

Two certainties in life -
Death and Taxes!

- *Anonymous*

Born free, Taxed to death!

- *A Windscreen sticker*

CHAPTER ONE

DIRECT TAXES : A CONTEMPORARY PERSPECTIVE

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1.1 INTRODUCTION:

1.1.1 Historicity of Taxation:

From the earliest days of recorded history, one of principle challenges to Government has been the management of public finance. General taxes (that is, those compulsory levies collected by the Government that are unrelated to particular expenditure items) make up a bulk of the government revenue. Tax revenue is usually considered under two headings, namely, direct taxes on individuals and firms, and indirect (commodity) taxes on goods and services. Carolyn Webber and Aaron Wildavsky (*History of Taxation and Expenditure in the Western World, 1986*) offer the following glimpse into the taxation policies from ancient times to the present:

"No matter what a society's patterns of taxing and spending are, supporting government has always been problematic. In this respect at least, past and present merge. ... Virtually every aspect of modern budgetary behaviour that we regard as especially distinctive has its analogue in ancient practices. Governments, from the Mauryan kings of ancient India to early Roman emperors to the feudal monarchies of medieval Europe and the new nation-states of the early-modern era,

have tried to maintain accounts of tax receipts, and sometimes (but never successfully) to keep records of spending for different purposes.

"Ancient, medieval and early-modern governments certainly lacked effective technical and administrative instruments, but they did use expedients to help stay afloat. They taxed the land and necessities..... When officials could not get inside houses, they taxed columns, windows, and doors. They levied hundreds of taxes on the production and sale of commodities and services. In doing this, governments alienated their subjects, debased public morality, and wrought havoc with trade. But, for the most part, they got by. And when, after centuries of reform, such venal and inefficient practices were abolished, governments still faced financial crises. The big difference today is that crises take place at much higher levels of expenditure and revenue.

"Whether or not governments stay solvent, efforts by governments at diverse times and places to raise and spend revenue convey the message that taxing and expenditure are never a straightforward matter."¹

In India, of course, there are the wellknown tales of Mughal Emperor Akbar's courtier, Birbal, who is said to have taxed the boatmen for the waves they made on the river waters, and also of another Mughal Emperor Aurangzeb, who imposed an

annual 'per head' tax ('Ziziya') on all Kaffirs (Non-Believers). Direct taxation, thus, is not a novelty in India introduced by the British, but a most ancient and wellknown institution.

1.1.2 Foundational Aspects:

Adam Smith (d.1790), who is credited with laying down the foundation of the modern-day science of Political Economy (or Economics), was the first to propose the maxims of taxation based on Proportional Tax-Incidence. His pioneering work '*Wealth of Nations*' (1776) "has been the guide for successive generations of economists and the starting point of all their speculation".² While dealing with the theory of taxation, he enunciated four maxims, namely:

(a) The subjects of every state ought to contribute towards the support of the government, as early as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the State.

(b) The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all be clear and plain to the contributor, and to every other person.

(c) Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

(d) Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above, what it brings into the treasury of the State".³

Although the original approach elemental in these maxims must have raised a great deal of interest in England, which at the time, was in the early phases of testing the practicality of the ideas thrown up during the Renaissance Period (late 14th to late 17th Centuries) and also had launched herself on the territorial conquests in the New World. Adam Smith did not survive to witness the putting into practical use of his innovative thinking.

The taxation on personal income, i.e. income-tax, was imposed in England in the year 1798 by William Pitt, so as to raise the funds needed by the British Government to meet the financial difficulties caused by the war with France. It was for the first time a Royal Decree accorded equal treatment to all the taxpayers in the sense that the rate was applied uniformly to each corner of income but the tax incidence was proportional. Right since its commencement, income-tax was never thought to be a permanent measure of taxation and as a result, during the subsequent years, it recorded a chequered career. The following condensed version of Simon's narrative (*Simon's Income Tax, 2nd Edition*) reveals this aspect:

"The final shape of the income-tax in the Napoleonic wars was achieved by an Act passed in 1806. The rate of tax was increased and remained unchanged until the expiry of the tax in 1815. After the political revolution of 1830's, the only alternative was to restore the income tax for three years only (But with this reimposition), the modern income-tax began its long, fruitful and uninterrupted career. Gladstone's expectation of the disappearance of the income-tax by 1860 was doomed to disappointment, for during the Crimean war (1855-56), the rate (of income tax) rose. At the General Election of 1873, Gladstone (had) promised the complete repeal of the income-tax but the electors rejected his government on other issues and **henceforth, the tax was regarded as an integral part of the country's permanent fiscal system**" (emphasis added).⁴

From the brief historic account given above, it is clear that gradually the taxation of income became a tool in the hands of the Government to raise the necessary revenues for meeting the exigencies faced by it; initially, those brought on by wars, and later on, those forced on a Government by the country's fiscal necessities.

