

CHAPTER THREE

CONCEPTUAL AND PROCEDURAL ASPECTS

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3.1 INTRODUCTION:

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As already stated in 1.2 ante (Statement of the problem), section 14 of the Income-tax Act, 1961, lays down that for the purposes of charge of income-tax and computation of total income, 'salaries' shall be included in an individual's total income. The charge of tax as also the assessment and collection and recovery procedures in respect of the tax on salary income are, therefore, and should be, similar to the other heads of income. The assessment of income from salary, however, is somewhat different than the assessment of other types of incomes under the Income-tax Act because of the typical exemptions and procedural formalities laid down under the Act. In the succeeding paragraphs, an attempt is made to clarify the basic conceptual and procedural aspects of the salary income and the procedure relating to its assessment.

3.2 DEFINITIONS:

3.2.1 Assessment:

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The word 'assessment' is used in the Income-tax Act, meaning sometimes the computation of income, sometimes the determination of the amount of the tax payable and some-

times, it means the whole procedure laid down in the Act for imposing liability on the taxpayer. The word 'assessment' must be understood in each section of this Act with reference to the context in which it is used; in some sections, it has a comprehensive meaning and includes re-assessment (section 265) and in some sections, it has a restricted meaning and is used as distinct from re-assessment (section 147). The method prescribed by the Act for making an assessment to tax - using the word 'assessment' in its most comprehensive sense as including the whole procedure for imposing liability upon the taxpayer - consists of the following steps. In the first place, the taxable income of the assessee has to be computed. In the next place, the sum payable by him on the basis of such computation has to be determined. Finally, a notice of demand in the prescribed form specifying the sum so payable has to be served upon the assessee. The first two steps are taken under sections 143 or 144, while the notice of demand is served under section 156.

3.2.2 Assessment year [Section 2(9)]:

The financial year, i.e. the period of 12 months commencing from the 1st day of April every year, is defined as the 'assessment year'. This time frame has relevance for determining not only the income chargeable to tax but also the rate at which tax is to be imposed. It is usually indicated by mentioning the two years in which the 1st of April and 31st

March fall, e.g. assessment year 1988-89 refers to the period from 1st April 1988 to 31st March 1989.

3.2.3 Prescribed rates [Section 4]:

The Income-tax Act only lays down the machinery for the computation of income and not the rates of tax. Section 4 of the Act stipulates that "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". These rates are specified in the Annual Finance Acts.

3.2.4 Person [Section 2(31)]:

This section defines a 'Person' to include: (i) an individual, (ii) a Hindu undivided family, (iii) a company, (iv) a firm, (v) an association of persons or a body of individuals, (vi) a local authority, and (vii) every other artificial juridical person. A **salaried taxpayer** falls under the category of an **individual**. Section 2(7) designates the person from whom tax becomes payable as an 'assessee'.

3.2.5 Previous year [Section 3]:

It is now a well-settled principle of the law that the income from salary is chargeable to income-tax on 'accrual' basis and not on 'receipt' basis. Thus, the income to be

charged to tax in an assessment year is the income of the 'previous year', also known as the 'accounting year' or the 'income year'.

3.2.6 Residential status [Section 6]:

(a) Meaning of 'residence':

The residential status of an assessee is relevant to decide the extent of his tax liability. The term 'residence' has a specific meaning for this purpose and does not have the restricted dictionary meaning of 'an abode'. Under the Income-tax Act, the term 'residence' indicates a personal quality and not the person's property.

(b) 'Residence' for every previous year:

The residential status does not depend on the nationality or domicile of the individual but is determined solely on the basis of physical presence for a prescribed number of days in India during the previous year. Such stay need not necessarily be continuous but can be intermittent. It is, therefore, absolutely essential that the status is determined for every previous year separately.

(c) Categories of 'residential status:

Section 6 of the Income-tax Act classifies the assessee into three categories:

1. Resident,
2. Resident but not ordinarily resident,

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3. Non-resident.

