CHAPTER - I

1. INTRODUCTION

Income-Tax enjoys a pride place in Indian Public finance and it is one of the mejor sources of revenew for the state. Although the Administration and collection of the tax is with the central Government Part of the proceeds goes into a divisible pool; and is shared by the state Government Accordingly, It is a tax in which both Central and State Governments are vitally interested. Assessee's in their capacity as tax payer's also get interested in the structure and the incidence of the tax on their incomes.

2. BRIEF HISTORY OF THE INCOME-TAX ACT, 1961

The Income-Tax was introduced in India for the first time in 1860 by British rulers following the mutiny of 1857. The period between 1860 to 1886 was a period of experiments in the context of Income-Tax. This period ended in 1886 when first Income-Tax Act came into existance. The pattern laid down in it.for levying of tax continues of operate even to day though in some changed form in 1918 another Act - Income-Tax , 1918 was passed but it was short lived and was replaced by Income Tax Act, 1922, and it remained in existance and operation till 31st March 1961.

THE INCOME-TAX ACT,1961

On the recommendation of law commission and Direct-taxes

Enquiry Committee; and in consultation with law ministry a new bill was framed. This bill was referred to select committee and finally passed in Sept. 1961. This Act came into force from 1st April 1862 in whole of the country.

The Income-Tax Act, 1961, is a comprehensive Act. It has more than 400 sections, numerous sub-sections and twelve schedules, for it's governance, the department has framed about 200 rules under the title 'Income-Tax Rules 1962'. Which in turn have hundreds of sub-rules. Many supplimentary laws have been enacted and many rules framed; all with a view to simplifying the tax structure. But all these efforts have complicated the law further.

The Income-Tax Act, 1961 which extends to the whole of India.came into force on 1st April 1962. The act retains the basic structure of the Act of 1922.but has re-arranged; its provisions in a more logical and convenient manner. It has amplified several provisions and introduced many new provisions with a view to simplifying the taxation processes and preventing avoidance and evasion of tax.

3. <u>COMPUTATION OF INCOME UNDER THE HEAD 'INCOME FROM BUSINESS, PROFESSION AND VOCATION'</u>

Under section 28 to 44 of the Income-Tax Act, 1961 profits and gains of business or profession form part of total income of an assessee. This head is most important source of tax collection for the Government. The computation

of income under this head is a very complex and difficult method but before going into calculation of income under this head, it is necessary to understand the meaning of terms used in this head -

BUSINESS

In view of section 2(13), business includes any (a) trade, (b) commerce, (c) Manufacture, or (d) any adventure or concern in the nature of trade, commerce or manufacture. It covers every fact of an occupation carried on by person with a view to earning profit production of goods from raw material, buying and selling of goods to make profits and providing services to others are different forms of "business". Profit arising therefrom is, therefore, chargeable to tax under the head, "Profits and gains of business or profession". The term "business" is a word of wide import and in fiscal statutes it must be construed in a broad rather than a restricted sense Mazagaon Dock Ltd., V.CIT. (1958)34 ITR 368 (SC).

PROFESSION

A profession is an occupation requiring purely intellectual skill or mannual skill controlled by the intellectual skill of the operator e.g. lawyer; accountant, engineer, surgeon, author etc. So profession refers to those activities where the livelihood is earned by the persons through their intellectual or mannual skill.

VOCATION

The word "vocation" in the act, it implies natural ability of person for some particular work. The word "vocation" is analogous to"calling" meaning the way in which a man passes his life - Partridge. V. Mallandaine (1886) 18 QBD 276. A person can have more than one "vocation" need not be for making any income, nor need it n involve any systematic and organised activity. Even if an assessee is giving discourseson vedanta Philosophy without any motive or intention of making a profit out of such activity, this giving of discourses is a "Vocation". - CIT. V. Ram Kripal Tripathi (1990)4 Taxman 149 (All).

COMPUTATION OF INCOME

While computing income under the head profits and gains of business or profession' the following important guiding points should be kept in mind. A good part of Indian income tax Act is based up on court Judgements and these principles were the basis of so many court pronouncements. Which are always kept in mind while computing income under this head. So some of the principles based on the leading cases are as follows :

1. Business or profession carried on by the assessee.
2. Business or profession should be carried on during the previous year.

3. Income of previous year is taxable during the following assessment year.
4. Tax incidence arises in respect of all business or profession.
5. Legal ownership vs. Beneficial ownership.
6. Profits in the case of winding up.
7. Real profit Vs. Anticipated profit.
8. Real profit Vs. Notional profit.
9. Recovery of sum already allowed as deduction.
10. Mode of book entries not relevant.
11. Illegal business.

