UNIT 1 BASIC CONCEPTS-I

Structure

1.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the Income tax administration in India; and
- define specific terms which are relevant for the study of the subject.

1.1 INTRODUCTION

Income tax is one of the direct taxes levied by the Central Government. It is considered direct as it is payable in the Assessment Year, directly by the person on the income earned during the previous year (Accounting/Financial Year). Therefore, every student of income tax must know the meaning of the terms income, previous year, assessment year, total income and who are the persons liable to income tax in India. In this unit, we have traced the history of income tax in India and also defined all these terms as per the provisions of the Income Tax Act as amended up to date.

1.2 BROAD MECHANISM OF INCOME TAX IN INDIA

The First War of Independence in 1857 was a major financial burden to the English Government which brought great financial difficulties. Income tax was introduced and imposed in India for the first time in 1860 by 'Sir James Wilson' for the Fundamentals reason of financial necessities. However, to make it a permanent and main source of Government revenue, the British Government enacted the new Income Tax Act, 1886. The financial crunch resulting from the First World War brought to focus the inadequacies of the said Act. After extensive investigation, the Act of 1922 was enacted and was effective for about four decades.

These intervening years saw India gain independence and the new Indian Government felt that the Income Tax Act needed a thorough overhaul. The Law Commission submitted a draft bill in 1958. A committee appointed under the Chairmanship of Mahabir Tyagi in 1958, also known as the 'Direct taxes Administration Committee', to look into the direct tax structure submitted a draft. Finally, the old Indian Income Tax Act, 1922 was completely recast in 1961 and the new Income Tax Act came into force with effect from 1st April,1962.

The administration of the Income Tax Act, 1961 is done by the Central Board of Direct Taxes (CBDT), which works under the supervision of the Ministry of Finance. The CBDT is charged with the duty of framing rules for the administration of the Income Tax Act. These rules, known as the Income Tax Rules, 1962, contain various forms and miscellaneous details. The Government has set up a separate income tax department for this purpose. Income tax is an important source of income for the Central Government. The process of framing rules is a very elaborate one, it involves notifying the rule first for public deliberation, and then for adoption. They are also placed on the tables of the House for information. These Rules are changed as and when the situation warrants.

The CBDT also issues from time to time, various circulars for the direction of the officials of the Income Tax Department and for information of tax payers. Although income tax is levied and collected by the Central Government, yet a certain portion of it is distributed among the States for their projects. It is, therefore, necessary for a student of income tax to keep himself up-to-date with the latest provisions. The best way to do this is to regularly read various tax journals and other tax publications.

The Finance Act

You may be aware that the Finance Minister of the Government of India presents an estimate of income and expenditure for the coming financial year to the Parliament generally in the month of February every year. The document is popularly known as 'budget'. It is an important event of the country as it gives the public an idea of the direction the Government is going to follow in the ensuing year. To give legal shape to various tax proposals, a bill is also moved which is known as Finance Bill. It contains various provisions as regards direct and indirect taxes. Once the Finance Act is passed, it becomes a law according to which various taxes are charged. It is the Finance Act that contains the rate structure of income tax which would be applicable in that year.

It is therefore, necessary that any student of income tax should not only study the Income Tax Act but also the Income Tax Rules and the latest Finance Act. All these must be studied simultaneously.

Scheme of Income Tax-An Overview

Income tax is a tax on income, levied on the previous year's taxable income of an assessee (person) at the rates applicable for the assessment year. These rates are divided into various slabs of income.

Every entity whose income (computed in accordance with the Income Tax Act and the Income Tax Rules etc.) is more than the tax-free limit as prescribed by the relevant Finance Act, is required to pay tax. The Finance Act of 2023, as relevant for Assessment Year 2023-24 has the exemption limit to Rs. 2,50,000/3,00,000/5,00,000 as per the old tax regime.

Recognizing the diversity and the need for standardization of the sources of income, the Income Tax Act has identified five heads of income. They are Salaries, Income from House Property, Profits and Gains from Business or Profession, Capital Gains and Income from Other Sources. In this course, we will explain these five heads of income.

