

Subject: Income Tax

Topic: Introduction of Tax

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Introduction of Tax

1.1 Introduction

The most important aim of any country's economic policy is to achieve economic growth of the nation and equitable distribution of the wealth for the betterment of the country. Growth depends upon the sources of revenues-direct and Indirect. In spite of several revenues of Government, Government generates revenues directly or indirectly through the biggest source of public revenue, called Taxation. It is an important weapon for attaining a proper model of resources allocation, distribution of income and wealth, reduction of poverty among people and economic stability, in order that the benefits of economic development are evenly scattered. A tax-payer is not entitled to claim any return against payment of his\her taxes, though modern taxation policy aims at the fulfillment of the objectives of social welfare.

1.2 Meaning and Definitions

The term tax is derived from the Latin word "Taxo" which means touch sharply or charge. Tax is a kind of money which is compulsorily imposed by a public authority and legal duty of every citizen of a country to pay it honestly. It may be levied on income, property, profit services and even at the time of purchase of commodity.

Many economists like Adam smith, Taylor, Bastable, Seligman, Taussing, Dalton etc. tried to define taxation in different ways as stated below.

1. Adam smith: "A tax is a contribution from citizens for the support of the state."

2. P. E. Taylor: 'A compulsory payment to Government without expectation of direct return in benefit to the taxpayer is known as tax'.
3. Prof. Bastable: 'A tax is compulsory contribution of the wealth of a person or body of persons for the services of public powers'.
4. According to Seligman: "A tax is compulsory contribution from the person to the Government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred".
5. Taussing: "The essence of a tax as distinguished from other charges by government in the absence of a direct quid pro quo between the tax-payer and public authority."
6. Dalton. "A tax is a compulsory contribution imposed by a public authority irrespective of the exact amount of service rendered to the taxpayer in return".
7. The dictionary of Modern Economist: "Taxation means "Compulsory levies on private individuals and organs made by government to raise revenue to finance expenses on public goods and services and to control the volume private expenditure in the economy".

The unanimous opinion of the above authores describe that "the tax is a compulsory payment to the Government by taxpayer without any expectation of some specified return.

Thus in a simple words we can say that tax is a mandatory payment by the citizen to the government whenever imposed by the Government. If a person denies the tax payment, he may be punished in the court of law.

1.3 Types of Taxes

The taxes are generally classified into Direct Tax and Indirect Tax; -

A. Direct Tax: A Direct tax is a kind of charge, which is imposed directly on the assessee and paid directly to the government by the persons (juristic or natural) on whom it is imposed. A direct tax is that tax where the incidence and impact of taxation falls on the same entity i.e the burden of direct tax cannot be shifted by the taxpayer to someone else. Income Tax, Corporation Tax, Property Tax, Inheritance (Estate) Tax, and Gift Tax are examples of direct tax.

1.4 Characteristics of Direct Tax: -

1. Economy: Direct taxes are usually collected at source and are paid directly to the Govt. Therefore, the cost of collecting of taxes for the government is relatively low. In this sense the direct taxes are economical.
2. Elasticity: -Income from direct taxes depend upon the increase and decrease in income of the people. Income from these taxes also increased by increasing the rate of taxation in appropriate way. In this way direct taxes also satisfy the canon of elasticity.
3. Educative value: Direct taxes have also the educative value among the common masses. People are aware about the amount collected from them and can check the wastage in public expenditure.

4. **Certainty:** Every taxpayer knows about his income before paying the tax. The taxpayer is certain as to how much he is expected to pay as the tax rate are decided in advance. The Government can also estimate the tax revenue from direct tax with a fair accuracy.

5. **Equity:** Direct taxes are based upon the principle of ability to pay. Persons are in a similar income group are taxed at the same rate. Persons with different income group are taxed at different rate. Thus, there is both vertical and horizontal equity under direct taxation.

6. **Reduction in Inequality:** As direct taxes are progressive in nature, the persons belonging to higher income groups are imposed higher rate of taxation. on the other hand, the low-income groups are ever exempted of some taxes.

Indirect Tax: In reverse of direct tax where the incidence and impact of taxation does not fall on the same entity i.e. burden of tax can be shifted by the taxpayer to someone else is called indirect tax. The indirect taxes are imposed on goods/services. Indirect tax has the effect to raising the price of the products on which they are imposed. Thus, the immediate liability to pay indirect taxes lies on the manufacturer/service provider/seller, etc. But the burden is ultimately shifted to the consumers. Tax on sale, service tax, and custom duty is examples of Indirect tax.

