a loss from dwelling property carried forward under section 71B are exempt from this requirement.

11.8 LOSSES IN SPECULATION BUSINESS

[SECTION 73]

- (i) The definition of "speculative transaction" as given in section 43(5) and the handling of speculative business revenue have already been covered under the heading "Profits and gains of business or profession."
- (ii) The losses incurred in speculation cannot be carried forward and set off against other income in the following years, nor can they be set off in the same year against any other non-speculation income, since speculation is considered a business distinct and separate from any other business conducted by the assessee.
- (iii) As a result, if an assessee's losses in a speculation business cannot be deducted from any other speculation profit in the same year, they may be carried over to later years and deducted only from revenue from any speculation business the assessee conducts.
- (iv) Only a maximum of four years after the conclusion of the applicable assessment year for which the loss was calculated may the loss in a speculative business be carried forward. However, a loss resulting from trading derivatives should not be seen as a speculative loss.
- (v) According to this section's explanation, a company will be considered to be engaging in speculative business to the extent that any portion of its operations involves buying and selling shares of other businesses.

However, the following businesses are exempt from this deeming provision:

- (1) A business whose gross total income primarily consists of income chargeable under the headings "Interest on securities," "Income from house property," "Capital gains," and "Income from other sources";
- (2) A business whose primary business is (i) trading in shares; (ii) banking; or (iii) granting loans and advances.

As a result, this explanation would not apply to these businesses. Therefore, these businesses would not be considered engaging in speculative activity if they engaged in the buying and selling of shares of other businesses.

11.9 CARRY FORWARD & SET OFF OF LOSSES BY SPECIFIED BUSINESSES [SECTION 73A]

- (i) Only the profits and gains, if any, of any other specified business may be used to offset any loss calculated in relation to the specified business mentioned in section 35AD.
- (ii) Any unabsorbed loss shall be carried over and deducted from any designated business's income and gains in the subsequent assessment year, and so on.
- (iii) Such a loss can be carried forward forever for set-off against income from selected businesses because there is no temporal limit on carry-forward and set-off.

- (iv) However, for carryover of loss from defined business, the return of loss must be filed by the deadline stated in section 139(1).

11.10 LOSSES UNDER THE HEAD 'CAPITAL GAINS' [SECTION 74]

According to Section 74, if the net result under the head "Capital gains" for any assessment year is either a short-term or long-term capital loss, the loss will be carried over to the subsequent assessment year and set off as follows:

- (i) If the loss so carried forward is a short-term capital loss, it will be deducted from any long-term or short-term capital gains that occur that year.
- (ii) If the loss carried forward is a long-term capital loss, it will only be offset by long-term capital gains that occur in that year.
- (iii) Income under any other heading cannot be deducted from net loss under the capital gains head.
- (iv) Up to a maximum of eight assessment years immediately following the assessment year for which the loss was initially calculated, any unabsorbed loss will be carried over to the subsequent assessment year.

11.11 LOSSES FROM THE ACTIVITY OF OWNING AND MAINTAINING RACE HORSES [SECTION 74 A (3)]

- (i) Section 74(3) states that an assessee's losses from owning and maintaining race horses cannot be deducted from their income from any other source.
- (ii) For a maximum of four assessment years, this loss may be carried forward and deducted from future earnings from the ownership and upkeep of race horses.
- (iii) For this reason, the "amount of loss incurred by the assessee in the activity of owning and maintaining race horses" refers to the difference between the assessee's revenue expenditures and their income from stake money. For example, $\text{Loss} = \text{Stake Money} - \text{Revenue Expenditure for Race Horse Maintenance}$.
- (iv) Additionally, the term "horse race" refers to a horse race where it is legal to gamble or bet.
- (v) "Income by way of stake money" refers to the total amount of prize money earned by the owner of a racing horse or race horses as a result of the horse or horses, or any one or more of the horses, winning, placing second, or finishing lower in horse races.



Check Your Progress-A

1. MCQs.

1. Under the Income Tax Act, inter-source set-off refers to:
 - A. Set-off of loss of one head against income of another head
 - B. Set-off of loss from one source against income from another source under the same head
 - C. Carry forward of losses to future years
 - D. Adjustment of brought forward losses only
2. Which of the following losses cannot be set-off against income from another source under the same head of income?
 - A. Loss from non-speculative business
 - B. Loss from speculative business
 - C. Loss from house property
 - D. Loss from other sources
3. Which of the following statements is correct regarding long-term capital loss?
 - A. It can be set-off against short-term capital gains
 - B. It can be set-off against income from house property
 - C. It can be set-off only against long-term capital gains
 - D. It can be set-off against income from any head
4. Loss from the activity of owning and maintaining race horses can be set-off against:
 - A. Income from business or profession
 - B. Income from other sources
 - C. Income from house property
 - D. Income from the same activity only

Q2. State True or False

1. Unabsorbed loss from house property can be carried forward for a maximum period of 8 assessment years and can be set-off only against income from house property.
2. Loss from speculation business can be carried forward for 8 assessment years and set-off against any business income.
3. Loss from specified business under section 35AD can be carried forward for an indefinite period and set-off only against profits from specified business.

4. Long-term capital loss can be set-off against both short-term and long-term capital gains and carried forward for 8 assessment years.

11.12 ORDER OF SET OF LOSSES

According to section 72(2), brought forward business loss must be deducted before unabsorbed depreciation. Set-off shall therefore be applied in the following order:

- (a) current year depreciation, current year capital spending on scientific research, and current year expenditure on family planning, to the extent permitted.
- (b) Losses brought forward from employment or business [Section 72(1)]
- (c) Section 32(2) Unabsorbed depreciation
- (d) Capital expenditure for scientific research that is not absorbed [Section 35(4)]
- (e) Unabsorbed family planning costs [Section 36(1)(ix)]

11.13 SUMMARY

Important sections of the Income-tax Act of 1961 include set-off and carryover of losses, which enable an assessee to correctly evaluate taxable income by adjusting losses against income. Set-off of losses refers to the, subject to certain limitations, adjustment of losses against revenue from the same source, another source under the same head, or under a separate head of income. Losses may be carried over to other years for adjustment against specified incomes if they cannot be completely offset in the same assessment year. The head of income against which losses can be set against and the time frame for which they can be carried forward, however, vary depending on the type of loss. For instance, speculative losses are carried forward for four years, corporate losses are carried forward for eight assessment years, and losses from specific businesses under section 35AD are carried over indefinitely. By granting taxpayers relief for actual losses while preserving statutory control over their adjustment, these rules guarantee equitable taxes.



11.14 GLOSSARY

Set Off: This refers to comparing your losses against earnings or revenue from other sources during the same fiscal year. Consider it like balancing your finances before figuring out how much you'll make in the end.

Carry Forward: You can carry forward your losses to subsequent years in order to offset them against future income if they cannot be properly adjusted in the current year. It's similar to keeping your unused loss for future use



11.15 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Q1.

- i) B
- ii) B
- iii) C
- iv) D

Q2.

- i) True
- ii) False
- iii) True
- iv) False



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11.17 SUGGESTED READINGS

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11.18 TERMINAL QUESTIONS

1. Explain the provisions relating to inter-source and inter-head set-off of losses under the Income-tax Act, 1961.
2. What is meant by carry forward of losses?
3. Discuss in detail the provisions relating to carry forward and set-off of business losses and unabsorbed depreciation.
4. Explain the treatment of capital losses under the Income-tax Act.
5. Distinguish between short-term and long-term capital losses with respect to their set-off and carry forward.

UNIT-12

CLUBBING AND AGGREGATION OF INCOME

Contents

- 12.1 Introduction**
- 12.2 Conceptual Basis of Clubbing of Income**
- 12.3 Clubbing of Income due to Asset/Income Transfer (Sections 60–63)**
- 12.4 Clubbing Provisions concerning Spouse and Relatives (Section 64(1))**
- 12.5 Special Case: Income of Minor Child (Section 64(1A))**
- 12.6 The Doctrine of Cross Transfers and Secondary Income**
- 12.7 Aggregation of Income**
- 12.8 Clubbing, Tax Planning, and Managerial Decision Making**
- 12.9 Illustrative Examples / Applications**
- 12.10 Summary**
- 12.11. Glossary**
- 12.12 References / Bibliography**
- 12.13 Suggested Readings**
- 12.14 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, the learner will be able to:

- ✓ Explain the objective and underlying principles of the Clubbing Provisions (Sections 60 to 64) in the context of anti-tax avoidance.
- ✓ Differentiate between the transfer of income without asset (Section 60) and revocable transfers of assets (Section 61).
- ✓ Analyze the conditions under which the remuneration received by a spouse from a concern where the assessee holds a substantial interest is clubbed.
- ✓ Determine the tax implications of transferring assets to a spouse or son's wife without adequate consideration, including income from converted assets.
- ✓ Apply the specific rules governing the clubbing of a minor child's income, identifying key exceptions related to skill, talent, and disability.
- ✓ Calculate the mandatory exemption available under Section 10(32) in case of minor child clubbing.
- ✓ Describe the judicial doctrine of cross transfers and the non-clubbing rule for secondary

income.

- ✓ Formulate the step-by-step process of aggregating income from all five heads, including clubbed income, to compute the Gross Total Income (GTI).

12.1 INTRODUCTION

Previous units focused on computing income under the five standard statutory heads: Salaries, House Property, Profits and Gains of Business or Profession, Capital Gains, and Income from Other Sources. However, the general principle of taxation is that the person who earns the income is the person who pays the tax. This unit introduces a crucial exception to this rule: The Clubbing Provisions (Sections 60 to 64) of the Income-tax Act, 1961. India employs a progressive tax system, meaning that as an individual's income increases, they move into higher tax brackets and pay a greater percentage of their earnings as tax. Historically, taxpayers sought to reduce their overall tax burden by distributing or 'splitting' their income among family members, typically a spouse or minor child, who might have little or no taxable income. This strategy artificially lowered the income of the high-earning individual, enabling them to pay tax at a lower marginal rate.

To counter this form of artificial tax avoidance, the legislature introduced the Clubbing Provisions. These rules act as an anti-avoidance mechanism, ensuring that income arising from assets transferred without adequate compensation is still treated as the income of the original transferor. Even though the income legally accrues to the relative (the transferee), it is added back, or "clubbed," into the income of the individual who transferred the asset. Mastering the rules of clubbing and aggregation is essential for sound financial planning and managerial decision-making. Individuals need to understand the precise limitations of gifting and asset transfer to ensure that their actions constitute legal tax planning rather than generating unintended tax liabilities or, worse, attracting scrutiny for unlawful tax avoidance. This unit will first detail the various scenarios specified under the law that trigger clubbing. It will then conclude with the process of Aggregation, which is the final step of totaling income from all sources, including any clubbed income and adjusted for set-off of losses, to arrive at the Gross Total Income (GTI), the starting point for deductions.

12.2 CONCEPTUAL BASIS OF CLUBBING OF INCOME

12.2.1 Definition and Purpose

Clubbing of Income is a specialized legal mechanism enshrined in the Income-tax Act, 1961, which mandates the inclusion of income earned by a specified person (the transferee) into the total income of another person (the transferor/assessee). This is required when the income generated by the transferee is traceable to assets originally transferred to them by the assessee without adequate consideration, or when the transfer itself is artificial or revocable.

The core objective of these provisions is to enforce the principle of *substance over form*. If a transaction lacks genuine commercial or legal substance and is primarily intended to reduce

tax liability by shifting income to a lower-taxed relative, the law views the original transferor as the economic owner of the income. Therefore, the income is taxed in the transferor's hands.

12.2.2 Clubbing Provisions in the context of Tax Planning

Understanding the clubbing rules is essential for differentiating between legal tax planning and questionable tax avoidance:

- 1) **Tax Planning:** This involves legally utilizing the provisions, exemptions, and deductions explicitly provided in the law (such as investments under Section 80C in PPF or claiming interest deductions on home loans) to minimize tax liability. This is ethical, legal, and recommended.
- 2) **Tax Avoidance:** This involves exploiting technical ambiguities or loopholes in the law to reduce tax burden in a manner that is often unacceptable to the revenue authorities. The Clubbing Provisions were introduced precisely to negate common methods of tax avoidance, such as gifting assets to family members.
- 3) **Tax Evasion:** This is an illegal practice involving deceit, concealment of income, or misrepresentation of facts to avoid paying tax. Examples include hiding cash payments, maintaining false records, or claiming fictitious expenses. Tax evasion leads to heavy penalties and possible criminal prosecution.

