



CONCEPT OF TOTAL INCOME

To understand Total Income one must know the following:

- (A) **Definition of Income.**
- (B) **Concept of Income.**
- (C) **Gross Total Income.**
- (D) **Deductions permissible from Gross Total Income**

(A) DEFINITION OF INCOME [SECTION 2(24)]: Income includes:

- (i) profits and gains;
- (ii) dividend;
- (iia) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes or by an association or institution referred to in clause (21) or clause (23), or by a fund or trust or institution referred to in sub-clause (iv) or sub-clause (v) or by any university or other educational institutions referred to in sub-clause (iiia) or sub-clause (vi) or by any hospital or other institutions referred to in sub-clause (iiiae) or sub-clause (via) of clause (23C) of section 10 or by an electoral trust;
- (iii) the value of any perquisite or profit in lieu of salary taxable under clauses (2) and (3) of section 17;
- (iiia) any special allowance or benefit, other than perquisite included under sub-clause (iii), specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit;
- (iiib) any allowance granted to the assessee either to meet the personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living;
- (iv) the value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company, or by a relative of the director or such person, and any sum paid by any such company in respect of any obligation which, but for such payment, would have been payable by the director or other person aforesaid;
- (iva) the value of any benefit or perquisite, whether convertible into money or not, obtained by any representative assessee mentioned in clause (iii) or clause (iv) of sub-section (1) of section 160 or by any person on whose behalf or for whose benefit any income is receivable by the representative assessee (such person being hereafter in this sub-clause referred to as the 'beneficiary') and any sum paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary;
- (ivb) any sum chargeable to Income-tax under clauses (ii) and (iii) of section 28 or section 41 or section 59;



- (va) any sum chargeable to Income-tax under clause (iiia) of section 28;
- (vb) any sum chargeable to Income-tax under clause (iiib) of section 28;
- (vc) any sum chargeable to Income-tax under clause (iiie) of section 28;
- (vd) the value of any benefit or perquisite taxable under clause (iv) of section 28;
- (ve) any sum chargeable to Income-tax under clause (v) of section 28;
- (vi) any capital gains chargeable under section 45;
- (vii) the profits and gains of any business of insurance carried on by a mutual insurance company or by a co-operative society computed in accordance with section 44 or any surplus taken to be such profits and gains by virtue of provisions contained in the First Schedule;
- (viii) the profits and gains of any business (including providing credit facilities) carried on by a co-operative society with its members;
- (ix) any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever;

For the purpose of this sub-clause-

- (1) "lottery" shall include winnings from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever under any scheme or arrangement by whatever name called;
 - (2) "card game and other game of any sort" shall include any game show, an entertainment programme on television or electronic mode, in which people compete to win prizes or any other similar game.
- (x) any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or any fund set up under the provisions of the Employees' State Insurance Act, 1948 or any other fund for the welfare of such employee;
 - (xi) any sum received under a Key-man Insurance Policy including the sum allocated by way of bonus on such policy;
 - (xii) any sum referred to in clause (va) of section 28;
 - (xiii) any sum referred to in clause (v) of sub-section 2 of section 56;
 - (xiv) any sum referred to in section 56(2)(vi).
 - (xv) any sum of money or value of property referred to in section 56(2)(vii) and (viii).
 - (xvi) any consideration received for issue of shares as exceeds the fair market value of the shares referred to in clause (viib) of sub-section (2) of section 56.



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(xvii) any sum of money referred to in clause (ix) of sub-section (2) of section 56.

Income is a word of wide import: The Supreme Court in **Dooars Tea Co. Ltd. v CIT** has held that the word 'income' is of the widest amplitude and it must be given its natural and grammatical meaning.

Inclusive definition, not exhaustive: The definition of the term 'income' starts with the word includes; the list is inclusive and not exhaustive. The Supreme Court in **CIT v Karthikeyan (G.R.) [(1993) 201 ITR 866 (SC)]** has held that the purpose of the inclusive definition is not to limit the meaning but to widen its net, and the several clauses therein are not exhaustive of the meaning of income; even if a receipt did not fall within the ambit of any of the clauses, it might still be income if it partakes of the nature of income.

Nomenclature used by the parties unhelpful: It has been held that the nomenclature used by the parties in describing a particular receipt as income or otherwise (such as, compensation, damages, etc., betokening a capital affair) in their correspondence or the treatment by the parties in their accounts of the receipts as income receipts, though helpful, is not decisive of the character of the receipts.

(B) CONCEPT OF INCOME

All receipts are not assessable to tax. All receipts by an assessee cannot necessarily be deemed to be income of the assessee for the purpose of income-tax and the question whether any particular receipt is income or not depends on the nature of the receipt and the true scope and effect of the relevant taxing provision **[Mehboob Productions (P) Ltd. v CIT (1977) 106 ITR 758 (Bom)]**. The income-tax authorities cannot assess all receipts; they can assess only those receipts that amount to income. Therefore, before they assess a receipt, they must find that to be income. They cannot find so unless they have some material to justify their finding. **[Lal Chand Gopal Das v CIT (1963) 48 ITR 324 (All)]**.

Reimbursement of expenses does not amount to income: No part of reimbursement of specific and actual expenses received by the assessee which do not involve any mark up can be treated as income of the assessee. **[Linklaters LLP v ITO (2010) 132 TTJ 20 (Mum)]**.

Excess cash received from customer is not income: Excess cash received at the cash counters of the bank represents the liability to pay to the customers as and when they may demand payment, therefore such excess cash collection cannot be considered as the income of the assessee. **[CIT v Balik of Rajasthan Ltd (2010) 233 CTR 530 (Bom)]**.

The interest on interest free loans availed by assessee from two companies in which she was a director could not be treated as her deemed income in terms of section 2(24)(iv) of the Act. **[CIT v Madhu Gupta (2012) 205 Taxman 303 (P&H)]**.



In the facts of **CIT v State Farming Corporation of Kerala Ltd. [(1989) 180 ITR 669 (Ker)]**, it has been held that the penalties levied by the assessee on the contractors were not receipts of the assessee but were only by way of reduction of expenditure and, therefore, not taxable.

Generally speaking, the word 'Income' covers receipts in the shape of money or money's worth which arise with certain regularity or expected regularity from a definite source. However, all receipts do not form the basis of taxation under the Act. Broadly, an analogy is drawn of a tree and the fruits of that tree. The tree symbolises the source from which one gets fruits which symbolises 'Income'. The receipt arising from the sale of tree itself is, therefore, considered a capital receipt which is not income; but the receipts flowing from this source viz., fruits is income. On application of this analogy, it can be said that while the receipt arising from the sale of a house is not income, the receipt arising from the realisation of rent is income. In the same way, receipt from the sale of a machine is not income but from the sale of produce brought out from the machine is income. In these cases, however, if a person deals in purchase and sale of house properties or machines, these assets do not remain a source and the profit derived from activities of purchase and sale becomes income. The source need not necessarily be tangible as the return for human exertion is also income.