The concept of 'Proportional Tax-Incidence' held the

field for almost one and half centuries; but soon, the ramifications of the Industrial Revolution forced Adam Smith's followers to propound an alternative theory of 'Progressive Tax-Incidence'. In contrast to the proportional basis, progressive taxation involves the application of gradually increasing rates of tax to progressively increasing amounts of income. Simon's another account reveals the political and popular thinking that went into changing the income-tax from being proportional to progressive:

"All suggestions for 'gradation' of the tax were met with a non-possum. In 1811, the then Chancellor of the Exchequer (Spencer Perceival) told the House of Commons, "As for laying a higher income-tax on the richer classes that would be a complete subversion of all the principles of justice by which the property of all men should be equally protected by the law". Later on, Gladstone also rejected the idea of 'Gradation' as "tending to communism". The progressive taxation, however, was firmly ensconced by Lloyd-George in 1909, with the comment that, "It (the income-tax) is no longer temporary but the centre and sheet-anchor of our fiscal system".⁵

1.1.3 Genesis of Progressive Tax-Incidence:

Indeed, the economists of the Progressive School took

great pains to spell out the conditions subject to which alone the 'liberal' or 'progressive' variant of 'equal sacrifice' or 'ability to pay' was to be put into practice by the State. Professor A.C.Pigou, (*'Economics of Welfare'*) after pointing out that poor people in civilized countries are usually given help through the agency of the State, thinks that for a variety of reasons, income-tax is the best means of doing so. According to him, income-tax really "represents what is, in effect, a transfer of income from relatively rich for the benefit of the relatively poor persons".⁶ In order to meet this end, the Professor strongly advocates the application of 'coercion' by the State through the following process of reasoning:

"A considerable amount of coercive transference is, therefore, also necessary; which means, in one form or another, taxes, and probably in the main, direct taxes, graduated against the owners of large incomes and properties".⁷

Thus, Adam Smith's first maxim, as modified by the theories forged by the successive generations of scholars of Pure and Applied Economics, means that the direct taxes should be so contrived as to ensure the well-being and prosperity of all the citizens of the State, those who pay the tax as well as those who do not.

Adam Smith's second and third maxims spell out other characteristics of the taxes, which, equally with the scale

of tax-rates, should be made to exercise harmonious reaction on the taxpayer's capacity as well as the will to pay income-tax. These two maxims are often expressed with the terms 'Certainty' and 'Convenience'.

As for the fourth maxim, Adam Smith had anticipated that the cost of collecting the direct taxes would be a small percentage of the total collections, particularly when with the rising rates of taxes, more money would come into the coffers of the State with no extra cost.

One of the advantages of 'direct taxes' recognized by the advocates of progressive taxation is that it develops 'tax consciousness', inasmuch as the payer of such tax is definitely conscious of a making a contribution to the welfare resources of the State and can be expected to take interest in improving/removing governmental waste and inefficiency.

By the turn of the 19th Century, the earlier ideas about direct taxation were being rejected as orthodox and a new doctrine formulated, which propounded that:

- (1) Proportional income-tax was unfair and inequitable, because it merely gave 'equality of sacrifice' in 'financial sense' only, and
- (2) Progressive income-tax was invented to give more equitable, juster and fairer method of achieving 'equal sacrifice' between the taxed rich and the taxed poor.⁸

Also around this time, the Conservatives of England gave way to the Liberals and Lloyd-George was the first British Prime Minister to adopt the new Doctrine of Progressive Taxation.

It, however, ought to be pointed out at this stage that as is true in case of many abstract and purely theoretical concepts, the noblest idea of 'taxation on income' (to lend support to the State's activities to ensure wellbeing and prosperity of its citizens) also ran into interpretational difficulties over what could, and rightly should, constitute an 'income' of a person and what could rightly be called 'tax'.

