

UDHNA COLLEGE

ADVANCED ACCOUNTING & AUDITING-II

(ACCOUNTANCY & TAXATION)

UNIT -3 DIRECT TAX

I. BASIC CONCEPTS:

1. Assessment Year [Sec. 2(9)]

Assessment year means the period of twelve months starting from April 1 of every year and ending on March 31 of the next year. For instance, the assessment year 2025-26 (which will commence on April 1, 2025) will end on March 31, 2026. The period of assessment year is fixed by statute.

Income of previous year of an assessee is taxed during the following assessment year at the rates prescribed for such assessment year by the relevant Finance Act.

2. Previous Year [Sec. 3]

Income earned in a year is taxable in the next year. The year in which income is earned is known as previous year and the next year in which income is taxable is known as assessment year. In other words, it can be said that income earned during the previous year 2024-25 is taxable in the immediately following assessment year (*i.e.*, 2025-26) [*see* para 2.2 for exception to this rule].

2.1 Uniform Previous Year – From the assessment year 1989-90 onwards, all assessees are required to follow financial year (*i.e.*, April 1 to March 31) as the previous year. This uniform previous year has to be followed for all sources of income.

2.1.1 Previous Year in the Case of Newly Set-Up Business/Profession – In the case of a newly set-up business/profession or in the case of a new source of income, the previous year is determined as follows –

	First previous year	Second and subsequent previous years
Starting Point	It commences on the date of setting up of the business/profession or on the date when the new source of income comes into existence	April 1
Ending Point	Immediately following March 31	March 31 of the following year
Duration of previous year	12 months or less	12 months

On the basis of the above table, the following broad conclusions can be drawn —

1. The first previous year commences on the date of setting up of the business/profession (or, as the case may be, the date on which the source of income newly comes into existence) and ends on the immediately following March 31. Thus, in the case of a newly set-up business/profession or new source of income, the first previous year is a period of 12 months or less than 12 months. It can never exceed 12 months.
2. The second and subsequent previous years are always financial years. The second and subsequent previous years are always of 12 months each (*i.e.*, April to March).

2.1.2 Previous year as defined in section 3 – Except in the case mentioned in para 2.1.1, previous year is the financial year immediately preceding the assessment year. For

instance, for the assessment year 2025-26, the immediately preceding financial year (*i.e.*, 2024-25) is the previous year.

2.2 When income of previous year is not taxable in the immediately following assessment year – The rule that the income of the previous year is assessable as the income of immediately following assessment year has certain exceptions which are given in paras 2.2.1 to 2.2.5. These exceptions have been incorporated in order to ensure smooth collection of income tax from these taxpayers who may not be traceable if tax assessment procedure is postponed till the commencement of the normal assessment.

2.2.1 Shipping business of non-residents [Sec. 172] – Section 172 is applicable if the following conditions are satisfied –

Condition 1 – There is a non-resident.

Condition 2 – He owns a ship or ship is chartered by the non-resident.

Condition 3 – The ship carries passengers, livestock, mail or goods shipped at a port in India.

Condition 4 – The non-resident may (or may not) have an agent/representative in India.

If all the aforesaid conditions are satisfied, 7.5 per cent of amount paid (or payable) on account of such carriage (including demurrage charge or handling charge or similar amount) to the non-resident shall be deemed to be the income of the non-resident. For this purpose, the master of the ship shall submit a return of income before the departure of the ship from the Indian port (such return may be submitted within 30 days of the departure of the ship, if the Assessing Officer is satisfied that it will be difficult to submit the return before departure and if satisfactory arrangement for payment of tax has been made)¹. Unless the tax has been paid (or satisfactory arrangements have been made for payment thereof), a port clearance shall not be granted by the Collector of Customs². Under the above noted provisions of section 172, 7.5 per cent of amount of freight, fare, etc., is deemed as income of the non-resident taxpayer and tax is payable at the rate applicable to

a foreign company. Income is, thus, taxable in the same year in which freight, fare, etc., is collected and not in the immediately following assessment year.

