# UNIT 2 BASIC CONCEPTS-II

## Structure



## 2.0 OBJECTIVES

After studying this unit, you should be able to :

- explain agricultural income, and taxation thereof,
- explain casual income and tax treatment thereof,
- differentiate between capital and revenue.

## 2.1 INTRODUCTION

In Unit 1 you have learnt about various terms used in the Indian Income Tax Act. Two terms namely agricultural income and casual income need further elaboration because they are treated as exempted incomes under the Act subject to certain limitations. This unit also explains the capital and revenue incomes and the importance of distinction between them for determining the inclusion of a particular income in the total income of a person.

## 2.2 AGRICULTURAL INCOME

Agricultural income is not taxed under the Income Tax Act, 1961, because agriculture being a State subject, it is the State Government alone which is competent to tax income therefrom. The exemption to this income is provided under Section 10 (1) of the Act. Since it is not taxed, the definition thereof has assumed significance. The assessee would naturally be interested in classifying his income as agricultural incomes howsoever distantly it might have been related to agriculture. On the other hand, the tax authorities would like to interpret the term conservatively and thus there is a possibility of some dispute between the parties as regards the meaning of the term. The Income Tax Act, 1961, has defined the term 'agricultural income' under Section 2(1A) exhaustively.

### 2.2.1 Definition of Agricultural Income

Agricultural income as defined under Section 2(1) means **any rent or revenue derived from land which is situated in India and is used for agricultural purposes (2(1)(a)).** The definition makes it very clear that any rent or revenue (in cash or kind) will be agricultural in nature only if the following conditions are fully satisfied :

a) rent or revenue is derived from land,
b) the land is situated in India, and
c) the land is used for agricultural purposes.

Since the term 'agriculture' will determine the nature of income, it is necessary for us to be able to understand what is agriculture. Income is said to have been derived from land, from agriculture when that land is subjected to the labour and skill of man whether in the form of cultivation or otherwise. Though tilling is not a necessary part of agriculture, human labour and skill are supposed to be expended on the land itself and not merely on the growth from land.

The Supreme Court has in CIT v. Raja Benoy Kumar Sahas Roy expounded on the terms 'Agriculture' and 'Agricultural Purposes'. The relevant portion of the judgment is given below :

i) Agriculture in its most primary sense denotes the cultivation of the field and is restricted to the cultivation of the land in the strict sense of the term, meaning thereby tilling of land, sowing of seeds, planting arid similar operations on the land. It also includes in its scope all the operations which foster the growth and preservation of the produce along with the operations required to make the produce marketable. The term comprises within its scope all types of produce regardless of its nature.

ii) In order to decide whether a particular piece of land has been used for agricultural purpose. there has to be some measure of cultivation of land and some expenditure of skill and labour upon it. Consequently, income from the sale of forest trees growing naturally and without any human intervention cannot be treated as agricultural income.

## 2.2.2 Kinds of Agricultural Income

Agricultural Income is of Five kinds

i) Any rent or revenue derived from land

ii) Income derived from Agriculture

iii) Any income derived from marketing process performed by cultivator or receiver of rent in kind

iv) Any income derived from the sale of product

v) Income from farm building.

(ii), (iii) and (iv) can be combined under one heading and explained. Let us now discuss the different kinds of income in detail.

**i) Any** rent **or** revenue derived **from** land

Rent or revenue derived from land situated in India and used for agricultural purposes is agricultural income. Rent is received by one person from another for the grant of right to the other person to use land. It may be in cash or in kind and the recipient of rent may or may not be the owner of the land.

If the land has been let out by the person on rent and the rent is in the nature of produce, he is termed as 'receiver of rent in kind'. Where the land is used by the receiver of rent in kind for carrying out any process to make the produ'ce marketable or where he derives any income on the sale of such produce, this will be treated as agricultural income in his hands too. It is, of course, agricultural income in the hands of the cultivator.

**ii) Income** derived **from such** land by agriculture or **from** manufacturing **process (2(1A)(b) )**

The words 'such land' are of significance here. These words limit agricultural income to the land situated in India which is used for agricultural purposes. The income generated by the following activities is considered agricultural income:

a) agriculture

b) process ordinarily employed by a cultivator to render the produce marketable

c) sale by cultivator of the produce without any further processing except the one mentioned in (b) above.

