CHAPTER NINE

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Chapter 9
TAX IMPLICATIONS

9.1 Resident and non-resident for tax purposes

The residential status of an individual under the I.T. law is based on the duration of his stay in India in the relevant financial year.

An individual will be "resident" in India in a previous year if he satisfies one of the following two conditions:

i) he is in India in that year for a period or periods totalling not less than 182 days or

ii) he has been in India (a) for a total period of 365 days or more in the four years preceding that year and (b) for 60 days or more in that year.

Clause (ii) above has the following exceptions:

a) Where a citizen of India leaves the country in any year for taking up employment abroad, he will be treated as a non-resident for that year unless he has been in India for 182 days or more. Thus an Indian citizen could leave India during any financial year and not be liable to pay tax in India on his foreign income provided his stay in India during that year is less than 182 days.

Illustration

Mr. Sayyad Hussain, an Indian citizen leaves India for the first time on 15/11/85 to take up employment in Abudhabi. He earns Rs.80,000 in Abudhabi and Rs.20,000 in India during the year 1985-86. Since his stay in India is less than 182 days during the year 1985-86 he is a "Non-resident" for assessment year 1986-87 and will be taxed in India on Rs. 20,000 only.
b) An Indian citizen visiting India and staying here in any previous year for a period of not more than 89 days will be regarded as "non-resident" for that year irrespective of the duration of his stay in India in the earlier years.

A non-resident Indian, for tax purposes, is an individual, being a citizen of India or a person of Indian origin, who is not a "resident".

A partnership firm or an association of persons established abroad will be treated as "Non-Resident" if its entire control is held outside India. Similar is the case with a company or other body corporate incorporated in a foreign country.

9.2 Special income tax provisions for NRIs

To encourage the flow of foreign exchange remittances to India and investment in the country by NRIs, the Finance Act, 1983, introduced a new Chapter, XII A, in the Income Tax Act, 1961. Sections 115C to 115 I in this Chapter detail the concessions applicable to NRIs. Briefly, a concessional rate of tax viz. 20% is charged on (a) investment income and (b) long term capital gains derived from a "foreign exchange asset" i.e. any "specified asset" which the assessee had acquired with or subscribed to in "convertible foreign exchange".

"Investment income" means any income derived from a foreign exchange asset.

"Long-term capital gain" means income chargeable under the head "Capital Gains", relating to a capital asset, being a foreign exchange asset held by the NRI for more than thirty six months.
"Specified asset" means any of the following:

i) shares in an Indian company;

ii) debentures issued by an Indian company, other than a private company;

iii) deposits with an Indian company other than a private company;

iv) securities of the Central Government and

v) any other asset specified in this behalf by the Central Govt. by notification in the Official Gazette. (Twelve percent 6 year National Savings Certificates VIth and VIIth Issues are examples of such assets notified by the Government.)

"Convertible foreign exchange" means foreign exchange treated by the RBI as such for the purposes of FERA. It includes, all foreign currencies except those of Nepal and Bhutan.

Since tax at a flat rate of 20% is payable by the NRI on his gross total income consisting only of investment income or income by way of long term capital gains or both, the initial exemption of Rs.18000/- per annum, to which the resident individual is eligible, is not available to him. Similarly no deduction for any expenditure incurred by the NRI in earning such income is allowed. For instance, if an NRI has borrowed money for investing in shares of Indian companies, the interest paid on the loan will not be allowed to be deducted from the investment income from these shares. Similarly, the deduction up to a maximum of Rs.12,000/- p.a. allowed to a resident individual in computing his income from bank interest, dividends on shares and units and
certain other sources, under Section 80L of the I.T. Law is not available to the NRI. When the total income of the NRI includes any income besides investment income and/or long term capital gains, the flat concessional rate of 20% will be charged only on the latter; the former would be taxed at appropriate rates applicable thereto as in the case of resident Indians, subject to the provisions of the Act dealing with deductions, exemptions etc.