2.2.2 Persons leaving India [Sec. 174] – Section 174 is applicable as follows –

1. It appears to the Assessing Officer that an individual may leave India during the current assessment year or shortly thereafter.
2. He has no present intention of returning to India.
3. The total income of such individual up to the probable date of his departure from India shall be chargeable to tax in that assessment year.

2.2.3 Bodies formed for short duration [Sec. 174A] – Section 174A is applicable as follows –

1. There is an association of persons or a body of individuals or an artificial juridical person, formed or established or incorporated for a particular event or purpose.
2. It appears to the Assessing Officer that the abovementioned association, body, etc., is likely to be dissolved in the assessment year (*i.e.*, April to March) in which such association of persons or body of individuals or artificial juridical person was formed or established or incorporated or immediately after such assessment year.
3. The total income of such association or body or juridical person for the period from the expiry of the previous year for that assessment year up to the date of its dissolution shall be chargeable to tax in that assessment year.

2.2.4 Person likely to transfer property to avoid tax [Sec. 175] – The salient features of section 175 are given below –

1. It appears to the Assessing Officer during any current assessment year that a person is likely to charge, sell, transfer, dispose of (or otherwise part with) any of his asset.
2. Such asset may be movable or immovable.
3. The taxpayer is likely to part with the asset with a view to avoiding payment of any liability under the Income-tax Act.

4. The total income of such person from the first day of the assessment year to the date when proceeding is started under section 175 is taxable in that assessment year.

2.2.5 Discontinued business [Sec. 176] – The salient features of section 176 are as follows –

1. A business or profession is discontinued in any assessment year.
2. Income of the business/profession from April 1 of the assessment year (in which the business/profession is discontinued) to the date of discontinuation may be taxable in the assessment year in which the business/profession is discontinued.
3. The above income is taxable at the discretion of the Assessing Officer in the assessment year in which business is discontinued or it may be taxed in the normal assessment year (*i.e.*, assessment year immediately following the previous year).
4. If it is taxable in the assessment year in which the business/profession is discontinued, then it is chargeable to tax at the rate applicable to that assessment year.

It may be noted that in the first four exceptions discussed earlier (*i.e.*, shipping business of non-residents, persons leaving India, bodies formed for short duration and transfer of property) tax shall be charged in the previous year itself (it is mandatory on the part of the Assessing Officer). But in the case of discontinued business, it is at the discretion of the Assessing Officer.

3. Person [Sec. 2(31)]

The term “person” includes :

1. an individual;
2. a Hindu undivided family;
3. a company;
4. a firm;
5. an association of persons or a body of individuals, whether incorporated or not;

6. a local authority; and
7. every artificial juridical person, not falling within any of the preceding categories.

4. Assessee [Sec. 2(7)]

Assessee means a person by whom any tax or any other sum of money (*i.e.*, penalty or interest) is payable under the Act.

5. Income [Sec. 2(24)]

The definition of the term “income” in section 2(24) is inclusive and not exclusive. Therefore, the term “income” not only includes those things which are included in section 2(24), but also includes such things which the term signifies according to its general and natural meaning.

6. Tax Evasion

Among **tax evasion and avoidance**, evasion is an illegal method. It is a fraud in which the person aims to pay fewer taxes. They may show less income or not report any source. Tax evasion happens often, and the authorities are responsible for curtailing it.

- Tax evasion can be when a business owner doesn't report a few cash sales to show a lower income, leading to lower taxes.
- Tax evasion can also be when a person claims an unjustified deduction. One may report they've paid more interest for life insurance. It is a deduction for taxable income.
- Business owners may present a personal expense as a business expense. It reduces the profit and the tax.
- Tax evasion can also be through concealing documents or if records are not maintained.

These practices are illegal and punishable.

