

## Unit- 1

### PROFITS AND GAINS OF BUSINESS AND PROFESSION:

#### Income from business:-Section 28 to 44D

**Business: Section 2 (13):-** As per section 2 (13) of the income tax act business includes any trade, commerce or manufacture of any adventure or concern in the nature of trade, commerce or manufacture.

**Profession:-** A profession is an occupation requiring either purely an intellectual skill or manual skill controlled by the intellectual skill of the operator. Example:- Medicine, Law, Engineering, Auditing, Painting etc.,.

All professions are business but all business are not profession. Only those businesses are professions the profit of which are dependent mainly upon the personal qualifications and in which no capital expenditure is required or only capital expenditure of a comparatively small amount are required.

Under section 2 (36) of the income tax act, profession includes **vocation**. It implies natural ability of a person for some particular work. It is an activity upon which the person spends the major portion of his time and out of which he makes his living. For instance, teaching Vedanta is a vocation. Writing of books contribution of articles to periodicals and magazines constitutes the vocation of an assessee.

#### Incomes taxable under business or profession:- Section 28

1. **Profits:** - Under section 28 profits and gains of any business or profession which was carried on by the assessee at any time during the previous year are chargeable to income tax under this head. However the following receipts are taxable as income from business even if no business is carried on by an assessee in the year of receipts which are called **deemed profits**.
  - a) Recovery against any deduction.
  - b) Sale of an asset used for scientific research.
  - c) Sale of depreciable asset by power generating unit.
  - d) Amount withdrawn from a reserve created.
  - e) Recovery against bad debts.
  - f) Cash credit.
  - g) Unexplained investments.
  - h) Unexplained money.
  - i) Amount of investments not fully disclosed in books of accounts.
  - j) Unexplained expenditure.
2. Compensation due or received by any person managing the affairs of an Indian company or the affairs in India of any other company.
3. Income of trade or professional association.
4. Value of benefits or perquisites arising from business or the exercise of a profession.
5. Profit on sale of license granted under imports and exports control act, 1947.

6. Cash assistance against exports under any scheme of the government.
7. Duty of customs or excise repaid or repayable.
8. Beneficial payments to partners like interest, salary, bonus, commission etc,
9. Profits from managing agency.
10. Receipts on Key man Insurance Policy including the bonus allocated on such policy.
11. Speculative profits.
12. Illegal business.

**Note:** The income tax law is not concerned with the legality or illegality of the business. Profits from carrying on such illegal business are taxable. The loss in illegal business can also be set-off against the profits of such business.

**Trading Losses:-** Generally while computing income from business or profession an item of loss incidental to the carrying on a business is treated as trading loss and deducted.

Some of the usually occurring types of trading losses are as follows-

- a) Loss of stock-in-trade.
- b) Loss through embezzlement by an employee or agent.
- c) Loss by robbery or theft.
- d) Loss incurred in the capacity of surety.
- e) Loss of security deposit.
- f) Loss in illegal business.

### **Expenses expressly allowed:- Sections- 30 to 35**

#### **1. Expenses in respect of business premises:- Section- 30.**

The following expenses in respect of premises used for the purpose of the business/profession are allowed as deduction.

- a) Where the premises are occupied by the assessee as a tenant, the rent paid for the premises and any amount paid on account of repairs of such premises.
- b) Where the premises are owned by the assessee the amount paid by him on repairs to the premises.
- c) Any sum paid on account of land revenue, local rates / municipal taxes and insurance premium against fire or earthquake etc,

#### **2. Repairs and Insurance of machinery, plant and furniture:- Sec- 31**

If machinery, plant and furniture are owned and used for the purpose of the business/profession by an assessee current repairs and insurance premium in respect of such asset is an allowable deduction.

