Business Taxation

Third Edition

Business Taxation

Third Edition

Akhileshwar Pathak
Professor
Indian Institute of Management
Ahmedabad

Savan Godiawala
Senior Director
Deloitte Touche Tohmatsu India Pvt. Ltd.

McGraw Hill Education (India) Private Limited
NEW DELHI

McGraw Hill Education Offices

New Delhi New York St Louis San Francisco Auckland Bogotá Caracas
Kuala Lumpur Lisbon London Madrid Mexico City Milan Montreal
San Juan Santiago Singapore Sydney Tokyo Toronto

McGraw Hill Education (India) Private Limited

Published by McGraw Hill Education (India) Private Limited
P-24, Green Park Extension, New Delhi 110 016

Business Taxation, 3e

Print Edition
ISBN (13): 978-93-392-1822-5
ISBN (10): 93-392-1822-1

Ebook Edition
ISBN (13): 978-93-392-1823-2
ISBN (10): 93-392-1823-X

Managing Director: *Kaushik Bellani*
Head—Higher Education Publishing and Marketing: *Vibha Mahajan*
Senior Publishing Manager—B&E/HSSL: *Tapas K Maji*
Publishing Manager: *Surabhi Khare*
Associate Sponsoring Editor: *Shalini Negi*
Manager (Editorial Services): *Hema Razdan*
Production System Manager: *Manohar Lal*
Junior Production Manager: *Atul Gupta*
Assistant General Manager—Higher Education Marketing: *Vijay Sarathi*
Senior Product Specialist: *Navneet Kumar*
Senior Graphic Designer (Cover Design): *Meenu Raghav*
General Manager—Production: *Rajender P Ghansela*
Manager—Production: *Reji Kumar*

Typeset at Bharati Composers, D-6/159, Sector-VI, Rohini, Delhi 110 085, and Printed at

Cover Printer:

For my mother, Subhadra Pathak

— Akhileshwar Pathak

For my mother, Yogini; my wife, Pinki; my son, Aan; and my sister, Seju

— Savan Godiawala

Preface

The practice of taxation is all-pervasive. Businesses have to take it into account while making business plans and decisions. Managers have to deal with taxation on a daily basis. Recognising the relevance of taxation to businesses, business schools have introduced foundation courses for the students on the subject. We have been developing and teaching a course on business taxation at the Indian Institute of Management, Ahmedabad for some years now. This book is an outcome of our engagement in developing a course material and teaching the course. We readily recognised that new methods have to be designed for introducing the subject to management students and managers. Taxation encompasses various sub-fields including excise, custom, sales tax, service tax and income tax; each being a specialised one. Every business, big or small, would necessarily be supported by a taxation specialist. The specialist can be in-house or on a retainer basis.

The intent of a management student, who studies the subject of taxation, is not to replace the specialist but to work jointly with him/her for effective functioning. A foundational understanding of the subject will help the manager develop a perspective of the field and thus enable him/her to identify the points on which specialised resources should be sought. This will minimise the risk of violating the tax laws. The taxation specialist has knowledge about the taxation function, but may not necessarily be aware of the nuances of business practices. On the other hand, the manager has a comprehensive understanding of the business practices. The manager–specialist interface can therefore, effectively reorganise business practices, maximising tax advantages while making the practices compliant with the ever-changing tax laws. A foundational understanding of the subject will also help the manager understand the scope and implications of the changes in taxation.

The details regarding the procedural aspects of taxation fall within the purview of the specialist. We could, therefore, concentrate on the core organising principles of taxation for each of the fields. There are two ways of doing this. First, the conventional method, wherein the principles are listed and the reader receives these as information. In this, the reader is a passive recipient of information. A more engaged method of understanding the subject is interactive, wherein the reader is encouraged to ask questions about the principles and their connection to one another. In thus asking questions and seeking answers, the reader—in addition to understanding the principles—develops a conceptual understanding of the field. In this book, we have adopted the second method, where we invite the reader to engage with the subject to develop an understanding of the field. The book is supported by PowerPoint™ presentations on its companion web site, which are an integral part of the overall learning architecture. The book and the PowerPoint™ presentations may be used by the student and the faculty and in the following manner.

The student reads through the relevant chapter(s) before the class. Each chapter, systematically, introduces certain principles and analyses them. Each principle is followed by illustrations for the student to grasp the scope of the principle, which is followed by unanswered cases/problems for the student to attempt. While attempting the problems, the student rehearses the concepts and the principles become clearer. Due to its exhaustive and dynamic nature, the field of taxation, beyond a point, cannot be studied as principles alone. We will have to take the legal provisions for what these are. Towards understanding the text of the law, the text is followed by related questions for the student to explore. In answering the questions, the student discovers the meaning and scope of the legal provisions. Further comments confirm and reinforce the learning of the student. This is followed by illustrations, cases and problems. Through this process, the student gradually moves from simple to complex, discovering the principles and the law. The next stage of learning happens in the classroom.

The faculty takes forward the learning of the student with the PowerPoint™ presentation (hosted on the web site of the book). The PowerPoint™ presentations are organised chapter-wise, and the presentation for each chapter opens with a quick summary of the principles. This is followed by a new set of short cases and problems. The students are invited to attempt the problems and give answers. The instructor clarifies the doubts of the students, makes further comments and poses questions for classroom discussion. Through this interactive process, each student firms up the learning and brings the study of the theme to a close. Needless to add, we are suggesting this method as we have found it effective. The instructors are welcome to improvise and adapt.

We are glad the third edition of the book, incorporating the changes introduced by the Finance Act, 2014, has been readied by McGraw-Hill in a very short period of time. This has been possible only with the unwavering commitment of the McGraw-Hill team – Tapas K Maji, Surabhi Khare, Shalini Negi, Manohar Lal, Atul Gupta and Hema Razdan.

We look forward to comments and suggestions to make the subsequent editions more engaging.

Akhileshwar Pathak
Savan Godiawala

Publisher's Note

We value your views, comments and suggestions and hence look forward to your communication at *info.india@mheducation.com.* Please feel free to report piracy issues, if any.

Brief Contents

Contents

1

CHAPTER

Introduction

This book has been written for management students. Each stage of business practice involves incidence(s) of taxation. Business activity has to be planned with taxation in view and business practices have to be in compliance with the taxation laws in force at that time. The all pervading nature of taxation makes it an important field of study for management students. The field of taxation is highly detailed. Chartered accountants and lawyers are specialists in this field. Therefore, they form an integral part of organisations, either as employees or as consultants. However, managers act as the link between the specialists and the organisation's practices. To liaison effectively with these specialists, the managers too should have a basic knowledge of the core and founding aspects of the field of taxation. As our aim is not to become a lawyer or a chartered accountant but to become a manager, we need to understand the basic, underlying principles of the field. Our approach towards the study of the subject of taxation would also be different. Let us appraise these related concerns by first exploring the nature of the field of taxation.

✦ Constitution and Taxation

Taxation has been around for very long. In the early days, a ruler could sustain himself only by imposing taxes on his subjects. Thus, one of the earliest laws that was laid down stated that the ruler had the right to tax. The right to rule and the right to collect tax were two sides of the same coin. The sovereign (ruler) had the right to tax, and vice-versa, that is, the one who had the right to tax, was the sovereign. As a result, it has been a cardinal principle of taxation that there can be no tax without the authority of the law. Article 265 of the Constitution provides: 'No tax shall be levied or collected except by the authority of law.' Consistent with this, the Constitution of India makes elaborate provisions on the rights of the Union and the states to impose taxes. The Constitution of India separates the legislative functions of the Union and the states. It contains three lists, the Union List, the State List and the Concurrent List. The Union alone can legislate on the entries in the Union List. The states alone can legislate on the entries in the State List. However, both, the Union and the states can legislate on the entries in the Concurrent List. Some of the important entries in the Union List are as follows:

82. Taxes on income other than agricultural income.
83. Duties of customs including export duties.

84. Duties of excise on tobacco and other goods manufactured or produced

in India except— (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics …

92A. Taxes on the sale or purchase of goods … where such sale or purchase takes place in the course of inter-state trade or commerce.

92C. Taxes on services.

Entry 82 acts as the basis for the Parliament to enact laws imposing a tax on the income of persons. The currently applicable law is the Income Tax Act, 1961. This Act levies a tax on the income of individuals, legal persons, incorporated bodies and unincorporated associations of persons. Entry 83 forms the basis for the Parliament to make laws imposing tax on imports as well as exports. The tax levied on imports is known as the customs duty. The Customs Act, 1962 levies duties on imports and exports. Entry 84 acts as the basis for the Parliament to levy tax on the manufacturing of goods. This tax has come to be known as excise duty. The Parliament is competent to make laws that give the government the right to levy tax on the manufacturing of all goods others than alcohol for human consumption, opium and narcotic substances. The applicable law on the taxation of goods manufactured is the Central Excise Act, 1944.

At the time when the Constitution was adopted, provision of services was not a prominent activity. Thus, it did not find a mention in the Constitution. The service industry emerged as an important activity and the Parliament introduced a service tax in 1994. The Parliament has the power to make laws on subjects that do not find mention in any of the lists. Following this residual power, the Parliament imposed a service tax for the first time, in the Finance Act, 1994. Subsequently, the Constitution of India was amended to add Entry 92C in the Union List, under the head, 'taxes on services'. This has created an explicit basis for the Parliament to enact laws imposing service tax. The provisions regarding the imposition of the service tax introduced in the Finance Act, 1994, have been amended from time to time. This provides the law on service tax. There is no separate act on service tax. Entry 92A gives the power to the Parliament to impose a tax on the sale of goods when the sale takes place across the states as opposed to within a state. The Parliament has enacted the Central Sales Tax Act, 1956, imposing tax on inter-state sale of goods.

The following are some of the important entries in the State List, upon which the states have the legislative power to impose taxes:

45. Land revenue …

51. Duties of excise on … (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics …

54. Taxes on the sale or purchase of goods other … subject to the provisions of entry 92A of List I.

62. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

63. Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

Land Revenue is levied on agricultural land on the basis of the productivity of the land. Earlier, in an agrarian society, this was the most prominent source of revenue for the state. Since then, its role has come down in relative terms. Entry 54 gives power to the state legislatures to impose tax on sale of goods within their states. The states gave effect to this with their respective Sales Tax Acts. The states have recently replaced these Acts with Value Added Tax Acts. As the states have created these Acts in co-ordination with the Centre, the Acts are similar. The name of the Act of a particular state is preceded by the name of that state. To recall, taxing inter-state sales comes within the domain of the Centre. Some of the other taxes under the legislation of the states are motor vehicle registration, stamp duty and registration, excise duty on alcohol and narcotic substances and entertainment tax.

The taxes noted above have been classified under two heads: direct taxes and indirect taxes. Income tax, wealth tax, corporate tax and gift tax come under direct taxes. Excise duty, service tax, sales tax and customs duty come under indirect taxes. Direct taxes refer to those taxes that a person pays directly from his income, wealth or estate. These are paid after the income or benefit reaches the hands of the person. Such a tax is in proportion to the benefit derived. Indirect taxes are attached to goods and services consumed. They fall on any person who consumes a good or service. For this reason, they are called indirect taxes.

✦ Legal Instruments

As taxes can only be levied, collected or authorised by the law, a study of taxation becomes a study of the taxation law. Law is a general term which includes different legal instruments, like acts, rules, notifications, ordinances and bye-laws. Let us become familiar with these different legal instruments. Conventionally, law making has been the sole prerogative of the legislature. The law made by the legislature is called an act. The Parliament is the Union Legislature for India. Let us take up the process of law-making by the Parliament, as provided for in the Constitution of India. The process begins with a member of the Parliament, say, a member of the Lok Sabha, introducing a bill. A bill is a draft form of an act. The Lok Sabha takes it up for discussion. Thereafter, the bill can be accepted, rejected or referred to a 'select committee' for necessary revision. If it is passed, it is sent to the other House of the Parliament, the Rajya Sabha. The Rajya Sabha can accept the bill, reject it or accept it with modifications. If the bill is modified, it is sent back to the Lok Sabha for acceptance. At the end of this process, if the bill gets passed by both the Houses of the Parliament, it is then sent to the President for his/her assent. After it receives the assent of the President, it becomes an act. It is through this process that, for example, the Income Tax Act was enacted in 1961.

The legislature, having made an act, may wish to change the law afterwards. If it is competent to make an act, it should also be competent to amend it. Thus, the Parliament has been held to be competent to amend an act enacted by it. An amendment is brought about through the same process through which an act is enacted. It begins with the tabling of an amendment bill and ends with the assent of the President. For example, the Income Tax Act is amended by the Parliament every year, often, more than once. A state legislature follows the same process for the enactment and amendment of a bill on a legislative subject in its domain. In the case of the states, a bill passed by the legislature is sent to the Governor for assent.

Law making was the exclusive domain of the legislature. However, with increased specialisation in the economy and society, it has no longer been possible for the legislature to provide the details of the law on every subject. The modern legislature, for example, the Parliament, does not have the time or resources to provide all the details necessary for governance. Hence, it lays down the overall framework of the law on a subject, through an act, and delegates the function of providing the details to the executive. The executive is a body comprising all the ministries and departments, headed by the Prime Minister. Each of the departments has the requisite expert knowledge about the working of a field. For example, under the Ministry of Finance there are departments of Direct taxes and Indirect Taxes. The department of direct taxes, which exclusively deals with the subject of income tax, has the specialised knowledge on the working of the law on income tax.

The executive provides the details for the working of an act through several instruments. The first in the hierarchy of the instruments is the 'rules'. Every act authorises the executive and gives wide powers to it to make rules to give effect to the act and provide the details. The rules are required to be tabled before the parliament for approval. A rule under an act has to be in conformity with the act. For example, the executive has formulated the Income Tax Rules, 1962. This document was authored by the executive and approved by the Parliament. The rules made by the executive also need to be changed from time to time. For making these changes, the executive does not have to take the proposal for changes to the Parliament for its approval. It amends the rules on its own. An amendment is published in the gazette, which is called a notification. Acts also make provisions for the executive to give effect to the respective acts by issuing notifications directly under the act.

The term, 'notification', refers to bringing to the notice of the people. How would people know the law if it is not brought to their notice? With the invention of the printing press, the British government came up with the 'gazette' where the laws made by it were printed. Printing in the gazette amounted to bringing the law to the notice of the public. In fact, all the three legal instruments, acts, rules and notifications, are published in the gazette. With the advent of the internet, the notifications have become readily available. The relevant department, simultaneously with its publication in the gazette, puts up the notification on its webpage.

Government officers make several communications to each other as well as to the public. As these officers work according to the law, every communication is in relation to some act or rules. However, all communications cannot be published in the gazette. The remainder of the communication from the government explain or clarify the rules or notifications and further detail them. These communications go by different names, for example, guidelines, government orders, executive orders and circulars. The key difference between these and a notification is that a notification is published in the gazette while these documents are not. Technically, these documents can be found only in the files of the government. However, ministries and departments make these available to the public through their webpages.

✦ Scope of the Book

The law on a subject is contained in the hierarchy and network of the act and the rules and notifications under it. The courts further contribute by interpreting the legal text. The law on taxation is a lot more detailed than that on any other subject. There are several reasons for this. The state needs resources. Towards this, it is forever looking for newer sources for taxation and increasing its tax collection. Not surprisingly, the commanding principle of taxation has been that the state has the sovereign right to impose and collect tax, at the threat of punishment. The subject, on the other hand, is forever looking for ways and means of getting out of the imposition. The most obvious means is wilful evasion of tax. To prevent this, taxation laws have created law enforcement departments and vested them with wide powers to ensure compliance with the law. The other means available to the subject is often legitimate. This involves structuring a transaction in such a way that it does not attract the tax. In effect, the tax payer finds a loophole in the tax law to avoid paying the tax. Another means is to contest the meaning of the legal text. The meaning of every word used in the tax law gets contested by the state and the tax payer. The meaning given to each word will decide whether the tax applies to the subject or not in the given case. To outdo the tax payer in these strategic plays, the state is forever changing the law and making it more and more detailed. This has made the field of taxation highly specialised. Each of the fields, that is, income tax, excise, custom, service tax and sales tax, has emerged as a specialised area in itself.

The vastness of the field of business taxation should not overwhelm us. We are not studying the subject to acquire the capabilities of a lawyer or a chartered accountant and substitute him. On the contrary, we are studying the field in order to become better managers and develop the capacity to be able to bring the expert knowledge of the specialists closer to the everyday business practices. This would take place at several levels. One, we ought to know the core aspects of the field so as to be able to integrate them in the business practices on our own. Two, we should possess adequate knowledge of the field so as not to be in violation of the law. Three, we should be able to recognise an incidence of taxation and seek the help of a specialist. Four, the specialist might have extensive knowledge of the field of taxation but might not be aware of the business practices. Therefore, a manager should possess adequate knowledge of taxation to be able to be an effective link while receiving expert opinion and helping the organisation re-structure its practices accordingly.

This helps us in delineating the scope of our study. Each of the fields of taxation has elaborate provisions on enforcement, adjudication and punishment. This is the procedural aspect of the law and will be handled by the specialist. We need not engage with this field. We should concentrate on the substantive part of the law. The substantive law is also highly detailed. Our aim would be to grasp the founding aspects of the substantive law. We begin our study with the most elaborate field—income tax. This constitutes Part 1 of the book. Part 2 of the book will contain indirect taxes—sales tax, service tax, excise duty and customs duty.

Part 1

Direct Taxation

2

CHAPTER

Income Tax: Introduction

The taxation of income is governed by the Income Tax Act, 1961. The Income Tax Act is very detailed. Often a provision has an exception, the exception has further exceptions under it and these exceptions in turn, may have several qualifying conditions. The law would be inadequate if it did not provide all the details. Lack of details could lead to ambiguities, providing opportunities for the subjects to evade tax. A simple and uniform law, for example, a law imposing income tax on all persons, at a standard rate on all levels of incomes, could be highly unjust. Therefore, the law is detailed. However, our objective is to understand the basic framework of the Act. Towards understanding the core of the Act, the provisions have been edited. The deletions are indicated by '…'.

The purpose of the law is to provide specific and clear directions. Towards this, acts are thematically organised. An act is broken up into parts and the parts into chapters. A chapter is further broken up into entries, which take forward the theme of the chapter. The entries are serially numbered. An entry in an act is called a section. The components of a section are called sub-sections. Section 2 of every act is alike. It is titled, 'definitions' and it comprises all the key words occurring in the act, in an alphabetical order, and defines them. We will frequently need to refer to Section 2 of the Income Tax Act.

Section 4 of the Income Tax Act states the basis for charging income tax. It provides that income tax is to be charged for 'any assessment year … in respect of the total income of the previous year of every person.' Section 4 is very compact. It applies to 'every person'. The expression suggests a wide application of the law. A person may have income from different sources. The Act applies only after the totalling of the income. The totalling has to be done on an annual basis. The Act explains in detail, each of the terms — person, assessment year, previous year and income. Further, each of the terms is related to the other terms. To fully understand the import of one term, one has to understand the meaning of the other terms as well. In this context, the best strategy to develop an understanding of the law would be to take a preliminary view of all the terms and their relationships. Having developed this core, the theme could be visited and revisited to develop a comprehensive understanding of the terms and their relationships with each other.

✦ Persons to whom the Act Applies

Section 4 makes 'every person' liable to pay income tax. Section 2(31) defines a 'person' in the following extended sense:

2(31) "person" includes—

(i) an individual,

(ii) a Hindu undivided family,

(iii) a company,

(iv) a firm,

(v) an association of persons or a body of individuals, whether incorporated or not,

(vi) a local authority, and

(vii) every artificial juridical person, not falling within any of the preceding sub-clauses.

Explanation—For the purposes of this clause, an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains;

Explore whether the following 'persons' are potential income tax payers:

1. Neil is a proud post-graduate student. Instead of depending on his parents, he teaches guitar and earns to pay his college fee and living expenses.
2. Asha Deep is a non-government organisation, registered as a society, helping promote education among street children. It runs a journal and gets income from the subscriptions of the journal.
3. Symmetry Communications Private Limited is a company engaged in the business of manufacturing material for communication. It receives income from the sale of its products.
4. The students of a newly constituted college created a committee called the 'Winter Festival Committee'. The committee organised a cultural festival for the students. It received ₹ 20 lakh as sponsorships and ₹1 lakh through sale of tickets. The committee saved ₹ 3 lakh, which it retained for use by the students next year.
5. The employees of an organisation formed an Employee Welfare Credit Co-operative Society.
6. A Student Welfare Society is registered under the Societies Act of Gujarat. It was created by a group of alumni of an Institute to support the current students of the Institute. The society earns resources by investing its corpus.
7. Amandeep is a retired person, supporting himself with the pension he gets from the government.
8. Three N Ltd. is a company engaged in the business of manufacturing electronics equipment.
9. Ravi and Deep are partners in a business running bakery stores in the city. The business is run under the name, 'Everfresh Bakery'.
10. Life Insurance Corporation of India is a distinct legal person created by an Act of the Parliament, the Life Insurance Corporation Act, 1956.

The above exploration brings out the fact that the scope of the Act is very broad. It applies to individuals as well as companies. Some disciplines use the term, 'firm', to refer to any entity engaged in business. In legal texts, however, the term, 'firm', refers to partnerships. Thus, the Act applies to partnerships as well. The Act also applies to all other 'artificial juridical persons'. These are mostly created by the legislature or the executive. The term, 'local authorities', refers to panchayats, municipal corporations and port trusts. Such bodies are also covered by the Act. Further, the Act also applies to associations of persons, even if they are not incorporated. We are, however, interested in and would focus only on 'companies' and 'individuals'.

✦ Residential Status

We know that Non Resident Indians (NRIs) get certain benefits under the Income Tax Act. This raises questions in relation to the term, 'every person', used in the Act. The law in India requires that every person on the highway to keep to the left side of the road. Does this law apply to a French national visiting India as well? The law certainly applies to everyone on the territory of India. On the same note, does the law also give the right to the French national to vote during the General Elections? It does not. Thus, some laws apply to every person in the territory of India while others apply to only the citizens of India.

Let us take the case of a citizen of India on a visit to France. The Indian law that a person must drive on the left side of the road would not apply to him in France. However, the provisions of the Passport Act, requiring every person to report any loss or damage to his/her passport, would be applicable, whether the passport holder is in India or abroad. Thus, some laws are applicable to Indian citizens even if they are abroad. What is the scope of the Income Tax Act in this context? A general answer that can be stated is that the Income Tax Act applies to foreign nationals who earn income in relation to India as well as to Indian citizens abroad.

Towards clarifying this point, Sections 5 and 6 introduce the concept of 'resident'. The Act applies to all residents. Among others, individuals who have been in India for 182 days or more in the year are treated as residents. A company incorporated in India is resident and, thus, would always be subject to the Act. Section 9 of the Act provides that any income that arises through or from any business connection in India, or property or asset in India, is taxable under the Act, irrespective of the nationality or location of the person. Thus, the Act applies to companies as well as individuals with any business interest in India. A foreign national employed and based in India (for longer than 182 days) would also be a resident. The Act applies to him on both the counts, residence as well as business connection.

Further, all Indian citizens, depending on the patterns of their stay in and outside of India, are grouped under the heads: 'resident and ordinarily resident', 'resident but not ordinarily resident' and 'non-resident'. The Act gives some exemptions to 'non-resident Indians' and 'resident but not ordinarily resident' Indians. Indian income is always taxable in India, irrespective of the residential status of the tax payer. Foreign income is taxable in the hands of the resident. Foreign income is not taxable in the hands of those who are non-resident in India. The above discussion gives a general and broad overview of the issue of residential status and taxation. The law on residential status and income tax is complex, unclear and contested. Exploring the field further, at this preliminary stage, will distract us from developing an overall view of the subject. Let us now proceed to grasp the meanings of some other terms used in the Act.

✦ Previous Year and Assessment Year

All persons have to pay income tax on the total income of the previous year. Section 4 provides that the income tax has to be calculated and paid 'in respect of the total income of the previous year.' Section 3 defines 'previous year' as follows:

> Section 3: Previous Year: For the purposes of this Act, "previous year" means the financial year immediately preceding the assessment year:
>
> Provided that, in the case of a business or profession newly set up, or a source of income newly coming into existence, in the said financial year, the previous year shall be the period beginning with the date of setting up of the business or profession or, as the case may be, the date on which the source of income newly comes into existence and ending with the said financial year.

Previous year is defined with reference to the 'assessment year'. Section 2(9) defines assessment year thus:

> Section 2(9): Assessment Year: "assessment year" means the period of twelve months commencing on the 1st day of April every year;

Illustration: Previous Year

Dilip is a management consultant. His last four receipts from clients are as follows:

(Amount in ₹ Lakh)

S. No.	*Date*	*Amount*
1	January, 14, 2013	2
2	March 22, 2013	1
3	June 12, 2013	2
4	August 17, 2014	6
5	November 18, 2014	3

Identify the previous year and the assessment year for Dilip.

(Amount in ₹ Lakh)

S. No.	*Date*	*Amount*	*Previous Year*	*Assessment Year*
1	January 14, 2012	2	April 1, 2012 to March 31, 2013	April 1, 2013 to March 31, 2014
2	March 22, 2012	1	April 1, 2012 to March 31, 2013	April 1, 2013 to March 31, 2014
3	June 12, 2012	2	April 1, 2013 to March 31, 2014	April 1, 2014 to March 31, 2015

4	August 17, 2014	6	April 1, 2014 to March 31, 2015	April 1, 2015 to March 31, 2016
5	November 18, 2014	3	April 1, 2014 to March 31, 2015	April 1, 2015 to March 31, 2016

The financial year starts from April 1 of the year and ends on March 31 of the next year. The Act has made the previous year and the assessment year co-terminus with the financial year. The short-form for writing the financial year, for example, April 1, 2013 to March 31, 2014, is 2013-14. We can, thus, tabulate the income of Dilip under different years in the following manner:

(Amount in ₹ Lakh)

Previous Year	*Assessment Year*	*Income*
2012–13	2013–14	3
2013–14	2014–15	2
2014–15	2015–16	9

The year of interest for Dilip, as for any income tax payer, is the previous year. It is the income earned during this year that has to be taken into account for paying the income tax. Why then is the year consigned to a secondary status by giving it the name, 'previous' year? It could have been called by a name signifying its importance, say the 'income' year. Income tax law is quite old. It was first introduced in India through an Act in the 1850s. At that time, agricultural was the main source of revenue. Income tax made an entry as a secondary source of revenue. The first information the administration got of an incidence of taxation was when a person reported his annual earnings for assessment of tax and its payment. Thus, the year in which the administration started its work came to be called the assessment year. The assessment was to be done for the income earned in the year gone by. Thus, the year in which the income was earned came to be called the previous year. As the person's income was being assessed, the tax payee came to be called the assessee. Section 2(7) defines an assessee to be 'a person by whom any tax or any other sum of money is payable under this Act.' In the present context, income tax has become an important source of revenue. The tax administration now requires persons to calculate their provisional tax liability and pay advance tax as money is earned during the current year. However, referring to the year in which income is earned as the previous year has continued.

Case: Previous and Assessment Year

Identify the previous year and the assessment year for the following persons:

1. Ocean Pearl Limited received ₹ 40 lakh on February 7, 2014, ₹ 50 lakh on April 15, 2014 and ₹ 15 lakh on November 18, 2014.
2. Manjit gets a consolidated salary of ₹ 60,000 a month. The salary is credited to his bank account on the 28th of every month. He joined a company on January 1, 2014 and left it on August 31, 2014, to pursue further studies.
3. A management consultant received the following fee from his clients:

S. No.	*Date of receipt*	*Amount in ₹ Lakh*
1	February 10, 2014	3.00
2	April 20, 2012	2.50
3	May 10, 2012	2.00
4	June 24, 2013	1.00
5	May 20, 2014	4.00

Complete the following table

S. No.	*Date of receipt*	*Previous Year*	*Assessment Year*	*Amount in ₹ Lakh*
1	February 10, 2014			3.00
2	April 20, 2012			2.50
3	May 10, 2012			2.00
4	June 24, 2013			1.00
5	May 20, 2014			4.00

✦ Heads of Income

Section 2(24) of the Act, defines income very widely, so as to include profits, gains, dividends, perquisites, benefits, allowance, and winnings and prizes. The definition is indicative of the intention of the law to levy tax not on every 'income', that is, on 'everything coming in', but on 'income' in the sense of surplus from an activity. This is understandable. A tax can be sustained only on surplus. Section 14 requires income to be classified under one of five heads.

Section 14: Heads of Income. Save as otherwise provided by this Act, all income shall, for the purposes of charge of income-tax and computation of total income, be classified under the following heads of income—

Salaries.

Income from house property.

Profits and gains of business or profession.

Capital gains.

Income from other sources

Let us become familiar with the heads of income by taking up the following case.

Illustration: Heads of Income

A man joined a two-year business management programme in June, 2013. He had already worked for three years in a computer software company at Bangalore. As he was leaving a secured job, he mobilised resources from different sources for his studies. The income received by Aman during the previous year, 2013–14, is mentioned below in a chronological order.

1. Aman was employed by a company, Datamatic Ltd., till May 31, 2013. The company used to pay salary to its employees by directly crediting it in their bank accounts on the last day of the month. The salary paid into the bank account of Aman was ₹ 30,000, in each of the months, April and May, 2013.
2. Aman had bought a flat in Bangalore. When he was moving out of Bangalore for his studies, he rented the flat out. The flat was rented out from June 1, 2013, for an annual rental of ₹ 1,20,000. He received a cheque for the entire rent amount due for the first year.
3. Aman applied for and was allotted 500 shares through an Initial Public Offer, for ₹ 50,000 on October 10, 2009. As he needed money for his studies, Aman sold off all the shares for ₹ 80,000 in July, 2013. He received the payment on July 28, 2013.
4. Aman's institute offered scholarships to meritorious and deserving students. The scholarship of ₹ 28,000 per year was to partially cover the tuition fee. Aman had applied for the scholarship and he was awarded the scholarship. He received the entire amount for the first year of studies on August 10, 2013.
5. Datamatic Ltd. gave a bonus of ₹ 5,000 to every employee who had worked with them. Aman received his cheque on September 5, 2013.
6. The bank credited ₹ 654 as interest on his savings bank account on September 30, 2013.
7. Aman had a long break in October. While working in Bangalore for Datamatic Ltd., he had been assigned several times to a retail store, Shoppers Ltd., to develop some software for their operations. Shoppers Ltd. wanted to upgrade the software. As Aman was thoroughly familiar with the software as well as with the operations of Shoppers Ltd., they wanted only Aman to do the job. They contacted him and convinced him to do it for them during his October break. It involved 15 days of work. Shopper Ltd. paid Aman ₹ 2 lakh for the job on October 27, 2013.
8. While working in Bangalore, Aman had bought shares of a company listed on a recognised stock exchange and received ₹ 10,000 as dividend on January 12, 2014.
9. Aman received ₹ 8,000 on February, 18, 2014, as dividend from his investment in a mutual fund.
10. Aman had bought shares of a public company, listed on a stock exchange in Mumbai, through a stockbroker, for ₹ 30,000 in January, 2010. He sold off the shares on March 22, 2014, for ₹ 45,000.

Arrange the various incomes under the heads listed in Section 14.

Aman's income can be classified under the different heads as follows:

Previous Year: 2013–14

Income Head	*Amount*
Salaries	₹ 60,000 ₹ 5,000
Income from house property	₹ 1,00,000

Profits and gains of business or profession	₹ 2,00,000	(Shoppers Ltd.)
Capital gains	₹ 30,000	(Acquired through IPO in Oct 2009)
	₹ 15,000	(Acquired through Stockbroker in Jan, 2011)
Income from other sources	₹ 28,000	(Scholarship)
	₹ 10,000	(Dividend from company)
	₹ 8,000	(Dividend from Mutual fund)
	₹ 654	(Interest from bank)

Income from other sources is a residual category. Whatever does not fit in the first four specific heads, would need to be taken to this category. Thus, scholarship, dividend and interest have been taken under this head.

Case: Heads of Income

Classify the income of the following persons:

1. Symmetry Limited is a company engaged in the manufacture of pharmaceutical products. It has invested some of its reserves in the equity of another company. It received ₹ 32 lakh as dividend from that company on November 12, 2014.
2. Sun Bank runs a credit card operation. It gives an option to its cardholders to pay only 10% of the money owed for the billing period. The remaining sum can be paid in the next two months. The bank charges interest for this facility. The bank earned ₹ 2 crore as interest in the previous year, 2013–14.
3. Three N Ltd. is a company involved in the manufacture of furniture and office equipment. It owns a residential building in Mumbai. Some of the flats in that building were occupied by its executives, while four of the flats were rented out. The company received ₹ 36 lakh as rent during the previous year, 2013–14.
4. Three N Ltd. is a company involved in the manufacture of furniture and office equipment. The company owned an office building in Mumbai. It sold off the office building for ₹ 40 crore to pay-off some of its debts. The sale was done on November 12, 2014 and the entire sale consideration was received on the same day.
5. Anuj is a lawyer. He is engaged by three companies on a retainer basis. Anuj gives one day a week to each company and attends to all their legal work. He receives ₹ 2 lakh from each company.
6. Three N Limited received ₹ 20 lakh as dividend on its investments in the shares of a company, on October 12, 2014.

✦ Exemptions

The Act, thus, applies to every person, whether a natural individual or an artificial legal person. It applies to every kind of income. The Act applies even to organisations created, controlled and managed by the government. It is illogical for the government to collect taxes from its own organisations. The Act also applies to organisations involved in charity, social development or relief work. However, there is no justification for taxing organisations whose aim is not to make profit. Eventually, the Act would not apply to several organisations and kinds of income. The Act, like other acts, follows a particular organising strategy. The Act begins by casting its application very broadly, so as to ensure that no one escapes from its application. Thereafter, the Act introduces provisions through which it makes exemptions from the application of the Act. The strategy ensures that no one escapes due to the wording of the law. At the same time, the law-maker extends exemptions to the identified persons or categories.

The Income Tax Act has an entire chapter, 'Chapter III: Incomes Which Do not Form Part of the Total Income', running from Section 10 to Section 13A, exempting certain persons and kinds of income from the application of the Act. Let us get a map of the provisions in the chapter by appraising the title of the sections. The titles of Sections 11 and 12 of the Act are as follows:

> Section 11: Income from property held for charitable or religious purposes
>
> Section 12: Income of trusts or institutions from contributions

We can expect the above sections to give partial/full exemption to charitable and developmental organisations from the application of the Act. Most organisations that are not seeking profits qualify as 'charitable'. The sections, thus, are of much interest to non-government organisations, development organisations and educational institutions. Section 10 has a general application. It reads:

> **Section 10. Incomes not included in total income.-** In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—

This section has over fifty sub-sections and most of the sub-sections have further clauses and entries. It exempts partially or fully, certain kinds of income or certain kinds of persons. The list of exemptions under Section 10 is vast and varied. Each year, the list is changed through amendments. We could classify some of the exemptions in the following categories:

State-controlled Institutions: The chapter exempts organisations managed or controlled by, or related to the government. These organisations are mentioned by their names.

Institutions of Social Relevance: The chapter exempts institutions, with or without conditions, whose objectives are related to relief, or the development of education or research. The following are some examples:

1. Prime Minister's National Relief Fund
2. Prime Minister's Fund (Promotion of Folk Art)
3. Prime Minister's Aid to Students Fund
4. National Foundation for Communal Harmony
5. Income of a Scientific Research Association [Section 10(21)]
6. Income of a News Agency in India [Section 10(22B)]
7. Income of a Sports Association [Section 10(23)]
8. Income of a Professional Association [Section 10(23A)]
9. Income of Regimental Fund or Non-Public Fund established by Armed Forces [Section 10(23AA)].

Privilege by the State: Any award or reward given by the Central or state government, in public interest, is exempt from income tax. Similarly, family pension received by individuals awarded with the 'Param Vir Chakra' or 'Maha Vir Chakra' or 'Vir Chakra' or other notified gallantry awards, is exempt from income tax.

Agricultural Income: At the time of the making of the Constitution, there was much objection to levying of income tax on farmers and agriculturists. Therefore, it was taken out from the taxation ambit of the Centre and inserted in the domain of the states. Thus, a state could tax the farmers if it so wished.

Retirement Benefits: When a person retires after attaining a certain age, he is not likely to be employed and have sources of income. It is likely that he would be subsisting on the income received at the time of retirement. Thus, as a beneficial measure to individuals, there are exemptions for retiring employees.

Several of the exemptions under Section 10 relate to business, profession, salary, individual savings, companies and the residential status of a person. An edited version of the section, with its sub-sections, which could be of interest to individuals and companies, is as follows:

> **10. Incomes not included in total income—**In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—
>
> (1) agricultural income;
>
> (2A) in the case of a person being a partner of a firm which is separately assessed as such, his share in the total income of the firm. …
>
> (5) in the case of an individual, the value of any travel concession or assistance received by, or due to, him,—
>
> (a) from his employer for himself and his family, in connection with his proceeding on leave to any place in India ….
>
> Provided that the amount exempt under this clause shall in no case exceed the amount of expenses actually incurred for the purpose of such travel. ...
>
> (10) (i) any death-cum-retirement gratuity received under the revised Pension Rules of the Central Government …
> (ii) any gratuity received under the Payment of Gratuity Act, 1972 …
> (iii) any other gratuity received by an employee …
>
> (16) scholarships granted to meet the cost of education; ...
>
> (34) any income by way of dividends referred to in section 115-O;
>
> (35) any income by way of—
>
> (a) income received in respect of the units of a Mutual Fund specified under …
> Provided that this clause shall not apply to any income arising from transfer of units …
>
> (38) any income arising from the transfer of a long-term capital asset, being an equity share in a company or a unit of an equity oriented fund where …
>
> (b) such transaction is chargeable to securities transaction tax under that Chapter. ..

(43) any amount received by an individual as a loan, either in lump sum or in instalment, in a transaction of reverse mortgage referred to in clause (xvi) of Section 47.

A glance at the exemptions, as mentioned earlier, brings out that the exemptions are related to the other provisions of the Act. We would be able to develop a comprehensive understanding after studying the other provisions. Let us form an overview of the application of Section 10 by appraising Aman's sources of income and deciding whether he would benefit from Section 10 or not.

Illustration: Income of Aman

Previous Year: 2013—14

Income Head	*Amount*	*Application of Section 10*
Salaries	₹ 60,000 (From Datamatic Ltd.) ₹ 5,000 (From Datamatic Ltd.)	
Income from house property	₹ 1,00,000 (House in Bangalore)	
Profits and gains of business or profession	₹ 2,00,000 (Shoppers Ltd.)	
Capital gains	₹ 30,000 (Acquired through IPO in Oct 2009) ₹ 15,000 (Acquired through Stock broker in Jan, 2011)	
Income from other sources	₹ 28,000 (Scholarship) ₹ 10,000 (Dividend from company) ₹ 8,000 (Dividend from Mutual fund) ₹ 654 (Interest from bank)	

The income under each of the heads, as we would note, is allowed deductions only up to the extent of the expenditure incurred while earning it, so as to compute the profit, gain or surplus. We need to note, however, that expenditure incurred while earning an income that is exempt under Section 10, cannot be claimed. Section 14A provides that no deduction shall be made in respect of expenditure incurred by the assessee in relation to income which does not form a part of the total income under the Act. Let us now move on and explore the details under the heads of income. We will first take up the head, 'income from house property' in the next chapter.

3

CHAPTER

Income from House Property

The title, 'Income from house property', suggests that it applies to income from renting out of house property. Section 22 terms the rent as the 'annual value of property'. It reads as follows:

> **Section 22. Income from house property:** The annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property as he may occupy for the purposes of any business or profession carried on by him the profits of which are chargeable to income-tax, shall be chargeable to income-tax under the head "Income from house property".

The title of the head of income, i.e., 'house property', seems to convey the application of the head to residential premises only. However, it applies to income earned from 'any building' and even from land surrounding such building.

Illustration: Scope of House Property

Carlyle Limited, a pharmaceutical company in the centre of Mumbai, has a building complex. The following are the details of the occupancy of the different units of that building:

1. The building has a warehouse, which has been rented out to TDW Ltd. since the last five years.
2. The first floor is occupied by the marketing department of Carlyle Industries.
3. The second floor is rented out to Sincom Limited, for office use.
4. The third floor has four spacious flats. Flat No. 1 is rented out to a bank to house one of its executive.
5. Flat No. 2 is used as a guest house by Carlyle Ltd. for its visiting employees.
6. Flat No. 3 is used for the display and promotion of products of Carlyle Ltd.
7. Flat No. 4 is leased to Mrs. Sharon, an educationist. She runs a book and toy library for children.
8. There is a parking space around the building. A portion of this has been let out to Sincom Ltd., for its employees to park their vehicles.
9. Carlyle Ltd. also has a plot of land at another location in Mumbai. That plot of land has been let out for three years to Fairs Ltd., a company specialising in holding fairs and exhibitions.

There are two conditions for the application of this head of income. One, the income should arise from a 'building' or 'land adjoining a building'. And two, the building should not be occupied by the owner for his 'business or profession'. If the building is occupied by the owner for his business or profession, it would be treated under the income head of 'profits and gains of business or profession'. We would be taking up the discussion on this head of income in the subsequent chapters. Let us explore the application of Section 22 with the help of the above illustration. Decide whether the section is applicable to the different units or not and write your answers in the form of 'yes' or 'no' in the blank cells.

Unit	*Building/ Adjoining Land*	*Occupied for business of Carlyle Ltd.*	*Application of Income from House Property (Section 22)*
Warehouse			
First Floor Office			
Second Floor Office			
Third Floor—Flat 1			
Third Floor—Flat 2			
Third Floor—Flat 3			
Third Floor—Flat 4			
Parking Space			
Plot of Land			

The income earned by Carlyle Limited from the renting out of the warehouse, second floor office and flat numbers 1 and 4 is chargeable under 'income from house property'. As the parking space, which has been let out, is adjoining the building, income from letting it out is also chargeable under 'income from house property'. However, the plot of land let out to Fair Limited is neither a building nor 'land adjoining a building'. Thus, this income would not be considered under 'income from house property'.

✦ Annual Value

Section 22 states that the 'annual value' of a particular building would be the amount that would be charged for income tax. Section 23 explains the meaning of 'annual value', thus:

> **23. Annual value how determined.** (1) For the purposes of Section 22, the annual value of any property shall be deemed to be—
>
> (a) the sum for which the property might reasonably be expected to let from year to year; or
>
> (b) where the property or any part of the property is let and the actual rent received or receivable by the owner in respect thereof is in excess of the sum referred to in clause (a), the amount so received or receivable; …
>
> Provided that the taxes levied by any local authority in respect of the property shall be deducted … in determining the annual value of the property of that previous year in which such taxes are actually paid by him.

Section 23(1)(a) brings into play the idea of the expected rental value of a building. This is a notional value and is thus, different from the actual rental value. How would the owner or the tax authority know the expected rental value? Municipal bodies, for the purpose of charging house tax, routinely do valuations of properties. For the administration of the rent control law, the government also keeps a record of rentals in different areas. Similarly, the selling price of a building in an area can give an indication of the expected rent. Through these sources, the tax authorities can settle on an expected annual rent.

Illustration: Annual Value

Two flats on the same floor in a building, Flat 1 and Flat 2, had the same expected annual rental of ₹ 2 lakh. The municipal tax for each of the properties was ₹ 20,000. The owners have fully paid the property tax during the previous year, 2013–14. The rental details of the two flats for the previous year, 2013–14, are as follows:

Flat 1: The owner of Flat 1 was lucky to find a private bank executive who was insistent on taking a flat in the building as other bank executives were also staying in the same building. The owner rented out the flat for the year, 2012–13, for ₹ 3 lakh. He received the entire amount of money on April 5, 2012.

Flat 2: The owner of Flat 2 did not want to let out the flat to an unknown person. So, he let it out to his friend's son. It was uncomfortable for him to do hard negotiation for rent with his friend's son. As a result, he settled on a rent of ₹ 1.5 lakh for 2013–14. The owner received the entire amount of money on April 5, 2013.

Find the annual values of Flats 1 and 2 for the previous year, 2013–14.

The expected rental value of a building is taken to be the earning (deemed income) from the building, even if the owner has let it out for a lesser amount. Thus, in every case, we need to compare the value for which the building has been rented out with the expected rental value, and then, take the higher of the two. The higher of the two for Flat 1 is ₹ 3 lakh and that for Flat 2 is ₹ 2.0 lakh. The owners had paid ₹ 20,000 as house property tax to the local authority. The last paragraph in Section 23 provides for this. Having taken the higher of the two values, the expected rent and the actual rent, the section allows for the deduction of the taxes actually paid to arrive at the annual value. Thus, the annual value for Flat 1 is ₹ 2.8 lakh and for Flat 2, it is ₹ 1.8 lakh.

In the above cases, the tenancy was for the entire year. In the cases where the tenancy is not for an entire year, two situations can arise. One, the rental can still be higher than the expected annual rent. In that case, the actual rent will be the annual value. Two, the rent can be lower than the expected annual rent due to vacancy during the remaining year. Section 23(1)(c) provides for this situation. We have not introduced this provision as it is a special case and the calculation of the annual value depends on several other provisions of the Act.

Case: Annual Value

The table below lists some companies that own office premises, with the respective expected annual rental of their premises, the actual rentals received by them, the amounts of property tax due from them for the year 2013–14, and the taxes paid on the premises to the local authorities during 2013–14. The values are for the previous year, 2013–14. Calculate the taxable income under the head of 'house property' for the previous year, 2013–14.

(Amount in Rupees Lakh)

Owner	*Expected Rent*	*Rent Received*	*House Tax Payable*	*House Tax Paid*	*Annual Value*
Company 1	125	145	15	15	
Company 2	180	195	25	25	
Company 3	190	165	15	20	
Company 4	240	230	20	10	
Company 5	265	290	30	–	
Company 6	285	345	30	35	

✦ Annual Value of Residential Property

Having grasped the core principles of the theme of 'income from house property', we can now take note of some further details in relation to residential houses. Take the case of a person who lives in his own house. The expected annual rental value of that house is ₹ 2 lakh. Section 23(1) would take the annual value of the property to be ₹ 2 lakh and proceed to calculate the taxable income under the head of house property. The law could not have intended this. Section 23(2) neutralises this by exempting self-occupied houses from its application. It provides:

Section 23 (2) Where the property consists of a house or part of a house which–

(a) is in the occupation of the owner for the purposes of his own residence; or

(b) cannot actually be occupied by the owner by reason of the fact that owing to his employment, business or profession carried on at any other place, he has to reside at that other place in a building not belonging to him,

the annual value of such house or part of the house shall be taken to be nil

(3) The provisions of sub-section (2) shall not apply if—

(a) the house or part of the house is actually let out during the whole or any part of the previous year; or

(b) any other benefit therefrom is derived by the owner.

(4) Where the property referred to in sub-section (2) consists of more than one house-

(a) the provisions of that sub-section shall apply only in respect of one of such houses, which the assessee may, at his option, specify in this behalf;

(b) the annual value of the house or houses, other than the house in respect of which the assessee has exercised an option under clause (a), shall be determined under sub-section (1) as if such house or houses had been let out.

Illustration: Self-Occupied House

The following table illustrates the ways in which a residential property might be used. Identify and mention the applicable sections and sub-sections in Column 3, titled 'Section'. Apply the relevant section and mention in Column 4 whether the person earns income under the head of income from house property.

S. No.	*Description*	*Section*	*Taxable Yes/No*
1	An individual owns only one house and he lives in it		
2	An individual owns only one house, situated in Mumbai. The person is employed by a company and posted in Delhi. He has kept his house in Mumbai locked up		
3	An individual owns only one house. He had rented out the house for the first six months. He lived in the house for the remaining six months		
4	An individual owns only one house, situated in Mumbai. The person is employed by a company and posted in Delhi. He rented out the house in Mumbai for two months		
5	An individual owns two houses. He lives in one and uses the other as his weekend home		
6	A person owns three houses. He lives in the one that is situated in Mumbai. The other two houses, which are in Pune and Bangalore, are not rented out. He uses these houses during vacations		

The answers to the above questions are clear. The annual value in the case of a single house property is nil if the person lives in it or cannot live in it as he has his business, profession or employment elsewhere. However, if the property is let out for a part of the year, this benefit is lost entirely. A person who owns more than one house, has to necessarily pay tax on income from house property on all the houses other than the one of his choice, even if none of them have been rented out. Further, as the law has settled that the annual value of one house property would be nil, the house tax payable on that property or the house tax paid on that property is of no consequence.

✦ Deduction from Annual Value

Section 24 provides for deductions from the annual value. It reads thus:

24. Deductions from income from house property. Income chargeable under the head "Income from house property" shall be computed after making the following deductions, namely—

(a) a sum equal to thirty per cent of the annual value;

(b) where the property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital, the amount of any interest payable on such capital:

Provided that in respect of property referred to in sub-section (2) of Section 23 the amount of deduction shall not exceed thirty thousand rupees:

Provided further that where the property referred to in the first proviso is acquired or constructed with capital borrowed on or after the 1st day of April, 1999 and such acquisition or construction is completed … the amount of deduction under this clause shall not exceed two lakh rupees.

Let us first develop a broad understanding of this section by determining whether Section 24(a) and 24(b) would apply to the following persons:

S. No.	*House Property*	*Section 24(a) Yes/No*	*Section 24(b) Yes/No*
1	A person inherited a house, which he has rented out		
2	A person bought a house for ₹ 20 lakh, with his own funds, and has rented it out		
3	A company has rented out a flat that is surplus and gets ₹ 2 lakh as annual rental		
4	A person bought a house for ₹ 30 lakh with borrowed funds, on which he is paying interest, and has rented it out for ₹ 1 lakh a year		
5	A person bought a house from borrowed funds, on which he is paying interest. He lives in the house		
6	A person owns a warehouse and has rented it out for an annual rental of ₹ 4 lakh		

Section 23(a) applies to every property. Every property would get a standard deduction of 30% of its annual value. However, Section 23(b) applies only to the cases where a person has taken a loan to buy that property and is paying interest on that loan. We need to take note of the terms used and follow them carefully and consistently. The 'annual value', in the case of a rented premises, is calculated after taking into account the actual rent received, the expected annual rent and the property tax actually paid. In the case of a self-occupied residential property, the annual value can be nil or equal to its expected annual rental, depending on the number of units owned by the person. The 'annual value' for a property is arrived at after taking all these factors into account. If the 'annual value' has been mentioned, the above mentioned details become irrelevant. Income tax is charged not on the receipt, but on the net gain. The 'annual value' is of the nature of a receipt. Section 24 has allowed certain deductions to the receipt so as to arrive at the gain from a letting out. It calls this value, the 'income chargeable under the head, income from house property'. This can be written in full or shortened as 'income chargeable under house property' or 'taxable income under house property'. These terms refer to the income calculated after making the deductions from the annual value.

Section 23(a) allows a standard 30% deduction from the annual value of every property. In addition, Section 23(b) allows deductions to the extent of the interest being paid on borrowed capital. Let us first become familiar with the application of Section 23(a).

Illustration: Deduction

Expected annual rental of an office building:	₹ 10 lakh
Actual rent received during 2013–14:	₹ 11 lakh
Property tax paid to the local government during 2013–14:	₹ 1 lakh

Calculate the income chargeable under the head of house property for the previous year, 2013–14.

As the actual rent received is higher than the expected rent, we would begin with ₹ 11 lakh. The property tax paid would be deducted to arrive at the annual value. Thus, the annual value is ₹ 10 lakh. Under Section 24, 30% of the annual value would be deducted to arrive at the net income under the head. Thus, income chargeable under the head is ₹ 7 lakh.

We should understand the significance of the deduction that has been allowed. While the tax is on the 'income', every income requires an investment of capital, labour and initiative. The measure of the capacity of a person to pay would depend on the surplus being generated, i.e., the difference between the income and the outgoings in relation to that property. For example, a person may have a very large amount of money coming in. However, he may still be making huge losses and being driven to penury. The Act recognises this. It intends to tax only the surplus.

What are the expenditures that a person might have to undertake towards getting an annual income from a building? Expenditures could be incurred in acquiring the asset, maintaining and repairing the building, making payments in respect of the charges of a real estate broker for finding a tenant or those of a lawyer for drafting the rental contract. Why does the law not allow the actual expenditure? This would be a more realistic basis for computing the surplus. The problem is from the point of view of administration of the law.

The assessee is not required to submit copies of all the receipts and bills supporting the expenditure. If it were so, the tax authorities would be inundated with heaps of paper. The tax authorities merely ask the assessee to give a statement of income earned under the five heads, with certain limited documentary support. On applying themselves to the statement submitted, if they find incongruities, they may get back to the person and ask him to furnish further details. The administrative cost of scrutinising a large number of cases in detail would be unbearably high. Thus, the government would not be able to scrutinise most of the cases. This would lead to property owners taking advantage of the situation and making false claims of expenditure.

The government, thus, came up with a strategy. It allows a deduction at a fixed percentage of the annual value, irrespective of the actual expenditure. The government must have made an estimate of the kind of expenditure a house-owner ordinarily undertakes, before arriving at the figure of 30%. The Act has adopted a similar strategy in the notion of 'annual value' being different from the actual annual rent. If the actual rent were to be the basis for the income under the head, house owners would have evaded tax by under-reporting their rental earnings. The tax authorities would have found it difficult to prevent this. Therefore, a means of plugging this loophole was found by estimating the expected rent and insisting on this as the minimum for working out the income tax. If a person voluntarily rents out his property for a value less than what his property is capable of, he must bear the implications while paying tax.

Illustration: Income Chargeable under House Property

Calculate the income chargeable under the head of house property for the previous year, 2013–14, for an owner with the following details:

Expected annual rental of the office building: ₹ 11 lakh

Actual rent received during 2013–14: ₹ 9 lakh

Property tax paid to the local government during 2013–14: ₹ 1 lakh

Cost incurred in paying an agency for getting a tenant: ₹ 20,000

Lawyer's charges for drafting the tenancy documents: ₹ 10,000

Repairs of the premises: ₹ 30,000

As the expected rent is higher than the actual rent received, we will begin with the figure of ₹ 11 lakh. The property tax paid would then be deducted from it to arrive at the annual value. Thus, the annual value would be ₹ 10 lakh. The actual expenditure incurred in relation to the premises and tenancy, are not to be deducted. Instead, under Section 24, a standard 30% of the annual value is to be deducted, irrespective of the amount of expenditure. Thus, income chargeable under the head is ₹ 7 lakh.

Illustration: Income Chargeable under House Property

Calculate the income chargeable under the head of house property, for the previous year, 2013–14, for an owner with the following details:

Expected annual rental of the office building: ₹ 10 lakh

Actual rent received during 2013–14: ₹ 13 lakh

Property tax paid to the local government during 2013–14: ₹ 1 lakh

The owner did not incur any expenditure in repairing the premises or organising the tenancy.

As the expected rent is higher than the actual rent received, we will begin with the figure of ₹ 13 lakh. The property tax paid will be deducted to arrive at the annual value. Thus, the annual value of the office building is ₹ 12 lakh. Under Section 24, whether the owner has actually incurred any expenditure or not, a standard 30% of the annual value is to be deducted to arrive at the income chargeable under the head of income from house property. Thus, income chargeable under the head is ₹ 8.4 lakh.

Case: Income Chargeable under House Property

The table below lists some office premises owned by companies, the annual value of those premises for the previous year, 2013–14, and the actual expenses incurred towards the repair and maintenance of these properties during 2013–14. Calculate the taxable income under the head of house property for the previous year, 2013–14.

(Amount in Rupees Lakh)

Owner	*Annual Value*	*Expenses*	*Taxable Income*
Company 1	120	1	
Company 2	160	1	
Company 3	150	-	
Company 4	240	-	
Company 5	300	2	
Company 6	330	3	

Deduction of Interest

Section 24(b) allows the interest paid to be deducted from the annual value of the house property. Section 24(b) is reproduced below.

> Section 24(b). where the property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital, the amount of any interest payable on such capital:
>
> Provided that in respect of property referred to in sub-section (2) of Section 23 the amount of deduction shall not exceed thirty thousand rupees:
>
> Provided further that where the property referred to in the first proviso is acquired or constructed with capital borrowed on or after the 1st day of April, 1999 and such acquisition or construction is completed … the amount of deduction under this clause shall not exceed one lakh fifty thousand rupees.

This sub-section has three paragraphs. The first paragraph is the main provision. The two following paragraphs qualify the main provision and therefore, these are called provisos. We would call these paragraphs Proviso 1 and Proviso 2. The main provision applies to every property other than the properties covered by Proviso 1 and 2. Proviso 1 applies to every property covered under Section 23(2). Section 23(2) provides that the annual value of a self-occupied property is nil. Proviso 2 makes a distinction between the cases where the loan for a self-occupied house was taken before or after April, 1999. If the main paragraph alone applies to a property, all interest payable can be deducted. However, if Proviso 1 applies, the maximum interest on borrowed capital that can be claimed as deduction is ₹ 30,000. If Proviso 2 applies, the maximum interest on borrowed capital that can be claimed as deduction is ₹ 1.5 lakh. The Finance Act, 2014 has raised the deduction (under proviso 2) to two lakh rupees. However, the deduction will apply to income for the previous year, 2014-15.

Illustration: Deduction of Interest

Determine whether the main provision of Section 24(b) and Proviso 1 and Proviso 2 would apply to the following properties and calculate the maximum interest that can be claimed as deduction in each case:

S. No.	*House Property*	*Maximum deduction of Interest*
1	A person took a loan from a bank to buy a house in 1995 and has rented out the house.	
2	A person took a loan from a bank to repair and renovate his ancestral house in 1996. The house is rented out.	
3	A person took a loan from a bank in 1995 and constructed a house. The house is let out.	
4	A person took a loan from a bank in 1995 and constructed a house. The house is occupied by the person.	
5	A person took a loan from a bank in 2007 and constructed a house. The house is occupied by the person.	
6	A person took a loan from a bank in 2007 and bought a house. The house is occupied by the person.	
7	A person took a loan from a bank to repair and renovate his ancestral house in 2009. The house is occupied by the person.	
8	A person took a loan from a bank in 2007 and bought a unit in a shopping complex. He has let out the unit.	
9	A person took a loan from a bank in 1996 and bought a unit in a shopping complex. He has let out the unit.	

The main provision applies to every ‘property’ and not just to residential units. It is applicable to all cases where a person has rented out the property. Further, it is also applicable to cases where a person has multiple units in self-occupation. The annual values of all the properties except one, are taken to be their expected annual rents. In both the cases, there is no limit on the deduction of interest. Further, the loan taken need not have been intended for buying or constructing a unit alone, but could also have been taken for repair and renovation of a house. The second proviso, allowing a deduction of up to ₹ 1.5 lakh, is available only if the loan has been taken after April, 1999, for buying or constructing a house. It is not available for loans taken for repair and renovation. In other cases, that is, in cases where the loan is taken before April, 1999 or it is taken for the purpose of repair and renovation and if the unit is occupied by the person, Proviso 1 applies. Under Proviso 1, a maximum of ₹ 30,000 only can be claimed. It is to be noted that the deduction is for ‘interest payable’, not interest paid. Thus, the person need not have paid the interest. If the amount is due or accrued, the person can claim a deduction. The provision was introduced as an initiative towards promoting housing.

Case: Interest on Borrowed Capital

The following persons were living in houses bought with borrowed funds. For each property, the month and year in which the fund was borrowed and when the property was acquired, as well as its expected annual rent and the interest payable in the previous year, are mentioned. Calculate the net income from each house property for the previous year.

Person	*Borrowed On*	*Interest Payable*	*Expected Annual Rent*	*Net Income from House Property*
Person 1	June 1997	50,000	2,00,000	
Person 2	January 2007	2,00,000	6,00,000	
Person 3	January 2013	3,00,000	10,00,000	
Person 4	April 2008	1,40,000	4,00,000	
Person 5	February 2012	80,000	2,50,000	

Case: Interest on Borrowed Capital

The following persons bought houses with borrowed funds and these houses were rented out for the entire previous year, 2013–14. The table below mentions the 'annual values' of the houses, the months and years in which the funds were borrowed and the properties acquired and the interest amounts payable for the previous year, 2013–14. Calculate the net income from the house properties for the previous year.

Person	*Borrowed On*	*Interest Payable*	*Expected Annual Rent*	*Net Income from House Property*
Person 1	April 2008	1,40,000	4,00,000	
Person 2	February 2012	80,000	3,00,000	
Person 3	January 2013	3,00,000	10,00,000	
Person 4	January 2007	2,00,000	6,00,000	
Person 5	June 1997	50,000	2,00,000	

Review Cases

Case 1: SOAL Ltd., a shipping company based in Mumbai, owned two flats on the top floor of a building in Mumbai. The municipal authority of Mumbai had estimated the expected rent for each of the flats at ₹ 2,40,000 per year. The first flat was used as a guest house for the visiting employees of the company. The second flat was leased to a private bank, which had put up one of its senior executives there. The bank was paying SOAL Ltd., ₹ 3,25,000 per year. SOAL Ltd. paid ₹ 25,000 for each flat as property tax to the corporation on April 15, 2013. SOAL Ltd. had a yearly contract with a cleaning company for ₹ 5,000 per year, per flat. The workers of the cleaning company would scrub clean the floor, tiles and window panes with machines. Thus, during the previous year, 2013–14, the expenditure incurred on the cleaning of each of the flats was ₹ 5,000. In addition, in the flat occupied by the bank executive, the old electrical wiring in the entire flat was removed and new one put in. The job was done in May, 2013, and the contractor was paid by SOAL Ltd., an amount of ₹ 35,000 for the job.

Calculate the income chargeable under the different heads of income, for SOAL Ltd., for the above transactions for the previous year, 2013–14.

Case 2: Anagram limited owned a flat in Mumbai. The expected rental of the flat was ₹ 6.3 lakh a year. The company was running its office from the flat. In the previous year, 2013–14, the company spent ₹ 30,000 in repairs and maintenance of the flat. How would the use of the premises and repairs be treated while calculating the company's taxable income?

Case 3: Jeet formed a company, Jeet Consulting Private Limited. The company was the modality through which Jeet intended to run a consulting business. Jeet leased his house to the company, for ₹ 10 lakh per year. The expected annual rental value of the property was ₹ 9 lakh. The company gave Jeet rent-free accommodation in his own house on the second floor. The first floor became the office of the company. How would the use of the premises be treated for Jeet and the company? Calculate the income after deductions.

Case 4: A person was living in his ancestral house in Ahmedabad. He took a loan, constructed a house and rented it out. The details of the rented house in relation to the previous year, 2013–14, are as follows:

Expected annual rental: ₹ 22.5 lakh

Actual rent: ₹ 32 lakh

Property tax paid during 2013–14: ₹ 2 lakh

Year in which funds were borrowed: 2006-07

Repayment of capital in 2013–14: ₹ 20 lakh

Repayment of interest in 2013–14: ₹ 10 lakh

Calculate the income chargeable under the head of income from house property for the person.

4

CHAPTER

Income from Business and Profession

The four main heads of income are salary, house property, profits and gains from business or profession and capital gains. The fifth head, 'other sources', is a residual category. Let us categorise the following types of income:

Income of most of the doctors, lawyers, architects, consultants, stockbrokers, carpenters and electricians

Income of shopkeepers and traders

Income of companies

The income of self-employed professionals, from their practice, for example, the income of doctors, lawyers, architects, consultants, stockbrokers, carpenters and electricians, falls under the head, 'profits and gains of business or profession'. Shopkeepers and traders are in business, thus, their income from running shops and trading will also come under this head. All companies are engaged in business, and thus, their income from business will also come under this head. The head of income from 'profits and gains of business or profession' has wide application. Section 2 defines 'business' and 'profession' in very broad terms, as follows:

> Section 2(13) "business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture;
>
> Section 2(36) "profession" includes vocation

Section 28 specifies the scope of the head. It provides:

> **28. Profits and gains of business or profession.** The following income shall be chargeable to income tax under the head "Profits and gains of business or profession"—
>
> (i) the profits and gains of any business or profession which was carried on by the assessee at any time during the previous year; ….

Section 28(i) applies to 'any' business or profession. Section 2 defines the terms, 'business' and 'profession', broadly. Thus, the term, 'any business or profession', in Section 28 makes the scope of the head very broad. The reference to 'any time during the previous year' also makes it clear that one need not be engaged in full-time activity to earn income under this head. Even casual earning from a profession or business would fall under this head. We have noted earlier that the Act applies not on the 'income', but on the surplus. Consistent with this, Section 28 applies to 'profit and gains' from any business or profession. Let us explore this with the following example.

Niraj, with some of his friends, sets up a company for running restaurants—Niraj Private Limited. For starting any business, a person needs capital. The person may use his own money or might have to borrow from a bank or other sources. Similarly, a company may use its own money. This would have come from the share contributions made by the owners of the company. In some situations, the company may need to borrow additional capital. What are the expenses that the company created by Niraj might need to undertake? The company would need to buy kitchen equipment, like a stove, oven, food processors, etc., besides some furniture for the restaurant. The company may buy a place to run the restaurant or rent a place. The company would hire chefs, waiters and other employees. The company would also need to pay for the ingredients, the salary of the employees, electricity, water and fuel, etc. All this would be done with the aim of getting customers and receiving payments from them. The money coming in is called receipts.

Let us explore the receipts of Niraj's company further. The company may have invested its surplus funds in shares. Dividends on these shares could be a source of income. This income would be taken under the head of 'income from other sources'. The company could buy a building, occupy a part of it and let out the surplus space. The rental income would be treated under house property. Income from the payments made by the customers would be treated under the head of business income. The company may sell packed food. The income from the sale of this packaged food would also be treated under the head of business income. Similarly, the company may conduct training programmes for chefs and waiters. As this activity is related to its restaurant business, fees received for the training would be taken to the head of business income.