It is thus clear that the cultivator may need to make the produce marketable as the produce as such may not be sold. He is allowed the use of a process which is generally employed by all the cultivators to make the produce marketable. Tobacco leaves are generally dried before being sold, and therefore, the income from the sale of dried tobacco leaves will. be agricultural in nature. However, the income from the sale of beedies made out of the same tobacco will not be treated as agricultural income, because marketable produce has been further processed and made more valuable.

**iii) Income from agricultural house properly a farm buildings (2 (1A) (c) )**

Income derived from any building in the following cases will he agricultural income:

a) the building is owned and occupied by the receiver of rent or revenue of any such land;

b) the building is on or in the immediate vicinity of the agricultural land in India;

c) the agriculturist needs it by virue of his connection with the land and uses it as a dwelling house, store house or as an outhouse;

d) the land on which such building is situated must be subject to land revenue in India or subject to a local rate assessed and collected by the officers of the said Government;

e) if the land is not subject to land revenue, it must be outside the urban area, i.e., area comprising a cantonment board, municipal board, notified area, town area. municipal corporation or any other name by which it is known and which has a population of 10.000 or more;

f) if it is notified by the Central Government in the Official Gazette, it must not be situated within a distance of 8 kilometre or within the area of such lower limits from the jurisdiction of such municipal board etc. as the Central Government may notify in this regard.

## 2.2.3 *Instances* of Non-agricultural *Income*

The following incomes though connected with land arc not agricultural in nature:

1) Annuity payable to Vendor of agricultural land or to a person giving up his claim to a piece of agricultural land.
2) Commission for selling agricultural produce.
3) Income from Dairy Farm.
4) Forest produce resulting from wild growth.
5) Fisheries.
6) Ginning of cotton.
7) Harvesting of crop on purchased land.
8) Letting out of land for stocking timber or crops.
9) Dividend paid out of agricultural income.
10) Commission earned by the landlord for selling agricultural produce.
11) Profit earned on purchase of standing crop.
12) Rearing of silk worms.
13) Income from quarries.
14) Royalty income of mines.
15) Income from poultry farming.

## 2.2.4 *Partly Agricultural Income*

There are certain instances where it becomes extremely difficult to classify an income as agricultural or non-agricultural. These are cases where the said income satisfies some characteristics of agricultural income and a few characteristics of business income. Such incomes are said to be partly agricultural in nature. Profit of a sugar mill which grows its own sugarcane is cited as one of the examples of partly agricultural income. In this case income earned till harvesting of sugarcane is agricultural in nature whereas income accruing from the manufacture of sugar is taxable income. Similarly income from growing and selling of tea is partly agricultural income. These two cases have been dealt with under rules 7 and 8 of the Income Tax Rules, 1962.

## 2.2.5 *Taxation of Agricultural Income*

Until the assessment year 1974-75, the agricultural income of an assessee had been completely left out the purview of the Income Tax Act, 1961. However, it was felt that the assessees earning both agricultural income and non-agricultural income have higher taxable capacity. It is correct that the Central Government cannot tax agricultural income but they can certainly tax non-agricultural income at a higher rate if the taxable capacity of the assessee warranted that, In the light of this logic a scheme of partial integration of agricultural income was devised to tax non-agricultural income in the hands of those who were earning both types of incomes.

As per the provision of the act the agricultural and non-agricultural income of the individual earning both the incomes will be clubbed together to find out the rate of tax to be applied for calculating the income tax on non-agricultural income. This will result in a higher income tax as compared to what he would have paid had he not clubbed the, two types of income. The provisions are that all assessees other than companies, registered firms and cooperative societies are required to club the agricultural income with other incomes for determining the rate of tax. ii) These provisions will apply only if the non-agricultural income exceeds minimum taxable limit (Rs. 22,000) and agricultural income exceeds Rs. 600.

**Check Your Progress A**

1) Read the following carefully and tick mark the correct. answer:

   i) Agricultural income is left out of the purview of the Income Tax Act, 1961 because
      a) India is a socialist democracy
      b) Agriculture is a State subject
      c) The Government wants to encourage farmers.

   ii) Which of the following is non-agricultural income
      a) Dairy
      b) Income from land let out for drying tobacco leaves
      c) Income from tilling and sowing cotton.

   iii) In determining the market value of agricultural produce not ordinarily sold in the market, the profit is
      a) A flat rate of 15% of the total expenses
      b) An amount to be determined by the agriculturist
      c) An amount to be determined by the Assessing Officer.

   iv) The assessee who is not required to club its agricultural and non-agricultural income for rate purpose is
      a) A company
      b) An individual
      c) A HUF.