12.3 CLUBBING OF INCOME DUE TO ASSET/INCOME TRANSFER (SECTIONS 60–63)

The Act identifies certain transfers that are considered suspect because the transferor retains some degree of control or interest, or separates the asset from its income stream.

12.3.1 Transfer of Income without Transfer of Asset (Section 60)

Section 60 addresses transactions where the asset itself remains under the legal ownership of the assessee, but the right to receive the income generated by that asset is transferred to another person. In such a case, the income, regardless of the agreement or arrangement, must be included in the total income of the person who owns the asset (the transferor). For instance, if Mr. A owns a fixed deposit but executes an agreement stating that the yearly interest income shall be given to his spouse, the interest income remains taxable in Mr. A's hands because he retains ownership of the underlying asset (the fixed deposit).

12.3.2 Revocable Transfer of Assets (Sections 61 and 63)

Section 61 governs income arising from assets transferred under a 'revocable transfer'. When an asset is transferred under a revocable transfer, the income generated from that asset is deemed to be the income of the transferor and is clubbed accordingly. The definition of a Revocable Transfer is provided specifically in Section 63 for the purposes of Sections 60, 61, and 62. A transfer is considered revocable if:

- 1) It contains any provision for the re-transfer (directly or indirectly) of the whole or any part of the income or the assets back to the transferor.

- 2) It, in any way, grants the transferor a right to reassume power (directly or indirectly) over the whole or any part of the income or assets.

A transfer is considered revocable if the transferor assumes the right to re-acquire the asset or the income derived from it, either wholly or partially, at any point during the lifetime of the transferee. This rule ensures that if the transferor retains control, even potentially, they cannot escape tax liability simply by temporarily diverting the income.

12.3.3 Irrevocable Transfers: The Exception (Section 62)

The clubbing provisions related to revocable transfers (Section 61) do not apply under certain conditions, primarily when the transfer is genuinely irrevocable. Specifically, the provisions of Section 61 are not attracted if the transfer meets one of the following criteria under Section 62(1):

- 1) The transfer is irrevocable for the entire lifetime of the transferee.
- 2) The transfer is irrevocable for a specified period (for example, for 15 years), provided that the transferor derives no direct or indirect benefit from the income arising from such asset during that period.

However, even if a transfer is initially irrevocable for a specific period, the income will become chargeable to tax in the hands of the transferor as soon as the power to revoke the transfer becomes exercisable. For instance, if Mr. B transfers assets to a trust irrevocably for 5 years, the income is not clubbed during those 5 years, *if* Mr. B receives no benefit. But if the transfer is deemed revocable thereafter, the income will be clubbed after the fifth year.

12.4 CLUBBING PROVISIONS CONCERNING SPOUSE AND RELATIVES (SECTION 64(1))

Section 64(1) addresses specific scenarios involving income transfer to close relatives (spouse, son's wife, and minor children) aimed at splitting taxable income.

12.4.1 Remuneration to Spouse from a Concern with Substantial Interest (Section 64(1)(ii))

This provision aims to prevent taxpayers from diverting profits out of a controlled entity (firm or company) in the form of inflated salary or commission paid to a spouse who does not contribute significantly to the business. Two primary conditions must be met for the spouse's remuneration to be clubbed with the transferor's income:

- 1) **Substantial Interest:** The individual (transferor) must possess a "substantial interest" in the concern (e.g., a company, firm, or HUF).
 - An individual is deemed to have a substantial interest if they, alone or together with their relatives, beneficially hold, at any time during the previous year:
 - 20% or more of the equity shares (in the case of a company); OR
 - An entitlement to 20% or more of the profits (in the case of a concern other than

a company, like a partnership firm).

- *Note on Relatives:* For calculating substantial interest, "relative" includes the spouse, brother, sister, or any lineal ascendant or descendant of the individual.
- 2) **Lack of Professional Qualification:** The spouse must receive remuneration (salary, commission, fees, etc.) from that concern, and the payment must be made without possessing the required technical or professional qualifications, or the income is otherwise not solely attributable to the application of their knowledge and experience.

If both conditions are met, the spouse's remuneration is clubbed with the income of the individual holding the substantial interest.

Exception (Genuine Skill): If the spouse possesses genuine technical or professional qualifications and the remuneration received is *solely* attributable to the application of that knowledge and experience, the clubbing provisions do not apply. The law recognizes income genuinely earned by a qualified spouse, even if the other spouse controls the business.

Scenario of Both Spouses Having Substantial Interest: If both the husband and wife have a substantial interest in the concern and both receive remuneration without the necessary professional qualifications, the remuneration of *both* spouses is clubbed with the income of that individual whose total income (excluding such remuneration) is higher.

12.4.2 Transfer of Asset to Spouse without Adequate Consideration (Section 64(1)(iv))

This is the most common clubbing provision. It addresses direct or indirect transfers of income-generating assets to a spouse.

- 1) **Conditions:**
 - An individual (the transferor) transfers an asset, either directly or indirectly.
 - The transfer is made to their spouse.
 - The transfer is made without adequate consideration (e.g., a gift).
 - The transfer must not be in connection with an agreement to live apart.
- 2) **Clubbing Rule:** Any income arising directly or indirectly from that transferred asset is clubbed with the income of the transferor.

Exclusion of House Property: This specific provision (Section 64(1)(iv)) applies to all assets *except* House Property. The transfer of House Property to a spouse without adequate consideration is governed by Section 27, which deems the transferor to be the "deemed owner" of the house property, resulting in the rental income being taxed in the transferor's hands under the head "Income from House Property".

12.4.3 The Converted Asset Rule (Indirect Transfer)

The clubbing provisions cannot be bypassed simply by changing the form of the asset. The law is explicit that clubbing applies even if the asset is converted by the transferee spouse.

- If Mr. X gifts cash to Mrs. X, and Mrs. X uses that cash to purchase shares or invest in a Fixed Deposit, the dividends or interest income arising from the purchased asset (the converted asset) will be clubbed with the income of Mr. X. The law looks through the

immediate transaction to the original source of funds (the gift without adequate consideration).

12.4.4 Transfer of Asset to Son's Wife (Daughter-in-law) (Section 64(1)(vi))

Similar to the spouse, income arising from assets transferred by an individual to their son's wife (daughter-in-law) without adequate consideration is clubbed with the transferor's income.

Key Exception: Clubbing does not apply if the asset transfer occurred before the marriage of the son to the daughter-in-law.

12.4.5 Transfers for the Benefit of Spouse or Son's Wife (Section 64(1)(vii) and (viii))

These clauses cover scenarios where the asset is transferred to a third party (such as a trust or an association of persons) but the transfer is made specifically for the benefit of the individual's spouse or son's wife, and without adequate consideration.

The income arising from the transferred asset, to the extent it benefits the specified relative, will be included in the income of the transferor. This provision targets complex structures used to indirectly transfer income benefits while maintaining a legal distance from the spouse.

12.5 SPECIAL CASE: INCOME OF MINOR CHILD (SECTION 64(1A))

The clubbing of a minor child's income is one of the most significant anti-avoidance measures, applying specifically to income accruing to a child below 18 years of age.

12.5.1 General Clubbing Rule for Minor's Income

The general rule is that any income arising or accruing to a minor child shall be compulsorily clubbed with the income of the parent.

Identifying the Parent: The income is clubbed with the total income of that parent whose total income (excluding the minor's income to be clubbed) is greater.

Rule of Consistency: Once the minor's income is included in the total income of a specific parent, any such income arising in succeeding years must continue to be included in the total income of the same parent. This consistency applies unless the Assessing Officer is satisfied, after giving the parent an opportunity to be heard, that a change is necessary.

Parents not Living Together (Non-subsisting Marriage): If the marriage of the parents does not subsist (e.g., they are legally separated), the income of the minor child will be clubbed with the parent who maintains the minor child in the relevant previous year.

12.5.2 Exceptions to Clubbing of Minor's Income

The strict rule of clubbing does not apply to income earned by a minor from specific sources, recognizing the minor's individual capability to earn income:

- 1) **Income from Manual Work:** Income earned by the minor child through sheer manual labour is not clubbed.
- 2) **Income from Skill or Talent:** Income arising from any activity involving the application of the minor child's skill, talent, specialized knowledge, or experience is not clubbed. For example, earnings of a child artist from stage shows or a minor sportsperson's endorsement fees are taxed in the child's name and are not added to the parent's income.
- 3) **Disabled Child:** Income of a minor child suffering from a disability specified under Section 80U is exempt from the clubbing provisions. This provides relief in cases of severe disability.
- 4) **Major Child:** Income earned by an individual who is no longer a minor (i.e., attained 18 years of age) is never clubbed with the parent's income, even if the income is derived from assets gifted to them during their minority.

It is important to note the interaction between exceptions and clubbing: If a minor child earns income through skill (which is exempt from clubbing, e.g., ₹1,00,000 as a child artist), and then invests that money in a fixed deposit, the subsequent interest income (e.g., ₹6,000) generated from this investment will be clubbed with the parent's income, as this secondary income is not attributable to the child's skill.

12.5.3 Exemption under Section 10(32)

When the income of a minor child is clubbed with the parent's income, the law provides a partial relief mechanism. The parent is entitled to claim an exemption under Section 10(32). The exemption amount is calculated as: ₹1,500 per minor child whose income is clubbed, or the actual amount of income of the minor child so clubbed, whichever is less.

This exemption is claimed by the parent who includes the minor's income in their total income. If a parent has multiple minor children whose income is clubbed, this exemption can be claimed for each child, up to a maximum of two children. If the clubbed income is, say, ₹1,200, the exemption claimed will be restricted to ₹1,200, not ₹1,500.

12.6 THE DOCTRINE OF CROSS TRANSFERS AND SECONDARY INCOME

12.6.1 Cross Transfers (Indirect Transfers)

Taxpayers occasionally attempt to circumvent clubbing provisions by using interconnected transactions involving two different individuals (A and B) who exchange assets or funds for the benefit of each other's specified relative (spouse or minor child). This is known as the Doctrine of Cross Transfers.

The judicial interpretation and statutory rules treat such transactions, if simultaneous or interconnected, as a single scheme of tax avoidance. The net effect is that the assets are deemed to have been transferred directly between A and B for the benefit of their own family member. For instance, Mr. A gifts ₹50,000 to Mrs. B (Mr. B's wife). Simultaneously, Mr. B gifts shares worth ₹50,000 to Mr. A's minor son. In this case, the income generated by the shares gifted to

Mr. A's minor son will be clubbed with Mr. A's income, and the income generated by the cash gifted to Mrs. B will be clubbed with Mr. B's income.

12.6.2 Income Derived from Clubbed Income (Secondary Income)

A critical distinction exists in clubbing rules between the income arising directly from the transferred asset (primary income) and any subsequent income generated by reinvesting that primary income (secondary income).

The clubbing provisions apply strictly to the income arising from the asset that was transferred without adequate consideration. If the transferee (e.g., a spouse or minor) takes the interest, rent, or dividend that was clubbed in the transferor's hands, and then re-invests this clubbed income to earn further income, this secondary income is explicitly NOT subject to clubbing. This secondary income is taxed in the hands of the transferee (the spouse or minor). This boundary provides a clear limitation on the reach of the clubbing net, preventing indefinitely complicated clubbing chains.

12.7 AGGREGATION OF INCOME

Aggregation is the procedural step where all computed income streams are brought together to determine the overall taxable base. This occurs after applying the specific provisions related to set-off and carry forward of losses (covered in Unit XI) and the Clubbing Provisions (Sections 60-64).

12.7.1 The Five Heads of Income

As per the structure of the Income-tax Act, 1961, income is computed only if it falls under one of the following five heads ¹:

- 1) Income from Salary
- 2) Income from House Property
- 3) Profits and Gains of Business or Profession (PGBP)
- 4) Capital Gains
- 5) Income from Other Sources

12.7.2 Computation of Gross Total Income (GTI)

Definition: Gross Total Income (GTI) is the aggregate of the income calculated under the five heads, after applying the rules of clubbing and set-off of losses, but before allowing any deductions available under Chapter VI-A (Sections 80C to 80U).