1.5 Characteristics of Indirect Taxes

1. **Important source of revenue:** Indirect taxes are a major source of tax revenues for Governments worldwide and continue to grow as more countries move to consumption-oriented tax regimes. In India, indirect taxes contribute more than 50% of the total tax revenues of Central and State Governments.

2. **Tax on commodities and services:** It is levied on commodities at the time of manufacture or purchase or sale or import/export thereof. Hence, it is also known as commodity taxation. It is also levied on provision of services.

3. **Shifting of burden:** There is a clear shifting of tax burden in respect of indirect taxes. For example, GST paid by the supplier of the goods is recovered from the buyer by including the tax in the cost of the commodity.

4. **No perception of direct pinch:** Since, value of indirect taxes is generally inbuilt in the price of the commodity, most of the time the tax payer pays the same without actually knowing that he is paying tax to the Government. Thus, tax payer does not perceive a direct pinch while paying indirect taxes.

5. **Inflationary:** Tax imposed on commodities and services causes an all-round price spiral. In other words, indirect taxation directly affects the prices of commodities and services and leads to inflationary trend.

6. **Wider tax base:** Unlike direct taxes, the indirect taxes have a wide tax base. Majority of the products or services are subject to indirect taxes with low thresholds.

7. **Promotes social welfare:** High taxes are imposed on the consumption of harmful products (also known as ‘sin goods’) such as alcoholic products, tobacco products etc. This not only checks their consumption but also enables the State to collect substantial revenue.

8. Regressive in nature: Generally, the indirect taxes are regressive in nature. The rich and the poor have to pay the same rate of indirect taxes on certain commodities of mass consumption. This may further increase the income disparities between the rich and the poor.

1.6 Difference between direct taxes and indirect taxes

The distinction between direct and indirect taxes is the common and popular one. Prof.Dalton made a distinction between direct and indirect taxes as “ a direct tax is really paid by a person on whom it is legally imposed, while an indirect tax is imposed on one person, but paid partly or wholly by another owing to consequential change in terms of some contact or bargaining between them.”

According to J.S Mill, “A direct tax is one, demanded from every person who is intended or desired, should pay it .Indirect taxes are those which are demanded from one person in the expectation and intention that he shall identify himself at the expenses of another,”

Serial. No.	Basis of Distinction	Direct Tax	Indirect Tax
1.	Incidence of Tax	The person paying the tax to the Government directly bears the incidence of the tax(i.e. impact and incidence falls on the same person)	The person paying the tax to the Government collects the same from the ultimate consumer. Thus, incidence of the tax is shifted to the other person (i.e. impact and incidence falls on different persons)
2.	Nature	Progressive in nature – high rate of taxes for people having higher ability to pay.	Regressive in nature - All the consumers equally bear the burden irrespective of their ability to pay.
3.	Levied	Direct taxes are levied on income or property	Indirect taxes are levied on home trades and foreign trades and also on services.
4.	Rate	Rate of taxes are different at different range of income.	Rate of duties varies with the type of commodity & Service
5.	Distribution of Revenue	Entire revenue goes to Central Government of India.	Revenue goes to Central Government of India, State Government and Union Territories.
6.	Previous year	Previous year income is assessed in the assessment year.	There is no previous year and assessment year concept
7.	Monitoring	Monitored by Central Board of Direct Taxes (CBDT)	Monitored by Central Board of Indirect Taxes & Customs (CBIC)

8.	Occurrences	Direct taxes become payable after the benefit/ income reaches the tax payer	Indirect taxes are payable even before the goods/services reach the tax payer.
9.	Examples	Income tax, corporation tax are main sources of direct tax	Customs and GST are major indirect taxes in India.

1.7 HISTORY of Income Tax

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

1.8 PRESENT ACT:

On the recommendation of Law commission and Direct taxes enquiry committee and in consultation with law ministry a bill was framed. This bill was referred to a select committee and finally passed in September 1961. This act came into force from 1st April 1962 in whole of the country. Income tax act 1961 is comprehensive act and consists of 298 sections, sub sections running into thousands, schedules, rules and sub rules etc. and is supported by other acts and rules. This act has been amended by several amending acts since 1961. the annual finance bills presented to parliament along with budget make far reaching amendments in this act every year.