It is only NRIs in the higher income brackets, whose effective marginal rates of tax are higher than 20%, who stand to benefit by the concessional tax rate. This scheme may be disadvantageous to the smaller assessee whose effective tax rate is less than 20% either due to the basic exemption factor or due to deductions under Chapter VI-A of the I.T. Law in respect of insurance payments (Sec. 80 C), specified income from shares, interest on bank deposits etc., (Sec. 80 L), deduction in respect of long term capital gains (Sec. 80 T) etc., Such a person may, however, elect not to be governed by the provisions of Chapter XIIA. This can be done by filing a written declaration along with the return of income that the provisions of this Chapter shall not be applied to him for the relative assessment year. Where such a declaration is furnished, the NRI will be assessed on his total Indian income, including investment income and long term capital gains, like any other resident Indian.

The following illustrations will help clarify the position regarding the NRI’s tax liability.
Illustration I

Mr. R., being a Non-resident Indian, has the following income for Assessment year 1986-87:

<table>
<thead>
<tr>
<th>Income</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Long term capital gains (before deduction u/s 80 T)</td>
<td>4,00,000</td>
</tr>
<tr>
<td>Business income</td>
<td>2,00,000</td>
</tr>
</tbody>
</table>

If option under Chapter XlIIA is not exercised, tax liability will be as under:

a) Tax @ 20% on Rs. 7,00,000 = 1,40,000

b) Tax @ ordinary rates on Rs. 2,00,000 = 79,250

Total = Rs. 2,19,250

If option is exercised, the calculation would be as under:

<table>
<thead>
<tr>
<th>Income</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Income</td>
<td>2,00,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Less exemption u/s 80L</td>
<td>7,000</td>
</tr>
<tr>
<td>Long term Cap. gains</td>
<td>4,00,000</td>
</tr>
</tbody>
</table>

Less exemption u/s 80T presuming that the shares are held for more than 3 years (basic exemption Rs. 5,000 +40% of balance Rs. 3,95,000) = 1,63,000

Total = 2,37,000

Tax on Rs. 7,30,000 = Rs. 3,44,250

Thus, there will be a net saving in tax of Rs. 1,25,000 if the option is not exercised, i.e. if the NRI allows the new provision to be operative in his case.
Illustration II

Mr. R., an NRI, has a Dividend income of Rs. 21,500 from foreign exchange assets for Assessment Year 86/87.

His tax liability will be as under:

i) If option under Chapter XIIA not exercised

<table>
<thead>
<tr>
<th></th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>21,500</td>
</tr>
<tr>
<td>Less 20% tax</td>
<td>4,300</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td><strong>17,200</strong></td>
</tr>
</tbody>
</table>

ii) If option is exercised:

<table>
<thead>
<tr>
<th></th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>21,500</td>
</tr>
<tr>
<td>Less deduction S.O.L</td>
<td>7,000</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>14,500</strong></td>
</tr>
</tbody>
</table>

N.B. As taxable income is less than Rs. 18,000 he will not be liable to tax at all. Hence his entire income will be on hand.

The benefits under Chapter XIIA will be available even after the NRI becomes "resident" in India in a subsequent year. This, however, will not apply to investment income from shares in an Indian company. It will only apply to other "investment income". For this purpose the NRI should furnish a written declaration along with his return of income. This concession will be available till these assets are converted into money.

The concessions in Chapter XIIA are available to NRI individuals only — not to firms, trusts, societies or corporations of NRIs.
9.3 NRI concessions in other direct tax laws

a) Wealth Tax - Foreign exchange assets in the hands of NRIs and persons of Indian origin are exempt from Wealth Tax. Wealth in the form of Notified savings certificates held by them is also so exempted. Other wealth tax concessions for NRIs are those in respect of agricultural property (totally exempt), the value of a conveyance in the possession of the NRI (exempt upto a value of Rs.75,000/-), investments in the new equity issues of companies in the priority sector (totally exempt), and, in the case of NRIs returning to India for permanent settlement, moneys and value of assets brought into India and the value of assets acquired out of such moneys (exempt for a period of seven years).