The calculation process requires several steps:

- 1) **Computation under Heads:** Compute the net income (or loss) under each of the five heads by applying the specific rules, deductions, and exemptions relevant to that head.
- 2) **Inclusion of Clubbed Income:** Include any income mandated by the Clubbing Provisions (Sections 60 to 64) in the corresponding head of the transferor's income (e.g., clubbed interest is added under Income from Other Sources; clubbed rental income is added under

Income from House Property).

- 3) **Adjustment for Losses:** Apply the rules for the set-off of current year losses (intra-head and inter-head) and the carry forward and set-off of previous years' losses.
- 4) **Final Aggregate:** The resulting total is the Gross Total Income (GTI).

The computation proceeds as follows:

Table 12.1: Process Flow from Income Heads to Total Income

Stage	Calculation Component	Outcome
Initial Stage	Sum of Income/ Loss under 5 Heads	Preliminary Aggregate Income
Middle Stage	+ Clubbed Income (Sec 60-64)	Adjusted Aggregate Income
Middle Stage	- Set-off and Carry Forward of Losses	Final Aggregate Income
Intermediate Outcome	Gross Total Income (GTI)	Starting point for deductions
Final Stage	- Deductions under Chapter VI-A (Sec 80C to 80U) [Unit X]	Allowed Deductions
Final Outcome	Total Income (TI)	The amount used for tax rate calculation

12.7.3 Total Income

Total Income (TI) is the amount remaining after subtracting all eligible deductions under Chapter VI-A (Sections 80C to 80U) from the Gross Total Income (GTI). Total Income is the figure on which the final tax liability is calculated based on the prevailing tax rates for the Assessment Year.

12.8 CLUBBING, TAX PLANNING, AND MANAGERIAL DECISION MAKING

For BBA and B.Com graduates, especially those advising family businesses or handling personal finance, the clubbing rules impose strict limitations on how family wealth can be structured to minimize taxes. Managerial decisions must be carefully balanced against these anti-avoidance measures.

- 1) **Need for Adequate Consideration:** The most straightforward way to avoid clubbing under Section 64(1)(iv) and (vi) is to ensure that assets transferred to a spouse or daughter-in-law are exchanged for adequate consideration (fair market value). If the asset is sold for fair value, the resulting income is not clubbed, regardless of the relationship.
- 2) **Structuring Spouse Remuneration:** In family concerns, if a spouse is employed, the documentation must clearly demonstrate that the remuneration is justified by their **technical or professional qualifications** and that the income relates solely to the application of that expertise. Simply paying a salary to an unqualified spouse will trigger clubbing if the other spouse holds substantial interest.

- 3) **Strategic Gifting:** If tax reduction via gifting is desired, assets should be transferred to relatives not specified under Section 64, such as major children (over 18), parents, or siblings. Income from such transfers is generally taxed in the recipient's hands.
- 4) **Monitoring Reinvestment:** Tax planning can utilize the secondary income rule. If a gift is made to a spouse, the initial income generated is clubbed, but the subsequent income derived from reinvesting that clubbed income is taxed in the spouse's hands. This allows for long-term legal income splitting.
- 5) **Documentation:** All transactions within family enterprises must be transparent and well-documented. Lack of adequate proof regarding the source of funds or the justification for remuneration can lead the Assessing Officer to invoke clubbing provisions.

12.9 ILLUSTRATIVE EXAMPLES / APPLICATIONS

Illustration 1: Clubbing of Minor Child Income and Section 10(32) Exemption

Mr. P and Mrs. P are married. Their incomes (excluding minor children's income) are:

- Mr. P's Income: ₹15,00,000 (Income from Business)
- Mrs. P's Income: ₹18,00,000 (Income from Salary)

They have three minor children with the following income during the year:

- 1) Minor A: Bank interest from gifted FD: ₹1,200.
- 2) Minor B: Earnings from stage performance (skill-based): ₹15,000.
- 3) Minor C: Interest from gifted debentures: ₹3,000.

Step-by-Step Solution:

Steps	Minor A (₹)	Minor B (₹)	Minor C (₹)	Notes
1. Identify Clubbing Parent	Mrs. P (₹18,00,000) is the higher-earning parent. Income is clubbed with Mrs. P.			
2. Minor's Gross Income	1,200	15,000	3,000	
3. Exempt Income (Skill/Talent)	-	15,000	-	Minor B's income is due to skill; not clubbed.
4. Clubbable Income	1,200	0	3,000	Minor A and C income are from investment (gifted assets).
5. Exemption u/s 10(32)	Actual income (₹1,200) or ₹1,500, whichever is less.	-	Actual income (₹3,000) or ₹1,500, whichever is less.	Exemption is restricted to actual income for A.

6. Net Income Clubbed	$(1,200 - 1,200) = 0$	0	$(3,000 - 1,500) = 1,500$	
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The net income clubbed in Mrs. P's hands is ₹0 + ₹1,500 = ₹1,500. Mrs. P's total income will be ₹18,00,000 + ₹1,500 = ₹18,01,500. Minor B must file a separate return for ₹15,000 if required, but this amount is not clubbed.

Illustration 2: Spouse Business Apportionment

Mr. Z started a proprietary firm with his own capital of ₹6,00,000 on April 1, 2023. On the same date, he gifted ₹4,00,000 cash to his wife, Mrs. Z, who immediately invested the entire amount in the firm as her capital contribution. The firm earned a profit of ₹3,00,000 during the financial year 2023-24.

Rule: When a spouse invests gifted funds (without adequate consideration) into a proprietary business, the profit earned by the business that is attributable to the gifted capital must be clubbed with the transferor's income. This is calculated proportionally based on the capital employed.

Step-by-Step Solution:

Particulars	Capital Contributed (₹)	Proportion (%)
Mr. Z's Own Capital	6,00,000	60% (6,00,000/10,00,000)
Gifted Capital (Mrs. Z)	4,00,000	40% (4,00,000/10,00,000)
Total Capital Employed	10,00,000	100%

- **Total Business Profit (PGBP):** ₹3,00,000
- **Proportion of Profit attributable to Gifted Capital:** 40%
- **Income to be Clubbed in Mr. Z's hands:** ₹3,00,000 x 40% = ₹1,20,000.

Thus, ₹1,20,000 of the business profit is clubbed with Mr. Z's income under the head Profits and Gains of Business or Profession. The remaining ₹1,80,000 is taxed in Mrs. Z's hands.



Check Your Progress – As

1. What is the minimum percentage of holding required for an individual to be deemed to have a "Substantial Interest" in a concern?

2. State two conditions under which an irrevocable transfer of asset's income would *not* be clubbed with the transferor.

-
-
3. Mr. Yash gifted ₹2 lakh to his wife, who invested it in a Fixed Deposit (FD). The interest income of ₹15,000 from the FD was clubbed with Mr. Yash's income. Mrs. Yash used that ₹15,000 interest to buy mutual funds. Will the dividends earned from those mutual funds be clubbed with Mr. Yash's income? Why or why not?
-
-
-

12.10 SUMMARY

Unit 12 explains the important anti-tax-avoidance provisions relating to Clubbing and Aggregation of Income under the Income-tax Act, 1961. The general rule of taxation is that income is taxed in the hands of the person who earns it. However, Sections 60 to 64 create exceptions to prevent artificial income shifting among family members to reduce tax liability. Clubbing provisions ensure that income arising from assets transferred without adequate consideration, or under revocable arrangements, is taxed in the hands of the original transferor. The unit discusses transfer of income without transfer of asset (Section 60), revocable transfers (Sections 61–63), and situations involving spouses, minor children, and daughter-in-law (Section 64). Special attention is given to the clubbing of a minor child's income under Section 64(1A), along with key exceptions such as income earned through skill, talent, or manual work, and relief under Section 10(32). Judicial concepts like cross transfers, converted assets, and the non-clubbing of secondary income are also explained. The latter part of the unit focuses on Aggregation of Income, where income from all five heads, including clubbed income and after set-off of losses, is combined to compute Gross Total Income (GTI). GTI forms the base for deductions, leading to the computation of Total Income.



12.11. GLOSSARY

- **Clubbing of Income:** Statutory rules forcing the inclusion of a relative's income into the transferor's income.
- **Revocable Transfer (Sec 63):** A transfer agreement that allows the transferor to reclaim the asset or income at some point in the future.
- **Irrevocable Transfer (Sec 62):** A permanent transfer or one that cannot be taken back within a specified beneficial period.
- **Substantial Interest:** Holding 20% or more of the equity shares or 20% or more of the profit share in a concern.
- **Adequate Consideration:** Transferring an asset in exchange for its fair market value.
- **Minor Child:** An individual below the age of 18 years.
- **Section 10(32):** The specific section allowing a maximum exemption of ₹1,500 on the clubbed income of a minor child.
- **Converted Asset:** An asset acquired by a transferee using funds or assets gifted by the

transferor.

- **Gross Total Income (GTI):** The aggregate of income from the five heads, post-clubbing and set-off of losses, but pre-deductions (Chapter VI-A).
- **Total Income (TI):** The GTI minus deductions under Chapter VI-A; the final taxable amount.
- **Cross Transfers:** Reciprocal gifts or transfers made by two individuals to each other's family members to avoid clubbing rules.
- **Secondary Income:** Income generated from the reinvestment of previously clubbed (primary) income.



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12.15 TERMINAL QUESTIONS

1. Explain the rationale behind introducing the clubbing provisions under the Income-tax Act, 1961.
2. Distinguish between transfer of income without transfer of asset (Section 60) and revocable transfer of assets (Sections 61–63).
3. Discuss the conditions under which income arising from assets transferred to a spouse is clubbed with the transferor's income.
4. Explain the concept of substantial interest and its relevance in clubbing of spousal remuneration.
5. Analyze the provisions relating to clubbing of a minor child's income under Section 64(1A) along with exceptions.
6. Explain the exemption available under Section 10(32) and its practical application.
7. What is meant by converted assets and secondary income? Discuss their tax treatment with examples.
8. Explain the doctrine of cross transfers and its significance in preventing tax avoidance.
9. Describe the step-by-step process of aggregation of income leading to the computation of Gross Total Income (GTI).
10. Differentiate clearly between Gross Total Income (GTI) and Total Income (TI).
11. Discuss the role of clubbing provisions in tax planning and managerial decision-making.
12. Illustrate how clubbing provisions impact family business arrangements and asset transfers.
13. Minor Child Income Calculation:
 - Mr. P's Income (excluding minor's income): ₹15,00,000.
 - Mrs. P's Income (excluding minor's income): ₹18,00,000.
 - Minor child A: Interest from gifted debentures: ₹1,200.
 - Minor child B: Income from stage performance (skill): ₹15,000.
 - Minor child C: Interest from gifted FD: ₹3,000.
 - *Required:* Compute the net income to be clubbed in the hands of the appropriate parent for the relevant Assessment Year. (Hint: Apply Section 10(32) for each eligible child.)

14. Spouse Business Apportionment:

- Mr. Z started a firm with capital of ₹6,00,000.
- He subsequently gifted ₹4,00,000 to his wife, Mrs. Z, who invested the entire amount in the same firm.
- The firm earned a profit of ₹3,00,000 during the year.
- *Required:* Calculate the amount of business profit to be clubbed in Mr. Z's hands.

14. Revocable Transfer:

- Mr. V transfers a fixed deposit certificate yielding ₹50,000 interest per annum to his friend for 7 years, after which the FD will be re-transferred to Mr. V.
- *Required:* Determine the clubbing liability under the relevant sections, assuming the transfer is conditional.