The concept of "income" has proved to be elusive and has defied analysis. Professor Irving Fisher attempts to differentiate between "Capital" and "Income" in the following words:

"'Capital' is a fund and 'income' a flow ... Capital is wealth and income is the service of wealth. A stock of wealth existing at an instant of time is called Capital. A flow of services through a period of time is called Income. ... From the time of Adam Smith, it has been asserted by economists, ... that only particular kinds of wealth could be Capital, and the burning question has been, What kinds? ... almost every year, there appears some new attempt to settle the disputed conception, but unfortunately, no authoritative

result has yet followed these attempts. On the contrary, many of them only served to put more combatants in the field and furnish more matter to the dispute.⁹

Confining the present discussion to the taxation of income, possibly the best definition of 'income' comes from the Supreme Court of the United States:

"(Income), ... a gain ... coming in, being derived, that is, received or drawn by the recipient (taxpayer) for his separate use, benefit, and disposal; that is income. Nothing else answers the description".¹⁰

For the taxing statutes as they were applicable in the British Empire then, Sir George Lowndes, Judge on the Privy Council, pronounced the following in the year 1932:

"Income connotes a periodical monetary return coming in with some sort of regularity or expected regularity from definite sources. The source is not necessarily one which is expected to be continuously productive, but it must be one whose object is the production of a definite return, excluding anything in the nature of windfall ... It is essentially the produce of something which is often loosely spoken of as 'Capital'".¹¹

The Privy Council elaborated this definition further in the year 1943 as:

"... Income is not necessarily recurrent return from a definite source, though it is generally of that character. Income again may consist of a series of separate receipts, as it generally does in the case of professional earnings".¹²

In India, the definition of 'income' handed down by the Supreme Court in the year 1962, more or less, is valid for the purposes of the Income-tax Act, 1961:

"The word 'income' has not been defined in the Income-tax Act. In the definition which is enacted, certain receipts are said to be included in the concept of income, but it does not say what 'income' itself means ... In business, it was also pointed out that income was the produce of something "loosely spoken of as capital". ... The Income-tax Act does not restrict the meaning of the word 'income' by implication, and that the whole expression is 'income' writ large".¹³

Likewise, the definition of the concept of 'tax' has defied precise expression. E.R.A.Seligman (*'Essays on Taxation'*, 1921), defines 'tax' thus:

"A tax is a compulsory contribution from the citizens to the Government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred".¹⁴

Quite plainly, the sums collected by way of taxes are not Government's own money, but people's money; and the annual flow of the economic goods produced and services performed by the Government have to be of the optimum size for meeting the needs of the citizens as well as of the State. Professor Cooley, (*'Constitutional Law', 1935*), however, looks at tax revenue from the public finance angle and offers the interpretation of the term 'tax' as:

"The word 'taxes', in its most enlarged sense, embraces all the regular impositions made by the Government upon the person, property, privileges, occupations and enjoyments of the people, for the purpose of raising public revenue".¹⁵

The Privy Council of England shrouded the meaning of the term 'tax' in the Royal Court's language by stating that:

"The primary meaning and object of taxation is raising money for the purposes of the Government by means of contributions from individual persons".¹⁶

The Americans, without being prosaic or verbose and also without mincing words, offered a more earthly meaning:

"A tax, in the general understanding of the term, ... signifies an exaction of money for the support of the Government".¹⁷

The World Bank (*'World Development Report', 1988*) has shunned all the verbosity and scored a bulls-eye:

"Taxes are unrequited compulsory payments collected primarily by the Central Government".¹⁸

Thus came to pass Adam Smith's first and singularly important maxim that, "The subjects ... ought to contribute towards the support of the government ...".

1.1.4 The Indian Scene:

The history of personal taxation as narrated by Simon has revealed that the government wields the tool of income-tax for meeting the revenue exigencies faced by it; firstly, those brought on by wars, and secondly, those forced on it by the fiscal necessities.

In India, the financial difficulties faced by the Government, following the Sepoy Mutiny of 1857 brought the imposition of the law of taxation on income in the year 1860 (more than 60 years later than England) and which then was known as the "Duties of 3 and 1 percent". Pal, (*Law of Income-tax in British India*, 1940) gives the following account:

"The history of income-tax in India may be divided into three periods: (1) 1860-65, (2) 1866-1914, and (3) from the (First) World War to date (1940). The first period was a period of experiment. The tax was twice introduced - in 1860 and 1869 - and twice abandoned - in 1865 and 1869. In the second period, the income-tax policy of the government overgrew

its trial-and-error stage and came to acquire definiteness. The third period is the period of vital reforms in income-tax law. In the earlier part of this period, the enactments relating to the tax were so numerous that the necessity arose of repealing all the previous enactments and having one single statute in their place. Thus, came the Income-tax Act of 1922".¹⁹

The Indian Income-tax Act of 1918 had, for the first time, introduced the concept of aggregating the income of a person from all the sources for the purposes of fixing the tax-incidence; while the Indian Income-tax Act of 1922, for the first time, introduced the principle of fixing the rates of tax through the Annual Finance Acts instead of by the Schedule attached to the Income-tax Act.