1. The above is a broad generalisation. While a distinction is generally made between the capital receipt and revenue receipt, as illustrated above, the Act has widened the scope of income by expressly including within the meaning of "Income", the receipts which do not fall under the broad concept explained above. For instance, the Act specifically makes the profit arising from the sale of certain capital assets also subject to tax under certain circumstances as income under the head Capital Gains. The winnings from lotteries, crossword puzzles, races, card games, etc. which do not arise from any definite source and do not have the element of regularity have also been specifically clarified to be 'Income' under the Act.

Similarly, gifts exceeding aggregate amount of ₹ 50,000 in a previous year, from unrelated persons shall also be treated as income as per section 56(2)(vii). Further, gift of immovable property and specified moveable property exceeding aggregate amount of ₹ 50,000 on or after 1.10.2009 shall also be treated as income of the recipient as per section 56(2)(vii).

2. It is not the gross receipts but only the net receipts arrived at after deducting the related expenses incurred in connection with earning such receipts, that are made the basis of taxation.
3. Some important principles which explain the importance of income for income-tax purpose are given below:

- (i) **Regularity of Income:** Income connotes periodical monetary return coming in with some sort of regularity or expected regularity from definite sources. The source is not necessarily one which is expected to be continuously productive but it must be one whose object is production of a definite return, excluding anything in the nature of a mere windfall. However, this does not mean that income which does not arise regularly will not be treated as income for tax purposes e.g. winnings from lotteries, etc.



- (ii) **Form of Income:** The income received by the assessee need not be in the shape of cash only. It may also be some other property or right which has monetary value. **[CIT v Central India Industries Ltd. (1971) 82 ITR 555 (SC)]**. Wherever income is received in kind like perquisites then their value has to be found as per the rules prescribed and this value shall be taken to be the income.
- (iii) **Tainted/Illegal Income:** Income is income, though tainted. For purposes of Income-tax, there is no difference between legal and tainted income. Even illegal income is taxed just like any legal income. By taxing such income, the State is not taking part in the crime or condoning it, nor would it become a principal or a sharer in the illegality. The revenue merely looks at an accomplished fact, viz, on profits having been earned and assess the same.
- (iv) **Application of Income v Diversion:** Where an assessee applies an income to discharge an obligation after the income reaches the hands of the assessee, it would be an application of income and this would result in taxation of such income in the hands of the assessee. However, where there is a diversion of income before it reaches the hands of the assessee, it cannot be treated as an income of the assessee.

Diversion or application of income: An obligation to apply the income in a particular way before it is received by the assessee or before it has accrued or arisen to the assessee results in the diversion of the income. On the other hand, an obligation to apply income which has accrued or arisen or has been received amounts merely to the apportionment of the income, and not to its diversion. **[Raja Bejoy Singh Dudhuria v CIT (1933) 1 ITR 135 (PC)]**.

Where the income accrues to the assessee directly and is merely applied, upon such accrual, to discharge an obligation of the assessee, it is a case of mere application of the income of the assessee. **[Vibhuti Glass Works v CIT (1989) 177 ITR 439 (SC)]**.

Payment made by assessee to its retiring partners were a self-imposed obligation being gratuitous and hence, application of income not allowable as deduction. **[S.B. Billimoria & Co. v ACIT (2010) 125 ITD 122 (Mum)]**.

It is not every obligation to apply income in a particular way that results in diversion of income before it reaches the assessee. Unless and until there is an overriding obligation, the amount received from the assessee cannot be treated as income of the person receiving the amount. **[Arvind Singh v CIT (1986) 160 ITR 908 (Raj)]**.

In case of diversion of income by overriding title, person in whose favour income is to diverted should be aware about exact amount of such income which it has earned. If such fact is not proved to the satisfaction of Assessing Officer, such income shall be taxable in the hands of the recipient. **[U.P. Bhumi Sudhar Nigam v CIT (2005) 280 ITR 197 (All)]**.

True Test: In order to decide whether a particular disbursement amounts to diversion or application of income, the true test is to probe into, and decide, whether the amount sought to be deducted, in



truth, did not or did reach the assessee as his own income. Obligations are there in every case, but it is the nature of the obligation which is the decisive factor. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be part of his income of the assessee. Whereby the obligation, income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence in law does not follow. It is the first kind of payment which can truly be excused and not the second. The second payment is merely an obligation to pay another a portion of one's own income which has been received and is since applied. The first is a case in which the income never reaches the assessee, who even if he were to collect it, does so, not as part of his income but for and on behalf of the person to whom it was payable. **[CIT v Sitaldas Tirathdas (1961) 41 ITR 367 (SC)].**

It is only when income or a portion of income is diverted at the source by an overriding title before it started flowing into the channel which was to reach the assessee concerned that it could be excluded from his assessable income. **[CIT v L. Bansi Dhar (1968) 67 ITR 374 (Del)].**

If the obligation is on the receipt of the income and not on the source of it, the legal effect is different. In the one case, income is diverted at source and hence cannot be deemed to have accrued or arisen therefrom. In the other case, the income has accrued and therefore, it has to be applied in a particular manner. In the former case, the income is not included at all. In the latter case it is.

- (v) **Disputed Income:** Any dispute regarding the title of the income cannot hold up the assessment of the income in the hands of the recipient. The recipient is, therefore, chargeable to tax though there may be rival claims to the source of the income.
- (vi) **Contingent income:** A contingent income is not income. Until the contingency has happened, it cannot be postulated that income has accrued or has arisen to the assessee. **[Franklin v IRC 15 TC 464].**
- (vii) **Basis of Income:** Income can be taxed on receipt basis or on accrual basis. In case of income from business or income from other sources, the taxability would depend upon the method of accounting adopted by the assessee, while in other cases, it would generally be taxed on receipt or accrual basis, whichever happens earlier. However, a contingent income i.e. an income which may or may not arise can not be taxed unless and until such contingency actually occurs and the income arises to the assessee.
Tuition fees received in advance can be charged to tax only to the extent of receipt which accrued to the assessee as income during the relevant previous year and not for the entire receipts. **[Career Launcher (India) Ltd. v ACIT (2011) 56 DTR 10 (Del)(Trib)]**
- (viii) **Personal Gifts:** Gifts received by the employee from his employer valuing in excess ₹ 5,000 is to be included in the gross salary of the employee.



As per section 56(2)(vii), gift received from unrelated persons shall be fully taxable if the aggregate sum of money received as gift from one or more person exceeds ₹50,000. Gift in kind received from unrelated persons shall also be taxable in certain cases.