7. Tax Avoidance

Tax avoidance is an activity of taking unfair advantage of the shortcomings/loopholes in the tax rules to avoid the tax payments.

Tax avoidance is an act to minimize tax liability through legal methods. In other words, it is the legal usage of the tax law to reduce the tax amount by means that are within the law. Tax avoidance is not advisable as it could be used for one's advantage to reduce the amount of tax payable.

Tax avoidance is considered immoral because it involves dodging of tax, and it leads to the deferment of tax liability. One of the ways to do tax avoidance is to adjust the accounts in such a manner where there will be no violation of tax rules. Tax avoidance is lawful, but, in some cases, it could be considered as a fraud.

8. Tax Planning:

Tax planning involves strategically organising your financial affairs to ensure that, while fully complying with the provisions of the Income-tax Act, 1961, you take maximum advantage of all exemptions, deductions, rebates, allowances, and other benefits available under the law. The goal is to minimise your tax liability to the maximum extent possible without violating any legal requirements.

Incidence of tax:

The term tax incidence refers to the legal and economic burden of taxation. From a legal standpoint, it refers to who is responsible for paying the tax regardless of who remits it to the government.

For determining incidence of tax we need to first determine residential status of person.

- **Residential Status of Person:**

The taxability of an individual in India depends upon his residential status in India for any particular financial year. The term residential status has been coined under the income tax laws of India and must not be confused with an individual's citizenship in India. An individual may be a citizen of India but may end up being a non-resident for a particular year. Similarly, a foreign citizen may end up being a resident of India for income tax purposes for a particular year. Also to note that the residential status of different types of persons viz an individual, a firm, a company etc is determined differently.

How to Determine Residential Status?

For the purpose of income tax in India, the income tax laws in India classifies taxable persons as:

- A resident and ordinarily resident (ROR)
- A resident but not ordinarily resident (RNOR)
- A non-resident (NR)

The taxability differs for each of the above categories of taxpayers. Before we get into taxability, let us first understand how a taxpayer becomes a resident, an RNOR or an NR.

- **Resident**

A taxpayer would qualify as a resident of India if he satisfies one of the following 2 conditions:

1. Stay in India for a year is 182 days or more in previous year

or

2. Stay in India for the immediately 4 preceding years is 365 days or more and 60 days or more in the relevant financial year

Exceptions to Residential Status

- In the event an individual who is a citizen of India leaves India as a member of the crew of an Indian ship or for the purpose of employment during the FY, he will qualify as a resident of India only if he stays in India for 182 days or more.
- Indian citizen or person of Indian origin who stays outside India comes on a visit to India during the relevant previous year. However, such a person having a total income, other than the income from foreign sources which exceeds Rs.15 lakhs during the previous year will be treated as a resident in India if – he stays in India during the relevant previous year for 182 days or more, or he stayed in India for 365 days or more during the previous 4 years and has been in India for at least 120 days in the previous year.

As mentioned as a significant amendment above, the individual will be treated as a “deemed resident of India” if a citizen of India having total income (other than foreign sources) exceeds Rs 15 lakh and nil tax liability in other countries.

- **Resident Not Ordinarily Resident**

If an individual qualifies as a resident, the next step is to determine if he/she is a Resident and ordinarily resident (ROR) or Resident but not ordinarily Resident (RNOR). He will be an ROR if he meets both of the following conditions:

1. Has been a resident of India in at least 2 out of 10 years immediately previous years

and

2. Has stayed in India for at least 730 days in 7 immediately preceding years

Therefore, there are 3 situations in which an individual is said to be RNOR

- if any individual fails to satisfy either or none of the above-mentioned conditions.
- If an individual is an Indian citizen or person of Indian origin having a total income more than exceeding Rs.15 lakhs (excluding foreign income), who has been in India for 120 days or more but less than 182 days during that previous year.
- If an individual is deemed to be a resident in India, by default, he will be considered as a Resident and Not Ordinarily Resident.

