

LESSON 4

INCOME UNDER THE HEAD

SALARIES - I

Dr. Gurminder Kaur

STRUCTURE

- 4.0 Introduction
- 4.1 Objectives
- 4.2 Heads of Income
- 4.3 Meaning of salary
- 4.4 Incomes forming part of Salary - I
 - 4.4.1. Basic Salary
 - 4.4.2 Fees, Commission and Bonus
 - 4.4.3 Taxable Value of Cash Allowances
- 4.5 Summary
- 4.6 Glossary
- 4.7 Self assessment questions
- 4.8 Sources and further readings

4.0 INTRODUCTION

As discussed in an earlier lesson, income means a receipt in the form of money or money's worth which is derived from definite source with some sort of regularity or expected regularity. These definite sources of income are salaries, house property, business or profession, capital gains and any other source. If an income is not derived from any of these sources, it is not taxable under the Income Tax Act, 1961 (hereinafter referred as 'Act'). For example, if a person finds a purse containing Rs.1000 on road, it is not treated as income since it is not received from any definite source.

We have also learnt that scope of total income is determined with reference to residential status of a person i.e. total income of each person is based on his residential status. Once we know what incomes of a person are taxable, then we need to know how to compute total taxable income according to the provisions of Income Tax Act.

The present lesson starts with the classification of incomes into various heads. A detailed study of these heads of income is made lesson wise. This lesson is devoted to the first and most important head of income "Salaries". The lesson is divided into various sections. First we define the concept of salary income i.e. what are the characteristics, which make an income fall under this head. Then, incomes falling under this head are enumerated, followed by the detailed

descriptions of income tax provisions regarding three of these incomes. The description of remaining two incomes forming part of salary will be covered in the next lesson along with procedure for computation of salary income. Finally, all the provisions covered in this lesson are summarized for the sake of convenience.

4.1 OBJECTIVES

After reading this lesson, you should be able to understand:

- Classification of income into various heads.
- Concept of salary income
- Incomes forming part of salary
- The computation of basic salary in grade system
- Types of commission an employee can get
- The concept of allowances
- Various income tax provisions for computing taxable value of allowances
- Computation of taxable value of allowances

4.2 HEADS OF INCOME

Income of a person is classified into 5 categories. Thus, income belonging to a particular category is taxed under a separate head of income pertaining to that category. Section 14 of the Act, has classified five different heads of income for the purpose of computation of total income. The five heads of income are:

- 1) Income under the head salaries (Section 15 – 17)
- 2) Income from house property (Section 22 – 27)
- 3) Profits and gains from business or profession (Section 28 – 44)
- 4) Capital gains (Section 45 – 55)
- 5) Income from other sources (Section 56 – 59)

It may be noted here that an income belonging to a specific head must be computed under that head only. If an income cannot be placed under any of the first four heads, it will be taxed under the head “Income from other sources”. Certain expenses incurred in earning incomes under each head are allowed to be deducted from its gross income according to the provisions applicable to that specific head. Then, the net income under various heads is aggregated together to compute gross total income of the person. After making certain deductions which are allowed from gross total income (relating to certain expenses incurred or payments made or certain incomes earned) we arrive at the figure of total income for taxation purpose.

4.3 MEANING OF SALARY

Salary, in simple words, means remuneration of a person, which he has received from his employer for rendering services to him. But receipts for all kinds of services rendered cannot be taxed as salary. The remuneration received by professionals like doctors, architects, lawyers etc. cannot be covered under salary since it is not received from their employers but from their clients. So, it is taxed under business or profession head. In order to understand what is included in salary, let us discuss few characteristics of salary.

Characteristics of Salary

1. The relationship of payer and payee must be of employer and employee for an income to be categorized as salary income. For example: Salary income of a Member of Parliament cannot be specified as salary, since it is received from Government of India which is not his employer.
2. The Act makes no distinction between salary and wages, though generally salary is paid for non-manual work and wages are paid for manual work.
3. Salary received from employer, whether one or more than one is included in this head.
4. Salary is taxable either on due basis or receipt basis which ever matures earlier:
 - i) Due basis – when it is earned even if it is not received in the previous year.
 - ii) Receipt basis – when it is received even if it is not earned in the previous year.
 - iii) Arrears of salary- which were not due and received earlier are taxable when due or received, which ever is earlier.
5. Compulsory deduction from salary such as employees' contribution to provident fund, deduction on account of medical scheme or staff welfare scheme etc. are examples of instances of application of income. In these cases, for computing total income, these deductions have to be added back.