For being treated as 'resident', the assessee's total stay in India during the previous year must at least be 182 days. 'Resident but not ordinarily resident' is a special category of the assessee and their residential status has to be determined on individual basis. Generally, the assessee 'who has not been a resident in India in nine out of ten previous years preceding the previous year under consideration and whose total stay in India during the seven previous years preceding the year under consideration does not exceed 729 days' could be placed in this category. An individual is treated as 'non-resident' for the previous year if he is neither a 'resident' nor 'resident but not ordinarily resident' during the previous year.

3.2.7 Place of accrual/receipt of income [Sections 5, 7 and 9]:

The incidence of tax depends not only on the residential status, but also on the place where income has accrued or has been received, i.e. whether in India or outside India. The Supreme Court has observed that, "Income is said to be received when it reaches the assessee; when the right to receive the income becomes vested in the assessee, it is said to accrue or arise". (CIT v. Ashokbhai Chimanbhai 56 ITR 42 (SC)). The Act has inserted the concept of 'accrual' in order to ensure that income, though earned in India, does not escape tax merely because it is received outside India.

In addition, the Act also specifies that certain items will be deemed to have been received or accrued in India. The following items fall under these categories:

(a) Deemed as received in India:

1. Employer's contribution to a recognized provident fund, which is in excess of 10 percent of the employee's salary;
2. Interest credited to such provident fund account of an employee, which is in excess of interest calculated by the Central Government;
3. Balances transferred to a newly recognized provident fund.

(b) Deemed as accrued in India:

1. Income falling under the head "Salaries" is deemed to accrue in India, if it is earned in India, i.e. if the services are rendered in India;
2. Salary paid by the Government (Central or State) to an Indian citizen for services rendered outside India is deemed to accrue in India;
3. Pensions, granted for the services rendered in India; as also the pensions earned abroad but received directly in India.

3.2.8 Total Income [Section 2(48)]:

The concept of total income is very important, since ultimately, the tax is charged on the total income. The Income-tax Act does not give a comprehensive definition of the term 'income' and section 2(24) merely mentions that certain

specified items are includible in the income. Normally, 'income' connotes a 'periodical monetary return coming with certain amount of regularity or expected regularity, from a definite source'. Another important aspect is that only revenue receipts are taxable. The term 'revenue receipts' generally means any receipt derived from an income-producing source, without destroying the source. Where the source itself is destroyed, it becomes a 'capital receipt'.

3.3.9 Computation of total income:

Section 10 of the Income-tax Act enumerates the items which are not at all includible in the total income. These are popularly known as 'exemptions'. Sections 15 to 17 of the Act deal with the computation of the salary income, while sections 80A to 80VV cover the permissible deductions of a general nature. Computation of the total income will, therefore, have to be made in the following stages:

- (1) **First**, the exemptions must be allowed, i.e. the items of income which are not includible in terms of section 10 must be excluded;
- (2) **Secondly**, compute the total income under each head of account separately and aggregate all income so computed, the resultant figure is known as the gross total income.
- (3) **Thirdly**, compute the total deductions permissible under sections 80A to 80VV.

The total income liable to tax will be (2) minus (3).

3.2.10 Payment of tax:

In the case of the salaried employees, it is the responsibility of the employer to deduct the tax at source while making payment of salary. Therefore, if the salary is the only source of income for an employee, there will be no occasion for him to pay the income-tax separately. However, if the employee has income from other sources also (like house property, capital gains and investments), he may furnish the particulars of such income to his employer so that tax can be deducted at source on such income also. Alternatively, he may file a separate return of income, showing the income from salary, tax deducted at source and his total tax liability could be worked out then. If he chooses the latter course, he becomes liable to pay advance-tax/self-assessment tax on their respective due dates.