1.1.5 The Indian Income-tax Act of 1922:

The Indian Income-tax Act of 1922 was subsequently amended by nearly forty amending Acts, notably in 1939 (prior to Independence). The stiff taxes during the Second World War, combined with the colossal fortunes, particularly in black markets and the failure of the Government to strengthen the administration adequately and in time, led to extensive evasion of taxes. The Government, therefore, appointed Income-tax Investigation Commission in 1947 and suitable amendments

were incorporated into the Act in 1948 and again in 1951. It was this very Act that India inherited from the British on its attaining Independence.

1.1.6 Direct Taxation in Modern India:

In the Sovereign Democratic Republic of India, the power of the Government to levy and collect the taxes flows out of the Constitution. Article 245(1) of the Constitution of India authorizes the Parliament to make laws for the whole of India and grants to it exclusive power to "make laws with respect to any of the matters enumerated in List-I in the Seventh Schedule" (or Union List). List-I specifies Entry No.82 (which deals with Income-tax Act and the Annual Finance Acts) as being the matters relating to the imposition of taxes.

Accordingly, Section 2(c) of the Central Board of Revenue Act, 1963, declares that:

"'Direct Tax' means -

- (1) Any duty leviable or tax chargeable under:
 - i. the Estate Duty Act, 1953 (XXIV of 1953);
 - ii. the Wealth-tax Act, 1957 (XXVII of 1957);
 - iii. the Expenditure-tax Act, 1957 (XXIX of 1957);
 - iv. the Gift-tax Act, 1958 (XVIII of 1958);
 - v. the Income-tax Act, 1961 (XLIII of 1961);
 - vi. the Super Profits Tax Act, 1963; and
- (2) Any other duty or tax which having regard to its

nature or incidence, may be declared by the Central Government by notification in the Official Gazette, to be a Direct Tax".

Subsequently, the Super Profits Tax Act was replaced by the Companies (Profits) Surtax Act, 1964, which continues to date. The Expenditure-tax was abolished with effect from 1966-67. In addition to the above, the Indian Income-tax Act, 1922; the Excess Profit Tax Act, 1940; and the Business Profits Tax Act, 1947; though not prevalent at the time when the Central Board of Direct Taxes was constituted by the Central Board of Revenue Act, 1963; have been declared to be "direct taxes" by a notification dated 1.1.1964.

The first to come in point of time, income-tax, occupies the pride of place among the direct taxes being currently imposed in India.

1.1.7 The Income-tax Act, 1961:

With the advent of political Independence in 1947, the ruling party felt the ever-increasing need for money. It was also felt that too many amendments had made the 1922 Act an oddly compact piece of legislation which needed replacement. The matter was referred to the Law Commission in 1956. After two years of deliberations, the Law Commission submitted its 12th Report, incorporating the Bill of a new Act. The Direct Taxes Administration Enquiry Committee, constituted in 1958, also

considered the matter. Finally, the Income-tax Bill, 1961, successfully came out of the legislative anvil and the Income-tax Act, 1961, received the Presidential assent on 13.9.1961 to come into force from April 1, 1962, replacing the 1922 Act.²⁰

The Income-tax Act, 1961, is, as set out in its Preamble, "An Act to consolidate and amend the law relating to income-tax and super-tax". It has 23 Chapters, each dealing with a separate subject-heading and further divided into 298 sections. In addition, 12 schedules were originally attached to the Act, of which Schedules 6th, 9th, 10th and 12th have since been deleted. The Act is also accompanied by 125 rules, known as the Income-tax Rules, 1962. These rules are divided into fifteen parts and they supplement the main statute. There are frequent amendments and alterations of these rules, from time to time. Appendix-I attached to the rules deals with depreciation rates and under Appendix-II, a total of 57 different Forms are provided.

Since its commencement in 1961 to the present date, almost 65 Finance Acts and Adaptation Orders have amended the Income-tax Act, 1961. According to N.A.Palkhivala, the Income-tax Act, 1961, has undergone more than 3300 amendments.²¹

1.2 COLLECTION AND RECOVERY OF TAXES UNDER THE INCOME-TAX ACT, 1961:

Chapter-XVII entitled "Collection and Recovery of Tax",

under the Income-tax Act, has been divided into seven heads, namely:

- (1) A - General (containing sections 190 and 191);
- (2) B - Deduction at source (sections 192 to 206B);
- (3) BB - Collection at source (section 206C);
- (4) C - Advance payment of tax (sections 207 to 219);
- (5) D - Collection and recovery (sections 220 to 232);
- (6) E - Tax payable under provisional assessments (sections 233 and 234, since omitted);
- (7) F - Interest chargeable in certain cases (section 234).