For calculating the profit from a business, the expenditure incurred for earning would need to be deducted from the receipts. The items of expenditure for the company, that could be involved in running the restaurant business would include the annual rental of the premises, purchase of ingredients, salary of employees and electricity and water bills. The amount calculated after deducting the expenditure from the receipts of the previous year would be indicative of the income earned in that year. There must have been some other expenses that the company would have made towards buying of goods or services whose use would run for longer than a year. Examples of such goods are stove, burner, oven, food processor, computer, air-conditioner and furniture. As an illustration, the company may have bought a food processor for ₹ 12,000 and expects it to last for six years. Thus, the company understands that it should distribute the expenditure of ₹ 12,000 over 6 years. In other words, some expenses incurred are towards items that would be entirely consumed in a short time, while others have a longer utility and are successively used. As accounting is done on an annual basis, a year is taken to be the basis in time for making the distinction. An item of expenditure that is consumed in up to a year is called 'revenue expenditure'. An expenditure incurred for the acquisition of items whose use runs over more than a year is called 'capital expenditure'. We would later see that the courts continue to puzzle over the categorisation of expenses as revenue or capital expenditure. Revenue expenditure is deducted from the receipts while capital expenditure is meted out a different treatment. The deduction of capital expenditure is spread out over a number of years. This is called depreciation.

We saw earlier that while dealing with house property, the Act standardised the expenditure at 30% of the annual value. However, the extent and scope of the head 'income from business and profession' is vast. It is not possible to standardise it in relation to the income. Different businesses and professions work with different profit margins. Moreover, the margins for a person can vary from year to year. Consistent with this, the Act recognises the actual expenses and admits them in the calculation of the profit. Further, revenue and capital expenditure are given different treatments. Revenue expenditure is allowed to be deducted from the receipts, while capital expenditure is depreciated over a number of years. Let us further explore the theme of revenue expenditure.

✦ Revenue Expenditure

Let us list some of the usual revenue expenditures a company would need to make:

1 A prudent person would have the property and equipment insured. The premium for insurance is to be paid yearly.

2 Equipment, for example, air-conditioners, usually require annual maintenance or service contracts.

3 Even a rented building entails frequent expenditure including that in relation to repairs and payment of property taxes.

4 All capital assets, for example, furniture and equipment, need repairs to keep them going. While the purchase of an asset is a capital expenditure, repairs are made from time to time and are spread over the lifetime of the asset.

5 The law imposes different kinds of taxes on a business. For example, the company would need to pay service tax on the receipts from its customers.

6 The law may require the employer to provide certain benefits to the employees, like contribution to provident fund and gratuity.

7 The company may have taken a loan for starting the business, on which it would need to pay some annual interest.

Towards the deduction of revenue expenditure, let us first note Sections 30, 31 and 36.

30. Rent, rates, taxes, repairs and insurance for buildings. In respect of rent, rates, taxes, repairs and insurance for premises, used for the purposes of the business or profession, the following deductions shall be allowed—

(a) where the premises are occupied by the assessee—

(i) as a tenant, the rent paid for such premises; and further if he has undertaken to bear the cost of repairs to the premises, the amount paid on account of such repairs;

(ii) otherwise then as a tenant, the amount paid by him on account of current repairs to the premises;

(b) any sums paid on account of land revenue, local rates or municipal taxes;

(c) the amount of any premium paid in respect of insurance against risk of damage or destruction of the premises.

31. Repairs and insurance of machinery, plant and furniture. In respect of repairs and insurance of machinery, plant or furniture used for the purposes of the business or profession, the following deductions shall be allowed—

(i) the amount paid on account of current repairs thereto;

(ii) the amount of any premium paid in respect of insurance against risk of damage or destruction thereof.

Section 36. Other Deductions. (1) The deductions provided for in the following clauses shall be allowed … in computing the income referred to in Section 28 …

(i) the amount of any premium paid in respect of insurance against risk of damage or destruction of stocks or stores used for the purposes of the business or profession;

(ib) the amount of any premium paid to effect or to keep in force an insurance on the health of his employees …

(ii) any sum paid to an employee as bonus or commission for services rendered …

(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession. …

(iv) any sum paid by the assessee as an employer by way of contribution towards a recognised provident fund or an approved super-annuation fund …

(v) any sum paid by the assessee as an employer by way of contribution towards an approved gratuity fund …

(vi) … the amount of any bad debt … which is written off as irrecoverable in the accounts of the assessee for the previous year….

37. General. (1) Any expenditure (not being expenditure of the nature described in Sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

Explanation—For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

Legal text is systematically organised. The subject matter of an act is broken up into chapters and the chapters into sections. Each section deals with a particular sub-topic under the chapter, which is indicated by the title to the section. Thus, 'profits and gains of business or profession' is a chapter under the Income Tax Act. The cluster of sections from Section 30 to Section 37 details the deductions. The purpose of the legal text is to provide clear and definite direction for every situation. In every case, one has to identify the section(s) and clause(s) that apply to it. Let us take up the following cases and illustrations to explore the application of the above sections.

Case: Garment Manufacturing Business

Montage Limited is engaged in the manufacturing of garments. Identify the applicable sections for the following items of expenditure:

Expenditure	*Revenue or Capital*	*Applicable Section*
Purchase of fabric		
Purchase of sewing machine		
Maintenance contract for air-conditioner		
Interest paid to bank on the borrowed capital for running the business		

Rent for the premises		
Repair of sewing machine		
Contribution to provident fund of employee		
Payment to consultant-designer		
Salary to employees		
Insurance of raw material		
Repair of the building owned by the company		
Insurance of air-conditioner		

The above exercise brings out the fact that the four sections have distinctive applications, as indicated by their titles. Section 30 pertains to revenue expenditure in relation to only buildings. Section 31 deals exclusively with revenue expenditure incurred in relation to other capital assets, i.e., plant and machinery. Section 36 lists the revenue expenditures that are general to all business organisations, for example, interest on borrowed capital for business, provident fund and insurance of raw material. Section 37 admits as deductions, all other revenue expenditure incurred in relation to the business. We can now focus on each of these sections.

Case: Office Premises

Omega Financial Consulting Private Limited is engaged in providing consulting services in the field of financial investments. It has two offices in the city. It owns one of the office premises while the other one is rented. We will refer to the two premises as 'owned premises' and 'rented premises'. Identify the application of the sub-sections and clauses of Section 30 to the following expenditure items:

Expenditure	*Section and Sub-section*
Tax paid for the owned premises	
Tax paid for the rented premises	
Insuring owned premises against fire	
Adding new rooms to the owned premises	
Brokerage paid on selling off the owned premises	
Repairing a broken windowpane in the rented premise	

The purchase of a building or premises is a capital expenditure. Investing for the purpose of upgrading or enhancing the value of a building is also a capital expenditure. However, expenses incurred so as to maintain or preserve the building come under revenue expenditure. Section 30 expresses this concept.

Let us take up the following expenditure items of Omega Financial Consulting Private Limited, to further explore the application of Section 31.

Expenditure	*Section and Sub-section*
Purchase and annual maintenance contract of computer	
Printing paper	
Yearly subscription of anti-virus software	
Annual maintenance contract of computer	
Insurance of office equipment	
Purchase of computer workstations	
Purchase of Windows software for the computers	
Purchase of the copyright in an artwork to use it as logo of the company	
Repair of a computer workstation	

Plant, machinery and furniture have a long term utility. Thus, their purchase is a capital expenditure. However, the expenditure made towards preserving or maintaining their utility is continuous and recurrent. The value or yield of this latter investment is also immediate. Thus, expenditure on repairs, maintenance and preservation of plant, machinery and furniture is taken as revenue expenditure. Section 31 expresses this principle. Thus, the purchase of a computer is a capital expenditure, but the expenditure on an annual maintenance contract for the computer is a revenue expenditure. Similarly, an insurance policy bought to preserve the plant and machinery is a revenue expenditure.

Section 36 allows some specific heads of expenditure to be deducted, which include insurance of raw material, inventory, health of the employees, bonus and commission, and interest on borrowed capital. Section 37 allows the deduction of all other revenue expenditure. To claim a deduction under Section 37, the following conditions should be satisfied:

Condition	
1	The expenditure should not be of the nature described under Sections 30 to 36
2	It should not be in the nature of a capital expenditure
3	It should not be a personal expenditure of the assessee
4	It should have been incurred in the previous year
5	It should be in respect of the business carried on by the assessee
6	It should have been expended wholly and exclusively for the purpose of such business
7	It should not have been incurred for any purpose which is an offence or is prohibited by any law

Section 37 allows deductions that are not specifically covered under Sections 30 to 36. Thus, under the head of 'business and profession', in general, all actual revenue expenses relating to a business or profession are allowed as deductions. Let us illustrate this through the following case.

Case: Business Expenses

Omega Financial Consulting Private Limited is a newly formed company, providing consulting services. The company received ₹ 30 lakh in fees from its clients during the previous year, 2013-14. The expenditure incurred by the company during the year is as shown below. Group the different items of expenditure according to the applicable sections and calculate the taxable income for the company.

Previous Year: 2013–14

(Amount in Rupees lakh)

S. No.	*Description*	*Amount*	*Applicable section for deduction*
1	Rent for hiring office premises	1	
2.	Insurance premium of office building	0.1	
3.	Repair of office building	0.1	
4.	Salary of employees	3	
5.	Travel expenses	1.2	
6.	Interest paid to a bank on loan for business	0.3	
7.	Local conveyance expenses	0.4	
8.	Purchase of computers	1	
9.	Insurance of office equipment, like air-conditioners and computers	0.15	
10.	Paper, stationery and folders consumed	0.03	

All the above expenses, other than the purchase of computers, would come under the head of revenue expenditure and are, therefore, deductible from the fees received from the clients, while calculating the taxable income.

✦ Receipt v. Mercantile System

Profit is understood as the surplus from an activity, arrived at by subtracting the total expenditure from the receipts. The taxation law insists on calculating the profit on a yearly basis, the year being April 1 to March 31. Let us take the following case. The only business Symmetry Private Limited did in the previous years, 2012–13 and 2013–14, was to manufacture and sell a crane to a buyer. The expenditure of the company was ₹ 25 lakh in the year 2012–13. The machine was delivered to the buyer on February 15, 2013. The buyer paid the contract price of ₹ 30 lakh on May 5, 2013. The expenditure and receipts of the company would be as follows:

Previous Year	*Receipt*	*Expenditure*	*Profit*
2012–13	–	25 lakh	– 25 lakh (loss)
2013–14	30 lakh	–	30 lakh

By thus arranging the revenue and expenditure, we are totalling up everything that is actually received during a previous year to arrive at the total receipt. Similarly, the expenditure is worked out by totalling up all the payments made. The difference between the two becomes the profit for the year. As money received or paid is taken to be the basis for working out the profit in this manner, this type of accounting is called the receipt method of accounting, or cash basis of accounting.

Symmetry Private Limited, however, understands that it neither made a loss of ₹ 25 lakh in 2012-13, nor a profit of ₹ 30 lakh in 2013–14. Through the activity of making the crane, it made a profit of ₹ 5 lakh. As soon as it successfully delivered the machine to the buyer on February 15, it became entitled to receive ₹ 30 lakh during 2012–13. Even if the money was to be actually received in 2013–14, for calculating its profit, it could take that ₹ 30 lakh had accrued to it. It was only a matter of time before it actually received the money. Accordingly, the company would view its profit as follows:

Previous Year	*Receipt*	*Expenditure*	*Profit*
2012–13	30 lakh	25 lakh	5 lakh
2013–14	–	–	–

This method of accounting is called the accrual method of accounting or mercantile accounting. Once the person becomes entitled to an income, the money accrues to him, even if it has not actually been received by him. Similarly, an expense is taken to have been incurred, even if the money is yet to be paid. Section 145 allows the assessee to follow either of the two methods in computing income from a business or profession. It provides:

> 145. Method of accounting (1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall … be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

However, the assessee has to be regular and consistent in following one of the two systems. Frequent changes from one system to another would attract a doubt that it is being done to gain undue advantage. Further, the Act requires certain heads of income to be treated according to the accrual basis only and certain items of expenditure according to the cash basis only, irrespective of the accounting system of the assessee. Further, the Companies Act requires companies to follow the accrual method of accounting. Thus, all companies incorporated under the Companies Act, 1956, follow the accrual method of accounting.

In this chapter, we have explored the provisions on deduction of revenue expenditure. In the following chapter, we will study the arrangement provided by the Act for making deductions for capital expenditure.

Review Cases

Case 1: Railley Limited is engaged in the manufacturing of garments. The following are the items of expenditure made by the company in the previous year, 2013–14. For each item of expenditure, determine whether it can be deducted while calculating income under the head of business and profession. Identify the relevant section for the answer.

Expenditure	*Revenue or Capital*	*Applicable Section*
Purchase of fabric		
Purchase of sewing machine		
Maintenance contract for air-conditioner		
Interest paid to a bank on the borrowed capital for running the business		
Rent for the premises		
Repair of sewing machine		
Contribution to provident fund of employees		
Salary to employees		
Insurance of raw material		
Repair of the building owned by the company		

Case 2: Ocean Pearl Limited is a company engaged in the manufacture of paper and cardboard products. The details of the income and expenditure of the company during the previous year, 2013–14, are mentioned below. Calculate the taxable income of the company (before deducting the depreciation allowance) under the head of income from business and profession.

(Amounts in ₹ lakh)

Expenditure	*Amount*	*Income*	*Amount*
Material costs	115	Sales	230
Manufacturing	45	Interest on bank account used for running business	1
Purchase of Machinery	50	Dividend on shares	4
Selling and distribution	40	Rent from office building	6
Interest on bank loan	15		
Computer Purchase	2		
Rent paid for warehouse	3		
Insurance of stock	2		
Travelling	10		
Repair of owned office-building rented out	1		

5

CHAPTER

Capital Assets and Depreciation

Revenue expenditure is deducted from the receipts while capital expenditure is meted out a different treatment. The deduction of capital expenditure is spread out over a number of years. This is called depreciation. Let us explore how a business views the use of a capital asset. Take the case of a doctor who buys some equipment for ₹ 12 lakh. He expects the machine to last for 6 years. So, he would spread the cost of the machine over six years at ₹ 2 lakh per year. Thus, even though he had to pay ₹ 12 lakh for buying the machine, up-front, in the first year itself, he would deduct only ₹ 2 lakh in that year from his receipts to estimate his profit. He would do the same the next year. Thus, to begin with, the value of the machine was ₹ 12 lakh. The next year, its value would come down to ₹ 10 lakh due to its use in the preceding year. This is called depreciation of capital assets. This method of depreciation is called the straight line method of depreciation.

The problem with this method is that at the end of six years, the doctor would show the value of the machine as nil. But this would not be correct. The machine would have some residual value. If nothing else, it could still be sold as scrap. To take care of this, depending upon the expectation about the length of use of the machine, a percentage rate of depreciation is fixed. Every year, the value of the machine is lowered by that percentage. For example, if the rate were fixed at 20% for the above machine, depreciation in the first year would be 20% of ₹ 12 lakh, i.e., ₹ 2.4 lakh. Deducting this much from the cost of the machine for the first year's use would give us a value of (₹ 12 lakh – ₹ 2.4 lakh =) ₹ 9.6 lakh. This would be the written down value (WDV) for the next year. At the end of the second year, the depreciation would be calculated at 20% of ₹ 9.6 lakh to get the depreciation and the new written down value.

✦ Block of Assets

The Act follows the principle of 'Block of Assets' for allowing depreciation. However, instead of leaving it to the assessee to decide the rate of depreciation, the law fixes the rate. Depreciation is the value of the use of the capital asset for the year. Thus, its significance is that it is allowed as deduction from the income of the year. Let us explore the arrangement provided by the Act. Section 2(11) requires all the capital assets to be classified and grouped under different 'blocks of assets'. Section 2(11) reads:

Sec 2 (11): 'block of assets' means a group of assets falling within a class of assets comprising—(a) tangible assets, being buildings, machinery, plant or furnitures; (b) intangible assets, being know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, in respect of which the same percentage of depreciation is prescribed;

The blocks of assets and their rates of depreciation have been specified in Appendix I under Rule 5(1) of the Income Tax Rules, 1962. Excerpts from the Appendix are as follows:

Block of Assets	*Rate (%)*
Part A: Tangible Assets	
1. Building	
a) Buildings mainly used for residential purpose except hotels and boarding houses	5
b) Buildings other than those used for residential purpose	10
2. Furniture and Fittings	
a) Furniture and fittings including electrical fittings	10
3. Machinery and Plant	
a) General Plant and Machinery	15
b) Motor cars other than those used in business for running them on hire	15
c) Pollution Control Equipments	100
d) Computers including Computer Software	60
e) Energy Saving Devices	80
f) Renewal Energy Devices	80
Part B: Intangible Assets	
a) know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature	25

The Annexure in the Income Tax Rules regarding the blocks of assets, contains the following explanatory notes:

Notes:

1. "Buildings" include roads, bridges, culverts, wells and tubewells.
2. A building shall be deemed to be a building used mainly for residential purposes, if the built-up floor area thereof used for residential purposes is not less than sixty-six and two-third per cent of its total built-up floor area and shall include any such building in the factory premises. …
5. "Electrical fittings" include electrical wiring, switches, sockets, other fittings and fans, etc. …
7. "Computer software" means any computer program recorded on any disc, tape, perforated media or other information storage device. …

Illustration: Block of Assets

Sigma Limited is a newly formed company, engaged in pharmaceutical manufacturing. It owns a three-floor building. The occupants of each of the floors and the assets therein are as below:

Ground floor—Occupied by the company.

Assets : 10 Tables, 20 chairs, 5 filing cabinets, 10 computers, 5 printers, 1 photocopier, 3 air-conditioners, 3 ceiling fans and 1 refrigerator.

First floor—Rented out to a bank.

Second floor—The floor has a flat, which has been given to the managing director of Sigma Ltd. to stay in. The company has provided two air-conditioners, one refrigerator and one washing machine.

Roof—It houses a wind turbine for producing electricity for the building.

The main business of the company is to manufacture bulk drugs for which it had bought patents from an American company.

Identify the blocks of assets for the company and the corresponding rates for depreciation.

The blocks of assets for Sigma Ltd. would be as follows:

Block of Assets	*Contents*	*Rate (%)*
Residential Building	Second floor of the building	5
Non-residential building	Ground floor of the building	10
Furniture and fittings including electrical fittings	Tables—10 Chairs—20 Filing cabinets—5 Ceiling fans—3	10
General Plant and Machinery	Air conditioners—5 Photocopier—1 Refrigerators—2 Washing Machine—1	15
Computers including Computer Software	Computers—10 Printers—5	60
Energy Saving Devices	Wind turbine	80
Intellectual Property	Patents	25

Thus, we need to cluster the capital assets under the relevant blocks of assets.

Case: Block of Assets

Identify the blocks of assets for the cotton weaving business of Pearl Limited.

Sl. No.	*Asset*	*Block of Asset*	*Rate*
1	Warehouse		
2	Weaving machines		
3	Trucks		
4	Furniture & fixtures		
5	Computer		

6	Purchased Trademark		
7	Factory building		
8	Factory Land		
9	Windows Operating System		
10	Solar Panels		

✦ Depreciation and Written Down Value

Section 32 provides for the charging of depreciation. It reads:

32. Depreciation.

(1) In respect of depreciation of--

(i) buildings, machinery, plant or furniture, being tangible assets;

(ii) know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April 1998,

owned, wholly or partly, by the assessee and used for the purposes of the business or profession, the following deductions shall be allowed--

...

(ii) in the case of any block of assets, such percentage on the written down value thereof as may be prescribed:

We need to note that depreciation is not allowed on the cost of the land on which the building is erected, but only on the building. Further, under Section 32(1), depreciation on machinery and plant is allowed only to the owner who actually uses it for the purpose of his business or profession. Thus, in the case of machinery or plant acquired under a hire-purchase agreement, the lessee is allowed depreciation.

We have already noted the blocks of assets and the rates of depreciation. Section 32 further provides for only half of the depreciation allowance for the year of acquisition if an asset is used for less than 180 days. The relevant portion reads as follows:

Provided further that where an asset ... is acquired by the assessee during the previous year and is put to use for the purposes of business or profession for a period of less than one hundred and eighty days in that previous year, the deduction under this sub-section in respect of such asset shall be restricted to fifty per cent of the amount calculated at the percentage prescribed for an asset…

We now need to become familiar with the term, 'written down value', for a block of assets. The Act means the following by the term, 'written down value':

Section 43 (6) "written down value" means—

(a) in the case of assets acquired in the previous year, the actual cost to the assessee;

(b) in the case of assets acquired before the previous year, the actual cost to the assessee less all depreciation actually allowed to him under this Act

***

(c) in the case of any block of assets—

> (i) … the aggregate of the written down values of all the assets falling within that block of assets at the beginning of the previous year and adjusted—
>
> (A) by the increase by the actual cost of any asset falling within that block, acquired during the previous year; and
>
> (B) by the reduction of the moneys payable in respect of any asset falling within that block, which is sold or discarded or demolished or destroyed during that previous year, together with the amount of the scrap value, if any, so, however, that the amount of such reduction does not exceed the written down value as so increased;

Let us explore the application of these provisions.

Illustration: Depreciation

Montage Ltd. was a newly formed company, engaged in engineering consulting. For a year, it occupied rented premises. On June 7, 2012, it bought a building which it put to use as its office. The building cost it ₹ 15 lakh. Calculate the written down value and depreciation for the previous years, 2012–13 and 2013–14.

The building falls under the category of 'occupied for non-residential purpose'. The rate of depreciation for this category is 10%.

To begin with, on April 1, 2012, Montage Limited did not have any asset under this block. Thus, the written down value in the beginning of the year was nil. The written down value at the end of the previous year, that is March 31, 2013, would be calculated as follows:

Written down value on March 31, 2013 = Written down value on April 1, 2012
+ cost of assets acquired – net receipts
from assets sold

Written down value on March 31, 2013 = 0 + 15 lakh – 0 = 15 lakh

Full depreciation would be allowed at the rate of 10% as the asset was used for more than 180 days during the previous year. Thus,

Depreciation = 10 % of ₹ 15 lakh = ₹ 1.5 lakh

Thus, the written down value on March 31, 2013, after depreciation, becomes ₹ 15 – 1.5 lakh = ₹ 13.5 lakh.

This would be carried forward as the opening written down value of the block of assets on April 1, 2013. The exercise can then be repeated. The information can be best presented in a tabular form as shown below:

Name of the Block: Building put to non-residential use

Rate of depreciation: 10 %

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13	0	0 + 15 = 15	1.5	13.5
2013–14	13.5			
2014–15				

In this tabular form, in column 2, April 1 will always refer to the first day of the previous year because the previous year starts on April 1 and ends on March 31 of the next calendar year. Thus, there can be only one April 1 in a previous year. Similarly, March 31 in columns 3 and 5 will always refer to the last day of the previous year.

As no further assets are acquired or sold off, we can complete the table by depreciating the written down value at the rate of 10% each year. This would be shown as follows:

Name of the Block: Building put to non-residential use

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13	0	0 + 15 = 15	1.5	13.5
2013–14	13.5	13.5	1.35	13.5 – 1.35 = 12.15
2014–15	12.15			

Case: Depreciation

After his graduation in April, 2012, Ajay became self-employed as a management consultant. He bought a laptop for his consulting business on April 10, 2012 for ₹ 80,000. This was the only purchase he made in that year. Complete the table below:

Name of the Block: Computer and Software

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13				
2013–14				
2014–15				

Case: Depreciation

A newly formed company, Summer Delights Private Limited, started its first kiosk for vending ice creams in 2012–13. The company bought a freezer for storing the ice cream on May 15, 2012 for ₹ 1,00,000. Complete the table below:

Name of the Block: Plant and Machinery

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13				
2013–14				
2014–15				

Illustration: Depreciation

Montage Ltd. was a newly formed company. For a year, it made do with rented premises. On April 7, 2012, it bought a building, which it put to use as its office. The building cost it ₹ 15 lakh. It soon realised, however, that the building was not in a good neighbourhood. It purchased another office building for ₹ 26.5 lakh in a good locality, on June 5, 2013. It had hoped to sell its first building but was not being offered a good enough price. Calculate the written down value and depreciation for the previous years, 2012–13 and 2013–14.

Name of the Block: Building put to non-residential use

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13	0	0 + 15 = 15	1.5	13.5
2013–14	13.5	13.5 + 26.5 = 40	4	36
2014–15	36			

Case: Depreciation

After his graduation in April, 2012, Ajay became self-employed as a management consultant. He bought a laptop for his consulting business on April 10, 2012, for ₹ 80,000. On June 5, 2013, he bought a printer for ₹ 18,000. Complete the table below:

Name of the Block: Computer and Software

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13				
2013–14				
2014–15				

Case: Depreciation

A newly formed company, Summer Delights Private Limited, started its first kiosk for vending ice creams in 2012–13. The company bought a freezer for storing the ice cream on May 15, 2012, for ₹ 1,00,000. The company bought a machine for vending ice cream in a cone for ₹ 35,000 on August 10, 2013 and put it to immediate use. Complete the table below:

Name of the Block: Plant and Machinery

Rate of depreciation: 15%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Illustration: Depreciation

Montage Ltd. was a newly formed company. For a year, it made do with rented premises. On April 7, 2012, it bought a building, which it put to use as its office. The building cost it ₹ 15 lakh. It soon realised that the building was not in a good neighbourhood. It purchased another office building for ₹ 26.5 lakh in a good locality on April 5, 2013. It sold the first building for ₹ 20 lakh on May 12, 2013. Calculate the written down value and depreciation for the previous years, 2012–13 and 2013–14.

Name of the Block: Building put to non-residential use

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13	0	0 + 15 = 15	1.5	13.5
2013–14	13.5	13.5 + 26.5 – 20 = 20	2	20 – 2 = 18
2014–15	18			

Explanation: While calculating the written down value on March 31, we have to reduce the written down value before depreciation by the amount realised from the sale of assets during the year. Thus, we have subtracted ₹ 20 lakh while calculating the WDV on March 31, 2013.

Case: Depreciation

After completing his graduation in April, 2012, Ajay became self-employed as a management consultant. He bought a laptop for his consulting business on April 10, 2012, for ₹ 80,000. On

June 5, 2013, he bought a printer for ₹ 18,000. Ajay sold off the laptop for ₹ 40,000 on December 5, 2013 and borrowed a computer from a relative for his work. Complete the table below:

Name of the Block: Computer and Software

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Case: Depreciation

A newly formed company, Summer Delights Private Limited, started its first kiosk for vending ice creams in 2012–13. The company bought a freezer for storing the ice cream on May 15, 2012, for ₹ 1,00,000. The company bought a machine for vending ice cream in cones for ₹ 35,000 on August 10, 2013 and put it to immediate use. The freezer turned out to be smaller than required. The company, therefore, sold it off on September 5, 2013. It got ₹ 60,000 from the sale of the freezer. Instead of buying a new freezer, it rented a bigger freezer. Complete the table below:

Name of the Block: Plant and Machinery

Rate of depreciation: 15%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Illustration: Depreciation

Montage Ltd. was a newly formed company. For a year, it made do with rented premises. On April 7, 2012, it bought a building, which it put to use as its office. The building cost it ₹ 15 lakh. It soon realised that the building was not in a good neighbourhood. It purchased another office building for ₹ 26.5 lakh, in a good locality, on April 5, 2013. It sold the first building for ₹ 20 lakh on May 12, 2013. It bought a warehouse on November 8, 2013, for ₹ 10 lakh. Calculate the written down value and depreciation for the previous years, 2012–13 and 2013–14.

Name of the Block: Building put to non-residential use

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13	0	0 + 15 = 15	1.5	13.5
2013–14	13.5	13.5 + 26.5 – 20 + 10 = 30	2 + (1/2) 1 = 2.5	30 – 2.5 = 27.5
2014–15	27.5			

Explanation: The warehouse has been bought on November 8, 2013. The asset is put to use in the previous year of acquisition, i.e. 2013–14, for less than 180 days. Thus, only half the depreciation will be allowed for the warehouse.

Case: Depreciation

After completing graduation in April, 2012, Ajay became self-employed as a management consultant. He bought a laptop for his consulting business on April 10, 2012, for ₹ 80,000. On June 5, 2013, he bought a printer for ₹ 18,000. Ajay bought a personal computer on December 4, 2013, for ₹ 50,000, and sold the laptop for ₹ 40,000 on December 5, 2013. Complete the table below:

Name of the Block: Computer and Software

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Case: Depreciation

A newly formed company, Summer Delights Private Limited, started its first kiosk for vending ice creams in 2012–13. The company bought a freezer for storing the ice cream on May 15, 2012, for ₹ 1,00,000. The company bought a machine for vending ice cream in cones for ₹ 35,000 on August 10, 2013 and put it to immediate use. The freezer turned out to be smaller than required. The company, therefore, sold it on October 5, 2013, for ₹ 60,000, and bought a new one on the same day for ₹ 1,40,000. Complete the table below:

Name of the Block: Plant and Machinery

Rate of depreciation: 15%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Illustration: Depreciation

The written down value of a block of assets consisting of building(s) occupied for non-residential purposes was ₹13.5 lakh on April 1, 2012. The company purchased another office building for ₹ 26.5 lakh on April 5, 2012. Calculate the written down value and depreciation for the previous years, 2012–13 and 2013–14.

Name of the Block: Building put to non-residential use

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2012–13	13.5	13.5 + 26.5 = 40	4	36
2013–14	36	36	3.6	32.4
2014–15	32.4			

Explanation: In the previous cases, we started out with a new company and empty blocks so that we could grasp the working of the law. In this case, there are already pre-existing assets. We just have to begin with the written down value of the block.

Case: Depreciation

After his graduation, Ajay became self-employed as a management consultant. The WDV for the block of assets comprising computers on April 1, 2012, was ₹ 20,000. He bought a laptop for his consulting business on April 10, 2012, for ₹ 80,000. On June 5, 2013, he bought a printer for ₹ 18,000. Complete the table below.

Name of the Block: Computer and Software

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Case: Depreciation

The WDV on April 1, 2012 of the block of assets comprising plant and machinery of Summer Delights Private Limited, engaged in running kiosks selling ice cream, was ₹ 20,00,000. The company bought a freezer on November 10, 2013, for ₹ 2,00,000. Complete the table below:

Name of the Block: Plant and Machinery

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Illustration: Depreciation

Rajesh is a young struggling lawyer in a high court. He received a total income of ₹ 3,00,000 from clients. The following are the expenditures made by him in the previous year, 2013-14.

(Amount in Rupees)

S. No.	*Description*	*Amount*
1	Rental paid for a chamber in the High Court premises	30,000
2	Repairs, whitewashing and cleaning	2,000
3	Amount paid to typist, charging on per page basis	40,000
4	Annual subscription of internet law library	15,000
5	Paper, stationery and folders	3,000
6	Purchase of a computer on September 20, 2013	30,000
7	Purchase of four wooden chairs for visitors on October 5, 2013	4,000

Rajesh had purchased a writing desk and two plastic chairs for his office in the preceding years. The written down value of the block of assets, 'Furniture', on April 1, 2013, was ₹ 7,000. As the chairs were not sturdy, he sold them off on February 15, 2014, for ₹ 1,000. Calculate the income of Rajesh under the head of 'income from business and profession'.

As the treatment for revenue expenditure and that for depreciation of capital assets is different, we first need to separate out the revenue and capital expenditure incurred during the year, 2012–13. The revenue expenditure during 2013–14 is as follows:

Previous Year: 2013–14

S. No.	*Description*	*Amount in Rupees*
1	Rental paid for a chamber in the high court premises	30,000
2	Repairs, whitewashing and cleaning	2,000
3	Amount paid to typist, charging on per page basis	40,000
4	Annual subscription of internet law library	15,000
5	Paper, stationery and folders	3,000
	Total Revenue Expenditure	90,000

Rajesh has two blocks of assets, namely, (1) furniture and (2) computer. We need to work out the depreciation for the two blocks.

A. Block of Assets: Computer

Rate of depreciation: 60%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2013–14	0	30,000	18,000	12,000
2014–15	12,000			

B. Block of Assets: Furniture

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2013–14	7,000	(7,000 – 1,000) + 4,000	600 + 1/2 (400) = 800	9,200
2014–15	9,200			

(The wooden chairs are put to use in October. Thus, only half depreciation will be allowed for the acquisition)

Total depreciation from the two blocks of assets = 18,000 + 800 = 18,800

The total of revenue expenditure and depreciation = 90,000 + 18,800 = 1,08,800

Thus, Rajesh's taxable income for the previous year, 2013–14 = ₹ 3,00,000 – 1,08,800 = ₹ 1,91,200

Rajesh would need to keep track of the written down values of the two blocks of assets on April 1, 2014. These will be used for claiming depreciation in relation to his income during the previous year, 2014–15.

Case: Depreciation

AMM Ltd. is a computer software developing company. The company received a total of ₹ 50 lakh as revenue from different clients, for developing software. The total revenue expenditure of the company, including rental of building, salary, electricity and telephone bills was ₹ 24 lakh. The company had capital assets under the following blocks of assets:

(Amount in Rupees Lakh)

Block of Assets	Written down value on April 1, 2013
Computers	10
Furniture	4
Building for office use	20

AMM acquired 20 new computers at ₹ 25,000 apiece, in December, 2013. The company bought additional furniture in February, 2014, for ₹ 2 lakh. Calculate the taxable income for AMM.

Block of Assets: Computers

Rate of depreciation: 60%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Block of Assets: Furniture

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

Block of Assets: Building for office use

Rate of depreciation: 10%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*

✦ Additional Depreciation: New Manufacturing Machinery

We are now ready to take note of some additional factors in relation to depreciation. The Income Tax Act allows a special additional depreciation for new plant and machinery used for manufacturing of goods. Clause (iia) of Section 32 provides for this. It reads as follows:

> (iia) in the case of any new machinery or plant (other than ships and aircraft), which has been acquired and installed … by an assessee engaged in the business of manufacture or production of any article or thing or in the business of generation or generation and distribution of power, a further sum equal to twenty per cent of the actual cost of such machinery or plant shall be allowed as deduction under clause (ii) :
>
> Provided that no deduction shall be allowed in respect of–
>
> (A) any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person; or
>
> (B) any machinery or plant installed in any office premises or any residential accommodation, including accommodation in the nature of a guest-house; or
>
> (C) any office appliances or road transport vehicles; or
>
> (D) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profits and gains of business or profession" of any one previous year;

Case: Special Deduction

Omega Limited is a company engaged in the manufacture of several products. It bought the following capital goods in the previous year, 2013–14. Is the 20% depreciation under Section 32(iia) available to the company in relation to the following goods?

1. Air-conditioners for its guest house
2. Computer for maintaining the stock registers on the factory floor
3. Air-conditioner for the factory
4. Second hand lathe machine
5. Photocopier for the office
6. Machine for moulding plastic

As is clear, the special deduction is available only in the case of industries engaged in manufacture and production. Further, the section provides a rider that this deduction is not available for 'any machinery or plant installed in any office premises', any office appliances, or 'any residential accommodation, including accommodation in the nature of a guest house'. Further, the allowance is not available for used machines.

Decide whether the additional depreciation allowance is available in the following cases by writing yes or no in the second column.

Acquisition	*Yes/No*
A new computer bought by a pharmaceutical company	
An old printer bought by a pharmaceutical company	
A new exchange bought by a telecommunication company	
A new air-conditioner bought by a retail store	
A new air-conditioner installed by a garment manufacturing company in its factory	
A software installed in a computer in the factory premises for aiding block printing	
A new photocopier installed in the quality control section of a factory manufacturing food products	
A new power generator bought by a pharmaceutical company for its factory	
A new tanker for carrying milk from a chilling plant to the factory for manufacturing dairy products	
A new power generator for the head office of a food manufacturing company	
A second-hand machine for pulverising bio-mass for manufacturing paper-board	
A new power generator for a software development company	

Illustration: Additional Depreciation

Sigma Limited is engaged in the manufacturing of cotton fabric. The written down value of the block of assets comprising plant and machinery, on April 1, 2013, was ₹ 40 lakh. In June, 2013, the company bought a new machine for dying the fabric, for ₹ 20 lakh. This was the only addition to the block of assets. Calculate the depreciation for the previous year, 2013–14.

Block of Assets: Plant and Machinery

Rate of depreciation: 15%

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2013–14	40	40 + 20 = 60	15% of 40 + 15% of 20 + 20% of 20 = 13	60 – 13 = 47
2014–15	47			

Case: Additional Depreciation

Ujala Illumination Limited is engaged in the manufacturing of electric bulbs. The written down value of the block of assets comprising plant and machinery, on April 1, 2013, was ₹ 200 lakh. In

August, 2013, the company bought a new machine for making bulbs, for ₹ 100 lakh, and put it to immediate use. In November, 2013, the company sold off the old machine for making bulbs for ₹ 50 lakh. Calculate the depreciation for the previous year, 2013–14.

Block of Assets: Plant and Machinery

Rate of depreciation:

(Amount in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation*	*WDV on March 31 after depreciation*
2013–14				
2014–15				

The Finance Act, 2013 has introduced a special short-term additional deduction for acquisition of new plant and machinery to industries engaged in manufacturing or production, by inserting Section 32AC to the Act. The criterion for new plant and machinery and industry engaged in manufacturing and production was the same as above. It gave an additional deduction of 15% on acquisition of plant and machinery worth more than ₹ 100 crore during April 1, 2013 to March 31, 2015. The Finance Act, 2014 has extended the additional deduction upto the Previous Year 2017-18 and lowered the eligibility amount of cost of acquisition to ₹ 25 crore.

✦ Time and Cost of Acquisition

A company contracts to buy a machine in February. The money is paid and the ownership is transferred in April. The seller delivers the machine in June. A platform had to be made for the machine and special electrical wiring was required. Hence, it was only in August that the machine could become operational. From which month should we start claiming depreciation for the machine? Depreciation is available only if the person owns the machine. However, the machine will create economic value or depreciate, the two being obverse sides of the same coin, only when it gets used for business activity. Thus, depreciation should be counted from August. The Act expresses this principle by using the expression, 'put to use for the purposes of business or profession'. Ascertaining the time is important in deciding whether an addition to the block of assets attracts full or half depreciation.

A retail store acquires an air-conditioner. The cost price of the air-conditioner is ₹ 40,000. The retail store has to bear the expenses for carriage from the premises of the seller, loading and unloading and insurance. The total of these costs came to ₹ 8,000. At the buyer's premises, wood work had to be done to make a platform for installing the air-conditioner. This cost the retail store, ₹ 5,000. A technician charged ₹ 1,000 for installing the machine and for doing the necessary electrical work. What should be the cost of the asset for the purpose of calculating the depreciation? The air-conditioner becomes an asset for the company only when it starts working and delivering value. The cost of the asset for the company is the cost of getting it going. Thus, all the costs associated with the acquisition of the asset and of bringing it up to the stage where it is ready for use have to be added to get the actual cost.

A company buys a building to run its office. The cost of acquisition of the asset is the total of the cost of the building, registration, stamp duty, lawyer's fee and real estate agent's fee. What if the company builds a building on a plot of land it owns? The company has created a capital asset. The total of all the expenses incurred in creating the building will be the cost of the asset. Thus, the costs of material, labour, construction and supervision would accumulate in constituting the cost of the asset. This is called capitalisation of expenses.

A company takes a loan to buy plant and machinery. The interest on the borrowed money, after the machinery has been put to use, cannot be charged to the cost of acquisition of the machine because the machine has already been acquired. However, can the interest amount, till the machine is put to use, be added as a cost for acquiring the capital asset? The issue came up before the Supreme Court in Challapalli Sugar Ltd. v. Commissioner of Income-tax, A. P.[1] The Supreme Court noted that the term used in the Act is 'actual cost'. The way businesses understand 'actual cost' is as an all-inclusive cost. Thus, it was decided that interest on loan for acquisition of a capital asset, till the asset is put to use, can be capitalised. However, once the asset is put to use, the interest has to be charged as revenue expenditure under Section 36(1)(iii).

Review Cases

Case 1: A publishing company bought the copyright of a book, to print and publish it in India, for ₹ 50 lakh, on May 5, 2013. It put the acquisition to immediate use and the book was released in June, 2013. How will the expenditure be treated?

Case 2: A business processing company installed a speech-recognition software in all its computers on November 5, 2013. It cost the company ₹ 20 lakh. The written down value of the block of assets comprising the computers, on April 1, 2013, was ₹ 50 lakh. Calculate the written down value of the block of assets on April 1, 2014.

Case 3: The WDV of a block of assets comprising plant and machinery of an automobile manufacturing unit of a company was ₹ 600 lakh on April 1, 2013. The company bought new machinery for painting the automobiles, for ₹ 80 lakh, during 2013–14. The machine was put to use on May 10, 2013. Calculate the depreciation allowance for the block for the previous year, 2013–14.

Case 4: The WDV of the block of assets comprising plant and machinery of an electrical appliance manufacturing company was ₹ 400 lakh on April 1, 2013. The company bought a new machine for making tube lights for ₹ 100 lakh, during 2013–14. The machine was put to use on June 10, 2013. After successfully using the new machine, the company sold the old machine for ₹ 40 lakh on January 6, 2014. It had bought that machine for ₹ 70 lakh on June 10, 2011. Calculate the depreciation allowance for the block for the previous year, 2013–14.

Case 5: The WDV of the block of assets comprising plant and machinery of a telecommunication company, providing telephone and mobile services, was ₹ 800 lakh on April 1, 2013. The

[1] Challapalli Sugar Ltd. v. Commissioner of Income-tax, AIR 1975 SC 97.

company bought new equipment for installing a relay tower for ₹ 60 lakh during 2013–14. The machine was put to use on July 10, 2013. Calculate the depreciation allowance for the block for the previous year, 2013–14.

Case 6: Sigma Private Limited is a newly formed Indian company. The statement of its accounts and transactions are as follows:

June 1, 2011 to March 31, 2013

Sigma Private Limited bought a computer for ₹ 50,000 on June 10, 2012, and put it to immediate use. It bought a laptop on November 15, 2012, for ₹ 1 lakh and put it to immediate use.

During June 1, 2012 to March 31, 2013, Sigma Private Ltd. received ₹ 34 lakh. It had incurred a total revenue expenditure of ₹ 24 lakh towards salary, travels, rental of office, electricity and maintenance during this period.

April 1, 2013 to March 31, 2014

Sigma Private Ltd. sold off the computer for ₹ 40,000 on February 12, 2014. It received ₹ 40 lakh from its consulting activities. It had incurred a total revenue expenditure of ₹ 28 lakh towards salary, travels, rental of office, electricity and maintenance.

Compute the taxable income of the company under the head of 'income from business', for the previous years, 2012–13 and 2013–14.

6

CHAPTER

Business Income: Special Provisions

In the preceding chapters, we grasped the core operating provisions for calculating income from business and profession. Around this core, the Income Tax Act admits of several special and specific treatments to various industries, activities and expenditures. Additional provisions provide the details for the working of the core ideas covered in the preceding chapters. In this chapter, we will further our understanding of the taxation of income from business or profession. Let us glance at the title headings of the sections allowing expenditures.

Section 33: Development Rebate

Section 33 AB: Tea development account, coffee development account and rubber development account

Section 33ABA: Site restoration account

Section 35: Expenditure on scientific research

Section 35 A: Expenditure on acquisition of patent rights or copyrights

Section 35 AB: Expenditure on know-how

Section 35 ABB : Expenditure for obtaining licence to operate telecommunication services

Section 35 AC: 35AC. Expenditure on eligible projects or schemes

Section 35 CCA: Expenditure by way of payment to associations and institutions for carrying out rural development programmes.

Section 35 CCB: Expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources

Section 35 D: Amortisation of certain preliminary expenses

Section 35E: Deduction on prospecting, etc. for certain minerals.

Section 32 A and 33: Section 32 (iia) allowed a depreciation of 20% for new plant and machinery, other than ships and aircrafts. Section 32 A supplements it by allowing depreciation on ships and aircrafts for the first year of their acquisition. The provision is of interest to shipping and airline companies.

Section 33 AB: The tea development account, coffee development account and rubber development account give allowances so as to promote the tea, coffee and rubber industries.

Section 33ABA: The site restoration account gives special allowance to the companies engaged in the prospecting, extraction or production of natural gas. The provision is of interest to the petrochemical sector. Section 35E is a similar provision for mines.

Section 35: This section provides for special deductions for expenditure towards scientific and industrial research.

Section 35 ABB: This section provides a special allowance for the telecommunication industry.

Section 35 AC: This section aims at encouraging deals with the public sector for certain eligible projects.

Section 35 AD: This section allows deductions in respect of expenditure of capital nature incurred, wholly and exclusively, for the purposes of the development of a cold chain facility, warehousing facility for storage of agricultural produce, or a cross-country network for the distribution of natural gas or crude or petroleum oil pipeline.

Section 35 CCA: This section allows any contribution made to an association or institution engaged in carrying out of rural development programmes. Similarly, Section 35 CCB allows any contribution made to an association or institution engaged in carrying out programmes of conservation of natural resources.

Section 35 D: Business expenditure can be deducted only if the assessee has got into a business. This section allows certain expenditures that were incurred by the assessee before getting into business, i.e., while still in the planning stage.

Section 35 E: This section promotes exploration of mines and minerals by allowing certain expenditures.

Thus, some provisions give special support to specific industries, for example, shipping, airlines, mines and minerals and petrochemicals. Other provisions admit certain contributions as business expenditure, even when these are entirely unrelated to the business, as in the case of contribution towards rural development or preservation of natural resources. Having developed an overview, we can take up the provisions which have a wider application, in detail. The first such provision is Section 35: Expenditure on scientific research.

✦ Expenditure on Scientific Research

The objective of this section is to promote scientific research. Section 43(4)(i) defines scientific research as 'any activity for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries.' There are two aspects to this provision. The first one is similar to treating a business expenditure as a contribution made towards rural development. The expenditure is unrelated to the business of the assessee. However, the law allows it as expenditure so as to encourage contribution towards a social goal. Similarly, Section 35 intends to encourage contributions, unrelated to business, towards the development of social science, science and research.

The section allows 1.75 times the actual contribution as deduction in the case of contributions to a research association, university, college or other institutions, for scientific research. The section allows a lower rate of 1.25 times the actual contribution to be deducted in the case of contribution towards 'research in social science or statistical research', to a research association, university, college or other institutions. The section also allows 1.25 times the actual contribution as deduction for contribution to a company registered in India, which is engaged in scientific research and development. As the concession can be misused, the section requires the recipient institution to seek registration from the government. Only contributions to an eligible institution would bring in the benefit for the assessee. An application for seeking eligibility has to be disposed of within 12 months. Also, it is a one-time approval. The provision is worded as follows:

> **35. Expenditure on scientific research.** (1) In respect of expenditure on scientific research, the following deductions shall be allowed: …
>
> (ii) an amount equal to one and three-fourth times of any sum paid to a research association which has as its object the undertaking of scientific research or to a university, college or other institution to be used for scientific research: ….
>
> (iia) an amount equal to one and one-fourth times of any sum paid to a company to be used by it for scientific research: ....
>
> (iii) an amount equal to one and one-fourth times of any sum paid to a research association which has as its object the undertaking of research in social science or statistical research or to a university, college or other institution to be used for research in social science or statistical research:

Illustration: Contribution towards Research

Jupiter Software Solution Ltd. made a contribution of ₹ 40 lakh during 2014–15, to a university of national prominence, for research on promotion of literacy in rural areas of India. The company can make a deduction of ₹ (1.25)*(40) lakh = ₹ 50 lakh. This deduction would come under Section 35(1)(iii).

Case: Contribution towards Research

Airwaves Limited, a company engaged in providing mobile phone services, made a grant of ₹ 50 lakh to a recognised research institution, for research on alternate sources of energy. How would the expenditure be treated?

Case: Contribution towards Research

Horizon Limited made a grant of ₹ 80 lakh to a prominent university to evaluate the impact of mobile phones on rural credit in two districts of a state in India. How would the expenditure be treated?

The second aspect of Section 35 is in relation to expenditure incurred by the company on in-house scientific research related to its business. The section provides as follows:

35. Expenditure on scientific research. (1) In respect of expenditure on scientific research, the following deductions shall be allowed: ...

(i) any expenditure (not being in the nature of capital expenditure) laid out or expended on scientific research related to the business.

...

(iv) in respect of any expenditure of a capital nature on scientific research related to the business carried on by the assessee, … Provided that no deduction shall be admissible under this clause in respect of any expenditure incurred on the acquisition of any land…

(2AB)(1) Where a company engaged in the business of bio-technology or in any business of manufacture or production of any article or thing, not being an article or thing specified in the list of the Eleventh Schedule …any expenditure on scientific research (not being expenditure in the nature of cost of any land or building) … shall be allowed a deduction of a sum equal to two times of the expenditure so incurred.

(2) No deduction shall be allowed in respect of the expenditure mentioned in clause (1) under any other provision of this Act.

Some prominent entries in Schedule XI are as follows:

1. Beer, wine and other alcoholic spirits
2. Tobacco and tobacco preparations
3. Cosmetics and toilet preparations
4. Tooth paste, dental cream, tooth powder and soap
5. Aerated waters in the manufacture of which blended flavouring concentrates in any form are used

   Explanation: 'Blended flavouring concentrates' shall include, and shall be deemed always to have included, synthetic essences in any form.
6. Confectionery and chocolates

10. Photographic apparatus and goods

22. Office machines and apparatus such as typewriters, calculating machines, cash registering machines, cheque writing machines, intercom machines and teleprinters

    Explanation: The expression 'office machines and apparatus' includes all machines and apparatus used in offices, shops, factories, workshops, educational institutions, railway stations, hotels and restaurants for doing office work and for data processing (not being computers).

Thus, Section 35 deals with the revenue and capital expenditure of a company on in-house scientific research, related to the manufacturing business activity of the assessee. The treatment of such expenditure can be in one of the following three ways: one, its deduction may not be allowed; two, full deduction may be allowed; or three, deduction of twice the amount of the actual expenditure might be allowed. The table below lists some forms of expenditure. Decide whether deduction of each of these would be 'not allowed', 'allowed', or allowed with a weightage of two times.

S. No.	*Expenditure*	*Not Allowed*	*Allowed fully*	*Allowed (two times)*
1	A pharmaceutical company bought a plot of land for ₹ 20 lakh, for setting up a laboratory for drug development.			
2	A pharmaceutical company constructed a building at a cost of ₹ 50 lakh, for setting up a laboratory for drug development.			
3	A pharmaceutical company bought a piece of equipment for its laboratory for drug development for ₹ 20 lakh.			
4	The salary bill of the scientists of a pharmaceutical company engaged in drug development was ₹ 1.5 crore.			
5	A toy manufacturing company bought a piece of equipment for ₹ 25 lakh, for development of materials for toy making.			
6	A company engaged in manufacturing toilet soap set up a research centre for developing new products. Towards setting up the centre, it bought a plot of land for ₹ 40 lakh.			
7	A toilet soap manufacturing company bought a building for ₹ 2 crore, for setting up its research and development centre, which would be engaged in developing soap with new materials.			
8	A chocolate manufacturing company bought a centrifuge for ₹ 20 lakh, for its research and development centre. The centre was engaged in development of chocolate with tropical fruit flavours.			
9	A pharmaceutical company bought a machine for ₹ 2 crore to replace the existing machinery in its production line.			
10	A chocolate manufacturing company constructed a building at the cost of ₹ 2 crore for setting up its factory.			

The above exploration brings out that we first need to segregate expenditure on in-house scientific research. Expenditure for acquiring land cannot be deducted. Land will form a block of assets that will attract a rate of depreciation of 0%. Cost incurred in buying a building or developing a building for scientific research can be fully deducted. Irrespective of the nature of the business activities of a company, there is no weightage for the expenditure incurred in acquiring a building. For all other revenue and capital expenditure incurred for scientific research, for example, equipment, materials and salary, the fact whether the company is engaged in activities covered under Schedule XI or not becomes relevant. A company not covered by Schedule XI can claim two times the expenditure actually made.

What is the net effect of this provision? The best way of understanding this is to ask how the different expenditures on in-house research would have been treated if the provision were not there. As scientific research is aimed at furthering the business of a company, it would have been a part of business expenditure. Revenue expenditure would then be deducted while capital expenditure would be depreciated under the relevant block of assets. The salary of the scientists, material costs and other revenue expenditures would be deducted, even if the provision were not there. Section 35, however, does make a difference to companies not covered by Schedule XI. These companies can deduct two times the salary of the scientists. In the absence of this section, all capital assets would form part of different blocks of assets and would be depreciated at the prescribed rate. The section makes no difference in the case of acquiring land. It, however, does make a difference in the case of acquisition of a building. Instead of depreciating the building at the rate of 10%, as a part of the block of 'assets put to office use', the entire expenditure can be fully deducted in the same year. In the case of other capital assets, instead of depreciating them under a block of assets, the entire expenditure will be deducted, with or without the multiplier of two, depending on the application of Schedule XI.

Illustration: Scientific Research (Covered by Schedule XI)

Pearl Hygiene Ltd., a bathing soap manufacturing company, set up a research centre for material and product development in 2014–15. The income of the company from its sales in 2014–15 was ₹ 300 lakh. The company's expenditure on manufacturing, salary and other administrative expenses was ₹ 80 lakh. The company incurred the following expenditure during 2014–15, towards the research centre:

Acquisition of land: ₹ 20 lakh

Construction of building: ₹ 50 lakh

Equipment for research: ₹ 40 lakh

Salary of scientists: ₹ 20 lakh

Decide on the treatment of the expenditure on the research centre.

The expenditure was incurred towards an in-house research facility, connected with the business. The general provision for scientific research includes all expenditures other than acquisition of land. Thus, all expenditure other than ₹ 20 lakh is eligible for deduction. The cost of acquisition of the building does not get any weightage. Thus, ₹ 50 lakh will be deductible for the construction of building. For the other items of expenditure, as the company is covered by Schedule XI, the deduction will be without the multiplier of two. Thus, the total deduction allowed under Section 35 would be: ₹ 110 lakh. The net income of the company is ₹ (300 – 80 – 110) lakh = ₹ 110 lakh.

Illustration: Scientific Research (Not Covered by Schedule XI)

Tulip Oscar Ltd., a pharmaceutical manufacturing company, set up a research centre for developing new medicines. The income of the company from its sales in 2014–15 was ₹ 300 lakh. The company's expenditure on manufacturing, salary and other administrative expenses was ₹ 80 lakh. The company incurred the following expenditure during 2014–15, towards its research centre:

Acquisition of land: ₹ 20 lakh

Construction of building: ₹ 50 lakh

Equipment for research: ₹ 40 lakh

Salary of scientists: ₹ 20 lakh

Decide on the treatment of the items of expenditure on the research centre.

The expenditure was made towards the in-house research facility, connected with the business. The general provision for scientific research allows all expenditures other than acquisition of land to be deducted. Thus, all expenditure other than ₹ 20 lakh is eligible for deduction. The cost of acquisition of building does not get any weightage. Thus, ₹ 50 lakh will be deductible for the construction of building. For the other heads of expenditure, as the company is not covered by Schedule XI, the deduction will be twice the actual expenditure. Thus, the total deduction under Section 35 would be: ₹ 50 + (2)(40 + 20) lakh = ₹ 170 lakh. The net income of the company is ₹ (300 – 80 – 170) lakh = ₹ 50 lakh. Note that the above two illustrations had the same income and expenditure, but the activities of the companies were different.

Case: Expenditure on In-house Research

Tulip Ltd. is a company engaged in the manufacturing of pharmaceutical products. The details of its income and expenditure in Rupees lakh during 2014–15 are as follows:

Revenue from sales: 300

Manufacturing and administrative expenses: 100

Equipment acquired for research: 40

Remuneration to scientists: 20

Other expenses of the research centre: 10

Explore the deduction of expenditure.

Case: Expenditure on In-house Research

Libra Telecom Private Ltd. is a company engaged in the manufacturing of telecommunication switching devices. The company set up a research centre for developing better switching devices. The income of the company from its sales in 2014–15 was ₹ 600 lakh. The company's expenditure on manufacturing, salary and other administrative expenses was ₹ 300 lakh. The company incurred the following expenditure during 2014–15 towards the research centre:

Acquisition of land: ₹ 20 lakh

Construction of building: ₹ 50 lakh

Equipment for research: ₹ 40 lakh

Salary of scientists: ₹ 20 lakh

Explore the deduction of the various heads of expenditure.

Case: Expenditure on Scientific Research

Mint Confectionery Ltd. is a company engaged in the manufacturing of chocolates and confectionery. The details of its income and expenditure in Rupees lakh during 2014–15 are as follows:

Revenue from sales: 400

Manufacturing and administrative expenses: 200

Grant to a recognised research institute for scientific research: 20

Equipment acquired for research: 60

Remuneration to scientists: 40

Other expenses of the research centre: 20 lakh

Explore the deduction of the different heads of expenditure.

✦ Amortisation of Preliminary Expenses

To recall from the chapter on business income, expenditure on business can be revenue expenditure or a capital expenditure. On the capital assets, a depreciation allowance can be claimed. Sections 30 to 36 provide for deduction of some specific expenditure incurred for the purposes of the business. Section 37 includes all expenditure incurred for the purposes of the business. It provides:

> **37. General.** (1) Any expenditure (not being expenditure of the nature described in Sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

Let us explore the application of this section with the help of the following example. Raj wanted to start a coffee shop in Delhi. Towards this, he visited several coffee shops in India, so as to acquaint himself with the business. He attended a two-day seminar on running a restaurant business. He bought a coffee maker and a food processor. All this cost him ₹ 2 lakh. However, in the meantime, he got a fellowship to study abroad. He decided to proceed for higher studies instead of starting the business. Can he claim the expenses he incurred under the head, 'for the purposes of the business'? He intended to get into the business but did not actually get into it.

Now, let us take the case where he did not abandon the idea. He rented a place in the month of September. The place was refurbished and decorated in October. Raj put in advertisements in the paper for the inauguration and opening of the coffee shop on November 15. Can the rental for the month of September and October be claimed as business expenditure? Can the advertisement expenses be claimed as expenditure? Raj still only intends to get into the business. If he decides to abandon the plan on the morning of November 15th, he would still not have got into the business of running a coffee shop yet, but would only be close to it. He can claim to be in business only on getting the first customer. Thus, as Raj has no business as yet, the expenses cannot be claimed as being for the 'purposes of the business'.

Now, let us assume that the coffee shop was inaugurated on November 15. From November 16 onwards, customers started coming to the shop. The business has commenced. The coffee maker and food processor are put to use. The capital assets have been put to use. The expenditure incurred in acquiring them will become a part of the block of assets. However, the revenue expenditure incurred before the start of the business would not be taken as expenditure for the purposes of income tax. In a business sense, Raj will take out all the expenses incurred before the business started while working out his profits. However, the government is reluctant in allowing this benefit. If it were allowed, all personal expenses could be claimed as expenditure for some intended business. The expenditure could be shown as business losses to be set off against income from other sources, depriving the state of its revenue. At the same time, every business incurs some expenditure before the business commences. It would be harsh to completely ignore these expenses. Therefore, the Act allows it in a measured way. The allowing of deduction of the expenses incurred before the commencement of a business is called amortisation.

Section 35 D provides for amortisation. It includes three checks to prevent the misuse of amortisation. One, amortisation can be claimed only after the business has commenced. Two, only the expenses listed in the section can be amortised. Three, there is a limit on the total expenses that can be amortised. The limit is fixed according to the size of the business. The section reads as follows:

> **35D. Amortisation of certain preliminary expenses.-** (1) Where an assessee, being an Indian company or a person (other than a company) who is resident in India, incurs … any expenditure specified in sub-section (2),—
>
> (i) before the commencement of his business, or
>
> (ii) after the commencement of his business, in connection with the extension of his undertaking or in connection with his setting up a new unit,
>
> the assessee shall, in accordance with and subject to the provisions of this section, be allowed a deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the business commences or, as the case may be, the previous year in which the extension of the undertaking is completed or the new unit commences production or operation:
>
> (2) The expenditure referred to in sub-section (1) shall be the expenditure specified in any one or more of the following clauses, namely—
>
> (a) expenditure in connection with preparation of feasibility report … project report; conducting market survey or any other survey … ; engineering services relating to the business of the assessee:
>
> (b) legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up or conduct of the business of the assessee;
>
> (c) where the assessee is a company, also expenditure—
>
> (i) by way of legal charges for drafting the Memorandum and Articles of Association of the company;
>
> (ii) on printing of the Memorandum and Articles of Association;
>
> (iii) by way of fees for registering the company under the provisions of the Companies Act, 1956 (1 of 1956);
>
> (iv) in connection with the issue, for public subscription, of shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus;

(3) Where the aggregate amount of the expenditure referred to in sub-section (2) exceeds an amount calculated at five per cent—

(a) of the cost of the project, or

(b) where the assessee is an Indian company, at the option of the company, of the capital employed in the business of the company,

the excess shall be ignored for the purpose of computing the deduction allowable under sub-section (1):

The allowance is available only to Indian companies and individuals resident in India. It is not available to companies incorporated in other countries. Before the business commences, there can be several stages where the expenditure may not form part of a business activity but is incurred towards getting into the business. For instance, a person forms a company to start a management consultancy. The business would commence when the first assignment comes and work starts. The expenses preceding this would need to be amortised. Sometime later, the company decides to set up a unit to provide financial services as well. This is a new activity. Till this business starts, the expenses made will need to be amortised. The section provides for amortisation at different stages. However, the Act has fixed a ceiling to the total amount that can be amortised. The total amount cannot be more than five per cent of the cost of the project or the capital employed. The assessee can choose any of the two, the cost of the project or the capital employed, as the reference. The qualifying amount of the total expenditure, taking into account the above ceiling, is to be claimed as deduction over five years, in equal instalments.

For a new company, Section 35 defines the 'cost of the project' as the actual cost of the fixed assets, including land, buildings, plant, machinery, furniture and fittings, in the books of the assessee on the last day of the previous year in which the business commences. In the case of a company extending its existing undertaking or starting a new unit, 'the cost of project' is the value of the fixed assets associated with the new unit or the extension. For a new company, the 'capital employed in the business of the company' is the aggregate of the issued share capital, debentures and long-term borrowings as on the last day of the previous year in which the business of the company commenced. In the case of a new undertaking or unit of an existing business, the 'capital employed' is the share capital, debentures and long-term borrowings issued or obtained in connection with the extension or new unit.

We will explore only the cases where a new company is being formed and is getting into business, as opposed to cases of extension of an existing business and new units. Also, we will not get involved in calculating and working out the 'cost of project' or 'capital employed'. We will take it to be given. Thus, the following steps will need to be followed to determine the amount for amortisation:

1. Take the date of commencement of the business and identify all the expenses incurred before that date, which are eligible to be amortised.
2. Total the expenditure eligible for amortisation.
3. Compare the total expenditure with five per cent of the 'cost of project' and take the lower of the two. This is the value that will be actually amortised.
4. Divide the value to be amortised by five and deduct it in each of the five previous years, starting with the year in which the business commences.

Illustration: Amortisation (New Company)

Sigma Private Limited is a newly formed Indian company. It was given the certificate of incorporation on May 5, 2012. The following expenses were incurred in the month of April 2012, for the formation of the company:

1. Preparing and printing of the memorandum of association and the articles of association: ₹ 90,000
2. Registration fee paid for incorporation: ₹ 10,000

The company engaged itself in the consulting business. It started its business on June 2, with the first consulting assignment. The 'cost of project' (worked out as the actual value of its fixed assets on March 31, 2013) was ₹ 10 lakh. How much can the company amortise in the years, 2012–13 and 2013–14.

Under Section 35D, both the above heads of expenditure are eligible for amortisation. The total expenditure comes to ₹ 1,00,000. However, there is a ceiling on the total amount that can be amortised. This is fixed at 5% of the 'cost of project'. This works out to ₹ 50,000. Thus, only ₹ 50,000 will be amortised. This is to be done in five equal instalments over five years, starting with the previous year in which the business commences. Thus, ₹ 10,000 will be deducted in each year, 2012–13 and 2013–14.

Illustration: Amortisation (New Company)

Anagram Private Limited is a newly formed Indian company. It was given the certificate of incorporation on May 5, 2012. The following expenses were incurred in the month of April 2012, for the formation of the company:

1. Preparing and printing of the memorandum of association and the articles of association: ₹ 30,000
2. Registration fee paid for incorporation: ₹ 10,000

The company engaged itself in the consulting business. It started its business on June 2, with the first consulting assignment. The 'cost of project' (worked out as the actual value of the fixed assets on March 31, 2013) was ₹ 10 lakh. How much can the company amortise in the years, 2012–13 and 2013–14.

The total expenditure eligible for amortisation is ₹ 40,000. The 'cost of project' being ₹ 10 lakh, the ceiling on the total amount that can be amortised works out to ₹ 50,000. As the actual amount is less than the ceiling amount, the entire amount would be amortised in five equal parts, starting with the year, 2012–13. Thus, ₹ 8,000 will be deducted in each year, 2012–13 and 2013–14.

Case: Amortisation (New Company)

O&J Food Products Limited was incorporated on October 6, 2013. It raised money from the public through an initial public offer in February, 2014. The company started production of food products in August 2014. The company incurred the following expenditures before commencing its business:

1. Registration fee paid for incorporation: ₹ 20,000
2. Preparing and printing of the memorandum of association and the articles of association: ₹ 80,000
3. Preparation of prospectus for the initial public offer: ₹ 1,50,000
4. Advertisement of prospectus: ₹ 5,00,000
5. Project report and market survey conducted by the company: ₹ 6,50,000

Taking the 'cost of project' to be ₹ 300 lakh, determine the amount of deduction under Section 35D for the previous year, 2014–15.

In one case, a company paid money to the Registrar of Companies as filing fee for the enhancement of its authorised share capital. The company claimed that it could amortise this expenditure. Amortisation can be claimed only for revenue expenditure. Could the above expenditure be claimed as revenue expenditure? The Supreme Court ruled it to be a capital expenditure in Punjab State Industrial Development Corporation Ltd. v. CIT. [1] It noted:

> … we are of the opinion that the fee paid to the Registrar for expansion of the capital base of the company was directly related to the capital expenditure incurred by the company and although, incidentally, that would certainly help in the business of the company and may also help in profit-making, it still retains the character of a capital expenditure since the expenditure was directly related to the expansion of the capital base of the company.

In Brooke Bond India Limited v. Commissioner of Income Tax[2] it was argued that capital had been raised to meet the company's working capital requirements. The Supreme Court emphasised:

> though the increase in the capital results in expansion of the capital base of the company and incidentally, that would help in the business of the company and may also help in the profit-making, the expenses incurred in that connection still retain the character of a capital expenditure since the expenditure is directly related to the expansion of the capital base of the company.

✦ Deduction of Interest on Borrowed Capital

We explored the provisions made by Section 36 in a preceding chapter. That section also provides on deduction of interest on loans. Section 36(1) (iii) provides:

> **Section 36. Other Deductions.** (1) The deductions provided for in the following clauses shall be allowed … in computing the income referred to in Section 28 …
>
> (iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession.
>
> Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised in the books of account or not); for any

[1] Punjab State Industrial Development Corporation Ltd. v. CIT, 1997(225) ITR 792.