#### **3. Depreciation:- Section- 32**

In computing taxable profits of a business / profession the Income tax law permits the deduction of depreciation subject to the condition that-

- a) The assets should be owned by the assessee
- b) The assets should be actually used for the purpose of assessee's business / profession
- c) Depreciation will be allowed on the written down value of the block assets. Block assets being building, plants / furniture in respect of which the %of depreciation is fixed. Depreciation is allowed both on tangible and intangible assets.

**Tangible assets:-** Rate of depreciation depends upon the nature of assets. Buildings, Furniture and Fittings – 10%, Motor car, Plant and Machinery – 15%, Computers and Books – 40% (whether Annual publications or other than Annual Publications). From the A. Y 2018-19, maximum depreciation allowed is only 40%.

**Intangible assets:** - They are also subject to depreciation at the following rates: know-how, patents, trade marks, copy rights, licenses, franchises (voting rights) or any other business/ commercial rights of similar nature- 25% if they are acquired on or after 1/4/98.

If an asset referred above is acquired by the assessee during the previous year and is put to use for the purpose of business or profession for a period of less than 180 days, in its first year, depreciation on such asset will be allowed at the rate of 50% only in the first year of its acquisition. If any assets are sold during the year, no depreciation is charged on such assets.

#### 4. Expenditure on Scientific Research:- Section- 35

Scientific research means any activity for the extension of knowledge in the field of natural/ applied science including agriculture, animal husbandry or fisheries. The research is said to be related to business, if it is research of medical nature which helps in the welfare of the business employees.

Where the **assessee himself carries on scientific research and incurs revenue expenditure is allowed @ 100% for such expenditure only if such research relates to his business.**

Any expenditure of a **capital nature** incurred on scientific research related to assessee's business (**not being the cost of land**) the whole of such expenditure incurred in any previous year **shall be deducted** for that previous year.

Where the assessee does not himself carry on scientific research but makes contributions to other institutions for this purpose deduction is allowed if research is related or unrelated to the business of assessee –

- a) The payment is made to an approved scientific research association, approved university, college or other institution - **a deduction at 150% of the actual expenditure is allowed.**
- b) But if the research is related to social science or statistical science – **a deduction at 100% of the actual expenditure is allowed.**

- c) The payment is made to National Laboratory, University, IIT, or a specified person as approved by the prescribed authority – **a deduction at 150% of the actual expenditure is allowed.**
5. **Payment to an association and institution for carrying out rural development programmes: Sec – 35 CCA:** - actual expenses are allowed as deduction.
6. **Any expenditure incurred by an assessee on notified agricultural extension project: Sec – 35 CCC:** - a deduction at 150% of such expenditure will be allowed.
7. **Amortization of preliminary expenses: Sec – 35 D:** - It includes the cost of preparation of feasibility report, market survey expenditure, registration expenses etc. All these expenses are restricted to 5% of the cost of project /capital employed. Later it is allowed in 5 equal annual installments i.e., 1/5<sup>th</sup> every year.
8. **Amount paid to employee on voluntary retirement: Sec – 35 DDA:** - 1/5 is allowed as deduction in every year for 5 years.
9. Any payment made after closing previous year i.e., 31/3/2019 and before filing Income Tax returns are allowed as deduction.

### **Other Deductions:- Section- 36**

The following expenditure incurred in connection with the business/ professions are admissible deductions.

1. Insurance premium on stock and stores
2. Bonus / commission to employees
3. Interest on borrowed capital
4. Employer contribution to RPF, SAF, Approved gratuity Fund
5. Bad debts written off.

### **General deductions:-Section- 37**

1. Salary paid to the employees of the business but not proprietors.
2. Perquisites: Expenditure incurred by an assessee for providing any perquisites to an employee is deductible.
3. Staff welfare expenses
4. Compensation for termination of employment.
5. Compensation for termination of agreement of agency.
6. Damages.
7. Demurrage (penalty charged for taking excess time in loading and unloading).
8. Expenditure on raising loans connected with the business.
9. Expenditure incurred to avoid competition and defending title to business premises.
10. Contribution towards RPF and other approved funds.