b) Gift Tax - The following are exempted from Gift Tax:—
   i) gifts out of monies standing to the credit of the NRI’s NRE A/c in any Indian Bank;
   ii) gifts of foreign currency by NRIs to any of their relatives in India;
   iii) gifts by NRIs of property in the form of specified foreign exchange assets acquired with convertible foreign exchange;
   iv) gifts in the form of Capital Investment Bonds made by the NRI subject to a maximum of Rs. 10 lacs.
9.4 Tax incentives for business investment in India

It is necessary for the NRI returning home and investing his savings in business in India to know that the Indian direct tax laws provide substantial tax concessions in the form of special exemptions, deductions and reliefs linked to purposes which are important for the socio-economic development of the country. Thus, some of the major tax incentives have the objectives of stimulating industrial growth through setting up of new industries, expansion of the existing ones by fresh investment and encouraging fuller utilisation of installed capacity for increasing production. The objectives of certain other important tax concessions are to accelerate scientific research and technological development, facilitate foreign collaboration and import of advanced modern technology in certain fields of industry on a selective basis, augment foreign exchange resources through promotion of exports, and widening the base of the economy by encouraging the growth of the co-operative and small-scale industrial sectors, particularly in the rural or backward regions.

The main tax incentives in these areas are as under:

i) Funding scheme (Investment Deposit Account) (S 32AB)

ii) Depreciation allowance (S 32)

iii) Amortisation of certain preliminary expenses (S 35D&E)

iv) Allowance for expenditure on scientific research (S 35)

v) Exemption from tax of interest on deposits in Non-resident (External) account in India (S 10(4A)

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vi) Exemption from tax on interest payable by the Government, a local authority, a financial institution or a banking company etc., on loans raised in foreign countries (S 10(15) (IV)

vii) Exemption from tax of interest on certain securities (S 10(4))

viii) Concessional tax treatment of royalties, commission etc., received by Indian companies for providing technical know-how or services (S 80.0)

ix) Concessional tax treatment of inter corporate dividends (S 80 M)

x) Investment in new shares (S 80 CC)

xi) Tax holiday for new industrial undertakings (S80I & 80J)

xii) Tax concessions for small-scale industrial undertakings set up in rural areas (S 80 HHA)

xiii) Special deduction for newly established industrial undertakings, certain business activities or hotel business in backward areas (S 80 HH)

xiv) Deduction in respect of profits retained for export business (S 80 HHC)

xv) Tax concessions for investment in the Unit Trust of India (S 30 L)

Footnote *Source "Income Tax Guide for Non-Residents and Indian Nationals Abroad" published by Income Tax Dept., New Delhi. (The 1981 edition of this publication has been updated with reference to current tax provisions).

N.B. Indicated in brackets against each item is the relevant Section of the Income Tax Act, 1961.
9.4.1 Investment Deposit Account

The Government of India has recently introduced a new Investment Deposit Scheme in replacement of the erstwhile Investment Allowance. Under this Scheme an assessee is entitled to a deduction, of a maximum of 20% of his profit before tax, after making necessary adjustment for depreciation as per Income Tax Rules, provided he fulfills any one of the following conditions:-

1. he has invested within six months from the end of the previous year any amount in an account maintained by him with a Development Bank (e.g. IDBI);

2. he has utilised any amount during the previous year for purchase of any new machinery, plant, ship or aircraft in accordance with and for the purpose specified in a scheme framed by the Central Government.

Profit before tax is a pre-condition for claiming deduction.

Previously, Investment Allowance was allowed on the basis of investment in new machinery irrespective of profit from business.

9.4.2 Depreciation allowance

A taxpayer is entitled to normal depreciation allowance in respect of buildings, furniture, plant and machinery owned by him or used for the purpose of his business or profession. Such allowance is also available in respect of capital expenditure incurred by the taxpayer on the renovation, extension or improvement of his business premises, even though these premises may have been hired by him. The depreciation allowance is calculated at the
prescribed rates on the actual cost of acquisition of the asset for the first year of its use and thereafter on its written down value. Unabsorbed depreciation allowance is carried forward and set off against the profits of the business or profession in future years without any time limit.