3.2.11 Return of Income:

✓ Section 139 of the Income-tax Act enjoins upon every individual having no income from business or profession, but whose total assessable income during the previous year exceeds Rs.18,000, to furnish a return of income to the Income-tax Officer before 30th June of the assessment year. In the case of salaried employees, however, if their gross salary income (excluding all benefits and amenities not provided for by way of monetary payment

and excluding the various exemptions) does not exceed Rs.24,000 and if their only other source of income is the income from investments, which is deductible in full under section 80L, there is no obligation to file any return of income.

3.3 COMPONENTS OF SALARY INCOME:

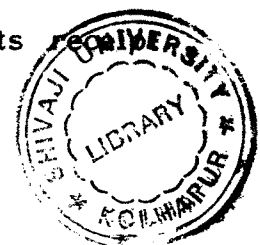
Section 17(1) of the Income-tax Act gives an inclusive definition to the term 'salary'. In common parlance, the salary of an employee is made up of many different payments received/receivable by him from the employer. Some of these payments are taxable in full, some only partly and some are totally exempt from tax. As shown in Chapter Four of this Dissertation, abundant case-law exists over the taxability or otherwise of these receipts. In the subsequent paragraphs, an attempt is made to describe in brief the various components that go into making of salary of an employee, taxable for the purpose of income-tax.

3.3.1 Basic Salary:

An employee's basic salary as well as dearness allowance are taxable in full.

3.3.2 Advance salary:

Advance of salary, as distinct from a loan taken from the employer, is taxable in full in the year of its



However, in order to avoid double taxation, Explanation to section 15 clarifies that where any salary paid in advance is taxed in the year of its receipt, it will not be taxed again in the year in which it becomes due.

3.3.3 Arrears of salary:

Arrears of salary are assessable on receipt basis, if the same have not been subject to tax earlier on due basis. This stipulation has been made in the Act so as to ensure that arrears do not escape tax on receipt basis merely because the arrears were due from an earlier date. Sometimes, arrears become payable due to re-fixation of pay from a retrospective date, in which case, it might not have been possible to assess them on due basis in the years to which they relate. Such arrears will be taxable in the year of their receipt, subject to admissibility of relief in tax.

3.3.4 Wages:

Under the Income-tax Act, wages are akin to 'salary'. Conceptually also, there is no difference between the two, both being a recompense for work done or service rendered. As already stated, 'salary' denotes payment for services of a non-manual type, while 'wages' is used for payments for manual services.

3.3.5 Annuity:

Annuity payable by the present employer is taxable, whether it is paid under a contractual obligation or voluntarily. Similarly, annuity received from an ex-employer, though not classifiable as salary is, nevertheless, taxable as profit in lieu of salary. The deferred annuity, however, is accorded separate treatment. The statutory definition makes a mention about 'annuity' only and not about deferred annuity and hence, the latter is not taxable as 'salary'. If an employer starts a deferred annuity scheme and makes contributions thereto, so that the employees may get periodic payments as annuity after their retirement, the annuity so received is similar to pension. The contributions made by the employer cannot be taxed in the employee's hands since the employees have only a contingent right in such contributions. The question of taxability will arise only when the employees actually receive the annuities.

3.3.6 Pension:

Pension is a recurring and periodic payment, which an employee receives after his retirement. Since the primary nexus for such payment is the 'employment' held, pension is taxed as salary. Family pension received by an employee's dependents after his death is, however, taxable as 'income from other sources' in the hands of the recipients.

3.3.7 Fees and Commission:

Fees and commission are taxable as salary if the employer is obliged to pay them under the contract of employment. If such contractual obligation is absent, these would still be treated as a benefit or perquisite and taxed under 'salaries'.

If an employee is paid commission as a fixed percentage of the turnover achieved by him, and if such payment is covered by the contract of employment, it will be treated as salary. Commission paid to a director of a company, who is not an employee, for standing guarantee to a loan taken by the company, is taxable under 'income from other sources'.