[2] Brooke Bond India Limited v. Commissioner of Income Tax, AIR 1997 SC 1336.

period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

Illustration: Interest on Loan

Omega Limited, going through a financial crisis, secured two loans from a bank. The first loan, Loan 1, was meant for meeting its administrative expenditure. The second loan, Loan 2, was taken for buying a new packing machine. Both the loans were approved and given to the company on February 1, 2013. The machine was purchased on October 1, 2013, and put to use on January 1, 2014. The company paid an interest of ₹ 12 lakh on Loan 1 and of ₹ 24 lakh on Loan 2 during the previous year, 2013–14.

The treatment of the interest paid to the bank during the year would be as follows: The interest on Loan 1, i.e., ₹ 12 lakh, can be deducted as expenditure. In relation to Loan 2, the provision comes to apply. As the machine was put to use only for three months during 2013–14, the interest for only three months, i.e., ₹ 6 lakh, can be deducted. According to the provision, the interest for the preceding months, i.e., ₹ 18 lakh, would not be allowed as deduction under this section. The interest for the period before the machine is put to use will be 'capitalised'. The interest on the borrowed capital, along with the cost of the machine, freight, insurance, handling and installation, constitutes a part of the 'cost of acquisition' of the capital asset. Section 36 provides only for the acquisition of an asset for the purpose of 'extension of existing business or profession'. In the case of a new business also, the same treatment is to be given to the interest, that is, it would be capitalised. This follows from the judgement of the Supreme Court in Challapalli Sugar Ltd. v. Commissioner of Income-tax. A.P.[3] The basis for the judgement was that in the ordinary way of conducting businesses, the cost of an asset includes all expenditure made to finally put the asset in use.

✦ Bad Debt

X Limited sells goods to a buyer in May, 2011. The buyer is to pay the price in July, 2011. Following the accrual method of accounting, the revenue accrues to X Limited in 2011–12. The company takes it as its income for determining the income tax. The buyer, however, fails to pay the money. The seller has a right to receive the money. However, the money may become irrecoverable. This may happen due to the liquidation of the debtor company. In other situations, the debtor may be unable to pay or simply, refuse to pay. For the creditor, the debt becomes irrecoverable or a bad debt. When a debt can be said to have become bad, depends on the facts and circumstances of each case and on business judgement about whether the amount can be recovered or not.

If the seller had been following the receipt basis of accounting, the problem would not have arisen. It is only fair for the state not to realise tax when there has been no actual income. The law recognises this in Section 36(1)(vii) and allows for deducting a bad debt in the previous year in which the debt is taken to have become a bad debt. Obviously, the deduction can be made only

[3] Challapalli Sugar Ltd. v. Commissioner of Income-tax, A.P., AIR 1975 SC 97.

if the accrual from that debt has been taken into account as income earlier, in the first place. For example, in 2008–09, a machine manufacturing company sold a machine and ₹ 50 lakh accrued to it. The company, accounting on the accrual basis, took ₹ 50 lakh into account while calculating its business income. The seller failed to pay the money. In 2012–13, the seller company declared the owed money as a bad debt. The company can claim this amount as deduction in 2012–13. However, if the seller had been maintaining its account on the receipt basis, it could not have claimed the bad debt because it would not have taken into account the income in the first place.

Let us take the case of a money lending business by a company. The company lends ₹ 1 lakh to a person on April 1, 2009, at the rate of simple interest of 10%. Thus, an interest of ₹ 10,000 accrues to the company each year. The company determines its tax after taking this amount into consideration. The debtor fails to pay the interest. The company declares the interest as well as the capital to be bad debt in 2014–15. The interest that had been taken as income accrued should be allowed as a deduction in 2014–15. How should the capital, which has been lost as a bad debt, be treated? The law allows the capital, which has become a bad debt, also to be deducted as a business loss.

✦ Measures to Prevent Tax Evasion

In the field of taxation, the state is always concerned about tax evasion by the tax payers by resorting to over-reporting of expenditure and understating of the receipts. However, in the case of business and profession, unlike in the case of house property, it would not be able to fix a standard deduction. To fix the profitability of businesses, in general, would amount to taking away the very basis of competitive business. Despite this, the Act has found a mechanism to prevent tax evasion. A set of provisions expressly disallow certain kinds of expenditure. A listing is as follows:

1. Section 40(a) disallows, *inter alia*, sums liable for tax deduction at source, payable outside India or to a non-resident, on which tax is not deducted at source by the assessee.
2. Section 40(b) disallows interest paid by a firm to its partners in excess of 12% per annum and remuneration to partners beyond the prescribed permissible limits.
3. Section 40A(2) disallows excessive and unreasonable expenditure involving relatives, directors of the company or person in whose business the assessee has an interest.
4. Section 40A(3) disallows deduction of any payments of more than ₹ 20,000 paid otherwise than by account payee cheques or account payee bank drafts.
5. Section 43B provides that certain kinds of expenses can be claimed only if they are actually paid and evidence of payment is submitted. These expenses include payment of any tax; a contribution to provident, superannuation or gratuity fund; payment of bonus or commission to employees; and interest paid on a loan advanced by a public financial institution or a scheduled bank.

Section 44AB provides that a person engaged in any business whose turnover or gross receipt is more than ₹ one crore, has to maintain books of accounts and get the accounts audited by a chartered accountant. Getting the accounts audited by a chartered accountant brings in impartiality and ensures compliance with the law. A chartered accountant would not certify the accounts unless the accounts are in compliance with the accounting standards and the law. The section requires the same from a person engaged in a profession, as opposed to a business. The ceiling on the income for a person engaged in a profession after which it would become mandatory to get the accounts audited is ₹ 25 lakh.

The Act assumes a minimum profitability in several kinds of business activities, particularly when the business is being done at a small level. The standard profitability is taken as the basis to impose tax. Section 44AD is an illustration:

> Special provisions for computing profits and gains of business
>
> 44AD.(1) Notwithstanding anything to the contrary contained in Sections 28 to 43C, in the case of an eligible assessee engaged in an eligible business, a sum equal to eight per cent of the total turnover or gross receipts of the assessee in the previous year on account of such business or, as the case may be, a sum higher than the aforesaid sum claimed to have been earned by the eligible assessee, shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".
>
> The above scheme is applicable to a resident assessee being an individual, HUF, or a partnership firm, for any business (except the business of plying, hiring, or leasing goods carriages) whose total turnover or gross receipts in the previous year does not exceed an amount of one crore rupees.

Thus, if Harshad runs a shop and his yearly receipts are ₹ 30 lakh, he would not be making any deductions for calculating the profits under the head of business and profession. It would be assumed that his profit is 8% of ₹ 30 lakh, that is, ₹ 2.4 lakh. Harshad can avoid this assumption by maintaining detailed audited accounts. The above provision is called presumptive taxation. That is, it assumes a certain income and imposes tax accordingly.

7

CHAPTER

Capital and Revenue Expenditure

Whether an expenditure is capital or revenue in nature is always contentious. The distinction has important taxation implications. This question often comes before the courts. The Supreme Court of India, in Assam Bengal Cement Company Limited v. Commissioner of Income Tax[1] reviewed several landmark judgements of the British courts, and reached a conclusion.

Court Case: Assam Bengal Cement Company Limited v. Commissioner of Income Tax

The following is an edited and abridged version of the case:

> The line of demarcation between capital expenditure and revenue expenditure is very thin as learned judges in England have from time to time pointed out the difficulties besetting that task. … Certain broad tests have however been attempted to be laid down and the earliest was … 'You do not use it 'for the purpose of' your concern, which means, for the purpose of carrying on your concern, but you use it to acquire the concern.'

The expenditure in the acquisition of the concern would be capital expenditure; the expenditure in carrying on the concern would be revenue expenditure.

Lord Dunedin suggested another criterion (Vallambrosa Rubber Co., Ltd. v. Farmer ((1910) 5 T.C. 529, 536):

> 'Now I don't say that this consideration is absolutely final or determinative, but in a rough way, I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is a going to be spent once and for all, and income expenditure is a thing that is going to recur every year.'

Atherton v. British Insulated and Helsby Cables Ltd. (1925 10 T.C. 155) laid down what has almost universally been accepted as the test for determining what is capital expenditure as distinguished from revenue expenditure. Viscount Cave, L.C. there observed:

> 'Lord Dunedin …. expressed the opinion that "in a rough way" it was "not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all and income expenditure is a thing which is going to recur every year"; and no doubt this is often a material consideration. But the criterion suggested is not, and was obviously not, intended by Lord Dunedin to be a decisive one in every case; for it is easy to imagine many cases in which a payment, though made "once and for all", would be properly chargeable against the receipts for the year.... But when an expenditure is made, not only once and for

[1] Assam Bengal Cement Company Limited v. Commissioner of Income Tax, AIR 1955 SC 89.

> all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.'

The Supreme Court, thus, summarised:

> If the expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business it is properly attributable to capital and is of the nature of capital expenditure. If on the other hand it is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to produce the profits, it is a revenue expenditure. If any such asset or advantage for the enduring benefit of the business is thus acquired or brought into existence it would be immaterial whether the source of the payment was the capital or the income of the concern or whether the payment was made once and for all or was made periodically. The aim and object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure. The source or the manner of the payment would then be of no consequence. …

✦ Ownership, Capital Assets and Depreciation

The courts have taken the position that creation of ownership is important for an expense to be treated as capital expenditure. There are cases where a person, by spending money, creates an asset of an enduring nature. However, the asset so created does not belong to the person. In such situations, the courts have held that the expenditure was incurred with the aim of improving the manner of carrying on of the business of the person, and thus, it should be allowed as expenditure. However, since there is no ownership over the asset, it cannot be a capital asset and therefore, the expenditure should be treated as a revenue expenditure.

In two cases, Lakshmiji Sugar Mills Co. P. Ltd. v. Commissioner of Income-tax, New Delhi,[2] and L.B. Sugar Factory and Oils Mills (P) Ltd. v. Commissioner of Income-tax, U.P.,[3] sugar manufacturing companies had paid for the construction and development of roads between the various sugarcane-producing centres and their factories. However, the roads were the property of the government. The court held that the expenditure was incurred for the purpose of facilitating the running of motor vehicles for the transportation of sugarcane to the factories. This was certainly for the purpose of facilitating the business and making it more efficient and profitable. However, the Supreme Court noted in Lakshmiji Sugar Mills Co. P. Ltd. v. Commissioner of Income-tax, New Delhi:[4]

> ... although the advantage secured was of long duration, it was not an advantage in the capital field because no tangible or intangible asset was acquired by the assessee; nor was there any addition to or expansion of the profit making apparatus of the assessee. ... It was, therefore, revenue expenditure.

In another case, Commissioner of Income-tax, Bombay City -I v. Associated Cement Companies Ltd.,[5] a company entered into an agreement to supply water to the municipality and provide water pipelines. It also put up transmission lines for street lighting. Further, it agreed to build a concrete

[2] Lakshmiji Sugar Mills Co. P. Ltd. v. Commissioner of Income-tax, New Delhi, AIR 1972 SC 159.
[3] L.B. Sugar Factory and Oils Mills (P) Ltd. v. Commissioner of Income-tax, U.P., AIR 1981 SC 395.
[4] Lakshmiji Sugar Mills Co. P. Ltd. v. Commissioner of Income-tax, New Delhi, AIR 1972 SC 159.
[5] Commissioner of Income-tax, Bombay City - I v. Associated Cement Companies Ltd., 1988 (172) ITR 257.

road from the factory to the railway station. In return, the company got immunity from paying municipal taxes for 15 years. The Supreme Court reasoned that no capital asset got created for the company as it did not own the installations.

In Commissioner of Income-tax v. Bombay Dyeing and Manufacturing Co. Ltd.,[6] Bombay Dyeing contributed certain amount of money to the State Housing Board for construction of tenements for its workers. The tenements remained the property of the Housing Board. The court held that the expenditure was incurred for the welfare of the employees. Its purpose was to carry on the business of the company more efficiently by having a contented labour force. The expenditure, therefore, constituted legitimate business expenditure. However, the company acquired no ownership rights in the tenements. Therefore, the expenditure was taken to be a revenue expenditure.

Court Case: Commissioner of Income Tax, Tamil Nadu v. Madras Auto Service Private Limited

The Madras Auto Service was a public limited company carrying on the business of selling motor parts in Madras and other places.[7] Its head office was at Madras and it had branches at Bangalore and Vijayawada. It was looking for a building in Bangalore for housing its branch. It came cross a building in a good business locality. The building was rather old. The landlord was not in a position to invest his own money to remodel the building or to build it anew. But the Madras Auto Service was prepared to carry out the demolition and reconstruction, at its own cost and expense. The landlord was agreeable to this, provided that he be made the owner of the new building. In exchange, he was willing to grant a lease on a long-term basis, for a term of 39 years, at considerably lower rents as compared with the prevailing rates for similar business accommodation in the vicinity.

The monthly rent demanded by the landlord was ₹ 1,000 to begin with, and it was settled that it would go up to a maximum of ₹ 2,000 for the last four years of the lease. The prevailing rent in that area for the building's floor area of 8,000 square feet worked out to not less than ₹ 12,000, at the rate of ₹ 2 or ₹ 2.50 per square foot. The Madras Auto Service, therefore, entered into a lease agreement with the landlord, on February 1, 1966. Some of the relevant clauses of the lease agreement were as follows:

> This deed witnesseth that the Lessors (landlords) hereby grant a lease of the premises Nos. 64 and 64/, Sri Narasimharaja Road, Bangalore for a period of 39 years, commencing from 1st Jan., 1966 and agree that the lessee (Madras Auto Service) continue in occupation and enjoyment of the same for 39 years without any hindrance or interruption whatsoever subject to the following terms and conditions.
>
> 1. The Lessee (Madras Auto Service) shall have the right to demolish at their own expenses the existing premises and appropriate to themselves all the materials thereof without paying the Lessors (landlords) any compensation therefor and utilise them for any purpose they think fit and construct a new building thereon to suit the purpose of their business as per Plan approved by the lessors (landlords). The Lessee (Madras Auto Service) undertake to render all help to apply get the plan approved by the Corporation or other authorities concerned.

[6] Commissioner of Income-tax v. Bombay Dyeing and Manufacturing Co. Ltd., AIR 1996 SC 330.

[7] Commissioner of Income Tax, Tamil Nadu v. Madras Auto Service Private Limited, AIR 1998 SC 2667.

2. The Lessee (Madras Auto Service) shall pay a rent of ₹ 1,000 (Rupees one thousand only) per month by the 10th of the succeeding month for the first fifteen years and ₹ 1,500 (Rupees one thousand five hundred only) per month for the next ten years from the sixteenth year onwards, and ₹ 1,650 (Rupees one thousand six hundred and fifty only) per month for the next ten years from the 26th year and ₹ 2,000 (Rupees two thousands only) per month for the last years of this lease period and shall pay three month's rent namely ₹ 3,000 (Rupees three thousand only as advance deposit to be adjusted and given credit for at the termination of the tenancy. The rent shall be paid to each of the Lessors (landlords) in equal moieties.
3. The Lessors (landlords) agree to pay all Corporation taxes and other public dues payable to the Corporation of Government or other public body or bodies themselves.
4. The Lessee (Madras Auto Service) will demolish at their own cost and expenses the existing premises and put up new constructions as per details show in the plan attached to this Deed on the specific understanding that the construction shall right from the commencement of the work be the property of the Lessors (landlords) and upon completion of the work of construction the Lessee (Madras Auto Service) will only have the right to be a tenant for a period of 39 years subject to payment of rents and observations of other terms and conditions. The Lessee (Madras Auto Service) shall not be entitled to under any circumstances for any comprehension whatsoever on account of the new constriction to be put in place of the old.
5. The Lessee (Madras Auto Service) shall leave all the structure and building made including fixtures such as rolling shutters, window glasses etc., fixed or erected in fact for the benefit of the Lessors (landlords) at the time of vacating and giving vacant possession of the premises on termination of the tenancy.
6. The Lessee (Madras Auto Service) shall have the right to sub-lease whole or any portion thereof to any of their associate concerns or any other persons or body corporate with due intimation to the lessors (landlords).
7. The Lessee (Madras Auto Service) shall complete the new building and fit for occupation within a period of eighteen months from this date.

The Madras Auto Service demolished the existing building and raised a new construction in its place. It took two years to complete the job. In this, it incurred expenditure of ₹ 1,62,335 in the first year and ₹ 50,937 in the next year. It claimed these amounts as business expenditure. The Income-tax Officer did not doubt that the amount spent by the Madras Auto Service for demolition and reconstruction of the branch office building was for business purposes. He, however, disallowed the expenditure on the ground that it was capital in nature.

The Supreme Court observed:

> The assessee (Madras Auto Service) in the present case has spent the amounts in question in order to construct a new building after demolishing the old building. The new building, however, from inception was to belong to the lessor (landlords) and not to the assessee (Madras Auto Service). The assessee (Madras Auto Service), however, had the benefit of the existing lease in respect of the new building at the agreed rent for a period of 39 years. ...
>
> In order to decide whether this expenditure is revenue expenditure or capital expenditure, one has to look at the expenditure from a commercial point of view. What advantage did the assessee (Madras Auto Service) get by constructing a building which belonged to somebody else and spending money for such construction? The assessee (Madras Auto Service) got a long lease of a newly constructed building suitable to its own business at a very concessional rent. The expenditure, therefore, was made in order to secure a long lease of new and more suitable business premises at a lower rent. In other words, the assessee (Madras Auto Service) made substantial savings in monthly rent for a period of 39 years by expending these amounts. The saving in expenditure was

> saving in revenue expenditure in the form of rent. Whatever substitutes for revenue expenditure should normally be considered as revenue expenditure. Moreover, assessee (Madras Auto Service) in the present case did not get any capital asset by spending the said amounts. The assessee (Madras Auto Service), therefore, could not have claimed any depreciation. Looking to the nature of the advantage which the assessee (Madras Auto Service) obtained in a commercial sense, expenditure appears to be revenue expenditure.

The Supreme Court, in ascertaining the difference between capital expenditure and revenue expenditure, borrowed one of the standard tests laid down in Atherton v. British Insulated and Helsby Cables Ltd.[8] It said:

> When an expenditure is made, not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital. Whether by spending the money any advantage of an enduring nature has been obtained or not will depend upon the facts of each case. Moreover, as the above passage itself provides, this test would not apply if there are special circumstances pointing to the contrary.

The Supreme Court also summarised the tests laid down in Assam Bengal Cement Co. Ltd. v. Commissioner of Income-tax, West Bengal[9] as follows:

1. Outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment.
2. Expenditure may be treated as properly attributable to capital when it is made not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade ... If what is got rid of by a lump sum payment is an annual business expense chargeable against revenue, the lump sum payment should equally be regarded as a business expense, but if the lump sum payment brings in a capital asset, then that puts the business on another footing altogether.
3. Whether for the purpose of the expenditure, any capital was withdrawn, or, in other words, whether the object of incurring the expenditure was to employ what was taken in as capital of the business. Again, it is to be seen whether the expenditure incurred was part of the fixed capital of the business or part of its circulating capital.

By applying the above test number (2) to the argument, that Madras Auto Service got enduring benefit of a capital nature by spending the amount as it obtained a new building for a period of 39 years, the Supreme Court reasoned:

> The difficulty, however, in the present case, arises from the fact that this building was never to belong to the assessee (Madras Auto Service). Right from inception, the building was of the ownership of the lessor (landlords). Therefore, by spending this money, the assessee (Madras Auto Service) did not acquire any capital asset. The only advantage which the assessee (Madras Auto Service) derived by spending the money was that it got the lease of a new building at a low rent. From the business point of view, therefore, the assessee (Madras Auto Service) got the benefit of reduced rent. ... obtaining a business advantage. The expenditure is, therefore, to be treated as revenue expenditure.

[8] Atherton v. British Insulated and Helsby Cables Ltd. (1925) 10 Tax. Cases 155.

[9] Assam Bengal Cement Company Limited v. Commissioner of Income Tax, AIR 1955 SC 89.

8
CHAPTER

Capital Gains

'Capital gains' is one of the heads of income. Let us explore the meaning and scope of the term, 'capital gains', in its ordinary sense. Classify the following sources of income under one of the five heads of income discussed in the previous chapters:

1. Sumit bought a house for ₹ 15 lakh and rented it out for ₹ 1 lakh a year.
2. Sumit invested ₹ 20 lakh in opening a restaurant. He earned ₹ 2 lakh during the previous year, 2013-14.
3. Sumit had a vacant plot of land. He put the land to use by holding exhibitions and fairs there. He earned ₹ 1 lakh from this activity.
4. Sumit bought gold for ₹ 50,000 and sold it off for ₹ 70,000, three months later.
5. Sumit bought shares of a company for ₹ 25,000 and sold them off for ₹ 30,000.
6. Sumit got a good buyer for the vacant plot of land on which he used to organise exhibitions and fairs. He had bought that plot for ₹ 6 lakh in May, 2002. He sold it for ₹ 10 lakh, in October, 2013.
7. Sumit bought a lottery ticket for ₹ 10 and got a prize of ₹ 1 lakh.

The classification of Sumit's income under the five heads would be as follows:

S. No.	*Activity*	*Head of income*
1.	Renting of house	House Property
2.	Running of restaurant	Business
3.	Holding exhibitions and fairs	Business
4.	Selling gold	Capital gain
5.	Selling shares	Capital gain
6.	Selling land	Capital gain
7.	Lottery	Other sources

We notice that for earning any income, capital has to be deployed. Even a lottery needed deployment of ₹ 10. Capital can be in the form of money, land, gold or shares. What distinguishes capital gains from the other heads is that in the case of capital gains, the ownership of capital is transferred. The owner loses the ownership of capital and in the process, he makes a gain. The

Income Tax Act understands capital gains in this very sense. Section 45 defines capital gains as follows:

> **45. Capital gains.** (1) Any profits or gains arising from the transfer of a capital asset effected in the previous year shall … be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

The key terms in the section are 'gains', 'transfer' and 'capital asset'. Let us explore these terms.

✦ Capital Asset

A capital gain arises on the 'transfer' of a 'capital asset'. Thus, the asset must be a 'capital' asset. Let us explore whether the following assets are capital assets for the owner:

1. A garment manufacturing company owned shares in another company. It sold the shares to a buyer.
2. A garment manufacturing company bought sewing machines. It used the machines in its factory for 15 days. As a new and better machine arrived in the market, the company sold off the older machines. It made a gain of ₹ 5,000.
3. A garment manufacturing company sold a building owned by it.
4. Sale of sewing machines by a company manufacturing sewing machines.
5. Sale of flats built by a construction company.
6. A wholesaler bought 100 sewing machines from the manufacturer and sold it to different retailers for a total of ₹ 22 lakh.
7. A garment manufacturing company bought 10,000 metres of Khaki fabric to tailor uniforms for a customer. The contract was terminated by the customer. The company had no use for the fabric. It sold off 7,000 metres of the fabric and made a gain of ₹ 50,000.
8. A company bought a patent right for ₹ 60 lakh in 2011. The company sold off the patent to another company for ₹ 80 lakh in February 2014.

In every sale, ownership will be lost and money, or worth of money, will come in. However, every transaction does not result in a capital gain. This would depend on the nature and purpose of owning the asset in the first place. Under the head of income from business and profession, there are revenue as well as capital assets. The assets that are constitutive of the business are its capital assets. Other assets are revenue assets, which would necessarily be bought, consumed and sold off for the purpose of running the business. Sale of such assets would not result in capital gains, but would be a part of income from business and profession. Thus, in the case of business and profession, we need to distinguish between revenue and capital assets. Only the sale of capital assets would result in capital gains.

Now, let us explore whether the illustrations above constituted capital gains or revenue income. Shares, buildings and sewing machines, in the hands of a garment manufacturing company, are the capital assets of the company. A capital asset can be tangible or intangible. For example, a patent right bought by a company is its capital asset. However, the sewing machine company has manufactured the machines. It did not acquire them as capital assets. It created the machines itself, through manufacturing. The sewing machines form the inventory and current assets of the company. Its income from the sale of those machines would be a part of its business income. The same treatment would be given to the building in the hands of the construction company.

The wholesaler, however, who sold sewing machines, has not manufactured the machines. He is in the business of buying and selling of machines. The machines are not his capital assets. His capital assets would include the buildings and warehouse, van, furniture and computer used by the employees. The receipt from the sale of sewing machines would be taken under the head of business income. The sewing machine is stock-in-trade for the wholesaler. In the case of a garment manufacturing company selling fabric and making a gain, again, the fabric was not a capital asset for the garment manufacturing company. Its sale would not result in a capital gain.

Let us take up some illustrations involving individuals. Are the following assets capital assets for the individuals?

1. Aman bought a flat for ₹ 12 lakh in 2008 and sold it for ₹ 16 lakh in March, 2014.
2. Ajit inherited a flat in June 2014. He sold it immediately for ₹ 18 lakh.
3. Mrs. Raman had no choice but to sell her jewellery to pay for the education of her children.
4. Aman bought a car for his personal use. He used it for one year and then sold it off.
5. Aman bought a painting for ₹ 80,000 in October, 2011 and sold it for ₹ 1 lakh in June, 2014.

In every sale transaction, ownership would be lost for cash. Thus, money would come in, leading to an incidence of capital gain. In the case of an individual engaged in a business or profession, goods owned by the person for business could be capital or revenue assets. The goods owned by the person for his personal use would necessarily be capital assets. We can now take note of the definition of 'capital asset' as given in the Act.

> **Section 2 (14) "capital asset"** means property of any kind held by an assessee, whether or not connected with his business or profession, but does not include, inter alia:
>
> (i) any stock-in-trade, consumable stores or raw materials held for the purposes of his business or profession;
>
> (ii) personal effects, that is to say, movable property (including wearing apparel and furniture) held for personal use by the assessee or any member of his family dependent on him, but excludes— (a) jewellery; (b) archaeological collections; (c) drawings; (d) paintings; (e) sculptures; or (f) any work of art.
>
> (iii) agricultural land in India, not being land situated within the local limits of any municipality/local authority having a population of ten thousand or more ...

Thus, a capital gain arises from the transfer of 'property of any kind', even if it is related to a profession or business. Section 2(14)(i) deals with persons engaged in some business or profession. It recognises the distinction between capital assets and other property created under the head of income from business and profession. Section 2(14)(ii) deals exclusively with the property of individuals not connected with any business and profession. Any property belonging to an individual, other than his/her personal effects, is a capital asset. Even things of personal effect, which people increasingly have come to own as investments, like jewellery, paintings and artwork, are capital assets. Section 2(14)(iii) exempts only agricultural land. Thus, non-agricultural land, no matter where it is situated, is a capital asset. Only agricultural lands, situated in certain locations, are not taken to be capital assets. District and urban administrations classify the land in their records. One of the classifications is agricultural land.

Case: Capital Assets

Identify whether the listed assets are capital assets as defined in Section 2(14).

S. No.	*Asset*	*Capital Asset (Yes/No)?*
1	Gold ring owned and worn by a person	
2	Washing machine for domestic use	
3	Television set for domestic use	
4	Expensive jacket bought by a person for his use	
5	A person bought a sculpture made by a renowned artist for decorating his living room	
6	A person owns equity shares listed on a recognised exchange	
7	Wooden dining table in a house	
8	Washing machine with a dry-cleaning company	
9	Washing machine in the guest house of a company engaged in the manufacturing of pharmaceutical products	
10	Cars in the warehouse of a car manufacturing company	
11	Cash in the wallet of a person	
12	A company owns equity shares of an unlisted company	
13	A person owns urban land in Ahmedabad, earmarked for constructing a building	
14	Office premises owned by a company	
15	Agricultural land within the jurisdiction of the Ahmedabad Urban Development Authority	
16	Copyright on some artwork with a company	
17	Trademark of a company	

Transfer of Capital Assets

An incidence of capital gain arises when the ownership of a capital asset is lost. Let us explore this dimension with the following cases. Do the following constitute cases of capital gain?

1. Aman bought two identical gold rings in June, 2010 for ₹ 10,000 each. He sold the first ring to Manu for ₹ 12,000 on June 15, 2014. On the same day, he gave the second ring to a shopkeeper in exchange for a television.

2. Aman bought a painting, which was insured. The painting got half burnt in a fire. The insurance company gave him the full value of the painting and took away the half-burnt painting.
3. A company hired a consultant. The consultant abandoned the project midway. In exchange for not meeting his contractual obligations, the consultant allowed the company to keep his laptop.

Sale of a capital asset is certainly a case of capital gain. However, in all the above cases, the person has lost the ownership in exchange for something of value or for an obligation. In a general sense, where the capital asset is not being sold, the owner would do a valuation of the benefit received to determine whether he has lost or gained by letting go of the ownership of his capital asset. In addition, if the meaning of capital gains were confined only to sales, everyone would alternately structure their transactions so as to avoid paying tax. Thus, 'transfer' of capital gain should include all cases where a person moves the ownership of a capital asset and gets a tangible or intangible benefit in exchange. Section 2(47) defines 'transfer'. This definition is consistent with our exploration.

Section 2(47) "transfer", in relation to a capital asset, includes—

(i) the sale, exchange or relinquishment of the asset; or

(ii) the extinguishment of any rights therein; or …

(v) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract; or …

Capital gain, thus, arises on the 'transfer' of a 'capital asset'. Let us explore the meaning of capital gain further, with the following illustration. Aman, while moving out from Bangalore for his studies, sold his flat for ₹ 19 lakh in June, 2014. He had bought the flat in January, 2014. He had paid the previous owner ₹ 15 lakh. What is Aman's capital gain? The gain Aman has made is the difference between the buying and selling price of the flat. Thus, Aman's capital gain is ₹ 4 lakh. While Aman may have got ₹ 19 lakh in hand, he had to spend ₹ 5,000 for hiring a lawyer, ₹ 10,000 for hiring a real estate agent, and ₹ 1,50,000 towards stamp duty and registration charges. What is Aman's real gain? There were costs involved in making the sale of the flat. The net value from the sale of the flat is the sale price minus the transaction costs. Aman got a net price of ₹ 19,00,000 – ₹ (5,000 + 10,000 + 1,50,000) = ₹ 17.35 lakh. Thus, Aman's capital gain would be ₹ 17.35 lakh – ₹ 15 lakh = ₹ 2.35 lakh.

Aman, while buying the property, had not only paid ₹ 15 lakh to the previous owner, but he also had to pay half of the charges of the lawyer, real estate agent and stamp duty. This came to ₹ 2 lakh. Thus, there was a cost incurred while acquiring the capital. The cost of acquiring the asset was the price he paid for the flat, plus all the transaction costs involved in acquiring the flat. Thus, the cost of acquiring the flat = ₹ 15 lakh + ₹ 2 lakh = ₹ 17.00 lakh. Thus, Aman's capital gain is ₹ 17.35 lakh – ₹ 17.00 lakh = ₹ 0.35 lakh.

Aman was not sure if the deal was as good as the above calculation suggests. When he had bought the flat, he had hoped he would be living in it. He had got the kitchen renovated by adding a new stone platform and tiles. This had cost him ₹ 30,000. This investment should be added to the cost of acquiring the flat. This will give us the total money Aman has had to pay for the flat. Thus, the total cost of the flat at the time of the sale = ₹ 17.00 lakh + 0.30 lakh = ₹ 17.30 lakh. Thus, Aman's capital gain is ₹ 17.35 lakh – ₹ 17.30 lakh = ₹ 0.05 lakh. The Act also understands capital gains in the same way. Section 48 provides the manner in which capital gains have to be computed.

> **Section 48. Mode of computation:** The income chargeable under the head "Capital gains" shall be computed, by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely:—
>
> (i) expenditure incurred wholly and exclusively in connection with such transfer;
>
> (ii) the cost of acquisition of the asset and the cost of any improvement thereto:

Long Term and Short Term Capital Gain

Let us continue our exploration with the following illustration. Aman sold shares of a company for ₹ 1.5 lakh in March, 2014. He had bought the shares for ₹ 1 lakh in August, 2006. The capital gain appears to be ₹ 0.5 lakh. Aman, however, is not convinced. In fact, he is left wondering whether he has actually benefited from the sale at all. Aman's discomfort has to do with the erosion of the value of money due to inflation in the economy.

Let us take a hypothetical case where a person was given a gift of two ₹ 100 notes. He went with one note of ₹ 100 to a store and bought two packets of rice, sugar, tea leaves and toothpaste. He kept the other ₹ 100 note in his cupboard. Thereafter, he forgot that he had kept a hundred rupee note in his cupboard. Seven years later, he found the note. He took the note to the same store but could buy only one packet each of exactly the same things. The value of his money had halved. If the person who had given the gift had to be as generous, he would need to give ₹ 400, seven years later, instead of ₹ 200. Economists calculate the general inflation in the economy by asking: what does it cost to buy a basket of goods, comprising common necessities, in different years? By comparing the cost of a basket of goods in different years, the inflation rate and price index are calculated.

Thus, the discomfort of Aman is justified. He is certainly not richer by ₹ 50,000. If anything, he might have suffered a loss. The Act recognises the concept of inflation and accounts for it in calculating the capital gain. Section 48(v) requires the Central Government to notify a 'Cost Inflation Index' for making conversions. It reads thus:

> (v) "Cost Inflation Index", in relation to a previous year, means such Index the Central Government may, having regard to seventy-five percent of average rise in the Consumer Price Index for urban non-manual employees for the immediately preceding previous year to such previous year, by notification in the Official Gazette, specify in this behalf.

The table of Cost of Inflation Index is as follows:

Finance Year	*Cost of Inflation Index*	*Finance Year*	*Cost of Inflation Index*	*Finance Year*	*Cost of Inflation Index*
1981-82	100	1992–93	223	2003–04	463
1982-83	109	1993–94	244	2004–05	480

1983–84	116	1994–95	259	2005–06	497
1984–85	125	1995–96	281	2006–07	519
1985–86	133	1996–97	305	2007–08	551
1986–87	140	1997–98	331	2008–09	582
1987–88	150	1998–99	351	2009–10	632
1988–89	161	1999–00	389	2010–11	711
1989–90	172	2000–01	406	2011–12	785
1990–91	182	2001–02	426	2012–13	852
1991–92	199	2002–03	447	2013-14	939

The Central Government has taken 1981–82 as the base year for calculating the index. Section 48 of the Act allows for indexing the cost of acquisition as well as that of any improvement made in the asset. It reads thus:

(iii) "indexed cost of acquisition" means an amount which bears to the cost of acquisition the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the first year in which the asset was held by the assessee or for the year beginning on the Ist day of April, 1981, whichever is later;

(iv) "indexed cost of any improvement" means an amount which bears to the cost of improvement the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the year in which the improvement to the asset took place;

If an asset was acquired prior to 1981–82, the assessee has the choice of either taking the actual cost of acquisition or the fair market value of the asset in 1981–82. The amount thus selected is to be indexed with the cost inflation index of 1981–82. Having, in principle, accepted the need to index acquisition and improvement costs, the Act recognises that if the time period between the acquiring and selling of assets is short, indexing would not make any significant difference in the capital gain. Towards this, it introduces the concept of Long Term Capital Gain and Short Term Capital Gain. In the case of Long Term Capital Gain, inflation is taken into account in working out the cost of acquisition with respect to the date of transfer of the asset, while in the case of Short Term Capital Gain, the inflation factor is ignored. The provisions read thus:

Section 2(42A) "short-term capital asset" means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer.

Provided that in the case of a share held in a company or any other security listed in a recognised stock exchange in India or a unit of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963), or a unit of an equity oriented fund of the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted. …

Section 2(42B) "short-term capital gain" means capital gain arising from the transfer of a short-term capital asset;

Section 2(29A) "long-term capital asset" means a capital asset which is not a short-term capital asset;

Section 2(29B) "long-term capital gain" means capital gain arising from the transfer of a long-term capital asset;

Section 10(38) defines equity oriented fund to be one which has invested more than a certain percentage of the investible funds in the equity shares of domestic company.

The provision on short term and long term capital assets can be expressed in the following tabular form:

	Nature of asset	*Short term capital asset*	*Long term capital asset*
1	Shares of a listed company	A year or less	More than a year
2	Securities (other than shares) listed on a recognised stock exchange in India or a unit of specified institution/ equity oriented mutual fund or a zero coupon bond	A year or less	More than a year
3	All capital assets other than those specified in (1) and (2) above	Three years or less	More than three years

The period of holding of the asset is computed as the period between the date of its acquisition and the date of its transfer. A capital gain arising from the transfer of a short-term capital asset is 'Short term capital gain' and that arising from the transfer of a long-term capital asset is 'Long term capital gain'. The relevance of the distinction is that the rate at which income tax is charged for long term and short term capital gains is different. Thus, the two kinds of capital gains have to be identified and maintained separately.

Case: Long Term and Short Term Capital Assets

Identify whether the following assets are long term assets or short term assets:

S. No.	*Particular of assets*	*Date of Purchase*	*Date of Sale*	*Long Term/ Short Term*
1	Gold ring owned by a person	18/7/2011	25/6/2014	
2	Equity shares listed on a recognised stock exchange	20/4/2013	25/6/2014	
3	Urban land within Ahmedabad city	18/3/2010	25/6/2014	
4	Painting by a renowned artist	15/1/2011	25/6/2014	
5	Unlisted equity shares	20/5/2013	25/6/2014	
6	Equity shares of a private company	12/10/2012	25/6/2014	
7	Unlisted equity shares of a public company	12/10/2012	25/6/2014	
8	Equity oriented units of a recognised mutual fund	6/3/2012	25/6/2014	

In the Income Tax Act, there was no distinction between long term and short term capital gains. Every capital gain was treated alike. Subsequently, shares and listed securities were given a different treatment. The distinction, between long term capital gain and short term capital gain was not done only through indexing but also through different rates of taxation. A Securities

Transaction Tax (STT) has been introduced on transactions involving securities, carried out through any stock exchange. It is to be collected as a percentage of the sale value of the security. While the title bears the name securities, it applies only to transactions involving equity shares and derivatives listed on a stock exchange. It also applies to equity linked units of mutual funds. The rate of taxation is even lower if the transaction is subject to the STT. Thus, the head of capital gains has got segmented along many axes: long term and short term, securities and non-securities, shares and securities, and transactions subject to STT and other transactions. Thus, the head has effectively become four heads.

To facilitate the understanding of the subject, we will first study the provisions in relation to assets other than securities. Having grasped the different dimensions of the working of capital gains, we will explore the theme of capital gain in relation to securities. In focusing our attention on capital assets other than securities, we will need to introduce another limitation. Depreciable assets in a business are also capital assets. On the transfer of a depreciable asset, there would be an incidence of capital gain. As we would see in a subsequent chapter, capital gain arising from the transfer of depreciable assets is treated differently. This leaves us only with non-depreciable assets employed in business, for example, land and capital assets with individuals, like, land, house, gold and jewellery. Thus, our illustrations will be confined to these.

Illustration: Capital Gain

Rajesh bought a house for ₹ 6 lakh on August 11, 2005. He sold it off for ₹ 14 lakh on March 20, 2014. Calculate the capital gain.

The house was a long term capital asset, as it was held for longer than 36 months, that is, three years. The gain arising from the sale would thus, be a long term capital gain.

Indexed cost of acquisition = (939/497) × ₹ 6,00,000 = ₹ 11,33,602

Long Term Capital Gain = ₹ 14,00,000 – ₹ 11,33,602 = ₹ 2,66,398

Conceptually, the effect of indexing is to say that instead of buying the property, if Rajesh had protected the value of his money, its value would have been (939/497) * ₹ 6 lakh in 2013–14. This could then be compared with the money he got by actually converting the house into cash again, through the sale.

Illustration: Capital Gain

Jeet bought gold in November, 2011 for ₹ 1,24,000 and sold it off for ₹ 1,20,000 in February, 2014. He had to pay commission charges of ₹ 6,000 to a dealer. Calculate the capital gain.

Since the asset was held for less than 36 months, it is a short term capital gain and the cost of acquisition will not be indexed. Thus, capital gain is ₹ (1,20,000 – 6,000) – 1,24,000 = – ₹ 10,000. From a transfer of a capital asset, a person can make a gain or a loss. The income from all sources under each head would be aggregated to get the income under each head. The income under each head would be further aggregated to get the total income of the person. The Act has a separate chapter on aggregation.

Illustration: Capital Gain

Deep sold a house for ₹ 45 lakh in March, 2014. He had bought the house in August, 2002 for ₹ 14 lakh. In October, 2008, he bought a neighbouring plot of land, which became a part of the unit that he sold. He had bought the plot of land for ₹ 2 lakh. Calculate the capital gain.

Physically, the house, with the plot of land, is a single unit for dwelling. It is being sold through a single contract as a composite unit. However, the transaction transfers two different capital assets, as the assets were acquired at different times.

The indexed cost of acquisition of the first capital asset, that is, the house = ₹ 14,00,000 (939/447) = ₹ 29,40,940

The indexed cost of acquisition of the plot of land = ₹ 2,00,000 (939/582) = ₹ 3,22,680

Total indexed cost of the entire property = ₹ 25,76,242 + ₹ 3,09,256 = ₹ 28,85,498

Capital Gain = ₹ 45,00,000 – ₹ 42,63,620 = ₹ 2,36,682

Illustration: Capital Gain

Som bought a house in August, 2002, for ₹ 14 lakh. In October, 2011, he bought a neighbouring plot of land, which became a part of the dwelling unit. He bought the plot of land for ₹ 2 lakh. In February, 2014, he sold the entire dwelling unit and received ₹ 33 lakh. Calculate the capital gain.

There are two different capital assets sold through one transaction. Further, the first asset is a long term asset, while the second one is a short term capital asset. We would need to know the sale price of the two assets separately to be able to proceed. Taking the consideration for the house to be ₹ 27 lakh and that of the plot of land, ₹ 3 lakh, we would proceed as follows:

Long term capital gain = ₹ 30,00,000 – ₹ 14,00,000 (939/447) = ₹ 59,060

Short term capital gain = ₹ 3 lakh – ₹ 2 lakh = ₹ 1 lakh.

The two gains will have to be maintained separately as the rates for taxation applicable to the two are different.

Illustration: Capital Gain

Neil bought a flat for ₹ 20 lakh in October, 2005. In November, 2009, he renovated the house by putting floor tiles in the flat at a cost of ₹ 50,000. Neil sold the flat for ₹ 35 lakh in October, 2013. Calculate his capital gain.

In this case, there is only one capital asset, the flat. The flat is a long term capital asset. However, capital had been invested in the flat for improvement. Within the provisions, the cost of improvement is to indexed irrespective of when the improvement was taken up.

Indexed cost of the flat = ₹ 20,00,000 (939/497) = ₹ 37,78,672

Indexed cost of Improvement 1 = ₹ 50,000 (939/497) = ₹ 74,288

Cost of Improvement 2 = ₹ 30,000

Total indexed cost of the flat (including improvement) = ₹ 38,52,966

Long term capital gain = ₹ 35,00,000 – ₹ 38,52,960 = – ₹ 3,52,960

Thus, the person has suffered a long term capital loss. The Act has a separate chapter providing on adjustment of losses with gains under each of the heads. We will be taking it up in a subsequent chapter.

Illustration: Capital Gain

Rajesh bought a piece of jewellery for ₹ 1,000 in 1975–76. He sold it off for ₹ 15,000 on February 20, 2014. The fair market value of the jewellery in 1981-82 was ₹ 1,200. Calculate the capital gain.

The index to be used for the years preceding 1981–82 is the same as for the year 1981–82. However, the tax payer can take the actual cost or the fair market value of the asset in 1981–82. As the fair market value in 1981–82 is higher, Rajesh would settle for ₹ 1,200.

Long term capital gain = ₹ 15,000 – ₹ (939/100) 1,200 = – ₹ 3732

✦ Special Transactions

Having grasped the core aspects of capital gains, let us consider different kinds of transactions. A person buys a ring for ₹ 10,000 and gifts it to his niece on the same day, on her wedding. The ring was a short term asset in his hands. There is certainly a transfer of a capital asset to the niece. The person has sustained a capital loss of ₹ 10,000. The state would be uncomfortable with this outcome. If left unattended, everyone would claim to have made gifts to cook up capital losses. The capital losses would get aggregated with capital gains, depriving the state of its revenue. Consider the case where a company, X Limited, amalgamates with another company, Y Limited. X Limited transfers to Y Limited, a plot of land bought by it for ₹ 8 lakh, in 2005. There is a transfer of the land from X Limited to Y Limited, but in the course of it, X Limited ceases to exist. There can be no question of capital gain as the person has ceased to exist. In one sense, the company does not transfer the land, but is itself subsumed by Y Limited. Section 47 of the Income Tax Act disqualifies certain kinds of transactions from being 'transfer of capital assets'. It provides:

47. Transactions not regarded as transfer

...

(iii) any transfer of a capital asset under a gift or will or an irrevocable trust:

(iv) any transfer of a capital asset by a company to its subsidiary company, if— (a) the parent company or its nominees hold the whole of the share capital of the subsidiary company, and (b) the subsidiary company is an Indian company;

(v) any transfer of a capital asset by a subsidiary company to the holding company, if— (a) the whole of the share capital of the subsidiary company is held by the holding company, and (b) the holding company is an Indian company:

(vi) any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company;

Will and irrevocable trust are also forms of gift, where ownership moves without consideration from the other party. If allowed, the estate of the person making the will, or the person creating the trust, will claim capital loss. If irrevocable trust is taken to be a transfer, X can transfer property to Y for the benefit of his own son and claim it to be a capital loss. Thus, 'will' and 'trust' are clubbed with 'gift'. The concept underpinning Clauses (iv) and (v) is that a person cannot transfer to himself. If a subsidiary company is completely contained in the holding company, it becomes a case of a person dealing with oneself. In the case of an amalgamating company, the company does not transfer, but is subsumed by the amalgamated company. On the same lines, Section 46 provides that the partition of a joint Hindu family is not a transfer of capital assets. The reason is that a person gets to inherit what he jointly owned with others.

X buys a ring on April 6 for ₹ 5,000 and gifts it to Y on April 10. Y sells the ring for ₹ 8,000 on April 16. Y has transferred a capital asset and made a capital gain. What is the cost of acquisition of the capital asset for Y? Should we take it to be nil? After all, it was a gift. If the cost of acquisition for Y were to be nil, to be consistent, the gift should have been recognised as a transfer. X would have claimed capital loss and Y, a capital gain. The state would have got the tax on the balance between the gain and loss. The law recognises this. If there never was any transfer between X and Y, X and Y continue to be the same persons. Thus, the cost of acquisition for Y is taken to be the cost of acquisition of the asset by X. This is applied to all transactions that are disqualified as transfers under Section 47. Section 49 provides:

> … the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be.

As the cost of acquisition is the cost to the first person, to be consistent, the time reference for deciding whether the asset is a short term or long term capital asset, should also be the date of acquisition by the first person. The Act has provided for this. The definition of short term capital assets, in Section 2(42A), specifically mentions that in the above cases, under Section 47, where a transaction does not constitute a transfer, the time of acquisition of the asset is taken to be the time of acquisition by the earlier person. Further, to be consistent, the indexing should be done with reference to the year of acquisition by the first person. However, the wording of the law has not taken care of these special cases. The indexed cost of acquisition is defined as:

> (iii) "indexed cost of acquisition" means an amount which bears to the cost of acquisition the same proportion as Cost Inflation Index for the year in which the asset is transferred bears to the Cost Inflation Index for the first year in which the asset was held by the assessee or for the year beginning on the 1st day of April, 1981, whichever is later;

The term used is 'held' by the assessee. The assessee comes to hold the asset only when the gift is made or companies amalgamate. Thus, indexing should be done with reference to the year in which the gift was made or property moved to the amalgamated company. There have been debates and disputes over this issue. In Deputy Commissioner of Income-Tax v. Manjula J. Shah,[1] the Income Tax Appellate Tribunal, Mumbai Special Bench, extended the indexing to the time at which the donor came to hold the asset. The tribunal held that it is illogical to hold it otherwise. According to the Tribunal, a reading of all the provisions would bring it out that the legislative

[1] Deputy Commissioner of Income-Tax v. Manjula J. Shah, 2009 (318) ITR(AT) 417.

intent was to give the benefit of indexation and thus, it should be allowed. As it is a judgement of a tribunal, subject to appeal and revision, we would not take it as binding and follow the conservative position of indexing from the date the beneficiary came to hold the capital asset.

Illustration: Disqualification of Transfer

1. A person bought a house for ₹ 12 lakh in October, 2002 and gifted it to his son in November, 2011. The son sold the house to another person in February, 2014, for ₹ 20 lakh. The cost of acquisition for calculating the capital gain for the son would be taken to be ₹ 12 lakh. The son makes a long term capital gain. However, the indexing will be done with reference to the year in which he got the house, that is, 2011–12. Thus, long term capital gain = ₹ [20 – (939/785)12] lakh = ₹ 5,64,586.
2. X Private Limited is a 100% subsidiary of Y Limited. Both the companies are incorporated in India. A private company needs at least two shareholders. To create a fully owned (100%) subsidiary company, the holding company holds most of the shares. The other person(s) who hold the shares, do so as nominees of the holding company. Thus, the company becomes a 100% subsidiary company. X Private Limited had bought a plot of land for ₹ 20 lakh in 1998–99. It sold this to Y Limited for ₹ 22 lakh in July, 2012. Y limited sold it to Z Limited in January, 2014. The cost of acquisition for calculating capital gains for Y Limited will be taken to be ₹ 20 lakh. It is a case of long term capital gain. However, indexing will be done with reference to 2012-13.
3. B Limited amalgamated with C Limited in July, 2009. C Limited sold a plot of land for ₹ 50 lakh to Z Limited in February, 2014. The plot of land was bought by B Limited in August, 2002, for ₹ 30 lakh. In this situation, ₹ 30 lakh will be taken to be the cost of acquisition for C Limited. It is a long term asset. However, indexing will be done with reference to 2009–10.

Let us explore another special case. B is a dealer in paintings and artwork. He buys paintings from artists and sells them at his art gallery. The paintings in the gallery are stock-in-trade for B. The income and expenditure of B will be assessed under the head of business and income. Contrast his situation with that of C's, who collects paintings. A sale by C, of a painting from his collection, would be treated under the head of capital gains. Let us now combine the two.

Z was a collector of paintings. In 2007–08, he started dealing in paintings. He put his own collection for sale, and also bought new paintings for selling. In 2012–13, he sold three paintings from his own collection and 12 from the lot that he had bought after becoming a dealer. The collection of Z was a capital asset. The income arising from the 'transfer' should be assessed under the head of capital asset. When do we take the 'transfer' of the asset to have taken place — 2012–13 —when he sold the paintings? An alternate construction can be that he transferred these paintings in 2007–08, to his own business. A person cannot sell to himself. However, the Income Tax Act specifically provides that the transfer is deemed to take place at the time of conversion, at a fair market value. However, the tax is to be paid in the year the asset is actually sold. Section 45(2) provides:

(2) … the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him as stock-in-trade of a business carried on by him shall be chargeable to income-tax as his income of the previous year in which such stock-in-trade is sold or otherwise transferred by him and, for the purposes of Section 48, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

Completion of Transfer

The transfer of a capital asset is crucial for an incidence of capital gain to arise. Only where there is a transfer, there would be a capital gain that would be taxable. The second relevance of ascertaining transfer is that the capital gain would be charged to tax in the previous year the 'transfer' takes place. Let us decide the point at which the transfer takes place in the following different arrangements between the parties:

Case 1: X enters into a contract with Y to sell a particular gold ring for ₹ 10,000 on March 15. According to the contract, Y pays the full price on March 20 and X delivers the ring on April 5.

Case 2: X enters into a contract with Y to sell a particular gold ring for ₹ 10,000 on March 15. According to the contract, X delivers the ring on March 20 and Y pays the money on April 5.

Case 3: X enters into a contract with Y to sell a particular gold ring for ₹ 10,000 on March 15. The contract does not provide on the transfer of ownership. In the case of a sale of a specific good, where the parties do not provide the time for transfer of ownership, ownership transfers when the contract is made. Thus, the ownership of the ring transfers to Y on March 15, but the ring is delivered on April 5. Does the transfer take place in March or in April?

In the context of capital gains, 'transfer' seems to refer to the delivery of the goods. However, the delivery is in relation to a sale, where the ownership has to move from the seller to the buyer. The courts combine the two positions to maintain that a moveable capital asset is transferred when it is delivered towards the performance of a contract of sale. The sale of an immovable property (land and building), however, involves more steps. The law does not recognise change of ownership of an immovable property unless the sale is registered with the Registrar of Records. Thus, while a contract for the sale of an immovable property can be made orally, for its performance, the parties have to record the sale in writing and sign it. This is called 'execution of the sale deed'. The signed document then has to be registered with the Registrar of Records. Only after registration, would the administration change the name of the owner and recognise the new owner. In the records of the government, the ownership passes only after the registration. However, subsequent to the registration, the transfer is deemed to have taken place at the time of execution (signing the sale contract). The reason for this circuitous position is thus explained in Commissioner of Income Tax v. Ghaziabad Engineering Company Private Limited:[2]

The question that emerges for consideration is as to on which date the transfer became operative. It is well established that a document so long as it is not registered is not valid, yet once it is registered, it takes effect from the date of its execution. Section 47 of the Indian Registration Act, 1908, provides that a registered document shall operate from the date it would have commenced to operate if no registration thereof had been required or made and not from the date of its registration.

[2] Commissioner of Income Tax v. Ghaziabad Engineering Company Private Limited, 2001 (249) ITR 244.

Further, following a written contract, if the buyer has paid the price and taken the possession of the property, the asset is deemed to have been transferred, even if it is not registered. The position comes from the decision of the Supreme Court in Alapati Venkataramiah v. Commissioner of Income-tax, Hyderabad.[3]

Review Cases

Case 1: X bought gold for ₹ 50,000 on July 5, 2012 and sold it off for ₹ 60,000 on July 20, 2014. Calculate the capital gain on the transfer.

Case 2: X bought gold for ₹ 50,000 on July 5, 2008 and sold it off for ₹ 60,000 on July 20, 2014. Calculate the capital gain on the transfer.

Case 3: A person bought a house on October 6, 2007, for ₹ 21 lakh. He had to spend ₹ 40,000 towards lawyer's fee for drafting the sale agreement and ₹ 1.6 lakh for registration. He sold the house on July 20, 2014 for ₹ 26 lakh. He paid ₹ 50,000 as lawyer's charges for the sale deed and ₹ 1.5 lakh towards registration charges. The real estate broker charged him ₹ 40,000 for finding a buyer. Calculate the capital gain.

Case 4: A person bought a house for ₹ 12 lakh on June 6, 2006. He constructed an additional room in the house at a cost of ₹ 1 lakh in October 2007. In November, 2009, he spent ₹ 40,000 for putting a new roof on the house. In October, 2012, he spent ₹ 60,000 for putting new floor tiles. He sold the house on July 20, 2014, for ₹ 18 lakh. Calculate the capital gain for the person.

Case 5: X Ltd. acquired a flat for ₹ 5 lakh on June 2010. It transferred the flat to its fully owned subsidiary, Y Ltd., on November, 2012. Y Ltd. sold the flat for ₹ 8 lakh on July 20, 2014. Calculate the capital gain for Y Ltd.

Case 6: Neil bought a piece of jewellery for ₹ 1,000 in 1977–78. He gifted it to his daughter in 1985–86. The daughter sold the jewellery for ₹ 10,000 on June 20, 2014. The fair market value of the jewellery in 1981–82 was ₹ 900. Calculate the capital gain for the daughter.

Case 7: Deep was a collector of paintings. He became an art dealer in 2010–11 and converted the following three paintings to his stock-in-trade on December 12, 2010. The details of the three paintings were as follows:

Painting 1: Acquired on Nov 20, 2006, for ₹ 70,000

Painting 2: Acquired on October 25, 2008, for ₹ 60,000

Painting 3: Acquired on December 10, 2009, for ₹ 50,000

He sold Painting 1 for ₹ 90,000 on June 5, 2014, and Painting 3 for ₹ 80,000 on July 10, 2014. Painting 2 remains unsold. The fair value of Painting 1 in 2010–11 was ₹ 75,000 and that of Painting 3 was ₹ 54,000. Calculate the capital gain for Deep.

---

[3] Alapati Venkataramiah v. Commissioner of Income-tax, Hyderabad, AIR 1966 SC 115.

Case 8: B Limited, engaged in the manufacturing of plastic wares, owned a flat. The flat was bought on December 3, 2008, for ₹ 16 lakh. It was rented out at the same time. The company amalgamated with C Limited on February 18, 2014. C Limited sold the flat for ₹ 20 lakh on June 22, 2014. Calculate the capital gain for C Limited.

9
CHAPTER

Capital Gains: Securities

The definition of capital asset includes all property. Thus, shares, debentures, bonds and units of mutual funds are capital assets. Further, shares listed on recognised stock exchange held for one year become long term assets as opposed to the requirement of three years in the case of other assets. Listed debentures and equity oriented units of recognised mutual funds also become long term assets if held for more than one year. Securities are different from other kinds of assets. These are not tangible property, but they create a right.

A reference to securities and securities market suggests complexity. There are many kinds of securities—shares, equity shares, preference shares, debentures, bonds and units of mutual funds. Unless specifically declared to be a preference share, a share denotes an equity share. An instrument can be bought from the primary market or the secondary market. A transaction can take place through a recognised stock exchange or without it. Derivatives and futures are some of the terms associated with securities. The other terms associated with securities are brokers, depositories and dematerialisation. The securities market is heavily regulated by the law. The key regulator is the Securities Exchange Board of India, known by its abbreviated name, SEBI. As a result, a security transaction appears complex and incomprehensible to most.

The complexities should not come in our way of understanding and exploring these transactions in relation to capital gains. Some of the questions that arise are: Is a particular security a capital asset? When and at what cost is it deemed to be acquired? When and for what price is it deemed to have been transferred by the owner? Let us first explore the theme in relation to shares, the capital of a company.

✦ Company and Shares

A person employs ₹ 10 lakh of his own money to start a taxi service. He hires a driver at a monthly salary of ₹ 10,000. He also takes a loan of ₹ 6 lakh, which has to be returned in a year along with an interest of ₹ 60,000. Even if the business fails, he has to pay the salary and return the money with interest to the bank. And if the business does well, the employee cannot demand a higher salary and the bank, a higher interest. What the person brings to the business is the capital. He bears the risk of the business failing or the capital yielding profits. Equity is the capital of a company as distinct from loans. A ‘share’ is a share of this capital.

Company law, like other business law, emerged from practices. Traders pooled their capital to do business. This became a partnership. When a large number of traders conglomerated their capital, several issues arose. If a trader wished to withdraw his/her share of capital, there was no point in bringing the conglomeration to an end. The interest of the others was best served by letting the trader sell his interest in the conglomeration to another person. Thus, a conglomeration once formed, tended to exist in perpetuity and became an entity on its own. Moving in and out of the capital of the individual members was facilitated by breaking the capital in the conglomeration into smaller units. The unit came to be called an equity share. As the number of the capital contributors became larger and larger, an intermediate body, the board of directors, emerged to manage the business on their behalf. The capital contributors retained control over the conglomeration through periodic meetings, which came to be called 'General Meetings'. The state assimilated the features of these practices and enacted the company law.

The Companies Act, 1956, governs the formation and management of companies in India. Persons desiring to form a company can sign a memorandum of association and articles of association and register a company with the Registrar of Companies. The Registrar issues a certificate of incorporation. The certificate indicates the birth of the new entity, the company. The memorandum of association, among other details, contains the name of the company and the share capital of the company. The subscribers to the memorandum of association are required to foresee the amount of capital they would need for the business. The memorandum of association also has to break up the capital into shares by fixing a denomination to a share. The capital listed in the memorandum of association is the authorised share capital of the company. After incorporation, the company can issue shares to persons and collect money. Of course, the company, as an issuer, would like to issue the shares at a price higher than the face value of the shares. Through this exercise, the company would raise capital for its business and the shareholder acquires a share (capital asset). A share gives the owner a right to receive dividends and participate in the general meetings held to discuss issues about the management of the company. The cost of acquisition of such an asset is the total amount spent, including the price paid to the company, for acquiring the asset.

The Companies Act provides for two kinds of companies, private companies and public companies. The purpose of a public company is to conglomerate capital. For this, it is required to approach a large number of people and issue shares to raise capital. However, as the public entrusts its money, the raising of money as well as the working of the company has to be regulated. On the other hand, to provide an organisational form to family and small businesses, the Companies Act provides for private companies as well. A private company would not raise capital from the public and keep the capital contributors to a small number. Such a company would not be subjected to elaborate requirements of the law.

As a company is a conglomeration of capital, it is natural that capital would move in and out of a company and shares would change hands. To facilitate this, companies started issuing share certificates to the owners of the shares in the company. Like for any other commodity, markets developed where people could buy and sell shares. These markets came to be known as the stock exchanges. Some persons developed specialisation in the buying and selling of shares.

They became the stockbrokers, who acted as agents of the buyers and sellers, and bound their principals into contracts. The state came to stringently regulate this market. In India, regulation happens through the Companies Act and the Securities Exchange Board of India, created under an Act of the same name.

Share and Share Certificate

A company is registered with an authorised share capital, which is broken into shares of a specific denomination. The authorised share capital is also called the registered capital or nominal share capital of the company. A company issues shares as and when it wants additional capital. A public company can raise money by soliciting subscriptions from the public as well as by privately negotiating with parties. A private company can raise capital only through privately placing its shares or getting them subscribed. The issue of a share is a contract between the company and the subscriber, where the subscriber acquires the right of being a shareholder and pays the price for it to the company. The cost of acquisition of the capital asset is the cost the subscriber incurred to get the share. When a public company issues a share, it is called the primary market.

The shares of a company are numbered as units, starting from one. Each subscriber gets shares identifiable by their respective numbers. The subscribers are given share certificates indicating their names and the number of shares held by them. A share certificate is not issued for each share. If it were so, large shareholders would have to deal with tons of paper. A certificate is issued for an optimum number of shares, keeping in view the requirements of trading in shares.

A share certificate is not a property in itself, but only a documentary evidence of the share in the company. The property is the right to receive dividends from the company (when declared) and participate in the general meetings of the company. A company can issue dividends to the shareholders if it makes profits. A company can issue two kinds of shares, equity shares and preference shares. A preference share is in contrast and in 'preference' to an equity share. A preference shareholder has to be preferred over the equity shareholders during the paying of dividend. A preference share specifies a minimum dividend. In other words, if a company decides to pay dividend, it would first pay the preference shareholders. However, preference shareholders have limited rights of participation in the management of the company. In contrast to the equity and preference shares of the company are the borrowings of the company.

A share is acquired first on allotment. A subscriber pays the money and is issued a share. A share, once acquired, is a movable property like any other movable property, and thus, is transferable. A property can be transferred through different means. The owner of the property can sell it to another person. This would be transfer through contract. On the death of the owner, the heirs succeed to the property. This happens in accordance with the personal law applicable to the owner. The owner of a property can write a will as to who would inherit the property on his/her death.

A share is different from other properties, however, in one respect. It is a right in relation to a company. The company would not get to know of the transfer unless informed. The Companies Act requires the seller to hand over the shares with a signed transfer form, which gives the details of the buyer, seller and the shares. The buyer surrenders the shares with the transfer form to the company, requesting the company to enlist the buyer in the list of members of the company. The company enters the buyer's name as the owner of the shares and issues a share certificate in his name. In the case of inheritance through succession or will, the person applies to the company with documentary evidence of his right to succeed. The company enters the person's name in the register of members and issues a share certificate in his name. The company gives dividend to the person in whose name the shares are registered. Similarly, the company invites persons whose names are in the register of members, for its general meetings.

Most of the share transactions are done through stockbrokers. In this, both, the buyer and the seller, contract through their agents, the stockbrokers. The seller's stockbroker hands over the share certificate and transfer form to the stockbroker who has contracted to buy the shares and receives cash from the buyer.

A capital asset is a long term or a short term asset depending on whether it is held for longer than a year or not. An interesting question that arises in the present context is: when can we say that the 'transfer' of a share is complete — when the contract is performed by the seller by handing over of the share certificates along with the transfer order, or when the company registers the name of the buyer. There will always be a time gap between the two. Further, a company may not register the buyer's name at all if the articles of association do not allow it. In that case, the company will continue to recognise the original shareholder. However, as the shareholder has sold his property, he receives the benefits from the company as a trustee for the buyer. He will need to pass on the dividends to the buyer and would act for him in the general body meeting. Thus, the 'transfer' happens when the share certificates, with the transfer form, are handed over.

As mentioned earlier, stock exchanges emerged as the market where securities could be traded. The Securities Contracts (Regulation) Act, 1956, licenses and regulates the working of stock exchanges. A stock exchange can be created and made functional only after receiving recognition from the government. Currently, there are about 20 recognised stock exchanges in India. Some examples of recognised stock exchanges are: Bombay Stock Exchange Limited; OTC Exchange of India; National Stock Exchange of India Ltd.; Calcutta Stock Exchange Association, Calcutta; Madras Stock Exchange Ltd., Madras; The Ahmedabad Stock Exchange Association Limited, Ahmedabad; The Delhi Stock Exchange Association Ltd., New Delhi; Vadodara Stock Exchange Ltd., Vadodara; and Madhya Pradesh Stock Exchange Ltd., Indore.

As we know, only public companies can raise money from the public. Before a company can raise money from the public, it has to get the shares to be allotted listed on at least one recognised stock exchange. Listing on a stock exchange is not automatic. Each stock exchange has its own list of criteria for listing a company and its shares. A company has to apply to a stock exchange for the listing of its shares. If successful, it is said that the shares of a company are 'listed' on that particular stock exchange.

Earlier, the stockbrokers physically converged and traded on the floor of the exchange. The development of the electronic medium has made it possible to sell and purchase shares from any location, through online facilities. As a result, the stock exchanges that made use of the electronic facility first, i.e., the Bombay Stock Exchange Limited; the OTC Exchange of India; and the National Stock Exchange of India Ltd., flourished while the other exchanges decayed. For our purposes, whether a seller communicates with the buyer face to face, or through stockbrokers, through an electronic grid, it would remain a contract where the seller transfers a capital asset to the buyer.