- **Non-resident**

An individual failing to satisfy the condition of stay in India for :

182 days or more in the previous year

or

60 days or more in the previous year and 365 days in the 4 years preceding previous years will be considered as a Non-Resident for that financial year.

Points to Note

- Stay in India includes stay in the territorial waters of India i.e. 12 nautical miles into the sea from the Indian coastline.
- The period of stay need not be continuous or active.
- Both the date of departure as well as the date of arrival in India are considered while counting the number of days stayed in India.

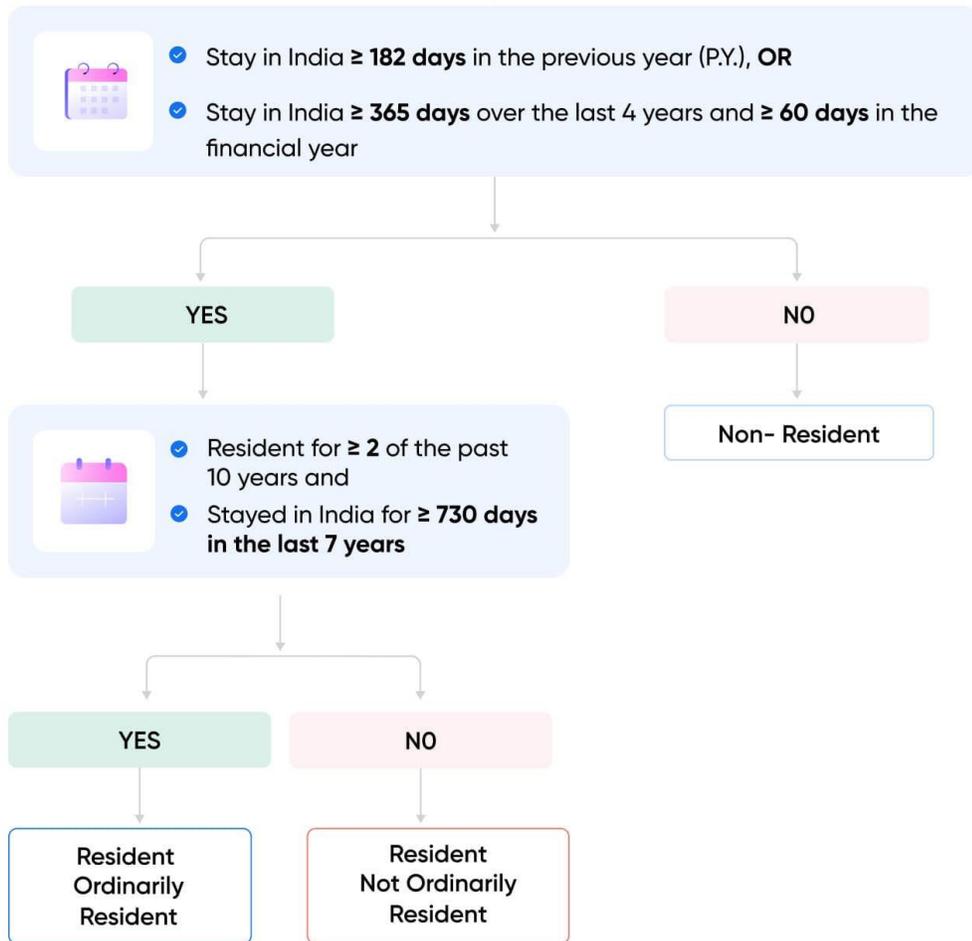
- For Income tax purposes the residence of an individual has nothing to do with citizenship, place of birth or domicile. Therefore, an individual can be resident in more than one country even though he has only one domicile.