11. Legal expenditure in connection with the business.
12. Diwali and mahurat expenses in the nature of business expenditure not of personal, social or religious nature.
13. OYT deposit (Own Your Telephone):- The payment made under OYT scheme is fully deductible in the year of payment.
14. Security deposit for telex connection.
15. Gifts and presents: - If gifts and presents are made in the normal course of business as a device to sales promotion it is allowed in full.
16. Sales tax, Customs and Excise duty:- Sales tax, Customs and Excise duty are expenses incidental to business and hence allowed. Interest paid by an assessee to the sales tax department on arrears of sales tax is allowed when the amount has been paid.
17. Establishment and enquiry expenses are admissible.
18. Audit fee is fully deductible including income tax appeal expenses.
19. Expenditure on special advertisement campaign at the time of opening of new branches is allowed even though capital in nature.
20. Entertainment expenditure is allowed in full.
21. Expenditure incurred in the course of purchase and sale of goods including manufacturing of such goods.
22. Expenses incurred in the day to day administration and running of business in general.
23. Royalties paid in connection with mines, patents, and copy rights.
24. Annual listing fee paid to a stock exchange by a company.
25. Subscription paid to trade associations and organizations.
26. Expenses on guest houses and holiday homes are fully allowed.
27. Ordinary advertisements expenses to maintain sales: - Expenses incurred on installation of NEON or other sign boards were treated as advertisement expenses. But with effect from 1/4/98 the cost of sign board being capital expenditure shall qualify for depreciation at 10% and cost of NEON sign board also at 10% (electric installation.)

To sum up that in order to claim deduction u/s 37 the following conditions should be satisfied:-

1. Expenditure should not be of the nature described u/s 30 to 36.
2. It should not be in the nature of capital expenditure.
3. It should not be personal expenditure of the assessee.
4. It should have been incurred in the previous year.
5. It should be in respect of the business carried on by the assessee.
6. It should have been expended wholly and exclusively for the purpose of such business.

**Advertisement in souvenir of political parties is not allowed: - Sec- 37(2b).**

### **Expenses expressly disallowed:- Section- 40**

Section 40 expressly provides that the following expenses shall not be deducted in computing profits and gains of business/ profession.

1. Wealth tax, gift tax, income tax.
2. Provisions or reserves for depreciation, doubtful debts, taxation and transfer to General and other reserves.
3. Income tax paid in advance.
4. Capital expenditure.
5. Interest on capital other than borrowed capital.
6. Interest on loan borrowed other than for business / profession.
7. Interest payable outside India with out TDS.
8. Expenses incurred against other heads of income charged to firm's account.
9. Payments made to non-working partners of the firm / proprietor of the business such as salary, commission, and bonus.
10. Personal expenses such as drawings, personal use of business premises, motorcar etc,.
11. Any payments exceeding Rs.10,000/- must be made by an Account payee cheque / Account payee demand draft, otherwise 100% of such payment is disallowed.
12. Charities and donations are disallowed.
13. Fines and penalties imposed for breach on any law are disallowed.
14. Fine for adulteration is disallowed.
15. Life insurance premium and carried forward losses are disallowed.

### **EXEMPTED INCOMES:-**

Following incomes are not taxable-

1. Interest on post office savings bank account up to Rs.3,500 for Individual account and Rs.7,000 for Joint account
2. Agricultural income from the land situated in India.
3. Refund of taxes.
4. Maturity value of Life Insurance Policy.
5. Share of income from HUF and partnership firm.
6. Bad debts recovered disallowed earlier.
7. Dividends from Indian Company or Domestic Company.
8. Gifts received from relatives.

### **Following incomes are taxable under other heads:-**

1. Income from salary.
2. Rent from house property.
3. Profits on sale of assets.
4. Interest on personal deposits.
5. Interest on Govt., securities.
6. Casual incomes.
7. Dividends from foreign companies and co-operative societies.