To complete our discussion on the theme of shares, let us become familiar with some additional terms. 'Primary market' refers to the company allotting shares to the subscribers. In contrast, a stock exchange is the secondary market. Bonus shares are the allotment of shares to the existing shareholders, without charging them for it. A company allots bonus shares from its profits or reserves, instead of declaring dividends. Rights shares are allotted to the existing shareholders, at a concessional price.

✦ Debentures

'Debenture' is an instrument by which companies raise loans. The term 'debenture' means acknowledgement of a debt. It can have many forms. In its popular form, a company puts out debentures for the public to buy. A company interested in raising a loan from the public, breaks up the total amount of the loan to be raised into smaller units. The company invites the public to offer to buy the debentures. The face value of debentures in India is usually ₹ 100. The company would certify the loan by issuing debentures, mentioning the number of units bought and the total amount loaned. A debenture is in the form of a certificate. It usually provides for the payment of the principal at a specified date. Interest can be paid annually, half yearly, quarterly or on maturity. The certificate would specify the details.

Both, shareholders and debenture holders, invest their money in the company and get returns on their investments. However, there are several differences between the two. One, a shareholder is a member of the company and enjoys all the rights of membership, for example, the right to participate and vote in the general meetings of the company, while a debenture holder is only a creditor of the company. Two, the debenture holders are entitled to a fixed rate of interest mentioned in the instrument, whether there are profits or not. In contrast, a shareholder is paid dividend only out of the profits of the company. Third, the company pays back the debenture holder his/her principal. However, the company is not obliged to pay back the capital of a shareholder, though the company may resort to a buy-back of its shares out of its reserves, so as to reduce its capital base. Only in the case of winding-up, does the shareholder get a share of the residual capital, after all the other claims have been met.

Debentures can also be listed on stock exchanges. A person who has invested in debentures may need liquidity and a person with surplus cash might want to invest. The changing rates of interest on capital and the anticipation of changes in the interest rates create the basis for trading in debentures. Listing debentures on the stock exchange facilitates trading. A bond is like a debenture. It is also an instrument through which a loan is taken and debt acknowledged. In India, it has come to be associated with long term debt raised by the central and state governments and by public sector organisations. Another instrument through which a loan can be raised is a zero coupon bond, also known as a deep discount bond. A zero coupon bond is issued at a discounted face value. For example, a four year zero coupon bond of face value ₹ 100 may be issued at ₹ 70. The holder will not be paid period interest, but can claim the face value of ₹ 100 on maturity.

✦ Mutual Fund

A small investor has neither the knowledge nor the capital to gainfully invest in equity. Investment in a company or two would expose the investor to the risk of the companies failing. To create a portfolio of 40–50 companies needs a large capital and specialised knowledge. 'Mutual funds' have bridged this gap. A mutual fund company creates a specific mutual fund. The fund mobilises money from the public. The company then invests this fund in a portfolio of equities. The dividend and capital gains from the investment accrues to the fund and the fund grows. The subscriber participates by acquiring units in the fund. The net value of the fund, after the company has deducted its administrative charges, belongs to the unit holders.

Mutual fund companies have a wide array of funds (products). Some funds are mandated to be invested only in the equity of companies. Others can be invested only in debt instruments, like debentures and bonds. Yet others can be invested in equity as well as debt, but in a specified ratio, say 60% in equity and 40% in debt. A mutual fund may have declared that it would invest only in some kinds of companies or sectors, for example, blue chip companies, pharma sector companies, infrastructure companies and information technology companies. An investor receives dividend, if the fund earns profits and the company declares a dividend. A mutual fund company periodically declares the 'net asset value' (NAV) of a unit of the fund. A person can buy a unit by paying the NAV to the company. Later, a unit holder can redeem his units from the company. There is no mechanism for trading in the units of a mutual fund. A unit holder acquires the capital asset from the mutual fund company when he buys it and transfers the capital asset back to the company when he sells it to the mutual fund.

The mutual fund business is controlled and regulated by SEBI. A mutual fund business can be started only after obtaining licence and permission from SEBI. The first mutual fund in India, though it was not known by the name, 'mutual fund', was created by the Unit Trust of India, a body created by an act of the Parliament. The Unit Trust of India follows the same arrangement of selling units to the subscribers and redeeming those units as discussed above. As the Unit Trust of India was created by the Parliament and is controlled by the government, there has been no need to bring it under the supervision of the SEBI.

'Securities' is an all inclusive term. The Securities Contracts (Regulation) Act, 1956 defines it to include shares, scripts, bonds, debentures, or other marketable securities of a like nature. In addition, it includes government securities, even if these are not marketable. Thus, shares, debentures, bonds, government securities and units of mutual funds are securities. We can now revisit the definition of short term capital gains. Section 2(42A) provides:

> **Section 2(42A) "short-term capital asset"** means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer.
>
> Provided that in the case of a share held in a company or any other security listed in a recognised stock exchange in India or a unit of the Unit Trust of India or a unit of an equity oriented fund … the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted. …

Case: Long Term and Short Term Capital Assets

The following assets were held for 13 months. That is, the period between the acquisition and the transfer of the assets was 13 months. Identify whether each of the following assets is a long term asset or short term asset.

S. No.	*Particulars of asset*	*Long Term/Short Term*
1	Equity share of a private company	
2	Unlisted equity share of a public company	
3	Listed equity share of a public company	
4	Unlisted debenture	
5	Equity oriented unit of a mutual fund	
6	Listed debenture	
7	Unlisted government security	
8	Unlisted preference shares of a public company	
9	Listed preference shares of a company	
10	Unlisted zero coupon bond	
11	Equity share of a company incorporated in the UK	
12	Debenture of a company incorporated in the UK and traded only on stock exchanges in the UK	

The definition of short term capital assets uses the term 'shares held in a company'. Thus, all shares, equity or preference, in private or public companies, are long term assets if held for longer than a year. The shares may be of a company incorporated in India or in another country. In the case of other securities, that is, debentures and bonds, if the security is listed on a recognised stock exchange in India, the security will be held to be a long term asset on being held for longer than one year. The law can be expressed in the following tabular form:

S. No.	*Security*	*Listing*
1.	Equity and preference shares in a company	Both, listed and unlisted
2.	Other securities, like debentures, bonds, government securities	Only if listed on a recognised exchange
3.	Unit of UTI	Both, listed and unlisted
4.	Unit of mutual fund	Both, listed and unlisted

The definition of short term capital assets uses the term a security (other than a unit) listed in a stock exchange in India. Thus, all listed shares, are long term assets if held for longer than a year. The shares may be of a company incorporated in India or in another country. The law can be expressed in the following tabular form:

S. No.	*Security*	*Listing*
1.	Equity and preference shares or other securities like debentures, bonds and government securities.	Only if listed on a stock exchange in India
2.	Unit of UTI	Both, listed and unlisted
3.	Equity oriented unit of mutual fund	Both, listed and unlisted

We need to note at this stage that Section 48 provides that for a 'long-term capital asset being bond or debenture other than capital indexed bonds issued by the Government', the owner cannot index the cost of acquisition. The rates of taxation for long term capital gains and short term capital gains are different. Thus, long term capital assets in the form of bonds and debentures will not have the benefit of indexing but will be charged capital gains tax at a lower rate.

✦ Securities Transaction Tax and Tax Exemption

The Income Tax Act provides for a Securities Transaction Tax (STT), to be charged on transactions of securities done through recognised stock exchanges. The tax is charged by the stock exchanges as a prescribed percentage of the sale value. The reason for the introduction of this tax was that the government could not control the evasion of taxes on capital gains. It was left for the seller to report the capital gain and pay the tax on it. The STT, on the other hand, could be collected at the time of the transaction itself, on the value of the sale, and be a substitute for the capital gain tax. Most capital gains arise in relation to equity shares. Debentures and bonds yield interest. Thus, there is no significant capital gain in transactions involving debentures and bonds. Similarly, preference shares are closer to debt instruments. As a result, while the title of the tax is 'Securities Transaction Tax', it has been applied to equity shares and to equity linked units of mutual funds. As a tax is already charged from the persons transferring these capital assets, the Income Tax Act makes exemptions and rebates in capital gains arising through transactions for which STT has been paid. A transaction of equity shares through an exchange means that the STT has necessarily been charged. Similarly, redemption of the units of a mutual fund takes place only after paying the STT. We would recall that Section 10 of the Act exempts income from these sources from the application of the Act. Section 10(38) provides:

> (38) any income arising from the transfer of a long-term capital asset, being an equity share in a company or a unit of an equity oriented fund where— … such transaction is chargeable to securities transaction tax under that Chapter.
>
> Explanation—For the purposes of this clause, "equity oriented fund" means a fund … where the investible funds are invested by way of equity shares in domestic companies to the extent of more than sixty-five per cent of the total proceeds of such fund …

Case: Exemption of Long Term Equity Linked Securities

The following securities are long term capital assets. Decide for each asset whether it is exempt from taxation under Section 10(38), or not:

S. No.	*Securities: Long Term Capital Assets*	*Exempt Yes/No*
1.	Equity share of a private company	
2.	Unlisted equity share of a public company	
3.	Listed equity share of a public company sold through a stock exchange	
4.	Listed debenture sold through a stock exchange	
5.	Unit of an equity linked mutual fund	
6.	Listed equity share of a public company sold without going through a stock exchange	
7.	Listed preference shares of a company sold through a stock exchange	
8.	Unit of a mutual fund that had invested 50% of its funds in equity and 50% in debt instruments	

The exemption is available only for 'equity' shares transacted through a stock exchange. Thus, the exemption is not available for preference shares. Similarly, it is not available for debt instruments, like debentures and bonds. However, it is available for equity linked mutual funds.

Illustration: Equity Shares

X purchased equity shares of a public company listed on a recognised stock exchange, through a broker, in April, 2013, for ₹ 50,000. The shares were sold off in July, 2014, for ₹ 70,000, through a broker. Calculate the capital gains.

The shares of a company, whether private or public, are long term capital assets, if held for more than one year. Thus, the asset is a long term capital asset. The shares were sold through a recognised stock exchange. The Securities Transaction Tax (STT) is charged on all equity share transactions done through a recognised stock exchange. Under Section 10(38), a long term capital asset on which STT has been paid, is exempt. Thus, the income is completely out of the ambit of the Income Tax Act and no tax is payable on the amount.

Illustration: Equity Shares

X purchased equity shares of a private company in December, 2012, for ₹ 30,000. The shares were sold off in February, 2014, for ₹ 50,000. Calculate the capital gains.

The shares are a short term asset for X. The shares of a private company cannot be listed on a stock exchange. Thus, there is no question of the transaction being done through a stock exchange. As a result, the income is not exempt from taxation. As it is a long term capital asset, the cost of acquisition will not be indexed.

Short term capital gain = ₹ 50,000 – ₹ 30,000 = ₹ 20,000

Illustration: Equity Shares

X Ltd. purchased equity shares of a public company listed on a recognised stock exchange, for ₹ 40,000, in April, 2012. The company sold the shares to a business associate directly, for ₹ 60,000 in March, 2014. Calculate the capital gain.

As the shares were held for longer than a year, the asset is a long term capital asset. The shares are listed on a recognised stock exchange. However, the shares were not sold through a stock exchange and STT was not paid. Thus, the capital gain is not exempted under Section 10(38).

Long term capital gain = ₹ [60,000 – 40,000(939/852)] = ₹ 15,915

Illustration: Equity Shares

X purchased equity shares of a public company listed on a recognised stock exchange, through a broker, in October, 2013, for ₹ 50,000. The shares were sold off in July, 2014, for ₹ 70,000, through a broker. Calculate the capital gains.

The shares are a short term capital asset. STT has been charged on the transaction. However, only long term capital gain is exempt from taxation. Thus, the short term capital gain is ₹ 20,000.

Illustration: Preference Shares

X purchased preference shares of a company listed on a recognised stock, in May, 2012, for ₹ 30,000. The shares were sold off in February, 2014, for ₹ 50,000. Calculate the capital gains.

The shares are a long term asset for X. The transaction was done through a stock exchange. However, STT is not charged on preference shares. Further, Section 10(38) exempts only equity shares and not preference shares. Thus, there is a long term capital gain.

Long term capital gain = ₹ [50,000 – 30,000(939/852)] = ₹ 16,937

Illustration: Units of Mutual Fund

X purchased units of an equity linked mutual fund in May, 2012, for ₹ 90,000. The fund had invested 90% of its funds in equity. The units were redeemed in June, 2014, for ₹ 1,10,000. Calculate the capital gains.

The units are a long term capital asset. As the units are equity linked, the capital gain is exempted under Section 10(38).

Case: Share Transaction

Duke Limited purchased 60 equity shares of a company listed on the National Stock Exchange, in April, 2013, for ₹ 2,000 a share. The company sold the shares as indicated below:

1. 10 shares were sold in February, 2014, for ₹ 2,500 each. The transaction was done through a stock broker and the securities transaction tax was paid.
2. 10 shares were sold in March, 2014, for ₹ 2,300 each. The transaction was done off-market and as a result, the securities transaction tax was not paid.
3. 20 shares were sold in June, 2014, for ₹ 2,500 each. The transaction was done through a stock broker and the securities transaction tax was paid.
4. 20 shares were sold in July, 2014, for ₹ 2,300 each. The transaction was done off-market and as a result, securities transaction tax was not paid.

Calculate the capital gain for each transaction and indicate whether the special reduced rate or the normal rate would be applicable to the transactions.

Case: Share Transaction

A person sold 100 equity shares of a company, listed on the NSE, on February 20, 2014, at the rate of ₹ 500 per share. He had bought 50 shares on July 15, 2013, at the rate of ₹ 40 per share. The other 50 shares were bought on December 15, 2012, at the rate of ₹ 30 per share. Calculate the capital gain for the person.

Case: Share Transaction

Anagram Office Equipment Limited acquired 1,000 listed equity shares of a company at a cost of ₹ 5 lakh, in November, 2005. The company allotted one bonus share for every 2 shares held, in March, 2010. Anagram Office Equipment Limited sold 200 of the original shares and 300 bonus shares in July, 2014. The sale was done through a stock exchange and STT was paid. Determine the capital gain for Anagram Office Equipment Limited.

Case: Share Transaction

A person got an allotment of 100 shares during the initial public offer of a company, in December, 1998, for ₹ 40,000. The company allotted him 100 bonus shares in June, 2005. Another 200 bonus shares were allotted to him in June, 2012. The person sold all the shares of the company in February, 2014, at the rate of ₹ 50 per share. The sale was done through a stock exchange and STT was paid. Determine the capital gain for the person.

Case: Share Transaction

A person got an allotment of 100 shares during the initial public offer of a company, in December, 1998, for ₹ 40,000. The company allotted him 100 rights shares in June, 2005, for ₹ 50 a share. The fair market price of each share at that time was ₹ 55. The company allotted him 200 bonus shares in June, 2012. The person sold all the shares of the company in February, 2014, at the rate of ₹ 50 a share. The sale was done through a stock exchange and STT was paid. Determine the capital gain for the person.

✦ Special Transactions

In an earlier chapter, we had noted that under Section 47, several transactions which otherwise meet the definition of a transfer, are not taken to be transfer for the purposes of capital gains. We have reproduced the excerpted part of Section 47 below:

47. Transactions not regarded as transfer

...

(iii) any transfer of a capital asset under a gift or will or an irrevocable trust:

(iv) any transfer of a capital asset by a company to its subsidiary company, if— (a) the parent company or its nominees hold the whole of the share capital of the subsidiary company, and (b) the subsidiary company is an Indian company;

(v) any transfer of a capital asset by a subsidiary company to the holding company, if— (a) the whole of the share capital of the subsidiary company is held by the holding company, and (b) the holding company is an Indian company:

(vi) any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company;

(vii) any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if— (a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company, and (b) the amalgamated company is an Indian company;

All the above provisions apply to capital assets, including shares. However, Section 47(vii) applies only to shares and not to other securities or capital assets. When a company amalgamates with another, the company ceases to exist. A share in a company that does not exist, is meaningless. The property of the shareholder ought to be reflected as a property in the company with which the amalgamation has taken place. Thus, the existing shares are extinguished and new shares are allotted. The section does not consider this to be a transfer. Section 49(2) provides the corresponding provision in relation to the cost of acquisition. The 'amalgamating company' is the one which is going to get subsumed in the 'amalgamated company'. The section reads:

(2) Where the capital asset being a share or shares in an amalgamated company, which is an Indian company, became the property of the assessee in consideration of a transfer referred to in clause (vii) of Section 47, the cost of acquisition of the asset shall be deemed to be the cost of acquisition to him of the share or shares in the amalgamating company.

Illustration: Gift of Shares

A person bought shares in a company listed on a recognised stock exchange, for ₹ 1 lakh, on July 5, 2012. He gifted it to his son on June 10, 2013. The son sold the shares for ₹ 1.5 lakh, on July 15, 2014. The shares were sold through a stock exchange. The gift is not a transfer. However, a transfer does take place when the son sells the shares. The period of holding the asset will be taken to be the period starting from the time the father acquired the asset. Thus, the asset is a long term asset. As STT has been paid on the transaction, the capital gain is exempt from taxation.

Illustration: Amalgamation

X Limited amalgamated with Y Ltd. X Limited owned shares, debentures and units of mutual funds. In the course of amalgamation, Y Limited became the owner of the securities. Y Limited sold the securities a year later. The acquisition of the shares by Y Limited from X Limited is not a transfer. The transfer takes place when Y Limited sells the securities. The period of holding the assets by Y Limited will be taken to begin from the time X Limited came to acquire the assets. The cost of acquisition will be the cost X Limited had to incur to acquire the shares.

Illustration: Shares in Amalgamated Company

C bought 100 shares of X Limited, for ₹ 10,000 on October 6, 2011. X Limited amalgamated with Z Limited in 2012. In lieu of his shares in X Limited, C received 50 shares in Z Limited, on February 6, 2013. C sold the shares on July 20, 2014, through a stock exchange. The cost of acquisition of the shares will be taken as ₹ 10,000. Also, the period of holding will be taken to start from the time the shares were acquired in the amalgamating company, that is, October 6, 2011. As the STT has been paid, the long term capital gain is exempt from taxation.

Case: Shares

C bought 100 shares of X Limited, for ₹ 20,000, on October 6, 2009. C received 50 bonus shares on February 15, 2010. X Limited amalgamated with Z Limited in 2012. In lieu of his shares in X Limited, C received 70 shares in Z Limited, on March 6, 2013. C sold the shares on July 20, 2014, through a stock exchange for ₹ 50,000. Calculate the capital gain for C.

✦ Dematerialised Securities

We can now take note of the significance of 'dematerialised securities'. The issuance of securities and their transfer involves a lot of paper work. In the case of shares, the transfer has to be registered with the company. This leads to delays in registration. It also creates possibilities for fraud and malpractices. Like many other fields, this was a field where the electronic medium could facilitate the process. This opportunity was identified and taken advantage of through the Depositories Act, 1996. This Act provides for the formation of depositories. Depositories are like banks, holding shares, debentures, bonds and units of the owners in an electronic form. A depository deals with its customers only through agents called Depository Participants (DPs). Several banks have formed subsidiary companies to become DPs. A customer opens an account with a DP, in much the same way as one opens an account with a branch of a bank.

Let us explore the working of the depositories in relation to shares. A shareholder can get a credit of shares in his account by 'dematerialisation.' The account holder applies to the DP for the conversion of physical share certificates into the electronic form. The physical shares are surrendered to the DP. The DP, in communication with the company, replaces the share certificates with an electronic record of membership. This is called dematerialisation. Similarly, an investor can apply for allotment in dematerialised form. In this case, the company will credit shares in the account as opposed to mailing a share certificate.

An account holder can sell shares or gift shares to another account holder by submitting a form to his DP, instructing it to transfer the specified shares to the specified account. The depositories, DPs, stockbrokers and companies are electronically connected with each other. All the parties are regulated by the SEBI. While buying shares through a stockbroker, the buyer gets a credit of the shares, through the account of the stockbroker, rather than receiving the physical share certificates. Dematerialisation, undoubtedly, has made the process of transfer of shares efficient. It has also brought about some conceptual challenges. These relate to the time of acquisition of shares. We can understand this by first exploring transfer of shares in the physical form.

X enters into an agreement to sell 20 shares of a company for ₹ 10,000 to Y. The capital asset is transferred when X delivers the share certificates, along with a transfer form. The share certificate and shares are different. The capital of the company is broken into shares of a given face value. Each share is numbered from 1 onwards. A share certificate would be a record of ownership of multiple shares. For example, X may hold a share certificate documenting ownership of the share numbers 181 to 190 and another share certificate bearing numbers 191 to 200. X would give both the certificates to total the number of shares transferred to 20. Thus, Y would become the owner of 20 specific shares, numbering 181 to 200.

A share is a right in relation to the company. The company will take note of the transaction when the transfer is registered in the buyer's name. However, the transfer of the right is concluded at the time of handing over of the share certificates with the transfer form. If X fails to deliver the share certificates, he would be in breach of contract. He would have to pay damages. But there would be no transfer of the capital asset. Extending this logic, if the sale is being done through stockbrokers, the asset would be transferred when the buyer's stockbroker receives the share certificate with the transfer form.

However, a stockbroker acts on behalf of several principles. He/she does not have to disclose the names of the persons the shares are being bought or sold for. Thus, even when a stockbroker receives the shares of a company from different other stockbrokers, it is uncertain as to who the shares or a particular share certificate is for. Only when the stockbroker assigns and informs the buyer, specifying the share numbers, the property is ascertained. It can now be held that the stockbroker has come to hold the specific shares on behalf of the buyer. Thus, the transfer of asset is taken to have taken place at the time when the stockbroker issues the said note to his principal.

In the case of a dematerialised transaction, the account of the seller is debited and the account of the stockbroker is credited. The stockbroker then debits his account and credits the account of the buyer. This happens on the same day or in a short period of time. Thus, the time of acquisition of shares is taken to be the time when shares got credited in the account of the buyer. The depository system, however, creates another problem. It does not record the specific share numbers. Thus, the record of a person owning specific distinguishable shares is lost. It only records the total balance of the shares of a particular company. This has significance in deciding whether an asset is a long term asset or a short term asset.

Take the case of a person who has several shares of a company, bought over the past 10 years. All the share certificates are stored in a drawer. The person sells 50 shares through a stockbroker, through a stock exchange, and needs to hand over one share certificate. If he picks up a certificate from the top, which was bought a month back, and hands it over to the stockbroker, it will be a case of a short term capital gain. Instead, if he had picked up a certificate from the bottom of the pile, it would have been a case of a long term capital gain. As the transaction took place through a stock exchange, the latter gain would have been exempt from taxation.

In the case of the depository system, however, as the shares do not bear any number, it is not meaningful to ask which shares got sold. A logical way of resolving this issue, which is also beneficial to the account holder, is to hold that the shares which come in first get sold first. This is called the First-in-First-out (FIFO) method. The Board of Direct Taxes has issued a circular specifying the application of the FIFO method. If a person has multiple accounts, he can decide to use any of the accounts. FIFO will be applied to the account from which the shares are debited. The system of depository is available not only for shares, but also for debentures, bonds and units of mutual funds. However, it is not available for the shares of private companies.

Review Cases

Case 1: A person bought 100 equity shares in a listed company for ₹ 80,000 on July 22, 2008. He received 50 bonus shares on February 15, 2012. The fair market value of the shares on February 15, 2012, was ₹ 8,500 per share. He sold all the shares on August 10, 2014, for ₹ 1,50,000. The sale was done through a stock exchange and STT was charged. Calculate the capital gain.

Case 2: A person subscribed to a monthly investment plan of a mutual fund. Under the plan, the person invested ₹ 5,000 every month, in buying equity linked units of the mutual fund. The units were allotted on the sixth of the month. The number depended on the prevailing Net Asset Value of a unit on that day. The plan was started on January 1, 2013. The person made investments for 18 months. That is, the last investment of ₹ 5,000 was made on June 6, 2014. He redeemed all the units on August 10, 2014. What is the capital gain of the person?

Case 3: C bought 100 shares of X Limited for ₹ 40,000 on October 6, 2009. C received 50 bonus shares on February 15, 2010. X Limited amalgamated with Z Limited in 2012. In lieu of his shares in X Limited, C received 70 shares in Z Limited on March 6, 2013. C sold the shares on July 20, 2014, through a stock exchange, for ₹ 1,00,000. Calculate the capital gain for C.

Case 4: X Limited bought 100 equity shares of a company for ₹ 80,000, on August 10, 2008. The company received 40 bonus shares on February 15, 2009. X Limited amalgamated with Z Limited on April 15, 2009. Z Limited received 50 bonus shares on July 15, 2009. Z Limited sold all the shares of the company through a stock exchange in July, 2014. The transaction was charged the STT. Calculate the capital gain for Z Limited.

10

CHAPTER

Capital Gains: Depreciable Assets

A pharmaceutical company bought a plot of land for ₹ 20 lakh on June 5, 2013. It sold off the plot on August 12, 2014, for ₹ 25 lakh. The company bought a car for office use for ₹ 10 lakh, on June 12, 2012. It sold off the car for ₹ 7 lakh on July 3, 2014. It bought another car for ₹ 12 lakh on July 16, 2014. Appraise the capital gain from the sale of the capital assets.

Capital gain arises from a 'transfer' of capital assets. A plot of land is a capital asset. The transfer of the plot in the above case is a short term capital gain. The car purchased by the company is also a capital asset. We recall that a capital asset is defined as a 'property of any kind'. The car was used for more than two years and then transferred. This is certainly a case of transfer of asset and thus, an incidence of capital gain. How do we work out the capital gain in relation to the car? How do we take account of the fact that the car had already been used for more than two years? As we recall, the capital assets of a business or profession are to be depreciated as a block of assets. The difference between the two assets is that a plot of land is not a depreciable asset while a car is. The block of assets in relation to the car would be as follows:

Block of assets: Motor car for non-hiring purposes

Rate of depreciation: 15%

(Amounts in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation value*	*WDV on March 31 of the previous year, after deducting depreciation*
2012–13	0	10	1.5	8.5
2013–14	8.5	8.5	1.275	7.225
2014–15	7.225	(7.225 – 7) + 12		

'Depreciation' signifies lowering of the value of a capital asset on account of its use. The use of the car for the previous year 2012–13, has been valued at ₹ 1.5 lakh. Thus, the value of the car on April 1, 2013, can be taken as ₹ 8.5 lakh. Similarly, the use of the car for the year 2013–14, has been valued at ₹ 1.275 lakh. The value of the car on April 1, 2014, can be taken as ₹ 7.225 lakh. Thus, the written down value of an asset on April 1 represents its value during the previous year. The calculation of capital gain is easy hereafter. We just have to subtract the written down value on April 1, 2014 from the sale value of the car, to get the capital gain. But, the Act does not require us to take this amount as the capital gain. Instead, as we would recall from our study of the working out of depreciation for blocks of assets, it provides for the lowering of the written down value by subtracting from it, all receipts from its sale. Let us explore the effect of this.

Illustration: Capital Gain (Depreciable Assets)

Dr. Mishra is a medical practitioner. He bought a van for carrying provisions and equipment for his clinic. The van was bought on May 12, 2011, for ₹ 9,69,000. Dr. Mishra had to visit different clinics in the city. For this, he bought a car on June 3, 2012, for ₹ 3.52 lakh. Dr. Mishra sold the car on July 5, 2013. The block of assets for the profession of Dr. Mishra would be as follows:

Block of assets: Motor car for non-hiring purposes

Rate of depreciation: 15%

We will write down the distinct contributions of the two items in the block of assets, to understand the effect of the sale of the car. We would take the price Dr. Mishra sold the car for to be X.

(Amounts in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation value*	*WDV on March 31 of the previous year, after deducting depreciation*
2011–12	0	9.69	1.45	8.24
2012–13	8.24	8.24 + 3.52	1.24 + 0.52	7 + 3
2013–14	7 + 3	7 + 3 – *X* = 7 – (*X* – 3)		

Rupees X-3 lakh is the capital gain in selling the car. Let us understand the effect of different sale prices on the written down value of the remaining asset, the van.

WDV due to Van	*Capital Gain (x-3)*	*WDV on 31 March (column 1 +2)*
7 –	1 – 3 = –2	9
7 –	2 – 3 = –1	8
7 –	3 – 3 = 0	7
7 –	4 – 3 = 1	6
7 –	5 – 3 = 2	5
7 –	6 – 3 = 3	4
7 –	7 – 3 = 4	3
7 –	8 – 3 = 5	2
7 –	9 – 3 = 6	1
7 –	10 – 3 = 7	0
7 –	11 – 3 = 8	–1
7 –	12 – 3 = 9	–2

In the first two cases, there is a capital loss. In this case, the WDV goes up. If the car is sold at exactly its own WDV for the year, it would not make any difference to the written down value of the block. As the car gets a better price, it keeps eroding the WDV of the only asset, the van. A stage comes when it completely wipes off the WDV of the van. This happens when the capital gain is ₹ 7 lakh. Thereafter, the capital gain exceeds the asset and turns its value negative. Thus, the car comes in and goes out from the block of assets, leaving its impact on the only other asset, the van.

The arrangement the Act has made is that capital gain tax is not to be charged on the sale of depreciable assets. However, the capital gain reduces the WDV of the block of assets by the amount of the capital gain. Thus, the depreciation claim gets lowered. As a result, income charged under the head of business and profession increases. Thus, the government loses out under the head of capital gain, but makes up for it under the head of business and profession. The advantage of this system is that in the case of every sale, the asessee does not have to calculate the capital gain and pay tax on it. Sales of capital assets can keep getting adjusted under the remaining assets in the block.

In this arrangement, however, a significant issue arises when the WDV of the block turns negative. It is absurd for the WDV to be negative. We know, however, that this can happen if the capital gain from a sale is high enough to wipe out the contribution of the remaining assets. For a going concern, a possible suggestion could be to ignore it. Additions in the subsequent years, in the block of assets, would make the WDV positive. The state, however, cannot risk this as it will open the route for all to evade capital gains tax by creating businesses as fronts. The WDV of these entities would remain negative for ever. Thus, the Act, the moment the WDV turns negative on 31 March of the previous year, claims the negative value as the net capital gain and charges it under the head of capital gains. The value of the remaining assets in the block becomes nil. A similar treatment has to be applied when the block of assets becomes empty. We will demonstrate this with the following illustration.

Illustration: Capital Gain (Empty Block of Assets)

Deep, an architect, bought a car for his office use in April 2012, for ₹ 4.71 lakh. He sold off the car in February 2014, for an unknown amount, X. Work out the written down value of the block.

Block of assets: Motor car for non-hiring purposes

Rate of depreciation: 15%

(Amounts in Rupees lakh)

Previous Year	*WDV on April 1*	*WDV on March 31 before depreciation*	*Depreciation value*	*WDV on March 31 of the previous year, after deducting depreciation*
2012-13	0	4.71	0.71	4
2013-14	4	4 – *X*		

The WDVs of the block of assets for different sale prices would be as follows:

Sale Price X	*Capital gain = X – 4*	*WDV = –(x – 4)*
1	1 – 4 = –3	3
2	2 – 4 = –2	2
3	3 – 4 = –1	1
4	4 – 4 = 0	0
5	5 – 4 = 1	– 1
6	6 – 4 = 2	– 2
7	7 – 4 = 3	– 3
8	8 – 4 = 4	– 4
9	9 – 4 = 5	– 5

How can a block of assets have a value when it does not have any asset under it? We know that this is happening as a result of capital gains. Thus, once a block of asset becomes empty on March 31, the WDV on March 31 is taken to the head of capital gain. If the value of WDV is positive, there is a capital loss for the person, whereas, if the WDV is negative, it is a case of a capital gain.

Should these gains be treated as long term capital gains or short term capital gains? Conceptually, the sale price of a depreciable asset is being subtracted from the WDV of the block of assets in that previous year. Thus, the reference year for the cost and the selling price is the same. In much the same way as indexing brings parity in the buying and selling years, depreciation also brings parity in the buying and selling years. Thus, in the case of depreciable assets, a capital gain will be a short term capital gain. Section 50 provides for the above exploration.

Section 50. Special Provision for computation of capital gains in case of depreciable assets.

… where the capital asset is an asset forming part of a block of assets in respect of which depreciation has been allowed under this Act .... the provisions of Section 48 and Section 49 shall be subject to the following modifications—

(1) where the full value of the consideration received or accruing ... as a result of the transfer of any other capital asset falling within the block of the assets during the previous year, exceeds the aggregate of the following amounts, namely—

(i) expenditure incurred wholly and exclusively in connection with such transfer or transfers;

(ii) the written down value of the block of assets at the beginning of the previous year; and

(iii) the actual cost of any asset falling within the block of assets acquired during the previous year,

such excess shall be deemed to be the capital gains arising from the transfer of short-term capital assets;

(2) where any block of assets ceases to exist as such, for the reason that all the assets in that block are transferred during the previous year, the cost of acquisition of the block of assets shall be the written down value of the block of assets at the beginning of the previous year, as increased by the actual cost of any asset falling within that block of assets, acquired by the assessee during the previous year and the income received or accruing as a result of such transfer or transfers shall be deemed to be the capital gains arising from the transfer of short-term capital assets.

The import of the wording of the provision is that we should take care of all the transaction costs incurred while acquiring and selling an asset. We could summarise the calculation of depreciation/capital gain of a block of assets in the following step-by-step manner.

Summary of Steps for Calculating Depreciation/Capital gain for Block of Assets

1. Identify the block of assets and the rate of depreciation.
2. List the written down value of the block of assets on April 1 of the previous year. This we would call the WDV on April 1.
3. Record the net amount received from sale of assets from the block during the previous year. This we call Receipt from Sale.
4. Make a note of any addition of new assets to the block. Organise the cost of acquisition of the new assets under two categories, new assets put to use for less than 180 days (roughly six months), and assets put to use for 180 or more days.

   Total Value of New Assets = Value of new assets used for less than 6 months + Value of new assets used for 6 months or more.
5. The written down value of the block on March 31 of the previous year, before depreciation, is to be arrived at by using the above values and the computation, (2 – 3) + 4. That is,

   WDV on March 31 before depreciation = (WDV on April 1 – Receipt from Sale) + Value of new assets used for less than 6 months + Value of new assets used for 6 months or more.

   Reorganise the above as follows.

   WDV on March 31 before depreciation = (WDV on April 1 – Receipt from Sale + Value of new assets used for 6 months or more) + Value of new assets used for less than 6 months.
6. Hereafter, three situations may arise:
   (a) The WDV on March 31 before depreciation is negative. This value is to be treated as a short-term capital gain.
   (b) The block has become empty through the sale of all the assets of the block. The WDV on March 31 will be a capital gain or loss. If the WDV on March 31 is negative, it will be a short-term capital gain and if it is a positive value, it will be a short-term loss.
   (c) The block is not empty and the WDV on March 31, before depreciation, is positive. Then the block of assets will continue under the head of business and profession and be able to claim depreciation. The calculation of the depreciation value is explained in the next step.
7. The depreciation will be calculated as follows, by using the WDV on March 31:

   Depreciation = [(WDV on April 1 – Receipt from Sale + Value of new assets used for 6 months or more) + (1/2)(Value of new assets used for less than 6 months)] [% rate of depreciation/100]

8. Calculate WDV on March 31 after depreciation as:

   WDV on March 31 after depreciation = WDV on March 31 before depreciation – Depreciation
9. WDV on March 31 after depreciation is taken as the WDV on April 1 for the next previous year. The exercise can be repeated the next previous year.

In the case of a new plant and machinery for manufacturing, the addition of depreciation allowance, as discussed in the chapter on business income, will need to be done.

Illustration: Depreciable Assets

A consulting company bought four laptop computers at the rate of ₹ 50,000 per computer, on July 6, 2012, and put them to immediate use. The laptops were for use by its professional employees. Later, the company realised that there were problems related to the sharing, maintenance and security of the laptops, being faced by its employees. It proposed that it would be much better if its professional employees purchased their own laptops. The company could help/compensate them towards this. On this suggestion, two of the employees bought laptops for themselves. Following this, the company sold off two laptops for a total value of ₹ 90,000, on March 5, 2014.

The company also bought its only car for ₹ 5 lakh, to be used by its professional employees, in November, 2011. The car was underutilised as all the professional employees had their own cars and preferred using their own vehicles. The company sold off the car on March 12, 2014, for ₹ 4,10,000.

The calculation of depreciation for the block of assets of computers would be as follows:

WDV on March 31, 2013, before depreciation: ₹ 50,000 × 4 = ₹ 2,00,000

Depreciation allowance for 2012–13: ₹ 2,00,000 × 0.6 = ₹ 1,20,000

WDV on March 31, 2013, after depreciation: ₹ 2,00,000 – 1,20,000 = ₹ 80,000

WDV on March 31, 2014, before depreciation: ₹ 80,000 – 90,000 = – ₹ 10,000

Since the WDV is negative, it is a case of short term capital gain of ₹ 10,000

The calculation of depreciation for the block of assets of motor cars is as follows:

WDV on March 31, 2013, before depreciation: ₹ 5,00,000

Depreciation allowance for 2012–13 (half year): ₹ (5,00,000 × 0.15)/2 = ₹ 37,500

WDV on March 31, 2013, after depreciation: ₹ 5,00,000 – 37,500 = ₹ 4,62,500

WDV on March 31, 2014, before depreciation: ₹ 4,62,500 – 4,10,000 = ₹ 52,500

As the block has become empty and the WDV is positive, it becomes a case of capital loss of ₹ 52,500.

Review Cases

Case 1: Home Furnishing Limited sold stocks lying in its showroom for ₹ 14 lakh on November 20, 2013. The stock was bought on December 15, 2011. Calculate the capital gain.

Case 2: A recently formed computer software company bought 100 computers at the rate of ₹ 30,000 per computer, on September 6, 2012, and put them to immediate use. Soon thereafter, a new generation of computers got introduced in the market. The newer computers were far more useful for the kind of work the software company was doing. The company decided to start using the new generation computers. Towards this, it sold off 70 of its computers at the rate of ₹ 20,000 a computer, in February, 2014. Explore the tax implication of the sale.

Case 3: A recently formed computer software company bought 100 computers at the rate of ₹ 30,000 per computer, on September 6, 2011, and put them to immediate use. Soon thereafter, a new generation of computers got introduced in the market. The newer computers were far more useful for the kind of work the software company was doing. The company decided to start using the new generation computers. Towards this, it sold off 50 of its computers at the rate of ₹ 20,000 a computer, in February, 2013. Work out the written down value for the assessment years, 2012–13, 2013–14 and 2014–15.

Case 4: The WDV on April 1, 2013, for the block of assets comprising plant and machinery for a manufacturing company was ₹ 20 lakh. The company bought an old packaging machine for ₹ 10 lakh on February 1, 2014, and sold two of the earlier machines for ₹ 15 lakh. Explore the tax implication of the sale.

Case 5: The WDV on April 1, 2013, for the block of assets comprising plant and machinery for a manufacturing company was ₹ 30 lakh. The company bought an old packaging machine for ₹ 10 lakh on March 10, 2014 and sold four of the earlier machines for ₹ 45 lakh. Explore the tax implication of the sale.

11

CHAPTER

Income from Salary

The Act defines income broadly to include any income received by a person. Further, each income has to be classified under one of the five heads, namely, salary, house property, business and profession, capital gains and income from other sources. There is very little possibility of confusion between salary and house property or salary and capital gain. We, thus, only need to distinguish 'salary' from 'business and profession'. 'Income from other sources' is a residual category.

It is evident that salary is a material thing while 'business and profession' is an activity. One receives salary from an employer while a person doing a business or profession is self-employed. Thus, salary is a consideration one receives in an employer-employee relationship. In other words, an employer-employee relationship is a must for the head of salary to apply. The difference between a self-employed person and a salaried person is that the salaried person works under the control, supervision and direction of the employer. Let us explore whether the following income earned by Jeet in a previous year, constitute salary income:

1. Jeet works from 7.00 PM to 10.00 PM, Monday to Saturday, doing home delivery of pizza for a restaurant. He is paid ₹ 5,000 a month.
2. Jeet works from 11.00 AM to 5.00 PM as a sales person in an auto-showroom. He gets ₹ 10,000 a month. The showroom gives him a commission of 0.1% on every sale of a car. He received ₹ 8,000 in November towards commission.
3. Till January, Jeet had worked in a retail store. At the end of the financial year, the store gave a bonus to all the employees who had worked during the year. Jeet received a cheque for ₹ 5,000 on November 18.
4. In the months of February and March, Jeet could only get casual employment. A retail store employed him on daily wages.

In all the above cases, there is a significant difference in the ways in which the income was earned, for example, between daily wages and regular employment. However, as all the sources of income have to be classified under one of the five heads, the head of salary is the most appropriate one for all of them. The head of salary should include every benefit flowing to the employee from the employer, irrespective of the name given to it.

✦ Salary and Dearness Allowance

Let us take our exploration further with Nilesh, who got employed as a driver with a company for a monthly salary of ₹ 7,000. Nilesh is based in Anand, a district town in Gujarat. The company finds Nilesh's work satisfactory. It wants to maintain the status quo with regard to him. The company maintains the salary of Nilesh at ₹ 7,000. Due to inflation, the worth of ₹ 7,000 becomes less than what it was in the preceding year. To maintain parity, Nilesh must be given an additional amount of money to cover the effect of inflation. As a result, in most regular employment situations, the salary has a component called the basic pay. This is the salary the parties settle on at the time of employment. Thereafter, each year, an additional amount, called 'dearness allowance', is worked out as a percentage of the basic pay and given to the employee. The government announces the rate of inflation in the economy, which serves as the basis for the calculation of this allowance.

An employee gains experience and value with each passing year. The employers, on satisfactory performance, increase the basic salary. Due to this, the basic salary is generally quoted as a range, indicating the increment to be given each year. The range also constitutes the grade of the employee. An employer may also give a commission in addition to the salary, to an employee, for the business secured by that employee. A bonus, on the other hand, is given to all or a group of employees if the organisation generates surplus.

✦ House Rent Allowance

Another important aspect of an employer-employee relationship is the provision of housing facilities for the employees. Nilesh, who is based in Anand, is transferred by the company to Mumbai. As housing in Mumbai is more expensive, and therefore, the transfer would bring down the real wages of Nilesh. Salary is linked to the cost of living. To maintain parity, Nilesh must be given an additional amount. Further, the residence may be at a distance from the work place. The employee would need to spend some additional amount in commuting to work. Besides providing adequate remuneration to the employees, maintaining uniformity among a class of employees is also an important concern for the employer. Thus, employers often break-up the salary into various components. The basic salary and the grade become the core part. To this are added the dearness allowance, house rent allowance, transport allowance and other allowances. The employers also give free or concessional benefits, like, medical facilities, motor cars and food. Benefits can take the form of reimbursements, like medical reimbursements, leave travel, transport allowance and house rent allowance.

✦ Retirement Benefits

An employee gets salary in the course of his employment. However, it is also a concern for the state that the employee should have resources to subsist on when he retires or loses the employment. The law specifically charges the employer to provide for the retirement benefits of the employees. The three common retirement benefits are: provident fund, gratuity and superannuation.

Provident and Pension Fund: The Employees' Provident Fund and Miscellaneous Provisions, 1952, provide social security benefits to workers and, in the case of their death, to their dependents. The Employee Provident Act requires every organisation employing 20 or more employees in the specified industries, to create a provident fund benefit for the employee. Participation in the scheme is compulsory for all employees with earnings less than ₹ 6,500 per month. Participation is optional for employees earning above this amount. As is evident, the mandatory part of the Act is not for managers, who would be earning more than ₹ 6,500 per month. However, most large organisations create a provident fund for the benefit of all their employees.

The Act has created the Employees' Provident Fund Scheme, 1952 and the Employees' Pension Scheme, 1995, for enforcing the Act. The employer contributes 12% of the earnings of the employee. This is broken into two parts, 8.33% and 3.77%, totalling 12%. The 8.33% contribution is taken to the Employees' Pension Scheme, 1995 and 3.77% to the Employees' Provident Fund Scheme. A matching contribution of 12% is deducted from the earnings of the employee and taken fully to the Employees' Provident Fund Scheme. The Employees' Provident Fund is managed by government agencies or employers through private trusts. The interest from the Fund is credited to member accounts at the rate declared by the Government of India. The accumulated sum in the account can be claimed in the case of retirement, total and permanent disablement, death in service, and early retirement. The 8.33% contribution of the employer is taken to the Employees' Provident Fund Organisation (EPFO) under the Employees' Pension Scheme, 1995. The scheme provides a small pension for life, to members, upon retirement.

Gratuity: Gratuity literally means gratitude. This is paid by the employer when the employee leaves the employment. The Payment of Gratuity Act, 1972, applies to all employers with a workforce of 10 or more employees. The Act is applicable to all permanent employees, regardless of category or salary. An employee earns gratuity on serving the employer for five years. The mandatory benefit under the Act is 15 days of salary for each year of service, with the upper limit of ₹10,00,000. An employer, of course, is free to provide a larger gratuity.

Superannuation: The provident fund and gratuity benefits are not significant. Thus, employers offer voluntary and additional benefits to the employees. These are called superannuation plans. The employer makes a contribution to a fund towards retirement benefits for the employee. A trust is created which manages the fund itself or hands over the management to a life insurance company.

✦ Salary and Income Tax

In accordance with the nature of income tax and our exploration, Section 17 understands salary to also mean all perquisites and any other profit from employment. Towards this, Section 17 lists salary, perquisites and profits separately as sub-sections. Section 17(1) provides for salary to include wages, annuity or pension, gratuity, fees, commissions, salary advance, leave encashment and contributions to pension fund and provident fund. Section 17(2) lists the perquisites which would be considered a part of the salary. It explicitly mentions that the value of a rent-free accommodation and concession in rent for accommodation is to be included. In addition, it includes any benefit the employer might give in general terms, by including the words, 'any benefit or amenity granted or provided free of cost or at concessional rate'. Section 17 makes the following limited exemptions to such benefits:

1. Reimbursement of up to ₹ 15,000 of medical expenses for the benefit of the employee or his family members.
2. Mediclaim insurance premium paid by the employer or reimbursed by the employee.
3. In-house medical facilities like hospitals or clinics.

Rule 3 of the Income Tax Rules provides for the valuation of the perquisites. Through this, every facility is given a value and included in the salary of the employee.

✦ Exemptions from the Act

Section 10 makes several exemptions for the benefit of retiring employees. Some exemptions of general interest are as follows:

1. House Rent Allowance: Section 10(13A) exempts the least of the following in the computation of taxable House Rent Allowance:

- HRA actually received
- Rent paid in excess of ten per cent of the salary.
- Fifty per cent of the salary if the house is situated in Mumbai, Kolkata, Delhi or Chennai and forty per cent in other places.

The salary refers to the total of the basic salary, dearness allowance and commissions.

Case: Salary

Niraj is employed by a company in Mumbai. The details of his salary for the concluded previous year are as follows:

Basic salary: ₹ 40,000 per month

Dearness Allowance: ₹ 10,000 per month

HRA received from employer: ₹ 2.4 lakh per annum

Rent paid to the house owner: ₹ 2.5 lakh per annum

Calculate the amount exempted under Section 10(13A)

2. Transport Allowance: Section 10(14) exempts transport allowance of up to ₹ 800 per month, towards the cost incurred in travelling from the employee's residence to the place of duty. In this context, it should be noted that the section allows unlimited exemption of reimbursement of conveyance expenditure for the performance of official duties. The section is, however, applicable only in cases where the employer has not provided a conveyance to the employee.

3. Leave Travel Concession: Section 10(5) exempts reimbursement of actual travel fare for journey taken up by the employee and his family. This is available for two journeys performed in a block of four years. The Act declares the block. The upper limit for exemption is economy class airfare or first class air-conditioned train fare.

Having filtered out the income through the application of Section 10, the total salary income is calculated. Section 16 allows two small deductions.

1. Deduction for entertainment allowance: This is available only to government employees, up to a maximum amount of ₹ 5,000
2. Deduction for professional tax: Under Article 276 of the Constitution, a tax can be charged on a profession. Any tax charged under the article can be claimed as a deduction.

✦ Calculation of Salary and Deduction at Source

The computation of salary follows a combination of the accrual and receipt basis. The salary for the year is taken on accrual basis. If it were otherwise, the employer and the employee together, could work around it to reduce the tax liability of the employee. The employer often pays money earned during an earlier year. It could be a retrospective payment of dearness allowance and bonus. In this case, there is no point in revising the salary for an earlier year and re-working the tax. Thus, all arrears are taken on receipt basis. Advance salary is also taken on receipt basis. Section 192 requires the employer to estimate the salary income of all the employees and deduct tax at source, before paying the salary.

12

CHAPTER

Income from Other Sources

The income head, 'other sources', as the name suggests, is a residual category. Let us explore the organisation of this category by exploring the nature of the following sources of income:

1. Anil is a government employee. He has a savings bank account. The bank credited an interest of ₹ 800.
2. Sigma Limited has invested its surplus funds in the shares of a company. Sigma Limited received ₹ 50,000 as dividend from the company.
3. During a cricket match, the telecast sponsors invited the viewers to send SMSes predicting the man of the match. Aman sent an SMS. His entry turned out to be the only correct one. He won a prize of ₹ 50,000.
4. Deep owns debentures in a company, which paid him ₹ 40,000 in interest.
5. Jeet wants to start a coffee shop. Towards this, he bought a food processor and a coffee machine. Till the time the premises could be refurbished, he hired out the coffee machine to a person for ₹ 500.
6. Mars Limited is in the business of manufacturing dairy products. It hired out its surplus capacity of the packaging machine and earned ₹ 50,000 in one year.
7. Sigma Limited discontinued its business of manufacturing biscuits. It found a person who hired the unit for manufacturing biscuits for a year and paid Sigma Ltd. ₹ 5 lakh for it.
8. Jeet rented out the parking area in the building allotted to him to another resident for ₹ 3,000 a month.
9. Pratap rented out an open plot of land he owned in the city for three days, for holding an exhibition.
10. A person gifted ₹ 1 lakh to his friend's son for his studies.
11. Amar occupies a flat as a tenant. He sub-rented a room in the flat to a paying guest and earned ₹ 60,000 in a year.

Income that cannot be taken to the first four heads of salary, house property, business and profession or capital gains, is to be taken to the head, 'other sources'. The first four heads are specific. Salary arises only in relation to employment. Income from house property can arise only on ownership and rental of a building and/or adjacent land. Capital gain requires ownership and transfer of an asset. The head of income from business and profession is the broadest of the four heads. However, this also applies only if there is a subsisting business or profession. An intended business or a business that has ceased does not qualify under the head. Thus, most of the sources of income listed above would fall under the head of income from other sources.

Dividend income cannot be taken under any of the first four heads. Income from renting surplus capacity of the plant and machinery of a going business arises in the course of the business. Thus, the income from such rental would be a business income. However, if the business is yet to start or has ceased to exist, there is no business for there to be any income or expenditure accruing to it. Similarly, just as the plant and machinery are the capital of a business, money forming a part of a particular business is also capital of the business. For example, interest from a bank account used for receiving receipts and making payments for the business is income from the business, as the capital belongs to the business. However, although appropriated profits and surplus funds of a company are also capital assets of the company, they do not form a part of the business. Interest on this money cannot be taken to the head of business income. It can only be taken to the head of income from other sources. The same reasoning applies to interest on securities like debentures and bonds. Further, as a gift comes in to a person, it can potentially be a source of income. If it comes from an employer, it becomes a part of the salary. If it comes in the course of one's business, it can become a business income. In other cases, it can only fall under the head of income from other sources. Section 56 expresses our exploration. An abridged and edited version of Section 56, which provides the scope of the head, 'income from other sources', is as follows:

> **56. Income from other sources.** (1) Income of every kind … shall be chargeable to income-tax under the head "Income from other sources", if it is not chargeable to income-tax under any of the heads specified in Section 14..
>
> (2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely:
>
> (i) dividends;
>
> ...
>
> (ib) …. (any winnings 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.)
>
> (id) income by way of interest on securities, if the income is not chargeable to income-tax under the head "Profits and gains of business or profession"
>
> (ii) income from machinery, plant or furniture belonging to the assessee and let on hire, if the income is not chargeable to income-tax under the head "Profits and gains of business or profession" ….
>
> (iii) where an assessee lets on hire machinery, plant or furniture belonging to him and also buildings, and the letting of the buildings is inseparable from the letting of the said machinery, plant or furniture, the income from such letting, if it is not chargeable to income-tax under the head "Profits and gains of business or profession";
>
> (vii) where an individual … receives, in any previous year, from any person or persons … any sum of money, without consideration, the aggregate value of which exceeds fifty thousand rupees …

This head of income is a residual head. If an income does not fall under the four specific heads, it would fall under this head. Section 56(1) expresses this general idea. With the proliferation of economic activity, certain incomes started falling under this head with regularity. Following this, the Act has been amended to include such sources of income. Section 56(2) lists the sources of income which have to be treated under this head. Section 56(2)(ii) and (iii) relate to businesses that have been discontinued. If a business is continuing, the income from hiring out of plant and machinery will go under the head of income from business. If a person gets into the very business of hiring out plant and machinery, it will be a new business. The income will again go to the head of income from business. If the business, however, has ceased, hiring of the plant and machinery, with or without the building, will be treated under the head of income from other sources.

Section 56 has listed the sources of income, that is, the money coming in to the person. Section 57 allows revenue expenditure incurred for earning the income. It provides:

> (iii) any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income.

In addition, it specifically provides on dividend income, income from securities and income from hiring out of plant and machinery. Section 58, however, prohibits certain deductions. For example, Section 58(4) specifically bars deduction for expenditure incurred towards income from lotteries, crossword puzzles, races including horse races, card games and other games. We can explore the working of the provisions in relation to dividend and interest on securities, hiring out of plant and machinery and gifts further.

✦ Dividend and Interests

Dividend received by a person is necessarily chargeable under the head. It has been argued that taxing dividend in the hands of the shareholder amounts to double taxation. The company pays tax on its profits. The dividend is then declared from the taxed profits. When the shareholder pays tax on the dividend income, he pays tax on the same income, for the second time. A counter argument is that a company and a shareholder are different legal persons. Their properties and incomes are different and thus, it is appropriate to tax the income at both the levels. A compromise has been struck between the two positions in relation to Indian public companies. The company pays a dividend distribution tax on the total amount it distributes as dividend. This rate is lower than the income tax rate. The dividend, in the hands of the recipients, is exempt from taxation under Section 10. This works out to be beneficial for the shareholders. Income from securities may, in some situations, fall under the head of income from business. For example, if the working capital of a business is invested in securities, the interest earned from it would be business income. However, if the capital does not belong to the business, the interest will be taken to the head of income from other sources. The treatment of interest on securities has been specifically mentioned in the Act.

If any kind of interest on money, for example, interest paid on a bank account, does not fall under the head of business, it would fall under the head of income from other sources. If a bank or a moneylender receives interest from a customer, it is an interest on money, but it would fall under business income. Similarly, interest earned on the working capital of a business belongs to the business. Thus, this would also be business income. However, if the interest cannot be taken to the head of business, it would be treated under the head of other sources.

In addition to the general deduction allowed for the revenue expenditure incurred towards earning income from dividend or interest on securities or interest, Section 57 specifically mentions, 'any reasonable amount paid as commission or remuneration to a banker or any other person for the purpose of realising such dividend or interest on securities', other than dividend which is exempt from taxation. Explore whether the following heads of income are taxable and fall under the head of income from other sources or not:

S. No.	*Income*	*Other Sources (Yes/No)*
1.	Dividend received from a company incorporated in the UK	
2.	Dividend received from a private company	
3.	Dividend received from an Indian company listed on the NSE	
4.	Interest from the reserve fund of a company	
5.	Interest on securities parking working capital temporarily	
6.	Interest on debentures bought from the reserve fund of a private company	

Illustration: Dividend Income

Suresh took a loan from a bank for buying shares of a UK company listed on a stock exchange in London. He bought shares and earned a dividend amount of ₹ 50,000 during 2012–13. He paid an interest of ₹ 30,000 to the bank. Suresh is claiming a deduction for the interest paid to the bank. As the loan was taken for earning the dividend income, the deduction of interest would be allowed.

Case: Interest Income

A small new consulting company has a bank account that it uses for receiving fees and making expenditure. The bank credited an interest of ₹ 20,000 to the account. Decide on the treatment of the income.

Case: Dividend Income

The objective of X Limited was to invest in shares of companies and earn dividend income. In a previous year, the company received a total of ₹ 30 lakh in dividends. The expenditure of the company on salaries and other administrative expenses was ₹ 20 lakh. The company had acquired a computer and a printer for ₹ 50,000 on April 5 of the previous year. Calculate the taxable income of the company for the previous year.

Illustration: Dividend Income

Sigma Limited took a loan from a bank for buying shares of an Indian company listed on the NSE. It bought some shares of the company. The company did not declare any dividend during

2013–14. However, Sigma Limited paid ₹ 1.5 lakh in interest on the loan. The company claims a loss of ₹ 1.5 lakh under the head of income from other sources. Is the claim justified?

✦ Hiring of Plant and Machinery

A hiring of plant and machinery can be with or without the building. If the hiring can be separated into two different contracts, one for the building and the other for the plant and machinery, the building part would be taken under the head of income from house property. Where letting of the building is inseparable from the letting of the said machinery, plant or furniture, the income from the letting, if it is not chargeable to income-tax under the head of 'Profit and gains of business or profession', shall be chargeable under the head of 'income from other sources'. From the income, expenses falling under this head, like repairs, insurance and depreciation can be claimed. The basis for claiming the deduction and depreciation is the same as in the case of income from business and profession (Sections 30, 31 and 32).

✦ Gift and Inheritance

A son gives ₹ one lakh to his father for his maintenance. Money has certainly come to the father. It is an income and can be taken only under the head of income from other sources. It would create a stir if it were suggested that the father should be taxed for receiving the money from his son. The reason is that in social and family relations, there is mutuality and people help each other. The exchanges are not economic in nature or aimed at generating income. The parties also do not see themselves as generating income. From one perspective, a gift is given where there is a belonging to the extended family. Thus, the money stays within the extended family. From another perspective, in the mutuality of social and family relations, a gift will have to be reciprocated. Thus, a gift is a kind of a debt. Thus, as a general principle, gift should not be taken to be income. However, if gifts were exempt from taxation, it would become a route for tax evasion. Towards this, a line should be drawn specifying where the family ends. Section 56 (2)(vii) expresses this principle. It provides as follows:

(vii) where an individual … receives, in any previous year, from any person or persons … —

(a) any sum of money, without consideration, the aggregate value of which exceeds fifty thousand rupees, the whole of the aggregate value of such sum;

(b) any immovable property,—

(i) without consideration, the stamp duty value of which exceeds fifty thousand rupees, the stamp duty value of such property;

(ii) for a consideration which is less than the stamp duty value of the property by an amount exceeding fifty thousand rupees, the stamp duty value of such property as exceeds such consideration …

(c) any property, other than immovable property,-

(i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration: ….

Provided further that this clause shall not apply to any sum of money or any property received—

(a) from any relative; or

(b) on the occasion of the marriage of the individual; or

(c) under a will or by way of inheritance; or …

The provision applies only to 'individuals and Hindu undivided family' and not to other forms of legal persons. A relative has been defined to include the lineage of the person as well as the spouse and the lineage of the spouse.

Explore whether the following sources of income are taxable under Section 56(2)(vii) or not:

S. No.	*Income*	*Section 56(2)(vii) applies (Yes/No)*
1	A husband transferred ₹ 2 lakh to his wife's account	
2	Ajit received ₹ 80,000 under a will	
3	Deep was gifted ₹ 60,000 by a friend on his birthday	
4	Harish was gifted ₹ 60,000 at the time of his wedding by a friend	
5	Maya gifted diamond studded jewellery, worth ₹ 70,000, to her daughter	
6	Maya gifted diamond studded jewellery, worth ₹ 70,000, to her friend's daughter	
7	On the death of his father, Sanjay inherited ₹ 5 lakh and a flat worth ₹ 9 lakh.	

The provision does not apply if the income moves from a relative, at the time of marriage or under a will or inheritance. A will is a document a person draws for bequeathing his property on his death. The property of a person that is not covered by the will devolves according to the personal law of the deceased. The personal law governs as to who the heirs of the property would be. When a person dies without leaving a will, it is called dying intestate. The devolution of property is called inheritance. Thus, the section has no application to an income, irrespective of the amount, that comes from a relative or is inherited. The section also has no relevance if the property comes under a will, whether the person bequeathing it was a relative or not. Further, the section has no application to gifts received at the time of marriage, irrespective of who the person giving it was.

We can now explore the application of the provision in Clause (a), pertaining to receiving of cash. Decide whether the income of the following persons, who received cash in gift from persons other than their relatives, in the previous year 2013–14, would be taken as income or not. Also, mention the income under the head of other sources.

S. No.	*Income*	*Taxable under Section 56(2)(vii)(a) (Yes/No)*	*Income under 'Other Sources'*
1.	Arman was gifted ₹ 40,000		
2.	Sandeep received ₹ 20,000, ₹ 10,000 and ₹ 30,000 in gift from three different people		
3.	Deep was gifted ₹ 51,000		
4.	Ajay was gifted ₹ 10,000, ₹ 5,000 and ₹ 8,000 by three different people		

Clause (a) applies if the total income received in gift by the person is more than ₹ 50,000. Thus, it applies to Sandeep and Deep. Once the clause gets attracted, the entire aggregate amount becomes income under the head of income from other sources. The tax implications of the above persons would be as follows:

S. No.	*Income*	*Taxable under Section 56(2)(vii)(a) (Yes/No)*	*Income under 'Other Sources'*
1.	Arman was gifted ₹ 40,000	No	Nil
2.	Sandeep received ₹ 20,000, ₹ 10,000 and ₹ 30,000 in gift from three different people	Yes	₹ 60,000
3.	Deep was gifted ₹ 51,000	Yes	₹ 51,000
4.	Ajay was gifted ₹ 10,000, ₹ 5,000 and ₹ 8,000 by three different people	No	Nil

If the provision were left at this, it could easily be circumvented by gifting in kind, that is, by transferring property. However, the section blocks this route. A property can be either movable or immovable. Clause (b) relates to immovable property and Clause (c), to movable property. Clause (b) refers to the stamp duty value of immovable property. A sale of immoveable property, like land and building, has to be recorded in writing on a stamp paper and signed by the parties. The state governments levy a duty on the transaction. The duty is a percentage of the value for which the property is mentioned in it to have been sold. This duty is levied as stamp duty. The parties have to buy a stamp paper worth the duty amount and write the contract on it. The signed papers are submitted for registration to the Registrar of Records. The sale is registered only if everything, including the stamp duty, is in order.

Higher the sale value, higher the duty. To evade duty, parties often under-report the sale value. The balance amount changes hand informally. This practice leads to the generation of black money and evasion of tax. To pre-empt this practice, state governments, on the basis of past transactions and surveys, fix the minimum stamp duty value of properties in different locations. Even if the parties enter into a contract for sale at a price lower than the stamp duty value, the stamp duty has to be calculated with reference to this minimum stamp duty value. For a higher sale value, the actual value becomes the reference. Let us now explore the application of Clause (b). Decide whether the income of the following persons receiving the below-mentioned properties from persons who are not their relatives, during 2013-14, would be taken as income or not. Also, mention the income under the head of other sources.

S. No.	*Income*	*Taxable under Section 56(2)(vii) (b) or (c) (Yes/No)*	*Income under 'Other Sources'*
1.	Arman was gifted a flat whose stamp duty value was ₹ 3 lakh.		
2.	Deep received in gift, a plot of wasteland of stamp value ₹ 45,000.		
3.	Sudip bought a flat for ₹ 9 lakh, whose stamp duty value was ₹ 10 lakh.		
4.	Y limited bought a flat from Z Limited for ₹ 18 lakh. The stamp duty value of the flat was ₹ 20 lakh.		
5.	Z received a flat from C Limited as a gift for his good performance in a sporting event. The stamp duty value of the flat was ₹ 20 lakh.		
6.	Y Limited received as a donation, a plot of land from C. The stamp duty value of the plot was ₹ 15 lakh.		

A transaction of immovable property can either be a gift or a sale. Clause (vii)(b) applies to both. If a gift is of a property whose stamp duty value is more than ₹ 50,000, the entire amount would be taken as income under the head. If, however, it is ₹ 50,000 or less, it would not be taken as income under the head. If the transaction is a sale, and the consideration is lower than the stamp duty value exceeding ₹ 50,000, the entire difference will be taken as income under the head, for the buyer. If the difference, however, is ₹ 50,000 or less, it would not be taken as income under the head. In other words, if there is a shortfall in the consideration, the shortfall is treated like a gift. The clause, however, applies only to individuals and Hindu undivided families. Further, it applies only if the gift or sale is from a non-relative. Thus, the application of the clause to the above cases would be as follows:

S. No.	*Income*	*Taxable under Section 56(2)(vii) (b) or (c) (Yes/No)*	*Income under 'Other Sources'*
1.	Arman was gifted a flat whose stamp duty value was ₹ 3 lakh.	Yes	₹ 3 lakh
2.	Deep received in gift, a plot of wasteland of stamp value ₹ 45,000	No	Nil

3.	Sudip bought a flat for ₹ 9 lakh, whose stamp duty value was ₹ 10 lakh	Yes	₹ 1 lakh
4.	Y limited bought a flat from Z Limited for ₹ 18 lakh. The stamp duty value of the flat was ₹ 20 lakh.	No	Nil
5.	Z received a flat from C Limited as a gift for his good performance in a sporting event. The stamp duty value of the flat was ₹ 20 lakh.	Yes	₹ 20 lakh
6.	Y Limited received as a donation, a plot of land from C. The stamp duty value of the plot was ₹ 15 lakh.	No	Nil

Clause (c) deals with gifts and undervalued sales of movable property to an individual from non-relatives. The explanation to Clause (vii) has given a specific meaning to 'property'. It reads:

Explanation—For the purposes of this clause, …

(d) "property" means the following capital asset of the assessee, namely—

(i) immovable property being land or building or both;

(ii) shares and securities;

(iii) jewellery;

(iv) archaeological collections;

(v) drawings;

(vi) paintings;

(vii) sculptures;

(viii) any work of art; or

"(ix) bullion;

Apply the provision to the following transactions:

S. No.	*Income*	*Taxable under Section 56(2)(vii) (a) or (c) (Yes/No)*	*Income under 'Other Sources'*
1.	Sandeep received a scooter in gift, whose fair market value was ₹ 55,000.		
2.	Jeet bought a car for ₹ 3 lakh, whose fair market value was ₹ 4.5 lakh.		
3.	X Limited struck a hard bargain and bought packaging material worth ₹ 10 lakh for ₹ 8 lakh.		