(ix) Gift received by a businessman/professional vis-a-vis gift received during the course of business or profession:

If the recipient of the gift is a businessman or a professional, the fact does not alter the character of the thing given. Hence, it will be treated as personal gift and its treatment shall be same as given in (viii) above. On the other hand, if the gift is received during the course of carrying on any business or profession it will be taxable as per section 28(iv) being the value of benefit or perquisite, whether convertible into money or not, arising from business or exercise of a profession.

Whether this is so or not in any given case would depend upon so many considerations such as, the nature of the business, the relationship between the giver of the gift and the recipient and various other circumstances.

Where the devotees out of natural love and affection and veneration used to assemble in large numbers on the birthdays of the assessee and voluntarily made gifts, it cannot be said that the amount received by the assessee by way of gift would amount to vocation or profession since it is not the case of the Department that the devotees were compelled to make gifts on the occasion of the birthday of the assessee and therefore the same were not taxable as income in the hands of the assessee. **[CIT v Gopala Naicker Bangaru (2010) 46 DTR 280 (Mad)]**. However, the aggregate amount of such gifts shall now be taxable as per section 56(2)(vii).

(x) Composite Income: Income-tax is a composite tax on all incomes received by or arising to a tax payer during a year. Therefore, tax will be imposed on the aggregate of all incomes earned/received by the assessee during the year.

(xi) Pin Money: Pin money received by a woman for her dress or private expenditure as also small savings effected by a housewife out of moneys given to her by her husband for running the expenses of the kitchen would not be income in the eyes of the law. Any property acquired with the aid of such money or savings would form a capital asset belonging to the lady. **[Naidu (RBNJ) v CIT (1956) 29 ITR 194 (Nag)]**.

(xii) Lump sum Receipt: If a receipt is an income then whether it is received in lump sum or in installments would not affect its taxability; for example, if a person receives arrears of salary in a lump sum amount, it would still be his income.

(xiii) Income must come from outside: A person cannot earn income from himself. In case of mutual activities, where some people contribute to the common fund and are entitled to participate in the fund and a surplus arises which is distributed to the contributors of the fund, such surplus cannot be called income. Further, it is not necessary for the mutual concern to distribute the surplus immediately. The participation in the surplus may be by way of reduction in future contribution or division of surplus on dissolution.



The fact that the mutual concern is incorporated as a company does not make any difference because incorporation does not destroy the identity of the contributors and participators.

The income of a mutual concern is exempt from tax as far as it is derived from activities of mutual nature. The income of trading, so far it is confined to own members are also exempt. Where a mutual concern derives any income from an outsider such income shall not be exempt.

(xiv) Voluntary payments (outside employment): Payment made by way of donation to a friend or a relation or a stranger or a company or a club out of benevolence or feeling of charity would not entail income in the hands of the recipient. Even if such payments happen to be made periodically at stated intervals in a definite sum, they would still remain donations.

(xv) Receipts due to pure chance: Although receipts due to pure chance are normally not income but the definition of income was amended by Finance Act, 1972 to specifically include the following as income.

Any winning from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever.

Winnings of lottery, etc.: In this case, the Supreme Court has held that the word income should be given its ordinary, natural and grammatical meaning. It should be given its widest connotation in view of the fact that it occurs in a legislative head conferring legislative power. The word "winnings" cannot be interpreted to mean only winnings from gambling/betting activities and that winnings from non-gambling and non-betting activities are not included. The words 'other games of any sort' were of wide amplitude and their meanings were not confined to mere gambling or betting activities.

A motor car rally is a contest if not a race. The assessee entered the contest to win it. The prize he got was a return for his skill and endurance. It was income construed in its widest sense. Though, it was casual in nature, it was nevertheless income. **[CIT v Karthikeyan (G.R.) (1993) 201 ITR 866 (SC)].**

(xvi) Compensation for death on account of fatal accident or fatal injuries sustained by the deceased: Any such compensation cannot be said to possess the attributes of income. **[CIT v Fletcher (1937) 5 ITR 428].**

(xvii) Payment by an insurer of sums insured ill life or endowment policies: Such payments carry no income content.

(xviii) Charity levies: Indian traders and businessmen charge their customers or clients a small fee on each transaction - for example, so many pies per bag of some commodity sold, the proceeds of which are supposed to be devoted to various religious, charitable or educational purposes. Such customary receipts and the corresponding expenditure should be left out of account altogether for income-tax purposes.

The vendor is not the beneficial owner and no portion of the fee could be regarded as an income arising from the vendor's business. **[Agra Bullion Exchange Ltd. v CIT (1961) 41 ITR472 (All)].**



Dharmada receipts: For such receipts, the Supreme Court has held that the amounts of dharmadas are undoubtedly a payment which a customer is required to pay in addition to the price of the goods which he purchases from the assessee, but the purchase of the goods by the customer would be the occasion and not the consideration for the dharmada amount taken from the customer. Such realisations made by the assessee from its customers for dharmada, if validly earmarked for charity or charitable purposes, could not be regarded as the assessee's income chargeable to income tax. **[CIT v Bijli Cotton Mills (P) Ltd. (1979) 116 ITR 60 (SC)].**

If laga receipts are collected by a trader in cotton along with sale price which are to be applied for charitable purposes then such receipts, having regard to the circumstances of the collection and the nature of the impost, do not constitute income in the hands of the trader as they are impressed initially with an obligation in the nature of trust. **[CIT v Chudgar Ranchhodlal Jethalal 1978 CTR 671 (Guj)].**

(xix) Revenue Receipt v Capital Receipt: Section 4 brings to charge tax on total income. Prima facie, in order to come within the scope of the charging provision, the receipt in question should normally be a revenue receipt. Capital receipts are normally exempt. However, certain capital receipts have been specifically included in the definition of income, some of which are:

- (a)** Income by way of capital gains [Section 45];
- (b)** Compensation for modification/termination of services [Section 17(3)(i)];
- (c)** Amount due to or received whether in lump sum or otherwise by any assessee from any person before joining his employment or cessation of his employment [Section 17(3)(iii)];
- (d)** Compensation or other payment due to or received by some specified person covered under section 28(ii)(a), (b), (c) and (d);
- (e)** Any sum whether received or receivable in cash or in kind under an agreement for not carrying out any activity in relation to a business or not sharing any know-how, patent, copyright, trade mark, license, etc. [Section 28(va)];
- (f)** Voluntary contributions received by a trust/institution created wholly or partly for charitable or religious purposes or by certain other specified institutions [Section 2(24)(iia)];
- (g)** W.e.f. 1.4.2006, gift of money, though capital receipt, shall be taxable if the same is received from unrelated persons and the aggregate sum of money received as gift from one or more person exceeds ₹ 50,000;
- (h)** Gift of immovable property or gift of movable property shall be taxable in certain cases if the same is received from unrelated persons. [Section 56(2)(vii)];
- (i)** Shares acquired by a firm or a closely held company without consideration or for inadequate consideration shall be taxable in certain cases [Section 56(2)(viiia)];
- (j)** Any consideration received for issue of shares as exceeds the fair market value of the shares referred to in section 56(2)(viib).