4.4 INCOMES FORMING PART OF SALARY: I

Section 17 of the Act gives an inclusive definition of salary. Broadly, it includes:

1. Basic salary
2. Fees, Commission and Bonus
3. Taxable value of cash allowances
4. Taxable value of perquisites
5. Retirement Benefits

Although, all the components of salary income are included in salary, there are certain incomes in each of these categories, which are either fully exempt or exempt upto a certain limit. The aggregate of the above incomes, after the exemption(s) available, if any, is known as 'Gross Salary'. From the 'Gross

Salary', the following three deductions are allowed under Section 16 of the Act to arrive at the figure of Net Salary:

1. Standard deduction - Section 16 (i)
2. Deduction for entertainment allowance – Section 16 (ii)
3. Deduction on account of any sum paid towards tax on employment – Section 16(iii).

CHECK YOUR PROGRESS

Activity A:

Identify key words and ingredients for an income to be considered as salary under the Act:

1. _____
2. _____
3. _____
4. _____

4.4.1 BASIC SALARY

All employees are entitled to a basic salary which is fixed as per their respective terms of employment either as a fixed amount or at a graded system of salary. Under this graded system, apart from the basic salary at which the employee will start, annual increments to be given to the employee are pre fixed in the grade. For example, if a person is employed on 1st May, 2004 in the grade of 12000 – 300 – 15000, this means that he will start at a basic salary of Rs.12000 from 1st May, 2004. He will get an annual increment of Rs.300 w.e.f. 1st May, 2005 and onwards every year on the same date till his basic salary reaches Rs.15, 000. No further increment is given thereafter till he is promoted and placed in other grade.

Advance Salary, if received in previous year for next year is taxable on receipt basis in the same previous year.

Illustration 4.1:

X joins service in the grade of Rs.12000 – 300 – 13800 – 400 – 17800 on 1st June, 1999. Compute his basic salary for the previous year 2005-06.

Solution:

For the previous year 2005-06, basic salary of X will be calculated as follows:

1 st June 1999 – 31 st May 2000	12000	1 st June 2003 – 31 st May 2004	13200
1 st June 2000 – 31 st May 2001	12300	1 st June 2004 – 31 st May 2005	13500

1 st June 2001 – 31 st May 2002	12600	1 st June 2005 – 31 st May 2006	13800
1 st June 2002 – 31 st May 2003	12900		

Basic Salary for April and May 2005 (Rs.13500 x 2)	27,000
Basic Salary for June 2005 – March 2006 (Rs.13800 x 10)	<u>1, 38,000</u>
Basic Salary for previous year	<u>1, 65,000</u>

CHECK YOUR PROGRESS

Activity B:

Salary of X is Rs.10, 000 per month. X has taken salary in advance for the months of April, 2006 to June, 2006 in March 2006. What is his gross salary for the previous year 2005 – 2006:

- (A) Rs.1, 20,000
- (B) Rs. 90,000
- (C) Rs.1, 50,000

4.4.2 FEES, COMMISSION AND BONUS

Any fees or commission paid or payable to an employee is fully taxable and is included in salary. Commission payable may be at a fixed amount or a fixed percentage of turnovers. In both the cases, it is taxable as salary only when it is paid or payable by the employer to the employee. When commission is based on fixed percentage of turnover achieved by employee, it is included in basic salary for the purpose of grant of retirement benefits and for computing certain exemptions that we will discuss later on.

4.4.3 TAXABLE VALUE OF ALLOWANCES

Allowance is a fixed monetary amount paid by the employer to the employee (over and above basic salary) for meeting certain expenses, whether personal or for the performance of his duties. These allowances are generally taxable and are to be included in gross salary unless specific exemption is provided in respect of such allowance. For the purpose of tax treatment, we divide these allowances into 3 categories:

- I. Fully taxable cash allowances
- II. Partially exempt cash allowances
- III. Fully exempt cash allowances

I. FULLY TAXABLE ALLOWANCES

This category includes all the allowances, which are fully taxable. So, if an allowance is not partially exempt or fully exempt, it gets included in this category. The main allowances under this category are enumerated below:

(i) Dearness Allowance and Dearness Pay

As is clear by its name, this allowance is paid to compensate the employee against the rise in price level in the economy. Although it is a compensatory allowance against high prices, the whole of it is taxable. When a part of Dearness Allowance is converted into Dearness Pay, it becomes part of basic salary for the grant of retirement benefits and is assumed to be given under the terms of employment.