Discribtion of above noted points- in a nutshell--

1. BUSINESS OR PROFESSION CARRIED ON BY THE ASSESSEE:

Business or profession should be carried on by the assessee u/s 28, it is the person, carrying on a business or profession, who is chargeable to tax. If owner of a business is incapacitated from carring on the business, he would not be liable to pay tax as he is not carrying on the business. The incapacity may be caused by natural reasons or by intervention of court. For instance the court may interveue and deprive the owner of the right of carrying on his own business and authorise someone else to carry on the business for him in which case the owner would not be chargeable to tax, since he cannot be regarded as carrying on the business -- saifuddin Alimohamed V.CIT (1954) 25 ITR 237 (Bom).

2. BUSINESS OR PROFESSION SHOULD BE CARRIED ON DURING THE PREVIOUS YEAR:

Business or profession is chargeable to tax under this head only if the business or profession is carried on by the assessee at any time during the previous year- Bombay steam Navigation Co. (1953) (P) Ltd. Vs. CIT. (1965) 56 ITR 52 (SC).

However, the following receipts are taxable even if no business or profession is carried on by the assessee during the previous year:-

* Recovery or excess recovery against a deduction (Sec.41 (1)).
* Balancing charge (Sec.41(2)).
* Sale of an asset used for scientific research (Sec 41(3)).
* Recovery or excess recovery against bad debts.(Sec. 41(4)).
* Sum received after discontinuance of a business or profession (Sec. 176(3A)).

3. INCOME OF A PREVIOUS YEAR IS TAXABLE DURING THE FOLLOWING ASSESSMENT YEAR :

Income of business or profession carried on by the assessee during the previous year is chargeable to tax in the next following assessment year. There are, however, certain exceptions to the rule laid down by sections 174, 175, and 176 (i).

4. TAX INCIDENCE ARISES IN RESPECT OF ALL BUSINESS OR PROFESSION :

Profits and gains of different businesses or professions carried on by the assessee are not separately chargeable to tax, tax incidence arises on aggregate income from all businesses or professions carried on by the assessee.

5. LEGAL OWNERSHIP Vs. BENEFICIAL OWNERSHIP :

Under section 28, it is not only legal ownership but also the beneficial ownership that has to be considered. The courts can go in to the question of beneficial ownership and decide who should be held liable for the tax after taking in to account the question as to who is, in fact, in receipt of the income which is going to be taxed. In the case of C.I.T. Vs. Bijli Cotton Mills Ltd. (1953) 23 ITR 278, the Allahabad High-court observed that though strictly speaking, the promoters of a company cannot be said to be trustee.

6. PROFITS IN THE CASE OF WINDING UP :

Profits made by an assessee in winding up of a business or profession, are not taxable u/s 28, as no business carried on in that case. However, such profits may be taxable as balancing charge under section 41 (2) as capital gain V/s 45 as business income u/s 28.

7. REAL PROFIT u/s ANTICIPATED PROFIT :

As accounting year is a self contained year taxable profit is the profit accrued or arising in that year

anticipated or potential profits or losses, which may occur in future, are not considered for ariving at taxable income of a previous year. This rule is, however, subject to one exception, i.e. stock-in-trade may be valued on the basis of cost or market value, whichever is lower.

8. REAL PROFIT V/s. NOTIONAL PROFIT :

The profits, which are taxed under section 28, are the real profits and not notional profits Kedarnath Uute Mgf. Co. Ltd V. CIT. (1971) 82 ITR. 363 (SC). The profits to be taxed under section 28 are the real profits which, from the commercial point of view, mean a gain to the person carrying on the business.

9. RECOVERY OF SUM ALREADY ALLOWED AS DEDUCTION :

Any sum recovered by the assessee during the previous year, in respect of an amount or expenditure which was earlier allowed as deduction, is taxable as business income of the year in which it is recovered. (Sec.41).

10. MODE OF BOOK ENTRIES NOT RELEVENT :

The mode or system of book keeping cannot override the substantial character of a transaction Ashoka Viniyoga Ltd. V. CIT. (1972) 84 ITR. 264 (SC). For instance, a trading receipt will remain as trading receipt even if it is not shown as trading receipt in the books of account kept by the assessee and therefore, it does not prevent

the assessing authority from treating it as such chowringhee sales Bureau (P) Ltd. V. CIT.(1973) 87 ITR. 542 (SC).

11. ILLEGAL BUSINESS :

The income tax law is not concerned with the legality or illegality of a business or profession. It can, therefore, be said that income of illegal business or profession is not exampt from tax.