A capital receipt is generally exempt from tax unless it is expressly taxable under section 45. [**Cadell Weaving Mills Co. P. Ltd v CIT(2001) 249 Taxman 265 (80m)**].

On the other hand, there are certain receipts which are though revenue receipts but do not form part of total income.

(1) Tests relevant for determination of nature of receipts:

- (i) Capital sales versus business sales:** The receipt would be on capital account where the transaction merely amounts to change of investment or is for the purposes of realisation of capital. Where, however, such transaction is one entered into in the ordinary course of business, it would be a revenue receipt.

Profits arising from the sale of a capital asset are chargeable to tax as capital gains under section 45 whereas profits arising from the sale of a trading asset, being of revenue nature, are taxable as income from business under section 28 provided that the same is in the regular course of assessee's business, or the transaction constitutes an adventure in the nature of trade.

- (ii) Nature of the initial receipt an important factor:** The character of the receipt at its initial stage plays a vital role in determining whether it is a capital or revenue receipt. This is clear from the decision of the Court of Appeal in **Morley v Tattersall TC 13R 264** in which it was held that if a particular amount is not received as a trading receipt in the course of the business at the first instance, it would not subsequently be regarded as a trading receipt due to change of things or circumstances.

- (iii) Fixed capital versus circulating capital:** A receipt referable to a fixed capital is a capital receipt, while what is referable to circulating capital or stock in-trade of an assessee would be a revenue receipt. What is a fixed capital for a person may be a circulating capital for another. A machinery would be a fixed capital for a person who uses the same in his trade for manufacture of an article. While it would be circulating capital for the machinery manufacture. For an ordinary investor, shares would be fixed capital, but for a dealer in shares, it would be circulating capital. Profit or realisation of fixed capital would be on capital account, and may attract capital gain tax while the same on realisation of circulating capital would be a revenue receipt. The Supreme Court in **CIT v Vazir Sultan & Sons TC 38R 925** has applied this principle.

Where the assessee, a firm, was appointed as sole selling agent by a company manufacturing cigarettes for the Hyderabad State in the year 1931 and subsequently in the year 1939 that agency was extended even in respect of the sales outside the Hyderabad State but in the year 1950 the said agency was restricted and confined only to the Hyderabad State and payment was made to the assessee as compensation for the loss by way of restriction of the area of the agency, it was held that the agency formed the capital asset of the company and the amount received by the assessee as compensation was a capital receipt and not income from business. [**CIT v Vazir Sultan (1959) 36 ITR 175 (SC)**]. However, although it is capital receipt it has been specifically included as income under section 28(2)(i).



- (iv) **Test in the hands of the recipient:** In deciding whether a certain receipt is income or not, the test is its character in the hands of the recipient and not character in the hands of the payer, nor the fund out of which the money came. What may be regarded as capital in the hands of the payer may yet be income in the hands of payee. **[CIT v Vazir Sultan & Sons (1959) 36 ITR 175 (SC)]**.
Where the assessee had teak trees on her land which had been planted long ago, and which had been cut and completely removed from the land together with roots thereof for the purpose of rubber plantation on the land, it was held that the sale proceeds of the trees was not income liable to tax but was a capital receipt in the hands of the assessee. **[Vishnudatta Antharjanam (AKT.K.M.) v CAGIT (1970) 78 ITR 58 (SC)]**.
On the other hand where the trees were not removed with roots and the stumps of the trees were allowed to remain in the land so that the trees may regenerate, it is an income liable to tax under the Income-tax Act and is not capital receipt. **[Venugopala Verma Rajah v CIT (1970) 76 ITR 460 (SC)]**.
- (v) **Casual or recurring receipts:** One test that is sometimes adopted is whether the receipt is a casual receipt or whether it is a recurring receipt: if the former, it is capital: if the latter, it is revenue. But this is not an unfailing test, for an annual or periodic receipt may be capital, and a single receipt may yet be revenue. So also, it cannot be said that only recurring receipts can be income and all non-recurring receipts should always be capital in nature. **[Yogam (SMDP) v CIT (1985) 154 ITR 624 (Ker)]**.
- (vi) **Premium receipts:** Premium received by an owner in consideration of the grant by him of a licence to realise a capital asset belonging to the owner is capital, but any sum received by the owner for his allowing another to use the capital asset is revenue. **[Maharaja Chintamani Saran Nath Sah Deo v CIT(1961) 41 ITR 506 (SC)]**.
- (vii) **Payer's motive not material:** In determining whether a payment amounts to a return for loss of a capital asset or is income, profits or gains liable to tax, one must have regard for the nature and quality of the payment, if the payment was not received to compensate for a loss of profits of business, the receipt cannot properly be described as income, profits or gains as commonly understood. To constitute income, profits or gains, there must be a source from which the particular receipt has arisen, and a connection must exist between the quality of the receipt and the source. If the payment is by another person, it must be found out why that payment has been made. It is not the motive of the person who pays that is relevant. More relevance attaches to the nature of the receipt in the hands of the person who receives it though in trying to find out the quality of the receipt one may have to examine the motive out of which the payment was made. The fact that the amount paid was large or that it was periodic in character, or described as pay remuneration, etc., do not determine its quality **[Divecha (P.H.) v CIT (1963) 48 ITR 222 (SC)]**.
- (viii) **Profit motive:** The existence or absence of profit motive is also neither decisive nor conclusive for arriving at a decision whether a particular receipt is income or not because even in the absence of



a motive to earn income, the assessee may derive income and would still be chargeable to tax.

[Vishnudatta Antharfanam (A.K.T.K.M) v CAGIT (1970) 78 ITR 58 (SC)].