3.3.8 Bonus:

The Income-tax Act does not specifically include 'bonus' in the definition of 'salary'. However, with the advent of the progressive legislation, the bonus has come to be treated as 'deferred salary'. The obligation to pay bonus may arise due to:

- (1) the service agreement between the employer and the employees;
- (2) the operation of Payment of Bonus Act, 1965;
- (3) the decision of a trade association, which is binding on its members;

- (4) an award passed by a competent Labour Tribunal.

In all these cases, bonus will be treated as 'salary'. However, when the bonus is paid gratuitously, it is treated as a 'monetary benefit' or a 'perquisite'.

3.3.9 Gratuity:

Gratuity, being a terminal payment arising out of the contract of employment, is taxable as 'salary'. Certain exemptions, however, are allowable in respect of the gratuity amount received.

3.3.10 Leave Encashment:

Section 17(1) has recently been amended to specifically include the payment received as 'leave encashment' in the definition of 'salary', in order to counter the view held in certain Tribunal decisions that it is a capital receipt. The amendment has come into force with effect from the assessment year 1978-79. Leave encashment received at the time of retirement will, however, be subject to certain exemptions.

3.3.11 Profits in lieu of salary:

Section 17(3) of the Act accords an inclusive definition to the term. Normally, the 'profits in lieu of salary' includes the following items:

- (a) Any compensation due to or received by an employee from his employer or former employer towards:
 - 1. termination of his employment,
 - 2. modification of the terms and conditions regarding his employment;
- (b) Any payment due to or received by an employee from his employer or former employer, other than:
 - 1. gratuity,
 - 2. commuted value of pension,
 - 3. retrenchment compensation,
 - 4. payments from a statutory provident fund,
 - 5. payments due from a recognized provident fund,
 - 6. house-rent allowance.

3.3.12 Perquisites:

The term 'perquisite' is neither exhaustively nor specifically defined in the Income-tax Act and section 17(2) only states that 'perquisites' would include certain specified items.

The Oxford Dictionary gives the meaning of the term 'perquisite' as:

"Casual profit additional to normal revenue or emolument; thing that has served its primary use and to which subordinate or servant has then a customary right; incidental benefit attaching to employment".

Black's Law Dictionary contains the following meaning of the term 'perquisite':

"Emoluments, fringe benefits, or other incidental profits or benefits attaching to an office or position. Shortened term 'perks' is used with reference to such extraordinary benefits afforded to business executives, e.g. free cars, club membership, insurance, etc.".

The term thus embraces all benefits and amenities provided by the employer to the employee in addition to salary or wages. Such benefits and amenities may either be in cash or in kind and may be provided voluntarily or under a service agreement. In fact, perquisites denote something that benefits the recipient by going into his pocket. However, where a necessary expenditure incurred in the performance of duties is reimbursed by the employer to the employee, such a reimbursement will not constitute a perquisite in the employee's hands. Circular no.33 dated 1.8.1955 issued by the CBDT clarifies that, "the value of the benefit or amenities will be included in the total income only if it is actually granted or provided to the employee". Consequently, the employee must actually accept the perquisite granted to him. If he chooses to waive the enjoyment of any benefit granted to him by the employer, the value of such benefit cannot be taxed in his hands as a 'perquisite'.

Classification of 'Perquisites':

Section 17(2) of the Income-tax Act contemplates a three-tier classification of taxable perquisites, viz.

1. certain specific items applicable to all employees;
2. any sum paid by the employer in respect of any obligation which, but for such payment would have been payable by the employee;
3. value of any benefit or amenity provided free-of-cost or at a concessional rate, to certain specified employees.

It is a basic requirement for tax purposes that the perquisite should arise out of the terms of the service contract and the employee must have an enforceable right to claim it, if the item falls under (c) above.