UNIT-13

ASSESSMENT OF INDIVIDUALS

Contents

- 13.1 Introduction**
- 13.2 Assessment Fundamentals and Identity**
- 13.3 The Computation Process: From GTI to Total Income (TI)**
- 13.4 Calculating Final Tax Liability: The Dual Regime Challenge**
- 13.5 Compliance and Return Filing**
- 13.6 Types of Assessment by the Income Tax Department**
- 13.7. Illustrative Examples / Applications**
- 13.8 Summary**
- 13.9. Glossary**
- 13.10 Answer to Check Your Progress**
- 13.11 References / Bibliography**
- 13.12 Suggested Readings**
- 13.13 Terminal & Model Questions**

Learning Objectives

Upon successful completion of this unit, the learner will be able to:

- ✓ Explain the concepts of Assessee, Previous Year, and Assessment Year and their interrelation in the income tax cycle.
- ✓ Analyze the step-by-step process of computing Gross Total Income (GTI) and Total Income (TI) for an individual.
- ✓ Differentiate between the Old Tax Regime and the New Tax Regime (Section 115BAC), including the critical role of Section 87A rebate.
- ✓ Calculate the total tax liability of a resident individual, incorporating basic income tax rates, surcharge, and Health and Education Cess.
- ✓ Identify the correct Income Tax Return (ITR) form (ITR-1, 2, 3, or 4) based on the individual's sources of income.
- ✓ Describe the various types of income tax assessments conducted by the Income Tax Department (143(1), 143(3), 144, 147).
- ✓ Evaluate the compliance requirements related to filing due dates and the consequences of filing a belated or updated return.

13.1 INTRODUCTION

This unit introduces the fundamental concepts and practical mechanics involved in the assessment of income tax liability for an individual taxpayer in India, governed primarily by the Income Tax Act, 1961. The process of assessment is formally defined as the evaluation and estimation of an individual's income to determine the correct quantum of tax payable to the government. It is not merely a bureaucratic task but a legal framework ensuring that every eligible person contributes their mandated share based on the principle of self-declaration followed by official verification.

For undergraduate students pursuing BBA or B.Com, mastering the assessment process is crucial, as it underpins personal financial planning and business decision-making. Individuals are often assessed not only on their salary but also on income derived from their capital investments, side businesses (especially proprietorships), or partnership shares. This means that effective tax planning, which involves optimizing investment choices (like those under Section 80C) and selecting the most beneficial tax regime (Old or New), is directly influenced by the computation rules.

A deep understanding of the assessment structure, including concepts like Gross Total Income (GTI), allowable deductions, and the intricacies of the dual tax regimes, enables future managers to structure their compensation, investment portfolios, and business transactions efficiently. Furthermore, knowledge about the different types of formal assessment—from the automated Summary Assessment (Section 143(1)) to the investigative Scrutiny Assessment (Section 143(3)) and the punitive Best Judgment Assessment (Section 144)—is essential for ensuring robust documentation and compliance, thereby mitigating financial risk and avoiding severe penalties. The decisions made during the assessment cycle directly impact disposable income, which is a critical factor in both personal liquidity and the capital available for business expansion or investment.

13.2 ASSESSMENT FUNDAMENTALS AND IDENTITY

The entire process of income taxation revolves around three foundational elements: the taxpayer (Assessee), the period during which income is earned (Previous Year), and the period when tax is determined and paid (Assessment Year).

13.2.1 Defining Assessment, Previous Year (PY), and Assessment Year (AY)

Assessment: In the context of the Income Tax Act, "assessment" signifies the procedural and legal determination of the quantum of taxable income and the corresponding tax liability of a person. While this evaluation is initially performed by the taxpayer themselves (self-assessment), the tax authorities subsequently review and finalize this determination.

Previous Year (PY): According to the Act, the Previous Year is defined as the financial year immediately preceding the Assessment Year. Income is first earned during this period. India follows the financial year cycle, which runs from April 1st of one calendar year to March 31st of the next.

- **Example:** For income earned between April 1, 2024, and March 31, 2025, the period constitutes the Previous Year (FY 2024-25).
- **Exception:** In the case of a new business or profession set up during a financial year, the PY begins on the date the business is set up and ends on March 31st of that financial year.

Assessment Year (AY): The Assessment Year is the period of twelve months, commencing on April 1st immediately following the Previous Year. It is the year during which the income earned in the PY is reviewed, assessed, and the tax is paid or refunded. For instance, for the Previous Year FY 2024-25, the Assessment Year is AY 2025-26.

The fundamental sequence is that income is *earned* in the Previous Year and *assessed* in the Assessment Year. This distinction is vital for applying the correct tax rates and claiming applicable benefits, as tax laws often change annually with the Finance Act.

13.2.2 The Role and Format of Permanent Account Number (PAN)

The Permanent Account Number (PAN) is the cornerstone of the assessment system in India. It is a unique 10-digit alphanumeric code issued by the Income Tax Department to identify every taxpayer.

Mandatory Usage and Significance: A PAN is mandatory for virtually all significant financial and tax activities. It links income tax returns, tax payments, Tax Deducted at Source (TDS), and Tax Collected at Source (TCS) to a specific individual. For students entering the business world, it is important to understand that PAN is required for opening bank accounts, purchasing or selling property, and engaging in high-value transactions, enabling the government to monitor financial activities seamlessly. The linkage of PAN with Aadhaar further strengthens the mechanism for tracking and compliance.

Format Breakdown: The 10-digit alphanumeric structure of PAN is standardized:

- 1) The first three characters are random alphabets.
- 2) The fourth character identifies the holder's status. For an Individual, this character is 'P'. Other codes include 'C' for Company, 'T' for Trust, and 'H' for Hindu Undivided Family (HUF).
- 3) The fifth character is the first letter of the PAN holder's last name (surname).
- 4) The next four characters are unique sequential numbers (0001 to 9999).
- 5) The tenth character is an alphabetic check digit.

The mandatory use of PAN across all transactions facilitates the digital process of assessment. When income is reported by third parties (e.g., employers via Form 16, banks via interest statements), the data is automatically aggregated against the individual's PAN. This cross-referencing is foundational to the subsequent steps of assessment, particularly the automated checks performed by the tax department. If the income declared in the Income Tax Return (ITR) does not match the financial activity reported against the PAN, it generates a discrepancy flag, increasing the risk of detailed scrutiny.

13.3 THE COMPUTATION PROCESS: FROM GTI TO TOTAL INCOME (TI)

The calculation of an individual's final tax liability involves a structured, multi-step approach defined in the Income Tax Act.

13.3.1 Step-by-Step Calculation

- 1) **Determine Residential Status:** The first critical step is to determine the individual's residential status (Resident, Non-Resident, or Resident but Not Ordinarily Resident). This status dictates which income sources (Indian or foreign) are included in the computation of total income.
- 2) **Classification of Income:** All income earned during the Previous Year must be categorized under the five prescribed heads of income:
 - Income from Salary (or Pension)
 - Income from House Property
 - Profits and Gains of Business or Profession
 - Capital Gains
 - Income from Other Sources (e.g., interest, dividends)
- 3) **Computation under Each Head:** For each head, the specific charging provisions and permissible deductions are applied. For example, standard deduction is allowed under the head Salary, and interest paid on housing loans is allowed under House Property. Exempt incomes (which do not form part of the total income, such as agricultural income up to certain limits) are excluded at this stage.
- 4) **Clubbing of Income:** To prevent tax evasion, income arising to certain specified persons (like a minor child or a spouse) may be legally included, or 'clubbed,' with the income of the individual taxpayer.
- 5) **Set-off and Carry Forward of Losses:** Current year losses (e.g., House Property Loss) can be adjusted against income from other eligible sources (inter-head set-off). If losses still remain, they can be carried forward to future assessment years for set-off against future income, subject to specific rules.

13.3.2 Calculation of Gross Total Income (GTI)

The aggregate of the income computed under the five heads, after applying the clubbing provisions and accounting for the set-off of current year and brought forward losses, is termed the Gross Total Income (GTI).

$$GTI = \sum \text{Income under all 5 Heads} \pm \text{Adjustments for Clubbing and Loss Set-off}$$

GTI serves as the base figure from which final statutory deductions are made to arrive at the taxable income.

13.3.3 Deductions under Chapter VI-A

Once GTI is determined, the individual is permitted to reduce it further by claiming specific deductions covered under Chapter VI-A (Sections 80C to 80U). These deductions are designed

to incentivize specific financial behaviors like saving, investing, and insuring.

Crucial Policy Consideration: It is extremely important for taxpayers to recognize that most of these Chapter VI-A deductions are not available if they opt for the New Tax Regime (Section 115BAC). This forces a strategic choice: utilize tax-saving investments (Old Regime) or accept lower tax rates without the investment mandate (New Regime).

Key Deductions for Individuals (Applicable under Old Regime):

- **Section 80C, 80CCC, 80CCD(1):** These sections provide deductions for payments made towards specified investments, such as life insurance premiums, contributions to Public Provident Fund (PPF), Equity Linked Savings Scheme (ELSS), tuition fees for children, and principal repayment of housing loans. The combined maximum deduction limit for these three sections is ₹1,50,000 per Financial Year.
- **Section 80D (Medical Insurance):** Deduction for premiums paid for health insurance (Mediclaim) for the individual, spouse, and dependent children. Higher limits are available if the premium covers senior citizens.
- **Section 80E (Higher Education Loan):** Deduction for the interest paid on a loan taken for the higher education of the assessee, spouse, or children. There is no upper limit on the amount of interest that can be claimed.
- **Section 80TTA (Interest on Savings Accounts):** Deduction up to ₹10,000 on interest earned from savings bank accounts (not available to senior citizens).
- **Section 80TTB (Interest for Senior Citizens):** Available *only* to resident senior citizens, this provides a deduction up to ₹50,000 on interest earned from savings and fixed deposits.
- **Section 80U (Disabled Persons):** Provides a fixed deduction for an individual who is disabled. The deduction is ₹75,000 for ordinary disability and ₹1,25,000 for severe disability.

Total Income (TI): After subtracting the permissible Chapter VI-A deductions from the GTI, the result is the Total Income. This is the figure on which the tax liability is computed, and it is rounded off to the nearest multiple of ₹10.

$$\text{Total Income (TI)} = \text{GTI} - \text{Deductions}$$

13.4 CALCULATING FINAL TAX LIABILITY: THE DUAL REGIME CHALLENGE

Tax calculation involves applying the appropriate slab rates, incorporating any available rebates, and adding statutory levies like Surcharge and Cess.

13.4.1 Structure of Old vs. New Tax Regimes (Section 115BAC)

The New Tax Regime (Section 115BAC), introduced to simplify compliance, is the default tax system since AY 2025-26. However, taxpayers retain the option to choose the Old Tax Regime.²³ This decision is critical as it fundamentally alters the calculation base. The Old

Regime supports high investment through deductions but has higher base rates, whereas the New Regime has lower rates but restricts most deductions.

The key distinction lies in the benefits sacrificed under the New Regime, such as Leave Travel Allowance (LTA), House Rent Allowance (HRA), children's education allowance, and the major deductions under Chapter VI-A (80C, 80D, etc.).

Table 13.1 Comparative Income Tax Slabs (Old vs. New Regime, AY 2025-26/FY 2024-25)

Total Income Slab (TI)	Old Regime (Below 60 yrs)	New Regime (Sec 115BAC)
Up to ₹ 2,50,000	NIL	NIL (Up to ₹ 3,00,000 is NIL)
₹ 2,50,001 to ₹ 3,00,000	5%	NIL
₹ 3,00,001 to ₹ 5,00,000	5%	5%
₹ 5,00,001 to ₹ 7,00,000	20%	5%
₹ 7,00,001 to ₹ 10,00,000	20%	10%
₹ 10,00,001 to ₹ 12,00,000	30%	15%
₹ 12,00,001 to ₹ 15,00,000	30%	20%
Above ₹ 15,00,000	30%	30%

13.4.2 Tax Reliefs: Rebate under Section 87A

The rebate under Section 87A offers direct tax relief for resident individuals who fall within the lower income bracket. This amount is subtracted directly from the computed tax liability, before the application of the Health and Education Cess.

- **Old Regime:** The rebate is capped at the lower of the total tax payable or ₹12,500. This effectively results in zero tax liability for resident individuals whose Total Income does not exceed ₹5,00,000.
- **New Regime (AY 2025-26):** The rebate is capped at the lower of the total tax payable or ₹25,000. This effectively grants zero tax liability for resident individuals whose Total Income does not exceed ₹7,00,000.
- **Future Policy Trajectory (FY 2025-26/AY 2026-27):** Continuous changes aim to simplify the new system. The rebate limit under the New Regime is further proposed to be enhanced, allowing an individual with income up to ₹12,00,000 to be entirely tax-free, with a potential rebate of up to ₹60,000. This legislative action underscores a strategic policy move to make the default New Regime universally attractive, particularly for middle-to-upper income salaried classes who might not rely heavily on the older deduction mechanisms.