The income tax read along with the Income Tax Rules and the Finance Act provides for all the possible situations that are likely to arise in the administration of income tax law.

The Income Tax Act, 1961 extends to the entire country and comprises of 298 sections and 14 Schedules.

1.3 CONCEPT OF INCOME

1.3.1 Definition of Income

Income tax is levied on income of an entity; it is important to know what income is and how it is computed. In this section, we will deal with the definition of Income and some basic principles related to it. The procedure of computing the total income will be dealt with in detail in some consequent sections.

The subject matter of income tax is 'Income', but no definition of income has been given in the Income Tax Act. Section 2(24), of the Act only indicates inclusion of certain items which are given below:

i) Profits and Gains

ii) Dividend

iii) Income from voluntary contributions received by following:

a) Any trust or institution which has been established for the purpose of charitable or religions purposes

b) A scientific research association

c) A games or sports association

d) A charitable fund or a trust or institutions created for wholly public religion purposes

e) Any university or other educational institution

f) Any hospital or other institution

iv) Perquisites or profits in lieu of salary to employees

v) Any special allowance or benefit besides perquisites to employees to meet expenses for performing their duties

vi) Income from units of Unit Trust of India (tax free W.e.f. A Y. 2004-05)

vii) Income from units of Mutual Fund (tax free W.e.f. AY. 2004-05)

viii) Income from Marketing Association (W.e.f. AY. 2003-04)

ix) Any allowance granted to meet increased cost of living

x) Value of any benefit or perquisites received by any director of company or any person having substantial interest in company or his relative

xi) Value of benefit or perquisite received by representative assessee

xii) Profits generated from any business or profession

xiii) Capital gain

xiv) Recovery of bad debts allowed in the past

xv) Refund of excise duty

xvi) Balancing charge

xvii) Any interest, salary, bonus, commission and other remuneration received by partner of a firm

xviii) Amount received from winning of lottery, crossword puzzles, play cards and horse race with effect from Assessment Year 2002-03. The term 'lottery' shall include winnings through draws or any other ways. Play cards and other games shall also include any game or any other entertainment programme on televisions, for the purpose of winning the prize

xix) Amount received from employees for contribution in following funds:

a) Any fund established under Employees State Insurance Act, 1948

b) Any fund established for labour welfare

c) Provident fund or superannuation fund for employees

xx) Profits from sale of license received under import control order, 1995

xxi) Cash subsidy in respect of export under any scheme of Government of India

xxii) Sum received exceeding Rs. 50,000 from non-relative without consideration

xxiii) Sum received under Keyman Insurance Policy. This sum also includes bonus

xxiv) Income shall include the profits and gain of any business of banking (including providing credit facilities) carried on by a co-operative society with its members (W.e.f. A.Y. 2007-08)

xxv) Maximum amount of casual income upto Rs 10,000 is exempt from tax deduction at source. However, there is no TDS on winnings from other than horse races, gambling, or betting.

The above definitions of income are not comprehensive. Besides the above items, other receipts and benefits are also treated incomes under Income-tax Act.

1.3.2 Basic Principles

As mentioned at the very outset, the Act does not define the concept of income but merely states what amounts are to be included in the term 'Income'. The word income has been given a very wide meaning. Therefore, in the absence of any such guidelines, the Income Tax Department and the taxpayers have to depend upon various judgments of the High Courts and the Supreme Court.

All receipts are not income. Only those receipts must be treated as incomes which satisfy the guidelines laid down by various High Court and Supreme Court.

1) The word 'Income' connotes a periodical monetary receipt coming in from some definite source with some sort of regularity. The source need not be continuously productive one but must be one whose object is income.

2) Income is a periodical yield measurable in terms of money or money's worth and arises out of use of real or personal property i.e., the income may be received in cash or kind. Thus, the receipts in kind, which can be measured in terms of money, shall be taxable as income.

3) Periodicity or regularity or at least expected regularity is an important element of income. Regularity does not imply that a single receipt is not income.