From assessment year 1988-89, the prescribed rates of depreciation are 5%, 10%, 20% and 100% for building, depending upon the nature of construction, 10% and 15% for furniture and fittings, depending upon usage and 33.33%, 50% and 100% for plant and machinery depending upon the nature of the equipment. Full depreciation is admissible even if the asset has been in use for only one day in the previous year. Assets of the value of Rs. 5,000 or less can be written off entirely in the very first year.

To encourage fuller utilisation of the installed capacity, an extra shift allowance equal to 50% of the normal depreciation is allowed for the period for which the plant or machinery has worked double shift. The allowance is increased by another 50% where machinery or plant has worked triple shift. In the case of an approved hotel belonging to an Indian company, the machinery and plant installed therein is eligible for an extra depreciation allowance of only 50% of the normal depreciation allowance.

9.4.3. Amortisation of certain preliminary expenses

Preliminary expenses incurred by an Indian company or any other resident taxpayer on setting up of a new industrial
unit or for extension of an existing industrial undertaking, to the extent of 2.5% of the cost of the project or, in the case of an Indian company, at its option, 2.5% of the capital employed in its business, are allowed to be amortised against profits in ten equal annual instalments beginning with the accounting year in which the new unit commences production or operation or the extension of the industrial undertaking is completed.

The various types of preliminary expenses qualifying for such amortisation include expenses incurred on the preparation of feasibility and project reports, conducting market or other surveys, obtaining engineering services related to the business, expenditure incurred on drafting and printing the Memorandum and Articles of Association of the company, fees paid for registration of the company and underwriting commission and other related expenses incurred in connection with any public issue of shares or debentures.

Preliminary expenditure incurred by a resident taxpayer on operations of prospecting for and the development of a mine for the extraction and production of specified minerals or groups of associated minerals during the period of five years up to the year in which commercial production commences is allowed to be amortised in ten equal annual instalments against the income derived from commercial exploitation of the mine. If any part of the allowance remains unabsorbed
due to insufficiency of such income, it is carried forward to succeeding years and allowed against the income of those years within the time limit of ten years. Such expenditure is allowed to be amortised even though any part thereof may have proved infructuous or abortive, provided that ultimately, commercial production is established.

9.4.4. Allowance for expenditure on scientific research

All expenditure, whether revenue or capital in nature, which is incurred on scientific research related to the business carried on by the taxpayer is deductible in the year in which it is incurred. Such expenditure is deductible in certain cases even if it is incurred prior to the commencement of the business. Any sum paid by a taxpayer to an approved university, college or other institution, or a scientific research association for being used for scientific research whether related to the taxpayer’s business or not, is allowable as a deduction in full. Where such payment has been made for scientific research undertaken under an approved programme, to an approved university, college, other institution, scientific research association or public sector company, having regard to the social, economic and industrial needs of India, the taxpayer is entitled to a weighted deduction at one and one third times the amount of the contribution. In respect of any expenditure, other than expenditure of a capital nature incurred on the acquisition of any land or building, or construction of building, incurred on
scientific research undertaken under an approved programme, having regard to the social, economic and industrial needs of India, the taxpayer is entitled to a weighted deduction at one and one-fourth times the amount of expenditure certified by the prescribed authority to have been so incurred during the previous year.

Contributions made to an approved university, college or other institution to be used for research in social science or statistical research related to the class of business carried on by the taxpayer are also deductible.

9.4.5. Exemption from tax of interest on deposits in a non-resident (external) account in India

Non-resident persons are exempt from tax on income by way of interest on moneys standing to their credit in a Non-resident (External) Account in any bank in India, provided the deposits therein have been made and the account has been maintained in accordance with the FERA and the rules made thereunder.

9.4.6. Exemption from tax on interest payable by the Government, a local authority, a financial institution or a banking company etc., on loans raised in foreign countries.