- **Taxability**

- 1. Resident and Ordinarily Resident:** A resident and ordinarily resident will be charged to tax in India on his global income i.e. income earned in India as well as income earned outside India.
- 2. Resident but not ordinarily resident:** There is a thin line in taxability of income between ROR and RNOR, on below incomes RNORs are not required to pay taxes. **Income earned outside India as well as received outside India.**
- 3. Non-Resident:** A Non-resident will be charged tax only on the income 'received in India' or source of income 'received from India'. However, income earned outside India, having no connection with India, is not taxable



Residential Status



- **Residential Status of HUF**

Resident: An HUF would be resident in India if its management is made from the members in India, if not will be considered a Non-resident.

Resident and ordinarily resident/ Resident but not ordinarily resident

If Karta (manager) of resident HUF satisfies the below conditions, then HUF will be treated as resident and ordinarily resident, otherwise, it will be resident but not ordinarily resident.

- **Residential Status of a Company**

A company would be resident in India in the following circumstances :

- If it is an Indian Company
- The place of effective management in the previous year is in India.

Note: Place of effective management means a place where management and commercial decisions that are necessary for the conduct of business or entity are taken.

- **Residential Status of Firms, LLPs, AOPs, BOIs, Local authorities and Artificial juridical persons**

In simple words, again, the residential status will depend on the place from where the management of the above persons management is made, similar to HUF, if it's done by members in India, then it will be resident, else it will be non-resident.

II. HEADS OF INCOME:

According to the Income Tax Act, a taxpayer's earnings are divided into 5 heads of income. At the end of each financial year, you must correctly classify your earnings under these heads of income for accurate tax calculation.

What are the 5 Heads of Income?

The 5 heads of income tax are:

1. Income from Salary
2. Income from House Property
3. Income from Profits and Gains from Business or Profession
4. Income from Capital Gains
5. Income from Other Sources

5 Heads Of Income As Specified Under The Income Tax Act,1961



Salary

Includes Basic salary, allowances, perquisites, bonuses.



House Property

Includes Rental income from owned property.



Profits and Gains of Business or Profession

Includes Self-employment, freelancing, business income.



Capital Gains

Includes Sale of shares, mutual funds and real estate.



Income from Other Sources

Includes Interest, dividends, lottery winnings, gifts.

1. Income from Salary

Any income that you receive in terms of the service you provide on a contract of employment is applicable for taxation under this head. This includes salary, advance salary, perquisites, gratuity, commission, annual bonus and pension.

The following section governs the Income from the Salary

- Section 15 describes the taxability of income from Salary
- Section 16 explains about deduction available under salaries
- Section 17 explains the components of the Salary like Monetary compensation, Perquisites etc.

2. Income from House Property

An individual's income from his or her house property or land appurtenant such property is taxable under the head of income from house property. To put it simply, this head includes the policy for calculating the tax on rental income that you receive from your properties.

Broadly Income from House Property has three sub-classifications

- Self Occupied Property
- Let out Property
- Deemed Let out Property

In case you own more than two self-occupied house, then only two of such houses is considered to be self-occupied and the rest are considered to be deemed let out.

3. Income from Profits and Gains from Business or Profession

The profits that you earn from any kind of business or profession are taxable under this head. You can subtract your expenses from the total income in order to determine the amount on which tax is chargeable.

Here are the types of income that are chargeable under this head:

- Profits generated from the sale of a certain license
- Gains earned by an individual during an assessment year
- The profits that an organisation makes on its income
- Cash received on the export of a government scheme
- The benefits that a business receives
- Gains, bonuses or salary that an individual receives due to a partnership with a firm.

4. Income from Capital Gains

When you earn profits by transferring or selling an asset that was held as an investment, that income is taxable under the head of income from capital gains. A large number of assets, like gold, bonds, mutual funds, real estate, stocks, etc., fall under capital assets.

Capital gains can be divided into:

- Short-term capital gains and
- Long-term capital gains.

5. Income from Other Sources

Among the five heads of income tax, this one includes any other income that does not have any mention in the above 4 heads. They fall under Section 56 sub-section (2) of the Income-tax Act and include income from dividends, interest, rent on plant and machinery, lottery, bank deposits, gambling, card games, sports rewards, etc.