(ii) City Compensatory Allowance

This allowance is paid to employees who are posted in big cities. The purpose is to compensate the high cost of living in cities like Delhi, Mumbai etc. However, it is fully taxable.

(iii) Tiffin / Lunch Allowance

It is fully taxable. It is given for lunch to the employees.

(iv) Non practicing Allowance

This is normally given to those professionals (like medical doctors, chartered accountants etc.) who are in government service and are banned from doing private practice. It is to compensate them for this ban. It is fully taxable.

(v) Warden or Proctor Allowance

These allowances are given in educational institutions for working as a Warden of the hostel or as a Proctor in the institution. They are fully taxable.

(vi) Deputation Allowance

When an employee is sent from his permanent place of service to some place or institute on deputation for a temporary period, he is given this allowance. It is fully taxable.

(vii) Overtime Allowance

When an employee works for extra hours over and above his normal hours of duty, he is given overtime allowance as extra wages. It is fully taxable.

(viii) Fixed Medical Allowance

Medical allowance is fully taxable even if some expenditure has actually been incurred for medical treatment of employee or family.

(ix) Servant Allowance

It is fully taxable whether or not servants have been employed by the employee.

(x) Other allowances

There may be several other allowances like family allowance, project allowance, marriage allowance, education allowance, and holiday allowance etc. which are not covered under specifically exempt category, so are fully taxable.

II. PARTIALLY EXEMPT ALLOWANCES

This category includes allowances which are exempt upto certain limit. For certain allowances, exemption is dependent on amount of allowance spent for the purpose for which it was received and for other allowances, there is a fixed limit of exemption.

(i) House Rent Allowance (H.R.A.)

An allowance granted to a person by his employer to meet expenditure incurred on payment of rent in respect of residential accommodation occupied by him is exempt from tax to the extent of least of the following three amounts:

- a) House Rent Allowance actually received by the assessee
- b) Excess of rent paid by the assessee over 10% of salary due to him
- c) An amount equal to 50% of salary due to assessee (If accommodation is situated in Mumbai, Kolkata, Delhi, Chennai)
‘Or’ an amount equal to 40% of salary (if accommodation is situated in any other place).

Salary for this purpose includes Basic Salary, Dearness Allowance (if it forms part of salary for the purpose of retirement benefits), Commission based on fixed percentage of turnover achieved by the employee.

The exemption of HRA depends upon the following factors:

- | | |
|------------------------|------------------|
| (1) Basic Salary | (3) Rent paid |
| (2) Place of residence | (4) HRA received |

If an employee is living in his own house and receiving HRA, it will be fully taxable.

Illustration 4.2:

Mr. X is employed in A Ltd. getting basic pay of Rs.20, 000 per month and dearness allowance of Rs.7, 000 per month (half of the dearness allowance forms part of salary for the purpose of retirement benefits). The employer has paid bonus @Rs.500 per month, Commission @1% on the sales turnover of Rs.20 lakhs, and house rent allowance of Rs.6, 000 per month. X has paid rent of Rs.7, 000 per month and was posted at Agra.

Compute his gross salary for the assessment year 2006-07

Solution:

Computation of Gross Salary	Amount / Rs.
Basic Salary (Rs.20,000 x 12)	2,40,000
Dearness Allowance (Rs.7,000 x 12)	84,000
Bonus (Rs.500 x 12)	6,000
Commission (1% of Rs.20,00,000)	20,000
House Rent Allowance (Rs.6,000 x 12 – Amount exempt Rs.53,800)	18,200
Gross Salary:	3,68,200

Amount of HRA exempt is least of 3 amounts:

1. 40% of Salary (Rs.2,40,000 + Rs.84,000 + Rs.20,000) = Rs.3,02,000
 2. Actual HRA received (Rs.6, 000 x 12) = Rs. 72,000
 3. Rent paid (Rs.7, 000 x 12 – 10% of salary Rs.30, 200) = Rs. 53,800
- Amount of HRA exempt is = Rs. 53,800**

CHECK YOUR PROGRESS

Activity C:

Amount of HRA exempt is least of the following 3 amounts:

1. _____
2. _____
3. _____

(ii) Entertainment Allowance

This allowance is first included in gross salary under allowances and then deduction is given to only central and state government employees under Section 16 (ii).

(iii) Special Allowances for meeting official expenditure

Certain allowances are given to the employees to meet expenses incurred exclusively in performance of official duties and hence are exempt to the extent actually incurred for the purpose for which it is given. These include travelling allowance, daily allowance, conveyance allowance, helper allowance, research allowance and uniform allowance.