Any interest payable by an industrial undertaking in India on a foreign loan is exempt from income-tax, if the money has been borrowed in a foreign country under a loan agreement entered into with a financial institution and the financial institution has been approved by the Central Government. The following institutions have so far been approved for this purpose:
i) International Finance Corporation, Washington, D.C.


iii) Export-Import Bank of Japan, Tokyo

iv) Development Loan Fund, Columbia, U.S.A.

v) Kreditanstalt fur Wiederaufbau (West German Bank for Reconstruction), West Germany.

vi) Export Credit Insurance Corporation of Ottawa, Canada

vii) Banque Francaise Du Commerce Exterieur, Paris

Tax exemption is also available on interest payable by an industrial undertaking in India-
a) on moneys borrowed or debts incurred by it for the purchase outside India of capital plant and machinery or raw-material, or
b) on a loan in foreign currency from sources outside India under an agreement approved by the Central Government having regard to the need for industrial development of India.

In either case, such exemption is limited to interest calculated at the rate approved by the Government having regard to the terms of the debt or loan and its repayment.

Similarly, there is an exemption from tax on interest payable by the IFC, IDBI and ICICI on loans by them from sources outside India to the extent of the interest calculated at the rate approved by the Central Government, having regard to the terms of the loan and its repayment.

The exemption is also available in respect of interest payable by any other financial institution or banking company in India on any moneys borrowed by it from sources outside India under a loan agreement approved by the Central Government for lending to industrial undertakings in India for importing any capital plant and machinery, raw material or other goods whose import is considered by the Central Government to be in the public interest. Here also the exemption is limited to the interest calculated at the rate approved by the Central Government.

9.4.7 Exemption from tax of interest on certain securities

Non-resident persons are exempt from income-tax on income by way of interest on specified securities, or on income by way
of interest on or from premium on the redemption of bonds issued by the Central Government under a loan agreement between the Central Government and the International Bank for Reconstruction and Development or under a loan agreement between the Central Government and the Development Loan Fund of the U.S.A., or by an industrial undertaking or financial corporation in India under a loan agreement with the said Bank or Fund which is guaranteed by the Central Government.

9.4.8 Concessional tax treatment of inter-corporate dividends
Where the gross total income of a domestic company includes any income by way of dividends from another domestic company, a deduction to the extent of 60% of such dividend income is allowed to the company receiving such dividends.

9.4.9 Investment in new shares
An individual, or a Hindu undivided family, or an association of persons or a body of individuals consisting only of husband and wife governed by the system of communal property in force in the Union territories of Dadra and Nagar Haveli and Goa, Daman and Diu, making any investment in equity shares, forming part of any eligible issue of capital, will be allowed a deduction on his total income of an amount equal to 50% of the cost of such shares, limited to an aggregate amount of Rs. 20,000/-.

The "eligible issue of capital" for purposes of such investment means the first issue of capital the equity shares of which are offered for subscription to the public, and satisfies the following conditions:
a. the issue is by a public company formed and registered in India with the main object of carrying on the business of construction, manufacture or production of any article or thing, other than an article specified in the list in the Eleventh Schedule to the Income Tax Law or

b. the issue is made by an approved public company which has been formed and registered in India with the main object of carrying on business of providing long-term finance for construction or purchase of houses for residential purposes.

9.4.10 Tax holiday for new industrial undertakings

A newly set-up industrial undertaking is entitled to exemption from income-tax for a period of five years (seven years in the case of a co-operative society) commencing from the year in which it goes into production, on its income upto 7.5 per cent of the capital employed in the undertaking. The concession is also available to the business of cold storage plants and the business of hotels and shipping carried on by Indian companies. Any deficiency of profits during any year of the "tax holiday" period can be carried forward upto eight years reckoned from the initial year of the new business.

For qualifying for this exemption, the industrial undertaking must:-

a. employ ten or more workers in a manufacturing process carried on by it with the aid of power or twenty or more workers in a manufacturing process carried on without the aid of power;
b. not be formed by the splitting up or the reconstruction of an existing business;
c. not be formed by the transfer to the new business of building, machinery or plant previously used for any purpose.

The new undertaking need not necessarily be established as an independent and separate organisation. A new unit set up in an existing undertaking and designed to expand the latter's productive capacity to a substantial extent is also entitled to the "tax holiday", provided it is not simply by way of renovation or replacement of the existing equipment.