The basic purpose of these provisions is to accord statutory force to the tax collection and recovery procedure. Over the years, these provisions have served their purpose so well that while delivering a keynote address to the "ASSOCHAM Seminar on Fiscal Policy for Growth" at New Delhi on 13.4.1990, N.A.Palkhivala observed that:

"Of the total revenues collected by way of income-tax and other direct taxes, as much as 96 per cent is paid to the government by way of voluntary tax compliance. ..."²²

1.3 STATEMENT OF THE PROBLEM:

Tax administration carries out the intent of tax legislation. Conversely, steps to simplify the task of tax administration would make tax policy more efficient. In order to improve the collection of the tax revenue, better collection and

administration methods have to be designed and implemented. This, of course, cannot be undertaken unless the prevalent collection and recovery procedures are critically studied, evaluated and alternatives suggested. Hence, the statement of the problem being studied could be expressed as: "Procedure for Collection and Recovery of Taxes under Income-tax Act, 1961".

1.4 OBJECTIVES OF THE STUDY:

Accordingly, the following have been framed as the objectives of the study:

- (1) To critically examine the statutory provisions under the income-tax Act, 1961, relating to the collection and recovery of tax;
- (2) To examine the relevant case-law in respect of the collection and recovery of tax;
- (3) To arrive at definitive conclusions and offer meaningful suggestions, as may be appropriate.

1.5 SIGNIFICANCE OF THE STUDY:

In the fiscal system of a developing country like India, revenue generation through direct taxes occupies a prominent place (although merely 0.75 percent of the total population of the country pay the personal income-tax). In a developing economy, it becomes essential to collect and/or realize tax dues as expeditiously as possible, once the procedural formalities are

completed. The revenue yield of a tax system could be substantially increased if effective measures to improve tax collections are implemented. Because, with the runaway inflation, tax revenue remained uncollected means tax revenue lost, having serious repercussions in the areas of the country's economic and social development. The present study, therefore, focuses its attention on offering meaningful suggestions to improve/increase the tax collections through reforming the prevalent collection procedure and also through implementing certain new measures.

1.6 SCOPE OF THE STUDY:

The present research work limits itself to generally appraise the provisions under Chapter-XVII of the Income-tax Act, 1961, as they pertain to the collection and recovery of tax. While following this course, however, it would also be necessary to foray beyond the defined framework to examine other relevant statutory provisions. Such occasional diversion is quite indispensable, since despite the best possible efforts at consolidation till date, the Income-tax Act itself singularly lacks proper codification.

1.7 METHODOLOGY ADOPTED FOR THE STUDY:

The present research work is based exclusively on the **secondary data**, that is, published sources. The interpre-

tative analysis has been carried out on the basis of the case law pronounced by the High Courts and the Supreme Court of the country. Reliance has also been placed on the comments of the tax-experts and authorities, as published in national and international press. The study has also exhaustively drawn from the reports of the various tax reforms and investigation committees set up by the Government during last forty years.

1.8 LIMITATIONS OF THE STUDY:

The Income-tax Act, 1961, has devoted one entire Chapter and a substantial number of rules to the issues related with the collection and recovery of tax. It would, however, be beyond the scope of this research work to study each and every provision together with its attendant rule, identify its individual implications in the overall tax administration structure and proceed with drawing specific conclusions. Hence, the study is being kept limited to the evaluation of the significant provisions only.

1.9 CHAPTER SCHEME:

The Dissertation has been divided into Four Chapters. **Chapter One** offers a contemporary perspective of the direct taxes in India and also deals with the framework aspects of the present research work such as statement of problem,

objectives of the study, methodology adopted, scope, significance and limitations of the study. **Chapter Two** presents text of the statutory provisions relating to the collection and recovery of taxes. **Chapter Three** focuses on the analysis and interpretation, together with a critical evaluation, of the statutory provisions presented in Chapter Two and summarizes researcher's observations. **Chapter Four** presents the conclusions arrived at at the end of the exercise and offers certain meaningful suggestions aimed at improving and simplifying the collection and recovery procedure. The researcher's endeavour, as a whole, concentrates on judging the spirit of the statutory provisions being studied and on identifying the areas for improvement in the tax collection and recovery procedures. A comprehensive **Bibliography** concludes the Dissertation.

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