DEDUCTIONS ALLOWED--GENERAL PRINCIPLES :

Section 30 to 37 of Income-tax Act. provide for the deductions to be allowed while computing profit under the head. Business or profession 'There are numerous types of expenses, varying from business to business and according to the nature of the unit under these sections an effort was made to enlist every type of expense any other expenditure if at all incurred for earning a particular income, the same shall be allowed as deduction to calculate the real profit. The admissibility of an item of expenditure is governed by the following general principles. These are -

1. On-us to prove admissibility of an expenditure.
2. Allowances are cumulative.
3. Expenditure should relate to the previous year.
4. Business should be carried on during the previous year.
5. Expenditure should have been incurred, in connection with assessee's own business.
6. Benefit of expenditure may extend to somebody else.

7. Benefit of expenditure may extended beyond the relevant previous year.
8. No allowance in respect of exhaustion of wasting assets.
9. No allowance in respect of a business.set up after the date of expenditure.
10. No allowance in respect of non assessable business.
11. Expenditure relating to illegal business.
12. No allowance in respect of a non existent liability.
13. No allowance in respect of anticipated losses.
14. No deduction in respect of depriciation of investment.
15. Relevance of distinction between capital and revenue expenditure.

Short discribtion of the above noted points are given in following manner :-

1. <u>Onus to prove admissibility of an expenditure</u> :

It is responsibility of the assessee to prove that a particular deduction is admissible in his case.

2. <u>Allowances are cumulative</u>

The allowances laid down under sections 30 to 37 are cumulative and not alternative. For instance, if a particular expense is expressly dealt by a particular section; its admissibility under the residual section 37 cannot be denied unless the particular section prohibits any allowance under any other provision.

3. Expenditure should relate to the previous year

In order to claim deduction it is necessary that the expenditure should relate to the previous year. In order to ascertain whether the expenditure relates to the relevant previous year or not, one has to examine the method of accounting generally adopted by the assessee. If the assessee keeps his books of account on the basis of mercantile system. Expenses of the previous year would be deductible irrespective of the fact whether they are actually paid during the previous year or not.

4. Business should be carried on during the previous year

In order to avail deduction of expenditure, it is necessary that the business, in respect of which expenses are incurred, should be carried on by the assessee during the previous year. If the business has been closed or discontinued before the commencement of the previous year, no deduction in respect of such discontinued business is permissible while computing the taxable income of the previous year from other sources.

5. Expemditure should have been incurred in connection with assessee's own business

An expenditure is allowable as deduction in computation of taxable income only if it is incurred for

the purpose of assessee's own business. For instance, parent company cannot be allowed a deduction in respect of an expenditure incurred for the benefit of it's subsidiary company.

6. Benefit of expenditure may extend to somebody else

If the expenditure is incurred primarily in connection with the assessee's own business, it would still be allowed as deduction, even if it enures to the benefits of someone else. For instance insurance, premium, repairs and other expenditure incurred on leased out business assets are deductible from the income of the less or even though the expenditure enures to the benefit of the lessee - Everest Hotels Vs. CIT (1978) 114 ITR 779 (Cal.)

7. Benefit of expenditure may extend beyond the relevant previous year

It is not necessary that benefit of the expenditure should be limited to the previous year in which the expenditure is incurred. A revenue expenditure - incurred during the previous year is deductable even if benefit of expenditure is extended beyond the year of expenditure. e.g. current expenditure on repairs of plant and Machinery.

8. No allowance in respect of exhaustion of wasting assets

No deduction is admissible in respect of diminution or

exhaustion of the capital asset from which income is derived. Wasting assets such as mines and quarries, timber-bearing land, leasehold interest, are capital assets and their diminution or exhaustion in value represents capital loss which is not allowable as deduction, as the Act permits deduction of revenue losses only.

9. No allowance in respect of a business set-up after the date of expenditure.

In the case of new business, the first previous year commences on the date when the business or profession is set-up. As expenditure incurred prior to setting up of a business falls outside the previous year and Sect. 28 applies only in respect of business carried on during the previous year, expenditure incurred before setting up of a business would not be deductible while computing income of the previous year.

10. No allowance in respect of non-assessable business -

Section 28 applies only in respect of business profits of which are assessable under the Income Tax Act. Therefore, the question of deduction of expenditure under Sections 30 to 37 arises only if profits of a business are assessable to tax under the Act. For instance,

if the assessee carries on a non taxable business no deduction on account of expenditure relating to such non taxable business can be claimed. For instance, expenditure would be deductible even if the business has sustained loss or earned profit which is less than the maximum amount of income chargeable at nil rate i.e. Rs. 18,000 in the case of an individual for the A.Y. 1988-89.

