UDHNA COLLEGE

SYBCOM SEM-III

Advanced Accounting & Auditing-II

(Accountancy & Taxation)

Unit-3 Tax Structure of India (Direct Tax)

Contents:

1) Basic Concepts

- **Income (from all the sources), Assessment year, Previous year, Person, Tax planning, Tax evasion and Tax avoidance**
- **Incidence of Tax (including determination of residential status)**

Important definition under Income-tax Act, 1961

1. **Assessee:**
   Assessee means a person liable for payment of taxes or any other sum of money under the Income-tax Act. It also includes the person for whom any proceeding has been initiated under the Income-tax Act. The term 'assessee' also includes 'deemed assessee' and 'assessee-in-default'.
2. Assessment Year:
   Assessment Year means the period of twelve months commencing on the 1st day of April every year.
3. Previous Year:
   Previous Year means the financial year immediately preceding the assessment year.
   In the case of a business or profession newly set up or a source of income newly coming into existence in a financial year, the previous year shall be the period beginning with the date of setting up of the business or

profession or the date on which the source of income newly comes into existence and ending with the said financial year.

4. Person:

Person includes an individual, a Hindu undivided family, a company, a firm, an association of persons or a body of individuals, whether incorporated or not, a local authority, and every artificial juridical person, not falling within any of the preceding sub-clauses.

5. Income:

Section 2(24) of the Income-tax Act specifically includes over 30 types of receipts or benefits in the definition of income. This provision outlines various notional items that are also considered income for tax purposes. Since the definition of income is inclusive, items not explicitly defined as income or deemed as income by the Act must be assessed according to the natural meaning of income and by considering the circumstances of each case.

Items specifically defined as income

Section 2(24) of the Income-tax Act has specifically included the following receipts and benefits as income:

Receipts or Gains

The following receipts or gains are considered as income:

a. Profits and gains;
b. Dividends;
c. Any interest, salary, bonus, commission or remuneration, due to, or received by, a partner of a firm.
d. Capital gains;
e. Any winnings from lotteries, crossword puzzles, races, including horse races, card games and other games of any sort or from any form of gambling or betting;
f. Any sum received by the assessee from his employees as contributions to the provident fund or superannuation fund or a fund set up under the provisions of the ESI Act, 1948, or any other fund for the welfare of such employees;
g. Receipts under a keyman insurance policy, including the sum allocated by way of bonus;
h. Receipts under a life insurance policy (other than ULIP and keyman insurance policy), including the sum allocated by way of bonus;
i. Specified sum received by a unit holder from a business trust;

j. Forfeiture of advance money on account of failure of transfer of a capital asset;
k. Deemed Income or gift under Section 56(2)(x), namely:
    - Receiving monetary benefits without consideration;
    - Receiving immovable property without consideration or for inadequate consideration;
    - Receiving specified movable properties without consideration or for inadequate consideration.

Voluntary Contributions

The voluntary contributions received by the following institutions are considered as income:

a. A trust or institution, created or established wholly or partly for charitable or religious purposes;
b. Research association.
c. Charitable or religious institution.
d. University or educational institution.
e. Hospital or other medical institution.
f. Electoral trust

Perquisites, Benefits or Allowances

The following perquisites, benefits or allowances are considered as income:

a. The value of any perquisite or profits in lieu of salary.
b. Any other special allowance or benefit granted explicitly to the assessee to meet his expenses wholly, necessarily and exclusively for the performance of his duties of an office or employment of profit;
c. Any allowance granted to the assessee either to meet his personal expenses at the place where he performs his duties or to compensate him for the increased cost of living;
d. The value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or a person substantially interested or by a relative of director or such person and any sum paid by company in respect of any obligation which would have been payable by any of such individuals;
e. The value of any benefit or perquisite, whether convertible into money or not, obtained by any representative assessee or beneficiary. Further, any sum paid by the representative assessee in respect of any obligation which would have been payable by the beneficiary is also an income;

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

Compensation

Income includes the compensation due to or received by the following:

a. Any person who is wholly or substantially managing the affairs of an Indian company, for the termination of his management or for the modification of the terms and conditions relating thereto.
b. Any person managing the affairs of any other company in India, for the termination of his office or modification of the terms and conditions relating thereto.
c. Any person holding an agency in India for any part of the activities relating to the business of any other person, for the termination of the agency or the modification of the terms and conditions relating thereto.
d. Any person for the vesting of the management of any property or business in the government or any corporation owned or controlled by the government.
e. Any person for the termination or modification of the terms and conditions of any contract relating to his business.
f. In connection with the termination of his employment or the modification of the terms and conditions relating thereto.

Subsidies or Incentives

The following subsidies, assistance, or incentives are taxable as income:

a. Profits on sale of license granted under the Import (Control) Order 1955, made under the Imports and Exports (Control) Act, 1947;
b. Cash assistance received or receivable by any person against exports under any scheme of the Government of India;
c. Any duty of custom or excise repaid or repayable as a drawback to any person against exports under the Customs and Central Excise Duties Drawback Rules, 1971;
d. Any subsidy, grant, cash incentive, duty drawback, waiver, concession, or reimbursement by the Government (Central or State) or any other authority, body, or agency in cash or kind to the assessee. Further, the CBDT has clarified that the LPG subsidy and other welfare subsidies received by individuals would not be taxable as income.