2) State whether the following statements are true or false

   i) The income of a company engaged in growing and selling tea is business income.

   ii) The clubbing provisions for rate purposes will apply irrespective of the amount of non-agricultural income.

   iii) The onus of proving that a source of income is agricultural in nature lies on the assessee.

   iv) Expenses on transportation of produce from the farm to the factory are agricultural expenses.

## 2.3 CONCEPT OF CASUAL INCOME

You will remember from earlier unit that one of the important characteristics of the term 'income' is its regularity or at least expected regularity. However, there may be certain incomes which are not regular and which do not arise from any source of income. They are known as 'casual incomes'.

### 2.3.1 Definition of Casual Income

The term 'Casual income' has not been defined anywhere in the Income Tax Act, 1961. It is for this reason that we have to depend upon the dictionary meaning of the word 'Casual' and also on the decisions of the various courts. .

The word 'Cnsual' has been defined to mean "subject to or produced by chance, accidental, fortuitous, coming at uncertain times, occasional, unforeseen." It therefore is something which comes in at uncertain times and something which carinot be relied upon or calculated to produce income or it may be something which is the result of chance or the result of a fortuitous circumstance.

Winning from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever, are also treated as casual incomes and are not taxable upto a maximum of Rs. 5,000.

One test which has been laid down in some cases is whether the receipt is one which is foreseen, known and anticipated and provided for by agreement. If it is a result thereof, it cannot be described ,as casual even if it is not likely to recur for a considerable time. Casual receipts are therefore receipts which are purely accidental and a result of windfall. They accrue without stipulation, contract, calculation and design.

Non-recurring nature means that the receipt is not bound to recur and the recipient has no right or claim to expect the recurrence. The burden of proof is on the assessee if he claims an item of income to belong to this category.

The following are excluded from the scope of casual income as per sec 10(3)

a) Capital Gains
b) Receipts arising from business, profession or occupation
c) Receipts by way of addition to the remuneration of any employee e.g. bonus.

### 2.3.2 Casual Income or Personal Gift

Casual income in excess of Rs. 5,000 is taxable whereas gift remains outside the purview of Income Tax Act, 1961. If the gifted amount exceeds Rs. 20,000, it will be taxed rmder the Gift Tax Act. Gift is a receipt which is of purely personal nature and therefore cannot be included in the term 'casual income.' The following extract from the Circular of the Board is relevant in this regard:

"Receipts which are of a casual and non recurring nature will be liable to income tax only if they can properly he characterised as "income" either in its general connotation or within the extended meaning given to the term by the Income Tax Act. Hence, gifts of a purely personal nature will not be chargeable to income tax except when they can be regarded as an addition to the salary or when they arise from the exercise of a profession or vocation." Circular No. 158 of 27.12.1974.

### 2.3.3 Chargeability of Casual Income

Until the assessment year 1974-75 all casual incomes were fully exempt from income. tax, but it was found that the provision was being misused and tax being avoided by treating receipts as casual income, hence a limit was imposed on the extent of exemption. At present all receipts, which are of a casual nature are exempted upto Rs. 5,000 in the aggregate.

This would mean that all casual incomes are to be added up to begin with. Then allow a deduction of Rs. 5,000. The resultant figure would be included under the head 'Income from other sources' and taxed like any other income.

### 2.3.4 A Few Examples

The following incomes are of a casual nature

a) Participation in lucky prize schemes was held not to amount to business receipts and were held to be casual in nature.
b) An assessee received a sum before he started business as grant-in-aid from the Government.
c) A golden hand shake given as a gift by a company to its auditors whose appointment was not renewed was held not to be a professional receipt.
d) The entrance fee charged by a banking company from its new shareholders.
e) Amounts received from activities which are indulged in as hobbies and not business.

The following incomes are not of a casual nature

a) Any receipt (whether in the form of a donation) received from the exercise of an occupation (like teaching Vedanta philosophy).
b) Tips given to taxi drivers.
c) Gifts received from clients.
d) Indirect benefits out of professional conduct.

## 2.4 CAPITAL AND REVENUE RECEIPTS – IMPORTANCE OF DISTINCTION

If is important to be able to distinguish between capital and revenue. The distinction is significant not only from the point of view of accounting but also for tax matters. Ordinarily speaking when we buy something of durable nature we say that we have incurred capital expenditure. For example buying of furniture is capital expenditure and it is shown bn the assets side of the Balance Sheet. On the other hand, expenditure incurred on repairs is supposed to be of routine type and it is therefore shown on the debit side of the Profiqand Loss Account. In the same way when some receipt is effected for unloading of a capital asset, we classify it as capital receipt. For example, an amount of Rs. 2,00,000 received on the sale of a piece of land will be a receipt of capital nature. On the other hand fees received by an advocate for rendering of professional services will be of revenue nature. It might be of interest to note that the Income Tax Act, 1961, has not defined the concept of capital and revenue anywhere and therefore we have to depend on the accounting conventions and pronouncements by courts in this area.