11. Expenditure relating to illegal business

Profits of illegal business are chargeable to tax. In arriving at chargeable profits, ordinary business expenditure incurred in carrying on an illegal business is allowable as deduction. However, infringements of law including breaches of obligations are not ordinary incidance of business and penelty or damages paid in connection with such infrigement do not constitute expenditure wholly and exclusively laid out for the business of assessee; such expenses are, therefore, no deductable - Cineramas Vs. CIT. (1977) 110 ITR. 762 (P, Unj & Har.)

12. No allowance in respect of non existent liability

The Income-Tax act makes a distinction between an existing liability and a contingent liability. While a payment in respect of the former is deductable, the payment in respect of latter is not deductible. However, once a

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liability has accrued and becomes an existing liability. It is immaterial whether it has been ascertained in the relevant accounting year or not.

13. No allowance in respect of anticipated losses

Under the present scheme of the Act, anticipated losses cannot be deducted, though the loss is certain. In other words, a loss which is neither suffered nor incurred in the accounting year, is not deductible against the actual receipt of the year - Edward Collins & Sons Ltd., V.IRC (1924) 12 TC 773. The only exception to this rule is that stock-in-trade may be valued at cost or market value, whichever is lower.

14. No deduction in respect of depreciation of investment

A deduction in respect of depreciation of investment in shares and securities is not allowable.

15. Relevance of distinction between capital and revenue expenditure

Whether the expenditure is capital expenditure or revenue expenditure is relevent only in the case of expenditure falling under section 37 (i), which expressly

excludes the items of the nature of "Capital expenditure" from being allowed as permissable deduction. However, expenditure following under sections 30 to 36, 37 (2A) and 37 (3) may fall either under the category of capital expenditure or revenue expenditure.

4. SCOPE OF THE INCOME UNDER THE HEAD " BUSINESS AND PROFESSION" CHARGING PROVISION Sec. 28

The following incomes shall be chargeable to income-tax under the head "Profits and gains of business or professions".

1. Profits from Business or Profession (Sec. 28 (i))

The profits and gains of any business or profession which was carried on by assessee at any time during the previous year, are chargeable under this head. The term business includes a varity of activities from or through. Which income is while the expression carried on by the assessee' suggests that the activities which constitute business should be those of the assessee.

2. Compensation (Sec. 28 (ii))

Any compensation or other payments due to or received by the following persons is taxable

a) Any person, by whatever name called, managing the whole or substantially the whole of the affair's of an Indian company at or in connection with the termination of his management or the modification of terms and conditions relating thereto.

b) Any Person, by whatever name called, managing the whole or substantially the whole of the affairs in India of any other company.at or a in connection with the termination of his office or the modification of the terms and conditions relating thereto,

c) Any person, by whatever name called, holding an agency in India for any part of the activities relating to the business of any other person at or in connection with the termination of the agency or the modification of the terms and conditions relating thereto.

d) Any person, for or in connection with vesting in the Government or in any co-operation owned or controlled by the Government under any law for the time being in force of the management of any property or business.

3. <u>Income of a Trade Association</u> (Sec 28 (iii))

There are two types of associations one Trading association that is association of Persons framed for doing business etc. Income of such association is taxable. Second trade association, that is an association formed by businessman

etc. for protection or advancement of their common interests.

4. Benefit arising from Business (Sec. 28 (iv))

The value of any benefit or perquisite whether convertable into money or not arising from business or the exercise of a profession.

5. Speculation

Profits derived from speculation business are also included in the profits from business for assessment purposes, but explanation 2 to section 28 states that the speculation business shall be deemed to be distinct and separate from any other business.

The term'speculation' has been defined u/s 43 (5) as "a transaction in which a contract for the purchase of sale of any commodity, including stocks and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity."

99' - Inserted by the finance Act, 1973, with retrospective effect from 1.4.1972.

JUDICIAL PRONOUNCEMENTS ON THE SCOPE OF SECTION 28.

The following judicial pronouncements should also be kept in view -

* When an amount is credited in business books, it is not an unreasonable inference to draw that it is a receipt from business - Lakhmichand Baijnath V. CIT (1959) 35 ITR 416 (SC).

* Where the assessee purchased land with a view to earning profit and sold the same at profit for want of finance, profit cannot be treated as the assessee's business income - CTI V Rajasthan Mines Ltd., (1970) 78 ITR 45 (SC),

* Where godowns, being used for storing business goods, were requisitioned by Government and thereafter business was carried on smaller scale, compensation paid for loss of earning was held to be taxable as business income - CIT V Manna Ramji & Co. (1972) 86 ITR 29 (SC).

* Payment arising from termination of a contract which has been entered into ordinary course of business is business receipt - CIT V. Gangadhar Baijnath (1972) 86 ITR 19 (SC).