4) Income includes money that has become due though not received.

5) A receipt which is 'income' will continue to be so even if it is exempt from tax.

6) Income means real income. Fictional or technical income cannot be termed as income for the purpose of the Income Tax Act, 1961.

7) Income must come from outside. Pocket money received by a student from his father cannot be termed as an income.

8) Legality or otherwise of income or source of income does not dictate whether a receipt can be termed income. You are required to pay tax on illegally earned income as well. This, however, does not grant immunity from prosecution.

1.4 DEFINITION OF PERSON

The term "Person" is defined in Section 2(31) of the Act. It is an inclusive definition implying list of entities which can be treated as a **"person"**. The term **person** includes the following:

1) An individual, e.g., Ramesh, Hari, Sita, etc.

2) A Hindu Undivided Family

3) A Company

4) A Firm

5) An Association of Persons or a body of individuals whether incorporated or not, e.g., co-operative society,

6) A Local Authority, e.g., Municipality, District Board, etc. and

7) Every artificial juridical person not falling within any of the categories mentioned above.

It will, thus, be seen that the word person is defined in very wide terms. A minor would also be included in the definition of persons in some circumstances. All the persons described above are liable to pay income tax under the Income Tax Act, 1961.

1.5 DEFINITION OF ASSESSEE

The term assessee has been defined in Section 2(7) of the Income Tax Act, 1961. "Assessee" means a person by whom any tax or any other sum is payable under this Act. The term is defined to include the following:

1) Every person in respect of whom proceedings have been started for the assessment of his income.

2) Every person who is assessable in respect of income of any other person.

3) Every person to whom a refund of tax is due.

4) Every person who is deemed to be an assessee under this Act.

5) Every person who is deemed to be an assessee in default under any provision of this Act.

An assessee in default is a person

i) Who is liable to deduct tax at source but does not do so.

ii) Who deducts the tax but does not pay it to the Government.

iii) Who fails to pay instalments of advance income tax in time.

The Act has given a very wide definition of this term. Anyone who is even remotely connected with the payment or refund of tax can be termed as assessee.

1.6 PERMANENT ACCOUNT NUMBER

Permanent Account Number (PAN) is a number which identifies a particular assessee to the Income Tax Department. It will not change even though the assessee changes his place of residence and consequently the income tax office which has jurisdiction over his place of business or residence.

Every person who is required to pay tax, either on his own behalf or on behalf of another person, is required to have a Permanent Account Number. In case the person has not already been allotted a PAN (if the income tax return happens to be his first return), he is required to make an application in Form No. 49A to the Assessing Officer seeking the number.

Ten Digit Permanent Account Number: The CBDT had introduced a new scheme of allotment of computerized 10-digit permanent account number. Therefore, everyone was required to apply for a fresh permanent account number even if he had already been allotted an account number earlier. However, the person to whom permanent account number, under the new series, had already been allotted, were not required to apply for such number again.

The Assessing Officer may allot a PAN to any person who in his opinion is liable to pay income tax. The assessee is required to quote the PAN not only on the Return of Income but also on all the correspondence and documents relating to the Income Tax Department. The Central Board of Direct Taxes has the powers to prescribe the transactions, documents etc. on which the PAN must be mentioned.

Check Your Progress A

1) Read the following carefully and tick mark the correct answers:

   a) Income tax is

      i) Levied by the State Governments ( )

      ii) A Direct tax ( )

      iii) An Indirect tax ( )

   b) Budget of the country is presented to the Parliament

      i) In the month of March ( )

      ii) In the month of February ( )

      iii) In the month of April ( )

   c) Income tax rules are framed by

      i) Central Government ( )

      ii) Income Tax Department ( )

      iii) Central Board of Direct Taxes ( )

d) TDS on casual income is exempted

i) Up to Rs. 10,000 ( )

ii) Fully ( )

iii) Up toRs.15, 000 ( )

e) A PAN number stands for

i) Permanent Account Number ( )

ii) Personal Account Number ( )

iii) Personal Access Number ( )

2) Define the term Person.