Apart from accounting implications, the distinction between capital and revenue receipts is of great significance in tax matters and in determining the tax liability. Revenue receipts are considered to be taxable in general whereascapital receipts are not. However, where the asset sold brings in some surplus (excess of selling price over the cost of an asset), it is termed as capital gain and will be treated under special provisions of the Act. Tax liability therefore cannot be determined accurately if the receipts are not properly classified as above.

### 2.4.1 Distinguishing Tests

Based on the judicial pronouncements, a few guidelines have been laid down for the purpose of determining the nature of a receipt. Some important guidelines are discussed below:

1) A receipt by way of price or compensation on the disposal of circulating capital or stock on trade is a revenue receipt whereas a receipt on the disposal of a capital asset is capital in nature. A capital asset is used to manufacture items or generate income **e.g.**, machines.
2) Receipt in substitution of a source of income is of capital nature while the amount that substitutes income itself shall be the income chargeable to tax. For example, compensation for the loss of an agency is a capital receipt while the amount received for the breach of a business contract is a revenue receipt.
3) In the case of an isolated transaction of purchase and sale of property, the motive of the seller is a deciding factor in determining the nature of receipt. Sale proceeds of securities (where they are held as investment) will be capital receipt whereas it will be of revenue nature if the securities are held as stock in trade.
4) When a sum is received for the surrender of certain rights under an agreement, it is a capital receipt because a certain capital asset in the form of those rights is being given up. If, however, the sum is received in the nature of compensation for the loss of future profits, it will be treated as a revenue receipt.

It would also help, if the following are also taken into consideration when trying to distinguish between capital and revenue receipts :

1) Nature **of** receipt at the initial stage : If the receipt at the **initial** stage possesses the characteristics of a trading receipt, it will be taxed as such. If however, at the initial stages, it looks like a capital receipt, it cannot be taxed irrespective of the magnitude and the appropriation of the same by the assessee.
2) Nomenclature not decisive : Irrespective of what the parties to a contract call the transaction and the receipt arising therefrom, the true nature of the receipt has to be ascertained based on the principles laid down and the circumstances of the case.
3) Nature **of** receipt in the **hands of** the receiver : It is important to note that when considering a receipt, its nature in the hands of the receiver'is important. This implies that even if an item of expenditure is of a capital nature in the hands of the giver, it very well could be an item of revenue receipt in the hands of the receiver. It is therefore, the nature of receipt in the hands of the receiver that is important and not the nature of the expenditpre in the hands of the giver.
4) Nature under company law not important : It has been held by the Supreme Court that there is no inconsistency between a receipt being a capital receipt under the Company Law and being a revenue receipt under the Income Tax Act, 1961.
5) **Lack** of **assessment in** earlier years **immaterial** : The mere fact that the Income Tax Authorities have failed to levy tax on the interest part of the annual receipt does not change the nature of the receipt. It continues to be part capital and part revenue in nature and thereby chargeable to tax on the revenue part.

6) **Income from consumable assets** : Profits arising from consumable assets would be of a revenue nature although capital asset seems to be getting exhausted or consumed.

7) **Exchange** rate **fluctuation** : Excess income arising to the assessee as a result of exchange rate fluctuation will be taxed as revenue receipt. If, however, the profit arises not as a result of the business of the assessee but as accrual to the investment, it will be treated as a capital receipt.

8) Perpetual annuity : The annuity receivable in exchange for a capital asset is taxable income. However, if the annuity is described as instalment of a capital sum received in exchange for the capital asset, it is not taxable.

### 2.4.2 Examples of Capital and Revenue Receipts

The following are a few examples of capital receipts

1) Receipt to meet the capital expenditure is a capital receipt.
2) Compensation received for the suspension of an export licence.
3) Pagdee received as consideration for grant of monthly tenancies.
4) Profit due to fluctuations in the rate of exchange of foreign currency.
5) Profit from the sale of foreign exchange when the purchase of capital goods in foreign country became impossible.
6) Entrance fee collected by a company in respect of new shares.
7) Sale of assets of a firm at the time of its conversion to a company to the extent the consideration is attributable to sale of land.
8) Compensation received for relinquishing the rights of a partnership.