Recovery of Loss or Expenditure

The following recovery of loss or expenditure is taxable as income:

a. Any recovery in respect of loss or expenditure which was allowed to be deducted in any year.
b. Excess of sale proceeds of an asset of an electricity undertaking to the extent depreciation has been allowed in earlier years.
c. Excess of sale proceeds of a scientific research asset over its amortised value, to the extent of deduction allowed.
d. Any recovery in respect of a debt which was allowed as a bad debt.;
e. Amount withdrawn from a special reserve.

Other Incomes

a. Income derived by a trade, professional or similar association from specific services performed for its members is considered as income.
b. The profits and gains of any business of insurance carried on by a mutual insurance company or by a cooperative society;
c. The profits and gains of any banking business (including providing credit facilities) carried on by a cooperative society with its members.
d. Income includes any sum, subject to certain exceptions, whether received or receivable, in cash or kind, under an agreement for:
    - not carrying out any activity in relation to any business or profession; or
    - not sharing any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision of services.
e. In the following situations, the income is computed in reference to the fair-market value of an asset:
    - The fair market value of inventory as on the date on which it is converted into, or treated as, a capital asset;
    - Any consideration received for the issue of shares that exceeds the fair market value of the shares.

6. . Tax Planning:

Tax planning is the process of arranging financial activities and transactions in a way that legally minimizes the amount of taxes an individual or business is required to pay. It involves utilizing available tax deductions, credits, exemptions, and incentives provided by the tax laws to optimize one's tax liability. Tax planning is a legitimate and accepted practice, encouraged by tax authorities, as it allows taxpayers to use the tax code to their advantage while remaining compliant with the law.

Common tax planning strategies include contributing to tax-advantaged retirement accounts, employing tax-efficient investment strategies, utilizing tax credits for eligible activities (e.g., research and development credits), and structuring business operations to maximize deductions.

7. Tax Evasion:

Tax evasion, on the other hand, is an illegal and unethical practice where individuals or businesses deliberately underreport income, overstate expenses, or use other deceptive means to evade paying taxes they owe. Tax evasion involves will full non-compliance with tax laws and can include actions such as hiding income, keeping unreported offshore accounts, falsifying documents, or engaging in other fraudulent activities. Tax evasion is a criminal offense in most countries and can result in severe penalties, including fines, imprisonment, and reputational damage.

8. Tax Avoidance: Tax avoidance is a strategy used to minimize tax liability by legally exploiting loopholes or ambiguities in tax laws. Unlike tax evasion, tax avoidance does not involve illegal actions or deception. It involves structuring financial affairs in a way that complies with the letter of the law but may not necessarily align with its intended spirit. While tax avoidance is technically legal, it can be a contentious topic, as some argue that aggressive tax avoidance by large corporations and wealthy individuals can result in a loss of tax revenue for governments and may lead to calls for tax law reforms.

9. 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.

Classification for Individuals and HUF:

a. Resident:

- Resident and Ordinarily Resident (ROR)
- Resident but Not Ordinarily Resident (RNOR)

b. Non-Resident (NRI)

Taxability Based on Residential Status

a. **Resident and Ordinary Resident (ROR)**

Taxable on:

- Income received or is deemed to be received by him in India in the previous year
- Income accrues or arises or is deemed to accrue or arise to him in India during such year
- Income accrues or arises to him outside India during such year

b. **Resident but Not Ordinarily Resident (RNOR)**

Taxable on:

- Income received or is deemed to be received by him in India in the previous year
- Income accrues or arises or is deemed to accrue or arise to him in India during such year
- Income accrues or arises to him outside India during such year if it is derived from a business controlled from India or from a profession set up in India

c. **Non-Resident (NR)**

Taxable on:

- Income received or is deemed to be received in India by such person in the previous year
- Income accrues or arises or is deemed to accrue or arise to such person in India during such year

<u>DETERMINATION OF RESIDENTIAL STATUS</u>

Individuals:

The residential status of an individual is determined based on stay in India during the relevant financial year. An Indian citizen is deemed a resident in India, even if he does not meet the stay requirement, if:

- His Indian income exceeds Rs. 15 lakh in a financial year, and
- He is not liable to tax in any other country due to domicile, residence, or similar criteria

Conditions for Residency

- **General Rule**: An individual is resident in India if:
  - Stay in India ≥ 182 days in the financial year, or
  - Stay in India ≥ 60 days in the financial year and ≥ 365 days in the last 4 years
- **Exceptions (Indian Citizens & PIOs)**:
  - Visit India & Income ≤ Rs. 15 lakh: "60 days" replaced with "182 days"
  - Visit India & Income > Rs. 15 lakh: "60 days" replaced with "120 days"
  - Leaving India for employment / ship crew: "60 days" replaced with "182 days"

An individual is treated as a non-resident in India if he does not satisfy any of the conditions required to be fulfilled to become a resident, as stated above.