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3) Who is an 'Assessee in default'?

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1.7 ASSESSMENT YEAR

Assessment Year (AY) is defined in Section 2(9) of the Income Tax Act, 1961. It means the period of 12 months commencing on the April 1 of each year and ending on March 31 next. For example, the current assessment year is 2023-24 which commences on April 1,2023 and will end on March 31, 2024.

It is the financial year in which the assessment takes place. An assessee is required to pay tax in the AY on the income earned by him in the Previous Year according to the rates of tax prescribed by Annual Finance Act.

To illustrate, the current assessment year is 2023-24 and an assessee is required to pay tax in this AY on the income that was earned by him in the previous year 2022-23.

As a precaution, it should be pointed out here that there are a few exceptions to the general rule that income earned in the previous year only is taxed in the assessment year. These exceptions are explained in sub-section 1.9.

1.8 PREVIOUS YEAR

Income tax is levied on net taxable income of previous year. So, it is very important to make clear the meaning of the term 'Previous Year'. It is defined in section 3 of Income Tax Act. In simple words, a previous year is that year in which the income is earned and received and the year in which it is taxed is termed as Assessment Year. As the Assessment Year starts on 1st April every year, it is essential to end previous year prior to 1st April or till 31st March every year. Previous year is also called 'Financial Year' or 'Accounting Year'.

In other words, previous year is a period of maximum twelve months which will certainly end on 31st March every year (prior to assessment year). For example, the period of previous year related to the assessment year 2023-24 ended on 31st March, 2023. Following points are important in reference to previous year.

1) **Preceding Financial Year:** Financial year immediately preceding the Assessment Year is called Previous Year; for example, Financial Year of 2022-23 will be Previous Year for the Assessment Year 2023-24.

2) **Previous year for every source of income:** Earlier, the assessee had the option to choose any previous year, i.e., Diwali Year, Dussehra Year, Calendar Year, etc. But at present, no assessee can choose separate previous year under the Direct Tax Amendment Act, 1987. Thus, amendment came into force from the assessment year 1989-90. Now for every source of income, it is essential to have only one previous year (from 1st April to 31st March). In brief, the previous year will be uniform for all assesses and for all sources of income.

3) **Separate Account Year:** If an assessee, due to any reason, does not keep accounts on financial year basis but keeps on any other basis, he may do so. But he must have his accounts upto 31st March every year separately for income tax purposes. Thus, the assessee will have to keep accounts two times, which is not practical. To avoid this difficulty, mostly the assesses keep their accounts on financial year basis (from 1st April to 31st March).

4) **Previous Year for newly started business or profession:** If a business or a profession is started on any day of financial year (during 1st April to 31st March), its duration from the date of commencing the business to next 31st March will be treated as previous year for the relevant assessment year. For example, Mr. Amit commences his business on 30th January, 2023; the previous year of his business shall be treated from 30th January, 2023 to 31st March, 2023.

5) **Previous Year for new source of income:** The period, from the date of new source of income to next March, will be treated as previous year for the relevant assessment year. For example, Mr.Rakesh a bank officer lets his house on rent for the first time on 1st January, 2023. The previous year for this source of income shall be from 1st January, 2023- 31st March, 2023.

6) **Previous Year undisclosed money:** If an income tax officer finds any undisclosed money in case of any person's account for which he does not explain its source satisfactorily, it is called undisclosed or unexplained money. This is considered as assessee's income. The previous year for this income shall be the same as in case of that business in which this unexplained income is found.

7) **Previous Year for the share in firm's profits:** In this case, the previous year of the firm's business will be treated as the previous year.

