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Income from Salary: Income Tax Act, 1961

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Abstract

This submission has been made to have a better understanding of income from salary as a source of income. In the course of the submission the meaning of income from salary is dealt along with its computation. Further, the important provisions relating to the computation of income from salary under Income Tax Act, 1961 have been discussed. The important provision of the concerned statute includes Section 15 which deals with the basis of charge, Section 16 dealing with deductions and Section 17 dealing with the constituents of salary which are divided into three heads i.e., income from salary, allowances and perquisites.

Keywords: Salary, basis of charge, deductions, allowances, perquisites

INTRODUCTION

There are many sources of income which includes income from salary, house property, business or profession, capital gains and other sources. Each source has its own basis of charge.

Meaning of Income from Salary

Income from salary is the remuneration that a person receives for services that he is providing or a contract that he has undertaken. This provision basically appropriates a person's remuneration for the services which he provides under the employment contract [1].

For the purposes of the Income Tax Act, this amount of remuneration will only be regarded as income if there is an employer-employee relationship between the person who makes and the person who receives the payment.

Conceptually, it involves several terms such as employer-employee, principal-agent, contract of service, contract for service, etc. Charges under this head of income presumes the relationship of an employer and an employee between the payer and the payee in contrast to that of a principal and an agent. The distinction between the two type of relationship is vital because income earned by employee from the employer comes under the head "Salaries" while the income earned by an agent is chargeable either under the head "Profits", and gains of business or profession or under the head "income from other sources" [2]. Further an employee works under the direct supervision and control of his employer. The employer controls as to what is to be done and how it is to be done. However, an agent is generally free to carry out the principal's instructions according to his own will.

Contract of Service and Contract for Service

The title of a contract cannot accurately determine whether it is a contract of or for service. The substance and terms of the contract becomes

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relevant. Employer-employee relation is a contract of service and principal-agent relationship is a contract for service.

Let us consider some instances to have a better understanding of income from salary:

***CIT v. Shiv Charan Mathur* [3]**

High Court held that Members of the Legislative Assembly (MLAs) and Members of Parliament (MPs) are not appointed by anybody, but they are elected by the people, their constituents, and it is consequent upon such an election that they gain constitutional status and are in charge of constitutional functions and duties. The remuneration they earn after swearing in cannot be defined as "salary" within the context of Section 15 of the 15 of the Income Tax Act, 1961. The fundamental requirement for attracting Section 15 is that there should be a relationship of employer and employee whether in existence or in past.

***Lalu Prasad v. CIT & Ors.* [4]**

It was held that the pay and allowances of a Chief Minister of a state could not be assessed as 'income from other sources' but would be taxed under the head of 'income from salary'. The reason being that they are employed by the government and thus have a relationship of employer and employee.

***Justice Deoki Nandan Agarwala v. Union of India & Anr*. [5]**

It was held that salaries of Judges of High Court and Supreme Court are a subject of tax under 'income from salary', as it is taxable under the Act of Parliament in just the same manner as income of any other citizen. Judges are full-time employees and thus taxed under the head 'income from salary'.

Computation of 'income from salary' is illustrated in Table 1.

Table 1. Computation of income from salary.

Particulars	Amount
Basic Salary	—
Add:	—
1. Fees, Commission and Bonus	—
2. Allowances	—
3. Perquisites	—
4. Retirement Benefits	—
5. Fees, Commission and Bonus	—
Gross Salary	—
Less: Deductions from salary	—
1. Entertainment Allowance u/s 16	—
2. Professional Tax u/s 16	—
Net Salary	—

BASIS OF CHARGE

Section 15 of Income Tax Act, 1961 deals with the basis of charge. Salary is a chargeable tax. It is chargeable either on "paid basis" or "due basis" whichever is earlier. This means that Section 15 has chargeability in terms of time. Also, it has to be read with Section 17 of the Income Tax Act, 1961which talks about the constituents of salary.

Hence, the taxable salary includes:

Advance Salary (Paid Basis)

Salary paid in advance is taxable in the year of collection or receipt under the heading 'Salaries.' This means when the salary is received in advance. It is also known as "advanced salary" or "on receipt basis." Such advance salary shall not again be included in the overall income until the salary is due.

Outstanding Salary (Due Basis)

Salary falling due is taxable in the year in which it falls due. It is taxable under heading 'Salaries.' Such advance salary shall not again be included in the overall income when received.