4.	Z received a painting from C Limited as a gift for his good performance in a sporting event. The fair market value of the painting was ₹ 2 lakh.		
5.	Y was gifted shares of a company by B Limited. The fair market value of the shares was ₹ 35,000.		
6.	T bought 100 shares of a company from P for ₹ 80,000. The prevailing price of the shares on the stock market was ₹ 2 lakh.		

Clause (vii)(c) applies only to individuals and not to corporate bodies. Further, it applies only if the movable property is transacted by a non-relative. Only certain valuable kinds of property are included in the definition of 'property'. Movable property has been given a limited scope. In the case of a gift, if the fair value exceeds ₹ 50,000, the entire amount becomes taxable under the clause. Similarly, in a sale, where the consideration is undervalued, the shortfall is taken as a gift and the same treatment is given to it as is given to a pure gift. The application of Clause (vii)(c) to the above persons would be as follows:

S. No.	*Income*	*Taxable under Section 56(2)(vii) (a) or (c) (Yes/No)*	*Income under 'Other Sources'*
1.	Sandeep received a scooter in gift, whose fair market value was ₹ 55,000.	No	Nil
2.	Jeet bought a car for ₹ 3 lakh, whose fair market value was ₹ 4.5 lakh.	No	Nil
3.	X Limited struck a hard bargain and bought packaging material worth ₹ 10 lakh for ₹ 8 lakh.	No	Nil
4	Z received a painting from C Limited as a gift for his good performance in a sporting event. The fair market value of the painting was ₹ 2 lakh.	Yes	₹ 2 lakh
5.	Y was gifted shares of a company by B Limited. The fair market value of the shares was ₹ 35,000.	No	Nil
6.	T bought 100 shares of a company from P for ₹ 80,000. The prevailing price of the shares on the stock market was ₹ 2 lakh.	Yes	₹ 1,20,000

A provision applicable to companies is covered under Section 56(2)(viib). It provides that if a company in which the public is not substantially interested, receives more than the fair market value during allotment of shares to a resident person, the surplus will be treated as income from other sources. The government will prescribe the method for working out the fair market value of the shares. However, a venture capital undertaking, receiving money from a venture capital company or a venture capital fund, is exempted.

Section 145 allows the assessee to follow either of the two accounting methods, cash or mercantile, in computing the income from other sources. It provides:

> 145. Method of accounting (1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall … be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

However, the assessee has to be regular and consistent in following one of the two systems. Frequent changes from one system to another would always attract a doubt as to whether it is being done to gain undue advantage.

Review Cases

Case 1: Suresh took a loan from a bank for buying shares of a foreign company. He bought shares and had to pay ₹ 30,000 as interest during the previous year. The company did not declare any dividend that year. Calculate Suresh's income.

Case 2: Anil bought a lottery ticket for ₹ 500. He won a prize of ₹ 30,000. This ₹ 30,000 is income under the head of 'other sources'. He is claiming ₹ 500 as expenditure incurred for earning the income.

Case 3: Explore the tax implications for the following:

1. Maya's mother gave her ₹ 5 lakh for her education. Maya put it in a bank account and received ₹ 20,000 in interest.
2. Neil got a gift of ₹ 60,000 from his father's friend.
3. Tapas received ₹ 40,000 in gift for his education, from his friend.
4. Mr. Parekh transferred ₹ 4 lakh from his account to his wife's account.
5. Azad got a gift of a house from his father's friend. The value of the house, for assessing the stamp duty, was settled at ₹ 5 lakh.
6. Deep's friend sold him his car valued at ₹ 4 lakh for ₹ 50,000.
7. X Limited sold a building assessed at ₹ 30 lakh to Y Limited, for ₹ 20 lakh.
8. Tapas received 5 shares of a company as a gift from his friend's father. The value of the shares was ₹ 60,000.
9. Rashmi received 200 shares of a company under a will made by her friend's father. The fair value of the shares was ₹ 2 lakh.
10. Nascent Art Limited bought a painting for ₹ 1 lakh, whose fair value was ₹ 2 lakh.

Case 4: Amar is an independent director of a company. He received ₹ 20,000 in sitting fees. How should the income be treated? How would the income be treated if Amar were an executive director?

13
CHAPTER

Aggregation and Carry Forward of Losses

A person may receive income from different sources. Each income of the person is to be taken to one of the five heads, i.e. salary, income from house property, income from business and profession, capital gains or income from other sources. As noted earlier, income tax is to be charged on the total income of the person. We would need to total the income from all the sources under each head and further total the income corresponding to the five heads. Chapter VI of the Income Tax Act, 'Aggregation of Income and Set off or Carry Forward of Loss', deals with the subject.

At the outset, let us take note of the key concerns of the state. If a person reports a gain from a source, after all the permissible deductions, the state considers itself justified in totalling up the gains and charging income tax on the amount. The state is concerned, however, about the cases where a person suffers a loss from a source or a head. If freely allowed to adjust losses against gains, persons would invent losses to evade paying tax. The state wants to limit this possibility. Thus, the law imposes restrictions on the aggregation of losses. Section 70 provides on aggregation of income under each of the heads:

> 70. Set off of loss from one source against income from another source under the same head of income—
>
> (1) Save as otherwise provided in this Act, where the net result for any assessment year in respect of any source falling under any head of income, other than "Capital gains", is a loss, the assessee shall be entitled to have the amount of such loss set off against his income from any other source under the same head.
>
> (2) Where the result of the computation made for any assessment year … in respect of any short-term capital asset is a loss, the assessee shall be entitled to have the amount of such loss set off against the income, if any, as arrived at under a similar computation made for the assessment year in respect of any other capital asset.
>
> (3) Where the result of the computation made for any assessment year … in respect of any capital asset (other than a short-term capital asset) is a loss, the assessee shall be entitled to have the amount of such loss set off against the income, if any, as arrived at under a similar computation made for the assessment year in respect of any other capital asset not being a short-term capital asset.

The section singles out the head of capital gains for special treatment. Under each of the other heads, the losses from a source can be set off against the gains from some other source under the same head. Section 70(2) provides that a short term loss can be set off against a short term or long term gain. Section 70(3), however, limits the setting off of a long term capital loss only against a long term capital gain. We can now explore the aggregation under each of the heads.

✦ Aggregation of Salary

A person in a previous year may have earned salary from more than one source. A person can concurrently have two or more jobs. A person changing jobs would also have two sources of salary in the year. Salary income is a consideration for employment. It can never be negative. The lowest it can be is nil, as in the case of an employee who has gone on a long special leave, say, for further studies. Thus, there is no question of any loss under the head. One has to total the net salary from each of the employers to arrive at the aggregated value for the head.

✦ Aggregation of Income from House Property

A person can own several buildings and can put them on rent. Thus, a person can have more than one source of income under the head. As the net income for any building is 70% of the annual value, ordinarily, there cannot be a loss from a source. However, Section 24 allows a deduction of the interest paid during the previous year on the capital borrowed for purchase, construction, repair or renovation of a house. The upper limit for the deduction in a year in case of a self-occupied property is ₹ 1.5 lakh. The annual value of the only self-occupied house is nil. However, the owner is allowed deduction of the interest payable. In this case, the net income from the house property would be negative. Further, for rented premises acquired or built by taking a loan, the net income from the house, after deduction of interest, may be negative. Section 70(1) allows a totalling up of the losses and gains under the head. The value of each of the sources under the head would be added to get the final value for the head. The aggregated value can be a gain or a loss.

Illustration

Raman owned two premises, a self-occupied house and a shop. The net income from the house was a loss of ₹ 50,000. The annual value of the shop, after deduction, was ₹ 80,000. The aggregation under the head would be as follows:

Income from house property after deduction
Source 1 (House): (– ₹ 50,000)
Source 2 (Shop): ₹ 80,000
Total income from House Property: ₹ 30,000

Illustration

Deep owned two premises, a self-occupied house and a garage. The net income from the house was a loss of ₹ 40,000. The annual value of the garage, after deduction, was ₹ 30,000. The aggregation under the head would be as follows:

Income from house property after deduction

Source 1 (House): (– ₹ 40,000)

Source 2 (Garage): ₹ 30,000

Total income from House Property: ₹ 10,000

✦ Aggregation of Income from Business and Profession

Let us explore the head with the following illustrations. Deepak is a chartered accountant. He also runs a transport business. Thus, Deepak has two sources of income under the head of income from business and profession. Omega Limited is involved in four business activities—telephony, textiles, transportation and software development. Each of the business activities is a source of income under the head. Lords Drycleaners Private Limited has two units, one in Delhi and another in Mumbai. The two function independently of each other. The two units are the two sources of business income for the company. A person can have several sources of income under the head. Section 70(1) allows the setting off of loss from one source from a gain from another source. Thus, loss from a source is absorbed by a profit in another.

Section 73, however, requires a separate treatment for speculative transactions. The accounts of transactions of a speculative nature are to be maintained separately. If the net value of such transactions is positive, it is to be added up with the income from other businesses. However, if the value reflects a loss, it has to be kept aside and not adjusted with the income from any other business. Let us explore the meaning of speculative business with the following illustrations. Trader A, realising that the value of edible oil was likely to go up, bought 10,000 cartons of one litre edible oil packs. He stored the cartons for a week. The price went up, at which time he sold them for a profit. While the trader speculated, the conduct of the trader cannot be distinguished from an ordinary business transaction. Ordinary trade is about buying, selling, delivering and prudence. However, contrast this situation with a transaction where trader B buys 10,000 cartons of one litre edible oil from trader, C, for a price of ₹ 60. The cartons are not to be delivered. A week later, if the prevailing price is more than ₹ 60, the seller will pay the difference to the buyer. If the price is lower than ₹ 60, the buyer will pay the difference to the seller. Here, the contract was not about trading, but was pure speculation on the price fluctuations. Transactions of this nature, where the goods are not intended to be delivered, are speculative transactions. Speculative business includes trading in shares of companies. However, dealing in derivatives has been exempted from being a speculative business.

Illustration

Omega Limited has the following income after deductions, including that of depreciation allowance:

Income from Business and Profession

Source 1: Textile business: ₹ 0.5 crore

Source 2: Retail Business: ₹ 1 crore

Source 3: Telephony business: (– ₹ 2.5 crore)

Total income from business and profession: (– ₹ 1 crore)

Illustration

Sigma Limited has the following income after deductions, including that of depreciation allowance:

Income from business and profession

Source 1: Textile business: ₹ 0.5 crore

Source 2: Retail Business: ₹ 1 crore

Source 3: Telephony business: (– ₹ 2.5 crore)

Source 4: Financial Services (Speculative): ₹ 2 crore

Total income from business and profession: ₹ 1 crore.

Illustration

Jupiter Limited has the following income after deductions, including that of depreciation allowance:

Income from business and profession

Source 1: Textile business: ₹ 0.5 crore

Source 2: Retail business: ₹ 1 crore

Source 3: Telephony business: ₹ 2.5 crore

Source 4: Financial services (Speculative): (– ₹ 2 crore)

The income under the head would be accounted for, under two categories:

Business income: ₹ 4 crore

Business income (Speculative): – ₹ 2 crore

We will explore the treatment given to the loss arising from speculative business later.

✦ Aggregation of Capital Gains

Section 70 (2) and (3) allow short term capital losses to be adjusted against short term capital gains and long term capital gains. However, long term capital losses can be adjusted against only long term capital gains. This requires computing the gains under two sub-heads, short term capital gains and long term capital gains. Further, the tax rates for short term capital gains and long term capital gains are different. Also, a short term capital gain or a long term capital gain arising from transactions of shares traded through a recognised stock exchange gets a special treatment. For these reasons, we need to keep short term and long term capital gains distinct. Within these, we need to keep the income from the different kinds of sources segregated. The different rates have implications on the setting off of losses.

For determining the rate for calculation of income tax on capital gains, we would need to divide capital assets into two categories. The first category would include equity shares listed on a recognised stock exchange as well as units of equity oriented mutual funds, transacted through a recognised stock exchange, on which securities transaction tax is charged. Only the securities listed on a recognised stock exchange can be traded through that stock exchange. On every transaction, a recognised stock exchange charges a Securities Transaction Tax (STT). However, a security listed on a recognised stock exchange need not necessarily be traded through the stock exchange. It can be traded without going to the stock exchange. This is called an 'off-market' transaction.

Equity Shares and Units of Mutual Funds: Section 10(38) exempts long term capital gains arising from transfer of equity shares and units of equity oriented funds, on whose transfer, the securities transaction tax has been charged, from the application of the Act. Short term gains arising from the transfer of equity shares or units of mutual funds, on which the securities transaction tax has been paid, under Section 111 A, are taxed at the rate of 15%.

Other Capital Assets: Under Section 112, the standard rate of income tax on long term capital gains is 20%. However, for a transaction of listed securities, that is, preference shares, debentures, bonds or zero coupon bonds, listed on a recognised stock exchange, the assessee has the option to avail the benefit of indexation and calculate the tax at the rate of 20% or not to avail the benefit of indexation and calculate the tax at the rate of 10%. It is also significant to note that Section 48 does not allow indexation of certain kinds of securities. There is no separate special rate for charging tax on short-term capital gains on assets other than those for which securities transaction tax has been paid. Thus, the usual rate of taxation, applicable in the previous year, would apply to such short term capital gains. We can call this the full rate or normal rate.

In the context of the different tax rates, we need to read Section 70 intensively to explore the principles provided for aggregation. The section allows each of the short term capital asset that has made a loss to be taken up and be set-off against a gain from another short term or long term capital asset. Similarly, the section allows each long term capital loss to be off-set with another gain arising out of a long term capital asset. Let us explore this with the following illustrations.

Illustration

The following were the different sources of long term and short term capital gains for a person. Aggregate the short term and long term capital gains.

(Amount in ₹ lakh)

Short Term Capital Gain	*Original Value*	*Aggregation*	*Rate of tax*
Listed security (STT paid)	2		15%
Jewellery	– 3		Full rate
Depreciable assets	4		Full rate

Long Term Capital Gain			
Listed security:	5		10%
Building	– 2		20%
Unlisted Security	1		20%

The most beneficial aggregation for the assessee would be as follows:

(Amount in ₹ lakh)

Short Term Capital Gain	*Original Value*	*Aggregation*	*Rate of tax*
Listed security (STT paid)	2	2	15%
Jewellery	– 3	0	Full rate
Depreciable assets	4	4 – 3 = 1	Full rate
Long Term Capital Gain			
Listed security:	5	5 – 1 = 4	10%
Building	– 2	0	20%
Unlisted Security	1	1 – 1 = 0	20%

The values could be consolidated as follows:

(Amount in ₹ lakh)

Gain	*Value*
STCG (Security STT Paid)	2
STCG (others)	1
LTCG (Listed Security)	4
LTCG (Others)	0

Illustration

The following were the different sources of long term and short term capital gains for a person. Aggregate the short term and long term capital gains.

(Amount in ₹ lakh)

Short Term Capital Gain	*Original Value*	*Aggregation*	*Rate of tax*
Listed security (STT paid)	2		15%
Jewellery	– 3		Full rate
Depreciable assets	– 4		Full rate
Long Term Capital Gain			
Listed security:	5		10%
Building	– 2		20%
Unlisted Security	1		20%

The most beneficial aggregation for the assessee would be as follows:

(Amount in ₹ lakh)

Short Term Capital Gain	*Original Value*	*Aggregation*	*Rate of tax*
Listed security (STT paid)	2	0	15%
Jewellery	– 3	0	Full rate
Depreciable assets	4	0	Full rate
Long Term Capital Gain			
Listed security:	5	5 – 1 = 4 – [2 + 1 (STCG)] = 1	10%
Building	– 2	0	20%
Unlisted Security	1	0	20%

The values could be consolidated as follows:

(Amount in ₹ lakh)

Gain	*Value*
STCG (Security STT Paid)	0
STCG (others)	0
LTCG (Listed Security – Off-market)	1
LTCG (Others)	0

Illustration

The following were the different sources of long term and short term capital gains for a person. Aggregate the short term and long term capital gains.

(Amount in ₹ lakh)

Short Term Capital Gain	*Original Value*	*Aggregation*	*Rate of tax*
Listed security (STT paid)	2		15%
Jewellery	3		Full rate
Depreciable assets	4		Full rate
Long Term Capital Gain			
Listed security (Off-market)	5		10%
Building	7		20%
Unlisted Security	1		20%

The most beneficial aggregation for the assessee would be as follows:

(Amount in ₹ lakh)

Short Term Capital Gain	*Original Value*	*Aggregation*	*Rate of tax*
Listed security (STT paid)	2	2	15%
Jewellery	3	3	Full rate
Depreciable assets	4	4	Full rate
Long Term Capital Gain			
Listed security:	5	0	10%
Building	– 7	– 1	20%
Unlisted Security	1	0	20%

The values could be consolidated as follows:

(Amount in ₹ lakh)

Gain	*Value*
STCG (Security STT Paid)	2
STCG (others)	7
LTCG (Listed Security – Off-market)	0
LTCG (Others)	– 1

✦ Aggregation of Income from Other Sources

Section 70(1) allows all income under the head of income from other sources to be aggregated. This includes profits from horse racing, lottery and games. However, the losses from horse racing, lottery, games and similar activities are to be treated separately. As these activities are of limited application, particularly to business, we would not explore these activities. Some of the other sources of income under the head are dividend, interest and hiring of plant and machinery. The value of income from a source can be positive or negative. For example, if a person takes a loan to buy shares and the company does not declare any dividend, the net income would be negative. The income from different sources can be aggregated to get a single value for the head.

✦ Aggregation Across the Heads of Income

The income tax is to be charged on the total income of a person. We have learned how to aggregate income under the five heads. The income would need to be further consolidated. Section 71 provides for the aggregation of income across the heads. It states:

> **71. Set off of loss from one head against income from another.** [(1) Where in respect of any assessment year the net result of the computation under any head of income, other than "Capital gains", is a loss and the assessee has no income under the head "Capital gains", he shall, subject to the provisions of this Chapter, be entitled to have the amount of such loss set off against his income, if any, assessable for that assessment year under any other head.

(2) Where in respect of any assessment year, the net result of the computation under any head of income, other than "Capital gains", is a loss and the assessee has income assessable under the head "Capital gains", such loss may, subject to the provisions of this Chapter, be set off against his income, if any, assessable for that assessment year under any head of income including the head "Capital gains" (whether relating to short-term capital assets or any other capital assets).

(2A) Notwithstanding anything contained in sub-section (1) or sub-section (2), where in respect of any assessment year, the net result of the computation under the head "Profits and gains of business or profession" is a loss and the assessee has income assessable under the head "Salaries", the assessee shall not be entitled to have such loss set off against such income.

(3) Where in respect of any assessment year, the net result of the computation under the head "Capital gains" is a loss and the assessee has income assessable under any other head of income, the assessee shall not be entitled to have such loss set off against income under the other head.

Let us illustrate Section 71 with examples.

Illustration

Abhijit runs a bakery shop. The income of Abhijit is as follows:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	0	
2.	House Property	0.5	
3.	Business Income	– 1	
4.	Capital gains		
	STCG (Securities-STT paid)	0	
	STCG (Others)	0	
	LTCG (Listed Security)	0	
	LTCG (Others)	0	
5.	Other Sources	0.1	

The case illustrates Section 71(1). It provides that a loss from business can be set-off against income from house property and other sources. The aggregated value would be as follows:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	0	0
2.	House Property	0.5	0
3.	Business Income	– 1	– 0.4
4.	Capital gains	0	0
5.	Other Sources	0.1	0

Illustration

Mandip is a salaried person with the following income:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	3.0	
2.	House Property	0.6	
3.	Business Income	– 2	
4.	Capital gains		
	STCG (Securities-STT paid)	0	
	STCG (Others)	0	
	LTCG (Listed Security)	0	
	LTCG (Others)	0	
5.	Other Sources	0.2	

The case illustrates Section 71(2A). The losses from business cannot be adjusted against salary. The aggregated value would be as follows:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	3.0	3.0
2.	House Property	0.6	0
3.	Business Income	– 2	– 1.2
4.	Capital gains	0	0
5.	Other Sources	0.2	0

Illustration

Aggregate the income of Sandeep under the following heads:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	3.0	
2.	House Property	– 0.4	
3.	Business Income	– 2	
4.	Capital gains	0	
5.	Other Sources	0.2	

Section 71(2A) prohibits the setting-off of business losses against salary. However, Section 71(1) allows the absorption of other losses, that is, from house property and other sources. The aggregated income would be as follows:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	3.0	2.6
2.	House Property	– 0.4	0
3.	Business Income	– 2	– 1.8
4.	Capital gains	0	0
5.	Other Sources	0.2	0

Illustration

The following illustration will bring out the scope of Section 72(2) and (3). The essence of Section 72(2) and 72(3) is that a capital loss cannot be set-off against other heads. However, if the aggregate value of any other head is negative, it can be set-off against a capital gain. Let us aggregate the following income.

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	3.0	
2.	House Property	0.6	
3.	Business Income	– 2	
4.	Capital gains		
	STCG (Securities-STT paid)	0.4	
	STCG (Others)	0.5	
	LTCG (Listed Security)	0	
	LTCG (Others)	– 0.3	
5.	Other Sources	0.2	

The income would be aggregated as follows:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Salary	3.0	3.0
2.	House Property	0.6	0
3.	Business Income	– 2	– 0.3

4.	Capital gains		
	STCG (Securities-STT paid)	0.4	0
	STCG (Others)	0.5	0
	LTCG (Listed Security)	0	0
	LTCG (Others)	– 0.3	– 0.3
5.	Other Sources	0.2	0

Illustration

Aggregate and set-off the income of Anagram Consulting Private Limited:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Business Income	4	
2.	Capital gains		
	STCG (Securities-STT paid)	– 0.4	
	STCG (Others)	– 0.5	
	LTCG (Listed Security)	0	
	LTCG (Others)	– 0.3	
3.	Other Sources	0.2	
	Total		

The income would be aggregated as follows:

(Amount in ₹ lakh)

S. No.	*Head of Income*	*Income*	*Aggregation*
1.	Business Income	4	4
2.	Capital gains		
	STCG (Securities-STT paid)	– 0.4	– 0.4
	STCG (Others)	– 0.5	– 0.5
	LTCG (Listed Security)	0	0
	LTCG (Others)	– 0.3	– 0.3
3.	Other Sources	0.2	0.2
	Total		4.2

✦ Carry Forward and Set-off of Losses

After aggregating and setting-off the losses, the net value for a head could be a loss. The Act provides for carrying forward of such a loss to subsequent years. Section 72 provides for carrying forward of a loss arising from business or profession.

Section 72. Carry forward and set off of business losses. (1) ….“Profits and gains of business or profession” … so much of the loss as has not been so set off … the whole loss shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

(i) it shall be set off against the profits and gains, if any, of any business or profession carried on by him and assessable for that assessment year:

(ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on:….

(2) Where any allowance or part thereof is, under sub-section (2) of Section 32 … carried forward, effect shall first be given to the provisions of this section.

(3) No loss (other than the loss referred to in the proviso to sub-section (1) of this section) shall be carried forward under this section for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed.

Thus, in the year a business loss has arisen, it would be set-off across other heads, as discussed earlier. The remaining loss, if any, can be carried forward and set-off only against gains from business and profession in the subsequent years. The loss can be carried forward for eight assessment years immediately succeeding the assessment year in which the loss arose. Further, Section 72(2) refers to depreciation allowance and stipulates that losses carried forward would be set-off first. It should be noted here that Section 32, which provides for depreciation allowance on the written down value of a block of assets, also provides for carrying forward of unadjusted depreciation allowance. Section 32(2) provides:

Section 32: Depreciation

Section 32 (2): Where, in the assessment of the assessee, full effect cannot be given to any allowance under sub-section (1) in any previous year, owing to there being no profits or gains chargeable for that previous year, or owing to the profits or gains chargeable being less than the allowance, then, subject to the provisions of sub-section (2) of Section 72 and sub-section (3) of Section 73, the allowance or the part of the allowance to which effect has not been given, as the case may be, shall be added to the amount of the allowance for depreciation for the following previous year and deemed to be part of that allowance, or if there is no such allowance for that previous year, be deemed to be the allowance for that previous year, and so on for the succeeding previous years.

Section 73 provides for losses in speculative business. The section is structured just like Section 72, which provides on losses arising from business. In other words, speculative business forms a category of its own for the purpose of setting-off and carrying forward of losses. Unabsorbed speculation loss will be carried forward and set-off against speculation profits of the subsequent assessment years, for up to four years. Section 74 deals with losses arising from capital gains. It states:

Section 74. Losses under the head “Capital gains.” (1) Where in respect of any assessment year, the net result of the computation under the head “Capital gains” is a loss to the assessee, the whole loss shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

(a) in so far as such loss relates to a short-term capital asset, it shall be set off against income, if any, under the head “Capital gains” assessable for that assessment year in respect of any other capital asset;

(b) in so far as such loss relates to a long-term capital asset, it shall be set off against income, if any, under the head “Capital gains” assessable for that assessment year in respect of any other capital asset not being a short-term capital asset;

(c) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year, and so on.

(2) No loss shall be carried forward under this section for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed....

Thus, a short-term capital loss can be adjusted in the subsequent years against both kinds of capital gains. However, a long term capital loss can be adjusted against only long term capital gains. It is clear that capital gains have been subject to special provisions. Similarly, losses under the head of income from house property can be absorbed for eight subsequent years from the year in which the loss arose.

The sequence in which losses are to be adjusted is of significance. The Act provides the following priority for carry forward and set-off of losses and allowances. The order is as follows:

1. Current scientific research capital expenditure
2. Current depreciation
3. Brought forward business/profession losses
4. Unabsorbed depreciation
5. Unabsorbed scientific research capital expenditure

Illustration

The unabsorbed losses from house property for a person were as follows:

(in ₹ lakh)

Loss arising in the Previous Year	*Amount remaining unabsorbed after adjustments in the previous year 2012–13*
2004–05	0.8
2010–11	1.5
2011–12	0.7

The aggregated income of the individual under the different heads of income for the previous year 2013–14 are as follows:

(in ₹ Lakh)

Head of Income	*Income*
Salary	0.5
House Property	– 2
Business and Profession	
Short Term Capital Gain	
Long term capital gain	– 0.2
Other Sources	1.1

Adjust the house property losses carried forward to 2013–14.

The inter-head set-off for the previous year has to be taken care of first. This leaves a loss of ₹ 0.4 lakh under the head of house property. House property losses are carried forward to eight succeeding years from the year in which the loss arose, to be adjusted against the income under the head of house property. The loss arising in 2004–05 is not eligible for absorption in 2013–14. As the income from house property in 2013–14 is negative, losses of 2010–11 and 2011–12 do not get absorbed. Unabsorbed house property losses are as follows:

(2010–11) : ₹ 1.5 lakh

(2011–12) : ₹ 0.7 lakh

(2013–14) : ₹ 0.4 lakh

Illustration

The unabsorbed business losses of a company were as follows:

(in ₹ lakh)

Loss arising in the Previous Year	*Amount remaining unabsorbed after adjustments in the previous year 2011–12*
2005–06	300
2012–13	275

The aggregated income of the company under the different heads of income for the previous year 2013–14 are as follows:

(in ₹ Lakh)

Head of Income	*Income*
Salary	
House Property	
Business and Profession	500
Short Term Capital Gain	50
Long term capital gain	30
Other Sources	2

Adjust the business losses carried forward to 2013–14.

Business losses are carried forward to eight succeeding years from the year in which the loss arose, to be adjusted against the income under the head of business. Losses of 2005–06 get fully absorbed. The losses of 2012–13 get partially absorbed, leaving an unabsorbed amount of ₹ 75 lakh to be carried forward to 2014–15.

Illustration

The unabsorbed long term losses of a company were as follows:

(in ₹ lakh)

Particulars	*Loss arising in Previous Year*	*Amount remaining unabsorbed after adjustments in the previous year 2012–13*
Unabsorbed long term capital loss	2004–05	55
Unabsorbed long term capital loss	2010–11	18

The aggregated income of the company under the different heads of income for the previous year 2013–14, are as follows:

(in ₹ Lakh)

Head of Income	*Income*
Salary	
House Property	
Business and Profession	500
Short Term Capital Gain	50
Long Term Capital Gain	– 20
Other Sources	2

Adjust the long term capital losses carried forward to 2013–14.

A long term capital loss remaining unabsorbed in a year can be adjusted only against a long term capital gain in the next eight years. The loss arising in 2004–05 is not eligible for absorption in 2013–14. The loss of 2009–10 does not get absorbed. Further, year 2013–14, generates its own losses to be carried forward.

Thus, unabsorbed losses to be carried forward are: 2010–11: ₹ 18 lakh

2012–13: ₹ 20 lakh

Review Cases

The cases below give the particulars of the incomes of different persons for a previous year. Aggregate the incomes intra-head and inter-head (that is, within each head and across the heads). Losses are indicated by putting the amount in brackets. All amounts are in Rupees lakh. The answers could be entered in the columns in the table.

Case 1:

S. No.	*Particulars*	*Income*	*Aggregated Income*	*Unabsorbed loss (if any)*
1.	Short term capital loss (Asset A)	(125)		
2.	Short term capital gain (Asset B)	50		
	Short term capital gain/loss			

3.	Long term capital gain (Asset C)	25		
4.	Long term capital gain (Asset D)	100		
	Long term capital gain/loss			

Case 2:

S. No.	*Particulars*	*Income*	*Aggregated Income*	*Unabsorbed loss (if any)*
1.	Short term capital loss (Asset A)	250		
2.	Short term capital gain (Asset B)	(100)		
	Short term capital gain/loss			
3.	Long term capital gain (Asset C)	(125)		
4.	Long term capital gain (Asset D)	75		
	Long term capital gain/loss			

Case 3:

S. No.	*Particulars*	*Income*	*Aggregated Income*	*Unabsorbed loss (if any)*
1.	Salaries	430		
2.	House Property (loss)	(130)		
3.	Capital gains			
	Short-term Capital gain	100		
	Long-term Capital gain	(150)		
4.	Business or Profession	300		
5.	Other sources	50		
	Total Income			

Case 4:

S. No.	*Particulars*	*Income*	*Aggregated Income*	*Unabsorbed loss (if any)*
1.	Salaries	430		
2.	House Property (loss)	(130)		
3.	Capital gains			
	Short-term Capital gain	0		
	Long-term Capital gain	(50)		
4.	Business or Profession (loss)	(200)		
5.	Other sources	(50)		
	Total Income			

Case 5:

S. No.	*Particulars*	*Income*	*Aggregated Income*	*Unabsorbed loss (if any)*
1.	Salaries	330		
2.	House Property (loss)	(130)		
3.	Other sources (loss)	(80)		

Case 6:

S. No.	*Particulars*	*Income*	*Aggregated Income*	*Unabsorbed loss (if any)*
1.	Salaries	410		
2.	House Property	90		
3.	Capital gains			
	Short-term Capital (loss)	(250)		
	Long-term Capital gain	100		
4.	Business or Profession	175		
5.	Other sources	25		
	Total Income			

Case 7:

Indicate the business losses to be carried forward to the previous year 2013–14.

S. No.	*Particulars*	*Loss arising in Previous Year*	*Amount remaining unabsorbed after adjustments in the previous year 2013–14*	*Losses to be carried forward to the previous year 2014–15*
1.	Unabsorbed business loss carried forward	2005–06	(250)	
2.	Unabsorbed business loss carried forward	2006–07	(300)	
3.	Unabsorbed business loss carried forward	2011–12	(450)	
4.	Business Income	2012–13	(550)	
	Total Business Income			

14

CHAPTER

Exemptions, Deductions and Rebates

'Exemption', 'deduction' and 'rebate' are commonly used terms in the computation of taxable income. To recapitulate, the Act defines the terms 'income' and 'person' very broadly. Thereafter, an entire chapter, Chapter III: Incomes Which Do not Form Part of the Total Income, running from Section 10 to Section 13B, exempts several kinds of persons and income from the application of the Act. This is called exemption. We are familiar with this concept. Examples of the exemptions provided for under Section 10 are scholarship, dividend income from Indian companies and long-term capital gains on certain listed securities, if the securities transaction tax has been paid.

The exempted income has to be completely ignored while computing the income tax. The remaining sources of income have to be taken to one of the five relevant heads of income. Income tax is to be charged on the income aggregated across the five heads. Deduction is a term which comes at this stage. Chapter VIA: Deductions to be made in Computing Total Income, running from Section 80C to 80U, allows deductions from the total income. The numbering of the sections should not surprise us. These sections have been inserted through amendments. In fact, the chapter number indicates that the chapter itself was inserted through an amendment.

✦ Deductions for Individuals—Section 80 C: Provident Fund and Life Insurance

Broadly speaking, Section 80C facilitates an individual's claim to deductions from the total income by making investments in certain kinds of instruments. These instruments create financial security for the person and his dependants. Under the chapter on salary, we noted that the employer deducts a part of the salary of the employee and puts it in a provident fund account. The employer also makes an additional contribution. The total amount thus credited to the provident fund account forms a part of the salary of the employee. Section 80 C allows the provident fund amount credited in the account of the person to be deducted while arriving at the net taxable income.

In addition, the employers create superannuation benefits for the employees. Like in the case of the pension fund, the employer and employee, both make contributions to this fund. The savings come to the employee in the case of loss of job or retirement. Section 80C allows this contribution to be deducted. One can readily discern the rationale for allowing the deduction. The state considers it important to encourage individuals and organisations to create a safety net for the employees and their families. The mandatory requirement covers only a limited set of employees and the mandatory rate of contribution is also small. Further, non-salaried individuals and their families also need protection. Towards this, the state has created or recognised investments which would be allowed deduction under Section 80 C.

Public Provident Fund: The Public Provident Fund (PPF) is an important example of such an investment. The creation and management of the PPF is done under the Public Provident Fund Act. Nationalised banks are allowed to create and manage PPF accounts. A person can open an account and deposit a maximum of ₹ 1,00,000 a year. The amount has been increased to ₹ 1,50,000 by the Finance Act, 2014. The fund gives a fixed rate of interest. However, the amount is fully secure. The fund has a maturity period of 15 years from the date of opening of the account, which can be further renewed in blocks of 5 years.

Life Insurance Policy: A standard life insurance plan requires the payment of an annual premium. In the case of death of the person, the insured amount is given to the nominated person. In addition, life insurance companies offer other products as well, which provide a mix of investment and life insurance. Section 80C allows the premium paid towards a life insurance policy as a deduction, up to a limit of 10% of the minimum amount assured under the policy on the happening of the insured event at any time during the term of the policy. Section 80C, however, sets ₹ 1,00,000 as the maximum limit for such deduction. The amount has been increased to ₹ 1,50,000 by the Finance Act, 2014.

Capital Repayment of Housing Loan: We may recall from the provisions on income from house property, under Section 24, that the payment of interest made in the previous year is deductible. One of the deductions allowed under Section 80C is for repayment of the loan amount (capital) borrowed for purchase or construction of a residential house. The benefit is available only if the loan is taken from a bank, a co-operative bank, or government approved institutions.

Medical Insurance Premia: Section 80D allows deductions in respect of medical insurance premia paid during the year. It provides:

> **80D. Deduction in respect to medical insurance premia.** (1) In computing the total income of an assessee, being an individual … there shall be deducted ….
>
> (2) … the sum … aggregate of the following, namely:
>
> (a) the whole of the amount paid to effect or to keep in force an insurance on the health of the assessee or his family or any contribution made to the Central Government Health Scheme or such other scheme as may be notified by the Central Government in this behalf or any payment made on account of preventive health check-up of the assessee or his family as does not exceed in the aggregate fifteen thousand rupees; and
>
> (b) the whole of the amount paid to effect or to keep in force an insurance on the health of the parent or parents of the assessee or any payment made on account of preventive health check-up of the parent or parents of the assessee as does not exceed in the aggregate fifteen thousand rupees.
>
> (2A) Where the amounts referred to in clauses (a) and (b) of sub-section (2) are paid on account of preventive health check-up, the deduction for such amounts shall be allowed to the extent it does not exceed in the aggregate five thousand rupees.

Educational Loan: Section 80 E allows deduction of interest paid on a loan taken for pursuing higher education. Section 80 E reads:

> **80E. Deduction in respect of interest on loan taken for higher education.** (1) In computing the total income of an assessee, being an individual, there shall be deducted, in accordance with and subject to the provisions of this section, any amount paid by him in the previous year, out of his income chargeable to tax, by way of interest on loan taken by him from any financial institution or any approved charitable institution for the purpose of pursuing his higher education or for the purpose of higher education of his relative.
>
> (2) The deduction specified in sub-section (1) shall be allowed in computing the total income in respect of the initial assessment year and seven assessment years immediately succeeding the initial assessment year or until the interest referred to in sub-section (1) is paid by the assessee in full, whichever is earlier.
>
> (3) For the purposes of this section—
>
> (c) "higher education" means any course of study pursued after passing the Senior Secondary Examination or its equivalent from any school, board or university recognised by the Central Government or State Government or local authority or by any other authority authorised by the Central Government or State Government or local authority to do so;
>
> (d) "initial assessment year" means the assessment year relevant to the previous year, in which the assessee starts paying the interest on the loan.
>
> (e) "relative", in relation to an individual, means the spouse and children of that individual or the student for whom the individual is the legal guardian.

Interest on Housing Loan: Under the head of income from house property, interest on loan, with limits, is deductible under Section 24. Section 80EE allows a further deduction of up to ₹ 1 lakh from the aggregated taxable income, to an individual buying his first residential house property. The deduction is applicable only for a loan taken during 2013–14. There are several qualifying requirements for being eligible to avail the deduction. One, the value of the residential house property should not exceed ₹ 40 lakh. Two, the loan must have been taken from a financial institution and should not exceed ₹ 25 lakh. Three, the individual should not own any other residential house property. Obviously, the same interest amount cannot be deducted under both, Section 24 and Section 80EE. Under Section 24, if a property is rented out, the entire interest amount can be deducted. Section 80EE cannot confer any benefit in this case. In the case of a self-occupied house, under Section 24, a deduction only up to ₹ 1.5 lakh can be made. Section 80EE will be of relevance only, in this case, in deducting the interest amount exceeding ₹ 1.5 lakh.

Donations: Section 80G allows deductions in respect of donations made to certain funds and charitable institutions. In some cases, the entire amount of the donation can be deducted, without any upper limit. For instance, donations made to the Prime Minister's National Relief Fund and National Defence Fund are eligible for 100% deduction. Donations made to some institutions are eligible for 50% deduction of the amount donated, without any qualifying limit. Donations to some other funds and charitable institutions are deductible, but a ceiling is applied. Often, employers facilitate donations by making it possible for the employees to donate money by encashing accumulated earned leave. The employer would put it up in advance that the money was being collected for a particular relief and the collected amount would be sent to, say, the Prime Minister's National Relief Funds. Newspapers carry similar campaigns for relief of victims of natural calamity. The amount thus collected is eligible for full deduction under Section 80G.

Section 80TTA allows deduction of interest earned on deposits in savings accounts with a bank (including co-operative banks) or a Post Office, up to a maximum limit of ₹ 10,000. The benefit is available only to individuals or a Hindu Undivided Family, and it does not apply to interest earned on fixed deposits.

Sections 80D, 80E, 80G and 80TTA are independent of Section 80C. There is no limit for claiming deduction under Section 80E.

✦ Rebate

After allowing deductions from the aggregated income, the tax liability will get calculated according to the rates applicable to the different slabs of taxable income. On the tax liability, the Act gives further rebate. Under Section 87A, an individual resident, whose taxable income is up to ₹ 5 lakh, gets a rebate of ₹ 2000. That is, ₹ 2000 will be subtracted from the tax liability that has been calculated.

✦ Deductions for Enterprises

Some of the deductions available to business enterprises are listed below:

Section 80-IA: Deduction in respect of profits and gains made by industrial undertakings or enterprises engaged in infrastructure development, etc.

Section 80-IAB: Deduction in respect of profits and gains made by an undertaking or enterprise engaged in the development of Special Economic Zones.

Section 80-IB: Deduction in respect of profits and gains of certain industrial undertakings other than infrastructure development undertakings.

Section 10AA gives exemption to newly established units in Special Economic Zones. The income of any undertaking, which has begun or begins to manufacture or produce articles or things, or to provide any service during the previous year relevant to an assessment year commencing on or after April 1, 2006, in any Special Economic Zone (as defined under Section 2(za) of the SEZ Act, 2005) is eligible for a 100% deduction of its profits and gains derived from exports of such articles or things or services, for a period of five consecutive assessment years, and thereafter, for a 50% deduction of such profits and gains for the next five assessment years, subject to conditions.

✦ Rate of Taxation

After making all the deductions, the net taxable income is arrived at. Income tax is charged as a percentage of this amount. The rate at which income tax is charged changes almost every year. What is popularly known as the 'union budget' is also an Act. A bill, called the Finance Bill for the year, is tabled in the parliament. On its passage through both the houses, it becomes an Act.

The Finance Act amends the provisions of other tax laws, for example, the Income Tax Act. The Income Tax Act anticipates the required flexibility in the rate. Section 4 provides:

> **4. Charge of income-tax.** (1) Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year ... in respect of the total income of the previous year of every person ...

The Finance Act, enacted each year, provides for the rate of taxation for individuals and companies for the year. On the total tax thus calculated, a further Education Cess and Higher Education Cess is charged as a percentage of the tax. Education Cess is 2% of the tax and and Higher Education Cess, 1% of the tax. Thus, a total of 3% of the income tax is levied in the form of the two education cesses, which are added to the tax calculated, to arrive at the final figure of payable tax.

15

CHAPTER

Wealth Tax and Other Themes in Income Tax

Wealth tax is a tax on the ownership of property by a person. It is a central tax levied under the Wealth Tax Act, 1957. The intent of the law is to encourage owners to put their property to productive use. It tends to tax only the property that is either being consumed only by individuals or lying idle. In this chapter, we will explore the broad features of the Wealth Tax Act, 1957. The tax applies only to individuals, Hindu undivided families and companies. We will focus on individuals and companies. The broad scheme the Act follows is that it lists certain kinds of properties that have to be taken as wealth. The value of the wealth has to be assessed on March 31 of the year. The net wealth has to be worked out by subtracting the debts owed by the person. Wealth tax is charged if the net wealth exceeds ₹ 30 lakh. What constitutes wealth is a central aspect of the Act.

✦ Wealth Tax

Section 3(2) provides that net wealth exceeding ₹ 30 lakh will be taxed at the rate of 1%. Section 2(ea) defines 'assets'. It reads:

> (ea) "assets" … means—
>
> (i) any building or land appurtenant thereto (hereinafter referred to as "house"), whether used for residential or commercial purposes or for the purpose of maintaining a guest house or otherwise including a farm house situated within twenty-five kilometres from local limits of any municipality (whether known as Municipality, Municipal Corporation or by any other name) or a Cantonment Board, but does not include—
>
> (1) a house meant exclusively for residential purposes and which is allotted by a company to an employee or an officer or a director who is in whole-time employment, having a gross annual salary of less than five lakh rupees;
> (2) any house for residential or commercial purposes which forms part of stock-in-trade;
> (3) any house which the assessee may occupy for the purposes of any business or profession carried on by him;
> (4) any residential property that has been let out for a minimum period of three hundred days in the previous year;
> (5) any property in the nature of commercial establishments or complexes;

(ii) motor cars (other than those used by the assessee in the business of running them on hire or as stock-in-trade);

(iii) jewellery, bullion and furniture, utensils or any other article made wholly or partly of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals:

Provided that where any of the said assets is used by the assessee as stock-in-trade, such asset shall be deemed as excluded from the assets specified in this sub-clause;

(iv) yachts, boats and aircrafts (other than those used by the assessee for commercial purposes);

(v) urban land;

(vi) cash in hand, in excess of fifty thousand rupees, of individuals and Hindu undivided families and in the case of other persons any amount not recorded in the books of account.

Wealth includes six broad categories of properties – building; urban land; motor car; jewellery, bullion and furniture; utensils, yachts, boat and aircraft; and cash. Let us explore the provisions on buildings first. The provisions use the term 'house' for every kind of building and adjoining land. It includes all buildings. We can understand the implications of the provisions better if we study those meant for a company and individuals separately. A company may have residential and non-residential buildings. A building that is occupied by the company for its business or is rented out is not to be included as an asset. A building which is in the nature of a commercial establishment is also excluded. A commercial establishment is a building where business or trade is carried on. Shops and office complexes are examples of commercial establishments. Even if these are not rented out or occupied, due to their very nature, they are not to be treated as assets. Further, a residential property that is rented out for 300 or more days in a year is not to be included in 'assets'. If a residential property is allotted to a full-time employee whose salary is less than ₹ 5 lakh, that property is not to be included as an asset. Thus, a residential property owned by a company, which is not rented out or is allotted to employees earning a salary of more than ₹ 5 lakh per year, is to be included as an asset. Buildings like a factory or a warehouse, if left unused or not rented out are to be treated as assets.

For an individual, the provision will work in a similar manner. If the property is of a commercial nature, whether it is put to use or not, it would not be treated as an asset. Property that is put to use for business or is rented out, is not to be included as an asset. This reduces the scope of the provision to residential property not put to any use. From the broad sweep of the definition, it would appear that a house occupied by a person for his residential use would be included as an asset, as it is neither rented out nor put to use for business or profession. However, Section 5(vi) has exempted one house, whether the individual is living in it or not, from the scope of 'asset'.

A motor car is treated as an asset unless it is being run as a taxi or 'for hire'. The provision makes no distinction between a motor car that is put to use for a business or profession or one that is used for personal use. Thus, all cars owned by a person or a company, unless these are being used for hire, would be assets under the Act. Jewellery, bullion or any other article made wholly or partly of gold, silver, platinum or any other precious metal, forms a part of the assets. The only situation in which such an asset is not included is where it forms a part of the stock-in-trade of the person. Yachts, boats and aircrafts are assets unless these are put to commercial use. For example, an aircraft, in the hands of an airline, is put to commercial use and is therefore, not an asset. Similarly, an aircraft used for carrying out a business is being used for a commercial purpose. Urban land is another asset. Urban land is a plot of land which is situated inside the jurisdiction of a municipality with a population of 10,000 or more. Let us explore further whether the following items are assets under the Act or not.

	Property	*Asset Yes/No*
1.	Factory building rented out by a company	
2.	Residential building rented out by a company	
3.	Warehouse used by a company for storing merchandise	
4.	A building complex owned by a company and rented to another company	
5.	A flat allotted to a full time employee with a salary of ₹ 7 lakh a month	
6.	Motor car of a company for use of its officers for office work	
7.	Motor car of a taxi company	
8.	Motor car of a salaried employee	
9.	Motor car of a businessman meant for his personal use	
10.	Jewellery of an individual	
11.	Gold bought by a pharma company as an investment	
12.	Helicopter used by an infrastructure company for taking its engineers to the project site	
13.	Aircraft held by an airline	
14.	A plot of vacant land held by a company in Mumbai	
15.	Shares and mutual funds held by a person	

It is not left to the tax payer to impute any value to the wealth. The schedules to the Act give detailed procedures for arriving at the value of the assets. Section 2(m) provides for the working out of the net wealth. Net wealth is to be arrived at by deducting the debt owed in 'relation to the assets'. Thus, not all personal debts, but only the debts in relation to the assets are to be deducted. Having arrived at the net value, no tax is to be paid on the first ₹ 30 lakh. On the amount exceeding ₹ 30 lakh, wealth tax is to be paid at the rate of 1%.

The Act makes a distinction on the basis of the residential status of an individual or a company. It borrows this criterion from the Income Tax Act. For a resident person or a company incorporated in India, property in and outside India forms the pool that constitutes the assets. A tax payer may readily transfer the wealth to a related person to evade wealth tax and yet continue to enjoy the property. To plug this loophole, Section 4 provides for 'deemed assets'. A transfer of property made to a spouse or a minor child or a son's wife is deemed to be wealth belonging to the tax payer. Similarly, a transfer of asset, which is revocable, is taken to be a deemed asset of the tax payer.

There are several other themes in the income tax law. The themes are detailed and procedural. The aim of the book has been to understand the basic idea of these themes, without getting entangled in the procedural details of the law. In this chapter, we will give a brief note on some of the themes.

✦ Tax Deduction at Source (TDS)

The financial year is the basis for computing the income tax liability. A tax payer will be able to determine his/her tax liability only when the previous year ends. Thus, the tax should be paid only after the year is over. However, following this procedure would mean that the government would have to wait for the entire year to get liquidity from the income earned during the year. The government has come up with two mechanisms to get revenue while the tax payer earns income. One is advance tax and the second is Tax Deduction at Source (TDS).

Under tax deduction at source, broadly speaking, a person paying money to another is required to treat the money as income in the hands of the recipient and deduct from it, a percentage, as advance tax, and deposit it with the government. The payer is required to issue a certificate of deduction to the tax payer. The tax payer, at the end of the financial year, will compute his taxable income and tax liability. The tax deducted at source will be a tax credit. The amount will be deducted from the tax liability to work out the amount to be paid by the tax payer. If the tax credit exceeds the tax liability, the balance amount would be payable by the government. The government will pay this money to the tax payer as a refund. This arrangement does two things for the government. The government gets a steady stream of revenue for its expenditure. Secondly, it reduces tax evasion by necessarily bringing the recipient within the grid of the tax administration. At the end of the year, if the tax payer deserves a refund, he will have to file a return of his income. This brings the tax payer in the view of the tax administration.

Having developed an overview, we can now note the broad arrangement of the law. Chapter XVII of the Income Tax Act, titled 'Collection and Recovery' of Tax, makes provisions for tax deduction at source. The following are some of the sources of income or transactions for which tax has to be deducted at source:

1. **Salary Income:** Section 192 requires any person who is paying any income to another person, that is chargeable under the head of salary, to deduct tax at source on the amount being paid. The employer has to estimate the salary of the employee for the entire year. However, while doing this, the employer has to take into account the eligible deductions under Section 80C and 80D and other tax-saving instruments. On the basis of the estimate, the annual income tax is calculated. This amount is deducted on a proportionate basis, each month.
2. **Interest on Securities:** Section 193 provides that tax has to be deducted at source when interest is paid to a security holder or is credited to his account. There are several exceptions to this on the basis of the nature of the security and the recipient. The rate for deduction can also vary on that basis. For example, if a payment is being made to an individual for interest on 8% Savings (Taxable) Bonds, 2003, and the interest amount is ₹ 10,000 or less, no deduction would be made.

3. **Other Interest:** Section 194A provides for deduction at source on any payment of interest other than on securities by non-individuals. An example of this is an account holder receiving interest from a bank on the account or a fixed deposit. There are exceptions to this. For example, if the recipient is a bank or financial institution, TDS is not to be deducted. If the interest earned on a savings account or fixed deposit is more than ₹10,000, tax is deducted at source.
4. **Payment to Contractors:** Section 194C provides on this. The section has a wide scope. It applies to:

> **…** Any person responsible for paying any sum to any resident … for carrying out any work (including supply of labour for carrying out any work) in pursuance of a contract …

The section defines 'work' as:

> (iv) "work" shall include—
>
> (a) advertising;
>
> (b) broadcasting and telecasting including production of programmes for such broadcasting or telecasting;
>
> (c) carriage of goods or passengers by any mode of transport other than by railways;
>
> (d) catering;
>
> (e) manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from such customer,
>
> but does not include manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from a person, other than such customer.

The section makes a familiar distinction between a works contract and a sale contract. In a sale contract, the contract is for transfer of ownership in goods. In a works contract, on the other hand, though goods may get consumed during the performance of the contract, the contract per se is for the performance of a work. The provision intends to apply to all works contracts. The following headings of the sections will indicate the other transactions on which the Act has made provisions:

194B	Winnings from lottery or crossword puzzle
194BB	Winnings from horse race
194C	Payments to contractors
194D	Insurance commission
194E	Payments to non-resident sportsmen or sports associations
194EE	Payments in respect of deposits under National Savings Scheme, etc.
194F	Payments on account of repurchase of units by Mutual Fund or Unit Trust of India
194G	Commission, etc., on the sale of lottery tickets
194H	Commission or brokerage
194I	Rent

194J	Fees for professional or technical services
194K	Income in respect of units
194L	Payment of compensation on acquisition of capital asset
194LA	Payment of compensation on acquisition of certain immovable property
194LB	Income by way of interest from infrastructure debt fund
194LC	Income by way of interest from Indian company

Part II to the first schedule of the Finance Act provides the rate for deduction at source.

✦ Advance Tax

Requiring the tax payer to pay tax in advance, in instalments, is another mechanism the state uses to maintain a steady stream of revenue. Every tax payer is required to estimate his/her tax liability for the year. Taking the income in the preceding year as the basis, the tax payer has to apply the rate of taxation in the previous year to estimate his/her tax liability. This is the advance tax liability of the tax payer. If the advance tax is more than ₹ 10,000, the tax payer is required to pay it in instalments, as provided by Section 211 below:

On or before	*Companies*	*Others*
June 15	Not less than fifteen per cent of advance tax	–
September 15	Not less than forty-five per cent of advance tax	Not less than thirty per cent of advance tax
December 15	Not less than seventy-five per cent of advance tax	Not less than sixty per cent of advance tax
March 15	The whole amount of advance tax	The whole amount of advance tax

✦ Minimum Alternate Tax

Following the provisions of the Income Tax Act studied so far, a company will compute its income under all applicable heads, adjust losses carried forward from the earlier years and arrive at its total taxable income. The tax payable by the company would be computed at the prevailing rate. It is possible for a company to have zero taxable income and yet make significant profits so as to be able to distribute dividends to the shareholders. This anomaly is not only possible but widely prevalent and expected. The Companies Act provides details about the manner in which companies are required to maintain and prepare accounts. One of the objects of the Companies Act is to protect the interests of the shareholders from that of the dominant members and management of the company. Further, there are standard accounting practices, which the companies and chartered accountants have to follow. The companies prepare their profit and loss statements according to the schedules in the Companies Act. A company can resolve to pay dividend if it has a profit.

In contrast, the Income Tax Act, besides getting revenue for the state, has acted as an instrument for achieving its social and economic objectives. It prescribes its own procedures for taking account of the income and expenditure under the five heads. For example, the rate of depreciation for computers and accessories is 60% under the Income Tax Act. This high rate of depreciation has been provided for with the aim of encouraging the adoption of computers. The Companies Act prescribes a lower rate of depreciation. Companies, in some sectors, for expenditure on equipment to be used for scientific research, can claim twice the amount of money actually spent as deduction under the Income Tax Act, whereas, the Companies Act would treat it as an ordinary acquisition of capital assets. As the Income Tax Act gives numerous incentives, it is possible for a company to legitimately avail the benefits and not pay any tax year after year. The object of such incentives is to create social benefits and not help companies avoid taxes forever. Realising this, the Income Tax Act was amended and the concept of a Minimum Alternate Tax (MAT) was introduced. This is covered under Section 115JB in the chapter on 'Taxation of Companies'. The section reads as follows:

> **115JB.** (1) Notwithstanding anything contained in any other provision of this Act, where in the case of an assessee, being a company, the income-tax, payable on the total income as computed under this Act in respect of any previous year … is less than eighteen and one-half per cent of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of eighteen and one-half per cent.

Thus, a company has to compare its payable income tax with 18.5% of its book profit. If 18.5% of the book profit is higher, the book profit will be taken to be the income and tax will be charged at the rate of 18.5% of the book profit. 'Book profit' is related to the profit declared by the company in its profit and loss statement. While calculating the profit, items like income tax to be paid, amounts set aside as reserves and dividends to be paid, etc., may have been taken into account. Thus, the section requires book 'profit', for the purposes of the Act, to be arrived at by adding these amounts. There is no point in giving benefits and then taking them away by imposing the MAT. The Income Tax Act allows the additional amount paid due to the MAT, that is, the difference between the MAT and the income tax calculated ordinarily, as tax credit. The tax credit can be availed in a year in which the tax payer comes to pay income tax ordinarily and not under MAT. Tax credit arising from one year can be carried forward for up to 10 succeeding years.

✦ Assessment and Tax Administration

The tax payer would have a tendency to attempt to pay less rather than more to the administration. The state, on the other hand, would be just as eager to get its due. To ensure this, the state can legislate, besides having the authority to scrutinise each and every transaction of the subjects. However, this would be administratively and financially infeasible. If the state ends up spending more in collecting the tax than the tax itself, it would not be financially viable. Thus, over a period of time, the state has come up with numerous strategies to improve tax collection and compliance. Registration, return and assessment form crucial parts of its strategy.

How would the state get to know that a person is liable to pay tax, without actually having to look into the income of all persons? It does this by enacting a law providing that every person who is bound to pay tax must pay it and inform the tax administration about it. In the early stages of income tax, the tax administration would take note of the income of a tax payer and determine the tax to be paid by him. As the tax administration was assessing, for itself, the tax liability of the person, the process came to be called assessment. As the field of tax administration developed, the state realised that this method of assessment was intensive and thus, time consuming. It innovated to reduce its load. It now required the tax payer to understand the law and work out for himself, his tax liability, and pay it. This has come to be called self-assessment.

If the matter, however, were left at this, the tax payer would under-report the income. The objective was not to abandon all control but to make tax administration more efficient. The law requires the tax payer to furnish the broad details of his/her income and the calculation done for arriving at the taxable income and the tax. This is called return of income. With the return of income before it, the tax administration has saved itself the labour of computing and assessing the income of each and every tax payer. It only has to review the return filed by the tax payer.

Filing of Return

Section 139 provides the details for filing of the return of income. All companies have to file a return, whether they have a net income or loss. Other persons have to file a return if their income, without the exceptions and deductions, is taxable. For example, individual tax payers make relevant investments to get tax deductions, which make it possible for them to reduce their tax liability. The section requires such persons to file their returns, even if they do not have to pay any tax. Under Section 139, the government notifies the forms and particulars that have to be filled in. The currently notified forms are ITR-1 (Sahaj), ITR-2, ITR-3, ITR-4 and ITR- 4S, ITR-5, ITR-6 and ITR-7. ITR stands for Income Tax Return. Some of the forms are meant for individuals while others are for companies. Further, there are different forms for different kinds of income. For example, whether an individual has business income or not is an important factor in deciding the appropriate form. The tax administration has facilitated the filing of returns electronically. Companies can file their returns only electronically. An individual with an income of more than ₹ 10 lakh also has to file the return electronically. With electronic filing of return, submission of supporting documents has been dispensed with.

The form requires the tax payer to furnish broad details in relation to his income, to calculate the tax and to indicate the tax paid and the balance tax payable or refundable. The return has to be filed within a prescribed period. A company is required to file its return by September 30. Persons other than a company, who need to get their accounts audited, are required to file their returns by September 30. Others are required to file their returns by July 31. What does the tax administration do with this voluminous information? We will describe the difficult situations and contexts that can arise from the tax administration's working on the documents.

Assessment and Scrutiny

The tax administration goes through the returns. This is called assessment and is done in accordance with Section 143. The administration will check the returns for any errors and inconsistencies. There could even be a calculation error. In electronic filing, this has become unlikely. The administration may come across incorrect claims. This could come to its notice due to inconsistencies in the entries in the return. A larger deduction than allowed by the law may have been claimed. Payment of an advance tax or tax deduction at source may have been claimed without the administration finding any support in its records. Most returns will clear the assessment. The government will not make any communication with regard to these.

In the cases where it finds an error or inconsistency, it will work out the payable tax, with interest, and intimate the tax payer. This is done so as to bring the error to the attention of the tax payer and to give him/her an opportunity to rectify the error. If the tax payer has indeed made an error, he should proceed and pay the tax demanded. Alternately, he can file for rectification under Section 154, bringing out that his return is correct and that the administration is mistaken in seeing an error or inconsistency. Through this process of communication, the matter will be resolved. This will complete the assessment of the tax payer.

So far, the tax administration has only done the assessment on the basis of the information mentioned by the tax payer in the return. If it were only required to make the return free of any calculation error or inconsistency, most returns would meet the criterion. What if the information itself is incorrect and the tax payer has under-reported his income? It would not be feasible for the tax administration to check and confirm the information given in all the returns. Thus, it selects a sample of the returns and confirms the veracity of those returns. This is called scrutiny. The law prescribes stringent penalty for under-reporting of income and for tax evasion. The penalty acts as a deterrent for the tax payers who attempt to under-report their income. The selection of returns for scrutiny is done through a computerised system. The tax administration sets the criteria on the basis of their experience about where they are most likely to find cases of tax evasion. From among the returns meeting those criteria, the software generates a random list. Assessment by scrutiny is done under Section 143(2). The assessing officer serves a notice to the tax payer, requiring evidence in support of the claims in the return. The notice is to be served within six months from the end of the assessment year. For example, if a return was filed in August 2013, the notice should be served before September 30, 2014. The assessing officer has the power to serve a notice to the tax payer requiring him/her to submit documents, accounts, records and information. After considering all the material and evidence, the assessing officer will assess the income and pass an assessment order determining the income of the tax payer and consequently, the amount to be paid or refunded by the government. When the assessment order is made and the tax payable is determined, the assessment is complete. The assessment officer performs a quasi-judicial function and has to act impartially.

Tax administration is further facilitated by Section 142. Under this section, the assessment officer can serve notices to those who have not submitted their returns, asking them to submit the returns. The tax administration would come to know about such cases through its records of the prior years and the taxes paid in those years. The section further gives powers to the assessment officer to serve notice on a person, requiring production of accounts, documents and information.

Reassessment

The assessing officer can open a case that has already been assessed, for reassessment. It can be done only if the assessment officer has reason to believe that income chargeable to tax has escaped assessment. Further, it could have happened due to an omission or failure on the part of the tax payer, to make full disclosure in the assessment. The reasons could also be a retrospective change in a law, evidence from any other source, another assessment proceeding, information received from revenue intelligence or a mistake apparent from the records. For the reassessment, the assessment officer has to issue a notice under Section 148, requiring the tax payer to furnish a return of income. The new return becomes the basis for the assessment officer to do scrutiny under Section 143. The reassessment can be undertaken till up to four years after the end of the assessment year, for any amount of money that may have escaped assessment. It can be opened within the next two years if the income that escaped assessment is more than ₹ 1 lakh.

The assessment and reassessment have several procedural requirements and time periods. On the one hand, the tax administration must have adequate time to do the assessment. On the other hand, the tax payer cannot be expected to maintain documents and records for all the preceding years. There has to be a closure to the processes. Toward this, a time period has been prescribed for all the steps in the assessment and reassessment. The administration has to act within the prescribed period. The outcome of an assessment is an order. The order can be challenged in appeal. The hierarchy of the appellate courts is: the Commissioner (Appeals), Income Tax Appellate Tribunal, the High Court, and finally, the Supreme Court. There are detailed procedures for moving in appeal.

✦ Double Taxation

Suppose that a person, who is resident in India, goes to another country and earns the equivalent of ₹ 3 lakh in 15 days. The income will certainly count as income in India for the purpose of paying income tax. It will also be income within the laws of the country where the income was earned and would be taxable there as well. The person will end up paying taxes in both the countries. This is an incidence of double taxation. The international community has recognised the unfairness of double taxation and its adverse effect on trade and commerce. The United Nations has passed a resolution, to which India is a signatory, to enter into double taxation avoidance treaties. India has signed up Double Taxation Avoidance Agreements (DTAA) with 65 countries, including the U.S.A, UK, Canada, Japan, Germany, Australia, Singapore and Switzerland. The Income Tax Act provides on the treaties and gives benefits even in relation to the countries with which there is no treaty.

Chapter IX of the Income Tax Act is titled 'Double Taxation Relief'. Section 91, under this chapter, provides that a person who is resident in India and has paid income tax in another country, can claim a deduction in paying the tax in India if there is no treaty between the countries. We would recall that the definition of a 'person' includes individuals and companies. The relief requires the following conditions:

1. The person or company should be a resident of India in the previous year.
2. The income should have accrued to and received by the tax payer outside India in the previous year.
3. The income should have been taxed in the country in which it had accrued.
4. India should have no tax treaty with the country.

Section 90 provides that the central government can enter into an agreement with the government of another country for granting relief in respect of income tax paid in both the countries on the same income and avoidance of double taxation of income in the two countries. Under the section, the Government of India has entered into Double Taxation Avoidance Agreements (DTAA) with 65 countries. The agreements are modelled on the draft adopted by the United Nations. The agreements follow two broad mechanisms. The first is the exemption method. If an income has been taxed in one country, it is not to be taxed in another. The second is the tax credit method. If a tax has been paid in one country, a credit is claimed and the amount deducted while calculating the income tax in the other country. Some aspects of the agreements are as follows:

1. Dividend income is taxable in both, the place where it got earned and the place where the person or corporation is resident.
2. Interest income is taxable in both, the place where it got earned and the place where the person or corporation is resident.
3. Capital gain is taxable where the capital asset is located.
4. Income from royalty can be taxed in the place of earning or place of residence or both.
5. Income from professional services is taxable in the place of residence.

✦ Transfer Pricing

When a company buys goods from another company, the price of those goods would be their market price. This market price would be based on the cost of production and certain other prevailing market conditions. However, when companies that are networked together as a group, transact with each other, price fixation amongst them need not be determined by the market. The associated companies are more interested in benefiting the persons controlling the group of companies rather than an individual company in the group. This has tax implications, which are particularly relevant for multinational group companies.

Countries have different tax regimes. Multinational group companies, in transactions with each other, would tend to manipulate the price so as to gain tax advantage. Let us explore this with an example. Company A buys goods for ₹ 1,000 in a country, X, and sells it to a group company, Company B, for ₹ 1,200, in country Y. Company A makes a profit of ₹ 200 in country X and would pay tax on it at the applicable rate in country X. Company B sells the goods for ₹ 3,200 in country Y. It would pay tax on the profit of ₹ 2,000 at the applicable rate in country Y. If Company A had directly sold the goods in country Y, it would have made a profit of ₹ 2,200 and paid taxes on it in country X. The companies have thus, used the route of associated companies and manipulated the prices to the disadvantage of country X. This has been done because the rate of taxation is lower in Y. At other times, a company might even sell at a loss to an associated company, to take advantage of differing tax regimes.