13.4.3 Additional Levies: Surcharge and Health & Education Cess

After applying the tax slab rates and any applicable rebate (Sec 87A), the computed tax liability may be further increased by two levies: Surcharge and Cess.

- 1) **Surcharge (Tax on Tax):** Surcharge is an additional tax levied on the amount of income tax itself. It is applicable only to individuals whose Total Income exceeds specific high

thresholds (currently ₹50 lakh and above). The rates for surcharge differ significantly between the two regimes:

Table 13.2: Surcharge Rates on Income Tax (AY 2025-26)

Total Income (TI) Slab	Old Regime Surcharge Rate	New Regime Surcharge Rate (u/s 115BAC)
Up to ₹ 50 Lakh	Nil	Nil
₹ 50 Lakh to ₹ 1 Crore	10%	10%
₹ 1 Crore to ₹ 2 Crore	15%	15%
₹ 2 Crore to ₹ 5 Crore	25%	25%
Above ₹ 5 Crore	37%	25% (Capped)

The capping of the maximum surcharge rate at 25% for the highest income bracket (above ₹5 Crore) under the New Regime, compared to 37% in the Old Regime, is a notable feature. This modification makes the New Regime potentially more financially appealing to high-net-worth individuals, even if they cannot claim many deductions, indicating a policy intent to simplify and unify compliance across all income brackets.

- 2) **Health and Education Cess (HEC):** This is a mandatory levy calculated at a fixed rate of 4% on the total amount of income tax plus the surcharge (if any). The HEC is applicable to *all* taxpayers who have an income tax liability, irrespective of their income bracket. Unlike the surcharge, which flows into general government revenue, the proceeds from the HEC are earmarked for specific social objectives, namely providing quality health services and universalized education.

The final tax payable by the individual is the sum of the basic tax liability, plus surcharge, plus the 4% HEC.

13.5 COMPLIANCE AND RETURN FILING

Timely and accurate compliance is fundamental to the assessment process. This includes filing the correct form by the statutory deadline.

13.5.1 Due Dates and Consequences

Normal Due Date: For most individual taxpayers, such as salaried employees and those not subject to mandatory tax audit, the typical deadline for filing the Income Tax Return (ITR) is July 31st of the Assessment Year. Due dates are often extended by the government.

Belated Return: If a taxpayer misses the normal due date, they are still permitted to file a return, known as a belated return, generally up until December 31st of the relevant Assessment Year.

- **Consequences of Delay:** Filing a belated return entails certain financial consequences:
 - 1) **Late Fee (Section 234F):** A late filing fee of up to ₹5,000 may be levied.
 - 2) **Loss of Interest on Refund (Section 244A):** If the individual is due a tax refund (meaning they paid excess tax through TDS or Advance Tax), interest on that refund,

calculated under Section 244A, only accrues from the date of filing the belated return, rather than from April 1st of the Assessment Year. This loss of several months of interest can be substantial in high-refund cases.

Updated Return (ITR-U): If a taxpayer misses the deadline for a belated return or later realizes they omitted income, they have the option to file an updated return (ITR-U). This provision allows correction of errors up to 48 months (4 years) from the end of the relevant Assessment Year. However, filing ITR-U requires the payment of additional tax along with penalties.

13.5.2 Choosing the Correct Income Tax Return (ITR) Form

The Income Tax Department mandates different forms based on the complexity and sources of the individual's income. Selecting the wrong form can result in the return being treated as defective or invalid.

Table 13.3: Applicability Criteria for Key ITR Forms for Individuals

ITR Form	Common Name	Applicable For	Ineligible If (Examples)
ITR-1	Sahaj	Resident Individual with Total Income ₹50 Lakhs from: Salary/Pension, One House Property, Other Sources (Interest, Dividend), and Agricultural Income up to ₹5,000.	Has income from Business or Profession, Short-term or Long-term Capital Gains (except Sec 112A CG up to ₹1.25 Lakhs), income from more than one House Property, or foreign assets/income.
ITR-2	-	Individual/ HUF who does NOT have income from business or profession. Covers complex sources like: Multiple House Properties, Capital Gains, Foreign Assets/Income, or unlisted equity shares.	Has income from Profits and Gains of Business or Profession.
ITR-3	-	Individual/HUF having income from Profits and Gains of Business or Profession (who maintain books of accounts). Also for those who have invested in unlisted equity shares.	Generally covers those ineligible for ITR-1, ITR-2, or ITR-4.
ITR-4	Sugam	Resident Individual/HUF with Total Income ₹50 Lakhs, opting for the Presumptive Taxation Scheme (Sec 44AD, 44ADA, 44AE) for business/profession income.	Is a Director in a company, holds foreign assets, or has brought forward or carried forward losses.

The proper selection of the ITR form is essential for compliance. For instance, the simplest form, ITR-1, is explicitly restricted for individuals with income from Capital Gains or business. Taxpayers with business income must consider ITR-3 or ITR-4, depending on whether they opt for presumptive taxation.

13.6 TYPES OF ASSESSMENT BY THE INCOME TAX DEPARTMENT

The Income Tax Act defines several modes by which the tax authorities verify and finalize the tax liability of an individual.

13.6.1 Self-Assessment (Section 140A)

This is the initial stage, where the individual taxpayer performs the calculation of their total income and the corresponding tax liability themselves. This process concludes when the assessee pays any outstanding tax (known as Self-Assessment Tax) before filing the Income Tax Return (ITR). The entire tax system relies fundamentally on the accuracy and honesty of this self-declaration.

13.6.2 Summary Assessment (Processing under Section 143(1))

Summary Assessment is the most common form of assessment, executed automatically and digitally at the Centralized Processing Centre (CPC).

- **Mechanism:** After the ITR is filed, the system performs a preliminary check, cross-referencing the declared income and deductions against the data available with the Income Tax Department (e.g., TDS details in Form 26AS, or information in the Annual Information Statement, AIS).
- **Scope:** The system corrects simple arithmetical errors and checks for incorrect or invalid claims that are immediately apparent from the return itself. For example, if a taxpayer claims a deduction that is explicitly disallowed under the chosen tax regime, the system automatically corrects it.
- **Outcome:** If discrepancies are found, the AO issues an intimation under Section 143(1), notifying the taxpayer of the proposed adjustments and the resultant tax payable or refund due. If no discrepancies are found, the return is deemed processed.

13.6.3 Scrutiny Assessment (Section 143(3))

Scrutiny Assessment involves a detailed and thorough examination of the taxpayer's return and supporting documents by the Assessing Officer (AO).

- **Objective:** The primary goal is to confirm the genuineness and correctness of various claims, deductions, and exemptions made by the taxpayer, ensuring that the income has not been understated and the tax has not been underpaid. This investigation goes far beyond the automated checks of Section 143(1).
- **Trigger:** Returns are selected for scrutiny via computer analytics (CASS) or manually if high-risk factors are identified. Common red flags include:
 - 1) Significant mismatch between income reported in the ITR and income reported by

- third parties (such as employers, banks, or stock exchanges) in AIS or Form 26AS.³¹
- 2) Non-disclosure of high-value transactions, such as large cash deposits or property purchases.
 - 3) Specific intelligence regarding non-disclosure of foreign income or assets, often revealed through data exchange agreements with foreign jurisdictions (AEOI framework).
- **Process:** The AO issues a notice, typically under Section 143(2), demanding comprehensive documentation, explanations, and evidence for every claim. Importantly, many scrutiny assessments are now conducted under a faceless regime, minimizing direct interaction between the taxpayer and the AO.

13.6.4 Best Judgment Assessment (Section 144)

The Best Judgment Assessment is invoked when the taxpayer fails to adhere to the fundamental rules of compliance, forcing the AO to determine the tax liability based on their own estimation.

- **Trigger (Compulsory):** The AO must initiate Best Judgment Assessment when the taxpayer is non-compliant or uncooperative, specifically in cases where the taxpayer:
 - 1) Fails to file the income tax return, even after being served a statutory notice.
 - 2) Fails to comply with any notice requiring the production of books of account or other specified documents, particularly during a Scrutiny Assessment.
 - 3) Files an incomplete, unverified, or unsigned return.
- **Mechanism:** The AO uses their best judgment, based on relevant material, previous history, industry averages, and any third-party data available (such as bank deposits or GST filings). The AO is required to act honestly, impartially, and without vindictiveness. This assessment often results in a higher tax demand because the AO is likely to err on the side of caution against the non-cooperative taxpayer.

13.6.5 Income Escaping Assessment (Reassessment under Section 147)

This process is a corrective mechanism, allowing the AO to re-open a previously completed assessment if it is later discovered that income chargeable to tax has "escaped assessment".

- **Trigger:** The AO must have "reason to believe" that taxable income was missed. Reasons for income escaping assessment include:
 - 1) Understatement of income by the taxpayer in the original return.
 - 2) The taxpayer failed to file a return despite having taxable income.
 - 3) Excessive deductions, allowances, or losses were wrongly granted during the original assessment proceedings.
- **Process:** The AO must record reasons in writing and issue a notice under Section 148 before proceeding with the reassessment. This power ensures that tax authorities can recover revenue when errors or omissions, whether intentional or unintentional, are identified after the initial assessment period has concluded.

13.7. ILLUSTRATIVE EXAMPLES / APPLICATIONS

These examples demonstrate the practical application and consequences of the concepts

discussed in the unit.

13.7.1 Case Application 1: Scrutiny Assessment Trigger (Non-disclosure of Foreign Income)

- **Scenario:** Ms. Geeta, a resident individual in India, files her ITR-1 declaring salary income of ₹25,00,000 for AY 2025-26. She had earned a dividend of ₹5,00,000 from shares held in a US company during the Previous Year, which she failed to disclose.
- **Application:** The Income Tax Department receives automatic information about this foreign dividend income and asset holding through international agreements (AEOI framework). The departmental analytics system detects a severe mismatch between the income reported in the ITR and the foreign financial data linked to her PAN.
- **Outcome:** Ms. Geeta is flagged as a "high-risk" case. The AO initiates a Scrutiny Assessment (Section 143(3)) to examine the non-disclosure.³¹ If the assessment confirms that she knowingly or negligently failed to disclose the foreign income, she faces not only the regular tax demand on the ₹5,00,000 but also severe penalties under the Black Money Act, which can include a 30% tax and a 300% penalty on the tax payable, highlighting the importance of complete compliance, especially regarding international assets.

13.7.2 Numerical Example: Comparison of Old vs. New Regime

Mr. Vivek (Age 35, Resident) has a Gross Salary Income of ₹15,00,000 for FY 2024-25 (AY 2025-26). He is eligible for a Standard Deduction of ₹50,000 in both regimes.² Under the Old Regime, he invested the maximum ₹1,50,000 (80C limit) and paid ₹25,000 for health insurance (80D). Under the New Regime, he cannot claim 80C or 80D.

Objective: Determine the more financially beneficial tax regime for Mr. Vivek.

Step-by-Step Solution (AY 2025-26):

Particulars (Income: ₹15,00,000)	Old Regime (OR) (Deductions Allowed)	New Regime (NR) (Deductions Restricted)
A. Gross Salary Income	15,00,000	15,00,000
B. Less: Standard Deduction (Sec 16(ia))	(50,000)	(50,000)
C. Gross Total Income (GTI) / Net Salary	14,50,000	14,50,000
D. Less: Chapter VI-A Deductions		
80C (PPF, LIC, ELSS)	(1,50,000)	Nil
80D (Health Insurance)	(25,000)	Nil
E. Total Income (TI)	12,75,000	14,50,000
F. Tax Calculation on TI		
F.1 Tax on ₹12,75,000 (OR)		
Up to ₹ 2,50,000: Nil	0	-
₹ 2,50,001 - ₹ 5,00,000 @ 5%	12,500	-
₹ 5,00,001 - ₹ 10,00,000 @ 20%	1,00,000	-
Balance ₹ 2,75,000 @ 30%	82,500	-

Subtotal Tax (OR)	1,95,000	-
F.2 Tax on ₹14,50,000 (NR)		
Up to ₹ 3,00,000: Nil	-	0
₹ 3,00,001 - ₹ 6,00,000 @ 5%	-	15,000
₹ 6,00,001 - ₹ 9,00,000 @ 10%	-	30,000
₹ 9,00,001 - ₹ 12,00,000 @ 15%	-	45,000
₹ 12,00,001 - ₹ 14,50,000 @ 20%	-	50,000
Subtotal Tax (NR)	-	1,40,000
G. Less: Rebate u/s 87A	Nil (TI > ₹5 Lakh)	Nil (TI > ₹7 Lakh)
H. Tax After Rebate	1,95,000	1,40,000
I. Add: Health and Education Cess @ 4%	7,800	5,600
J. Final Tax Payable (Rounded)	2,02,800	1,45,600

Thus, even though Mr. Vivek maximized his investments under the Old Regime, the New Regime results in a significantly lower final tax liability of ₹1,45,600, demonstrating that the structural benefit of lower rates can often outweigh large deductions, especially in the mid-to-high income brackets for AY 2025-26.