Resident but Not Ordinarily Resident (RNOR): An individual is RNOR if:

- Non-resident in 9 out of 10 preceding years, or
- Stayed in India for ≤ 729 days in the last 7 years
- Deemed Residents are always treated as RNOR
- Indian citizen / PIO visiting India earns over Rs. 15 lakhs, stays 120–181 days in that year, and 365+ days in the last 4 years

HUFs:

The residential status of an HUF is determined based on the location of its control and management. Additionally, the residential status of its Karta plays a key role in classifying an HUF as ROR, RNOR, or NR.

Classification of Residential Status

- **Resident (R)**:

- An HUF is resident if any part of its control and management is in India during the previous year

- **Non-Resident (NR)**:
  - An HUF is non-resident if its entire control and management is outside India
- **Resident and Ordinarily Resident (ROR)**:
  - Karta was resident in India for at least 2 years out of the last 10 years
  - Karta stayed in India for 730 days or more in the last 7 years
- **Resident but Not Ordinarily Resident (RNOR)**:
  - Karta was non-resident for at least 9 years out of the last 10 years
  - Karta stayed in India for 729 days or less in the last 7 years

Companies:

An Indian company is always treated as a resident in India. A foreign company is considered resident in India if its Place of Effective Management (POEM) is in India during the relevant financial year. POEM rules apply only if the foreign company's gross turnover exceeds Rs. 50 crore in the financial year.

Residential Status Determination

- **Indian Companies**:
  - Always resident in India, regardless of control from outside India
- **Foreign Companies**:
  - Resident if POEM is in India and gross turnover exceeds Rs. 50 crore
  - Non-resident if the POEM is outside India

Place of Effective Management (POEM)

- POEM is the place where key management and commercial decisions are made
- Determined on substance over form

Determining POEM

- **Active Business Outside India (ABOI Test)**:
  POEM is presumed to be outside India if:
    - Its passive income is not more than 50% of its total income; and
    - Less than 50% of its total assets are situated in India; and
    - Less than 50% of its total number of employees are situated in India or are resident in India; and
    - Payroll expenses incurred on such employees are less than 50% of its total payroll expenditure.
- If board decisions are overridden from India, POEM is in India
- **Not Engaged in Active Business Outside India (Business Management Test):**:
    - POEM is where key decisions are actually made
    - Assessed based on the location of board meetings, senior management, head office, and control over decision-making.

Firms, AOPs, BOIs, Local Authorities & AJPs:

The residential status of a partnership firm, an Association of Persons (AOP), a Body of Individuals (BOI), a Local Authority, or an Artificial Juridical Person depends on the location of its control and management. These entities can be classified as either Resident or Non-Resident but cannot have the status of Not Ordinarily Resident (RNOR).

Rules for Determining Residential Status

- **Resident**:
    - If any part of control and management is in India
    - Even a single key decision in India is sufficient
- **Non-Resident**:
    - If entire control and management is wholly outside India

- **2) Heads of Income chargeable to Tax under Indian Income Tax Act (Basic concept of all the heads)**

In India, the income of taxpayers is classified into five heads of income, such as Salary, House Property, Capital Gain, Business and Profession and Income from Other Sources. The income of a person shall be reported in each head of income accordingly. Each head has a different set of rules for deduction and exemption of income & expenses, such as a standard deduction available under the salary head, a deduction for interest paid on a home loan available under the house property head, etc. Classifying income correctly under each head ensures accurate tax filing and avoids penalties.

What are the Five Heads of Income?

The **Five Heads of Income Tax** are:

- Income from Salary
- Income from House Property
- Income from Profits and Gains from Business or Profession
- Income from Capital Gains
- Income from Other Sources

1. Home
2. >
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5. What are the 5 Heads of Income Tax?

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What are the 5 Heads of Income Tax?

By Ektha Surana

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Updated on: May 15th, 2026

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Income from Salary

Income from the salary head covers the income that you receive in terms of the service you provide on a contract of employment that 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.

Income from House Property

Income from House Property head of income covers 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

1. Self Occupied Property
2. Let out Property
3. Deemed Let out Property

In case assessee owns more than two self-occupied houses, then only two of such houses are considered to be self-occupied and the rest are considered to be deemed let out. The taxation occurs on income received from both commercial and residential property.

Income from Profits and Gains from Business or Profession

The Profits and Gains from Business or Profession head of income cover the profits that assessee earn from any kind of business or profession are taxable under this head. assessee subtract 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.
- Profit & loss from Future & Option Trading, Intraday Trading.

Income from Capital Gains

Capital Gain head of income covers profits earned 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.

Types of Capital Gains:

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

Income from Other Sources

Under the head of Income from other source covers income that does come under other four head income and includes income from dividends, interest, rent on plant and machinery, lottery, bank deposits, gambling, card games, sports rewards, etc.