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CHAPTER ONE

INTRODUCTION

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1.1 Foundational Aspects:

From the earliest days of recorded history, one of the principle challenges to governments has been the management of public finance.

General taxes (those compulsory levies collected by the government that are unrelated to particular expenditure items) make up a bulk of 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.[1]

Adam Smith, who is credited with laying dowr the foundation of the modern day science of Political Economy, was the first to propose the maxims of taxation based on proportional tax incidence, which could be summarized as under:

(1) The subjects of state ought to contribute towards the support of the government;

(2) The tax levied on individuals should be certain and not arbitrary;

(3) It should be convenient for the contributor to pay the tax levied.[2]

Two decades later, in 1798, taxation on personal income, i.e. income-tax, was imposed in England by William Pitt, so as to raise the funds needed by the British Government to meet the financial difficulties caused by its war with France. It gave equal treatment to all taxpayers, in the sense that the rate was uniformly applied to each corner of income but the incidence was proportionate. 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 it by the country's fiscal necessities.

1.2 Historical Review:

Direct taxation, however, is not a novelty in India introduced by the British, as too commonly supposed, but a most ancient and wellknown institution.

The first Income-tax Act was introduced in 1860 under the stress of the financial difficulties consequent on the mutiny in 1857 and was enacted to be in force for a period of five years.

This Act lapsed in 1865. The tax was revived in 1867, in the form of 'licence-tax' on trades and professions, on the basis of their annual income. Government servants were not required to take out a licence, but the tax was deducted from their salaries. In 1868, the Legislature introduced what was

known as 'certificate tax', which was materially different from the licence tax of the previous year. Agriculture income was excluded from the licence tax as well as certificate tax.

In 1869, certificate tax was converted into 'general income-tax'. The improvement in the financial situation by 1873 saw the abolition of the income-tax in that year. The great famine of 1876-78 brought about the revival of the direct taxation by the Act of 1877. These Acts continued, with amendments in 1880 and 1886, till 1886. There were as many as twentythree tax enactments.

Act II of 1886 was the first important landmark in the history of the income-tax in our country. This Act was a great improvement on its predecessors and stood in force for 32 years till 1918.

The year 1918 was the second landmark year in the history of the Indian taxation. Act VII of 1918 was introduced, by recasting the entire tax law. This Act was designed, inter-alia, to remedy certain inequalities in the assessment of individual taxpayers under the 1886 Act. The Act, however, was shortlived and was replaced by a more comprehensive Act of 1922.

The Indian Income-tax Act, 1922:

The Indian Income-tax Act of 1922 was subsequently amended

by nearly forty amending Acts, notably in 1939. The stiff taxes during the Second World War years, combined with the accumulation of 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 an 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 had inherited from the British on attaining independence.

The economic planners of the newly independent nation were actually aware of the flaws and lacunae in the Income-tax Act of 1922, particularly of the fact that the tax structure lacked buoyancy, i.e. automatic rise in the yields with increase in national production and income, which is a common feature of the tax systems in the western countries. Accordingly, the government entrusted Prof.Nicholas Kaldor of England to recommend suitable tax reforms. Prof.Kaldor submitted his report to the government in 1956, which aimed at:

- broadening the tax base through the introduction of an annual tax on wealth and a general gift-tax (which also aimed at the) elimination of tax evasion through the institution of a comprehensive reporting system on all proposed transfers and other transactions of a capital nature.

After the consideration of Prof.Kaldor's report, the Government enacted first the Wealth-tax Act, 1957, and subsequently, the Gift-tax Act, 1958.

Meanwhile, despite extensive amendments made to it in 1948, 1951, 1955, 1956 and 1957, the Indian Income-tax Act of 1922 had failed to check the extensive tax evasion.

In 1956, the government referred the Act to the Law Commission, in order to recast the Act on logical lines and make it intelligible and simple, without, at the same time, affecting the basic tax structure. The Law Commission, after two years of labour, sent up a draft Bill to the Goverment in September 1958. In the meantime, the Direct Taxes Administration Enquiry Committee, headed by Shri.Mahavir Tyagi, had been appointed by the government to consider the measures designed to minimize the inconvenience to the assessees and to prevent evasion of income-tax. This committee sent up its report to the Government in November, 1959.[3]

The Income-tax Bill, giving effect to the above recommendations,, was submitted to the Lok Sabha on 24th April, 1961. The discussions in the Lok Sabha lasted from 27th April to 1st May and the Bill was referred back to the Select Committee on 1st May 1961. The Select Committee sat on the Bill from 4th May 1961 to 7th August 1961 and its report was presented to the Lok Sabha on 10th August 1961.

The Bill passed through both the Houses of Parliament and received the President's assent on 13th September 1961, to come into force from April 1962, repealing the 1922 Act.

1.3 Direct Taxation in India:

In the Sovereign Democratic Republic of India, the power of the Government to levy and collect the taxes flows out of the Constitution. The term 'direct taxes' stands defined under section 2 of the Central Board of Revenue Act of 1963. Accordingly, a 'direct tax' means:

(1) Any duty leviable or chargeable under:

- i. the Estate Duty Act, 1953;
- ii. the Wealth-tax Act, 1957;
- iii. the Expenditure-tax Act, 1957;
- iv. the Gift-tax Act, 1958;
- v. the Income-tax Act, 1961;
- vi. the Super Profit-tax Act, 1963;

(2) Any other duty or tax which having 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 Profit-tax was replaced by the Companies (Profits) Surtax Act, 1964, which continues todate; the Expenditure-tax was abolished with effect from 1966-67. In addition to the above, the Indian Income-tax Act of 1922, the Excess Profits-tax Act of 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 the direct taxes by a notification dated 1.1.1964.