Check Your Progress – A

1. Differentiate between the Previous Year and the Assessment Year using an Indian financial calendar example.

2. What is the significance of the "P" in the fourth position of an individual's Permanent Account Number?

3. Name two major deductions that are generally forgone under the New Tax Regime (Section 115BAC).

13.8 SUMMARY

This unit explains the complete framework for assessment of income tax liability of individuals in India under the Income Tax Act, 1961. The assessment process is based on the principle that

income earned in a *Previous Year* is evaluated and taxed in the subsequent *Assessment Year*. A central element of this system is the Permanent Account Number (PAN), which uniquely identifies taxpayers and links all financial transactions, ensuring transparency and compliance. The unit details the structured computation process, beginning with classification of income under the five heads to arrive at *Gross Total Income (GTI)*. After applying provisions relating to clubbing of income and set-off or carry-forward of losses, eligible deductions under Chapter VI-A are allowed to compute *Total Income (TI)*. A key feature discussed is the choice between the Old Tax Regime and the New Tax Regime (Section 115BAC), highlighting trade-offs between higher deductions and lower slab rates. The role of rebate under Section 87A, surcharge on high incomes, and Health and Education Cess is also explained. Further, the unit emphasizes compliance requirements such as correct selection of ITR forms, adherence to filing deadlines, and consequences of belated or updated returns. It also outlines different types of assessments conducted by the Income Tax Department—summary, scrutiny, best judgment, and reassessment—underscoring the importance of accurate disclosure and documentation.



13.9. GLOSSARY

- **Assessee:** Any person who is liable to pay tax or any other sum of money under the Income Tax Act.
- **Previous Year (PY):** The financial year (April 1 to March 31) in which the income is earned.
- **Assessment Year (AY):** The financial year immediately following the PY, in which the income is officially assessed and taxed.
- **Permanent Account Number (PAN):** A mandatory, unique 10-digit code used to identify taxpayers for all financial transactions.
- **Gross Total Income (GTI):** The total income computed by aggregating income under all five heads, before making Chapter VI-A deductions.
- **Total Income (TI):** GTI reduced by allowable Chapter VI-A deductions, which forms the basis for tax calculation.
- **Surcharge:** An additional tax levied on the income tax amount of high-net-worth individuals.
- **Health and Education Cess (HEC):** A mandatory 4% tax on the income tax plus surcharge, earmarked for social spending.
- **Rebate u/s 87A:** A direct reduction in tax liability available only to resident individuals whose TI is below a specified threshold.
- **Summary Assessment (143(1)):** Automated processing of the ITR done at the CPC for preliminary corrections.
- **Scrutiny Assessment (143(3)):** A detailed examination by the AO to confirm the correctness of the taxpayer's claims.
- **Best Judgment Assessment (144):** Assessment determined by the AO's estimate when the taxpayer fails to comply or cooperate.
- **Income Escaping Assessment (147):** Procedure to reassess income chargeable to tax that was not assessed in the initial proceedings.
- **Belated Return:** An ITR filed after the original due date but within the extended time

limit (generally December 31st of the AY).



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13.12 TERMINAL QUESTIONS

1. Define the term assessment under the Income Tax Act, 1961 and explain its significance for individual taxpayers.
2. Distinguish clearly between Previous Year and Assessment Year with suitable examples.
3. Explain the importance of Permanent Account Number (PAN) in the assessment and compliance process.
4. Describe the step-by-step procedure for computing Gross Total Income (GTI) of an individual.
5. What is Total Income (TI)? Explain how deductions under Chapter VI-A affect its computation.
6. Compare the Old Tax Regime and the New Tax Regime (Section 115BAC) with reference to slab rates and deductions.
7. Explain the provisions of rebate under Section 87A and its impact on tax liability.
8. Discuss the role of surcharge and Health and Education Cess in determining final tax payable.
9. Explain the importance of selecting the correct Income Tax Return (ITR) form for individuals.
10. What are the due dates for filing income tax returns by individuals and what are the consequences of filing a belated return?
11. Explain the concept of Self-Assessment under Section 140A.
12. Describe the procedure and scope of Summary Assessment under Section 143(1).
13. What is Scrutiny Assessment under Section 143(3)? State the circumstances under which it is initiated.
14. Explain Best Judgment Assessment under Section 144 and the situations in which it is applied.
15. What is Income Escaping Assessment under Section 147? Discuss its relevance in ensuring tax compliance.
16. Mr. Kartik (Age 45) has a Gross Total Income (GTI) of ₹9,50,000. He is entitled to deductions under 80C of ₹1,00,000 and 80D of ₹15,000. Calculate his Total Income and Tax Payable for AY 2025-26 under the Old Regime. (Hint: Use the slab rates for TI in the range ₹5,00,001–₹10,00,000).
17. Mrs. Priya, a resident, has a Total Income of ₹18,00,000. Calculate her net tax liability for AY 2025-26 under the New Tax Regime, including the 4% Health and Education Cess. (Hint: Use the New Regime slabs and note that income is above the rebate limit).

UNIT-14

ASSESSMENT OF FIRMS AND PARTNERS

Contents

- 14.1 Introduction**
- 14.2 Legal Foundation for Firm Assessment: Compliance and Status**
- 14.3 Computation of Gross Total Income (GTI)**
- 14.4 PGBP Adjustments: Restrictions on Partner Payments (Section 40)**
- 14.5 Detailed Calculation of Book Profit and Allowable Remuneration (Section 40(b))**
- 14.6 Calculation of Final Total Income and Tax Liability**
- 14.7 Assessment of Partners' Income**
- 14.8 Alternative Minimum Tax (AMT) Provisions (Section 115JC)**
- 14.9. Illustrative Examples / Applications**
- 14.10. Summary**
- 14.11. Glossary**
- 14.12 References / Bibliography**
- 14.13 Suggested Readings**
- 14.14 Terminal Questions**

Learning Objectives

Upon successful completion of this unit, you will be able to:

- ✓ Explain the statutory requirements (Section 184) necessary for a partnership firm to be legally assessed as a firm under the Income Tax Act, 1961.
- ✓ Describe the special restrictive provisions governing the deductibility of interest on capital and remuneration (salary/commission/bonus) paid to working partners.
- ✓ Differentiate clearly between Net Profit, the statutory Book Profit, and the final Total Taxable Income of the firm.
- ✓ Compute the maximum allowable deduction for partner remuneration using the prescribed slab rates under Section 40(b).
- ✓ Analyze the tax implications of various receipts (share of profit versus salary/interest) in the hands of the individual partners.
- ✓ Apply the flat tax rate, applicable surcharge, and Health and Education Cess to accurately calculate the firm's final tax liability.

- ✓ Evaluate the applicability and mechanism of the Alternative Minimum Tax (AMT) under Section 115JC, including the calculation of Adjusted Total Income (ATI) and the utilization of AMT Credit.

14.1 INTRODUCTION

This unit is designed to provide you with a comprehensive understanding of how partnership firms, including Limited Liability Partnerships (LLPs), are assessed for income tax purposes in India under the Income Tax Act, 1961. Partnership firms constitute a critical segment of the Indian business landscape, often serving as the foundational structure for professionals, consultants, and Small and Medium-sized Enterprises (SMEs). Historically, the tax treatment of firms and partners has undergone significant changes to ensure fairness and prevent tax evasion. The current framework treats the partnership firm as a separate, taxable entity, distinct from the individual partners who own it. This means the firm calculates and pays tax on its total income, and the partners pay tax on their remuneration and interest received from the firm, but generally not on their share of profit. This dual assessment structure necessitates strict adherence to specific statutory requirements and computational rules.

Understanding these provisions is vital for effective managerial decision-making. Partners and financial managers must recognize that the ability of the firm to claim critical operating expenses, such as partner salaries and interest on capital, is not automatic. Instead, it is severely restricted by specific legal ceilings and conditions laid down primarily in Section 40(b). Non-compliance can lead to the disallowance of these expenses, drastically increasing the firm's tax burden (taxed at the high flat rate of 30%). Furthermore, assessing the impact of the flat tax rate and the potential application of the Alternative Minimum Tax (AMT) under Section 115JC is essential for accurate budgeting, cash flow optimization, and strategic investment decisions. This unit will guide you through the compliance framework, the computation methodology, and the implications for both the firm and its partners.

14.2 LEGAL FOUNDATION FOR FIRM ASSESSMENT: COMPLIANCE AND STATUS

14.2.1 Status and General Assessment Principle

Under the Indian Income Tax Act, 1961, a partnership firm, including a Limited Liability Partnership (LLP), is recognized as a distinct entity defined under the term 'person.' Consequently, the firm is required to file its own income tax return and is treated as a separate 'assessee.' The firm is assessed on its total income derived from various sources, such as business, property, capital gains, and other sources.

The unique tax challenge in assessing firms arises from the necessary balance between treating the firm as an independent taxpayer and recognizing that the firm's income ultimately belongs to its partners. The law achieves this balance through specific rules, particularly concerning the salary and interest paid to partners.

14.2.2 Mandatory Conditions for Assessment as a Firm (Section 184)

For a partnership firm to be assessed under the beneficial provisions applicable to firms (which include the crucial ability to claim deductions for partner remuneration and interest), it must strictly adhere to the conditions laid down in Section 184 of the Act.

These conditions are essentially documentation requirements that validate the existence and constitution of the firm throughout the previous year:

- 1) **Written Partnership Deed:** There must be a valid, written instrument of partnership (the partnership deed) in force during the previous year for which the assessment is being made.
- 2) **Filing of the Instrument:** A certified copy of this partnership instrument must accompany the firm's return of income, particularly for the first assessment year in which the firm seeks assessment as a firm.
- 3) **Clarity on Partner Shares:** The deed must clearly specify the individual shares of the partners in the firm's profits, and also the proportions in which losses, if any, will be shared.
- 4) **Updating Changes:** If any alteration occurs in the constitution of the firm (e.g., a change in partnership ratios, addition, or retirement of a partner), a certified revised instrument must be filed along with the income return for the year in which the change occurred.

14.2.3 Consequences of Non-Compliance

The meticulous compliance with Section 184 is not merely an administrative formality; it is a prerequisite for accessing key tax benefits. If a firm fails to comply with any requirement under Section 184 or faces non-compliance issues leading to assessment under Section 144 (Best Judgment Assessment), severe financial consequences follow:

- **Disallowance of Partner Payments:** The law explicitly disallows the firm from claiming any deduction for interest, salary, bonus, commission, or any other remuneration paid to partners. This means the entire amount paid to partners is added back to the firm's business income, increasing the firm's taxable income significantly.
- **Taxation of Partners:** Crucially, if the remuneration or interest is disallowed in the hands of the firm, it is **not** taxable in the hands of the receiving partner under Section 28(v).

This linkage between documentation and deduction means that tax compliance is intrinsically tied to legal formality. Management's failure to maintain proper and up-to-date statutory documentation can instantly convert otherwise deductible business expenditure into taxable income for the firm, leading to a substantial increase in tax liability at the 30% flat rate. This procedural risk highlights the necessity for proactive financial and legal management within a partnership structure.

14.3 COMPUTATION OF GROSS TOTAL INCOME (GTI)

A partnership firm computes its Gross Total Income (GTI) by aggregating income under the five main heads recognized by the Income Tax Act:

- 1) Income from Salary (Usually Nil for a firm).
- 2) Income from House Property.
- 3) Income from Profits and Gains from Business or Profession (PGBP).
- 4) Income from Capital Gains.
- 5) Income from Other Sources.