The fixing of price between associated companies is called transfer pricing and the price, the transfer price. In the case of unrelated companies, the price would be the market price, based on the cost of production and the market conditions. In the case of transactions between associated companies, the companies are not bound by the market conditions. They have the freedom to arbitrarily fix the price. Therefore, this price is called the transfer price. Chapter X of the Income Tax Act, titled Special Provisions Relating to Avoidance of Tax, makes provisions to prevent avoidance of taxation through the mechanism of transfer pricing. It defines group companies as associated enterprises, and imposes tax on the basis of 'arm's length dealing' in international transactions.

Section 92A defines associated enterprises. An associated enterprise is one which participates, directly or through intermediaries, in the management or control or capital of another enterprise. An enterprise can control another through several means, including shareholding, voting rights or power to appoint the management. Control can also flow through other means, including debt or dependence for raw material, technology, patent or know-how. An enterprise can control another directly or through intermediaries.

Section 92 B defines an international transaction. It includes:

> … a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises…

It also includes provisions in relation to the allocation of costs or expenses between enterprises.

Section 92 provides that income arising from an international transaction between associated enterprises would be computed having regard to the arm's length price. 'Arm's length price' is the price unrelated parties would have charged under similar conditions. Section 92C provides different mechanisms for working out the arm's length price. These include the comparable uncontrolled price method, resale price method, cost plus method, profit split method, and transactional net margin method. The provisions detail out the methods and require significant documentation by the tax payer.

Part 2

Indirect Taxation

16

CHAPTER

Introduction to Indirect Taxation

The major indirect taxes are excise duty, custom duty, sales tax and service tax. We have already outlined the constitutional arrangement for the levy of indirect taxes in the introduction to the book. Sales tax is a tax on the sale of 'goods'. Excise duty is levied on the production or manufacture of 'goods', whereas, custom duty is levied on the import and export of 'goods'. What constitutes 'goods' is relevant for levying all the indirect taxes. Excise duty and custom duty apply only to 'goods'. Similarly, a sale must be of goods, for sales tax to apply. None of the taxation laws defines 'goods'. The term, however, is defined in the Sale of Goods Act, 1930. The taxation laws have taken the meaning given to 'goods' by the Sale of Goods Act and adapted and employed it in the context of taxation. In this chapter, we will become familiar with the development of the meaning of the term 'goods'.

There are thousands of kinds of goods, ranging from motorised toothbrushes to concave mirrors. For the purpose of imposing taxes, being able to identify the different goods, without any miscommunication and dispute, became a challenge. The World Customs Organisation developed a scientific system of classifying goods, called the 'Harmonised System'. This has become the basis for identifying goods for the purpose of levying of excise duty and custom duty. We will explore the 'Harmonised System' in this chapter, as preparation for our study of indirect taxation. There is a move to integrate indirect taxes into a single tax based on value creation. The concept has been given effect to in some of the indirect taxes. We will end the chapter with an exploration of taxation on the basis of value addition.

✦ Meaning of 'Goods'

The law on sale of goods developed along with the other common law. In the course of the development of the economy, there emerged two kinds of property, immovable and movable. Immovable property, as it was attached to land, came to be treated as an interest in land, and was governed in accordance with the land laws. Other properties, like horse, cattle, food grain, etc., were movable property. Both properties were physical, tangible properties. The best way of defining movable property was by expressing it as everything that was not immovable property. Thus, Section 3(36) of the General Clauses Act, 1893, defines movable property as 'property of every description, except immovable property.' This begs the question as to what is immovable property. Section 3(26) defines immovable property as:

'(26) "immovable property" shall include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth.'

The law on sale of goods developed to deal with disputes arising in relation to movable property. As movable property was tangible, storage, possession, delivery and carriage became the pivotal terms and principles associated with the sale of goods. As the economy developed, intangible forms of property developed. For example, A loans money to B and has a right to be paid back the money. A has a right over B and this right itself is a property. Further, the property is movable property as it is not immovable property. Other examples of intangible forms of property are copyrights and patents. It could be claimed that these properties were movable properties and therefore, goods. However, the law had developed with and got organised around tangible movable property. The common law courts excluded the emergent form of property from the scope of 'goods'. Based on the common law, the Sale of Goods Act, 1930, defined 'goods' as:

"goods" means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale;

Sale of goods is a contract where the consideration for the buyer is ownership while that for the seller is the price in cash. Money is the very medium of exchange. It cannot be exchanged with itself. Further, money being the medium of exchange, it can readily get mixed up with other money and lose its distinctiveness. Thus, money has been excluded from the definition of goods. Stock and shares are only an interest in a property. However, these got included as goods because there was no other law then governing share transactions.

A factory owner bought a machine and mounted it on a platform with nuts and bolts, in his factory. After six months, he sold the machine to a buyer. The buyer, under the contract, was to disengage the machine from the platform and take it away. The machine was attached to the ground and thus, was not movable. However, once severed from the ground, it became a movable property. Thus, things attached to the ground, which are agreed to be severed from the ground, become movable property. The taxation laws have taken this meaning of the term in their respective domains. Working with this, several challenging questions have emerged. For example, is electricity goods? In a sale of a book, what is being sold—paper with ink on it or the ideas and concepts contained in it? We will explore these questions under the respective laws.

Harmonised System

Goods in the course of trade were described by their names, like tobacco, wheat, rice and cotton. With industrial development, there was a proliferation of goods. Traders, taxing authorities and law enforcement agencies could come to be at a loss as to what was being referred to. This could lead to disputes and unintended violations of the law. The World Customs Organisation (then the Customs Co-operation Council) took the lead in coming up with a scientific basis for classifying goods. The World Custom Organisation developed a scientific basis for classifying goods and assigning a code to each product or class of products. The classification came to be known as the Harmonised Commodity Description and Coding System. In short, it has come to be referred as the Harmonised System (HS). The classification first constituted goods into 21 groups. These are the Sections. The progression of the Sections was from natural goods to manufactured and complex goods. Each section has chapters. The chapters break up the theme of the section into constituents. A chapter is further broken into units and sub-units. The chapter number provides the first two digits of the HS code. The next two digits come from the unit number of the chapter. The next two digits come from the sub-unit of the unit. Thus, the HS code is a six digit number. There are so many goods that often, even the sub-units are unable to identify a particular item. They only describe the different classes of goods. The HS is supplemented by general rules for interpretations and explanatory notes.

The WCO has 206 members. All the WCO countries are required to follow the HS system of classification of goods. The member states cannot change the six digit classification or the interpretation rules. However, they can break up a sub-unit further as per their tariff needs and make the six digit code an 8 digit or 10 digit code. The WCO only requires a commitment in following the classification of goods. The member countries are free to fix their custom tariff for each code. As a large number of countries are members of the WCO, almost the entire international trade has come to be done under the HS system. The HS code has become the language of all international trade. Every shipment declares the HS code as the description of the goods. The exporter, importer and the custom officials of the importing country immediately come to know the custom duty treatment to be given to the goods. India is a signatory and has given effect to the HS in the Custom Tariff Act, 1975.

The objective behind designing the HS was to facilitate the application of custom tariff as well as the collection of data on international trade. However, once a scientific classification was in place, it also found use in the organising and levying of domestic taxes as well. The HS has been adopted for levying of excise duty in India. The Central Excise Tariff Act, 1985, contains a classification of the goods on the basis of the HS and mentions the rate of duty corresponding to each entry. Let us become familiar with the organisation of the HS by exploring the classification adopted in the Custom Tariff Act. There are 21 sections in the HS. Some of the sections within the section heads are mentioned below and one of the sections has been detailed for illustration.

Section 01—(Chapters 1–5)—Live Animals; Animal Products

Section 02—(Chapters 6–14)—Vegetable Products

Section 03—(Chapter 15)—Animal or Vegetable Fats and Oils and their Cleavage Products; Prepared Edible Fats; Animal or Vegetable Waxes

Section 11—(Chapters 50–63)—Textile and Textile Articles

Section 12—(Chapters 64–67)—Footwear, Headgear, Umbrellas, Sun Umbrellas, Walking-sticks, Seat-sticks, Whips, Riding-crops and Parts thereof; Prepared Feathers and Articles made therewith; Artificial Flowers; Articles of Human Hair

Section 17—(Chapter 86–89)—Vehicles, Aircraft, Vessels and Associated Transport Equipment

Chapter 86 : Railway or tramway locomotives, rolling-stock and parts thereof; railway or tramway track fixtures and fittings and parts thereof; mechanical (including electro-mechanical) traffic signalling equipment of all kinds.

Chapter 87: Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof.

Chapter 88 : Aircraft, spacecraft, and parts thereof.

<table>
<tr><th>HS Code</th><th colspan="2"></th></tr>
<tr><td>8801</td><td colspan="2">Balloons and dirigibles; gliders, hang gliders and other non-powdered aircraft</td></tr>
<tr><td>8802</td><td colspan="2">Other aircraft (for example, helicoptors, aeroplanes); spacecraft (including satellites) and suborbital and spacecraft launch vehicles helicopters :</td></tr>
<tr><td rowspan="6">8803</td><td colspan="2">Parts of goods of heading number 8801 or 8802</td></tr>
<tr><td>HS Code</td><td></td></tr>
<tr><td>88031000</td><td>Propellers and rotors and parts thereof</td></tr>
<tr><td>88032000</td><td>Undercarriages and parts thereof</td></tr>
<tr><td>88033000</td><td>Other parts of aeroplanes or helicopters</td></tr>
<tr><td>88039000</td><td>Classification of other</td></tr>
<tr><td>8804</td><td colspan="2">Parachutes (including dirigible parachutes and paragliders) and rotochutes; parts thereof and accessories thereto</td></tr>
<tr><td>8805</td><td colspan="2">Aircraft launching gear; deck-arrestor or similar gear; ground flying trainers; parts of the foregoing articles</td></tr>
</table>

Section 18—(Chapters 90–92)—Optical, Photographic, Cinematographic, Measuring, Checking, Precision, Medical or Surgical Instruments and Apparatus; Clocks and Watches; Musical instruments; parts and accessories thereof

Section 20—(Chapters 94–96)—Miscellaneous Manufactured Articles

Section 21—(Chapters 97–98)—Works of Art, Collectors' Pieces and Antiques

Section 17 has four chapters. We explored Chapter 88 on aircrafts and spacecrafts. The HS code of the chapter is 88. This forms the first two digits of the HS code. The chapter has five sub-heads. The sub-heads provide the next two digits of the HS code. Sub-head 8803, has further, four sub-heads. Thus, the wind shield of an aircraft would be classified under HS Code 88033000, while the solar panel of a satellite would fall under 88039000. As we can see, even the final entry does not manage to identify each individual article; it only provides a class of goods. A judgement has to be made as to under which class a particular thing falls. This is done with the help of the interpretation rules and the explanatory notes.

✦ Value Addition and Indirect Taxation

The state imposes taxes on, among other activities, the manufacturing of goods, sale of goods and provision of services. What basis underlies the taxation of these economic activities? In the context of a transition from an agrarian to an industrial and commercial society, economic activity itself represented a generation of surplus. Wherever there was a prospect of surplus, the state tended to draw resources for itself. Take the case of sale of goods and sales tax. Trading represented prosperity, or at least, a potential of it. That a person was buying a thing meant that he had resources to buy. The sale price became the reference for imposing sales tax. The price charged was the face of the transaction. In the nascent stages of the development of trade and commerce, perhaps, the price got understood as the measure of surplus.

Thus, the quantum of tax imposed on manufacturing was calculated with reference to the sale price of the manufactured goods, that of sales tax with reference to the sale price, and of services with reference to the value of the services provided. As the society has completely transformed so as to be based on manufacturing, trade and commerce, the foundations of economic activity have come to be understood differently. Each economic activity adds value. It is the value added which is a measure of the surplus generated, which should be taxed. Let us explore this with the following illustration.

X manufactures plastic buckets from plastic granules. He buys granules for ₹ 10,000. The seller charges him another ₹ 1,000 as excise duty and pays it to the government. X avails electricity for ₹ 1,000 for processing the granules. On this, the service provider charges him ₹ 100 in service tax and deposits it with the government. X buys floor cleaning detergent for cleaning the floor of the workshop. This costs X ₹ 200. The seller charges him ₹ 20 as tax on the sale. The manufacturer sells the finished goods corresponding to the granules for ₹ 15,000. X collects a manufacturing tax of ₹ 1,500 from the buyer and deposits it with the government. To charge tax on the value creation done by X, a rebate should be given for the taxes already paid, which come to a total of ₹ 1,120. Effectively, the tax would then be on the actual value created by X. We took up only a few inputs to illustrate the point. In reality, a manufacturing entity will be using several raw materials, goods and services. All taxes towards excise duty, sales tax, custom duty and service tax could be taken into account for working out the rebate. We can extend the arrangement to a person providing a service or trading. A service provider would pay input tax on goods bought and services availed, for which he should get credit.

For the idea to be put into practice, like for any other idea, several administrative arrangements would need to be put in place. For example, X buys goods of value ₹ 10,000 from Y. X is charged an additional ₹ 1,000 in tax. X sells the goods for ₹ 11,000 and collects ₹ 1,100 in tax. X should be required to pay only the difference in the tax, i.e., ₹ 100, to the government. However, for this, he must establish to the satisfaction of the tax collection agency, that a tax of ₹ 1,000 has already been paid to the government. This will be possible only if the tax collection agency requires every entity to register with it and maintains detailed accounts of all receipts of taxes. The law would need to ensure that every transaction is done with the supporting documentation, furnishing the details of the transaction and of the taxes paid on it. Thus, technically, there could be a single indirect tax based on the principle of value addition. The transition has already been made by several other countries.

India has been trying to introduce a single tax, to be called the Goods and Service Tax (GST). It will integrate the existing indirect taxes levied by the central government, like excise duty, custom duty and service tax and those levied by the state governments, like tax on sale of goods and entertainment tax. Every business entity, whether engaged in manufacturing, trading or providing a service, will get tax credit on all the taxes paid. The integration would have readily happened if all the taxes were paid to the same agency. However, in India, excise duty and service tax is levied and collected by the Centre, while the tax on sale of goods within the states is levied and collected by the states. The Centre cannot implement the integration without the support and concurrence of the states. The states have their concerns as the integration may lead to a reduction in their revenue and loss of autonomy. Putting the GST in place would also require an amendment to the Constitution. Efforts are afoot to seek convergence on GST.

Having looked ahead, let us look at the present and the past. The idea that taxation on the basis of value addition is rational, efficient and ensures tax compliance, has been there for some time. As excise duty and service tax are both with the Centre, the integration of the two taxes on the principles of value addition has already been put in place. This has been done through the CENVAT Rules. In most of the cases, excise duty is charged with reference to the value of the goods manufactured. The rate for different manufactured goods is different. Service tax is charged at a standard rate, with reference to the value of service provided. A manufacturer has to collect tax on the basis of the value and nature of goods produced. Tax credit takes into account all the excise and service tax paid. Similarly, a service provider gets tax credit on the excise duty and service tax paid while acquiring the inputs for providing the service.

The tax on sale of goods is in the legislative and administrative domain of the states. The states have adopted the principle of value addition tax for realising the tax on sale of goods. Input credit is given only for the tax paid on sale of goods. The states had named their acts with the words, 'Sales Tax Act', appended to the name of the state, for example, Gujarat Sales Tax Act. They have now shifted to titles with the words, 'Value Added Tax', attached, for example, Gujarat Value Added Tax Act. The acts continue to be about taxing sale of goods, but they are administered on the basis of value addition. With this general background, we will explore the working of the indirect taxes in the subsequent chapters.

17

CHAPTER

Sale, Goods and Sales Tax

As trade developed, imposing tax on sale of goods became a means for the state to earn revenue. The subject of tax on sale of goods has evolved over the decades, in terms of its scope, content and principles. With the changing nature of goods and business relations, it will continue to evolve in the future as well. We will explore how the field has developed over the decades. Before that, however, we would note the provisions in the Constitution of India for the imposition of a tax on sales. The Constitution of India has the following entries in the Union List and the State List:

> Union List: Entry 92A—taxes on sale and purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce.
>
> State List: Entry 54: Tax on sale or purchase of goods other than newspapers except tax on inter-state sale or purchase.

Leaving newspapers aside, a state can tax a sale of goods within that state only. If the sale is inter-state, tax on that sale falls in the domain of the Centre. In this context, let us explore different kinds of sales with reference to the movement of goods. A buyer could be getting goods from outside India. This would be import of goods. A tax on imports, called customs duty, falls in the domain of the Centre. The buyer will pay the customs duty on the goods imported. Similarly, a seller could be sending goods from India to a buyer in another country. This would be export of goods. However, this does not fall in either of the above two entries in the Lists. It falls under Entry No. 83 in the Union List: 'Duties of customs including export duties'. Thus, the Centre may impose an export duty but there can be no sales tax. If a sale takes place within a state, the state can impose a sales tax on it. If the sale is from one state to another, it will be an inter-state sale, and the Centre has the power to tax the sale. What constitutes a sale within the state and an inter-state sale can itself, at times, be contentious. The Central Sales Tax Act, 1956, sets out the principles for deciding whether a sale is within the state or inter-state.

Following the legislative arrangement, the Parliament has enacted the Central Sales Tax Act, 1956, for levying tax on inter-state sales. The states had enacted their own Sales Tax Acts. For example, Andhra Pradesh had enacted the Andhra Pradesh General Sales Tax Act. In the working of the sales tax laws, the meaning and scope of the terms 'sale' and 'goods' evolved over the decades. In this chapter, we will explore the development of the meaning and scope of these two words. In the subsequent chapter, we will review the existing sales tax laws in the states.

✦ Changing Meaning of 'Sale'

We need to start with the acts made by the Provincial Legislatures during British rule. Like the present Constitution, the Government of India Act, 1935, delineated the legislative powers of the Provinces. The Provincial Legislature could legislate on the subject of 'taxes on the sale of goods and on advertisements.'[1] Following this, the provinces made legislations imposing sales tax. The Madras General Sales Tax Act, 1939, was extended to cover work contracts and it taxed the materials used in the execution of works contracts as sales. In this case, a notional value was to be assigned to the material used and this value was to be charged to sales tax. M/s. Gannon Dunkerley and Co. was a company engaged in works contracts, including those of construction of buildings, roads and bridges.[2] The company contended that the legislature was competent to make laws pertaining to only 'taxes on the sale of goods.' It could impose a tax only if there was a 'sale of goods'. A project execution contract is not for selling of goods. Materials get used while executing the work. Thus, the company contended that the Act could not be extended to tax the materials used. As a result, the Act should be declared invalid.

The contention of the government was that the term, 'sale', has a broad meaning in everyday practices. It should be assigned its broader, popular meaning rather than the narrow technical meaning. In its broad popular meaning, the execution of a work contract has an element of sale where the customer becomes the owner of the material. The Supreme Court ruled that the meaning of the term 'sale', in its legal sense, is always one arising from a contract leading to the passing of the ownership. The Court noted:

> Thus, according to the law both of England and of India, in order to constitute a sale it is necessary that there should be an agreement between the parties for the purpose of transferring title to goods … that it must be supported by money consideration, and that as a result of the transaction property must actually pass in the goods. Unless all these elements are present, there can be no sale. …this Court has consistently held that though the word "sale" in its popular sense is not restricted to passing of title, and has a wider connotation … such levy [of sales tax] could, nevertheless, be made only when the transaction is one of sale, and it would be a sale only when it has resulted in the passing of property in the goods to the purchaser. … We must accordingly hold that the expression "sale of goods" in Entry 48 cannot be construed in its popular sense, and that it must be interpreted in its legal sense.

The term, 'sale of goods', was used for a very long time by the common law courts. It was later incorporated in the acts, like in the Indian Contract Act, 1872, and the Sale of Goods Act, 1930. The term had come to acquire a specific meaning in law. A sale was distinguished from an agreement to sell. An agreement to sell was a contract. It became a sale only when the seller transferred the ownership to the buyer. Thus, in the above case, the Court was of the view that there must be a transfer of ownership in goods for there to be a transaction that could be taxed. In a work execution contract, the material was not being sold. It was being used to execute the work. Thus, there could be no tax for a work contract. In numerous cases, the Supreme Court emphasised that for the incidence of sales tax to arise, all the elements of a contract and sale must be present. This problem with the application of sales tax to work contracts and service contracts persisted for a long time.

---

[1] State of Madras v. M/s. Gannon Dunkerley and Co. (Madras) Ltd., AIR 1958 SC 560.

[2] State of Madras v. M/s. Gannon Dunkerley and Co. (Madras) Ltd., AIR 1958 SC 560.

✦ Sale, Work and Service Contract

A contract of sale is different from a service contract. In a sale contract, the ownership transfers to the buyer for a consideration. In some contracts, however, both the aspects may be present. The buyer may become the owner of certain goods and also receive a service. Let us explore this theme with the following illustration. A car owner took his car to an authorised service station. Some of the charges displayed by the service station were: 'Car Servicing: ₹ 600', 'RTO approved sun filter (Price): ₹ 800' and 'Putting up of sun filter on the car windows: ₹ 200'. The customer asked for a servicing of his car and bought shades for the car. It was a single offer, leading to the formation of a contract, where the station was to service the car and fix sun filters. The intention of the parties was to sell the sun filters to the customer. The parties intended it to be three separate contracts, one for a servicing of the car, second for the sale of the sun filters and the third for putting up of the sun filters. The contract can thus be divided, as the parties intended it to be separate contracts.

Contrast this with a case where a technician comes to service a washing machine. The charge for servicing the washing machine is ₹ 200. The technician has a small roll of tape, whose maximum retail sale price is ₹ 10. He uses the tape on the joints of the water pipes. He exhausts the entire role of tape. It is technically possible to separate out ₹ 190 as the consideration for the service and ₹ 10 for the tape. However, the parties did not intend it to be two separate contracts, one for the supply of the tape and the second for the provision of the service. It was intended to be a single, non-divisible contract. Thus, whether a contract is divisible or not depends not on its capability of being broken up into its constituents, but on the intention of the parties.

Taking the above contract as one, is it a contract for sale or service? The contract was for the provision of a service, in the course of which, the tape got consumed. The essence of the contract was the service provided, while the use of the tape was incidental. Thus, it is a contract of service. In contrast, where a retailer has a contract to supply and set up a personal computer for ₹ 30,000, it is a contract of sale, even if it has an element of service. Thus, looking at the intention of the parties, a contract can be divided into its constituents. Secondly, if a contract involves both, supply of goods as well as provision of a service, and the two cannot be divided, we have to go by the essence or the dominant nature of the contract to characterise it as one or the other.

In India, service tax got introduced only in 1994. Till then, the decision about whether a contract was that of a sale or service was significant. A sale contract was subject to a sales tax, but a service contract was not. A large number of cases came before the Supreme Court involving work contracts, to decide whether they were sales or contracts of service. The case of Vanguard Rolling Shutters v. Commissioner of Sales Tax[3] can serve as an illustration that would reiterate the principles by the Supreme Court. Vanguard Rolling Shutters and Steel Works were fabricating and installing iron shutters according to the specific requirements of their customers. The sales tax authority took the transaction as a sale of iron shutters, while Vanguard Ltd. argued that it was a work contract. The Supreme Court noted:

---

[3] Vanguard Rolling Shutters and Steel Works, M/s. v. Commissioner of Sales Tax, AIR 1977 SC 1505.

> It is well settled that a work contract is a contract for construction of bridges, buildings etc., and includes contracts which combine labour, skill and materials executed for a lump sum. The question as to under what circumstances a contract can be said to be a work contract is not free from difficulty and has to depend on the facts of each case. It is difficult to lay down any rule of universal application, but there are some well recognised tests which are laid down by decided cases of this Court which afford guidelines for determining as to whether a contract in question is a work contract or a contract for supply of goods. One of the important tests is to find out whether the contract is primarily a contract for supply of materials at a price agreed to between the parties for the materials so supplied and the work or service rendered is incidental to the execution of the contract. If so, the contract is one for sale of materials and the sale proceeds would be exigible to sales tax. On the other hand, where the contract is primarily a contract for work and labour and materials are supplied in execution of such contract, there is no contract for sale of materials but it is a work contract. The circumstance that the materials have no separate identity as a commercial article and it is only by bestowing work and labour upon them, as for example, by affixing them to the building in case of window-leaves or wooden doors and windows that they acquire commercial identity, would be prima facie indicative of a work contract. So also, where certain materials are not merely supplied but fixed to an immovable property so as to become a permanent fixture and an accretion to the said property, the contract prima facie would be a work contract. This is exactly what has happened in the present case.

The process involved in the fabrication of a rolling shutter and its actual fixing at the site was a continuous one. The work would get completed only when the shutters were put up with masonry work. What got created in the end was a firmly fixed immovable property. The price charged was a lump sum amount, without reference to the material used up and the work done. These were important considerations behind the Court's holding that the transaction was a composite, consolidated contract of work.

Does a hotel sell food or provide the service of dining? This dispute came before the Supreme Court in State of H.P. v. M/s. Associated Hotels of India Ltd.[4] and Northern India Caterers v. Lt. Governor of Delhi.[5] The Supreme Court noted that a hotel runs a restaurant as an integral part of the amenities offered to its guests. A guest intends to enter into a composite contract for staying in the hotel and not merely for the sale of food. Even when an outsider goes to a restaurant, the customer enters into a contract for experiencing the hospitality of being served food and not just for the sale of food. The hospitality includes the decor, ambience, furniture, cutlery and service. Thus, serving of food does not constitute a sale of goods. The above judgements held levying of sales tax on provision of food and work contracts by the state governments unconstitutional.

✦ Sale and Hire-Purchase

The state governments took a hire-purchase to be a sale and imposed sales tax on it. The constitutional validity of this law was challenged. In an agreement to sell, there is an obligation on the seller to transfer ownership in the goods to the buyer. An agreement to sell becomes a sale when the seller performs his obligation and transfers the ownership to the buyer. The buyer pays the seller according to the terms of the contract. The contract may provide for a deferred payment or an instalment payment plan. In contrast, in a hire-purchase agreement, the hirer has an option

[4] State of H.P. v. M/s. Associated Hotels of India Ltd., AIR 1972 SC 1131.

[5] Northern India Caterers, M/s. (India) v. Lt. Governor of Delhi, AIR 1978 SC 1591.

to buy or not to buy the hired goods. As there is no legal obligation to buy, there is no agreement to sell. The Supreme Court explored the distinction between a typical hire-purchase agreement and a sale in K. L. Johar and Co., M/s. v. Deputy Commercial Tax Officer, Coimbatore III.[6] It noted that:

> The essence of a sale is that the property is transferred from the seller to the buyer for a price, whether paid at once or paid later in instalments. On the other hand, a hire-purchase agreement, as its very name implies, has two aspects. There is first an aspect of bailment of the goods subjected to the hire-purchase agreement, and there is next, an element of sale which fructifies when the option to purchase, which is usually a term of hire-purchase agreements, is exercised by the intending purchaser. Thus the intending purchaser is known as the hirer so long as the option to purchase is not exercised, and the essence of a hire-purchase agreement properly so called is that the property in the goods does not pass at the time of the agreement but remains in the intending seller, and only passes later when the option is exercised by the intending purchaser. The distinguishing feature of a typical hire-purchase agreement, therefore, is that the property does not pass when the agreement is made but only passes when the option is finally exercised after complying with all the terms of the agreement.

The Court thus ruled that sales tax could not be imposed on a hire-purchase transaction. Taking advantage of this, the parties would make a transaction where hire charges would be paid in several instalments. Thereafter, the buyer would have the option of purchasing the goods at a notional price of ₹ 1. Thus, ₹ 1 became the value relevant for the calculation of sales tax. Yet another area where the states suffered reverses was in cases of sales made by clubs and societies.

✦ Sale by Clubs and Societies

The exploration of the meaning of the term 'sale' arose from yet another vantage. Clubs and societies are created for the benefit of their members. A society could serve food and beverages to its members for a price. A sale requires a contract between two distinct persons. Is a society a distinct person or is it only acting for its members? This was the question that came before the Supreme Court in J. C. Tax Officer, Harbour Division II, Madras v. Young Men's Association (Regd.) Madras.[7] The Supreme Court ruled:

> If the club, even though a distinct legal entity, is only acting as an agent for its members in the matter of supply of various preparations to them, no sale would be involved as the element of transfer would be completely absent.

As a result, all sales by a society or club, to its members, could not be subjected to sales tax. If the club or society acted as an agent of the member, there would be no sale as the parties are not distinct. Thus, the Supreme Court declared that works contracts, catering contracts and hire-purchases were not be subject to sales tax. The provision of service by clubs and societies was also not sale if the society was acting as an agent for its members. However, the state governments intended to have a much broader scope for sales tax than the one given by the Supreme Court. The Parliament amended Article 366 of the Constitution of India through the 46th constitutional amendment, to reverse the effect of the court judgements. The amendment was as follows:

---

[6] K. L. Johar and Co., M/s. v. Deputy Commercial Tax Officer, Coimbatore III, AIR 1965 SC 1082.

[7] J. C. Tax Officer, Harbour Division II, Madras v. Young Men's Association (Regd.) Madras, AIR 1970 SC 1212.

> 366. In this Constitution, unless the context otherwise requires, the following expressions have the meanings hereby respectively assigned to them, that is to say— ...
>
> (29A) "tax on the sale or purchase of goods" includes—
>
> (a) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;
>
> (b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;
>
> (c) a tax on the delivery of goods on hire purchase or any system of payment by instalments;
>
> (d) a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration;
>
> (e) a tax on the supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;
>
> (f) a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration,
>
> and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made.

Each of these clauses was aimed at neutralising the implications of the decisions of the Supreme Court in different cases. The constitutional amendment gave the legislature, competence to impose sales tax on works contracts, sale of food, hire-purchase and sale by clubs and societies. Thus, the sales tax acts made by the states came to carry the above definition of sale.

✦ Scope of 'Goods'

Sales tax applies to sale of 'goods'. Like the scope of the term 'sale', the scope of the term 'goods' also got shaped by the law on sale of goods. The law on sale of goods developed to deal with disputes arising in relation to movable property. As movable property was tangible, storage, possession, delivery and carriage became integral terms and principles associated with sale of goods. As the economy developed, intangible forms of property developed. For example, A loans money to B and has a right to be paid back the money. A has a right over B and this right in itself, is a property. Further, the property is movable property as it is not immovable property. Other examples of intangible forms of property are copyrights and patents. It could be claimed that these properties were movable properties and therefore, goods. However, the law had developed with and got organised around tangible movable property. The common law courts excluded the emergent forms of movable property. Following these developments, the definition of goods in the Sale of Goods Act, 1930, came to be as follows:

> "goods" means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale;

An interesting question that emerged was, whether electricity was 'goods' within the Sale of Goods Act, 1930. The question was relevant from the point of view of taxation. The Madhya Pradesh High Court, in K. E. S. Corporation v. J. C. T. Officer,[8] gave very cogent reasons for it to be considered as goods. It noted that:

> Under the Sale of Goods Act, "goods" means every kind of movable property other than actionable claims and money, and includes stock and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. Under this definition "goods" must be property and it must be movable. The inclusive part of the definition would seem to indicate that the property contemplated is of a tangible character, which may be capable of possession' and touch and that the things which would come within the expression "goods" should be such as may be put to human or other use. The scheme of the Sale of Goods Act visualises delivery of possession, which again indicates that what is contemplated by "goods" under its provisions is tangible property which can be transmitted from hand to hand by delivery. …Any kind of property which is movable will, therefore, fall within the definition of "goods" provided it is transmissible or transferable from hand to hand or capable of delivery, which to my mind, need not necessarily be in a tangible or physical sense. … But having regard to the two fold division of property, if the property in question is not immovable, it must necessarily be movable. From these statutory definitions it is clear therefore, that if electricity is property and it is movable it will be "goods". It may perhaps be that when the Sale of Goods Act or the General Clauses Act was enacted, electricity as property was not so much in the contemplation of the legislature. But, as it seems to me, both from the scientific as well as the economic point of view, electricity appears to be such property as gas or water which is subjected to a particular process, bottled up and sold for consumption.
>
> After all what is property? I think anything which is of value in a commercial sense and is fit for use in any conceivable manner will be property, provided it is capable of possession and transfer, such possession or transfer not merely in the physical sense. Electricity answers that description. Every day it is sold, purchased and consumed, it is too late in the day to say that electricity is not capable of sale as property. Electricity seems to be also movable property, because it can undoubtedly be transmitted, of course, through insulators or through conductors from place to place. It is also capable of delivery in the same way for consumption though again subject to the protection which is required, having regard to the peculiar nature and quality of electricity. It may be that electricity cannot be possessed in a physical sense, like tangible goods. It may also be true partly that electricity cannot be stored except in the form of batteries and similar devices. If, therefore, electricity is property and is capable of movement and delivery in the sense I have mentioned, I do not see why it cannot be regarded as goods.

The reasoning of the Court was that every property that is not immovable property is movable property and would become 'goods' if it can be stored, possessed and delivered. The Supreme Court, in Commissioner of Sales Tax Madhya Pradesh, Indore v. Madhya Pradesh Electricity Board, Jabalpur[9] and in State of A.P. v. N.T.P.C. Ltd.[10] reiterated this view.

Court Case: Tata Consultancy Services v. State of Andhra Pradesh

Tata Consultancy Services, as part of their business, prepared and loaded on customers' computers, custom-made software.[11] The Court referred to this as 'uncanned software'. It also sold computer

---

[8] K. E. S. Corporation v. J. C. T. Officer, AIR 1964 Mad 477.

[9] Commissioner of Sales Tax, Madhya Pradesh, Indore v. Madhya Pradesh Electricity Board, Jabalpur, AIR 1970 SC 732.

[10] State of A.P. v. N.T.P.C. Ltd., AIR 2002 SC 1895.

[11] Tata Consultancy Services v. State of Andhra Pradesh, AIR 2005 SC 371.

software packages off-the-shelf. The Court referred to these as 'canned software'. The Andhra Pradesh Government levied sales tax on the 'canned software', contending that the software were 'goods'. The dispute was whether canned software could be considered to be 'goods' within the meaning of the sales tax laws of Andhra Pradesh. The contention of Tata Consultancy Services was that the term 'goods' only included tangible movable property and computer software was not tangible movable property, and, thus, not taxable within the Act. The Supreme Court, relying on the earlier judgements, noted:

> … this Court has held that the term "goods" for the purposes of sale tax, cannot be given a narrow meaning. It has been held that properties which are capable of being abstracted, consumed and used and/or transmitted, transferred, delivered, stored or possessed etc. are "goods" for the purposes of sales tax. … In India the test, to determine whether a property is "goods", for purposes of sales tax, is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed etc. Admittedly in the case of software, both canned and uncanned, all of these are possible. …
>
> In our view, the term "goods" as used in Article 366(12) of the Constitution of India and as defined under the said Act are very wide and include all types of movable properties, whether those properties be tangible or intangible. We are in complete agreement with the observations made by this Court in Associated Cement Companies Ltd. … A software programme may consist of various commands which enable the computer to perform a designated task. The copyright in that programme may remain with the originator of the programme. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it be in the form of books or canvas (in case of painting) or computer discs or cassettes, and marketed would become "goods". We see no difference between a sale of a software programme on a CD/ floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media, i.e. the paper or cassette or disc or CD. Thus, a transaction sale of computer software is clearly a sale of "goods" within the meaning of the term as defined in the said Act. The term "all materials, articles and commodities" includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed, etc. The software programmes have all these attributes.

The question then is, if the software had not been sold on a CD, but had been downloaded through the internet, would it have been taxable? The downloading of software meets all the criterion of 'goods'. Software is an intellectual property in which the copyright vests in the author. However, once the software is put on a server, the copyright has been put to use to produce a file that can be downloaded. The file is capable of being transmitted, possessed, delivered and used. Thus, it should not make any difference whether the software is sold on a CD or downloaded from the internet. As the question before the Court was only on 'canned software', the Court refrained from pronouncing on the general question. It noted:

> In both cases, the software is capable of being abstracted, consumed and used. In both cases the software can be transmitted, transferred, delivered, stored, possessed etc. Thus even unbranded software, when it is marketed/ sold, may be goods. We, however, are not dealing with this aspect and express no opinion thereon because in case of unbranded software other questions like situs of contract of sale and/or whether the contract is a service contract may arise.

The term 'unbranded software' referred to software that is not sold off-the-shelf. Such software is developed specifically for a party. In this case, we would first need to resolve whether it is a service contract or a contract for a sale of goods. This will depend on the intention of the parties. The dispute in the above case was in the context of the practices being followed in 1995–96. Since then, information technology has rapidly expanded and transformed. Software, music and information have come to be sold directly through the internet. The judgement has paved the way to provide an answer to the question about the application of sales tax on such sales.

18

CHAPTER

Sale of Goods: Value Added Tax

Following the constitutional amendments regarding sale of goods, the impediment created by the court judgements got removed. The states could tax a wide array of transactions. The states, however, were in competition with each other in giving tax incentives so as to earn more revenue. The tax 'war' had become unhealthy, creating distortions. The central government facilitated the rationalisation of the sales tax laws of the states by creating an 'Empowered Committee of the State Finance Ministers' in the early 1990s. The committee realised that imposing sales tax on the basis of 'value addition' was a more rational and efficient basis for tax administration. The Empowered Committee came up with a White Paper in 2005, suggesting a re-organisation of the sales tax law in the states. It created the framework and basic principles for the proposed tax regime. The states came up with new Acts, which they called Value Added Tax Acts. The name of the state was prefixed to it. For example, the State of Gujarat has called its act the Gujarat Value Added Tax, 2003. The law relates to tax on sale of goods within the state, but it is administered on a value added basis.

The Value Added Tax Acts incorporate both, new ideas as well as well-settled principles evolved over the decades. The new ideas relate to the levying and collection of tax on a value added basis. The settled principles relate to the scope of the terms, 'sale' and 'goods', which we explored in the earlier chapter. While the White Paper serves as the basis, there is variation in the Acts across the states. Let us become familiar with the general arrangement by exploring the White Paper and study some provisions of the Gujarat Value Added Tax, 2003, as an illustration. The Act came into force in 2006. It has been amended every year since 2007. The White Paper, taking from the previous sales tax acts, calls the person who is required to pay tax, 'dealer'.

✦ Who can be a 'Dealer'?

The Constitution empowers the states to impose sales tax on every sale of goods. However, the state is interested in taxing only commercial and business sales. Transactions are pre-dominantly commercial in nature. Thus, only marginal revenue is lost by not taxing every sale. Taxing non-commercial sales may put undue and unnecessary hardship on the citizen. Thus, sales tax is imposed on every sale which is of a commercial or business nature. The seller is required to collect the sales tax from the buyer. The seller, that is the tax payer, has been called a dealer in sales tax law. Before noting the definition of a dealer, which is very elaborate, let us work around it. As explored in the earlier chapter, 'sale' has been given an extended meaning. As a result, a dealer would also include all persons who can do any of those extended activities. Thus, a dealer includes a seller, a contractor executing a project, a person engaged in the service of provision of food, as well as a society or club. At times, an owner may sell goods through an agent or auctioneer. The definition must take this into account.

The other important aspect is to do with the nature of the tax being of a value added kind. A trader who buys goods and sells them within the state is certainly a dealer. A manufacturer might buy raw material from within the state, process it and sell the manufactured good within the state. He would be paying sales tax on the purchase of the raw material. At the time of sale, the buyer would be charged sales tax on the value of the goods. Thus, as the manufacturer is paying as well as collecting sales tax, he should also be included in the definition of a dealer. The following is an edited version of the definition, bringing out only the important and common application of the term.

> (10) "dealer" means any person who, for the purpose of … in connection with or incidental to or in the course of his business buys, sells, manufactures, makes supplies or distributes goods, directly or otherwise, whether for cash or deferred payment, or for commission, remuneration or otherwise and includes—
>
> (a) the Central Government or a State Government or any local authority ….
>
> (b) a casual dealer, that is to say, a person who … undertakes occasional transaction of a business nature in any exhibition-cum-sale or auction or otherwise in the State, whether for cash, deferred payment, commission, remuneration or other valuable consideration;
>
> (c) an auctioneer, who sells or auctions goods belonging to any principal whether disclosed or not …
>
> (d) a factor, broker, commission agent, del credere agent or an auctioneer or any mercantile agent, by whatever name called, who carries on business on behalf of any principal whether disclosed or not;
>
> (f) any person who transfers property in goods (whether as goods or in some other form) involved in the execution of a works contract;
>
> (g) any person who delivers goods on hire purchase or any system of payment by installments;
>
> (h) any person who transfers the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration; and
>
> (i) any person who supplies, by way of or as part of any service or in any other manner whatsoever, goods being food or any other article for human consumption or any drink (whether or not intoxicating) where such supply or service is for cash, deferred payment or other valuable consideration. …
>
> Exceptions—The following shall not be deemed to be a dealer within the meaning of this clause, namely:
>
> (i) an agriculturist who sells exclusively agricultural produce grown on land cultivated by him personally;
>
> (ii) an individual who sells exclusively any fish or any sea-food caught by him personally or by any member of his family on account of or on behalf of such individual; and
>
> (iii) a charitable, religious or educational institution, carrying on the activity of manufacturing, buying, selling or supplying goods, in performance of its functions, for achieving its avowed objects, which are not in the nature of business.

Thus, the term 'dealer' includes government and government bodies. It includes an auctioneer, mercantile agent, work contractor, a person hiring out goods on hire-purchase basis and a person supplying food and drinks. However, the definition excludes an agriculturist selling his produce, as it was thought that it might cause hardship to the farmers. Similarly, fishermen are excluded from the definition. As charitable organisations benefit the society, they have also been treated favourably. A dealer is a person engaged in 'business'. Section 2(4) defines business as:

(4) "business" includes—

(i) …. any adventure or concern in the nature of trade, commerce or manufacture, whether carried on with a motive to make profit or gain …and

(ii) any transaction of buying, selling or supplying plant, machinery, raw materials, processing materials, packing materials, empties, consumable stores, waste products, or such other goods, or waste or scrap of any of them which is ancillary or incidental to or resulting from such trade, commerce, manufacture, adventure or concern;

'Business' has been defined very broadly. Let us put the definitions of business and dealer together to explore whether the following qualify to be 'dealer' within the Act.

S. No.	*Person and Activity*	*Dealer (Yes/No)*
1.	A drycleaner based and operating in Ahmedabad	
2.	A manufacturing unit in Surat	
3.	Z is an agent who buys goods for a principal based in Mumbai	
4.	X, based in Baroda, bought a television for his household use	
5.	Y, an agent based in Ahmedabad, sells goods for a manufacturer based in Chennai	
6.	B Limited is a company registered in Mumbai. Its sales office in Ahmedabad gets the stock from the manufacturing units and sells it to the wholesalers in the state.	
7.	An office of the Government of India that runs a canteen for its employees and sells food at subsidised rates in Baroda	
8.	A trader in food grains based in a village, who procures from the farmers	
9.	Airlines landing their planes at the Ahmedabad airport and buying turbine fuel at the Ahmedabad airport	
10.	A kiosk selling cold drinks at a bus stand in Rajkot	
11.	A touring music group that sold their CDs to the audience after the performance.	
12.	A doctor practising in Surat	
13.	Agro Expo Limited is a hundred per cent export company. It procures raw materials locally but exports all its manufactures.	

The answer to the above exploration would be as follows:

S. No.	*Person and Activity*	*Dealer (Yes/No)*
1.	A drycleaner based and operating in Ahmedabad	No
2.	A manufacturing unit in Surat	Yes
3.	Z is an agent who buys goods for a principal based in Mumbai	Yes

4.	X, based in Baroda, bought a television for his household use	No
5.	Y, an agent based in Ahmedabad, sells goods for a manufacturer based in Chennai	Yes
6.	B Limited is a company registered in Mumbai. Its sales office in Ahmedabad gets the stock from the manufacturing units and sells it to the wholesalers in the state.	Yes
7.	An office of the Government of India that runs a canteen for its employees and sells food at subsidised rates in Baroda	Yes
8.	A trader in food grains based in a village, who procures from the farmers	Yes
9.	Airlines landing their planes at the Ahmedabad airport and buying turbine fuel at the Ahmedabad airport	No
10.	A kiosk selling cold drinks at a bus stand in Rajkot	Yes
11.	A touring music group that sold their CDs to the audience after the performance.	Yes
12.	A doctor practising in Surat	No
13.	Agro Expo Limited is a hundred per cent export company. It procures raw materials locally but exports all its manufactures.	Yes

The definition of a 'dealer' is broad and includes a person who 'buys, sells, manufactures, makes, supplies or distributes goods.' A person who only buys is also included in the definition. This will tend to include doctors and drycleaners. However, the definition of business is narrower. It only includes 'trade, commerce or manufacture.' Trade and commerce relate to goods, not to provision of services. Thus, a doctor or a drycleaner is not included in the definition of a dealer. An individual who buys for his own use is a consumer as he has not bought the goods in relation to any business. As we can see, the intention is to define 'dealer' broadly so as to bring everyone who is buying and selling in relation to business within the fold of the law. Towards making the base all inclusive, even a 'casual' trader has been included in the list. A 'casual trader' is a person who 'undertakes occasional transactions in the nature of business involving buying, selling, supply or distribution of goods or conducting any exhibition-cum-sale'.

As explored in the earlier chapter, the Act has given an expanded meaning to the term, 'sale'. A 'sale' includes:

1. A conventional sale where ownership in goods is transferred for a cash consideration.
2. Supply of goods by a society, club or company to its members.
3. Transfer of property in goods involved in the execution of a works contract;
4. Delivery of any goods on hire-purchase.
5. Supply of goods or other articles by restaurants, hotels, etc. as a part of the service provided by them.

✦ Charge of Sales Tax

The states have the legislative competence to tax only the sale of goods taking place within the state. Section 4 of the Act, thus, limits the scope of the Act:

4. Certain sales and purchases not liable to tax: Nothing contained in this Act or the rules made thereunder shall be deemed to impose or authorise the imposition of tax on any sale or purchase of any goods where such sale or purchase takes place—

(a) in the course of inter-State trade or commerce; or

(b) outside the State; or

(c) in the course of the import of goods into or export of goods out of the territory of India, and the provisions of this Act and the rules thereunder shall be construed accordingly.

Explanation—Sections 3, 4 and 5 of the Central Act shall apply for determining whether or not a particular sale or purchase has taken place in the manner indicated in clauses (a), (b) or (c).

The Parliament has enacted the Central Sales Tax Act, 1956, for the charge of sales tax on inter-state sale of goods. The Act defines what constitutes an inter-state sale and a sale outside a state. Sale within a state has been construed negatively as what is not export, import, inter-state sale or sale outside the state. Movement of goods, in association with the sale, is an important criterion for deciding whether a sale is an inter-state sale or not. Let us explore the application of the Gujarat Value Added Tax Act to the following transactions.

S. No.	*Transaction*	*Yes/No*
1.	A trader from Ahmedabad exported handicraft goods to UK.	
2.	A trader in goods in Baroda received services from another trader in Baroda.	
3.	A garment manufacturing company in Ahmedabad sold garments to a retail outlet in Mumbai.	
4.	A food manufacturing unit in Surat bought its ingredients from a trader in Baroda.	
5.	The Mumbai branch of a company registered in Gujarat, bought its raw material from the Mumbai branch of another company registered in Gujarat.	

The answer to the above is as follows.

S. No.	*Transaction*	*Yes/No*
1.	A trader from Ahmedabad exported handicraft goods to UK.	No
2.	A trader in goods in Baroda received services from another trader in Baroda.	No
3.	A garment manufacturing company in Ahmedabad sold garments to a retail outlet in Mumbai.	No
4.	A food manufacturing unit in Surat bought its ingredients from a trader in Baroda.	Yes
5.	The Mumbai branch of a company registered in Gujarat, bought its raw material from the Mumbai branch of another company registered in Gujarat.	No

As the first transaction is an export, it is out of the ambit of the Act. The second transaction is a provision of service and thus, is not included. The third transaction is an inter-state sale. The fourth transaction is a sale within the state. In the fifth transaction, the legal persons are registered in Gujarat but the contract of sale is made and executed in Mumbai. Thus, it is a sale outside the state of Gujarat.

✦ Liability to Pay Tax

Taxation on value added basis is efficient, but it requires detailed account keeping by the dealer. Compliance with the requirements would be harsh on a small dealer. Therefore, the White Paper recommended a compulsory registration of the dealers but exempted dealers with a gross annual turnover of up to Rupees five lakh from payment of tax. Section 3 of the Gujarat Value Added Tax Act provides that the dealers whose yearly turnover exceeds Rupees five lakh and whose yearly taxable turnover exceeds Rupees ten thousand, are liable to pay the tax. The total turnover is the value of all the goods sold by the dealer, whether within the state, inter-state or exports. Taxable turnover is the value of goods on which tax is levied under the Act. The dealer has to meet both the conditions of being liable to be taxed. Thus, a 100% export unit, with a turnover of Rupees five crore, is not liable to be taxed as it has no taxable turnover. A dealer, who only makes sales within the state, having a turnover of Rupees three lakh, is not taxable as his taxable turnover is more than ₹ 10,000, but his annual turnover is less than Rupees five lakh. Turnover is on the 'sale' of goods.

✦ Rates for Taxation

The Act prescribes different rates of tax for the sale of different commodities. We can understand the arrangement with reference to the recommendations of the Empowered Committee. The states need to tax so as to mobilise resources for its upkeep and developmental purposes. At the same time, the quantum of tax is an important source of equity and it also affects the consumption pattern and promotion of trade and commerce. The rates of tax range from complete exemption to high rates. The Empowered Committee recommended exempting some items from taxation altogether. The exempted category comprised natural and unprocessed products produced by the unorganised sector and commodities that are of wide use and utility.

The Empowered Committee proposed a modest rate of 1% for bullion, gold, silver or precious metals and items and jewellery made out of them, and for precious and semi-precious stones. For other commodities, three rates of taxation were recommended, 4%, 12.5% and 20%. Items including drugs, medicines, agricultural and industrial inputs and capital goods were to be taxed at the lowest slab of 4%. Some commodities in this category were of interest to the general public, for example, bicycles and hawai chappal. Most of the information technology products and cellular phone products were also included in this category as there was a view that the adoption of new technology should be encouraged. Petroleum products were to be treated outside of VAT as the prices for these was fixed by the central government. These were to be treated according to the special provisions made under the Act or some other law. The Empowered Committee was to recommend the rate for this group of commodities. All other goods that were not listed were to be charged at the standard rate of 12.5%. Each state, taking this as the base document, improvised before enactment and has subsequently modified the legislation and the rates of taxation.

The Gujarat Value Added Tax Act has given effect to the recommendations of the Empowered Committee by making three schedules to the Act. Section 7 of the Act provides the rates for the different goods. The goods in Schedule I are exempt from taxation. Schedule III contains petroleum related products. These are taxed at the rate of 24%. Schedule II contains 87 entries. Entry number 13 in the list was bullion. This was taxed at the rate of 1%. Other entries in the schedule were taxed at 4%. The last entry in Schedule II, entry number 87, provided that whatever was not included in the list was to be taxed at 12.5%. By subsequent amendments, the rates of some of the entries in Schedule II have been raised by 2.5%, and the remainder, excepting entry number 13, have been raised by 1%. The rate for the residual category in entry number 87 was raised by 2.5%. Thus, the effective rate for a commodity not included in any schedule is 15%. The state government has been given the power to reduce the duty for any of the goods listed in Schedule II or Schedule III. Thus, the above rates are only indicative. One would need to go through the notifications to confirm the existing rate. An abridged and edited version of the three lists illustrating some of the entries is given in the annexure.

✦ Tax Credit

The VAT credit is available to all registered dealers who are buying and selling in relation to 'business'. It, thus, applies to not only traders, retailers and wholesalers, but also to manufacturers. Further, VAT applies to the purchase of raw materials as well as capital goods. However, all input taxes are not claimable. The taxes that can be claimed are called tax credits. The advantage of tax credit is available for the following:

1. Goods bought within the state, against a sale within the state, an inter-state sale or an export.
2. Goods bought within the state, against a branch transfer to another state (subject to reduction by 4%).
3. Goods bought within the state, for the manufacture of goods or packing of goods for sale within the state, inter-state sale, branch transfer to another state or exports.
4. Capital goods bought within the state and used for the manufacture of goods sold within the state, inter-state or exported.

Tax credit is not allowed for certain purchases. These include:

1. Goods purchased in the course of inter-state trade.
2. Goods that are used in the manufacture of tax free commodities listed in Schedule I.
3. Capital goods used for the manufacture of commodities listed in Schedule I.
4. Vehicles and accessories, unless the dealer is engaged in the business of selling such goods.
5. Petrol, high speed diesel and crude oil, unless it is intended for resale.
6. Goods used as fuel in motor vehicles and for generation of electricity.

The liability of the dealer to pay is worked out by deducting the tax credit and the tax collected for the period. Availing the input credit is not tied to selling of specific goods. For example, if a trader buys goods in the month of November, he will get the credit for those goods even if the goods are lying unsold in his warehouse. As the VAT is a state tax, input credit cannot be claimed against inter-state tax, central excise duty, service tax and custom duty. It can only be claimed against tax on sale of goods within the state. The Act provides for a quarterly or monthly basis for calculating and paying the tax, depending on the turnover of the dealer. The Act has exempted small dealers with less than Rupees five lakh turnover from taxation. The Act further provides that a dealer to whom the Act applies and whose turnover is less than ₹ 50 lakh, can opt to pay 1% tax on the turnover instead of the VAT. However, the provision is subject to limitations. One of them is that the dealer should not be procuring goods from any place outside Gujarat or selling or supplying goods to any place outside Gujarat.

Proper documentation is the pillar of the VAT basis of taxation. One important document is the retail invoice. Words like 'Retail invoice' or 'Cash Memorandum' or 'Bill' should be indicated prominently on the retail invoice. This is the document that the seller gives to the buyer. It must contain the name, address and registration number of the selling dealer. Each of the bills should bear a serial number. The invoice should indicate the description, quantity, volume and value of the goods and services provided, inclusive of the amount of tax charged. Obviously, this must be authenticated by the signature of the seller and the date of the making of the document. This documentation has several elements to it. From the description of the goods sold, the rate at which VAT is to be charged can be worked out. Thus, the amount of VAT paid or payable can be worked out. It is to be assumed that the seller has paid the tax. Understandably, tax credit can be claimed only if the buyer has an invoice. A similar document is called a tax invoice. A tax invoice is to be issued by the seller on the request of the buyer. A tax invoice shows the VAT payable/paid for a transaction. A tax invoice should declare itself to be a tax invoice and contain the name, address and registration number of the selling dealer, the registration number of the purchaser, the date of the invoice and the volume and value of the goods as well as the tax charged. There are elaborate provisions that decide whether the tax is to be paid on a monthly basis or a quarterly basis. If the tax paid in a year exceeds ₹ 60,000, the dealer has to file the return and pay the tax on a monthly basis. The payment has to be made within 22 days of the end of the month. We will understand the subject further with the help of the following illustrations.

Illustration

X Ltd. is a company engaged in trading. It bought certain goods for selling to its customers, from a seller. The seller issued him an invoice for ₹ 9,000, inclusive of tax. The applicable VAT on the description of the goods was 12.5%. Can the company claim a tax input? If yes, what is the amount of tax that can be claimed as tax input?

When the buying price is inclusive of tax, the amount has to be broken up so as to separate out the price of the goods and the tax. The price goes to the credit of the seller and the tax, to the government. The calculation of the tax will be as follows:

Taking X to be the price of the goods, the total amount paid becomes:

$$X + 12.5\,X/100 = 112.5X/100 = 9000$$

$$X = 9000 \times 100/112.5 = 8000$$

Thus, the price of the goods is ₹ 8,000 and VAT is ₹ 1,000. X Limited will get an input tax credit of ₹ 1,000.

Illustration

Y Limited is a trader in electronic goods. It sold goods within the state for ₹ 3,120, inclusive of tax. What is the output tax liability of the company if the applicable rate of VAT is 4%?

The sum received will need to be broken up into the price for the goods and the tax.

Price of goods = ₹ 3120 × 100/104 = ₹ 3,000

Output Tax = ₹ 120

Illustration

A dealer in engineering goods bought a machine in the month of April. In the invoice, VAT was indicated to be ₹ 8,000. This was the only purchase made by him in the month. He could not sell the machine in April. However, he sold a machine he had bought in the month of January. The VAT indicated in the invoice for that machine was ₹ 9,000. This was the only sale he made in the month of April. The dealer has to pay VAT on a monthly basis. What is the amount of money he should be paying at the end of the month of April?

Availing input tax credit is not tied to the selling of the specific goods. Once goods are bought, tax has been paid by the dealer and it can be claimed as input tax credit. Thus, the amount of money paid in taxes would be related to the buying and selling of different things.

Illustration

A wholesaler bought one lot of goods in October and paid ₹ 18,000 in VAT. This was the only purchase he made in the month. He sold goods in the month of October to a buyer. The VAT indicated in the invoice was ₹ 25,000. This was the only sale in the month of October. The dealer pays VAT on a monthly basis. The opening balance of VAT is ₹ (–)3,000. How much tax would the dealer need to pay to the government in November?

In a month, the input tax credit may be more than the output tax. Then, the balance amount would be negative. The dealer would not need to pay any money. The balance amount would be adjusted the next time. Thus, the dealer would need to pay ₹ 4,000. It should be noted that the opening balance should never be positive. It would be positive only if the dealer had defaulted in paying the money in the last period.

Illustration

A wholesaler, in the month of October, bought stock from three different sources and paid the following taxes:

Import of goods – Customs duty paid: ₹ 25,000

Purchase from another state – Inter-state sales tax paid: ₹ 6,000

Purchase from within the state – VAT paid: ₹ 3,000

All the sales by the wholesaler took place in the local market. The total tax collected from the buyers in the month of October was ₹ 28,000. The wholesaler is required to pay VAT on a monthly basis. Following the closure of the month of October, what is the amount of tax the wholesaler would pay to the government?

The integration of the tax on sales on a VAT basis is allowed only if the sales take place within the state. Thus, only the tax due to the state government can be claimed as input credit. Customs duty is paid to the central government. Inter-state tax on sale has been collected by the seller in another state. Thus, the only input credit will be the tax on the purchase within the state. The wholesaler will get a tax credit of ₹ 3,000.

Illustration

Y Limited procures goods from the local market and exports them. The total input tax credit in the month of November was ₹ 80,000. There is no export tax on the commodities Y Limited deals in. Thus, Y Limited does not pay any tax to the central or state government. What treatment should be given to the input tax?

The input tax is available as tax credit. Y Limited can claim a refund from the government.

Illustration

A wholesaler buys goods locally and sells them within the state and to other states. The total input tax credit from purchases made within the state, in the month of October, was ₹ 35,000. The following was the output tax collected by the wholesaler from the sales:

VAT on goods sold within the state: ₹ 30,000

Central Sales Tax: ₹ 10,000

Following the closure of the month of October, what is the amount of tax the wholesaler would pay to the government?

Input credit is available against inter-state sales. Thus, the dealer would be able to carry forward ₹ 5,000, to be claimed as input tax credit, against the output tax of the subsequent month(s).

Illustration

A manufacturing company paid the following VAT on local purchases made in the month of February:

Raw material: ₹ 60,000

Capital Goods: ₹ 30,000

The company sold all its finished goods locally. The output tax in the month of February was ₹ 70,000. What is the amount of tax the company should pay to the government on the closure of the month of February?

VAT paid on the purchase of capital goods is allowed as an input credit. However, the amount may be adjusted over a period of time or in the year of purchase. Different states have fixed their own respective time periods. The White Paper had recommended a maximum of 36 monthly instalments.

Schedule – I

Goods, the sales or purchase of which are exempt from tax

Entry No.	*Description of goods.*	*Conditions and exceptions subject to which exemption is granted.*
2	Agricultural implements operated exclusively by human or animal agency for exclusive use in agricultural operations and the parts thereof, which are ordinarily not also used otherwise than as such parts,	–
6	Betel leaves and pan, tambul, vida, or patti prepared from betel leaves.	–
8	Books, periodicals and journals, timetables for railways and passenger transport services.	Except which are specified in entry 56 in Schedule II
9	(1) Bread in any form ...	–
12	(i) Cereals and pulses; (ii) Flour of cereals and pulses except Maize flour; (iii) Wheat flour, *rava*, *suzi* or *maida* made from wheat.	Except when sold in sealed package under a brand. [Explanation: The word 'brand' means any goods sold under a trademark registered under the Trade Mark Act, 1999.]
15	Chillies, tamarind and turmeric, whole or in powder form.	Except when sold in sealed package under a brand. [Explanation: The word 'brand' means any goods sold under a trademark registered under the Trade Mark Act, 1999.]
21	Electrical energy.	–
24	Fish, sea food, and other aquatic products.	Except when sold in sealed containers under a brand.
28	Fresh fruits, fresh vegetables, edible tubers and garlic.	–
38	Kites (*Patang*).	–
41	(i) Milk—whole or separated, or pasteurised milk (except milk powder) (ii) Butter *milk*, curd, *lassi*, and *chakka*.	–
53	Water (other than aerated, mineral, purified water, medicinal, ionic, distilled, battery, de-mineralised water and water sold in sealed container).	–

Schedule – II

Goods, the sales or purchase of which is subject to tax and the rate of tax

Entry No.	*Description of Goods.*
1	Agricultural implements to which Entry 1 in Schedule I does not apply and agricultural machinery.
6	Bicycles, tricycles, cycle rickshaws, pedal rickshaws, and cycles combination and accessories and parts thereof
6A	Biscuits (Unbranded)
13	(i) Bullion and specie, gold, silver, and other precious metals, (ii) Articles or jewellery made of gold or silver or both or of other precious metals (studded or not studded with precious stones or pearls whether real, artificial or cultured). (iii) Precious stones, semi-precious stones and pearls of all types.
14	Candle made of wax.
19	Chemical fertilizers of all types.
22	Coffee beans and seeds, cocoa pods, green tea leaf and chicory tubers or chicory roots whether cut or dried or processed.
23	Communications equipment such as, Private Branch Exchange (P.B.X) and Electronic Private Automatic Branch Exchange (E.P.A.B.X), etc.
28A	(i) Drugs, medicines and vaccines including bulk drug but excluding— (a) food and dietary supplements including food for special dietary uses, (b) Cosmetics and toilet preparations including tooth paste, tooth powder, hair oil, face and body lotions and cream, soaps.
30	(i) Edible oils (ii) Washed cotton seed oils (iii) Vegetable non-essential oils (iv) Hydrogenated vegetable oils including vanaspati
36	Hosiery goods
41	Incorporeal goods or intangible goods, that is to say, copyright, patent, trademarks, brand name, import licence.
42A	Industrial inputs or agricultural inputs as may be specified by the state government by notification in the official gazette.
43	Iron and steel, that is to say ....
45	IT products as may be specified by the state government by notification in the Official Gazette.
48	(i) *Kirana* and spices of all varieties and forms, as may be specified by the notification, including *amchur, ajma* (*ajwa*), *asalia*, coconut copra, dry fruits, *isabgul*, *kalingada* seeds, *khas khas* (red poppy seeds), *jira* (cumin seeds), *variali* (aniseeds), *methi* (fengru seeds), *suva, dhana, dhana dal,* and pepper and spices, (ii) Processed fruits, processed vegetables including fruit jams, jelly, pickle, fruit squash, paste, fruit drink and fruit juices.

	(iii) Following goods, when sold in sealed packages under a brand:- (a) x x x x (b) Powder of chillies, tamarind of turmeric or powder of any other *masala* (c) *Farsan*, that is to say eatables (other than sweet preparations) (d) Meat, fish and all sea food. Explanation: The word 'brand' means any goods sold under a trademark registered under trademarks Act, 1999.
55	Packing materials as may be specified by the Government.
56	(i) Papers of all types including newsprint (ii) Stationery articles such as— exercise books, graph book and laboratory notebook, drawing books, examination answer books, catalogues and publications to which Entry 8 of Schedule I does not apply Pre-printed or printed material, calendar or calendar datta; charts, maps and globes for educational use Writing instruments such as fountain pens, stylograph pens, ball-point pens, lead pencils and pencils of all types and spare parts and accessories of pens and pencils, crayons, foot rules, slide rules, geometrical instruments, scientific instruments, mathematical instruments or parts thereof or mathematical instrument boxes, school colour boxes, blackboard, rubber erasers, pencil sharpners, dissection boxes, audio picture cards, printing ink, cartridges and toner, drawing pin, drawing brushes, rubber rings, stationery articles made of plastics
59	Plastic footwear
60	Readymade garments and articles prepared from any textile.
67	Sim cards
68	Software
70	(i) Sports goods, excluding footwear (ii) Equipment of physical exercise
74B	Tea in leaf or powder form.
80	Utensils of all types.
87	All goods other than those specified in Schedule I and in the preceding entries of this schedule.

Schedule – III

Goods, the sales or purchase of which is subject to tax and the rate of tax

Sr. No.	*Description of Goods*
1.	High speed diesel oil
2.	Aviation gasoline (Duty paid)
3.	Aviation gasoline (Bonded)
4.	Aviation turbine fuel (Duty paid)
5.	Aviation turbine fuel (Bonded)
6.	Any other kind of motor spirit

19

CHAPTER

Central Sales Tax

Sale of goods in the course of inter-state trade and commerce is taxed under the Central Sales Tax Act, 1956 (CST Act). The CST Act, like the VAT Acts, requires dealers to register, so as to facilitate effective collection and assessment of tax and prevention of tax evasion. It specifies the commodities and the rate of taxation applicable to each of them. An important aspect of the Act is to delineate what constitutes an inter-state sale, to which the Act is going to apply. The Act extends its scope by elaborating three themes. It defines inter-state sale and purchase. The Act is to apply to these transactions. It also defines what constitutes a sale or purchase within the state. The transactions that do not fit in this definition will be treated as sale or purchase outside the state and thus, as inter-state transactions. The Act defines sale and purchase in the course of export and import. It exempts these transactions from its scope. We can now explore what constitutes an inter-state sale. Section 3 of the Act provides as follows:

> When is a sale or purchase of goods said to take place in the course of inter-state trade or commerce: A sale or purchase of goods shall be deemed to take place in the course of inter-state trade or commerce if the sale or purchase—
>
> (a) occasions the movement of goods from one state to another; or
>
> (b) is effected by a transfer of documents of title to the goods during their movement from one state to another.