1.9 CONSTITUTIONAL VALIDITY OF TAXES

The Constitution of India is the supreme law of India. It consists of a Preamble, 22 parts containing 444 articles and 12 schedules. Any tax law, which is not in conformity with the Constitution, is called ultra vires the Constitution and held as illegal and void. Some of the provisions of the Constitution are given below: Article 265 of the Constitution lays down that no tax shall be levied or collected except by the authority of law. It means tax proposed to be levied must be within the legislative competence of the legislature imposing the tax¹. Article 246 read with Schedule VII divides subject matter of law made by legislature into three categories

- Union list (only Central Government has power of legislation on subject matters covered in the list)
- State list (only State Government has power of legislation on subject matters covered in the list)
- Concurrent list (both Central & State Government can pass legislation on subject matters). If a state law relating to an entry in List III is repugnant to a Union law relating to that entry, the Union law will prevail, and the state law shall, to the extent of such repugnancy, be void. (Article 254).

1.10 FUNDAMENTAL CONCEPTS:

1.10.1 ASSESSMENT YEAR (A.Y.) [SEC. 2(9)]

Assessment year means the period of 12 months commencing on the 1st day of April every year. It is the year (just after the previous year) in which income earned in the previous year is charged to tax. E.g., A.Y. 2019-20 is a year, which commences on April 1, 2019 and ends on March 31, 2020. Income of an assessee earned in the previous year 2018-2019 is assessed in the A.Y. 2019-20. Taxpoint:

- Duration: Period of 12 months starting from 1st April.
- Relation with Previous Year: It falls immediately after the Previous Year.
- Purpose: Income of a previous year is assessed and taxable in the immediately following Assessment Year.

1.10.2 PREVIOUS YEAR [SEC.3]

Previous Year means the financial year immediately preceding the Assessment Year. Income earned in a year is assessed in the next year. The year in which income is earned is known as Previous Year and the next year in which income is assessed is known as Assessment Year. It is mandatory for all assessee to follow financial year (from 1st April to 31st March) as previous year for Income-Tax purpose. Financial Year According to sec. 2(21) of the General Clauses Act, 1897, a Financial Year means the year commencing on the 1st day of April. Hence, it is a period of 12 months starting from 1st April and ending on 31st March of the next year. It plays a dual role i.e. Assessment Year as well as Previous Year. Example: Financial year 2019-20 is

- Assessment year for the Previous Year 2018-19; and
- Previous Year for the Assessment Year 2020-21.

1.10.3 ASSESSEE [SEC 2(7)]

“Assessee” means, a. a person by whom any tax or any other sum of money (i.e., penalty or interest) is payable under this Act (irrespective of the fact whether any proceeding under the Act has been taken against him or not); b. every person in respect of whom any proceeding under this Act has been taken (whether or not he is liable for any tax, interest or penalty) for the assessment of his income or loss or the amount of refund due to him; c. a person who is assessable in respect of income or loss of another person; d. every person who is deemed to be an assessee under any provision of this Act; and e. a person who is deemed to be an ‘assessee in default’ under any provision of this Act. E.g. A person, who was liable to deduct tax but has failed to do so, shall be treated as an ‘assessee in default’.

1.10.4 PERSON [SEC. 2 (31)]

The term person includes the following:

- (i) an Individual;
- (ii) (ii) a Hindu Undivided Family (HUF);
- (iii) (iii) a Company;
- (iv) a Firm;
- (v) an Association of Persons (AOP) or a Body of Individuals (BOI), whether incorporated or not;
- (vi) a Local authority; &
- (vii) every artificial juridical person not falling within any of the preceding categories.

Notes 1. On the basis of a well settled principle that “the Crown cannot be charged to tax”, it can be said that unless otherwise specifically mentioned the Union Government cannot be taxed in India.

2. An association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains. 3. A firm includes limited liability partnership.

1.10.4.a. Individual

The word ‘individual’ means a natural person, i.e. human being. “Individual” includes a minor or a person of unsound mind. However, Deities are assessable as juridical person. Trustee of a discretionary trust shall be assessed as an individual

1,10.4. b Hindu Undivided Family (HUF)

A Hindu Undivided Family (on which Hindu law applies) consists of all persons lineally descended from a common ancestor & includes their wives & unmarried daughters.

Tax point:

- Only those undivided families are covered here, to which Hindu law applies. It also includes Jain and Sikh families.
- Once a family is assessed as Hindu undivided family, it will continue to be assessed as such till its partition.