The calculation of PGBP is the most complex step for a partnership firm because it is subject to specific adjustments and restrictions detailed in Section 40(b), which deals exclusively with payments made to partners.

14.4 PGBP ADJUSTMENTS: RESTRICTIONS ON PARTNER PAYMENTS (SECTION 40)

Section 40 dictates which specific expenses, though paid by the firm for business purposes, are not allowed as deductions in computing the PGBP. Section 40(b) specifically restricts the allowance of interest and remuneration paid to partners.

14.4.1 Interest Paid to Partners

Interest paid to partners on their capital contribution or loans is generally allowed as a deduction, provided two conditions are met:

- 1) **Authorization:** The payment of interest must be explicitly authorized by the partnership deed.
- 2) **Rate Limit:** The deduction is allowed only up to a maximum simple interest rate of 12% per annum.

If the firm pays interest at a rate higher than 12% (e.g., 15%), the excess amount (the 3% differential) is disallowed and must be added back to the firm's Net Profit when calculating its PGBP.

14.4.2 Remuneration Paid to Partners (Salary, Commission, Bonus)

Remuneration paid to partners is allowed only under rigorous conditions and within statutory monetary limits.

- 1) **Authorization and Date:** The remuneration must be authorized by the partnership deed and must relate to a period after the date of the partnership instrument.
- 2) **Working Partner Requirement:** Remuneration is deductible only if it is paid to a Working Partner. A remuneration paid to a partner who is simply an investor (often called a silent partner) is fully disallowed.
- 3) **Definition of Working Partner:** Explanation 4 to Section 40(b) defines a working partner as one who is actively engaged in conducting the affairs of the business or profession of the firm. This legal definition connects the allowability of the expense directly to the productive contribution of the partner, ensuring that the deduction is linked to genuine business activity, not just profit distribution.
- 4) **Statutory Monetary Limit:** Even if authorized and paid to a working partner, the

deduction is strictly capped based on the firm's calculated Book Profit (BP).

14.5 DETAILED CALCULATION OF BOOK PROFIT AND ALLOWABLE REMUNERATION (SECTION 40(B))

The calculation of the maximum permissible deduction for partner remuneration requires an intermediate step: determining the firm's Book Profit (BP). Book Profit essentially represents the firm's Profits and Gains from Business or Profession *before* deducting any remuneration paid to partners.

14.5.1 Step 1: Calculating Book Profit (BP)

The process starts with the Net Profit (or Loss) reported in the Profit and Loss (P&L) Account and involves specific adjustments to arrive at the Book Profit:

Table 14.1: Calculation of Book Profit for Section 40(b)

Particulars	Amount (₹)	Notes on Adjustment
Net Profit/Loss as per P&L Account	XXXX	Starting point.
Add: General Business Disallowances	XXXX	Expenses disallowed under general PGBP rules (e.g., personal expenses, specific non-deductible items, or payments exceeding 12% interest to partners).
Add: Total Partner Remuneration (Debited)	XXXX	The full amount of remuneration paid/payable to partners must be added back, regardless of whether it is authorized or paid to working partners, to establish the profit <i>before</i> deduction.
Less: Income Taxable under Other Heads	(XXX)	Deduct any non-business income (like rental income, dividends, or capital gains) that might have been credited to the P&L account, as these are assessed separately.
Book Profit (BP)	XXXX	This resulting figure is the basis for applying the statutory limits.

The Book Profit calculation ensures a standardized base for determining the maximum allowable remuneration, independent of the firm's initial accounting treatment of partner salaries.

14.5.2 Step 2: Applying the Statutory Limits to Book Profit

Once the Book Profit (BP) is determined, the maximum amount of remuneration that the firm is legally allowed to claim as a deduction is calculated using the following slab structure:

Table 14.2: Maximum Deductible Remuneration Limits (Section 40(b) Slabs)

Range of Book Profit (BP)	Maximum Allowable Deduction (A)
On the first ₹3,00,000 of Book Profit (or in case of loss)	₹1,50,000 or 90% of BP, whichever is higher
On the Balance of Book Profit (i.e., above ₹3,00,000)	60% of the remaining Book Profit

(Note: Statutory limits are subject to change by Finance Acts. For example, some revisions have been proposed/enacted, such as the limit being set at ₹3,00,000 or 90% of the first ₹6,00,000 of book profits, effective from April 2025. However, the foundational principle of slab-based calculation remains the same.)

14.5.3 Step 3: Determining the Final Allowable Deduction

The final amount that the firm can deduct as an expense for remuneration in its PGBP computation is the **least** of the following three amounts:

- 1) **Actual Remuneration Paid:** The amount of remuneration actually paid or payable to the working partners.
- 2) **Authorized Remuneration:** The amount specified or calculated according to the formula explicitly laid down in the partnership deed.
- 3) **Statutory Limit:** The maximum limit calculated based on the Book Profit slabs (Table 2).

The use of the Book Profit mechanism ensures that high tax incidence is avoided. By linking the deduction ceiling to the actual operating profitability of the firm (Book Profit), the law prevents firms from artificially reducing their PGBP income through excessive partner remuneration, thereby discouraging tax avoidance by diverting profits. The allowable remuneration serves as a legitimate expense, reducing the firm's ultimate tax base.

14.6 CALCULATION OF FINAL TOTAL INCOME AND TAX LIABILITY

14.6.1 Final PGBP and Total Taxable Income

After deducting the final allowable remuneration and interest, the firm arrives at its net PGBP income. This PGBP income is then aggregated with income under the other heads (House Property, Capital Gains, Other Sources) to yield the Gross Total Income (GTI). From the GTI, the firm is allowed to claim specific deductions under Chapter VI-A (e.g., Section 80C, 80D, 80G, etc., applicable to firms). The result is the firm's Total Taxable Income.

14.6.2 Tax Rate Structure

Partnership firms and LLPs are subject to a straightforward tax structure:

- 1) **Flat Tax Rate:** The entire Total Taxable Income is taxed at a flat rate of 30%. Unlike

individuals, firms do not benefit from progressive slab rates.

- 2) **Surcharge:** A surcharge is levied on the calculated income tax, depending on the magnitude of the Total Taxable Income:
 - If Total Taxable Income is up to ₹1 Crore: Surcharge is Nil.
 - If Total Taxable Income exceeds ₹1 Crore: Surcharge is levied at 12% of the Income Tax amount.
 - *Marginal Relief:* If the income slightly exceeds ₹1 Crore, marginal relief is provided to ensure that the increase in tax payable is not greater than the income that exceeds ₹1 Crore.
- 3) **Health and Education Cess (HEC):** HEC is levied at a rate of 4% on the total amount of Income Tax plus Surcharge (if applicable).

The resulting total (Income Tax + Surcharge + Cess) is the final tax liability that the firm must pay.

14.7 ASSESSMENT OF PARTNERS' INCOME

The assessment of the partner is directly linked to the assessment of the firm. It is critical to differentiate between the two types of payments a partner may receive from the firm: the share of post-tax profit and the payment for services/ capital (remuneration/interest).

14.7.1 Tax Treatment of Share of Profit

The most significant feature of partnership taxation is the treatment of the partner's share in the net profits of the firm.

- **Exemption:** The share of profit received by a partner from a firm is fully exempt from tax in the partner's hands under Section 10(2A).
- **Preventing Double Taxation:** This exemption is provided because the firm has already been assessed and paid the flat 30% tax rate on its entire income, including the profits that are subsequently distributed. Taxing the partner again on this share would constitute double taxation, which the law seeks to avoid.

14.7.2 Tax Treatment of Remuneration and Interest

Any payment received by a partner as interest on capital, salary, bonus, commission, or any other form of remuneration, by whatever name called, is taxable in the hands of the individual partner.

- **Head of Income:** These receipts are classified and taxed under the head Profits and Gains from Business or Profession (PGBP) in the partner's individual income tax return. The partner must use the appropriate Income Tax Return Form (like ITR-3, depending on other income sources) for filing.
- **Critical Linkage:** The amount taxable in the partner's hands is restricted precisely to the amount that was allowed as a deduction in the firm's computation of PGBP under Section 40(b).
- **The Balanced Mechanism:** This creates a carefully structured balance: remuneration is

allowed as a deduction at the firm level (saving tax at the 30% flat rate) but is made taxable at the partner level (at the partner's potentially lower individual slab rates). If any portion of the remuneration is disallowed at the firm level (due to excess interest or exceeding the Book Profit limit), that disallowed portion is not taxable for the partner. This mechanism ensures that every rupee of income, whether compensation or profit, is taxed exactly once, optimizing tax flow while enforcing strict compliance rules.

14.8 ALTERNATIVE MINIMUM TAX (AMT) PROVISIONS (SECTION 115JC)

Partnership firms and LLPs are subject to the Alternative Minimum Tax (AMT) provisions under Section 115JC. AMT is a safeguard mechanism designed to ensure that even if a firm claims substantial tax deductions (like those available for developing special economic zones or for specified capital expenditure), it pays a minimum amount of tax on its actual economic activity.

14.8.1 Applicability and Scope

AMT applies to firms if they claim specific deductions that reduce their normal total income significantly. These specified deductions often include those claimed under:

- Section 10AA (deductions relating to units in Special Economic Zones - SEZ).
- Section 35AD (deduction for capital expenditure on specified businesses).

If a firm claims such deductions and its Adjusted Total Income exceeds ₹20 lakhs, it becomes liable to calculate and potentially pay AMT.

14.8.2 Calculation of Adjusted Total Income (ATI)

The starting point for AMT calculation is the Adjusted Total Income (ATI). ATI is computed by reversing the effect of the specified deductions claimed under the normal tax regime:

$$\text{ATI} = \text{Normal Total Income} + \text{Specified Deductions Claimed}$$

The deductions claimed under sections like 10AA or 35AD are added back to the Normal Total Income to arrive at the ATI.⁸ This adjustment creates a broader income base representing the firm's profits before these high-value incentives are factored in.

14.8.3 Computation and Payment of AMT

- 1) **AMT Rate:** The Alternative Minimum Tax is calculated at a rate of 18.5% of the Adjusted Total Income (ATI).
- 2) **Tax Payable Rule:** The firm is obligated to pay the higher of the following two amounts:
 - The Normal Tax Liability (30% flat rate on Normal Total Income plus Surcharge and Cess).
 - The AMT Liability (18.5% of ATI plus Surcharge and Cess).

If the firm's normal tax liability is less than 18.5% of its book profit (or ATI), the firm must

pay the AMT.

This mechanism forces managers to recognize that aggressive tax planning using incentives like 10AA or 35AD will not result in zero tax liability; a minimum tax floor of 18.5% must still be met. This affects the financial viability and capital budgeting decisions related to such incentivized projects.

14.8.4 AMT Credit and Compliance

If the AMT liability exceeds the Normal Tax liability, the firm must pay the higher AMT amount. The difference between the AMT paid and the Normal Tax liability is known as the AMT Credit.

- **Carry Forward:** This AMT Credit can be carried forward for a period of up to 15 assessment years.
- **Set-off:** The firm can utilize this credit to set off against its normal tax liability in any subsequent year when the Normal Tax liability exceeds the AMT liability. The credit reduces the tax burden only to the extent that the Normal Tax exceeds the AMT in that future year.

Firms liable for AMT must fulfill specific compliance requirements, including maintaining supporting documentation and submitting Form 29C. This form is certified by a Chartered Accountant and is necessary to disclose the correct computation of the Adjusted Total Income and the resulting AMT. Failure to comply with these filing requirements can lead to penalties and disqualification from carrying forward the AMT credit benefit.

14.9. ILLUSTRATIVE EXAMPLES / APPLICATIONS

To solidify your understanding of these complex computations, here are step-by-step numerical examples.

Numerical Example 1: Calculation of Book Profit and Allowable Remuneration

M/s Zenith Associates, a partnership firm, provides the following details for the year:

- Net Profit as per P&L Account: ₹7,00,000
- Interest paid to Partner X (Working Partner): ₹90,000 (Calculated at 15% p.a. on capital of ₹6,00,000).
- Salary paid to Partner Y (Working Partner): ₹4,00,000 (Authorized by deed).
- Non-deductible General Expenses (Sec 30-40A adjustments, excluding partner payments): ₹20,000.