(a) Taxable Perquisites for all employees:

The following perquisites are taxable in all cases:

1. value of rent-free residential accommodation provided to the employee by his employer;
2. value of any concession in the matter of rent, in respect of the residential accommodation provided to the employee;
3. Income-tax duee from the employee but paid by the employer;
4. employer discharging personal debts incurred by the employee;

5. Employer paying club membership fees, club bills and hotel bills of the employees, where they have no nexus to the employment;
6. Employer meeting the cost of education of the employee's children, either by paying fixed education allowance or by remitting the fees directly to the concerned educational institution. Free educational facility provided to the employee himself will not fall under this category;
7. Tiffin allowance paid by the employer to the employee;
8. Any sum payable by an employer, either directly or through a fund, to effect an assurance on the life of the employee or to effect a contract for an annuity. The sums payable to the following funds, however, will not be treated as perquisite:
 - (a) a recognized provident fund,
 - (b) an approved superannuation fund,
 - (c) a deposit-linked insurance fund established under the Coal Miners Provident Fund and Miscellaneous Provisions Act as also the Employees Provident Fund and Miscellaneous Provisions Act;
9. Rewards received from employer, except those that are exempt;
10. Issue of shares by a company to its employees at a concessional rate;
11. Legal charges incurred by the employer to save or defend the employee in respect of any infraction of law which is

not related to his official duties.

(b) Tax-free Perquisites for all employees:

The value of the following amenities is not required to be taxed in the hands of any employee as perquisites:

1. Provision of ordinary medical facilities to the employee or his family free-of-charge, subject to certain limit;
2. Reimbursement of such medical expenses to the employee after they are incurred;
3. Payment by the employer of the wages of a gardener and other servants employed for the proper upkeep of the house belonging to the employer which is in the occupation of the employee;
4. Provision of refreshments to the employees during office hours in the office premises (lunch or dinner will not come under the category of 'refreshments');
5. Provision of lunch or dinner at subsidized rates;
6. Provision of recreational facilities for groups of employees, provided the facilities are not restricted to selected few among the employees;
7. Where the employer is engaged in the carriage of goods or passengers, provision to any of its employees or to their family members and dependent relatives, of journey free-of-cost or at concessional fares, in any transport conveyance owned by the employer;
8. Privilege passes and privilege ticket orders granted by railways to its employees;

9. Fees paid by the employer on behalf of the employee for attending any training course or refresher course in management training;
10. Provision of telephone at the employee's residence at the expense of the employer, irrespective of whether the telephone is used for official or personal purposes;
- 11.. Free transport provided by the employer to the employees as a group for their journeys from residence to the place of duty and back. The amenity should not be restricted to any individual or to a few employees alone;
12. Supply of rations free-of-cost to armed forced personnel;
13. Sale of goods to employees at a concessional rates.

(c) Taxable Perquisites for 'Specified Employees' only:

The term 'specified employees' covers the following categories:

- (1) An employee who is a director of a company (whether whole-time or part-time);
- (2) An employee who has a substantial interest in his employer-company, i.e. he is the beneficiary-owner of the equity shares carrying atleast 20 percent voting power;
- (3) Any employee not covered by the above categories, but whose income under the head "Salaries", excluding the value of all benefits or amenities not paid in cash, exceeds Rs.24,000 for the relevant previous year.

The following items will be treated as 'taxable perquisites' in the case of specified employees:

1. Provision of free-boarding, the employer himself meeting the expenses incurred in this connection;
2. Value of free transport for private use;
3. Provision at the cost of the employer of holiday trips to the employees or to the members of their families, other than exempt items like leave travel concession and passage money;
4. Supply of gas, electricity or water for the employee's household consumption, free-of-cost;
5. Provision of domestic servants;
6. Sale of conveyance at book-value by the employer to the employee.