1.10.4.c Company [Sec. 2(17)]

Company means: a. any Indian company; or b. anybody corporate, incorporated under the laws of a foreign country; or c. any institution, association or body which is or was assessable or was assessed as a company for any assessment year on or before April 1, 1970; or d. any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Central Board of Direct Taxes to be a company.

Indian Company [Sec. 2(26)]

An Indian company means a company formed & registered under the Companies Act, 1956 & includes a. a company formed and registered under any law relating to companies formerly in force in any part of India other than the state of Jammu & Kashmir and the Union territories specified in (c) infra; b. a company formed and registered under any law for the time being in force in the State of Jammu & Kashmir; c. a company formed and registered under any law for the time being in force in the Union territories of Dadar & Nagar Haveli, Goa, Daman & Diu and Pondicherry; d. a corporation established by or under a Central, State or Provincial Act; e. any institution, association or body which is declared by the Central Board of Direct Taxes (CBDT) to be a company u/s 2(17). In the aforesaid cases, a company, corporation, institution, association or body will be treated as an Indian company only if its registered office or principal office, as the case may be, is in India.

Domestic Company [Sec. 2(22A)]

Domestic company means: i) an Indian company; or ii) any other company, which in respect of its income liable to tax under the Act, has made prescribed arrangements for the declaration and payment of dividends (including dividend on preference share), payable out of such income, within India.

Foreign Company [Sec. 2(23A)]

Foreign company means a company which is not a domestic company.

Company in which public are substantially interested [Sec. 2(18)]

Following companies are said to be a company in which public are substantially interested:

1. Government Company;
2. A company u/s 8 of the Companies Act, 2013;
3. Mutual benefit finance company;
4. Listed company;
5. Company in which shares are held by co-operative societies;
6. Company which is prescribed by CBDT

1.10.4.d Firm

As per sec. 4 of Indian Partnership Act, 1932, partnership means “relationship between persons who have agreed to share profits of the business carried on by all or any one of them acting for all”. Persons, who enter into such business, are individually known as partners and such business is known as a Firm. A firm is, though not having a separate legal entity, but has separate entity in the eyes of Income-tax Act

Tax point:

- ◆ A partnership firm is a separate taxable entity apart from its partners.
- ◆ In Income tax, a Limited liability partnership shall be treated at par with firm.

Association of Persons (AOP) or Body of Individuals (BOI)

An AOP means a group of persons (whether individuals, HUF, companies, firms, etc.) who join together for common purpose(s). Every combination of person cannot be termed as AOP. It is only when they associate themselves in an income-producing activity then they become AOP. Whereas, BOI means a group of individuals (individual only) who join together for common purpose(s) whether or not to earn income. Co-heirs, co-donees, etc joining together for a common purpose or action would be chargeable as an AOP or BOI. In case of income of AOP, the AOP alone shall be taxed and the members of the AOP cannot be taxed individually in respect of the income of the AOP

1.11 HEADS OF INCOME [SEC. 14]

According to Sec.14 of the Act, all income of a person shall be classified under the following five heads:

1. Salaries;
2. Income from house property;

3. Profits and gains of business or profession;

4. Capital gains;

5. Income from other sources.

For computation of income, all taxable income should fall under any of the five heads of income as mentioned above. If any type of income does not become part of any one of the above mentioned first four heads, it should be part of the fifth head, i.e. Income from other sources, which may be termed as the residual head.

Significance of heads of income

- Income chargeable under a particular head cannot be charged under any other head.
- The Act has self-content provisions in respect of each head of income.
- If any income is charged under a wrong head of income, the assessee may lost the benefit of deduction available to him under the correct head.

Distinguish between Heads of income and Sources of income

There are only five heads of income as per Sec. 14 of the Act, but the assessee may generate the income from various sources. In the same head of income, there may be various sources of income. E.g. under the head 'Income from house property', there may be two or more house properties and each house property shall be termed as a source of income. The source of income decides under which head (among the five heads) income shall be taxable.

1.12 GROSS TOTAL INCOME (GTI) [SEC. 80B (5)]

Gross total income is the aggregate of income under all the five heads of income after adjusting the set-off & carry forward of losses. Deductions under chapter VIA is provided from GTI, to arrive at Total income or taxable income.

Computation of Total Income for the A.Y. ____

Particulars	Amount
Salaries	
. Income from house property	
Profits and gains of business or profession	
Capital gains	

. Income from other sources	
Gross Total Income	
Less: Deduction u/s 80C to 80U	
Taxable Income	