### Computation of Taxable Business Income: Section-29

Generally profit and loss A/c is prepared to find out profit or loss of the business. However the net profit shown by profit and loss account is not taken into consideration to calculate taxable profit. Therefore a separate statement is prepared as follows-

#### Statement showing Business Income:

**Computation of Income from Business of Mr. \_\_\_ for the Assessment Year**  
**\_\_\_\_\_ (Previous Year \_\_\_\_\_ (1-4- \_\_\_\_\_ to 31- 03- \_\_\_\_\_))**

<b>Net profit as per profit and loss account</b>		<b>XXXX</b>
ADD Expenses disallowed		xxxx
ADD Incomes related to business but not credited to p&l a/c		xxxx
ADD Excess expenditure debited to p&l a/c		xxxx
ADD Over valuation of opening stock and		xxxx
ADD Under valuation of Closing stock		xxxx
	Profit	XXXX
Less Incomes not taxable	xxxx	
Less Incomes taxable under other heads	xxxx	
Less Expenses allowed but not debited to p&l a/c	xxxx	
Less Under valuation of opening stock and	xxxx	
Less Over valuation of closing stock	xxxx	xxxx
		<b>XXXX</b>
	<b>Taxable Business Income</b>	<b>XXXX</b>

**Problems on Business Income:-**

**Problem: - 1.** From the following profit and loss account of Sri Raju, a sole trader, compute the Income from business for the Assessment year 2019-20.

	Rs.		Rs.
To General expenses	5,000	By Gross profit b/d	40,000
To Fire insurance premium on stock	1,000	By Interest on commercial securities	3,000
To Bad debts	1,000	By Sales tax collected	5,000
To Salaries	5,000		
To Advertisement	2,250		
To Proprietors salary	2,500		
To Int. on capital	2,000		
To Depreciation	2,000		
To Income Tax	1,000		
To Sales Tax	5,000		
To Donation to NDF	2,250		
To Net profit	19,000		
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	48,000		48,000

**Problem- 2.** Mr. Prakash a small businessman gives the following details drawn from his books of accounts.

Net profit as per profit and loss account. Rs.55,000.

Provision and reserves debited to profit and loss account for doubtful debts Rs.30,000, for depreciation Rs.40,000. Household expenses Rs.60,000, Donation Rs.60,000, cheques issued for purchases Rs.10,000, OYT Deposits Rs.10,000, Advertisement expenses include Rs.5,000 spent on NEON Sign Board and gift to 50 customers at Rs.100 each. Audit fees Rs.20,000, Patents purchased Rs.70,000 in the previous year. Market Survey expenses Rs.20,000 on a project of Rs.1,00,000.

Incomes credited to profit and loss account are-

Bank interest Rs.5,000, Interest on post office savings bank a/c Rs.3,000, Interest on UTI bonds Rs.2,000.

Opening Stock is valued at cost plus 10%, the value is Rs.1,32,000 and Closing Stock is valued at cost minus 10%, the value is Rs.1,44,000.

Compute Mr. Prakash's Business Income for the Assessment Year 2019-20.



**Problem- 3.** From the following profit and loss a/c, Compute the income from business.

To Trade expenses	1,500	By Gross profit	1,00,000
To Wages	33,000	By refund of tax	15,000
To Advertisement	20,000	By Gift from relatives	5,000
To Income tax	7,500	By Dividend from Indian Co.	2,150
To Contribution to Staff welfare fund	1,000		
To Donation to rural development fund Approved	2,000		
To LIC premium	750		
To Provision for bad debts	5,000		
To Interest on capital	3,550		
To Provision for sales tax	2,500		
To Expenses on know-how	18,000		
To patents	5,000		
To Gift tax	3,500		
To Fire insurance premium	850		
To Legal expenses	8,000		
To Net profit	10,000		
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	1,22,150		1,22,150

**Additional Information:**

1. Legal expenses include Rs.5,000 spent for curing the defect in the title of the business.
2. Actual Bad debts Rs.3,000
3. Advertisement include Rs.3,000 for Neon Sign Board and Rs.4,000 for advertisement in Political Magazine.
4. Allowable depreciation as per IT rules Rs.4,000.