- (ix) **Nomenclature of transaction irrelevant:** The character of the receipt either as capital receipt or as income should not be based on the name given to the amount received by the assessee in his records because, in law, the real nature and character of the transaction must be determined in the light of the terms of the contract and the rights and obligations of the parties flowing therefrom unguided by the nomenclature of the transaction. **[National Cement Mines Industries Ltd. v CIT (1961) 42 ITR 69 (SC)]**

However, the nomenclature of the transaction or receipt as used by the parties may be of assistance to the Revenue to arrive at a view in regard to the intention of the party even though the nomenclature is not decisive particularly when the transaction is between two businessmen who are conversant with such phraseologies. **[CIT v Panbari Tea Co. Ltd. (1965) 57 ITR422 (SC)].**

A mere book-keeping entry cannot be income, unless income has actually resulted. **[CIT v Shoorji Vallabhdas & Co. (1962) 46 ITR 144 (SC)].**

- (x) **Entry in the books of account of a hypothetical income does not result ill income subject to tax:** Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz, the accrual of the income or its receipt; but the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book keeping, an entry is made about a "hypothetical income", which does not materialise. Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the income may be taxable. Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account. Where the company provided for additional remuneration to the directors subject to the approval of the Central Government but made no application for the approval and the directors forgo the additional remuneration prior to the end of the previous year, it was held that the additional remuneration does not accrue and is hence not taxable. **[Seth Madan Lal Modi v CIT(2003) 261 ITR 49 (Del)].**

Under the Income tax Act, income is to be computed not of the basis of accounting treatment but on the well-established principles of law interpreted by the Courts on the basis of law of income-tax. The company credited a certain percentage of the deposits collected from customers under a finance scheme as administrative and process charges in the profit and loss account. Later it filed a revised computation during the assessment proceedings claiming that the sum credited is part of the deposit received which is erroneously credited in the profit and loss account. It claimed that the receipt is capital in nature. It was held that the Court is compelled to go by the true nature of the receipts and not go by the entry in the books of account and therefore held that the entire receipt



of collection from the depositor is a loan sum being capital in nature despite being shown in the profit and loss account as income. **[CIT v Sahara Investment India Ltd. (2004) 136 Taxman 61 (All)].**

- (xi) **Treatment as income by the assessee is not conclusive:** A receipt which in law cannot be regarded as income cannot become so merely because the assessee has erroneously credited it to the profit and loss account. **[CIT v Stewarts & Lloyds of India Ltd. (1987) 165 ITR 416 (Cal); CIT v India Discount Co. Ltd. (1970) 75 ITR 191 (SC)].**
- (xii) **Disallowance in the hands of payer:** That the expenditure had been disallowed in payer's hands cannot be the basis for determining that it is not a revenue receipt in the hands of the recipient. The same should be viewed only from the recipient's angle. **[Lakshmi Rajyam v CIT (1960) 40 ITR 340 (Mad)].**
- (xiii) **Lump sum receipt versus receipt in instalments:** A revenue receipt may be received in single lump sum or a capital receipt may ensue through several instalments payments. **[CIT v Panbari Tea Co. Ltd. (1961) 57 ITR 422 (SC)].**

Where the assessee, who had served a company as director for a very long time desired to resign his directorship but was persuaded by the company not to resign and in consideration of the assessee acceding to the request, the company made lump sum payment to him, it was held that the lump sum amount received by the assessee was not a capital receipt but income in his hands being profit arising to him from his directorship. **[Cameron v Prendergast (Inspector of Taxes) (1940) 8 ITR Suppl (HL)].**

- (xiv) **Revenue receipts: Whether sums awarded by courts are income:** The Courts may give varied names to sum awarded like compensation but the courts have declined to be bound by labels and have always tried to look through it and to solve the question of substance by reference to the true character of the award. **[While v G & M Davies (1979) Simons TC 415 (Ch D)].**

(a) **Compensation, for land whether capital or revenue receipt:** Compensation received for immobolisation, sterilisation, destruction or loss, total or partial, of a capital asset is a capital receipt. Where compensation is recovered for an injury inflicted on a man's trading, so to speak, a hole in his profits, the compensation would fill that hole and would be a trading receipt. On the other hand, where the injury is inflicted on the capital assets of the trade, making, so to speak, a hole in them, the compensation recovered is meant to be used to fill that hole and is a capital receipt. **[CIT v Bombay Burmah Trading Corporation (1986) 161 ITR 386 (SC)]** Whether a particular receipt by way of compensation was capital or a revenue receipt had to be decided on a consideration of the legal basis of the claim. The fact that the measure or basis for the compensation was in relation to the assessee's profits, was not decisive of the nature of the receipt **[Associated Oil Mills Ltd. v CIT (1960) 40 ITR 118 (Mad)].** Nor can the matter of taxability or otherwise of a receipt be decided on the basis of the entries which the assessee may choose to make in his accounts; that has to be decided in accordance with the provisions of law **[Cf CIT v Mogul Line Ltd. (1962) 46 TC 590 (80m)].**



- (b) **Compensation received in respect of loss of a trading asset or stock-in trade:** A company entered into an agreement to develop some land belonging to a college. It undertook to erect houses on the lands, on completion of which the college was to grant to the company or its nominees leases of the lands at nominal rents for 99 years. A clause in the agreement enabled the college to vary the plan of development on due notice and to withdraw any plot from the scheme. Accordingly, the college served a notice withdrawing 87 plots and when the company objected that it was not a valid notice, the college paid £ 5,000 to the company to induce it to withdraw its objection. It was held that the sum of £ 5,000 so received by the company was a trading receipt, as the right to build on the plots was a trading asset or the stock-in-trade and not a capital sum, and further, that any sum received as compensation for such right ought to come into the trading account. **[Shadbolt v Salmon Estate 25 TC 52].**

The assessee firm which carried on the business of mining, held six mining leases. It transferred one of the mining leases for a certain consideration. The amount was not described as premium before the mining or Income-tax Authorities. Even after the transfer of the lease, the assessee's business had continued. It was held that the amount received constituted a business receipt. **[CIT v Lakshminarayana Mining Co. (1987) 165 ITR 326 (Kar)].**

- (c) **Compensation received for loss of profits:** Compensation received for loss of profits has the same characteristics as the type of receipts discussed immediately above. A company purchased the licence for producing certain dramatic plays in certain territories for a specified term and the licensor agreed that in those territories no talking film of the plays would be made. Subsequently, it was discovered that the film rights in those territories had already been sold by the licensor; thereupon, the licensee-company brought an action for damages which was awarded in a certain sum. It was held that the damages were income chargeable to income-tax and, further, that the damages were really the loss of profits which the assessee suffered by the breach. **[Vaughan v Archie Parnel & Alfred Zeitlin Ltd. 23 TC 505: (1942) 101 ITR Supp 17].**

Where the assessee, a cloth dealer, was awarded damages for the supply to it of a smaller quantity of cloth than the quota allotted to it, it was held that the damages were for the injury inflicted on his trading and hence for loss of profits. **[Trikamlal v CIT (1982) 134 ITR 450 (MP)].**

- (d) **Compensation for termination of agreement:** Where the agreement to run, manage and administer the hotel was entered into by the, assessee-company in the ordinary course of business, the compensation received on the termination of the agreement would be a trading receipt. **[CIT v Oberoi Hotels (India) Pvt. Ltd. (1994) 209 ITR 732 (Cal)].**