Arrear Salary

Arrears of salary are neither paid nor due. When an employee receives salary arrears for past years, which were not paid on a due basis previously, instead the salary earned is assessed on receipt basis. Explanation to Section 15 provides that the salary paid to "partners is taxable under the head 'income from business or profession'".

CONSTITUENTS OF SALARY

Section 17(1)[6] "salary" includes—

- Wages;
- Pension;
- Annuity;
- Gratuity;
- Advance salary paid;
- Fees, Commission, Perquisites, Profits in lieu of or in addition to salary or Wages;
- Annual accretion to the balance of Recognized Provident Fund;
- Leave Encashment;
- Transferred balance in Recognized Provident Fund;
- Contribution by Central Govt. or any other employer to Employees Pension A/c as referred in Sec. 80CCD.

Section 17 is so realistic that when salary is computed under this Section it reflects the true financial health of a person.

General Components of Salary

Fully Taxable

The following components under income from salary are fully taxable-

- Basic pay
- Dearness pay
- Advanced salary
- Arrears of salary
- Salary in lieu of notice
- Fess, commission, bonus
- Monthly pension
- Remuneration for extra duties
- Profits in lieu of salary

Having Certain Peculiar Treatment

Leave Encashment

In case of government employees, they have an exemption as to the taxability of leave encashment. On the other hand, for the non-government employees the leave encashment is calculated according to the formula. However, if the leave encashment is done during the employment then it is taxable for both government and non-government employees.

Gratuity

In case of government employees, they have an exemption as to the taxability of gratuity. On the other hand, for the non-government employees the gratuity is calculated according to the formula.

However, if the gratuity is during the employment then it is taxable for both government and non-government employees.

Commuted Pension

When a person retires, he can either opt for monthly pension which is fully taxable, or he can commute his pension (lump sum) which has a reduced rate of tax.

Voluntary Retirement Scheme

When an employee receives retirement voluntarily before the age of superannuation in lieu of compensation then such retirement is called Voluntary Retirement.

Voluntary retirement remuneration got or receivable by an employee is qualified for exception subject to the accompanying conditions [7]:

- compensation shall be obtained from a designated employer; or
- any company; or
- an agency founded under the National, State or Provincial Law; or
- a municipal agency; or
- a cooperative society; or
- a designated university; or
- an Indian Institute of Technology (IIT); or
- a government of any State; or
- a Federal Government; or
- a notified institution of management (Indian Institutes of Management (IIM) Ahmedabad, IIM Bangalore, IIM Calcutta, IIM Calcutta); or
- notified Institution.

Compensation shall be provided in compliance with the Voluntary Retirement Scheme (VRS) structured in compliance with the following rules as specified in Rule 2BA [8]:

- Scheme (VRS) shall extend to all employees (other than the Director) who are either 40 years of age or have served 10 years of service. (However, this rule does not apply in the case of a public sector employee.
- Such plan must be framed to diminish the quantity of workers.
- Not to fill up the gap left by VRS.
- The former employee shall not be working in any organization or corporation which belongs to the same management.
- The amount of pay does not exceed:
    - the payment equal to 3 months ‘salary for each year of service completed’; or
    - salary compounded by the remaining month of service left at the time of the retirement. Salary here means [Basic + DA (if it is part of a pension benefit) + fixed percentage of turnover commission], last drawn.

MEASURE OF EXEMPTION

- The actual amount that is received as per the guidelines; Or
- When a person receives a lump sum amount which is exempted up to ₹ 5,00,000

ALLOWANCES

When the salaried employee receives a fixed amount of money over and above his salary from his employer to meet a particular expenditure, it is an allowance. Allowances are considered as part of the salary and are taxable, except for cases on whom the various provisions of the Income Tax Act provide for specific exemptions. Allowances are purely discretionary in the hands of the employer. It may be considered as a top-up on salary for a specific purpose. Such allowances may be grouped into three categories depending on their respective tax status—*taxable, non-taxable, and partly taxable.*

Fully Taxable Allowances [9]

Some fully taxable allowances are as follows:

City Compensatory Allowance

It is an incentive given by the companies to its employees to meet the relatively high cost of living in the metropolitan cities.

Medical Allowance

It is a taxable allowance given to the employees to meet their cost of medical treatment.

Servant Allowance

It is a personal expense allowance given to the employees to meet their expenditure of hiring the services of servants.