The following are a few examples of revenue receipts :

1) Receipt of annuity for transfer of a capital asset.
2) Compensation received for compulsory acquisition of land.
3) Damages received in respect of repairs not carried out in time.
4) Cash assistance received under an export promotion scheme.
5) Lumpsum amount received for waiver of royalty.
6) Subsidy received by a cooperative society from Government.
7) Surplus left with the seller due to a reduction in export duty.
8) Damages receive by a company for breach of contract.
9) Sale of import entitlement received under an export promotion scheme against export.

**Check Your Progress B**

1) Distinguish between casual income and gift.

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2) Fill in the blanks :

i) Net Casual income is included under the head ..................

ii) Casual incomes are exempt from tax under section .................. of the Income Tax Act.

iii) The onus to prove a particular income as being of a casual nature is on the ..................

iv) .................. receipts arc to be added in computing the business income.

v) Sum received for the surrender of a right is a .................. receipt.

vi) Cash assistance received from the Government is a .................. receipt.

3) State whether the following are capital or revenue receipt :
   i) Compensation received for compulsory vacation of place of business.
   ii) Bonus shares received by a dealer of shares.
   iii) Sales tax collected from purchaser of goods.
   iv) Dividend
   v) Compensation received for suspension of export licence.

## 2.5 LET US SUM UP

Agricultural income being exempt from tax, it is necessary to comprehend the meaning correctly. Section 2(1) of the Income Tax Act defines it as any rent or revenue derived from land which is situated in India and which is being used for agricultural purposes, Income from house property situated on or in the immediate vicinity of agricultural land is also treated as agricultural income provided the house is being used by theagriculturist as outhouse, or for storing of agricultural produce, agricultural implements or cattle etc. It is exempted from tax u/s 10(1) of the Income Tax Act because agriculture being a State subject, Central Government cannot impose tax on income derived therefrom. Income from manufacture of sugar will be partly agricultural in nature if the sugar mill grows sugarcane on its own farms. Similarly income from sale of tea will also be partly agricultural in nature where the tea company grows its own tea. Rules 7 and 8 of the Income Tax Rules describe the method of determination of exempted and taxable portions of such incomes.

Casual income is also exempt but to a limited extent. It is tax free up to a maximum of Rs. 5,000. Excess of casual income over Rs. 5,000 is taxable. It is something which comes as windfall and totally unexpected. Capital gains, receipts arising from business, profession or occupation and receipts by way of addition to the remuneration of an employee are not casual incomes within the framework of law of income tax.

It is also important to distinguish between capital and revenue incomes. It is the revenue income that is taxable and not the capital receipts. Amount received for the goods sold and services rendered will be revenue in nature whereas the amount received in exchange of capital asset like house property will be capital receipt. On the basis of accounting principles and judicial pronouncements a few principles have emerged which help to distinguish the capital and revenue incomes.

## 2.6 KEY WORDS

**Agricultural Income : It** is income derived from agricultural land situated in India and is exempted from income tax.

**Capital Income :** Income received in exchange of a capital asset is capital income. It is not taxable. However, where the amount received is in excess over the cost of the asset, such excess is known as capital gain and is taxable.

**Casual income :** Casual income is the receipt which comes as a windfall. and is free from repetition. One can never expect it. Betting, winnings from lotteries etc. though included in the term 'income' u/s 2(24), is treated as casual income according to a circular issued by the Government.

**Partly agricultural income :** Income from tea gardens and from manufacture of sugar is partly agricultural in nature. Taxable portion is ascertained in accordance with Rule No. 7 and 8 of the Income Tax Rules, 1962.

**Revenue** Income : Income received as a matter of routine by way of sale of goods or services is revenue in nature and taxable.

## 2.7 ANSWERS TO CHECK YOUR PROGRESS

A 1) i) b ii) a iii) b iv) a

2) i) False ii) False iii) True iv) True

B 2) i) Income from other sources ii) 10(3) iii) Assessee iv) Revenue v) Capital vi) Assessee.

3) i) Revenue ii) Capital iii) Revenue iv) Revenue v) Capital

## 2.8 TERMINAL QUESTIONS EXERCISES

1) Define agricultural income and give examples.
2) Distinguish between agricultural income and partly agricultural income with examples.
3) What do you understand by casual income? How are they treated under the Income Tax Act?
4) Distinguish between capital and revenue incomes.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University, these are for your practice only.