**Problem- 4.** Following is the Profit and loss a/c for the year ended 31-03-2019.

	Rs.		Rs.
To Opening stock	80,000	By Sales	12,00,000
To Purchases	9,20,000	By Closing stock	90,000
To Gross profit	2,90,000		
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	12,90,000		12,90,000
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To Salaries	55,000	By Gross profit b/d	2,90,000
To Rent	25,000	By Bank Interest	500
To Commission	5,000		
To Legal charges	4,500		
To Bad debts	14,500		
To Reserve for bad debts	11,500		
To Repairs to Machinery	1,500		
To depreciation	26,500		
To Other expenses	2,000		
To Income tax	20,000		
To Net profit	1,25,000		
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	2,90,500		2,90,500

**Other Information:-**

- a) Sales includes goods worth Rs.50,000 which were drawn by the proprietor for his personal use. Cost price of such goods on the date of transfer was Rs.45,000 and the market value of such goods Rs.56,000.
- b) Rent includes Rs.3,600 for the house occupied by him for his residence.
- c) Bad debts includes Rs.3,000 which were not finally settled as irrecoverable.
- d) Legal expenses include Rs.500 towards stamp duty on purchase of building.
- e) Depreciation allowable Rs.30,000
- f) Both opening and closing stock was undervalued by 20%.

Compute Business income.

**Problem- 5.** Following is the Profit and loss a/c of a Merchant.

	Rs.		Rs.
To Rent	6,000	By Gross profit	52,300
To Rates	600	By Interest from debtors	2,800
To Salary to staff	5,400	By Rent from property	2,400
To Diwali pooja expenses	300	By Sundry income	1,600
To Interest on loan	12,500	By Commission	3,700
To Sundry expenses	5,400		
To Bad debts	600		
To Charity	100		
To Reserve for bad debts	200		
To Entertainment	850		
To Loss by theft	1,400		
To Net profit	29,450		
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	62,800		62,800

**Additional Information:-**

- a) Rent includes Rs.1,200 of a shop belonging to assessee himself.
- b) Salary of staff includes Rs.2,400 paid to his son who is B.com student who casually helps in the business.
- c) A loan of Rs.6,000 at 15% p.a is taken from his wife out of funds advanced by himself and this interest is included in interest on loan.
- d) Sundry expenses include Rs.900 being expenses incurred on pilgrimage to Haridwar.
- e) Entertainment includes Rs.150 spent on Tea to local MLA,
- f) Loss by theft took place when a pretended customer stolen a necklace worth Rs.600 and Rs.800 was stolen from his house in night by de locking.
- g) He earned Rs.4,000 in gold smuggling not shown in the books.
- h) Rates include Rs.400 for property let out.

Compute Business income of a Merchant.

**Problem- 6.** Compute the Business Income of a Merchant from the profit and loss a/c and the other information given below.

Profit and loss a/c of a Merchant for the year ended 31-03-2019.

To Opening stock	3,38,000	By Sales	8,70,000
To Purchases	3,29,800	By Closing stock	1,20,000
To Stores	21,900	By Miscellaneous income	2,490
To Power and Fuel	7,680	By Rent from House Property	6,000
To Rates and taxes	430	By Income from horse race	3,000
To Repairs	9,070		
To Mis. Expenses	15,860		
To Charity and donations	1,680		
To Salary	95,500		
To Contribution to RPF	6,200		
To Staff welfare expenses	1,020		
To Bonus	4,400		
To Insurance	2,500		
To commission	43,500		
To Selling expenses	780		
To Audit fees	980		
To Bad debts	2,100		
To License fees	1,090		
To Interest	26,500		
To Provision for tax	22,000		
To Depreciation	40,000		
To Net profit	30,500		
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	10,01,490		10,01,490

**Other Information:-**

- Miscellaneous expenses includes-
  - Penalty for violation of FEMA Rs.1,200
  - Expenses to defend a criminal case Rs.3,000 and
  - Donation to a cultural association Rs.5,000
- Bad debts include a sum of Rs.500 for advance to supplier of raw materials with whom the merchant had exclusive arrangement for purchase of such material.
- Miscellaneous income includes refund of advance income tax Rs.400.
- Allowable depreciation Rs.36,000.
- Repair expenses are related to the business premises.