Tiffin Allowance

Allowances to meet the meal, tiffin or refreshment of the employees is also a taxable allowance.

Dearness Allowance

DA is given to offset the effect of inflation on the employee during his / her time of employment. It depends on the cost of living. It is normally updated twice a year, first in January and then in July. And under Income Tax Act (ITA), it is taxable.

Thus, these are some of the fully taxable allowances. Other fully taxable allowance may include cash allowance, project allowance, overtime allowance, warden allowance, helper allowance etc.

Fully Exempt Allowances

Allowances Paid to the Judges of High Court and Supreme Court

These are known as sumptuary allowance. The allowances paid to the Judges of High Court and Supreme Court are fully exempted from taxability.

Allowances Paid to the Employees of United Nation Organization

The benefits received by the people working in the United Nation Organization are non-taxable.

Allowances to Indian Government Servants Serving Abroad

When the employees of the Indian government are serving their term in other countries then the allowance paid to them is non-taxable.

Partially Exempt Allowances

House Rent Allowance

An organization gives house rent payment to staff to help them deal towards their accommodation expenses. But if a person does not live in a rented house, then this allowance is taxable in full [10]. Employees may seek a deduction under Section 10(13A) of the house rent allowance (HRA) if:

- Actual HRA earned by an individual from his employer.
- If the employee resides in metro cities and the actual amount of rent paid is more than 50% of the basic pay.
- If employee resides in a non-metro city and the actual amount of rent paid is more than 40% of the basic pay.
- Over 10% of salary is the excess of rent paid.

Entertainment Allowance

Entertainment allowance is the amount of money allocated to an employee to pay for snacks, dinners, work trips, customer visits, hotels and more for their clients' hospitality. It is taxable for all private sector employees. However, the government employees can treat it as a deduction or exemption of tax if the conditions of Section 16 are fulfilled.

Special Allowances

Allowance up to the Expenditure

These are special type of allowances which are taxable only up to the amount of expenditure done. These include travelling allowance, daily allowance, research allowance etc.

Allowance up to the Prescribed Limit

In some kinds of allowances, a minimum limit is prescribed up to which there is an exemption of tax. Some of these include:

- *Child education allowance:* Minimum exemption up to ₹100 per month per child (to the maximum of two children).
- *Hostel allowance:* Minimum exemption up to ₹300 per month per child (to the maximum of two children).
- *Tribal area allowance:* Minimum exemption up to ₹200 per month.

PERQUISITES

Perquisites are the non-monetary benefits received by the employee. They are enshrined in Section 17(2) of the Income Tax Act, 1961. The basic difference between perquisites and allowances is that the former is a non-cash benefit while the latter in received by the employee in cash. As perquisites are not received in cash therefore, they cannot be partially taxed like allowance.

Fully Exempt Perquisites

Fully exempt perquisites mean that they are not taxable and some of them are:

- Motor car used by chairman of the Union Public Service Commission (UPSE) or the Judges of High Court (HC) or the Supreme Court (SC), etc.
- Paid to citizens of India by Government of India who are working outside India
- Rent-free accommodation to certain persons like leaders of opposition, Union Ministers, Judges of HC or SC, etc.

Taxable Perquisites

Taxable Perquisites can be further characterised into two.

Perquisites Taxable to Specified Employees

Specified Employees for the purpose of this Section refers to:

- Director employees
- Persons whose salary exceed ₹50,000
- Employees of a company having substantial interest (20% or more voting power) in that company.

Perquisites Taxable to Specified Employees includes motor car, medical facility, services of gardener, sweeper, watchman, free gas, water, electricity, etc.

Perquisites Taxable for All Employees

It is an obligation of the employer to pay to all its employees. This includes rent-free accommodation, movable asset, interest free or concessional loans (mostly for bank employees), etc.

CONCLUSION

On 1 February 2020, Budget was presented by the Hon'ble Finance Minister Ms. Nirmala Sitharaman. It gave an option to the taxpayer to choose between the rate and slabs of income tax between the old and new ones. Current tax slabs propose reduction of the existing tax rate from 20% to 10%, and in certain cases from 30% to 20%. In the event that the taxpayer opts for new slabs and rates, no exception or deduction may be sought, like those of savings on the basis of HRA, LIC premium, school fees, medication etc. Thus, these are some of the highlights and changes as proposed by the Budget 2020.

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