- (e) **Compensation received by purchaser from vendor for cancellation of contract to sell by the vendor:** The cancellation of a agreement leaves unaffected the structure of the business, and what all takes place in consequence of the cancellation is that the assessee loses a profitable



contract which has yet to run for a certain period of time, the assessee being able to carry on the same business (though, of course, by making alternative arrangements), the compensation paid represents profits which would have been earned in pursuance of the contract had it not been cancelled. It does not represent the purchase price of the contract itself. Hence, such compensation is income and not capital. **[Bush, Beach & Gent Ltd. v Road (1940) 8 ITR Supp 36].**

- (f) **Compensation received by the developer from the land owner on termination of development agreement:** Compensation received from the land owner on termination of development agreement was the deprivation of potential income and loss of future profits as mentioned in the settlement agreement and not for divesting the assessee of its earning apparatus, as restrictive covenant in the said agreement only prohibited the assessee from undertaking a similar project in the vicinity of the existing project without consent of the land owner for the limited duration of three years, and therefore; the compensation was a revenue receipt. **[Ansal Properties & Industries Ltd. v CIT (2011) 238 CTR 126 (Del)]**
- (g) **Compensation received by vendor from purchaser for cancellation of contract to buy by the purchaser:** A firm of ship-builders had entered into a contract to build ships for a purchaser. The purchaser was unable to complete the contract and, in order to free himself from the obligation to buy, made a lump sum payment to the ship builders as compensation for cancellation of the contract. It was held that it was a revenue receipt. **[Short Bros v IRC 12 TC 955 (CA)].**
- (xv) **Sales tax receipts and refunds:** It is now settled law that sales tax charged and collected from customers as part of the bills is in the nature of a trading receipt assessable to income-tax. In the case of an assessee who maintains his accounts on the mercantile system, sales tax collected but not paid to Government pending adjudication of dispute over his liability to pay sales-tax is a revenue receipt of the year in which it is collected. **[CIT v Naggi Reddy (T.) (1993) 202 ITR 253 (SC)].**
- (xvi) **Tax payable by assessee collected from customers:** The assessee, a dealer in grains and grocery, was under an obligation to pay mandi tax. The assessee collected the amount of tax from its customers and credited it in the balance sheet in that account. It was held that the assessee was not following the mercantile system of accounting and, as such, the mandi tax collected by him from the customers was liable to be taxed as its income. **[Dhariwal Sales Enterprises v CIT (1988) 171 ITR 212 (MP)].**
- (xvii) **Mesne profits:** The mesne profits received by the assessee under the consent decree granted by the Apex Court was capital receipt not chargeable to tax. **[Narang Overseas Pvt. Ltd. v ACIT(2008) 111 ITD 1 (Mum) (SB)].**



(2) Receipts on Capital Account

- (i) **Liquidated damages received in connection with a capital asset are capital receipt:** The damages received by the assessee were directly and intimately linked with the procurement of a capital asset viz, the cement plant. The amount received by the assessee towards compensation for sterilization of the profit earning source, not in the ordinary course of business was a capital receipt. **[CIT v Saurashtra Cement Ltd. (2010) 325 ITR 422 (SC)].**
- (ii) **Lump sum payment made gratuitously or by way of compensation or otherwise to widow/other heirs of an employee:** The Board has clarified lump sum payment made gratuitously or by way of compensation or otherwise to the widow or other legal heirs of an employee, who dies while still in active service, is not taxable as income under the Income-tax Act, 1961. **[Circular No. 573, dated 21.8. 1990: (1990) 185 ITR St. 31].**
- (iii) **Payment in lieu of alimony:** Where, under a decree, the assessee received, from her ex-husband, a lump sum together with a monthly alimony, it was held, that while the monthly alimony would be a taxable, the lump sum would be a capital receipt being in lieu of a capital asset viz. a right to get maintenance from her husband. **[Maheshwari Devi of Pratapgarh (Princess) v CIT (1984) 147 ITR 258 (Bom)].**
- (iv) **Amount received for surrendering leasehold rights:** The amount received by a lessee for surrendering his leasehold rights for the remaining period of the lease is in the nature of compensation and is, therefore, a capital receipt. The mere fact that the amount had been agreed to be received in monthly instalments cannot, by itself, be the sole criteria to hold that the receipt was a revenue receipt. **[CIT v Vardhini & Co. (1987) 165 ITR 342 (Kar)].**
- (v) **Compensation for deprivation of use and possession of the land:** The land of the assessee was unauthorisedly occupied and the civil suit instituted by the assessee for recovery of possession was decreed in his favour. During the pendency of the appeal, the parties arrived at a compromise where under the assessee was paid a sum which included what was styled as interest of a certain amount. It was held that the receipt was essentially in the nature of damages for use and occupation paid to the owner. It was compensation received by the owner for the deprivation of the use and possession of the land, and the receipt could not be included in the total income of the assessee. **[CIT v Italia (J.D.) (1983) 141 ITR 948 (AP)].**
- (vi) **Surrender of tenancy rights:** Amount received by way of consideration for relinquishment or surrender of tenancy rights is a capital receipt. However, such capital receipt is now chargeable to capital gains.
- (vii) **Transfer fees received by a co-operative housing society:** Normally the lease deed executed by a member of a co-operative society in favour of society stipulates that whenever a member makes a transfer of his flat or plot in favour of another person, he will have to pay to the society certain part of the premium received by him. In generic language, this is termed as transfer fees. The question is whether the amount which is received by the society pursuant to such stipulation is assessable to tax as its income. In the under noted case such receipt has been held taxable. **[CIT v Presidency Co-operative Housing Society**



Ltd. (1995) 216 ITR 321 (80m)]. However, later in the case of **Sind Co- operative Housing Society v ITO (2009) 182 Taxman 346 (80m)**, it was held that the amount received from outgoing and incoming members are not chargeable to tax, as it is surplus from mutual activity.