(iv) Special Allowances to meet personal expenses

There are certain allowances given to the employees for specific personal purposes and the amount of exemption is fixed i.e. not dependent on actual expenditure incurred in this regard. These allowances include:

a) Children Education Allowance

This allowance is exempt to the extent of Rs.100 per month per child for maximum of 2 children (grand children are not considered).

b) Children Hostel Allowance

Any allowance granted to an employee to meet the hostel expenditure on his child is exempt to the extent of Rs.300 per month per child for maximum of 2 children.

c) Transport Allowance

This allowance is generally given to government employees to compensate the cost incurred in commuting between place of residence and place of work. An amount upto Rs.800 per month paid is exempt. However, in case of blind and orthopaedically handicapped persons, it is exempt up to Rs. 1600p.m.

d) Out of station allowance

An allowance granted to an employee working in a transport system to meet his personal expenses in performance of his duty in the course of running of such transport from one place to another is exempt upto 70% of such allowance or Rs.6000 per month, whichever is less.

CHECK YOUR PROGRESS

Activity D:

1. Amount of children education allowance exempt is

2. Amount of hostel allowance exempt is

3. Amount of out of station allowance to transport employees is exempt to the extent of _____

III. FULLY EXEMPT ALLOWANCES

(i) Foreign allowance

This allowance is usually paid by the government to its employees being Indian citizen posted out of India for rendering services abroad. It is fully exempt from tax.

(ii) Allowance to High Court and Supreme Court Judges of whatever nature are exempt from tax.

(iii) Allowances from UNO organisation to its employees are fully exempt from tax.

Illustration 4.3: (based on different allowances received by employee)

From the following particulars, compute gross salary of Mr X for the assessment year 2006-07. He is employed in textile industry in Mumbai at a monthly salary of Rs.4000. He is entitled to commission of 1% on sales achieved by him, which were Rs.10 lakh for the year.

In addition, he received the following allowances from the employer during the previous year:

1. Dearness Allowance Rs.2000 per month which is granted under terms of employment and counted for retirement benefits.
2. Bonus Rs.32000
3. House Rent Allowance Rs.1000 per month (Rent paid for house in Mumbai Rs.1200 per month)
4. Entertainment Allowance Rs.1000 per month
5. Children Education Allowance Rs.500 per month
6. Transport Allowance Rs.1000 per month
7. Medical Allowance Rs.500 per month
8. Servant Allowance Rs.200 per month
9. City Compensatory Allowance Rs.300 per month
10. Research Allowance Rs.500 per month (amount spent on research Rs.3000)

Solution:

Computation of Income from Salary of Mr. X
for the Assessment Year 2006-07

	Amount / Rs.
Basic Salary	48,000
Dearness Allowance	24,000

Commission	10,000
Bonus	32,000
House Rent Allowance (Rs.1000 x 12 – Amount exempt Rs.6200)*	5,800
Entertainment Allowance	12,000
Children Education Allowance (Rs.500 x 12 – Amount exempt Rs.100 x 2 x 12)	3,600
Transport Allowance (Rs.1000 x 12 – Amount exempt Rs.800 x 12)	2,400
Medical Allowance (fully taxable)	6,000
Servant Allowance (fully taxable)	2,400
City Compensatory Allowance (fully taxable)	3,600
Research Allowance (Rs.500 x 12 – Amount exempt Rs.3000)	3,000
Gross Salary:	152,800

* Amount of HRA exempt is least of 3 amounts

- a) 50% of Salary (Basic Salary + DA granted under terms of employment + Commission based on percentage of turnover – Rs.48,000 + Rs.24,000 + Rs.10,000 = Rs.82,000) = Rs.41,000
- b) Actual HRA received : Rs.1000 x 12 = Rs.12,000
- c) Rent paid (Rs.1200 x 12) – 10% of Salary (Rs.82,000) Rs.14,400 – Rs.8,200 = Rs.6,200

CHECK YOUR PROGRESS

Activity E:

Classify these allowances into the following three categories:

Project allowance, Out of station allowance, Dearness allowance, Servant allowance, Hostel allowance, Uniform allowance, Dress allowance, Marriage allowance, Foreign allowance, overtime allowance:

1. Fully taxable allowances _____

2. Partially exempt allowances _____

3. Fully exempt allowances _____

Activity F:

Match the exemption in the following cases:

Name of Allowance	Exemption
1. Children Education Allowance	Rs.300 per month per child for maximum 2 children
2. Transport Allowance	Rs.100 per month per child for maximum 2 children
3. Hostel Allowance	70% of allowance subject to maximum of Rs.6, 000 per month.
4. Out of station allowance	Rs.800 per month