1.9 TAXATION OF PREVIOUS YEAR'S INCOME DURING THE SAME YEAR

As stated earlier, the income of the previous year is taxed in the assessment year. But there are certain incomes for which the tax is paid in the same year. They are discussed below: (Exceptions of income of Previous Year is taxable in the assessment Year)

1) **Income of non-resident shipping companies (Section 172):** The income earned by a non-resident shipping company in India will be taxed in the year in which it is earned. This has been provided for in Section 172 of the Income Tax Act, 1962. It specifies that before the departure of the ship from port in India, the master of the ship shall prepare and furnish to the concerned Assessing Officer a return of the full, amount paid or payable to the owner on account of the carriage of passengers, livestock etc. The Assessing Officer shall immediately assess the income and determine the tax payable. Seven and a half per cent (7.5 %) of the local freight (including demurrage charge or any amount of similar nature) earned at Indian port by the owner or charter or any other person on their behalf shall be deemed to be the taxable income of the shipping business of non-resident shipping company.

2) **Income of Persons leaving India (Section 174):** This section provides that if the Assessing Officer feels that an individual may leave India without the intention of coming back, he may determine the total income of the person from the date of expiry of the immediately preceding previous year to the date of intended departure. The Assessing Officer will also compute the tax payable and will ask the individual to pay the tax so computed before leaving the country.

3) **Income of an association of persons or body of individuals or artificial juridical person formed for a particular event or purpose (Section 174A):** If it appears to the assessing officer that any AOP or a BOI or an artificial judicial person, formed or established or incorporated for a particular event or purpose is likely to be dissolved in the assessment year in which such AOP or BOI or an artificial juridical person was formed or established or incorporated immediately after such assessment year, the total income of such association or body or juridical person for the period from the expiry of the previous year for that assessment year upto the date of its dissolution, shall be chargeable to tax in that assessment year.

4) **Income of Persons trying to alienate their assets (Section 175):** This section provides for the taxation of income of any person who, it appears to the Assessing Officer, is likely to sell, charge, transfer or dispose or otherwise part with, any of his assets with a view to avoiding payment of tax on his income in the same year in which it is earned. The Assessing Officer will determine the income from the date of expiry of the immediately preceding previous year to the day when such proceedings commence and will serve a demand notice on the assessee.

5) **Income of discontinued business:** Where any business or profession is discontinued in any year, the income of the period from the date of expiry of the immediately preceding previous year to the date of discontinuance of

such business shall be determined and tax on that income shall be computed. It has been provided that any person discontinuing any business or profession shall inform the Assessing Officer of such discontinuance within 15 days thereof.

1.10 CONCEPT OF TOTAL INCOME

The term 'total income' is quite important as it is the total income that is put to tax. The term is defined in Section 2(45) which says that "total income" means the total amount of income, profits and gains as referred to in Section 5 and computed in the manner laid down in the Act.

1) Compute taxable income under various heads of income i.e., salaries, house property, profits and gains of business and profession, capital gains and other sources, by allowing deductions in respect of expenses incurred by the assessee in earning those incomes up to the extent permissible under the provisions.

2) Net result of adding taxable incomes from various heads of income is Gross Total Income.

3) Out of the Gross Total Income so computed, give deductions allowed under Section 80 C to 80 U etc. in respect of various expenses such as L.I.C premium, contribution to Provident Fund, Medical Expenses etc., and various incomes such as dividends, interests etc.

The net income so remaining after allowing all such deductions is termed as total income which will be relevant for computation of tax liability. It is also called Taxable Income.

1.11 ACCOUNTING METHOD

There are three types of accounting methods which are accepted in the accounting world. Sometimes, the assessee maintains the accounts based on cash system, a system wherein, income is supposed to be received only when it is received in cash. Till the amount is received, no cognizance is taken of income even if it has been earned. On the other hand, there is a system which is based on accruals and not on cash receipts. Third system is a mix of the first two systems wherein, generally income is reported based on cash system and expenditure is recorded on the basis of mercantile system or accrual system.

Since, the assessee is at liberty to use any method of accounting, there is need to ensure that the assessee does not change his method of accounting in a manner that is prejudicial to the interests of the Revenue. The Income Tax Act, 1961, therefore, provides in Section 145 that the income chargeable under the head 'Profits and Gains of the Business or Profession" or 'Income from other sources' shall be computed in accordance with the method of accounting employed by the assessee If, however, the Assessing Officer is of the opinion that notwithstanding the correctness of the Accounts, the method employed is such that it does not permit proper computation of income, the computation shall be made upon such basis and in a manner that he may determine.