(d) Valuation of Perquisites: ✓

The modalities of valuation of perquisites are laid down in rule 3 of the Income-tax Rules, particularly in respect of the valuation of the following perquisites:

1. Provision of rent-free accommodation;
2. Provision of residential accommodation at concessional rate;
3. Provision of conveyance, free-of-cost or at concessional rate;
4. Free supply of gas, water or electricity for the employee's household consumption;
5. Free educational facilities for the employee's children;
6. Free transport facilities provided by the transport operators.

As regards valuation of other perquisites, it is laid down that their value will be determined "on such basis and in such amount as the Income-tax Officer considers fair and reasonable". In exercise of this discretionary power, the Income-tax Officer is expected to act in a judicious manner, after taking into account all relevant factors.

3.4 EXEMPTIONS:

Section 10 of the Income-tax Act enumerates as many as 65 items of exemptions, i.e. the incomes enumerated in this section are not only excluded from the taxable income of the assessee but also from his total income; in other words, they are not to be taken into computation for the purpose of determining either the taxable income or the rate of tax. These exemptions are of several types. Some deal with a particular source of income only, while others deal with a particular category of assessee. There are total exemptions as well as partial exemptions, and exemptions are also dependent on the residential status or citizenship status of the assessee. Following are only such of the exemptions which are of particular interest to the salaried assesseees:

1. Travel concession or assistance [section 10(5)];
2. Foreign allowance [section 10(7)];
3. Gratuity [section 10(10)];
4. Commutation of pension [section 10(10A)];
- (5) Leave encashment;

6. Retirement benefits [section 10(10C)];
7. Retrenchment compensation [section 10(10B)];
8. Payment from statutory Provident Funds [section 10(11)];
9. Payments from approved Superannuation Fund [section 10(3)].

Various sub-clauses of section 10(6) list a number of exemptions, both full and partial, available to the non-citizens in respect of their salary incomes. Section 10(17) makes the remuneration of the Members of Parliament and State Legislatures to be treated as 'income from other sources' and not under the head "Salaries".

3.5 RELIEFS:

Section 89 of the Income-tax Act, read with rule 21A, provides for the manner in which tax-reliefs are to be computed where salary has been received in arrears, or in advance, or more than 12 months' salary is received in any one year, or where terminal benefits assessable as 'profits in lieu of salary' are received. The necessity for granting the relief arises because under section 15 of the Act, salary is assessable on receipt basis, and terminal benefits received in one year may be the result of the services rendered for several years; so that on the grounds of equity, tax relief has to be granted in order to ensure that such lump sum payments do not suffer tax at higher rates.

Rule 21A(1) contemplates the following five situations

1. when salary is received in arrears or in advance;
2. when gratuity is received after putting in service of not less than five years;
3. when compensation for termination of employment is received, if the employee has rendered atleast three years continuous service, and the unexpired portion of his service is also of atleast three years;
4. when payment, by way of commutation of pension is received;
5. when any other payment is received, if the CBDT, having regard to the circumstances of the case, deem it fit to allow relief.

The manner for computation of the reliefs has been laid down in Rule 21A of the Income-tax Rules, 1962.

3.6 SUMMARY:

The above discussion on the conceptual and procedural aspects brings out the fact that the basic concepts about and procedural formalities for charge of income-tax on salary income have become clearer with the passage of time. The concept of perquisite, however, has remained unclear despite best efforts at its codification and CBDT's attempts to clarify the situation from time to time. This has already given rise to the classification of the perquisites as 'taxable', 'tax-free' and 'taxable for specified employees', which

is quite artificial, and may even be violative of Article 14 (equality before law) of the Constitution. Same is the case about 'exemptions' and 'reliefs'.

Moreover, as professionalism enters job market, employees are going to become more selective in their choice of employers. Employers, on the other hand, would try to offer competitive salary levels and more liberal perquisites, both tangible and intangible, to attract and retain the employees. In such situations, it is going to a trying endeavour for tax-gatherers to appropriately classify and quantify the various items of perquisites, exemptions and reliefs.