4.5 LET US SUM UP

1. Heads of Income: There are 5 heads of income into which income of persons can be divided namely Income from salary, house property, business or profession, capital gains and other sources.
2. Meaning of Salary: Any remuneration paid by an employer to an employee in consideration of his services is called salaries. It includes monetary value of those benefits and facilities, which are provided by the employer and are taxable.
3. Income forming part of salary: They include basic salary, advance salary, fees, commission, bonus, taxable value of cash allowances, perquisites and retirement benefits.
4. Allowances: These are of three types
 - (a) Taxable Allowances: Dearness allowance, Medical allowance, Servant allowance, Warden Allowance, Family allowance, City Compensatory allowance etc.
 - (b) Allowances exempt upto specified limit: House rent allowances, Entertainment allowance, Certain Special allowances, etc.
 - (c) Fully exempted allowances: Foreign allowance, sumptuary allowance to High Court / Supreme Court Judges, Allowances from U.NO.

4.6 GLOSSARY

Terms used in the lesson are as explained herein:

1. Proctor – Discipline Incharge of the institution.

2. Foreign allowance – These are the allowances paid to India citizens posted abroad by the Government of India.
3. Retirement benefits – These are the benefits given to the employees while in service to provide for their future when they retire.
4. Sumptuary – Expensive, huge

4.7 SELF ASSESSMENT QUESTIONS

1. Mr. X is employed in P Ltd. getting basic pay of Rs.20, 000 per month. The employer has paid him the following emoluments:

	Rupees
Bonus	6,000 per annum
Servant Allowance	500 per month
Project Allowance	1000 per month
Lunch Allowance	300 per month
Transport Allowance	900 per month
Deputation Allowance	1000 per month
Children Education Allowance (for 3 children)	400 per month
House Rent Allowance (He is living in his own house)	1000 per month

Compute his gross salary for the assessment year 2006-07:

Ans. Gross Salary: Rs.2, 84,400

Hints: 1. HRA is fully taxable

2. Children education allowance is exempt to the extent of Rs.100 per month per child for maximum 2 children
3. Transport allowance is exempt to the extent of Rs.800 per month

2. Mr. X is employed in A Ltd. getting basic pay of Rs.11,000 per month, dearness allowance Rs.4,000 per month and commission of Rs.10,000. Employer has paid children education allowance Rs.500 per month per child for 3 children. The employee has paid hostel allowance Rs.800 per month for 1 child and employer incurred Rs.2000 per month for the same. Employer also paid transport allowance of Rs.900 per month (X spent Rs.700 per month on it) and house rent allowance of Rs.4, 000 per month. The employee paid rent of Rs.2500 per month.

Compute his gross salary for the assessment year 2006-07

Ans. Gross Salary: Rs.2, 35,600

- Hints: 1. Hostel allowance is exempt up to Rs.300 per month
2. Dearness allowance is not forming part of salary for retirement benefits, so will not be included in computing exemption for HRA.
3. Since place of residence is not given; we assume it is not metro city.
3. Mr. X is employed in ABC Ltd., Amritsar and is getting basic pay of Rs.11,200 per month, dearness allowance 70% of basic pay (half of it is included for retirement benefits). The employee is working in the purchase department and is allowed commission @ 1.5% on purchase turnover of Rs.39 lakhs up to 28th February, 2006. Employer has paid house rent allowance of Rs.5, 000 per month. The employee has paid rent of Rs.3, 000 per month. The employee has submitted his resignation with effect from 1st March, 2006.

Compute his gross salary for assessment year 2006-07:

Ans.: Gross Salary: Rs.296, 672

- Hints: 1. Part of Dearness Allowance will be included in computing exemption for HRA.
2. Commission based on fixed percentage of turnover will also be included.
3. Salary for only 11 months will be included in Gross Salary

4.8 SOURCES AND FURTHER READINGS

Ahuja Girish and Ravi Gupta (2006), *Systematic Approach to Income Tax and Sales Tax*, Bharat Publication, Sahitya Bhawan, Agra

Chandra Mahesh and D.C. Shukla (2006), *Income Tax Law and Practice*, Pragati Publication, New Delhi.

Mehrotra H.C. (2006), *Income Tax Law and Accounts*, Sahitya Bhawan, Agra.

.Singhania V.K. and Monica Singhania (2006), *Students Guide to Income Tax*, Taxmann Publications, New Delhi.