It has been held that though the Assessing Officer may not accept the method of Accounting employed by the assessee, he has no right to impose his own method upon the assessee.

An assessee who intends to change his method of accounting is required to make an application to the Assessing Officer. He must prove that the change is regular and not for a casual period and if it is bonafide, the Assessing Officer has no reason to reject this change (Ramswarup Bengalimal v/s CIT 25 ITR 17).

Bansilal Abirchand v. CIT 3 ITC 57 holds that if the Department has been accepting the assessee's method of accounting for several years, they cannot arbitrarily seek to take him on a different basis in a particular year.

Check Your Progress B

1) Fill in the blanks:

   a) Assessment year is the financial year in which the..........................takes place.

   b) Assessment year ends on .... every year.

   c) Previous year is the .... immediately preceding the assessment year.

   d) Total income is ……………………….. income in respect of which income tax is payable.

   e) Income of discontinued business is taxed in the .... year.

2) X sets up a new business on October 1, 2022, and does not close his books on March 31, 2023. What will be the period of previous year for the assessment year 2023-24?

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1.12 LET US SUM UP

Income tax is a direct tax, administered by the Government of India through the Ministry of Finance and Central Board of Direct Taxes. The student is expected to have first-hand knowledge of the Income Tax Act, 1961, Income Tax Rules, 1962, the latest Finance Act and the landmark decisions of the High Courts and Supreme Court.

The term income is not exhaustively defined, and the Act simply enumerates certain items which are included in the term 'income'. Similarly, the term 'person' is also inclusively defined.

Assessment year is the current financial year in which income earned in the immediately preceding financial year (known as previous year) is put to tax. However, there are certain situations when income earned in a particular financial year is put to tax, in the same year and the ITO does not wait for the next financial year. Gross total income is arrived at by adding up taxable income from various heads. Out of Gross Total Income, certain deductions are allowed to arrive at Total Income which is put to tax.

The assessee can adopt either cash or accrual basis of accounting. However, once the method is adopted it cannot be changed without the satisfaction of the Assessing Officer.

1.13 KEY WORDS

Assessee: Assessee means a person by whom any tax or any other sum is payable under the Income Tax Act, 1961.

Assessment Year: It is a period of twelve months commencing on 1st April of each year.

Gross Total Income: It is the income arrived at after adding up all the taxable incomes from various heads of income.

Permanent Account Number: It is a ten-digit number allotted by the Income Tax Department to every assessee.

Previous Year: It is a period of twelve months immediately preceding the Assessment Year.

Total Income: It is the income on which tax is payable.

1.14 ANSWERS TO CHECK YOUR PROGRESS

Check Your Proess A

1) a) ii; b) ii; c) iii; d) i, e) i

Check Your Proess B

1) a) assessment b) March 31 c) Financial year d) taxable income
   e) same year

2) 6 months.

1.15 TERMINAL QUESTIONS/ EXERCISES

l) "The income of the previous year is taxed in the current year". Explain.

2) Distinguish between:

   i) Gross Total Income and Total Income.

   ii) Previous year and Assessment Year.

3) Are the following incomes as defined under the Income Tax Act, 1961?

   i) Amount received on sale of old Books.

   ii) Cash subsidy in respect of export under any scheme of Government of India.

   iii) Refund of excise duty.

   iv) Balancing charge.

   v) Recovery of bad debts allowed in the past.

   vi) Unclaimed balance distributed to partners.

vii) Compensation for relinquishing the rights of a partner.

viii) Value of benefit or perquisites received by representative assessee.

ix) Sum received under Keyman Insurance policy.

x) Income from marketing association.

(Answers)

i) No ii) Yes iii) Yes iv) Yes v) Yes vi) No vii) No viii) Yes

ix) Yes x) Yes.

Note: These questions and exercises 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.