Step 1: Calculate Disallowed Interest

The maximum allowed interest is 12%.

- Maximum Allowed Interest = 12% of ₹6,00,000 = ₹72,000.
- Interest Paid = ₹90,000.
- Disallowed Interest (to be added back) = ₹90,000 - ₹72,000 = ₹18,000.

Step 2: Calculate Book Profit (BP)

Particulars	Amount (₹)
Net Profit as per P&L Account	7,00,000
Add: Total Partner Remuneration (Salary to Y)	4,00,000
Add: Disallowed Interest (Excess over 12%)	18,000
Add: Non-deductible General Expenses	20,000
Book Profit (BP)	11,38,000

Step 3: Calculate Maximum Allowable Remuneration (Statutory Limit)

The maximum limit is calculated on BP of ₹11,38,000:

Slab	Calculation	Amount (₹)
First ₹3,00,000 of BP	Higher of (₹1,50,000 OR 90% of ₹3,00,000 = ₹2,70,000)	2,70,000
Remaining BP (₹11,38,000 - ₹3,00,000 = ₹8,38,000)	60% of ₹8,38,000	5,02,800
Total Statutory Limit		7,72,800

Step 4: Determine Final Deduction for Remuneration

- Actual Remuneration Paid to Y (Working Partner) = ₹4,00,000.
- Statutory Limit (from Step 3) = ₹7,72,800.
- Final Deduction (Least of Actual and Limit) = ₹4,00,000.

Numerical Example 2: Computing Firm's Total Income and Tax Payable

Continuing from Example 1, calculate the Total Taxable Income and Tax Payable for M/s Zenith Associates. Assume the firm has no Chapter VI-A deductions and no other income head besides PGBP.

Step 1: Calculate Total Taxable Income

Particulars	Amount (₹)
Book Profit (BP) (from Ex. 1, Step 2)	11,38,000
Less: Allowable Remuneration (from Ex. 1, Step 4)	(4,00,000)
Total Taxable Income	7,38,000

Step 2: Calculate Tax Liability

- Income Tax @ 30% on ₹7,38,000 = ₹2,21,400.
- Surcharge (Since income is below ₹1 Crore) = Nil.

- Health and Education Cess (HEC) @ 4% on ₹2,21,400 = ₹8,856.
- Total Tax Payable = ₹2,21,400 + ₹8,856 = ₹2,30,256.

Numerical Example 3: Taxability in the Hands of the Partners

Using the results from Example 1 and 2, determine the taxable income components for Partners X and Y.

- Partner X received: ₹90,000 Interest.
- Partner Y received: ₹4,00,000 Salary.
- Firm's Total Post-Tax Profit for distribution: ₹5,07,744 (₹7,38,000 Taxable Income - ₹2,30,256 Tax Paid). Assume X and Y share profits equally.

Analysis of Partner X's Income:

- 1) **Interest:** Only ₹72,000 (12%) was allowed as a deduction to the firm. This portion is taxable in X's hands under PGBP. The disallowed portion (₹18,000) is exempt.
 - Taxable Interest Income = ₹72,000.
- 2) **Share of Profit:** Partner X's share of post-tax profit (half of ₹5,07,744) is entirely exempt under Section 10(2A).
 - Exempt Profit Share = ₹2,53,872.
- 3) **Total Taxable Income from Firm** (for Partner X) = ₹72,000.

Analysis of Partner Y's Income:

- 1) **Salary:** The entire ₹4,00,000 salary was allowed as a deduction to the firm (Example 1, Step 4). This full amount is taxable in Y's hands under PGBP.
 - Taxable Salary Income = ₹4,00,000.
- 2) **Share of Profit:** Exempt under Section 10(2A).
 - Exempt Profit Share = ₹2,53,872.
- 3) **Total Taxable Income from Firm** (for Partner Y) = ₹4,00,000.

Conceptual Application 4: Consequences of Section 184 Non-Compliance

Suppose M/s Creative Designs failed to file a certified copy of its partnership deed for the current assessment year. The firm reported a Net Profit of ₹15,00,000 (after debiting ₹5,00,000 in partner salaries and ₹1,00,000 in partner interest).

Analysis of Tax Impact:

- 1) **Disallowance Triggered:** Because Section 184 compliance failed, the firm is automatically prevented from deducting *any* interest or remuneration paid to partners.
- 2) **Revised Taxable Income:** The firm must add back the entire amounts paid:
 - Net Profit as per P&L: ₹15,00,000
 - Add back Salary: ₹5,00,000
 - Add back Interest: ₹1,00,000
 - Revised Total Taxable Income = ₹21,00,000.
- 3) **Increased Tax Liability:** The firm pays 30% tax (plus HEC) on ₹21,00,000.
- 4) **Partner Impact:** Since the entire ₹6,00,000 paid as salary and interest was disallowed in

the firm's assessment, none of that ₹6,00,000 is taxable in the hands of the partners. The income remains taxable at the firm level, emphasizing the high managerial risk associated with procedural non-compliance.



Check Your Progress – A

1. What document is mandatory to be filed with the return to ensure assessment as a 'firm'?

2. What is the maximum rate allowed for interest paid to partners as a deduction?

3. If a firm's Book Profit is ₹2,50,000, what is the maximum remuneration that can be claimed as a deduction under Section 40(b)?

4. Define a 'Working Partner' as per the Income Tax Act.

14.10 SUMMARY

This unit explains the taxation framework applicable to partnership firms and their partners under the Income Tax Act, 1961. A partnership firm, including an LLP, is treated as a separate taxable entity and is assessed at a flat rate of 30%, along with applicable surcharge and Health and Education Cess. To be assessed as a firm and claim deductions for partner-related payments, strict compliance with Section 184 is mandatory, particularly the existence and filing of a valid written partnership deed specifying profit-sharing ratios. The computation of income primarily focuses on Profits and Gains from Business or Profession (PGBP), where special restrictions apply under Section 40(b). Interest paid to partners is allowable only up to 12% per annum, while remuneration (salary, bonus, commission) is deductible only if paid to working partners, authorized by the deed, and within statutory limits linked to Book Profit. Book Profit is a key concept, calculated by adjusting net profit for disallowed expenses and adding back partner remuneration. In the hands of partners, the share of profit from the firm is fully exempt under Section 10(2A), avoiding double taxation, whereas remuneration and interest allowed in the firm's assessment are taxable as PGBP. The unit also introduces Alternative Minimum Tax

(AMT) under Section 115JC to ensure a minimum tax outgo where substantial deductions are claimed. Overall, the unit emphasizes compliance, accurate computation, and balanced taxation of firms and partners.



14.11 GLOSSARY

- **Partnership Firm:** An entity recognized as a separate assessee under the Income Tax Act, 1961, paying tax at a flat rate.
- **Section 184:** The statutory section mandating documentation requirements (written deed, specific shares) for a firm to be assessed as such.
- **Working Partner:** A partner actively engaged in conducting the business or profession of the firm.
- **Book Profit (BP):** The PGBP of the firm calculated after all deductions and disallowances, but *before* deducting any remuneration paid to partners.
- **Allowable Remuneration:** The lesser of actual remuneration paid, authorized remuneration, or the statutory limit based on Book Profit.
- **Disallowed Remuneration:** The amount of partner salary or interest that exceeds the limits set by Section 40(b).
- **Flat Tax Rate:** The 30% tax rate applicable uniformly to the total income of a partnership firm.
- **Section 10(2A):** The provision granting exemption to a partner's share in the net profits of the firm.
- **Alternative Minimum Tax (AMT):** A minimum tax mechanism applicable to firms claiming specific deductions, calculated at 18.5% of ATI.
- **Adjusted Total Income (ATI):** The base for AMT calculation, derived by adding back specified deductions (e.g., Sec 10AA, 35AD) to the Normal Total Income.
- **AMT Credit:** The difference between the AMT paid and the Normal Tax liability, which can be carried forward for 15 assessment years.
- **Health and Education Cess (HEC):** A 4% levy on the Income Tax plus Surcharge.
- **Surcharge:** An additional tax levied at 12% on the income tax, applicable if the total income exceeds ₹1 Crore.
- **PGBP:** Profits and Gains from Business or Profession, the primary head of income for a firm.



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14.13 SUGGESTED READINGS

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- ✚ LexisNexis Publications. *Tax Law Dictionary - with Legal Maxims, Latin Terms and Words & Phrases*. (Useful for clarifying statutory definitions).
- ✚ A comprehensive publication covering Direct Taxes from The Institute of Cost Accountants of India (ICMAI) or similar professional body, for technical computational clarity
- ✚ Official Website of the Income Tax Department, Government of India (incometax.gov.in) for latest circulars, forms, and tax rates. (Essential for practical updates).



14.15 TERMINAL QUESTIONS

1. Explain the statutory conditions laid down under Section 184 for a partnership firm to be assessed as a firm under the Income Tax Act, 1961.
2. Discuss the consequences of non-compliance with Section 184 on the tax liability of a partnership firm and its partners.
3. Describe the procedure for computing Gross Total Income (GTI) of a partnership firm.
4. Explain the restrictions imposed by Section 40(b) on interest paid to partners and state

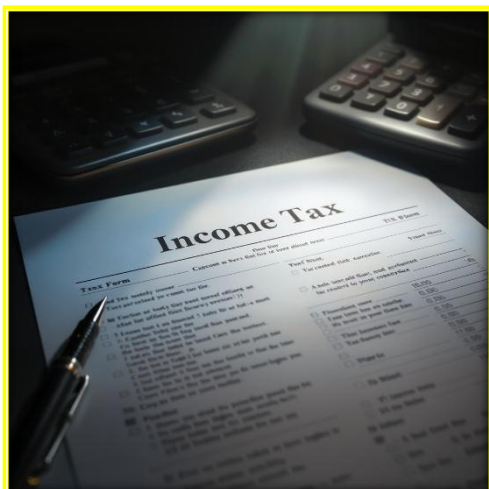
- the maximum permissible rate.
5. What is meant by “Book Profit” for the purpose of Section 40(b)? Explain the steps involved in its computation.
 6. Discuss the statutory limits for allowable remuneration to working partners and explain how these limits are applied.
 7. Differentiate between Net Profit as per Profit and Loss Account and Book Profit for firm assessment purposes.
 8. Explain the tax treatment of salary, commission, and interest received by partners from the firm.
 9. Why is the share of profit received by a partner exempt from tax under Section 10(2A)? Explain the rationale.
 10. Explain the complete procedure for computing the final tax liability of a partnership firm, including surcharge and Health and Education Cess.
 11. Discuss the applicability of Alternative Minimum Tax (AMT) to partnership firms under Section 115JC.
 12. Explain the concept of Adjusted Total Income (ATI) and its relevance in AMT computation.
 13. What is AMT Credit? Explain its carry-forward and set-off provisions.
 14. Analyze how excessive partner remuneration affects the taxable income of a firm and the taxability in the hands of partners.
 15. With suitable illustration, explain the linkage between the firm’s assessment under Section 40(b) and the partner’s individual tax liability.
 16. M/s Alpha & Beta provides the following figures: Net Profit (as per P&L) ₹12,00,000. General Disallowances ₹80,000. Interest paid to Partner Alpha (18%) ₹1,80,000 (Capital ₹10,00,000). Salary paid to Beta (Working Partner, authorized) ₹5,00,000.
 - *Required:* Compute the Book Profit, Maximum Allowable Remuneration, and the Firm's Total Taxable Income.

(Hint: Ensure interest is restricted to 12%. The total remuneration (₹5,00,000) must be added back to compute BP.)
 17. A firm's Total Taxable Income is ₹60,00,000. Compute the final tax liability, including Surcharge and HEC. (Assume no AMT is applicable).
 18. M/s Gamma & Delta reports a Normal Taxable Income of ₹25,00,000. During the year, it claimed a deduction of ₹15,00,000 under Section 35AD for specified business expenditure.
 - *Required:* Compute the Normal Tax Liability, Adjusted Total Income (ATI), AMT Liability, and the final tax payable. State the amount of AMT Credit, if any.

(Hint: Normal Tax is 30% of ₹25,00,000. ATI is ₹25,00,000 + ₹15,00,000. AMT is 18.5% of ATI.)

Income Tax

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