Both the clauses, Clause (a) and (b), appear to require a movement of goods. Let us first examine Clause (a). The Supreme Court has thus summarised the clause:[1]

> It is well settled by a catena of decisions of this Court that a sale in the course of inter-State trade has three essential ingredients: (i) there must be a contract of sale, incorporating a stipulation, express or implied, regarding inter-State movement of goods; (ii) the goods must actually move from one State to another, pursuant to such contract of sale; the sale being the proximate cause of movement; and (iii) such movement of goods must be from one State to another State where the sale concludes.

Thus, there must be a contract of sale, and goods must move from one state to another in relation to completion of the sale. The Court elaborated:

> It follows as a necessary corollary of these principles that a movement of goods which takes place independent of a contract of sale would not fall within the meaning of inter-state sale. In other words, if there is no contract of sale preceding the movement of goods, obviously the movement cannot be attributed to the contract of sale. Similarly,

[1] State of A.P. v. N.T.P.C. Ltd., AIR 2002 SC 1895.

> if the transaction of sale stands completed within the State and the movement of goods takes place thereafter, it would obviously be independently of the contract of sale and necessarily by or on behalf of the purchaser alone and, therefore, the transaction would not be having an inter-state element.

The Court illustrated with reference to prior court judgements, thus:

> … when the movement of the goods from one State to another is an incident of the contract it is a sale in the course of inter-State sale and it does not matter which is the State in which the property passes. What is decisive is whether the sale is one which occasions the movement of goods from one State to another. … a sale would be an inter-State sale even if the contract of sale does not itself provide for the movement of goods from one State to another provided, however, that such movement was the result of a covenant in the contract of sale or was an incident of the contract.

Thus, whether a sale is an inter-state sale or not is a question of both, fact and law. If, as a result of a contract, goods move from one state to another and there is a sale, the sale is an inter-state sale. We could illustrate this by listing the following as instances of inter-state sales:

1. A buys construction material from B, where both of them are based in Delhi. The sale contract states that goods are to be despatched to A's construction site in Cochin, Kerala. This is an inter-state sale, even if both the parties are based in Delhi, as there is a movement of goods from one state to another, in connection with the sale.
2. A manufacturing company has its principal office in Mumbai and its factory in another state. The dealers are spread all over India. The dealers pay to the Mumbai office and collect the delivery orders. They take delivery of the goods from the factory and take them to their respective states. This arrangement could lead to an inter-state sale as the taking of the goods to another state is a part of the whole contract of sale.
3. A commission agent in a state purchases goods on behalf of his principal and despatches them to the principal, who is in a different state. This would be an inter-state sale as movement of the goods is a part of the contract.

Manufacturers transfer goods from their factories to their branch offices and depots for sale. Let us take a case where M is a manufacturing unit of televisions, based in Mumbai. It has branch offices and depots in all states of India. M sends a truck load of television sets to its depot in Bangalore. In this case, there is an inter-state movement of goods, but no sale. A sale can only take place between two different persons. Similarly, if M has agents who stock up goods on behalf of M, there is no sale. M continues to be the owner of the goods. Thus, the CST Act would not apply. A problem, however, arises when this inter-state movement of goods becomes associated or connected with a sale. The proximity to sale makes it a case of inter-state sale as opposed to a routine stock transfer from one location to another. Let us look at the following illustrations.

1. M had a factory in Madras. A buyer in Mumbai contacted the Mumbai office. The Mumbai office asked the factory to manufacture and supply goods to the buyer's specifications. Goods were despatched to the Mumbai office and from there, sold to the buyer. This is not a case of stock transfer, but that of an inter-state sale.
2. A buyer placed an order for 10 ACs on the Mumbai office of an AC manufacturing company based in Mumbai. The factory of the company was in Gujarat. Ten ACs were

moved, against the order, from Gujarat to Mumbai and the sale was completed in Mumbai. This is a case of an inter-state sale.

3. A company was based in Delhi. Its factory was in Faridabad. The Delhi office received orders and sent production programmes. Goods were manufactured as per the specifications. The goods were brought to Delhi as Delhi had better warehouse and rail facilities. Bills were raised from Delhi and payments were received at Delhi. This was held to be an inter-state sale from Faridabad.
4. Indian Oil Corporation (IOC) had a factory in Barauni (Bihar) and a depot at Kanpur. The IOC entered into a contract to supply Naphtha to the Indian Explosives Ltd., for its fertiliser plant. The Indian Explosives Ltd. installed pipe lines from Barauni to Kanpur and from Kanpur to its fertiliser factory. Naphtha was stocked up for a certain number of days in Kanpur. IOC maintained that the movement of Naphtha from Barauni to Kanpur was stock transfer and from Kanpur to the fertiliser plant, a local sale. However, the terms of the contract of sale were such, the Supreme Court noted, that sale was not possible without a movement of goods from Barauni. Thus, it was held to be a case of inter-state sale.[2]
5. Goods were despatched from a factory to a buyer in another state. The invoice was raised through the depot in the city of the buyer. This was an inter-state trade.

✦ Central Sales Tax and Sale by Transfer of Documents

We now move to Clause (b) of Section 3, which deals with sale by transfer of documents, while the goods are in movement. When goods are given to a carrier, like railways, ships, planes or road transporters, the carrier gives a receipt. The receipt mentions the person who has the right to collect the goods from the carrier at the point of destination. Such a receipt is called a Lorry Receipt, Railway Receipt, Bill of Lading, or Air Way Bill, depending on the mode of transport. These are 'documents of title' because the one who submits such a document has a right to the goods. The document can be in the name of the buyer, an agent, or self. The person who is named can transfer the document by mentioning it on the document. This is called endorsement. Effectively, a delivery of the receipt amounts to a transfer of ownership.

Clause (a) requires that a sale should occasion a movement of the goods. On the other hand, under Clause (b), there is a movement of the goods, but this need not have been occasioned by a sale. For example, a manufacturing firm, M, is sending its goods as stock transfer from Delhi to Cochin. After the goods have been shipped, M gets a buyer in Cochin and transfers the title to him. This becomes an inter-state sale, even if the movement had not been occasioned by the sale.

It can, at times, be a contentious question whether the sale happened within the state or it was an inter-state sale. Another contentious question can be regarding the state in which the sale took place. The Act makes further provisions to clear the point.

[2] Indian Oil Corporation Ltd. v. Union of India, AIR 1981 SC 446.

✦ Rate of Central Sales Tax

The tax under the CST Act is levied, collected and appropriated by the respective state governments. There are numerous criteria for imposing the tax and determining its amount. Some of the principal ones are as follows:

1. If a particular good is exempt from local sales tax, the CST is nil.
2. If the local sales tax on a commodity is less than 2 per cent, the CST will be the same as the local tax.
3. In the case of an inter-state sale to the government, not covered by 1 and 2 above, a concessional rate of 2 per cent is charged.

The idea behind the Act is that if there is a resale within the state of destination, local sales tax will also apply. Further, if goods are being bought for manufacturing or packing, the finished goods will be sold and the incidences of levying of sales tax will rise. The law does not intend to effect multiple taxation. It, thus, has fixed a concessional rate of 2 per cent in the cases where goods are intended for resale or packing and manufacturing. However, this can also open up possibilities for tax evasion. Thus, the Act extends this concessional rate only to registered dealers. There are further procedural safeguards in the form of taking declarations in appropriate forms from the purchasing dealer or the manufacturer. Thus, a distinction is made between a registered and an unregistered dealer. The rates applicable to them are as follows:

1. Registered dealer: 2 per cent, if goods are for resale or packing or manufacturing.
2. Unregistered dealer: An unregistered dealer pays CST at the rate of the local sales tax.

20

CHAPTER

Service Tax

Service tax, as the title suggests, is a tax on provision of services. World-over, alongside manufacturing, provision of services developed as a significant economic activity. This happened in India during the 1980s. The state is forever looking for means of mobilising resources. Towards this, the Parliament, in 1994, made a law to impose a tax on services. This was done by introducing a chapter on Service Tax in the Finance Act, 1994. Initially, service tax was imposed only on three services. As service tax was not a known category at the time when the Constitution was made, there was no mention of service tax in the three lists in the Constitution. The Union List, however, gives the power to the Centre to levy tax on whatever is not mentioned in the three lists. This gave the power to the Centre to levy service tax. Subsequently, the entry, '92C Taxes on services', was made in the Union List, giving explicit powers to the Centre to levy service tax.

Over the years, each finance act brought more and more services within the ambit of service tax. This led to numerous amendments and modifications in the chapter on service tax in the Finance Act, 1994. In 2012, an entirely new basis has been brought in for the application of service tax. Instead of the provisions applying to the services listed in the Act, it applies to everything that is not listed in a list. Following this foundational change, most of the earlier rules and notifications have been rescinded and new rules and notifications made. Thus, leaving behind the history of service tax, we have to study it afresh. Before getting into the details, let us note some salient aspects of the law on service tax. As we have noted, taxes are levied on business and commercial activities. Thus, service tax applies wherever there is a contract of service. The Centre can tax only a service which is in its domain. When a service has an international dimension, there can be a question about whether the service falls in the domain of India or not. There are rules that clarify this aspect. Service tax is charged on the consideration for the service. The current rate of service tax is 12 per cent. On this, the two education cesses are charged, making the effective rate 12.36 per cent. Having developed an overview, we can explore the provisions.

✦ Scope of 'Service' Tax

Service tax can be imposed only on a 'service'. Let us first explore the meaning of 'service'. As noted earlier, taxes apply to business and commercial activities. Thus, a service should arise from a contractual activity. A contract will be based on an agreement that is backed up with consideration. A sale contract is distinct from a service contract. A contract of sale cannot be a contract of service. This is important as a contract of sale will attract sales tax and not service tax. However, we noted in the introductory chapter to this part that if a contract is divisible, it should be divided into sub-contracts. Even after the division, if the contract has elements of both, service and sale, it would have to be characterised as one or the other depending on its dominant nature. Every contract that is not for sale of goods will not be a service contract. An example of a contract that is neither could be a contract transferring ownership in an immovable property. The following is an abridged version of the definition of 'service' as provided in the Act.

> 65B(44) "service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include—
>
> (a) an activity which constitutes merely,—
>
> (i) a transfer of title in goods or immovable property, by way of sale, gift or in any other manner; or ...
>
> (ii) such transfer, delivery or supply of any goods which is deemed to be sale within the meaning of Clause (29A) of Article 366 of the Constitution; or
>
> (iii) a transaction in money or actionable claim;
>
> (b) a provision of service by an employee to the employer in the course of or in relation to his employment;
>
> (c) fees taken in any Court or tribunal established under any law for the time being in force.

Let us ignore the scope of 'transaction in money or actionable claims'. In relation to the others, let us explore whether each of the following constitute a service or not.

Activity	*Service (Yes/No)*
Sale of a washing machine	
Sale of a plot of land	
Hiring out of a washing machine at the charge of ₹ 300 per month	
Giving a laptop to a friend to use for a week, without any charge	
Services rendered by a driver employed by a person	
Services rendered by a manager employed with a company	
Services rendered by a freelance management consultant	
A High Court charging court fee and deciding a case	
Hiring out of an apartment	

The answer to the questions is as follows:

Activity	*Service (Yes/No)*
Sale of a washing machine	No
Sale of a plot of land	No
Hiring out of a washing machine at the charge of ₹ 300 per month	Yes
Giving a laptop to a friend to use for a week, without any charge	No
Services rendered by a driver employed by a person	No
Services rendered by a manager employed with a company	No

Services rendered by a freelance management consultant	Yes
A High Court charging court fee and deciding a case	No
Hiring out of an apartment	Yes

Giving a laptop to a friend for a week is not a service as there is no consideration moving from the friend. Section 66E declares certain activities to be services even if there is a doubt about the activity fitting within the definition of a service. An abridged version is as follows:

66E. The following shall constitute declared services, namely:—

(a) renting of immovable property;

(b) construction of a complex, building, civil structure or a part thereof, including a complex or building intended for sale to a buyer, wholly or partly, except where the entire consideration is received after issuance of completion certificate by the competent authority. …

(d) development, design, programming, customisation, adaptation, upgradation, enhancement, implementation of information technology software;

(e) agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;

(f) transfer of goods by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods;

(g) activities in relation to delivery of goods on hire purchase or any system of payment by instalments;

(h) service portion in the execution of a works contract;

(i) service portion in an activity wherein goods, being food or any other article of human consumption or any drink (whether or not intoxicating) is supplied in any manner as a part of the activity.

Inclusion of renting of immovable property and hiring of goods in the list is more in the nature of an explanation. It has been stated to remove any doubt. The mention of the service portion in a work contract and provision of food and drink has been made to bring out the concurrent application of VAT to these activities. A contract for construction, where the property is transferred after the completion of the construction, is a transfer of immovable property. All the construction costs get subsumed in the value of the immovable property. This is not a service. However, if the consideration is paid while the construction is still on, it is taken as a service of construction. Similarly, development of software has been deemed to be a service. The term ‘activity’, used in the definition of service, is a very broad term. Its scope has been further expanded by including ‘refraining from an act or tolerating an act’. For example, a company runs an advertisement campaign with an actor. It enters into a contract with the actor stating that the actor would not appear in advertisements of its rivals. The actor is paid a certain amount of money for this. The forbearance of the actor is an activity.

✦ Charge of Service Tax

Section 66B levies a charge on services as follows:

66B. There shall be levied a tax (hereinafter referred to as the service tax) at the rate of twelve per cent on the value of all services, other than those services specified in the negative list, provided or agreed to be provided in the taxable territory by one person to another and collected in such manner as may be prescribed.

A 'person' has been defined broadly to include individuals, all forms of legal persons and unincorporated bodies. 'Taxable territory' delineates the place where the service is provided. The service tax applies on all services other than the services listed in the negative list. Section 66 D provides the negative list. It is given in Annexure I. There are 17 main headings in the negative list. Each of the entries is further supported by definitions of the key terms that occur in it, to bring out the scope of the entry. We will briefly note the reason for the inclusion of some of the services. The government provides certain services to its subjects as a welfare measure. Some of the services are free and do not qualify as 'services' as there is no consideration. However, the government also subsidises certain services. Provision of health services is an example. There is no point in the state raising revenue from such an activity when the very object of the state is welfare. Thus, the services provided by the government and local bodies are in the negative list.

The government, however, also enters the market like any other service provider. Provision of the services of post and insurance are examples of this. The entry has been detailed so as to make it clear that such activities are not included in the negative list. 'Government' only refers to the central and state governments and not to public sector organisations. The Reserve Bank of India has been singled out for application. Agricultural operations are exempted as a concession to encourage promotion of agriculture. Also, a significant population depends on it for livelihood. Taxing it would cause hardships. Trading is passing ownership in the goods. It has been included so as to remove all doubts. Processes amounting to manufacture are exempted as these are taxed under the excise laws. An activity of entertainment may be paying entertainment tax. Thus, it is included in the negative list. The reasons for the inclusion of education, residential renting and low cost transport is obvious. An entry in the negative list which should be specifically mentioned is: '(n) Services by way of –(i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount'. If a loan were to be taken to be a taxable service, the effective interest rate would go up by 12 per cent. The state, as a part of its job of managing the economy, manages the interest rate. There is no point in fixing an interest rate and then charging a service tax. The government would rather fix the interest rate at a higher amount. For this reason, the interest part of the banking service is in the negative list. For this reason only, the services provided by the Reserve Bank of India have also been included in the negative list. A major service provided by the RBI is being a banker to the banks. If this service were to be taxed, the interest rates will go up.

In addition, Section 93 gives the power to the Government of India to exempt any service from service tax or lower the rate of tax by issuing a notification. The government, following the change in the basis for levying of service tax, has issued two different notifications consolidating all the previous notifications. Notification No. 25/2012, dated June 20, 2012, exempts certain services entirely. An indicative list has been provided in Annexure 2. Notification No. 26/2012, dated June 20, 2012, provides a rebate in the quantum of tax to be paid. Excerpts from the notification are contained in Annexure 3.

✦ Taxable Value

Having delineated the services on which the service tax would apply, let us explore the procedure of valuation of the services and calculation of the quantum of tax. Section 66B imposes a charge in the form of a percentage of the 'value of all services'. As explored earlier, a taxable service has to arise from a contract. The value of the service is the consideration the service provider receives for providing the service. The consideration for the service can be in money or non-money form. The term consideration comes from contract law. For taxation purposes, there must be valuation in money terms, of the consideration, for the tax to be worked out. Some means must be found to determine a money value or its equivalent, of the consideration. Section 67 provides on this. It reads:

> **67. Valuation of taxable services for charging service tax.** (1) Subject to the provisions of this Chapter, service tax chargeable on any taxable service with reference to its value shall—
>
> (i) in a case where the provision of service is for a consideration in money, be the gross amount charged by the service provider for such service provided or to be provided by him ….
>
> (ii) in a case where the provision of service is for a consideration not wholly or partly consisting of money, be such amount in money, with the addition of service tax charged, is equivalent to the consideration …
>
> (2) Where the gross amount charged by a service provider, for the service provided or to be provided is inclusive of service tax payable, the value of such taxable service shall be such amount as, with the addition of tax payable, is equal to the gross amount charged.
>
> (3) The gross amount charged for the taxable service shall include any amount received towards the taxable service before, during or after provision of such service.
>
> (4) Subject to the provisions of sub-sections (1), (2) and (3), the value shall be determined in such manner as may be prescribed.
>
> Explanation
>
> (a) "consideration" includes any amount that is payable for the taxable services provided or to be provided;
>
> (b) "money" includes any currency, cheque, promissory note, letter of credit, draft, pay order, travellers cheque, money order, postal remittance and other similar instruments but does not include currency that is held for its numismatic value;
>
> (c) "gross amount charged" includes payment by cheque, credit card, deduction from account and any form of payment by issue of credit notes or debit notes and book adjustment.

The section deals with several important and interesting questions. Let us first develop an overview of the themes. Sub-section (1)(i), deals with the normal case where a service provider will contract to provide a service for a specified cash consideration. The sub-section takes the entire cash consideration as the taxable income. The sub-section reiterates the point that the money can be received before, during or after the provision of the service. Further, the money can be received in instalments. The service provider may not be careful about collecting the service tax from the customer. He may contract to provide a service for a fixed value, for example, for ₹ 400. What are the implications in relation to service tax? The charge of service tax is not dependent on whether the parties were aware of the application of the service tax or not. It applies wherever a service is contracted to be provided for, in exchange of a consideration, and the service provider has received the contracted amount. The law does not make a provision to further demand the service tax from the customer. The service provider has to pay service tax from what he has received. Thus, the amount received should be broken into two parts, the taxable value of the service provided and the service tax. In other words, the amount received becomes inclusive of service tax. The service provider, instead of inadvertently forgetting the service tax, could have deliberately received value inclusive of the service tax. Sub-section (2) provides on this. The amount can be readily broken up to settle on the value of the taxable service.

For example, if the value of a service is X, at the effective rate of 12.36 per cent, service tax is 12.36 X/100

$$\text{Gross amount} = X + 12.36\ X/100 = X\ 112.36/100$$
$$X = \text{Gross amount} \times 100/112.36$$

Illustration

A dry-cleaner charged a customer, a gross amount of ₹ 200, for providing dry-cleaning services. Taking the service tax at the effective rate of 12.36 per cent, the value of the taxable service will be

₹ (200 × 100)/112.36 = ₹ 178.

The balance, that is, ₹ 22 is the service tax.

Case

A photo shop charged a total of ₹ 100 for developing a film roll and to provide a print of the photographs. Calculate the service tax the photo shop would be required to pay.

Section 67(1)(ii) provides for the working out of the value of taxable service with reference to the consideration for the service. Consideration is the benefit which moves from the customer to the service provider. It can also be a detriment on the customer. The consideration can be money, tangible property, intangible property or a right. Section 67(1)(ii) deals with the case where the consideration is not fully in cash. That is, a part of the consideration is in kind. The clause requires a money value to be worked out for the part of consideration that is in kind. Rule 3 of the Service Tax (Determination of Value) Rules, 2006, details this. The Rules are contained in Annexure 3. If the service provided has a specific value in the ordinary 'course of trade', that value can be made the basis for working out the money equivalent of the consideration in kind. Alternatively, the money value of the consideration in kind can be directly calculated. Let us illustrate the provision.

Illustration

A service provider, who maintains and repairs washing machines, visited a customer. The technician opened the machine and diagnosed that the motor of the machine had got damaged. He told the customer that there was no point in replacing it as it would be economical to buy a new machine instead. The machine was best discarded. The customer discussed with the technician about the possibility of finding a person who could buy the machine from him. The technician took the machine away and did not charge the customer for the visit. The standard charge of the service provider for a visit was ₹ 400. In this case, the customer has paid for the service in kind. The value of the service is ascertainable at ₹ 400. The value of the second hand washing machine should be taken to be ₹ 400.

✦ Service Provider as a Pure Agent

Rule 5 of the Service Tax (Determination of Value) Rules, 2006, requires all expenses made 'in the course of providing taxable service' to be included as part of the value of the taxable service. However, it exempts expenditure made by the service provider as a pure agent of the receiver of service. Let us explore this. X Limited hires Y Limited, a custom clearing house, to receive a consignment for a fee of ₹ 2 lakh. At the time of clearance, it turned out that the goods were dutiable. The custom clearing house paid ₹ 3 lakh in duty. X Limited paid the custom clearing house a total of ₹ 5 lakh. What is the taxable value of the service provided? It was the liability and responsibility of X Limited to pay ₹ 3 lakh to the customs directly. The clearing house paid the money on behalf of X Limited. It acted as the agent of X Limited in paying the money due. Thus, the custom duty paid will not be included in the value of the taxable service. Similarly, a service provider may act merely as an agent of the recipient of the service in buying goods from a third party or procuring a service. The reimbursement received for this would not be a part of the taxable service. The law recognises this. However, as this window can be misused, the Service Tax (Determination of Value) Rules, 2006, insist that the service provider must act as a 'pure' agent to be able to claim this.

Illustration

A property owner contracted with a real estate dealer to find a buyer and arrange to sell the property. The real estate dealer claimed the following expenses from the customer:

Fee for finding a buyer: ₹ 50,000

Payment of pending house property tax to the municipality: ₹ 20,000

Travel expenses: ₹ 20,000

Cost of stamp paper: ₹ 5,000

Service tax (@ 12.36%): _________

(Notes on the expenses: The owner had not paid house property tax for a year. The tax had accumulated on the property. The property could be sold only if the tax was paid. The dealer paid ₹ 20,000 to the municipality. The sale of an immovable property has to be executed on a stamp paper by the seller. The stamp paper has to be bought for a price. The dealer paid ₹ 5,000 to a vendor of the stamp and gave it to the lawyer who was helping the owner in the sale.)

What value should be entered against service tax?

The dealer has paid the taxes and bought the stamp paper as an agent of the owner. Thus, these two amounts will not be included in the value of the taxable service. Other expenses form the cost of the service.

Case

A custom clearing and forwarding agent raised the following bill to a customer:

Fee: ₹ 20,000

Travel: ₹ 2,000

Car parking: ₹ 200

Photocopying: ₹ 60

Payment of pending custom duty on goods: ₹ 3,000

Service tax (@ 12.36%): _________

What value should be entered against the service tax?

Section 67 only provides for the amount on which the tax is to be charged. There are detailed provisions for the charge to apply on a combination of accrual and receipt basis. Further, the amount charged is not to be deposited to the government account immediately. The Rules allow the party to accumulate the amount for a period of time and deposit the consolidated amount. We will explore this aspect later.

✦ Service and Sale of Goods

Service tax is payable on the value of a taxable service. At times, a contract could be for a service but may also involve a supply of goods. Let us study the following illustration. A technician, who had come to attend to a defective washing machine, diagnosed that a valve was defective. He put in a new valve. He charged the customer ₹ 600 for the new valve and ₹ 200 for attending to the machine. Is the value of the taxable service ₹ 800? We have to first apply the principle of divisibility. Did the parties intend it to be two separate contracts? If yes, the contract should be divided. The contract between the technician and the customer has two parts—sale of the valve and the service of repairing the machine. The service tax is chargeable only on the value of the service. Thus, service tax would be charged only on ₹ 200. The technician has sold the valve to the customer and the Value Added Tax would be paid on it. Contrast this with the other materials the technician used. The technician had a small roll of tape. He used the tape on the joints of the water pipes. He exhausted half the roll of tape. The roll of tape cost the technician ₹ 10. The technician has not sold tape worth ₹ 5 to the customer. It has been used by the technician in the course of providing the service. The use of the tape cannot be separated from the service, unlike the valve, and should be taken as an integral part of the service. As we have noted, certain contracts have been deemed to be contracts of sale. Similarly, certain contracts have been declared services. These contracts have to be taken as deemed by the law.

Case

A car owner took his car to an authorised service station. The charges displayed by the service station were as follows:

Servicing: ₹ 600

RTO approved sun filter (Price): ₹ 800

Putting up of sun filter on the car windows: ₹ 200

The car owner got the car serviced and also got sun filters fitted on the car windows. The service station gave him the following bill:

Servicing: ₹ 600

RTO approved sun filter (Price): ₹ 800

Putting up of sun filter on the car windows: ₹ 200

Service tax (@ 12.36%): _________

What value should the service centre enter against the service tax?

✦ Time of Charge of Service Tax

The Point of Taxation Rules, 2011, provide on the 'point of time' when the service tax gets charged. The amount is not to be paid immediately. It only gets attached to the service. It has to be consolidated and paid on the 5th or 6th of the month. Further, against the accumulated amount, input tax credit will be available. Rule 3 provides as follows:

3. Determination of point of taxation. For the purposes of these rules, unless otherwise provided, 'point of taxation' shall be,—

(a) the time when the invoice for the service provided or agreed to be provided is issued:

Provided that where the invoice is not issued within the time period specified in Rule 4A of the Service Tax Rules, 1994, the point of taxation shall be the date of completion of provision of the service;

(b) in a case, where the person providing the service, receives a payment before the time specified in clause (a), the time, when he receives such payment, to the extent of such payment.

Provided that for the purposes of clauses (a) and (b)—

(i) in case of continuous supply of service where the provision of the whole or part of the service is determined periodically on the completion of an event in terms of a contract, which requires the receiver of service to make any payment to service provider, the date of completion of each such event as specified in the contract shall be deemed to be the date of completion of provision of service;

(ii) wherever the provider of taxable service receives a payment up to rupees one thousand in excess of the amount indicated in the invoice, the point of taxation to the extent of such excess amount, at the option of the provider of taxable service, shall be determined in accordance with the provisions of clause (a).

Explanation—For the purpose of this rule, wherever any advance by whatever name known, is received by the service provider towards the provision of taxable service, the point of taxation shall be the date of receipt of each such advance.

The meaning of an invoice has been elaborated in Rule 4A of the Service Tax Rules, 1994. It includes a bill or a chalan or any document of that nature. It has to be serially numbered and has to contain the following:

(i) the name, address and registration number of the service provider;

(ii) the name and address of the person receiving taxable service;

(iii) description, classification and value of taxable service provided or agreed to be provided; and

(iv) the service tax payable of the service.

Rule 4A currently requires an invoice to be raised within 30 days of completion of the service. Let us explore the application of Rule 3. A person gave his jacket for dry-cleaning on Monday. The dry-cleaner gave a bill indicating the charges to be ₹ 100. The jacket was to be collected on Friday and the money was to be paid at the time of collection. The customer paid the money on Friday and collected his jacket. What is the point of time of taxation? It is Monday, the point of time when the bill was raised. Thus, the tax is being charged on accrual basis. It gets charged when the consideration for the service gets accrued and not when it is actually paid.

A person took his laptop to a repair shop on the first of the month. The mechanic told him that he would diagnose the problem, repair the laptop, service it and give it back to him on the tenth of the month. The shop told him that the charges would depend on the nature of the problem diagnosed. Further, the customer was requested to pay an advance of ₹ 500. The customer came to the shop on the tenth of the month. The shop raised an invoice for a total amount of ₹ 2,000, inclusive of service tax. The customer had already paid ₹ 500 as advance. In relation to the advance, Sub-clause (b) would apply. The tax gets charged on ₹ 500 on the first, when the money is received by the shop. On the balance amount, Sub-clause (a) applies. The date when the invoice is issued is the point of time at which the tax gets charged.

B was a regular customer of a computer maintenance service provider. The service provider sent his technician on the tenth of the month to the premises of B, to attend to the computer, which was not working. The technician fixed the computer and told the customer that his office would get back on the amount of money to be paid for the visit. B got an invoice demanding ₹ 1,200, to be paid on the 20th of the month. Sub-clause (a) applies here. As the invoice has been issued within 30 days of the completion of the service, the date of issue of invoice, that is, the 20th of the month, is the point of time of taxation.

Thus, the point of time of taxation is the date of invoice or that of payment, whichever is earlier, if the invoice is issued within 30 days of completion of the service. The Service Rules requires a service provider to issue an invoice within 30 days of completion of the service. It prescribes a penalty for a violation of this provision. Further, if the service provider issues the invoice after 30 days of completion of the service, the point of time becomes the day of the completion of service. In the above example, if the service provider had issued the invoice on the 20th of the next month, the 10th would have been taken as the point of time of taxation. The following table illustrates the provision.

S. No.	*Date of completion of service*	*Date of invoice*	*Date of receipt of payment*	*Point of Taxation*	*Remarks*
1.	April 10	April 20	April 30	April 20	Invoice issued within 30 days and before receipt of payment

2.	April 10	May 20	May 25	April 10	Invoice not issued within 30 days and payment received after completion of service
3.	April 10	April 20	April 15	April 15	Invoice issued within 30 days but payment received before invoice
4.	April 10	May 14	April 5 (part) and May 20 (remaining)	April 5 and April 10 for respective amounts	Invoice not issued within 30 days. Part payment before completion, remaining later

Thus, the dates of receipt of advance, completion of service and issue of invoice become important reference points.

B had entered into an annual computer maintenance contract with X. X was required to visit B and service the computer on the 10^{th} of every month. In addition, B could call X five times in the year. B was to pay X one-fourth the consideration in each quarter. In this situation, application of the Point of Taxation Rules would raise difficulties. Should the end of the contract period be taken as the time of completion of the service? Should the completion of service be taken at a pro-rata basis of each day? Or, should it be done on some other convenient division, like a month or quarter. The Point of Time Rules recognises the difficulties in applying the accrual basis to the services that are of a continuous nature. The proviso to Rule 3 resolves the problem in relation to continuous services. It states:

> (i) in case of continuous supply of service where the provision of the whole or part of the service is determined periodically on the completion of an event in terms of a contract, which requires the receiver of service to make any payment to service provider, the date of completion of each such event as specified in the contract shall be deemed to be the date of completion of provision of service;

The clause makes a reference to the contract for the provision of the service to determine if the contract has provided for intermediate completion points, requiring the service receiver to make periodic payments. The intermediate points break up the service into components and the standard rule is made to apply to the components. A government circular has thus illustrated the point:

> For example, in the case of construction services, if the payments are linked to stage-by-stage completion of construction, the provision of service shall be deemed to be completed in part when each such stage of construction is completed.

Rule 2(c) has defined ‘continuous supply of service’ thus:

> (c) “continuous supply of service” means any service which is provided, or agreed to be provided continuously or on recurrent basis, under a contract, for a period exceeding three months with the obligation for payment periodically or from time to time,” or where the Central Government, by a notification in the Official Gazette, prescribes provision of a particular service to be a continuous supply of service, whether or not subject to any condition;

Thus, any service that is continuously, or on a recurrent basis, provided for over three months, qualifies to be a ‘continuous supply of service’. In addition, the central government can notify any service to be a continuous supply of service. The central government has notified the following services to be 'continuous supply of services' in terms of Clause 2(c) of the Rules, through Notification No. 28/ST-2011, dated 01.04.2011:

1. Telecommunication service
2. Commercial or industrial construction
3. Construction of residential complex
4. Internet Telecommunication Service
5. Works contract service

Thus, these services are necessarily 'continuous supply of services', irrespective of the limitation of the three month period. Other services can be continuous supply if these are provided or agreed to be provided continuously for a period exceeding three months. We can consider the case of a customer who has taken a post-paid mobile phone service. Telecommunication service is notified to be a continuous service. Under the contract, if the bill is to be paid for the services availed each month, the end of the month marks the day of completion of the service for the entire month. Within 30 days of this, the invoice for the charges for the month will need to be issued. The date of issue of the invoice will become the point of time for the charge of service tax. Let us contrast this with a pre-paid mobile service. As, in this case, the charge has been paid before the provision of the service, the day of payment itself becomes the point of taxation. Service tax will get charged when the amount is paid.

✦ Export and Place of Service

It is a general principle that indirect taxes are to be collected in the territory where the consumption takes place. For this reason, export of services is not taxed while import of services is taxed. In situations where the service providers and receivers are in different locations, it can be difficult to identify situations of import and export of services. The Place of Provision of Service Rules, 2012, provide on the determination of the 'place of provision of service'. The Rules have two applications. The first one occurs when the place of provision of service is in India. In that case, the service will be taxable. If it is not in India, subject to other requirements, it will constitute an export and will not be taxed. The second one occurs in the situation where a service provider may not have opted to pay the service tax centrally. In this case, the service tax would need to be paid in the zone where the service is provided. The Place of Provision of Service Rules determine this according to the nature of the service, location of the service provider and that of the service receiver. The 'location of the service provider' and 'location of the service receiver' are important themes. Confining ourselves to companies, we observe that the location is not automatically the country of incorporation. It depends on several factors. Let us explore the matter of the determination of the location of the service provider. Rule 2(h) of the Place of Provision of Services Rules, 2012, provides:

> (h) "location of the service provider" means—
>
> (a) where the service provider has obtained a single registration, whether centralized or otherwise, the premises for which such registration has been obtained;
>
> (b) where the service provider is not covered under sub-clause (a):

(i) the location of his business establishment; or

(ii) where the services are provided from a place other than the business establishment, that is to say, a fixed establishment elsewhere, the location of such establishment; or

(iii) where services are provided from more than one establishment, whether business or fixed, the establishment most directly concerned with the provision of the service; and

(iv) in the absence of such places, the usual place of residence of the service provider.

Rule 4 of the Service Tax Rules, 1994, requires every person liable to pay service tax, to register with the department. During registration, the premises from where services are provided are also required to be registered. If the billing for the provision of service is centralised, the service provider can register the premises from where the billing is done. In the above provision, if the service provider is registered with one premises, that premises becomes the location of the service provider. If this does not apply, that is, either the service provider is not registered or is registered with multiple premises, the location becomes dependent on the way the person has organised the business and the way the service was provided. 'Taxation of Service—An Education Guide', a document prepared by the department, explains the Rules. Let us study the illustrations given in the document.

Illustration 1

A business has its headquarters in India, and branches in London, Dubai, Singapore and New York. Its business establishment is in India.

Illustration 2

An overseas business house sets up offices with staff in India, to provide services to Indian customers. Its fixed establishment is in India.

Illustration 3

A company with a business establishment abroad, buys a property in India, which it leases to a tenant. The property by itself does not create a fixed establishment. If the company sets up an office in India to carry on its business by managing the property, this will create a fixed establishment in India.

Illustration 4

A company is incorporated in India, but provides its services entirely from Singapore. The location of this service provider is Singapore, being the place where the establishment most directly concerned with the supply is located.

Thus, the establishment most directly connected with the provision of the service becomes the location of the service provider. Only if none of these are applicable, would we turn to the normal place of residence, which is the country of registration for a company. As most functioning companies would have some establishment(s), the place where the establishment(s) is located becomes the deciding factor, and not the place of incorporation. The location of the service receiver has been defined exactly in the same manner. Rule 2(i) defines it as follows:

(i) "location of the service receiver" means—

(a) where the recipient of service has obtained a single registration, whether centralized or otherwise, the premises for which such registration has been obtained;

(b) where the recipient of service is not covered under sub-clause (a)

(i) the location of his business establishment; or

(ii) where services are used at a place other than the business establishment, that is to say, a fixed establishment elsewhere, the location of such establishment; or

(iii) where services are used at more than one establishment, whether business or fixed, the establishment most directly concerned with the use of the service; and

(iv) in the absence of such places, the usual place of residence of the recipient of service.

Explanation—For the purposes of clauses (h) and (i), "usual place of residence" in case of a body corporate means the place where it is incorporated or otherwise legally constituted.

Explanation 2—For the purpose of clause (i), in the case of telecommunication service, the usual place of residence shall be the billing address.

Rule 3 is the default rule. It reads as follows:

Place of provision generally. The place of provision of a service shall be the location of the recipient of service:

Provided that in case the location of the service receiver is not available in the ordinary course of business, the place of provision shall be the location of the provider of service.

Rule 3 is followed by several rules, which deal with different kinds of services and provide on the place of provision of service for those services. The last rule, Rule 14, provides:

14. Order of application of rules. Notwithstanding anything stated in any rule, where the provision of a service is, prima facie, determinable in terms of more than one rule, it shall be determined in accordance with the rule that occurs later among the rules that merit equal consideration.

Thus, the subsequent rules are going to override Rule 3. Only if a subsequent rule is not applicable to the provision of a service, the default rule, i.e., Rule 3, will come to apply. Having developed this overview, we should start exploring the rules, starting from the last rule first. Rule 11 provides on passenger transportation. It reads thus:

11. Place of provision of passenger transportation service— The place of provision in respect of a passenger transportation service shall be the place where the passenger embarks on the conveyance for a continuous journey.

A person based in the UK buys a Delhi–London ticket on British Airways, in the UK. The passenger and the service provider may be based in the UK, but the place of provision of the service is Delhi and the service provider will have to pay service tax for the service. How will a Delhi–London–Delhi journey be treated? While answering this question, the meaning of the term 'continuous journey' becomes important. A journey is continuous if there is a single ticket for the journey. Thus, the place of provision of service for a Delhi–London–Delhi ticket is Delhi. Conversely, the place of provision of service for a London–Delhi–London journey would be London.

A passenger bought two separate tickets—(a) Delhi–New York–Delhi and (b) New York–Boston–New York. The place of provision of service for the first ticket is Delhi, while for the second, it is New York. Thus, only the first journey is taxable. A passenger bought two separate tickets— (a) London–Delhi–London and (b) Delhi–Chandigarh. The place of provision of service for the first journey would be London and it would not be taxable. The place of provision of service for the second journey would be Delhi and would be taxable.

Rule 10 provides on transportation services. It reads:

> **10. Place of provision of goods transportation services.** The place of provision of services of transportation of goods, other than by way of mail or courier, shall be the place of destination of the goods:
>
> Provided that the place of provision of services of goods transportation agency shall be the location of the person liable to pay tax.

The following is an illustration of Rule 10 in the Guide:

> A consignment of cut flowers is consigned from Chennai to Amsterdam. The place of provision of goods transportation service will be Amsterdam (outside India, hence not liable to service tax). Conversely, if a consignment of crystal ware is consigned from Paris to New Delhi, the place of provision will be New Delhi.

Rule 10, however, does not apply to mail or courier services. Thus, a courier sent from Chennai to Amsterdam will not fall under Rule 10. The place of provision of the service will be Chennai. Also, a proviso to Rule 10, in conjunction with the Service Rules, 1994, provides for a different treatment if a goods transportation agency is used for transportation by road. Rule 9 provides that for the provision of some services, the location of the service provider will be the place of provision of service. It reads:

> **9. Place of provision of specified services.** The place of provision of following services shall be the location of the service provider:—
>
> (a) Services provided by a banking company, or a financial institution, or a non-banking financial company, to account holders;
>
> (b) Online information and database access or retrieval services;
>
> (c) Intermediary services;
>
> (d) Service consisting of hiring of means of transport, other than (i) aircrafts, and (ii) vessels except yachts up to a period of one month.

Certain services are of a kind where the user of the service is an ordinary consumer and can be mobile. Let us explore the provisions regarding such services. Banking and financial institutions provide a wide array of services. Only the services provided to the account holder are covered under the rule. An account has been defined in the Rules as an 'account bearing interest'. Lending, deposits, safe deposit lockers, electronic transfers and mail transfers are some of the account related services of a bank. Suppose that an NRI holding a bank account with a bank branch in India makes an internet transfer of money from his account. The bank charges a transaction fee for transferring money through the internet. As the service provider is in India, service tax will be charged on the transaction.

The above rules deal with special kinds of services. The other rules are in relation to general services. Rule 8 provides:

> **8. Place of provision of services where provider and recipient are located in taxable territory.** Place of provision of a service, where the location of the provider of service as well as that of the recipient of service is in the taxable territory, shall be the location of the recipient of service.

Where the locations of both, the service provider and the receiver, are in India, the place of provision of service will be taken to be India. We should remind ourselves that the location of the service provider is not its place of incorporation. The location is to be decided on the basis of its business establishments and fixed establishments, as discussed in the opening part of this topic. However, if both are not located in India, Rule 8 will not apply. For such situations, we will need to group the services in one among the following groups, formed by Rules 4, 5 and 6. Ordinarily, each group would be distinct. That is, the service would fall only in one of the groups.

Rule 5—Services relating to immovable property—The service should be 'directly in relation to immovable property'. In this case, the place where the land or building is located becomes the place of provision of service. Examples of such services are, renting of immovable property; services of real estate agents, auctioneers, architects and engineers; construction, repair and interior design; and supply of hotel accommodation.

Rule 6—Services relating to events—Some services are in relation to a performance or an event at a place. Examples of such events are 'cultural, artistic, sporting, scientific, educational, or entertainment events, or a celebration, conference, fair, exhibition, or similar events'. The place of provision of service related to such events will be the place where the event is held.

Rule 4—Services related to place of performance—This group includes services where goods are required to be physically made available to the service provider; services provided in conjunction with supply of goods; and services that are ordinarily performed in the physical presence of the recipient of the service. In such cases, the place of performance of the contract becomes the place of provision of the service.

Thus, the sequence in which we need to ask the questions in relation to a service is as follows. Are both, the service provider as well as the receiver, located in India? If the answer is yes, the place of provision of service is in India. If the answer is no, we will see whether the service fits in one of the above categories. The place of provision of service will then get determined by the rules discussed above. If the service does not fall under the above three categories, we will apply the default principle stated in Rule 3, that is, the place of provision of service is the location of the service provider. The text of the Rules is contained in the annexure for reference. We can now further our understanding of the Rules with the help of the following illustrations.

Illustration

A bank in India provides services of merchant banking to a customer in the UK. As the service is not in relation to an account holder, it does not fall under Rule 9. As the service provider and the receiver are both not in India, Rule 8 does not apply. Rules 4, 5 and 6 do not apply. Thus, the issue of deciding on the place of provision of the service would be resolved by Rule 3. As the service receiver is in the UK, the place of provision of service could be the UK.

Illustration

The Guide has given the following illustration:

A helicopter of Pawan Hans Ltd (India based) develops a technical snag in Nepal. Say, engineers are deputed by Hindustan Aeronautics Ltd, Bangalore, to undertake repairs at the site in Nepal. But for this rule, Rule 4, sub-rule (1) would apply in this case, and the place of provision would be Nepal, i.e. outside the taxable territory. However, by application of Rule 7, since the service provider, as well as the receiver, are located in the taxable territory, the place of provision of this service will be within the taxable territory.

Repairing a helicopter requires the owner to make available, the helicopter, to the service provider. This falls under Rule 4. However, as both the parties are located in India, Rule 7 will apply and the service will be taxable. If the helicopter company were based in Sri Lanka, Rule 4 would have applied and the place of provision of service would have been Nepal. The guide has the following two illustrations on the application of Rule 6, where the place of provision of service becomes the place where the event is held.

A management school located in USA intends to organize a road show in Mumbai and New Delhi for prospective students. Any service provided by an event manager, or the right to entry (participation fee for prospective students, say) will be taxable in India.

An Indian fashion design firm hosts a show at Toronto, Canada. The firm receives the services of a Canadian event organizer. The place of provision of this service is the location of the event, which is outside the taxable territory. Any service provided in relation to this event, including the right to entry, will be non-taxable.

A company based in India is invited to do the interior designing of an office in the USA. The recipient of the service is based in the USA. As both, the service provider and the receiver, are not located in India, Rule 8 will not apply. As the service is directly related to an immovable property, Rule 5 will apply. The service will not be taxable in India. Contrast this with the following illustration. A and B are companies located in India. Company B buys a flat for its employees, in London, to stay while on tour to London. It gets Company A to do the interior design. As both, the service provider and the receiver are located in India, Rule 8 should apply. Rule 6A defines export of service as follows:

Rule 6A. Export of services. (1) The provision of any service provided or agreed to be provided shall be treated as export of service when,

(a) the provider of service is located in the taxable territory,

(b) the recipient of service is located outside India,

(c) the service is not a service specified in Section 66D of the Act,

(d) the place of provision of the service is outside India,

(e) the payment for such service has been received by the provider of service in convertible foreign exchange, and

(f) the provider of service and recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 2 of Clause (44) of Section 65B of the Act

The place of provision of service is only one of the requirements for a service to be considered to be export. When all the above requirements are met, the provision of service becomes export of service. The significance of this is that export of service is exempt from taxation.

Annexure 1

66D. The negative list shall comprise of the following services, namely—

(a) services by Government or a local authority excluding the following services to the extent they are not covered elsewhere—

  (i) services by the Department of Posts by way of speed post, express parcel post, life insurance and agency services provided to a person other than Government;

  (ii) services in relation to an aircraft or a vessel, inside or outside the precincts of a port or an airport;

  (iii) transport of goods or passengers; or

  (iv) support services, other than services covered under clauses (i) to (iii) above, provided to business entities;

(b) services by the Reserve Bank of India;

(c) services by a foreign diplomatic mission located in India;

(d) services relating to agriculture or agricultural produce by way of—

  (i) agricultural operations directly related to production of any agricultural produce including cultivation, harvesting, threshing, plant protection or testing;

  (ii) supply of farm labour;

  (iii) processes carried out at an agricultural farm including tending, pruning, cutting, harvesting, drying, cleaning, trimming, sun drying, fumigating, curing, sorting, grading, cooling or bulk packaging and such like operations which do not alter the essential characteristics of agricultural produce but make it only marketable for the primary market;

  (iv) renting or leasing of agro machinery or vacant land with or without a structure incidental to its use;

  (v) loading, unloading, packing, storage or warehousing of agricultural produce;

  (vi) agricultural extension services;

  (vii) services by any Agricultural Produce Marketing Committee or Board or services provided by a commission agent for sale or purchase of agricultural produce;

(e) trading of goods;

(f) any process amounting to manufacture or production of goods;

(g) selling of space or time slots for advertisements other than advertisements broadcast by radio or television;

(h) service by way of access to a road or a bridge on payment of toll charges;

(i) betting, gambling or lottery;

(j) admission to entertainment events or access to amusement facilities;

(k) transmission or distribution of electricity by an electricity transmission or distribution utility;

(l) services by way of—

  (i) pre-school education and education up to higher secondary school or equivalent;

  (ii) education as a part of a curriculum for obtaining a qualification recognised by any law for the time being in force;

  (iii) education as a part of an approved vocational education course;

(m) services by way of renting of residential dwelling for use as residence;

(n) services by way of—
  (i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount;
  (ii) inter se sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers;

(o) service of transportation of passengers, with or without accompanied belongings, by—
  (i) a stage carriage;
  (ii) railways in a class other than—
    (A) first class; or
    (B) an airconditioned coach;
  (iii) metro, monorail or tramway;
  (iv) inland waterways;
  (v) public transport, other than predominantly for tourism purpose, in a vessel between places located in India; and
  (vi) metered cabs, radio taxis or auto rickshaws;

(p) services by way of transportation of goods—
  (i) by road except the services of—
    (A) a goods transportation agency; or
    (B) a courier agency;
  (ii) by an aircraft or a vessel from a place outside India to the customs station of clearance in India; or
  (iii) by inland waterways;

(q) funeral, burial, crematorium or mortuary services including transportation of the deceased.

Annexure 2

Under Section 93, the government has issued Notification No. 25/2012, dated June 20, 2012, exempting several taxable services from 'the whole of the service tax leviable thereon'. An indicative list is as follows:

1. Services provided to the United Nations or a specified international organization;
2. Health care services by a clinical establishment, an authorised medical practitioner or para-medics;

…

8. Services by way of training or coaching in recreational activities relating to arts, culture or sports;

…

14. Services by way of construction, erection, commissioning, or installation of original works pertaining to—
    (a) an airport, port or railways, including monorail or metro;
    (b) a single residential unit otherwise than as a part of a residential complex;
    (c) low-cost houses up to a carpet area of 60 square metres per house in a housing project approved by competent authority empowered under the 'Scheme of Affordable Housing in Partnership' framed by the Ministry of Housing and Urban Poverty Alleviation, Government of India;
    (d) post-harvest storage infrastructure for agricultural produce including a cold storages for such purposes; or
    (e) mechanised food grain handling system, machinery or equipment for units processing agricultural produce as food stuff excluding alcoholic beverages;
19. Services provided in relation to serving of food or beverages by a restaurant, eating joint or a mess, other than those having the facility of air-conditioning or central air-heating in any part of the establishment, at any time during the year;
23. Transport of passengers, with or without accompanied belongings, by— (a) air, embarking or terminating in an airport located in the state of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, or Tripura or at Baghdogra located in West Bengal; or ...

Annexure 3

Under Section 93, the government has issued Notification No.26/2012, dated June 20, 2012, giving rebate to certain services. For the listed services, the taxable value is only to be the specified percentage of the ordinary value. In the table below, the percentage is indicated in the last column.

Sl. No.	*Description of taxable service*	*Percentage*
(1)	(2)	(3)
1.	Services in relation to financial leasing including hire purchase	10
2.	Transport of goods by rail	30
3.	Transport of passengers, with or without accompanied belongings by rail	30
4.	Bundled service by way of supply of food or any other article of human consumption or any drink, in a premises (including hotel, convention centre, club, pandal, shamiana or any other place, specially arranged for organizing a function) together with renting of such premises	70
5.	Transport of passengers by air, with or without accompanied belongings	40
6.	Renting of hotels, inns, guest houses, clubs, campsites or other commercial places meant for residential or lodging purposes.	60
7.	Services of goods transport agency in relation to transportation of goods.	25
8.	Services provided in relation to chit	70
9.	Renting of any motor vehicle designed to carry passengers	40
10.	Transport of goods in a vessel	50
11.	Services by a tour operator in relation to—	
	(i) a package tour	25
	(ii) a tour, if the tour operator is providing services solely of arranging or booking accommodation for any person in relation to a tour	10
	(iii) any services other than specified at (i) and (ii) above.	40
12.	Construction of a complex, building, civil structure or a part thereof, intended for a sale to a buyer, wholly or partly, except where entire consideration is received after issuance of completion certificate by the competent authority—	
	(a) for a residential unit satisfying both the following conditions, namely:—	
	(i) the carpet area of the unit is less than 2000 square feet; and	
	(ii) the amount charged for the unit is less than rupees one crore;	25
	(b) for other than the (a) above.	30

Annexure 4

Service Tax (Determination of Value) Rules, 2006

2A. Determination of value of taxable services involved in the execution of a works contract— Subject to the provisions of section 67, the value of taxable service involved in the execution of a works contract (hereinafter referred to as works contract service), referred to in clause (8) of section 66E of the Act, shall be determined by the service provider in the following manner, namely:—

(i) Value of works contract service shall be equivalent to the gross amount charged for the works contract less the value of transfer of property in goods involved in the execution of the said works contract.

Explanation—For the purposes of this clause—

(a) gross amount charged for the works contract shall not include value added tax or sales tax, as the case may be, paid, if any, on transfer of property in goods involved in the execution of the said works contract;

(b) value of works contract service shall include—
   - (i) labour charges for execution of the works;
   - (ii) amount paid to a sub-contractor for labour and services;
   - (iii) charges for planning, designing and architect's fees;
   - (iv) charges for obtaining on hire or otherwise, machinery and tools used for the execution of the works contract;
   - (v) cost of consumables such as water, electricity, fuel used in the execution of the works contract;
   - (vi) cost of establishment of the contractor relatable to supply of labour and services;
   - (vii) other similar expenses relatable to supply of labour and services; and
   - (viii) profit earned by the service provider relatable to supply of labour and services;

(c) where value added tax has been paid on the actual value of transfer of property in goods involved in the execution of the works contract, then, such value adopted for the purposes of payment of value added tax, shall be taken as the value of transfer of property in goods involved in the execution of the said works contract for determining the value of works contract service under this clause.

(ii) Where the value has not been determined under clause (i), the person liable to pay tax on the taxable service involved in the execution of the works contract shall determine the service tax payable in the following manner, namely:—

(A) in case of works contracts entered into for execution of original works, service tax shall be payable on forty per cent. of the total amount charged for the works contract:

Provided that where the gross amount charged includes the value of the land, in respect of the service provided by way of clause (8) of section 66E of the Act, service tax shall be payable on twenty five per cent. of the total amount including such gross amount;

(B) in case of other works contracts including completion and finishing services such as glazing, plastering, floor and wall tiling, installation of electrical fittings not covered under sub-clause (A), service tax shall be payable on sixty per cent of the total amount charged for the works contract;

Explanation 1—For the purposes of this rule—

(I) "original works" means—

(i) all new constructions;

(ii) all types of additions and alterations to abandoned or damaged structures on land that are required to make them workable;

(II) "total amount" means the sum total of gross amount and the value of all goods, excluding the value added tax, if any, levied on goods and services supplied free of cost for use in or in relation to the execution of works contract, under the same contract or any other contract:

Provided that where the value of goods or services supplied free of cost is not ascertainable, the same shall be determined on the basis of the fair market value of the goods or services that have closely available resemblance;

Explanation 2—For the removal of doubts, it is clarified that duty of excise paid on any goods, property which is transferred (whether as goods or in some other form) in the execution of works contract, shall not be availed as CENVAT credit.

2C. Determination of value of taxable service involved in supply of food and drinks in a restaurant or as outdoor catering—Subject to the provisions of section 67, the value of taxable service involved in the supply of food or drinks for consumption either in a restaurant or as outdoor catering service, either by itself or along with other services, shall be the percentage of total amount, specified in column 3 against the respective description of services mentioned in the following Table:—

Table

Sl. No.	*Description*	*Percentage of total amount*
1	2	3
1.	Service involved in the supply of food or any other article of human consumption or any drink at a restaurant	40
2.	Service involved in the supply of food or any other article of human consumption or any drink as outdoor catering service	60

Explanation 1—For the purposes of this rule, "total amount" means the sum total of the gross amount and the value of all goods, excluding the value added tax, if any, levied on goods or services supplied free of cost for use in or in relation to the supply of food or any other article of human consumption or any drink, under the same contract or any other contract:

Provided that where the value of goods or services supplied free of cost is not ascertainable, the same shall be determined on the basis of the fair market value of the goods or services that have closely available resemblance.

Explanation 2—For the removal of doubts, it is clarified that any goods classifiable under chapter 1 to 22 of the Central Excise Tariff Act, 1985 (5 of 1986) meant for human consumption shall not be considered as "inputs" for the service portion in an activity wherein goods, being food or any other article of human consumption or drink is supplied in any manner as part of the activity.

3. Manner of determination of value. Subject to the provisions of section 67, the value of taxable service, where such value is not ascertainable, shall be determined by the service provider in the following manner:—

(a) the value of such taxable service shall be equivalent to the gross amount charged by the service provider to provide similar service to any other person in the ordinary course of trade and the gross amount charged is the sole consideration;

(b) where the value cannot be determined in accordance with clause (a), the service provider shall determine the equivalent money value of such consideration which shall, in no case be less than the cost of provision of such taxable service.

5. Inclusion in or exclusion from value of certain expenditure or costs. (1) Where any expenditure or costs are incurred by the service provider in the course of providing taxable service, all such expenditure or costs shall be treated as consideration for the taxable service provided or agreed to be provided and shall be included in the value for the purpose of charging service tax on the said service.

(2) Subject to the provisions of sub-rule (1), the expenditure or costs incurred by the service provider as a pure agent of the recipient of service, shall be excluded from the value of the taxable service if all the following conditions are satisfied, namely:—

(i) the service provider acts as a pure agent of the recipient of service when he makes payment to third party for the goods or services procured;

(ii) the recipient of service receives and uses the goods or services so procured by the service provider in his capacity as pure agent of the recipient of service;

(iii) the recipient of service is liable to make payment to the third party;

(iv) the recipient of service authorises the service provider to make payment on his behalf;

(v) the recipient of service knows that the goods and services for which payment has been made by the service provider shall be provided by the third party;

(vi) the payment made by the service provider on behalf of the recipient of service has been separately indicated in the invoice issued by the service provider to the recipient of service;

(vii) the service provider recovers from the recipient of service only such amount as has been paid by him to the third party; and

(viii) the goods or services procured by the service provider from the third party as a pure agent of the recipient of service are in addition to the services he provides on his own account.

Explanation 2— For the removal of doubts it is clarified that the value of the taxable service is the total amount of consideration consisting of all components of the taxable service and it is immaterial that the details of individual components of the total consideration is indicated separately in the invoice.

6. Cases in which the commission, costs, etc., will be included or excluded. (1) Subject to the provisions of section 67, the value of the taxable services shall include—

(i) the commission or brokerage charged by a broker on the sale or purchase of securities including the commission or brokerage paid by the stock-broker to any sub-broker;

(ii) the adjustments made by the telegraph authority from any deposits made by the subscriber at the time of application for telephone connection or pager or facsimile or telegraph or telex or for leased circuit;

(iii) the amount of premium charged by the insurer from the policy holder;

(iv) the commission received by the air travel agent from the airline;

(v) the commission, fee or any other sum received by an actuary, or intermediary or insurance intermediary or insurance agent from the insurer;

(vi) the reimbursement received by the authorised service station, from manufacturer for carrying out any service of any motor car, light motor vehicle or two wheeled motor vehicle manufactured by such manufacturer;

(vii) the commission or any amount received by the rail travel agent from the Railways or the customer; ….

(2) Subject to the provisions contained in sub-rule (1), the value of any taxable service, as the case may be, does not include—

(i) initial deposit made by the subscriber at the time of application for telephone connection or pager or facsimile (FAX) or telegraph or telex or for leased circuit;

(ii) the airfare collected by air travel agent in respect of service provided by him;

(iii) the rail fare collected by rail travel agent in respect of service provided by him; and

(iv) interest on—

  (a) deposits; and

  (b) delayed payment of any consideration for the provision of services or sale of goods;

Annexure 5

The following is an abridged version of the Place of Provision of Services Rules, 2012.

...

3. Place of provision generally. The place of provision of a service shall be the location of the recipient of service:

Provided that in case the location of the service receiver is not available in the ordinary course of business, the place of provision shall be the location of the provider of service.

4. Place of provision of performance based services. The place of provision of following services shall be the location where the services are actually performed, namely:-

(a) services provided in respect of goods that are required to be made physically available by the recipient of service to the provider of service, or to a person acting on behalf of the provider of service, in order to provide the service:

Provided further that this clause shall not apply in the case of a service provided in respect of goods that are temporarily imported into India for repairs and are exported after the repairs without being put to any use in the taxable territory, other than that which is required for such repair;

(b) services provided to an individual, represented either as the recipient of service or a person acting on behalf of the recipient, which require the physical presence of the receiver or the person acting on behalf of the receiver, with the provider for the provision of the service.

5. Place of provision of services relating to immovable property. The place of provision of services provided directly in relation to an immovable property, including services provided in this regard by experts and estate agents, provision of hotel accommodation by a hotel, inn, guest house, club or campsite, by whatever, name called, grant of rights to use immovable property, services for carrying out or co-ordination of construction work, including architects or interior decorators, shall be the place where the immovable property is located or intended to be located.

6. Place of provision of services relating to events. The place of provision of services provided by way of admission to, or organization of, a cultural, artistic, sporting, scientific, educational, or entertainment event, or a celebration, conference, fair, exhibition, or similar events, and of services ancillary to such admission, shall be the place where the event is actually held.

7. Place of provision of services provided at more than one location. Where any service referred to in rules 4, 5, or 6 is provided at more than one location, including a location in the taxable territory, its place of provision shall be the location in the taxable territory where the greatest proportion of the service is provided.

8. Place of provision of services where provider and recipient are located in taxable territory. Place of provision of a service, where the location of the provider of service as well as that of the recipient of service is in the taxable territory, shall be the location of the recipient of service.

9. Place of provision of specified services. The place of provision of following services shall be the location of the service provider:—

(e) Services provided by a banking company, or a financial institution, or a non-banking financial company, to account holders;

(f) Online information and database access or retrieval services;

(g) Intermediary services;

(h) Service consisting of hiring of means of transport, up to a period of one month.

10. Place of provision of goods transportation services. The place of provision of services of transportation of goods, other than by way of mail or courier, shall be the place of destination of the goods:

> Provided that the place of provision of services of goods transportation agency shall be the location of the person liable to pay tax.

11. Place of provision of passenger transportation service. The place of provision in respect of a passenger transportation service shall be the place where the passenger embarks on the conveyance for a continuous journey.

12. Place of provision of services provided on board a conveyance. Place of provision of services provided on board a conveyance during the course of a passenger transport operation, including services intended to be wholly or substantially consumed while on board, shall be the first scheduled point of departure of that conveyance for the journey.

13. Powers to notify description of services or circumstances for certain purposes. In order to prevent double taxation or non-taxation of the provision of a service, or for the uniform application of rules, the Central Government shall have the power to notify any description of service or circumstances in which the place of provision shall be the place of effective use and enjoyment of a service.

14. Order of application of rules. Notwithstanding anything stated in any rule, where the provision of a service is, prima facie, determinable in terms of more than one rule, it shall be determined in accordance with the rule that occurs later among the rules that merit equal consideration.

21

CHAPTER

Central Excise Tax

The tax imposed on the production and manufacturing of goods has been known as excise duty. The Seventh Schedule of the Constitution has vested in the Centre, the power to impose excise duty on all goods other than alcoholic liquor for human consumption, opium and narcotics. The excise duty on alcoholic liquor for human consumption, opium and narcotics lies in the domain of the states. The excise duty levied by the Centre is called central excise. In this chapter, we will explore the nature and scope of central excise. Two acts, in conjunction, provide for the charge and the calculation of the quantum of excise duty – the Central Excise Act, 1944 and Central Excise Tariff Act, 1985.

Tax on manufacture and production of goods has been there for a long time. The Central Excise Act, 1944, was an act that consolidated the prior enactments. In fact, it was titled the Central Excise and Salt Tax Act, 1944. The term 'salt' was deleted from the title through an amendment in 1996. The government can tax only the production and manufacturing taking place within its own territory. Thus, understandably, the Act applies to only manufacturing and production within India. On goods manufactured outside India, custom duty is levied when these are brought in. The Central Excise Act, 1944, provides for the charge of excise duty, valuation of the goods and the power of the officers. That is, among others, it provides answers to questions such as: Who will pay excise duty? On what activities would excise duty be levied? On what basis would the excise duty be computed? The Act is supplemented by the Central Excise Tariff Act, 1985. This Act has adopted, with modifications, the Harmonised System of Classification of Goods. In Schedule 1, corresponding to each item, the rate of duty has been listed. Section 3 of the Central Excise Act is the charging section for levying of excise duty. It reads:

> Section 3—Duties specified in First Schedule and the Second Schedule to the Central Excise Tariff Act, 1985 to be levied. ...
>
> (1) There shall be levied and collected in such manner as may be prescribed—
>
> (a) a duty of excise to be called the Central Value Added Tax (CENVAT) on all excisable goods ... which are produced or manufactured in India as, and at the rates, set forth in the First Schedule to the Central Excise Tariff Act, 1985
>
> (b) a special duty of excise, in addition to the duty of excise specified in clause (a) above, on excisable goods ... specified in the Second Schedule to the Central Excise Tariff Act, 1985 which are produced or manufactured in India, as, and at the rates, set forth in the said Second Schedule.

Schedule 1 of the Central Excise Tariff Act, 1985, has adopted the Harmonised System and provided a corresponding rate of excise duty for every item. The excise duty, levied under Schedule 1, has been called Central Value Added Tax (CENVAT). It has been called CENVAT as input credit is available for this. Clause (b) above, makes it possible for the government to impose duty in addition to CENVAT, on goods. This is to be done by listing the items and the corresponding additional rates of duty, in the second schedule. Currently, there is no additional duty on any item. Thus, we need to focus only on Clause (a). The tax applies only on 'excisable goods' that are 'produced or manufactured in India'. Excisable goods have been defined in Section 2(d) of the Central Excise Act as:

> 2(d) "excisable goods" means goods specified in the First Schedule and the Second Schedule to the Central Excise Tariff Act, 1985 (5 of 1986) as being subject to a duty of excise and includes salt.
>
> **Explanation**—For the purposes of this clause, "goods" includes any article, material or substance which is capable of being bought and sold for a consideration and such goods shall be deemed to be marketable.

Thus, for an incidence of excise duty to arise, several things must happen. There must be a manufacture or production of goods. The manufacture or production must happen in India. The goods produced must find mention in the schedule of the Tariff Act. The Supreme Court, over several judgements, has elaborated the meaning of the terms 'manufactured', 'produced' and 'goods'.

✦ Manufactured or Produced Goods

The Supreme Court, in Dy. Commissioner of Sales Tax v. Pio Food Packers[1] noted the meaning of manufacture:

> Commonly, manufacture is the end result of one or more processes through which the original commodity is made to pass. The nature and extent of processing may vary from one case to another, and indeed there may be several stages of processing and perhaps a different kind of processing at each stage. With each process suffered, the original commodity experiences a change. But it is only when the change, or a series of changes take the commodity to the point where commercially it can no longer be regarded as the original commodity but instead is recognised as a new and distinct article that a manufacture can be said to take place.

The Supreme Court, in Commissioner of Income-tax, Orissa v. M/s. N. C. Budharaja and Company[2] further noted on manufacture and production that:

> The words "manufacture" and "production" have received extensive judicial attention … The word "production" has a wider connotation than the word "manufacture". While every manufacture can be characterised as production every production need not amount to manufacture. ... the test evolved for determining whether manufacture can be said to have taken place is whether the commodity which is subjected to the process of manufacture can no longer be regarded as the original commodity but is recognised in the trade as a new and distinct commodity. ... The word "production" or "produce" when used in juxtaposition with the word 'manufacture' takes in bringing into existence new goods by a process which may or may not amount to manufacture. It also takes in all the by-products, intermediate products and residual products which emerge in the course of manufacture of goods.

---

[1] Dy. Commr. of Sales Tax v. Pio Food Packers, AIR 1980 SC 1227.

[2] Commissioner of Income-tax, Orissa v. M/s. N. C. Budharaja and Company, AIR 1993 SC 2529.