- (viii) **Compensation for termination of distributorship agreement is capital receipt:** Compensation for termination of a distributorship agreement would have the character of capital receipt, even if it were receivable in instalments. Where the termination of the agreement resulted in substantial loss and that this agreement coupled with the obligation on the part of the assessee, that it would not compete in the same line of business would mean that it would not be a revenue receipt. It was pointed out by the High Court that substantial loss had been incurred by the assessee as a result of the termination, so that the compensation should be treated as loss of a source. **[CIT v T. I. & M. Sales Ltd. (2003) 259 ITR 116 (Mad)** following the decision of the Supreme Court in **P.H. Divecha v CIT (1963) 48 ITR 222 (SC)]**. However, it shall be subject to the provisions of section 28(ii) if applicable.
- (ix) **Amount forfeited on account of non-payment of call money on debentures is capital receipt:** Where the assessee issues partly convertible debentures and forfeits application moneys for non-payment of call moneys, such forfeited amount would be on capital account, so that there can be no inference of a revenue element therein. **[Deepak Fertilisers and Petro Chemicals Corporation Ltd. v Deputy CIT (2008) 304 ITR (AT) 167 (Mumbai). See also Prism Cement Ltd. v JCIT (2006) 285 ITR AT 43 (Mum)]**.
- (x) **Forfeiture of application money is a capital receipt:** Similarly share application money forfeited and credited to the capital reserve shall not be taxable. **[DCIT v Brijlaxmi Leasing & Finance Ltd. (2009) 309 ITR (AT) 211 (Ahd)]**.
- (xi) **Compensation for denial of job on basis of gender discrimination:** Where the amount was received by way of compensation for denial of job on basis of gender discrimination, it was held that such amount is not in nature of "profit in lieu of salary". Such amount received shall be capital receipt thus not taxable. **[CIT v Rani Shankar Mishra (2010) 320 ITR 542 (Del)]**.
- (xii) **Compensation for termination of technical know-how agreement:** Compensation for termination of technical know agreement received from the foreign collaborator 'M' by the assessee does not represent a capital asset in the hand of the assessee. It was a case where only a limited right for limited period to use patent and trade mark was given to the assessee by M without parting with any of its assets, patent or trade mark. Object of the agreement was to grant benefit of technical assistance to the assessee only for running the business' of manufacture and sale of tyres and tubes. It did not create any right in favour of the assessee in any tangible asset so as to form a capital asset of enduring nature. Thus, the amount received by assessee from M consequent upon termination of the agreement was not against any price for relinquishment of any right in capital asset or for parting with any asset of enduring nature. It was a sum paid in the ordinary course of business to adjust the relations between assessee and M so that the agreement comes to an end amicably. Therefore, amount received by assessee upon termination of the agreement constituted a revenue receipt. **[S Kumars Tyre Manufacturing Company Ltd. v Commissioner of Income Tax (2009) 30 DTR (MP) 233]**.



- (xiii) **Interest on deposit of margin money for import of machinery before commencement of business:** Interest on deposit of margin money for opening of letter for credit for import of machinery at the stage of setting up of industrial unit of the assessee is a capital receipt and the same is to be set off against preoperative expenses. [CIT v Arihant Threads Ltd. (2011) 49 DTR 251 (P&H)].
- (xiv) **Income received on account of affirmative voting on a resolution is capital receipt:** Amount received by assessee for affirmative voting on a resolution was not a business receipt, but received as bounty or windfall for voting affirmatively and supporting a resolution and was a capital receipt. Amount received by Assessee as casual receipt in the nature of windfall and not repetitive in character would not amount to income and therefore, not liable to tax. [CIT v David Lopes Menezes (2010) 195 Taxman 131: (2010) Vol 112 (10) Born LR 4655].
- (xv) **Difference on account of exchange rate fluctuation on remittance of share capital raised abroad is capital receipt:** Where a company raised share capital abroad by way of global depository receipts and remitted the proceeds to India only on requirement, the entire difference on account of exchange rate fluctuation was in the nature of capital receipt and not chargeable to tax. [CIT v Jagatjit Industries Ltd. (2011) 337 ITR 21 (Del)].
- (xvi) **Subsidy received with reference to capital investment, is a capital receipt:** Subsidy received for setting up agro based industrial unit in backward area was determined with reference to capital investment, is a capital receipt. [CIT v Siya Ram Garg (HUE) (2011) 49 DTR 126 (P&H)].

(C) GROSS TOTAL INCOME

As per section 14, all income shall, for purposes of Income-tax and computation of total income, be classified under the following heads of income:

- (i) Salaries,
- (ii) Income from House Property,
- (iii) Profits and Gains of Business or Profession,
- (iv) Capital Gains,
- (v) Income from Other Sources.

Aggregate of incomes computed under the above 5 heads, after applying clubbing provisions and making adjustments of set off and carry forward of losses, is known as Gross Total Income (GTI). [Section 80B]

(D) TOTAL INCOME:

The total income of an assessee is computed by deducting from the gross total income, all deductions permissible under Chapter VIA of the Income-tax Act i.e., deductions under sections 80C to 80U.

Various provisions in the Act and their functions: Section 4 levies the charge on the total income, section 5 defines its range; section 6 lays down rules for determining residential status. Sections 10, 10A, 10AA and 10B list the incomes which do not form part of total income; section 14 classifies the total income, sections 15 to 59 quantify



it; sections 70 to 80 allows for set off or carry forward of losses while aggregating income under various heads. Section 80A to 80U allows deductions from gross total income while computing total income; section 139 deals with return of income; sections 143, 144 and 147 empowers the Assessing Officer to assess/reassess the said total income in the manner prescribed thereunder. Sections 190 to 219 give the provisions for collection of tax by deduction at source/payment of advance-tax. Sections 246 to 265 lay down the procedure of appeal. Sections 271 to 280 list the penalties impossible and various offences and prosecutions.

Rounding off of Total Income [Section 288A]

The total income, as computed above, shall be rounded off to the nearest multiple of ten rupees and for this purpose any part of a rupee consisting of paise shall be ignored. Thereafter if such amount is not a multiple of ten, then, if the last figure is 5 or more, the amount shall be increased to the next higher multiple of 10 and if the last figure of Total Income is less than 5, the amount shall be reduced to the next lower multiple of 10.

For example, if the total income is ₹ 5,79,467, it shall be rounded off to ₹ 5,79,470 and if it is ₹ 5,79,464.90, it shall be rounded off to ₹ 5,79,460.

How to compute tax liability on Total Income

On the Total Income, tax is calculated according to the rates prescribed under the relevant Finance Act.

The amount so computed, shall be increased by a surcharge, if applicable and education cess calculated @ 2% + SHEC @ 1 % of (tax + surcharge if any). The amount so arrived at is the tax liability of the person for that year. W.e.f. A.Y. 2010-11, the surcharge was applicable only in case of a company assessee. However, w.e.f. A.Y. 2014-15 surcharge has been made applicable to all assessees provided the total income of the assessee exceeds the specified amount.

Rounding off of tax, etc. [Section 288B]

The amount of tax (including tax deductible at source or payable in advance), interest, penalty, fine or any other sum payable, and the amount of refund due, under the provisions of the Income-tax Act, shall be rounded off to the nearest multiple of ten rupees and, for this purpose, where such amount after ignoring paise contains a part of ten rupees then, if such part is five rupees or more, it shall be increased to ten rupees and if such part is less than five rupees it shall be ignored. Paise for computing five rupees shall be ignored.



Interpretative Rules to Central Excise/ Customs Tariff Schedule

The Central Excise / Customs Tariff have a set of six rules for interpretation of the tariff schedule. They help in appropriate classification of goods. The six rules (Rule 1 – 6) of the General rules for the interpretation of the First Schedule to Central Excise Tariff Act are described as follows:

Rule 1: Section and Chapter titles have no legal validity: The titles of Sections, Chapters and Sub-Chapters are provided for ease of reference only; for legal purposes, classification shall be determined according to the terms of the headings and any relative Section or Chapter Notes and, provided such headings or Notes do not otherwise require, according to the provisions hereinafter.