**Problem- 7.** From the profit and loss a/c of Mr. Ravi, Compute taxable income from business.

	Rs		Rs
To Salary to staff	75,000	By Gross profit b/d	2,50,000
To Salary to proprietor	9,000	By Agricultural income	6,300
To Interest on capital	10,000	By Commission	5,000
To Interest on wife's loan	2,500	By Interest on debentures	7,500
To General expenses	12,500	By Interest on deposits	3,675
To Drawings	50,000	By Rent from H.property	16,250
To Income tax	9,500	By Interest on post office	
To Provision for Bad debts	7,500	savings bank a/c	2,500
To Bad debts	5,000	By LIC policy maturity	
To LIC Premium	1,000	amount	25,000
To Fire insurance premium	1,250	By Miscellaneous income	1,025
To Legal expenses	6,750		
To Additions to building	6,250		
To Charity	750		
To Donation	4,000		
To Gift tax	3,500		
To Sales tax	20,000		
To Depreciation	17,500		
To Repairs	2,000		
To Net profit	73,250		
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	3,17,250		3,17,250

**Other information:-**

1. Depreciation allowable as per IT rules Rs.15,000
2. Income from smuggling Rs.20,000 not recorded in the books of accounts.
3. General expenses include Rs.2,500 paid for purchase of office furniture.
4. The loan given by his wife is out of her own earnings.
5. Legal expenses include Rs.2,000 paid for Income tax appeal and Rs.1,500 for rectifying the defect to the title of Building.

**Problem – 8.** Shri Gopala (age 52 years), a resident of Mysore submits the following profit and loss account for the year ending 31<sup>st</sup> March 2019.

Particulars	Rs.	Particulars	Rs.
Opening stock	1,10,000	Sales	36,00,000
Purchases	14,00,000	Closing stock	2,20,000
Wages	3,00,000		
Gross profit	20,10,000		
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	<b>38,20,000</b>		<b>38,20,000</b>
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Advertisement	2,00,000	Gross profit b/d	20,10,000
Salary to staff	6,60,000	Rent	2,40,000
Gopala's salary	1,20,000	Commission	1,50,000
Audit fees	60,000	Bad debts recovered	
Bad debts	40,000	(earlier disallowed)	70,000
Reserve for bad debts	50,000	Dividend on SRM Ltd.	
General expenses	2,50,000	Shares (Gross)	30,000
Municipal tax	24,000		
Fire insurance premium on goods	26,000		
Depreciation	78,000		
Patent rights	1,60,000		
Staff welfare fund	40,000		
Employees RPF	50,000		
Sales tax	1,90,000		
Donation to NDF	1,00,000		
Premium on Gopala's life insurance	36,000		
Net profit	4,16,000		
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	<b>25,00,000</b>		<b>25,00,000</b>

**Other Information:**

1. Opening stock and closing stock were overvalued by 10%.
2. Advertisement includes Rs. 1,00,000 being cost of permanent sign board.
3. Business income of Rs.70,000 was not recorded in the profit and loss account.
4. General expenses include Rs. 50,000 paid for securing business orders and Rs. 60,000 spent on Gopala's birth day.
5. Depreciation allowable on all assets including permanent sign board but excluding patent rights as per IT rules was Rs. 90,000.
6. Patent rights were acquired on 11-10-2018 on which depreciation allowable at 25%.

Compute taxable income from Business for the Assessment Year 2019-20.