Thus, bringing into existence a new thing, which is commercially distinct from the original commodity, is manufacturing and production. These principles have been employed in a wide array of cases to decide whether an activity constitutes manufacture or production or not. Let us study the scope of the terms with a review of the judgements of the Supreme Court.

Court Case: Income Tax Officer, Udaipur v. Arihant Tiles and Marbles (Private) Limited

Arihant Tiles and Marbles (Private) Limited was engaged in the conversion of marble blocks into slabs and tiles.[3] The process was as follows: Marble blocks were excavated by mine owners, in raw, uneven shapes. Such blocks were cut into square blocks. The square blocks were then sawn into slabs. The slabs were reinforced by filling the cracks with resin. The slabs were then polished and cut into tiles. The last stage was buffing of the tiles with shiners. The question was whether the activity constituted 'manufacture or production of article or thing'. The question had come up in relation to the Income Tax Act. The answer to this was, however, just as relevant to the Excise Act. The Supreme Court noted:

> At the outset, we may point out that in numerous judgments of this Court, it has been consistently held that the word "production" is wider in its scope as compared to the word "manufacture". ... The test for determining whether "manufacture" can be said to have taken place is whether the commodity, which is subjected to a process can no longer be regarded as the original commodity but is recognised in trade as a new and distinct commodity. The word "production", when used in juxtaposition with the word "manufacture", takes in bringing into existence new goods by a process which may or may not amount to manufacture. The word "production" takes in all the byproducts, intermediate products and residual products which emerge in the course of manufacture of goods.
>
> Applying the above tests ... to the facts of the present cases, we are of the view that blocks converted into polished slabs and tiles after undergoing the process indicated above certainly results in emergence of a new and distinct commodity. The original block does not remain the marble block, it becomes a slab or tile. In the circumstances, not only there is manufacture but also an activity which is something beyond manufacture and which brings a new product into existence ...

The tiles may be the same material as the slab or the stone that was extracted. But the process has created a new commodity, distinct from the stone. Thus, the process has been one of manufacture. There have been several cases on the application of this test. In India Cine Agencies; (2) Computer Graphics Limited v. Commissioner of Income Tax,[4] the companies were making small film rolls from jumbo rolls of photographic films. As the small rolls were a distinct commodity, the process was a 'manufacture' or 'production'. Orissa Bridge and Construction Corporation Limited, for its own use, was making shuttering items and other items from steel plates and sheets.[5] The Supreme Court noted this to be manufacturing. It held:

> ... plates and sheets, which are starting materials, get transformed into various products which are having a distinct name, identity, character and use. That the sheets, plates or angle irons cannot be used as cutting HS plates, Shuttering or other items for which purpose they are specifically transformed into new product.

[3] Income Tax Officer, Udaipur v. Arihant Tiles and Marbles (Private) Limited, 2010 (320) ITR 79.

[4] India Cine Agencies; (2) Computer Graphics Limited v. Commissioner of Income Tax, 2009 (308) ITR 98.

[5] Orissa Bridge and Construction Corporation Limited v. Commissioner of Central Excise, Bhubaneswar, 2011 (264) ELT 14.

In Commissioner of Central Excise, Chennai-II Commissionerate and Another v. Tarpaulin International,[6] tarpaulin sheets were cut to size, stitched and got eye-lets fixed. The Supreme Court, applying the test, did not hold it to be manufacture. It noted:

> Is there any manufacture when Tarpaulin sheets are stitched and eyelets are made? In our view, it does not change basic characteristic of the raw material and end product. The process does not bring into existence a new and distinct product with total transformation in the original commodity. The original material used i.e., the tarpaulin, is still called tarpaulin made-ups even after undergoing the said process. Hence, it cannot be said that the process is a manufacturing process. ... The process of stitching and fixing eyelets would not amount to manufacturing process, since tarpaulin after stitching and eyeleting continues to be only cotton fabrics. The purpose of fixing eyelets is not to change the fabrics. Therefore, even if there is value addition the same is minimum. To attract duty there should be a manufacture to result in different Goods and the Goods sought to be subject to duty should be known in the market as such.

The following processes have been held to come under 'manufacturing' or 'processing' in the court judgements: converting yarn into thread; cutting fabric to make bed sheets; ship breaking; processing paddy into rice; bleaching, dyeing and printing of fabric; and loading of software onto blank CDs.

✦ Scope of 'Goods'

A further requirement is that the article produced must be 'goods' and also find mention in the Tariff Act. The term, 'goods', is not defined in the Central Excise Act. The courts have drawn its meaning from the definition given in the Sale of Goods Act, 1930 and the general use of the term. 'Goods' was a term used by the traders and has had a commercial connotation. The following is a founding case on the scope of the term.

Court Case: Union of India v. Delhi Cloth and General Mills Co. Ltd.

Several companies were engaged in the manufacture of what was known as vanaspati, or hydrogenated oil.[7] The process for making it began with collecting oil seeds, like those of groundnut, sesame, mustard or cottonseed. Let us describe the process with the example of groundnut seeds. Groundnut seeds were crushed to expel the oil. This was the familiar groundnut oil, sold in the market. The groundnut oil was chemically treated to remove impurities and suspended matter. The impurities and suspended particles settled at the bottom. The oil was then chemically treated to bleach it. This removed the colour of the oil. This was followed by the passing of hydrogen through the oil, in the presence of a catalyst. This 'hydrogenated' the oil. The last stage was to take the smell away from the hydrogenated oil by deodorising it.

Companies were buying different kinds of oils and carrying out chemical processes to convert them into vanaspati. We know that excise duty is levied when goods are produced or manufactured. In a production process, the coming into existence of an intermediate item is also production. And thus, the manufacturer would be taxed for producing the intermediate item, according to

[6] Commissioner of Central Excise, Chennai-II Commissionerate and another v. Tarpaulin International, 2010 (256) ELT 481.

[7] Union of India v. Delhi Cloth and General Mills Co. Ltd., AIR 1963 SC 791.

the prevailing rate. The intermediate goods would get used to produce the final product. The manufacturer would then pay excise duty for producing the final product. The excise department imposed excise duty on the oil produced after bleaching, on the ground that it fell under the item, 'vegetable non-essential oils'. The oil, in that stage, was not fit to be sold in the market or to the consumer. The Supreme Court first brought out that excise duty can apply for an intermediate production. It noted:

> Excise duty is on the manufacture of goods and not on the sale. … therefore … the substance produced by them at an intermediate stage is not put in the market would not make any difference.

The Supreme Court, however, noted that for excise duty to apply, the thing produced must be goods. For the thing produced to be 'goods', it must be 'known to the consumers and the commercial community'. The article must be 'something which can ordinarily come to the market to be bought and sold'. If the oil, after bleaching, had been deodorised, it would have become refined oil. Oil of this description was sold in the market. But there was no oil known in the market that had been only cleaned and bleached. Thus, the oil was not 'goods' and excise duty would not apply to it. This founding principle has been applied in several cases. Let us explore it with the following review:

Court Case: Union of India v. Sonic Electrochem Private Limited

The case relates to the familiar household gadget, electro-mosquito repellents (EMR).[8] Sonic Electrochem Private Limited had manufactured the plastic frame for the gadget. This was an intermediate product. The frame was fitted with a plate for keeping the mat, electrical circuitry and wire to complete the gadget. The excise department levied excise duty on the manufacture of the plastic frame. The dispute was whether the plastic frame was 'goods'. The Supreme Court noted:

> The twin requirements of "goods" ... are: (a) manufacture, and (b) marketability. Insofar as the first requirement is concerned, there is no dispute ... The germane question is whether it has marketability. The plastic body is being manufactured to suit the requirements of EMR of the respondents and is not available in the market for being bought and sold. It is not a standardised item or goods known and generally dealt with in the market. It is being manufactured by the respondents for its captive consumption. It is not a product known in the market with any commercial name. ...
>
> Marketability of goods has certain attributes. The essence of marketability is neither in the form nor in the shape or condition in which the manufactured articles are to be found, it is the commercial identity of the articles known to the market for being bought and sold. The fact that the product in question is generally not being bought and sold or has no demand in the market would be irrelevant. The plastic body of EMR does not satisfy the aforementioned criteria. There are some competing manufacturers of EMR. Each is having a different plastic body to suit its design and requirement. If one goes to the market to purchase the plastic body of EMR of the respondents either for replacement or otherwise one cannot get it in the market because at present it is not a commercially known product. For these reasons, the plastic body, which is a part of EMR of the respondents, is not "goods".

[8] Union of India v. Sonic Electrochem Private Limited, AIR 2002 SC 3288.

The following is another case on the requirement of marketability for a thing to be 'goods'.

Court Case: Bata India Limited v. Commissioner of Central Excise, New Delhi

Bata, the shoe manufacturing company, made an intermediate product during the process of manufacturing shoes.[9] Various chemicals, rubber and solvent were mixed together. A thin layer of the mixed material was sandwiched between two layers of textile fabric. The sheet, thus formed, was cut and stitched to make shoe-uppers. After fixing the shoe-upper to the sole, the footwear was vulcanised. Only after this did the footwear become ready to be taken to the market. The excise department considered the intermediate product, the sheet, to be excisable goods. The Supreme Court noted:

> The test of marketability often called `Vendability test' ... is essentially a question … to be decided on the facts of each case and there can be no generalization, and the fact that goods are not in fact marketed is of no relevance ... Admittedly, the assessee is not marketing the product but still the question is whether the product is capable of being marketed. … The test of marketability is that the product which is made liable to duty must be marketable in the condition in which it emerges. No evidence has been produced by the Revenue to show the product unvulcanised sandwiched fabric as such is capable of being marketed, without further processing. The question is not whether there is a hypothetical possibility of a purchase and sale of the commodity but whether there is sufficient proof that the product is commercially known.

The Supreme Court noted that the onus was on the excise department, to establish marketability.

✦ Inclusion in the Tariff Act

A thing may have been manufactured or produced. However, it would be subject to the levy of excise duty only if it has been included in the Tariff Act. As noted earlier, the Tariff Act does not list goods by their names, but only describes a class of goods. The specific thing produced may not fit the description of the class. The following case illustrates this.

Court Case: Messrs Craft Interiors Private Limited v. Commissioner of Central Excise, Bangalore

Craft Interiors Private Limited were a contractors who undertook various works, including wood works.[10] The company had made tables, chairs, storage units, reception tables and a conference table at the premises of a client. The excise department levied duty on the items made by the company. The contention of the company was that the storage units, kitchen counters and conference tables were erected and they could not be removed or moved from one place to another. The company claimed that these could not even be dismantled and removed in complete or semi-knocked down condition, from one place to another. These could only be cannibalised,

---

[9] Bata India Limited v. Commissioner of Central Excise, New Delhi, 2010 (252) ELT 492.

[10] Messrs Craft Interiors Private Limited v. Commissioner of Central Excise, Bangalore, 2006 (203) ELT 529.

as a result of which, these would get reduced to broken pieces of wood and laminates. Thus, the items were immovable property and were not excisable goods. The excise department had levied the duty under Chapter Sub-heading 9403 of the Central Excise Tariff Act, which read: 'Other furniture and parts thereof'. The Supreme Court noted:

> ... a perusal of the definitions given in various dictionaries shows that ordinarily 'furniture' refers to movable items such as desks, tables, chairs, required for use or ornamentation in a house or office. Thus, ordinarily furniture is not something immovable or something which is fixed in a position which can be removed only by cannibalising. ... We hold that items which are ordinarily immovable or which ordinarily cannot be removed without cannibalising e.g. storage units, running counters, over-head unit, rear and side unit, wall unit, pantry unit, kitchen unit ... are not furniture. However, items like tables, desks, chairs etc. are furniture and hence excisable.

The Supreme Court did not answer the question of whether storage units and kitchen units were 'goods' or not. 'Goods' include things that can be severed from the ground. Even if the immovable items were 'goods', these did not fall under an excisable head and thus, were not excisable. We can now note the complete definition of manufacture as given in the Central Excise Act. It reads:

> 2(f) "manufacture" includes any process—
>
> (i) incidental or ancillary to the completion of a manufactured product;
>
> (ii) which is specified in relation to any goods in the section or chapter notes of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986) as amounting to manufacture; or
>
> (iii) which, in relation to the goods specified in the Third Schedule, involves packing or repacking of such goods in a unit container or labelling or re-labelling of containers including the declaration or alteration of retail sale price on it or adoption of any other treatment on the goods to render the product marketable to the consumer;

In the course of manufacturing, waste gets produced. It could also be incidental or ancillary to manufacturing. Thus, waste may be excisable goods. In Union of India v. Ahmedabad Electricity Co. Ltd.,[11] the question arose whether the ash produced in a thermal power station, by burning of coal, was taxable. The Supreme Count noted:

> In the case in hand also coal which leads to production of cinder is not used as a raw material for the end product. It is being used only for ancillary purpose that is as a fuel. Therefore, irrespective of the fact whether any manufacture is involved in production of cinder it should be held to be out of the tax net for the reason that it is not a raw material for the end product. In producing 'cinder,' there is no manufacturing process involved. Coal is simply burnt as fuel to produce steam. Coal is not tampered with, manipulated or transformed into the end product. For purposes of manufacture the raw material should ultimately get a new identity by virtue of the manufacturing process either on its own or in conjunction or combination with other raw materials. Since coal is not a raw material for the end product in all the cases before us, the question of getting a new identity as an end product due to manufacturing process does not arise. …
>
> Can burning of coal be called manufacturing? The locomotive steam engines used to run on coal. Coal was being constantly burnt in the boiler of the engines. The constant burning of coal produced cinder. Could it be said that the engine driver was manufacturing cinder? Is any manufacturing activity involved? Burning of coal for purposes of producing steam cannot be said to be a manufacturing activity. Therefore, neither ash nor cinder can be said to be products of a manufacturing process.

[11] Union of India v. Ahmedabad Electricity Co. Ltd., AIR 2004 SC 11.

Thus, the Court did not hold the residue from the burning of coal to be a manufacture or production, so as to be put to tax.

The Tariff Act, in the chapter notes, has declared some acts to be manufacture. Thus, even if an activity is not manufacture from the tests explored above, it is deemed to be manufacture if it has been included in the notes. Packing, re-packing or labelling, on its own, is not manufacture, as no new commodity emerges. However, in relation to the goods included in the third schedule of the Central Excise Tariff Act, these activities have been deemed to be manufacture.

✦ Manufacturer

In most of the cases, the liability for paying the excise duty is on the manufacturer or producer. Section 2(f) has defined a manufacturer to be one who engages in the production or manufacture, 'on his own account', or 'who employs hired labour'. Thus, a manufacturer is one who actually manufactures himself or through hired labour. The reference is not to the ownership of the raw material or goods produced, but to the act of manufacturing. Let us explore whether the following are manufacturers:

1. A food product company (not manufacturing goods specified in the third schedule of the Central Excise Tariff Act) buys oil seeds from the market. It gives the oil seeds to a unit, X, for crushing and extracting oil. The unit extracts oil and delivers it to the company. The company packs and sells the product to its distributors. Who is the manufacturer, the company or the unit?
2. A food product company buys oil seeds from the market. It gives the oil seeds to a unit, X, for crushing and extracting oil. The unit extracts oil, packs it in bottles bearing the logo of the company and delivers it to the company. The company sells the bottles to its distributors. Who is the manufacturer, the company or the unit?
3. Cold drink manufacturing companies work with bottling companies. They supply the drink concentrate and the bottling companies make and bottle the drink according to the specifications of the supplier company. Often, the technology and machines are approved by the supplier company. The bottling companies use the logo of the supplier company and sell the bottles to the distributors, who are often, subsidiaries of the supplier companies. Who is the manufacturer, the bottling company or the supplier company?
4. A leases B's factory to manufacture and sell its goods under its own brand name. Who is the manufacturer, the factory owner or the lessee?

In the first two cases, it is the unit which is the manufacturer, while in the third case, the bottling company is the manufacturer. In the last case, the lessee of the factory is the manufacturer. In the next chapter, we will explore the basis for working out the quantum of tax.

22

CHAPTER

Central Excise Tax: Valuation of Duty

Whether the manufacture or production of certain things would be subject to the levying of excise duty or not is decided on the basis of the criteria of marketability and inclusion in the Tariff Act. If excise duty is to be levied, the next question is: What should be the basis for working out the quantum of excise duty? This is called valuation of excise duty. Excise duty is a tax on the manufacture, and not sale or consumption of goods. Therefore, the reference for imposition of the tax is the goods coming into existence. The excise duty should be in proportion to the value of these goods. However, a value can be assigned to the goods only when the manufacturer makes a sale of the goods. Thus, the basis for the levying of duty became the price at which the manufacturer sold the goods. The point of levy and collection became the point of time when the goods, following the sale, left the manufacturer. As the Supreme Court, in Union of India v. Bombay Tyre International Ltd.,[1] explained:

> ... an excise is ... imposed in respect of the manufacture or production of an article, the point at which it is collected is not determined by the point of time when its manufacture is completed but will rest on considerations of administrative convenience, and that generally it is collected when the article leaves the factory for the first time. In other words, the circumstance that the article becomes the object of assessment when it is sold by the manufacturer does not detract from its true nature, that it is a levy on the fact of manufacture.

Excise duty is a tax on a manufacture or production of things. The tax gets attracted the moment goods are produced. Thus, the tax applies even if the goods are intermediate products and are consumed within the factory. As a court judgement explained:[2]

> There is in theory nothing to prevent the Central Legislature from imposing a duty of excise on a commodity as soon as it comes into existence, no matter what happens to it afterwards, whether it be sold, consumed, destroyed, or given away. A taxing authority will not ordinarily impose such a duty, because it is much more convenient administratively to collect the duty … when the commodity leaves the factory for the first time, and also because the duty is intended to be an indirect duty which the manufacturer or producer is to pass on to the ultimate consumer, which he could not do if the commodity had, for example, been destroyed in the factory itself. It is the fact of manufacture which attracts the duty, even though it may be collected later.

The price at which the manufacturer sells the goods cannot be taken as the reference to get to the fact of manufacture because the price itself is not standard. The price charged by the manufacturer can be dependent on other dealings and on the relationships between the parties.

---

[1] Union of India v. Bombay Tyre International Ltd., AIR 1984 SC 420.

[2] Province of Madras v. M/s. Boddu Paidanna and Sons, AIR 1942 FC 33 (35).

Take the case where a buyer of goods was to pay ₹ 3 lakh to the manufacturer and ₹ 1 lakh to a third party, who had provided the raw material to the manufacturer. While the manufacturer may have received only ₹ 3 lakh, the price of the goods sold is ₹ 4 lakh. Similarly, a buyer might have given an advance, to the manufacturer, of ₹ 12 lakh for a sale of goods. ₹ 1 lakh was to be deducted each month from this advanced amount for the supply of goods that month. In the month of July, the buyer paid ₹ 2 lakh to the manufacturer for the supply of only one consignment. The value of the consignment was actually ₹ 3 lakh, though the manufacturer received only ₹ 2 lakh. As another illustration, a buyer gives raw material to the manufacturer and the manufacturer sells the finished goods to the buyer. The manufacturer charges ₹ 80 per unit for the goods to the party, while to others, he sells the goods for ₹ 100. The value of the manufactured goods was not ₹ 80 per unit, but ₹ 100. The manufacturer could be giving a discount to the buyer for supplying raw material, tools, equipment, parts, design, packaging material or artwork. Thus, the price charged by the buyer can only be a starting point. It would need to be worked on and refined to arrive at a value on which duty should be levied. This value is the assessable value for the goods. Section 4 of the Central Excise Act, in conjunction with the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, provides on this. Let us note the framework created by Section 4. It reads:

> **Section 4—Valuation of excisable goods for purposes of charging of duty of excise.** (1) Where under this Act, the duty of excise is chargeable on any excisable goods with reference to their value, then, on each removal of the goods, such value shall—
>
> (a) in a case where the goods are sold by the assessee, for delivery at the time and place of the removal, the assessee and the buyer of the goods are not related and the price is the sole consideration for the sale, be the transaction value; ...
>
> (b) in any other case, including the case where the goods are not sold, be the value determined in such manner as may be prescribed.

Clause (a) refers to the place of delivery. This can be different places, for example, a factory, warehouse or depots and this will make a difference to the price at which the goods are sold. Let us take the case where the delivery is done at the factory itself, to understand the other aspects mentioned in the clause. The 'transaction value' is taken to be the assessable value for the levy of excise duty if two conditions are met. One, the buyer is not related to the seller. Second, price is the sole consideration for the sale. Let us explore these conditions.

Unrelated Buyer

X Ltd. is a manufacturing company. It manufactures goods on which excise duty is to be levied on the transaction value, at the rate of 10%. It sells goods to its subsidiary company, X Distributors Private Limited, at a unit cost of ₹ 80. The excise duty collected on the sale is ₹ 8. The subsidiary company sells the goods to a distributor for ₹ 400. In these transactions, the intermediation of the subsidiary company has been used to reduce the excise duty payable. The company should have sold directly to the distributor and paid ₹ 40 in excise duty. Another mechanism that could be used for evading tax could be for X Ltd. to sell to Y at a low price and pay excise duty. Thereafter, Y would sell it back to X Ltd., charging a small commission for the buying and reselling. X Ltd., having reduced its excise duty liability, can then sell the goods to its distributors. Thus, the condition that the buyer should not be related to the seller is essential for the transaction value to be a genuine price. Corporate entities can be 'related' if the manufacturer and buyer are 'inter-connected undertakings' or they have direct or indirect interest in the business of each other. If the buyer is 'related', Clause (a) fails and does not apply. Clause (b) gets to be applied. The government has made the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, to give effect to Clause (b). We will call them Valuation Rules. Valuation Rules make modifications and adjustments to the sale price and arrives at the assessable value. Rule 9 provides that the price at which the related person further sells to an unrelated person, will be taken to be the transaction value. Thus, in the case of a manufacturer, M, selling to a related buyer, R, for ₹ 100 per unit and R selling to a buyer unrelated to him, U, for ₹ 150 per unit, ₹ 150 will be taken to be the transaction value per unit for M. The manufacturer will pay excise duty on ₹ 150 per unit.

Additional Consideration

The second requirement is that the price should be the sole consideration for the sale. Take an example where a buyer has hired out machinery to a manufacturer. As a part of the agreement, the manufacturer has to give a 20% discount on the normal price to the hirer, for every purchase made by it in the year. Thus, the hirer buys the goods for ₹ 80 a unit while others buy it for ₹ 100. The manufacturer pays excise duty on ₹ 100 for an ordinary buyer but on only ₹ 80 for the buyer who has hired out the machine to him. The actual price of the goods is not ₹ 80, but ₹ 100. If this were allowed, manufacturers would restructure their transactions so as to evade tax. Therefore, the price is to be taken as the transaction value only if the requirement of price being the only consideration is met. The Valuation Rules provides the mechanism for working out the transaction value if there are other considerations. The other considerations can be, for example, exchange of raw material, tools, equipment, licence, credit, artwork and packaging material, etc. Rule 6 provides that the amount of money value of any additional consideration flowing directly or indirectly from the buyer to the assessee, will be added to the price to get the transaction value. Explanation 1 lists some of the additional considerations. It reads as follows:

> **Explanation—**For removal of doubts, it is hereby clarified that the value... of additional consideration flowing directly or indirectly from the buyer to the assessee in relation to sale of the goods being valued and aggregated accordingly, namely:—
>
> (i) value of materials, components, parts and similar items relatable to such goods;
>
> (ii) value of tools, dies, moulds, drawings, blue prints, technical maps and charts and similar items used in the production of such goods;
>
> (iii) value of material consumed, including packaging materials, in the production of such goods;
>
> (iv) value of engineering, development, artwork, design work and plans and sketches undertaken elsewhere than in the factory of production and necessary for the production of such goods.

A Supreme Court judgement on the theme is Commissioner of Central Excise, Bhubaneshwar-II v. Messrs IFGL Refractories Limited.[3] IFGL Refractories Limited, a manufacturer of refractories, sold a quantity to the Visakhapatnam Steel Plant, at a particular price. Thereafter, the parties

[3] Commissioner of Central Excise, Bhubaneshwar-II v. Messrs IFGL Refractories Limited, 2005 (186) ELT 529.

entered into four different contracts for the supply of refractories. The steel plant held a licence for the import of refractories. It surrendered the licence and against this, IFGL was given an Advance Intermediate Licence for the import of certain inputs. The price charged by IFGL for the subsequent refractories was much lower. The excise department contended that there was additional consideration to the sale price, which should be included. The Supreme Court agreed with the contention. It noted:

> ... without the Advance Licences of M/s Visakhapatnam Steel Plant, being made available to the Respondents [IFGL], the prices would have been as were quoted earlier. It is only because of the Advance Licences being surrendered by M/s Visakhapatnam Steel Plant and in lieu thereof Advance Intermediate Licences being made available to the Respondents [IFGL] that the Respondents could offer lower prices. ... This resulted in additional consideration by way of "Advance Intermediate Licence" flowing from M/s Visakhapatnam Steel Plant to the Respondents. The value received therefrom is includable in the price.

The requirement that the price should be the sole consideration makes the transaction value the assessable value. As clarifications, however, the law provides further adjustments. Transaction value has been defined to be as follows:

> (d) "transaction value" means the price actually paid or payable for the goods, when sold, and includes in addition to the amount charged as price, any amount that the buyer is liable to pay ... by reason of, or in connection with the sale, whether payable at the time of the sale or at any other time, including, but not limited to ... advertising or publicity, marketing and selling organisation expenses, storage, outward handling, servicing, warranty, commission or any other matter; but does not include the amount of duty of excise, sales tax and other taxes, if any, actually paid or actually payable on such goods.

The description of transaction value excludes excise duty, sales tax or other taxes, but includes costs like advertising, storage, handling and warranty.

✦ Exclusion of Taxes

The definition of transaction value specifically excludes excise duty, sales tax or other taxes. A discerning manufacturer would give a break-up of the price and the taxes, to the seller, in the invoice. Taking the excise duty to be 10% and sales tax 15%, an invoice would read as follows:

Value of the goods	₹ 100
Excise duty (@ 10%)	₹ 10
Sub-total	₹ 110
Sales tax (@15%):	₹ 16.50
Total Price	₹ 126.50

As excise is a tax on manufacture, it will get added to the value of the goods first. A sale would happen later. Thus, the sales tax will be charged on the aggregate value. Clearly, ₹ 100 is the transaction value. A manufacturer, however, may not indicate the break-up. It could be a deliberate step to charge an all inclusive price from the buyer. The manufacturer may be under the impression that the goods are not taxable when they, in reality, are taxable. Should the total amount charged by the manufacturer be taken as the transaction value and the taxes be worked out accordingly, for the manufacturer to pay? Or, should the price received by the manufacturer be taken as the total price, inclusive of taxes? In the second case, the amount will be broken up so as to separate the transaction value and the taxes. A plain reading of Section 4 brings out that the amount paid by the buyer is inclusive of taxes. An explanation to Section 4 further clarifies this. It reads:

> **Explanation**— For the removal of doubts, it is hereby declared that the price-cum-duty of the excisable goods sold by the assessee shall be the price actually paid to him for the goods sold ... and such price-cum-duty, excluding sales tax and other taxes, if any, actually paid, shall be deemed to include the duty payable on such goods.

Thus, if the taxes are not separately indicated, the price paid is called price-cum-duty. A court judgement on the theme is Commissioner of Central Excise, Delhi v. Messrs Maruti Udyog Limited.[4] Maruti Udyog Limited, while selling scrap, understood that excise duty was not required to be paid on scrap. The excise department contended and succeeded in its contention that excise duty had to be paid. The dispute was whether the amount received by Maruti Udyog Limited was the assessable value or the amount was inclusive of taxes. The Supreme Court noted:

> The facts indicate that after the sale transaction was completed, the purchaser was under no obligation to pay any extra amount to the seller ... The sale price realised by the respondent has to be regarded as the entire price inclusive of excise duty because it is the respondent [Maruti Udyog] who has, by necessary implication, taken on the liability to pay all taxes on the goods sold and has not sought to realise any sum in addition to the price obtained by it from the purchaser. The purchaser was under no obligation to pay any amount in excess of what had already been paid as the price of the scrap.

Thus, if a sale is made and the break-up is not indicated, the final price has to be broken up into its constituents to work out the excise duty and sales tax liability. The following illustration will bring this out.

Illustration

A manufacturer sold goods at the factory gate for ₹ 253 per piece, inclusive of excise duty and sales tax. The rate of sales tax is 15% and excise duty, 10%. What are the excise duty and sales tax liabilities of the manufacturer? If the assessable value is Y, the calculation of the taxes would be as follows:

Assessable value: Y

Excise duty: 0.1 Y

Sub-total: 1.1 Y

Sales tax: (1.1 Y) 15/100 = 0.165 Y

Total Price: 1.265 Y

We apply the equation to the all-inclusive price, i.e., ₹ 253.

$$1.265\,Y = ₹\ 253$$
$$Y = ₹\ 200$$

[4] Commissioner of Central Excise, Delhi v. Messrs Maruti Udyog Limited and Hilton Rubbers, AIR 2002 SC 1245.

We can confirm the calculation by working with the assessable value.

Assessable value	₹ 200
Excise duty (@ 10%)	₹ 20
Sub-total	₹ 220
Sales tax (@15%):	₹ 33
Total Price	₹ 253

Case

X Limited sold goods at the factory gate at an all-inclusive price of ₹ 1,265 per unit. The applicable excise duty was at the rate of 10% and sales tax, at 8%. Calculate the assessable value, the excise duty and the sales tax.

✦ Inclusion of Other Costs

For deciding whether a particular charge is to be included in the transaction value or not, it has to be assessed whether the charge is by reason of 'or in connection with the sale'. Illustrations of some of such costs are 'advertising or publicity, marketing and selling organisation expenses, storage, outward handling, servicing, warranty and commission'. A manufacturer may provide post-purchase servicing and warranty for a certain period of time. The definition of transaction value has clearly indicated that the value of these services would be included in the transaction value. That is, if the manufacturer indicates the cost of the machine to be ₹ 2 lakh, servicing charges ₹ 20,000 and warranty ₹ 30,000, the transaction value is to be taken to be ₹ 2.5 lakh. As normal packing is 'in respect of' the sale, it is included in the transaction value. Some goods, however, use returnable containers. Examples of such goods are cold drinks and gas cylinders. As the sale is only of the contents, the cost of the containers is not included in the transaction value. A Supreme Court judgement on the theme is Commissioner of Central Excise, Chennai v. Hindustan Lever Ltd.[5] Hindustan Lever Ltd. gave certain extra quantity free if the dealer bought a certain quantity. The contention of the excise department was that the free items should be assessed at a transaction value fixed on a pro-rata basis. The Supreme Court differed and recognised it to be a trade discount. It noted:

> Quantity discount, to put it simply, works thus: a dealer receives from the assessee a stated extra quantity if he buys a certain other quantity. That this will happen is known and agreed at the time the transaction is entered into. It is, therefore, a trade discount and the authorities below have correctly allowed it as such.

The price paid by the dealer includes the cost of the extra quantity given to him. It is another way of giving a trade discount.

[5] Commissioner of Central Excise, Chennai v. Hindustan Lever Ltd, 2002 (142) ELT 513.

✦ Time and Place of Removal

The time and place of sale is another variable that affects the transaction value. In our exploration above, we assumed that the place of delivery was at the factory gate, to be able to understand the other factors better. We can now explore the significance of the time and place of the sale and the removal of the goods. Excise duty is a duty on production. It gets attracted the moment goods are produced or manufactured. The excise department would like to collect it at the earliest possible. However, until a sale takes place, there is no transaction value for the excise department to use as base and work out the duty. A manufacturer can follow different arrangements for selling the goods. The simplest is that the manufacturer sells it at the factory gates. The goods leave the factory only on paying the excise duty, which is worked out on the basis of the transaction value. As the space in a factory may be limited, the excise department allows the manufacturer to move the goods to a warehouse, without paying the excise duty. The warehouse is registered with the excise department and the department ensures that there is no removal from the warehouse without paying of the duty. The two, the factory and the warehouse outside the factory, are conceptually the same. The warehouse becomes an extension of the factory. The goods leave the warehouse only on a paying of the excise duty, on the basis of the transaction value. The manufacturer, ordinarily, will charge a higher value while selling the goods from the warehouse as the charges involved in moving the goods to the warehouse would have got added. The price charged for delivery at the factory gate or the warehouse is thus, the transaction value.

A manufacturer might also like an additional arrangement. He may have depots in different cities, where he might like to move the goods. The goods would then be sold from each depot to the buyers in that city or region. An alternative to maintaining an establishment in a particular town is to have an agent there. Goods are sent to the agent, who stores it and sells it for the principal, in the town or the region. Such agents are called consignment agents. In a depot or consignment sale, the transaction value of the goods would be known only when the goods get sold. If the department were to wait till then, it would have to allow the manufacturer to move the goods, without paying excise duty. In addition, the department would have to keep a track of the inventory and sales in each depot and with every consignment agent. This would increase the workload of the department. It would also increase the risk of duty evasion. Thus, the law insists on the duty being charged on the manufacturer at the time the goods leave the factory. However, what should be the assessable value when there is no sale? The Excise Duty Rules provide for this situation.

The Rules take the assessable value of the goods leaving the factory to be the transaction value of such goods on that day, at the depot where the goods are being sent to. This is not a provisional value but the final value. The price at which the goods finally get sold from the depot does not matter. For example, goods were moved out from a factory in Chennai on October 1, to a depot in Ahmedabad. Goods of the same description were being sold at the factory gate in Chennai for ₹ 100 per unit. The price at which goods of the same description were being sold from the Ahmedabad depot on October 1 was ₹ 110 per unit. The goods got sold from the Ahmedabad depot on October 20, for ₹ 112 per unit. The excise duty would be charged to the manufacturer on October 1, at an assessment value of ₹ 110 per unit, at its factory in Chennai.

Case

A factory at Pune transferred goods to its depot in Mumbai, on October 5. The per unit price of the goods (exclusive of all taxes) on October 5 was ₹ 100 in Pune and ₹ 110 in the depot in Mumbai. The goods brought from Pune to the depot got sold on October 20 for ₹ 120 per unit (exclusive of all taxes). What is the transaction value that would be taken for working out the excise duty?

Consistent with this arrangement, Section 4 recognises that a sale can be made from the above three locations: factory, warehouse and depot or consignment agent, and it calls these the ‘places of removal’. In a sale and delivery at the factory gate or warehouse, the sale price is the transaction value. This is called an ex-factory or ex-warehouse sale and the price is called the ex-factory or ex-warehouse price. The buyer bears the cost of transportation beyond the factory gates. In the case of a depot transfer, the value is not an actual value but a notional one. It is the value prevailing on the same day at the depot. There may be another arrangement where the manufacturer could sell goods from its factory or warehouse, but may not transfer the ownership or give delivery at the gate. The arrangement may require the seller to take the goods all the way to the destination of the buyer and deliver them there. This is an important aspect of a sale and it is settled at the time of making of the sale contract. Thus, the price charged by the manufacturer may include the cost of transportation and insurance beyond the factory gates. Should the cost of transportation, insurance and handling be included in the assessment value? Where the delivery is not being made at the factory gate, Rule 5 of the Valuation Rules provides the answer. It reads:

> Rule 5. Where any excisable goods are sold … for delivery at a place other than the place of removal, then the value of such excisable goods shall be deemed to be the transaction value, excluding the cost of transportation from the place of removal up to the place of delivery of such excisable goods.
>
> **Explanation 1**— “Cost of transportation” includes—
>
> (i) the actual cost of transportation; and
>
> (ii) in case where freight is averaged, the cost of transportation calculated in accordance with generally accepted principles of costing.
>
> **Explanation 2**— For removal of doubts, it is clarified that the cost of transportation from the factory to the place of removal, where the factory is not the place of removal, shall not be excluded for the purposes of determining the value of the excisable goods.

This provision is also relevant for depot sales. The transaction value at the depot is used as the notional value for assessment at the factory. If the depot makes a sale where the delivery is being made to the location of the buyer, the cost of transportation would be excluded for working out the transaction value at the depot.

✦ Maximum Retail Price Based Valuation

The ‘transaction value’ based system has attempted, through elaborate provisions, to get to the actual price of the goods. It will always be in the interest of the manufacturer to reduce the assessable value. And the government would be finding means to prevent the manufacturer from doing this. The law makers discovered that this issue could be resolved by taking the Maximum

Retail Price (MRP) on a package as the basis for working out the assessable value. The printing of MRP on all packages is a requirement under the Legal Metrology Act, 2009. Under the Act, the Legal Metrology (Packaged Commodities) Rules, 2011, have been framed. [The Act and Rules were earlier called the Standards of Weights and Measures Act, 1976 and the Standards of Weights and Measures (Packaged Commodities) Rules, 1977.] These Rules require the manufacturer/packer to make certain declarations on every pre-packed commodity. The declarations include the name of the product, the quantity and the 'Maximum Retail Sale Price'. The manufacturer is free to fix the MRP. However, once the price is declared on the package, no person can alter or obliterate the declared price or make a sale at a price higher than the MRP. The MRP is inclusive of all taxes.

The government realised that to comply with the law, the manufacturer would have to take into account all the costs, as well as a margin, for fixing the MRP. As this would be the maximum price that can be realised from the consumer, there could be no under-reporting. Thus, the MRP could be taken as the basis for fixing the excise duty. As we have noted earlier, the assessable value is the price at which the manufacturer makes his first sale at the factory gate. What are the additional components that the MRP includes? These would be the taxes, freight and commissions of the distributor, wholesaler and retailer. If these additional costs could be estimated for a product, the MRP could be discounted to get to the assessable value. Section 4A of the Central Excise Act provides for this. It reads:

> **Section 4 A— Valuation of excisable goods with reference to retail sale price.** (1) The Central Government may, by notification in the Official Gazette, specify any goods, in relation to which it is required, under the provisions of the Legal Metrology Act, 2009 (1 of 2010) or the rules made thereunder or under any other law for the time being in force, to declare on the package thereof the retail sale price of such goods, to which the provisions of sub-section (2) shall apply.
>
> (2) Where the goods specified under sub-section (1) are excisable goods and are chargeable to duty of excise with reference to value, then, notwithstanding anything contained in section 4, such value shall be deemed to be the retail sale price declared on such goods less such amount of abatement, if any, from such retail sale price as the Central Government may allow by notification in the Official Gazette.

Thus, the government, through notifications, has been declaring the commodities that are to be assessed on the basis of their MRP prices and the rebates available to them. The rebate is mentioned as a percentage. The MRP is deducted by the rebate amount to arrive at the assessable value of the package. The excise duty becomes payable on the package at the prevailing rate. For example, the product, mobile phone, is included in the list of goods eligible for assessment on the basis of MRP, with a rebate of 35%. Thus, the assessable value for a mobile phone bearing an MRP of ₹ 2,000 would be ₹ 1,300. Excise duty would be paid at the prevailing rate. A large number of commodities have come to be notified for assessment on the basis of their MRPs.

Case

A manufacturer manufactures and sells its products in a packaged form. The excise duty on the goods is levied on the basis of the Maximum Retail Sale Price (MRP). On the basis of the following data, calculate the excise duty to be levied on each piece of the packaged commodity:

1. MRP (Inclusive of all taxes): ₹ 10
2. Abatement: 20%
3. Rate of Excise duty for the commodity: 12%

Case

A manufacturer manufactures and sells its products in a packaged form. The excise duty on the goods is levied on the basis of the Maximum Retail Sale Price (MRP). On the basis of the following data, calculate the excise duty to be levied on each piece of the packaged commodity:

1. MRP (Inclusive of all taxes): ₹ 50
2. Abatement: 30%
3. Rate of VAT for sale: 10%
4. Rate of Excise duty for the commodity: 12%

In some cases, goods are taken out from the factory, but are not sold. This happens in two situations. The goods may be marked as samples for free distribution to the trade channel or the customers. Free samples of medicines given to doctors, is an example of this practice. The other situation is where the manufacturer gives a replacement to a buyer under a warranty. Thus, the goods go out to the customer, but there is no sale as no cash consideration comes to the manufacturer. Such goods are assessed at the rate at which similar goods are sold from the place. In the case of packaged commodities, notified to be assessed on the basis of the MRP, the MRP of a similar package becomes the basis for working out the assessable value.

✦ Others Means of Valuation

Production Capacity: Section 3A of the Central Excise Act has given powers to the central government to notify the commodities on which excise duty would be charged on the basis of production capacity. The central government has notified pan masala, chewing tobacco and gutka for assessment on the basis of production capacity. The excise department determines the production capacity of each production unit. The production capacity is taken as the measure of production, irrespective of the actual production.

Specific Duty: Another means of valuation is on the basis of a certain unit, like weight, length and volume, instead of the value of the product. Some of the commodities assessed under specific duty are cigarettes, matches, sugar, marble slabs and tiles and molasses. For example, sugar is assessed on per kilogram basis. A manufacturer who manufactures sugar pays excise duty at a fixed rate for each kilogram of sugar, irrespective of the price at which he sells it to the buyers. The unit for assessing other commodities are, Cigarettes—length; marble slabs—square metre; and molasses—per ton.

Tariff Value: The government has the power to fix a notional value that is to be taken as the assessable value for a commodity. This is called the tariff value. Irrespective of the price at which the manufacturer sells such goods, duty is paid on the tariff value. For example, ready-made garments are assessed on tariff values.

✦ Other Themes

Under this heading, we will summarise some other general aspects of excise duty.

Excise and Small Scale Industries: Excise is a tax on manufacture, and thus, it should be payable by all. However, the government encourages the growth of small units. Further, it is administratively inconvenient and costly to collect revenue from numerous small units. Thus, units of Small Scale Industries (SSI), having a turnover of less than ₹ 4 crore in the preceding financial year, are entitled for SSI exemption in the current year. An SSI unit can avail full exemption of excise duty on the value of first clearances of excisable goods of up to ₹ 1.50 crore, subject to certain conditions. However, some items are not eligible for concessions.

Exemption from Duty: Certain goods may not fall under the Tariff Act. Thus, no duty is leviable on their production or manufacture. Further, the rate of duty against some goods may be 'nil'. These goods are chargeable to excise duty, but the rate being nil, no duty would be paid. Section 5A of the Central Excise Act gives the power to the government to exempt certain goods from excise duty, by issuing a notification. Such goods are called 'exempted' goods. In addition, there are special provisions for the levy of excise duty on manufacturing in special economic zones and hundred per cent export oriented units.

23

CHAPTER

Customs Duty

The tax on import of goods is called Customs Duty. The Centre alone has the competence to levy and collect customs duty. Two acts, in conjunction, provide for the charge and quantum of customs duty—the Customs Act, 1962, and the Customs Tariff Act, 1975. The Customs Act provides for the charge of customs duty, its valuation and the power of officers. The Act is supplemented by the Customs Tariff Act, 1975. As explored in the introductory chapter, the Harmonised System of Classification of Goods was devised to facilitate the levy of customs by the signatory countries. The Customs Tariff Act adopts the Harmonised System.

✦ Charge of Customs Duty

The Customs Act charges customs duty and gives wide powers to the Customs Department to levy and collect customs duty and enforce the provisions of the Act on the imports and exports of goods; as well as to enforce certain prohibitions and restrictions on imports and exports. The customs department has the power to search, seize and confiscate goods. Section 12 deals with the charging of the duty. It provides:

> **Section 12. Dutiable goods.** (1) Except as otherwise provided in this Act, or any other law for the time being in force, duties of customs shall be levied at such rates as may be specified under the Customs Tariff Act, 1975 (51 of 1975)], or any other law for the time being in force, on goods imported into, or exported from, India.
>
> (2) The provisions of sub-section (1) shall apply in respect of all goods belonging to Government as they apply in respect of goods not belonging to Government.

The section provides for charging of duty not only on imports, but also on exports. However, export duty is levied only on a few goods. The government, keen to earn foreign exchange, would not wish to make exports uncompetitive by charging export duty. Therefore, the Customs Act is mostly used to levy duty on imports. The Customs Tariff Act provides the rates of customs duty for different goods. The goods are classified according to the Harmonised Classification of Goods and the relevant rate of duty is mentioned against it. This is called the basic customs duty. There are additional customs duties charged by the Customs Tariff Act. When goods are exported, the exporting countries do not charge excise or sales tax. As a result, the imported goods have a price advantage over the domestic goods. The Customs Tariff Act charges further customs duty to create a level playing field. Section 3(1) provides as follows:

> **3.** (1) Any article which is imported into India shall, in addition, be liable to a duty (hereafter in this section referred to as the additional duty) equal to the excise duty for the time being leviable on a like article if produced or manufactured in India ...

The sub-section imposes a duty called 'additional duty', which is equal to the excise duty levied on similar goods produced in India. As the rate is equal to the prevailing excise duty, one has to determine it with reference to the excise laws. As the duty is aimed at countervailing the excise duty, it is called the Countervailing Duty (CVD). Section 3(5) provides for a 'special additional duty' to balance the effect of sales tax and other local taxes. The central government has to issue a notification imposing such duty. This duty cannot be more than four per cent of the value of the imported goods. The duty is called the Special CVD. Section 9 provides for the countervailing duty. If a country is providing any subsidy in the manufacture, transportation or export of any goods, the central government can impose a countervailing duty not exceeding the amount of such subsidy. As the term, 'countervailing duty' has already come to be used for the additional duties charged; this duty is distinguished by calling it the safeguard duty. Section 9A provides for an anti-dumping duty. If any country is exporting goods at less than its normal value, the central government can, by notification, impose an anti-dumping duty on such import. This duty should not exceed the margin between the export price and the normal price.

Thus, there are five kinds of customs duty: basic customs duty, countervailing duty (CVD), special countervailing duty (Special CVD), safeguard duty and anti-dumping duty. Each duty is distinct and has a specific purpose. The Customs Tariff Act also provides the sequence in which these are to be calculated and totalled. Customs duty is worked out on the value of the imported goods. First, the basic customs duty is calculated and added to the value of the goods. Then, the CVD is calculated on the aggregated value. The CVD is added to the aggregated value. The special CVD is levied with reference to the accumulated value. The countervailing duty and the anti-dumping duty would provide the basis on which these would apply.

The provisions of the Customs Act and the Customs Tariff Act give powers to the Central government to make exemptions and change the rates in the Customs Tariff Act by notification. Following this, there may be different rates of basic customs duty for imports from different countries. Some countries may have a special trading relationship with India. The government has excised and made notifications to exempt, among others, defence related imports made by the government organisations. Thus, in addition to the details in the Customs Tariff Act, one would also need to read the rules and notifications which exempt certain imports.

Under Section 12, customs duty is charged on 'goods imported into', or exported from, India. Section 2(23) defines import to be 'bringing into India' goods from a place outside India. Goods can come through different means of transport—sea, air, road and rail. The modalities of the goods coming in can also be different. The import could be through post, courier or as baggage of a passenger. The goods could also be imported as cargo. While the duty on imports would be the same, there are different procedures for importing the goods for the different modalities. Let us first explore the import of cargo. We will explore import through baggage and courier later. As there is limited import of goods through road or rail, we will focus on imports by sea and air.

✦ Cargo Import

The Customs Act, with the corresponding rules and notifications, provides for several mechanisms and controls to ensure that prohibited items do not get imported and duty is paid on imports. The imported goods can be brought in and unloaded only at specified places. Under the Customs Act, the Central Board of Excise and Customs (CBEC) specifies the airports where the aircrafts coming from a place outside India can land and unload. These are called customs airports. Similarly, the CBEC specifies the ports where vessels coming from outside India can enter and unload. These are called customs ports. For goods coming by road, there are appointed points at which a carrier can enter India. These are the land customs stations. A customs port, customs airport or land customs station is called a customs station.

An aircraft or ship can only enter India at a customs port or airport. In an emergency, like an accident or bad weather, however, a vessel or aircraft can land at a place other than a customs station. The commander of the aircraft or pilot-in-charge of the vessel has to, prior to its arrival at a customs station, submit an import manifest. This is done by the employees of the carrier company or an agent. The submission of the document can be done electronically, at the gateway created for the purpose. After examining the import manifest, the customs officer will grant an 'entry inward'. Goods can be unloaded only after the grant of 'entry inwards'. Only the goods mentioned in the import manifest can be unloaded. The goods have to be unloaded only at the specified place, under the supervision of the customs officer. The Port Trust Authority or the Airport Authority has been approved by the customs department to take custody of the goods and retain them under the control of the customs department. After unloading, the Port Authority or Airport Authority prepares a document listing all the items that have been unloaded and are in its custody. This is called a 'tally sheet' as it is tallied with the import manifest.

The importer submits a 'Bill of Entry' electronically, to the customs department. The Bill of Entry gives the details mentioned in the bill of lading or airway bill and other details of the consignment that the importer is entitled to receive. The bill of entry can be for home consumption or warehousing. A bill of entry for home consumption allows the goods to be released immediately on payment of the duty. Alternatively, the importer can apply for a bill of entry for warehousing. Under this, the customs department stores the goods in a warehouse under its control, without being paid the import duty. The importer gets the goods released by paying the duty as and when he needs the goods. This helps the importer to defer the paying of the duty.

The bill of entry for home consumption requires the importer to self assess the duty. That is, the importer has to identify the rate of duty, compute the amount of duty on the basis of the value of the goods and pay it. The Customs Officer verifies several things. Laws dealing with, among others, food products, pharmaceuticals, wildlife and atomic energy impose restrictions on imports. The Customs Officer verifies that the import is not in violation of these laws. Further, the Customs Officer verifies whether the duty has been correctly assessed. A physical examination of the goods is also done in the case of high-risk cargo. If satisfied, the Customs Officer will grant permission for the removal of the goods. The importer will pay the dues, if any, to the Port Trust or Airport Authority and get the goods cleared.

In the case of a bill of entry for warehousing, the Customs Officer follows the same procedure in all respects other than in relation to the payment of duty. The duty is assessed and the goods are taken to a warehouse. The importer furnishes a bond for paying the duty. The importer has to submit another bill of entry, called the 'bill of entry for ex-bond clearance.' If the duty has changed in the meantime, the change is taken into account. Thus, the importer pays the rate as applicable at the time of taking the goods out of the warehouse. The government has computerised all operations and most of the documents are submitted and processed electronically.

Most of the imports and exports now happen through containers. The containers are packed by the exporter at his premises and brought to the seaport or airport. They are loaded onto the ship or aircraft. Container shipment has several advantages. The importer, obviously, would like to receive the goods as close as possible to his base. To facilitate this, Inland Container Depots have been created. These are customs stations where the customs department brings the containers from the Customs Port or Customs Airport. The importer submits a bill of entry at the depot and gets the container released. The depot is a customs station like any customs airport or customs port.

There is a passage of time between the goods entering India, and finally getting released by the importer. What should be the date for determining the rate of duty? Section 15 gives the answer. It reads:

> **Section 15. Date for determination of rate of duty and tariff valuation of imported goods.** – (1) The rate of duty and tariff valuation, if any, applicable to any imported goods, shall be the rate and valuation in force—
>
> (a) in the case of goods entered for home consumption under section 46, on the date on which a bill of entry in respect of such goods is presented under that section;
>
> (b) in the case of goods cleared from a warehouse under section 68, on the date on which a bill of entry for home consumption in respect of such goods is presented under that section;
>
> (c) in the case of any other goods, on the date of payment of duty :
>
> **Provided** that if a bill of entry has been presented before the date of entry inwards of the vessel or the arrival of the aircraft by which the goods are imported, the bill of entry shall be deemed to have been presented on the date of such entry inwards or the arrival, as the case may be.
>
> (2) The provisions of this section shall not apply to baggage and goods imported by post.

Thus, the relevant point of time is not when the goods enter the territory of India. The importer is required to give a bill of entry to the customs department. A bill of entry can be submitted even before the vessel or aircraft arrives at the port. The provision contemplates three situations. For a bill of entry for home consumption, submitted after the arrival of the vessel or aircraft, the relevant date is the date of the bill of entry. For a bill of entry for home consumption, submitted before the arrival of the vessel or aircraft, the relevant date is the date of arrival of the vessel or aircraft. For a bill of entry for warehousing, the relevant date is the date of bill of entry for getting the goods released from the warehouse.

A question in this regard came up in Union of India v. Apar Private Ltd.[1] Apar Private Ltd. imported goods which were completely exempt from customs duty under a notification by the

[1] Union of India v. Apar Private Ltd., AIR 1999 SC 2515.

Government of India. The importer submitted a bill of entry for warehousing. The goods were in the warehouse. After the goods entered India, the Government of India rescinded the notification. The importer contended that when the goods entered India, there was no duty on the goods and thus, no duty was to be paid by the importer. The Supreme Court differed and brought out the law:

> … what is relevant is the day on which the bill of entry in respect of goods is presented under Section 46 and in the case of goods which are warehoused the relevant date would be the date on which the goods are actually removed from the warehouse.

The Supreme Court, in Kiran Spinning Mills v. Collector of Customs,[2] explained the general principle for the application of customs duty, thus:

> … in the case of duty of customs the taxable event is the import of goods within the customs barriers. In other words, the taxable event occurs when the customs barrier is crossed. In the case of goods which are in the warehouse the customs barriers would be crossed when they are sought to be taken out of the customs and brought to the mass of goods in the country.
>
> The import would be completed only when the goods are to cross the customs barriers and that is the time when the import duty has to be paid … The taxable event, therefore, being the day of crossing of customs barrier, and not on the date when the goods had landed in India or had entered the territorial waters.

✦ Valuation of Goods

The customs duty is paid on the value of the goods. The Customs Act refers to this as the assessable value. Section 14 takes the 'transaction value' to be the assessable value. The concept of transaction value here, is very similar to that in the Excise Act. It is the price actually paid or payable if certain conditions are met. The section is supplemented by the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007. If the conditions for the price to be the transaction value are not met, the Rules come to apply. The two, Section 14 and the Rules, together, work out the actual value of the goods. This becomes the assessable value. Section 14 provides:

> **Section 14. Valuation of goods.** (1) For the purposes of the Customs Tariff Act, 1975 (51 of 1975), or any other law for the time being in force, the value of the imported goods and export goods shall be the transaction value of such goods, that is to say, the price actually paid or payable for the goods when sold for export to India for delivery at the time and place of importation, or as the case may be, for export from India for delivery at the time and place of exportation, where the buyer and seller of the goods are not related and price is the sole consideration for the sale subject to such other conditions as may be specified in the rules made in this behalf :
>
> **Provided** that such transaction value in the case of imported goods shall include, in addition to the price as aforesaid, any amount paid or payable for costs and services, including commissions and brokerage, engineering, design work, royalties and licence fees, costs of transportation to the place of importation, insurance, loading, unloading and handling charges to the extent and in the manner specified in the rules made in this behalf:
>
> **Provided** further that the rules made in this behalf may provide for ...

---

[2] Kiran Spinning Mills v. Collector of Customs, AIR 2000 SC 3448.

The time and place for working out the price of the goods is the time of 'importation'. As we have discussed earlier, the import of the goods is completed only when the goods become a part of the mass of the goods of the country. Thus, all the charges till then, like freight, handling, insurance and unloading will get added to the cost of the goods. Any amount the buyer has to pay towards the costs, services, commission, brokerage, engineering, design work and royalties, is to be included in the transaction value. The rate of foreign exchange is determined as prevailing on the date on which the bill of entry is presented, whether the goods are meant for home consumption or warehousing. If the purchase is from a 'related' person, the price is not taken to be the transaction value. The Rules contains the details for determining the assessable value if the price cannot be taken to be the assessable value. As the principles are the same as for excise duty, they are not being discussed here. The following examples will bring out the point.

Illustration

The assessable value of certain goods was ₹ 20,000. Taking the rate of basic customs duty to be 10 per cent and CVD to be 15 per cent, calculate the total duty.

		Duty per cent	*Amount*	*Total Duty*
1.	Assessable value		20,000	
2.	Basic customs duty	10	2,000	2,000
3.	Total of above		22,000	
4.	CVD (15 per cent of 3)	15	3,300	3,300
5.	Education cess (2 per cent of 4)	2	66	66
6.	SAH education cess (1 per cent of 4)	1	33	33
7.	Total duty (2 + 4 + 5 + 6)		5,399	
8.	Education cess on customs duty (2 per cent of 7)			108
9.	SAH education cess on customs duty (1 per cent of 7)			54
10.	Sub-total for calculating Special CVD (1 + 7 + 8 + 9)		25,561	
11.	Special CVD (4 per cent of 10)		1,022	1,022
	Total Duty			6,583

Illustration

An importer bought goods on FOB terms. In an FOB term sale, the seller bears the costs incurred up to the shipment point in its country. Thereafter, all the costs are borne by the buyer. The FOB price of the goods, in Rupee equivalence, was ₹ 2,00,000. The other expenditures incurred by the importer were as follows:

Freight charges: ₹ 12,000

Marine insurance: ₹ 4,000

Commission to agent in India: ₹ 10,000

What is the assessable value of the goods? The assessable value is the cost of the goods at the time and place of importation. Thus, the importer may have paid only a certain amount to the seller, the other expenditure made by him would get added up to constitute the assessable value. All the above expenditures were incurred in relation to the goods. Thus, these would be added to the FOB price.

Case

The assessable value of certain goods is ₹ 10,000. Taking the rate of basic customs duty to be 10 per cent and CVD to be 10 per cent, calculate the total duty.

✦ Import as Baggage

Persons coming into India from outside might bring things with them. The Customs Act calls these goods 'baggage' and gives them a special treatment. The government has made the Baggage Rules, 1998, for giving concession in duty on goods brought as baggage. The Rules have been amended from time to time. The Act defines baggage to include 'unaccompanied baggage', but not motor vehicles and alcoholic drinks. Unaccompanied baggage, as the name suggests, is the baggage of the passenger that does not come with the passenger. It comes on a different carrier. The Baggage Rules treat unaccompanied baggage as baggage if it was sent by the passenger within a certain period of the arrival of the person.

Several provisions put together, explain the duty to be paid by a passenger for his baggage. In the Customs Tariff Act, baggage is classified as 'all dutiable articles, imported by a passenger or member of crew in his baggage'. The tariff rate in the Customs Tariff Act is 100 per cent. The central government, however, has made a notification fixing the rate at 35 per cent and exempting it from CVD. Thus, the effective rate for duty is 35 per cent. After charging the two education cess, the effective duty comes to 36.05 per cent. As a motor vehicle is not included in the definition of baggage, even if a motor vehicle is brought by a person from abroad, it will be treated not under the head of baggage, but as an import of a motor vehicle, attracting custom duty.

The central government has made a notification allowing a passenger to import a laptop without any duty. The notification reads:[3]

> In exercise of the powers conferred by sub-section (1) of section 25 of the Customs Act, 1962 (52 of 1962), the Central Government, being satisfied that it is necessary in the public interest so to do, hereby exempts one laptop computer (notebook computer) falling under tariff item 98030000 of the First Schedule to the Customs Tariff Act, 1975 (51 of 1975) when imported into India by a passenger of the age of 18 years or above (other than member of crew) from whole of the duty of Customs leviable thereon under the First Schedule to the said Customs Tariff Act.

Thus, any passenger, coming into India, from any country and by any mode of transport, can bring in one laptop or notebook computer. We can now note the further concessions given by the Baggage Rules. The Baggage Rules gives different concessions to resident Indians, foreign

[3] Notification No. 11 / 2004, dated January 8, 2004.

tourists and to Indian passport holders resident abroad, returning to be resident in India. The Rules make a single set of allowances for persons returning from Nepal, Bhutan, Myanmar and China, and for persons coming back after a visit to other countries. Rule 3 provides:

> An Indian resident or a foreigner residing in India, returning from any country other than Nepal, Bhutan, Myanmar or China, shall be allowed clearance free of duty articles in his bona fide baggage to the extent mentioned in column (2) of Appendix A.

Appendix A is as follows:

(a) All passengers of and above 10 years of age and returning after stay abroad of more than three days.	(i) Used personal effects, excluding jewellery, required for satisfying daily necessities of life. (ii) Articles other than those mentioned in Annex. I up to a value of ₹ 35,000 if these are carried on the person or in the accompanied baggage of the passenger.
(b) All passengers of and above 10 years of age and returning after stay abroad of three days or less.	(i) Used personal effects, excluding jewellery, required for satisfying daily necessities of life. (ii) Articles other than those mentioned in Annex. I up to a value of ₹ 15,000 if these are carried on the person or in the accompanied baggage of the passenger.
(c) All passengers up to 10 years of age and returning after stay abroad of more than three days.	(i) Used personal effects, excluding jewellery, required for satisfying daily necessities of life. (ii) Articles other than those mentioned in Annex. I up to a value of ₹ 6,000 if these are carried on the person or in the accompanied baggage of the passenger.
(d) All passengers up to 10 years of age and returning after stay abroad of three days or less.	(i) Used personal effects, excluding jewellery, required for satisfying daily necessities of life. (ii) Articles other than those mentioned in Annex. I up to a value of ₹ 3,000 if these are carried on the person or in the accompanied baggage of the passenger.

> Explanation— The free allowance under this rule shall not be allowed to be pooled with the free allowance of any other passenger.

The above provision makes a reference to Annexure 1. Annexure 1 is as follows:

Annexure I

1. Firearms.
2. Cartridges of fire arms exceeding 50.
3. Cigarettes exceeding 200 or cigars exceeding 50 or tobacco exceeding 250 gm.
4. Alcoholic liquor or wines in excess of two litres.
5. Gold or silver, in any form, other than ornaments.

There are other similar rules for resident Indians coming from Nepal, Bhutan, Myanmar and China. The baggage rules separately provide on foreign tourists, crew and professionals. Let us explore the provisions with the following examples.

Illustration

Anil, resident in Mumbai, went to France for a holiday, for seven days. On his way back, he brought in three one litre bottles of alcohol, each priced at ₹ 1,200. Does he need to pay any duty? Anil falls under Category (a) of the Annexure above. He can bring in goods worth ₹ 35,000, provided these are not contained in Appendix 1. Appendix 1 mentions the limit of two litres of alcohol. Thus, the third bottle does not qualify as baggage. He will pay duty on ₹ 1,200. As alcoholic drinks are excluded from baggage, he will have to pay according to the standard rates contained in the Tariff Act.

Illustration

Deep, resident in Delhi, visited his relatives in London for 15 days. On his way back, he brought in the following items: One laptop for ₹ 50,000, two one litre bottles of alcohol for ₹ 2,800 and a new mobile phone for ₹ 40,000. Are the imports by Deep dutiable? Deep falls under Category (a) of the Annexure 1. One laptop can be brought in without any duty. Thus, there is no duty to be paid on the laptop. Two litres of alcohol are allowed within the allowance of ₹ 35,000. The value of the mobile phone and alcohol put together comes to ₹ 42,800. Deep is allowed to import goods duty-free, up to ₹ 35,000. Thus, he will have to pay duty on ₹ 7,800. This will be charged at the specified rate for baggage, i.e., at 35 per cent. With the two education cess, the effective rate would be 36.05 per cent.

Illustration

A husband and his wife, resident in Delhi, visited Germany for seven days and brought the following things: a new camera for ₹ 25,000, a watch for ₹ 18,000 and a mobile phone for ₹ 22,000. The explanation to the Annexure mentions that the free allowances of the passengers cannot be pooled together. Thus, the allowance for the two cannot be taken together as ₹ 70,000. Each person comes with his own goods, which would be valued against his or her allowance. Thus, one person should claim the camera and the other, the watch and the mobile. Duty would need to be paid on baggage worth ₹ 5,000.

Case

A resident of India, returning from a 10 day visit to Singapore, brought the following goods: a TV priced at ₹ 18,000, a personal computer priced at ₹ 22,000 and new clothes valued at ₹ 12,000. What is the value for which customs duty is payable.

The Customs Act requires the owner of a baggage to make a declaration of the dutiable items. To facilitate passenger movement, airports provide for green channels and red channels. A passenger, who does not have dutiable goods as per the provisions above, can go through the green channel. There is a punishment prescribed for a person who has dutiable goods and yet attempts to pass through the green channel. A person who has dutiable items is supposed to go through the red channel and declare the goods.

✦ Import through Courier

The government has made Courier Imports and Exports (Clearance) Regulations, 1998, for facilitating imports and exports through courier. The Regulations makes provisions for a courier company to get registered with the customs department. A registered courier, effectively, becomes the importer. On the arrival of a consignment, the courier company files a bill of entry for the goods. There is no concession in the rate of duty. Thus, the rate of duty and exemptions apply just as in the case of cargo imports. The courier pays the duty and gets the goods released. Obviously, the courier company can collect the duty paid from the receiver of the consignment, under his contract with the sender/receiver.

The Regulations puts restrictions on the packages that can be imported by courier. The weight of an individual packet cannot be more than 70 kg. Some goods require certain conditions to be met with, under some specific laws. On import, it is assessed whether the goods meet these requirements of the law or not. Some goods cannot be imported by a courier. These can be imported only as cargo. Similarly, some goods require testing of samples or examination by experts before clearance. Such goods include perishables and 'precious and semi-precious stones, gold or silver in any form.' These goods cannot be imported by courier. Clause 4 of the Regulations provides:

> **4. Packing of goods to be imported or exported by courier.** (1) For the purposes of these regulations, the import or export goods shall be packed separately in identifiable courier company bags, with appropriate labels, in the following categories, namely:—
>
> (a) documents;
> (b) samples and free gifts;
> (c) dutiable or commercial goods;
>
> (2) Each package of import or export goods shall bear a declaration from the sender regarding the contents of the package and the value thereof.

Samples and gifts have been defined in the Regulations as follows:

> (c) "samples" means any bona fide commercial samples and prototypes of goods supplied free of charge of a value not exceeding ... ten thousand rupees for imports which are for the time being not subject to any prohibition or restriction on their ... import into India and for which no transfer of foreign exchange is involved;
>
> (d) "free gifts" means any bona fide gifts of articles for personal use of a value not exceeding ... rupees ten thousand for each consignment ... which are not subject to any prohibition or restriction on their ... import into India and for which no transfer of foreign exchange is involved;

✦ Import by Post

There are separate provisions for importing articles by post. The sender is required to declare for the accompanying goods, the description of the goods, their quantity and value. The declaration becomes the bill of entry for the goods. The parcels coming by post are allowed to pass to the Foreign Parcel Department of the Post Office, without payment of duty. The post office submits the details for each parcel, to the Customs Appraiser. The appraiser will allow or disallow the imports depending on the goods being imported. The parcels allowed for imports may be opened and examined. The appraiser will fix the duty payable for the parcel. Like in the case of courier, a gift of up to ₹ 10,000 of goods, which are not prohibited, can be sent duty-free by post.