Example: Note 2 to Chapter 42 provide that Chapter 42 does not cover cuff-links. Thus even if by application of the rules of interpretation, cuff-links may fall under Chapter 42, the cuff-links cannot be classified under Chapter 42 in view of express bar of Note 2.

Rule 2: Classification of incomplete / unfinished goods and of mixtures:

(a) Incomplete / unfinished or unassembled / disassembled goods or CKD (Completely Knocked Down) / SKD (Semi Knocked Down) goods — to be classified as complete / finished goods: Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also be taken to include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this rule), presented unassembled or disassembled.

Example: A furniture item would be classified as 'furniture', even if it is not yet polished.

(b) Mixtures or combinations of a material / substance: Any reference in a heading to a material or substance shall be taken to include a reference to mixtures or combinations of that material or substance with other materials or substances. Any reference to goods of a given material or substance shall be taken to include a reference to goods consisting wholly or partly of such material or substance. The classification of goods consisting of more than one material or substance shall be according to the principles of rule 3.

Example: The term 'gold' shall include a mixture of 'gold' with other materials.

Rule 3: Classification when goods classifiable under two or more headings: When by application of rule 2(b) or for any other reason, goods are, prima facie, classifiable under two or more headings, classification shall be effected as follows:



(a) Specific description heading to prevail over General description heading: The heading which provides the most specific description shall be preferred to headings providing a more general description. However, when two or more headings each refer to part only of the materials or substances contained in mixed or composite goods or to part only of the items in a set put up for retail sale, those headings are to be regarded as equally specific in relation to those goods, even if one of them gives a more complete or precise description of the goods.

Example: Suitcases are 'plastic articles', but, in view of specific heading relating to suit cases they will be classifiable under 'suit cases'.

(b) Essential character based classification: Mixtures, composite goods consisting of different materials or made up of different components, and goods put up in sets for retail sale, which cannot be classified by reference to (a), shall be classified as if they consisted of the material or component which gives them their essential character, insofar as this criterion is applicable.

Example: Though a pen stand may have a clock, but as per essential character principle, it continues to be 'pen stand' and does not become a clock.

(c) Latter the Better: When goods cannot be classified by reference to (a) or (b), they shall be classified under the heading which occurs last in numerical order among those which equally merit consideration.

Example: Heading 8215 covers spoons, forks, ladles, skimmers, fish-knives etc. while heading 7323 covers table, kitchen or other household articles of iron and steel. In order to classify steel forks, heading 8215 is preferred to heading 7323.

Rule 4: Akin Rule: Goods which cannot be classified in accordance with the above rules shall be classified under the heading appropriate to the goods to which they are most akin.

Example: Ceramic fountain for spraying and circulating water in an amusement park are more akin to a 'foundation' and would be classified accordingly.

Rule 5: Classification of packing materials: In addition to the foregoing provisions, the following rules shall apply in respect of the goods referred to therein:

(a) Classification of cases / containers used for packing of goods: Camera cases, musical instrument cases, gun cases, drawing instrument cases, necklace cases and similar containers, specially shaped or fitted to contain a specific article or set of articles, suitable for long-term use and presented with the articles for which they are intended, shall be classified with such articles when of a kind normally sold therewith. This rule does not, however, apply to containers which give the whole its essential character.

(b) Classification of packing materials and packing containers: Subject to the provisions of (a) above, packing materials and packing containers presented with the goods therein shall be classified with the goods if they are of a kind normally used for packing such goods. However, this provision does not apply when such packing materials or packing containers are clearly suitable for repetitive use.



Rule 6: Only sub-headings at same level are comparable: For legal purposes, the classification of goods in the sub-headings of a heading shall be determined according to the terms of those sub-headings and any related sub-heading Notes and, mutatis mutandis, to the above rules, on the understanding that only sub-headings at the same level are comparable. For the purposes of this rule the relative Section and Chapter Notes also apply, unless the context otherwise requires.

Unrealised Profit in case of Cross Holding

Unrealized profit:

If the holding company or the subsidiary company sales or purchases any goods from any of its subsidiary company or its holding company then the profit made by the former needs to be adjusted while preparing the Consolidated Balance Sheet. That portion of profit is known as Unrealized Profit.

- (i) Sale by the Holding company to subsidiary company i.e. **downstream transaction**: 100% of unrealized profits shall be adjusted against the reserves of the Holding company.
- (ii) Sale by the Subsidiary company to Holding company i.e. **upstream transaction**:
 - ❖ Share of the holding company shall be adjusted against Holding company's reserves
 - ❖ Share of minority shall be adjusted against Minority Interest.

and when there is a cross holding of shares —

that means the subsidiary is also holding shares of the holding company, the amount of unrealized profit is ascertained in the following manner:



Example:

H Ltd. the holding company has sold goods to S Ltd. the subsidiary company for ₹10,000 on which H Ltd. made a profit of ₹4,000. Out of that goods remaining as closing stock is of ₹6,000.

On the other hand S Ltd. sold goods of ₹20,000 on which S Ltd. had a profit of ₹ 5,000. Out of that goods remaining as closing stock of H Ltd. is of ₹10,000.

H Ltd. holds 80% shares of S Ltd. and S Ltd. holds 20% shares of H Ltd.

Decide the unrealised profit and their treatment.

Solution:

Let the total unrealised profit of H Ltd. be — H



and that of S Ltd. be — S



∴ Unrealised profit in case of H Ltd. is —

$$H = [\text{₹}6,000 \times \frac{\text{₹}4,000}{\text{₹}10,000}] + 80\% \text{ of } S$$

∴ Unrealised profit in case of S Ltd. is —

$$S = [\text{₹}10,000 \times \frac{\text{₹}5,000}{\text{₹}20,000}] + 20\% \text{ of } H$$

$$\therefore H = [2,400 + 0.8 S]$$

$$\text{And } S = [2,500 + 0.2 H]$$

Therefore, putting the value in place of H we will get —

$$H = [2,400 + 0.8 (2,500 + 0.2 H)]$$

$$\text{Or, } 0.84 H = 2,400 + 2,000$$

$$\text{Or, } H = 5,238$$

$$\text{and } S = [2,500 + 0.2 \times 5,238] = 3,548.$$

- Now this Profit of ₹5,238 of H Ltd. will be deducted from the consolidated profit.
- Again in case of the Profit of S Ltd. H Ltd.'s portion i.e. 80% of ₹3,548 i.e. ₹2,838 is to be deducted from the consolidated profit of H Ltd. and the balance that means the minority portion of 20% or ₹710 is to be deducted from the minority interest.