These "tax holiday" provisions will apply in relation to new industrial undertakings which go into production before 1/4/1981 or approved hotels which start functioning before that date or new ships which are brought into use on or before that date. In computing the value of the capital employed in the industrial undertaking or as the case may be, the business of the hotel, the value of certain assets will not be taken into account and the computation of the capital employed for any assessment year will be done in accordance with the provisions of rule 19A of the Income-tax Rules, as it existed on the first day of the relevant assessment year.

In respect of new industrial undertakings (including cold storage plants) which are set up after 31/3/1981, but before 1/4/1985, or approved hotels which start functioning after that date, but before 1/4/1985, or ships which are brought
into use after 1/4/1981, but before 1/4/1985, the basis of computing the "tax holiday" profits has been changed from capital employed to a percentage of the taxable income derived from the new industrial unit, ship or approved hotel. In the case of companies, 25 per cent of the profits derived from new industrial undertakings etc., will be exempt from tax for a period of eight years, and in the case of other taxable entities 20 per cent of such profits will be exempted for eight years. In the case of co-operative societies the exemption will be allowed for a period of ten years.

The benefit under the new scheme would be admissible to all small scale industrial undertakings, even if they are engaged in the production of articles in the non-priority sector as listed in the Eleventh Schedule to the Income-tax Act. In the case of other industrial undertakings, however, the deduction will be available, only if, the undertakings are engaged in the production of articles other than those listed in the said schedule.

9.4.11 Tax concession for small-scale industrial undertakings set up in rural areas

A taxpayer deriving income from a small-scale industrial undertaking newly set up in rural areas (except an undertaking engaged in mining) is entitled to a ten-year exemption from income-tax on 20 per cent of the profits from the undertaking. To qualify as a small-scale industrial undertaking, the aggregate cost of the machinery and plant installed in it, as on the last day of the relevant accounting year, should not exceed Rs.35 lakhs.
A rural area is one which is outside the jurisdictional limit of a municipal body or a cantonment board and which has a population exceeding 10,000 persons, or such area as is notified by the Government and is beyond a distance of fifteen kilometres from such municipal body or cantonment board.

9.4.12 Special deduction for newly established industrial undertakings or hotel business set up in a backward area

A deduction equal to 20 percent of the profits and gains derived by a new industrial undertaking or hotel set up in the specified backward areas is allowed in computing its taxable profits. This concession is available for a period of 10 years from the establishment of the industry or hotel. If such undertaking or hotel is also eligible for the tax concession referred to above, it can avail of only one of them, according to its option.

9.4.13 Deduction in respect of profits retained for export business

An assessee is entitled to a deduction of the whole of the income derived by him from the export of goods or merchandise, other than mineral oil and ores.

9.4.14 Tax concession for investment in the Unit Trust of India

In the case of a non-resident assessee who is an Indian citizen, or a person of Indian origin, or a Hindu undivided family, any income received by such assessee in the previous year in respect of units acquired by such assessee out of funds in the Non-Resident (External) Account will be exempt from income-tax.
9.4.15 Other deductible expenditure

Besides the above concessions, other deductions permitted on business income, besides normal business expenditure are:

a) bonus or commission paid to employees (S.36(i)(ii));

b) entertainment expenditure (S. 37 (2A));

c) advertisement expenditure (S.37 (2B) & 37 (3))

d) expenditure in respect of travelling (S 37 (3));

N.B. Only the major concessions available to industrial undertakings/commercial establishments under the I. Tax law have been dealt with above in a concise manner. For further details a reference to the Income Tax Act, 1961 is both necessary and advisable.

9.5 Income tax on limited companies

Before concluding this chapter a note may be made of the rates of income tax applicable to limited companies registered in India.

In the case of domestic incorporated companies the rates of income tax applicable are:

a. Where the company is one in which the public are substantially interested (i.e. widely held company)

b. Where the company is not one in which the public are substantially interested (i.e. closely held coy.)

i) in the case of a trading or investment company

ii) in any other case

In addition there is a surcharge 3% on income tax payable where the total taxable income of the company exceeds Rs.50,000/-