1.4 Income-tax Act, 1961:

The tax on income was levied for the first time in India in the year 1860 under the Indian Income-tax Act of 1860. This Act followed the pattern of law as was in force in England then. Between 1860 to 1886, various amending Acts were brought out and finally in 1886, the Act of 1860 was redrafted and named the Indian Income-tax Act, 1886.

The Act of 1886 was eventually replaced by the Act of 1918 with the primary objective of tightening the administrative machinery. The new Act, however, enjoyed only a brief span of life and was replaced soon by a more comprehensive Act in 1922.

Extensive amendments were brought about in the year 1939 to this Act also and since then upto the year 1956. The Act was amended on as many as 29 occasions. The Act of 1922 became so complicated that the Government decided to simplify the same. Accordingly, in 1956, the Government appointed the Law Commission which submitted its report in September 1958. In the meantime, a Committee known as the Direct Tax Administration Enquiry Committee was appointed by the

Government to consider the measures to improve public relations and to prevent evasion of income-tax.

The present Income-tax Act is the simplified and rearranged version of the 1922 Act, as is apparent from the preamble to the 1961 Act. The Income-tax Bill, 1961, was introduced in the Lok Sabha on 24th April 1961 and it was referred to the Select Committee, which submitted its report on 29th August 1961. The Bill was passed by the Parliament and received the assent of the President on 13th September, 1961.[4]

The Income-tax Act of 1961 sets out in its preamble "An Act to consolidate and amend the law relating to income-tax and super-tax". It has 23 Chapters, more than 298 sections and 12 schedules. For its governance, the Department has framed about 200 rules, which in turn, have hundreds of sub-rules. The Act extends to the whole of India.[5]

1.5 The Wealth-tax Act, 1957:

The Wealth-tax Act, 1957, and the Wealth-tax Rules, 1957, constitute the wealth-tax subject, on matters relating to tax on wealth, which had their origin in the recommendations made by Prof.Nichols Kaldor.

Mr.Kaldor surveyed that the Second Five Year Plan envisaged additional tax revenue (by the centre and the State)

by Rs.450 crores for the five year period. There was a deficit expenditure of Rs.1,200 crores and a gap of Rs.400 crores. In Mr.Kaldor's view, the amount of deficit expenditure which the Indian economy could absorb was not likely to exceed Rs.150 crores a year, or say Rs.800 crores, in the five year period. Thus, Mr.Kaldor concluded that if the targets of the Five Year Plan were to be fulfilled, the additional taxation required was more of the order of Rs.1,250 crores a year for the five years or Rs.250 crores a year over and above Rs.450 crores of the targeted years.

The proposals outlined in Mr.Kaldor's report "Indian Tax Reforms" (a report of the survey conducted by Mr.Nicholas Kaldor concluded on 30th March 1956) aimed at broadening the tax base through the introduction of an annual tax on wealth, the taxation of capital gains, a general gift-tax and personal expenditure tax. Prof.Kaldor's idea was that all the five taxes, namely, the income-tax, the capital gains-tax, annual wealth-tax, personal expenditure-tax and the general gift-tax should be assessed simultaneously on the basis of a comprehensive return. He further felt that these would be a self-checking in character, eliminating or considerably reducing the scope of tax evasion. He suggested that the maximum rate of tax on wealth should be 1½% on the excess of the capital value over Rs.15.0 lakhs. He advised an integrated tax structure on the grounds both of equity and administrative efficiency. He recommended tax on a graduated

scale with a low rate at the lowest rate so that the taxpayer could meet both the income-tax liability and the wealth-tax liability, without feeling the pinch.[6]

The Wealth-tax Bill, 1957, was introduced in the Lok Sabha on 15th May 1957 and as referred to the Select Committee which submitted its report in due course. The Bill was later adopted by Rajya Sabha. The assent was accorded to the Bill by the President on 12th September, 1957, and it was enacted as the Wealth-tax Act, 1957 (27 of 1957).

The Wealth-tax Act, according to section 1(2), extends to the whole of India, which is constituted of twentyfive States. The Wealth-tax Act, 1957, came in force in the State of Sikkim with the valuation date being 31st March, 1990. Thus, the Wealth-tax Act, 1957, has been made operative in the State of Sikkim for and from the assessment year 1990-91.[7]

Although the assent was given by the President on 12th September 1957, the Wealth-tax Act 1957 has retrospective operation by virtue of the provision of section 1(3) of the Act with effect from the assessment year.

1.6 The Gift-tax Act, 1958:

The Objects-and-Reasons of the Bill introduced in the Lok Sabha in 1958 were as under:

> The object of the Bill is to levy a tax on gifts by individuals, Hindu Undivided Families, Companies and Associations of Persons. Gifts from one person to another provided a convenient tool of avoiding/reducing tax liabilities to the estate-duty, income-tax, wealth-tax and expenditure-tax. The only objective, instead of checking such attempts at evasion or reduction of tax liability, is levying of a tax on gifts. With the introduction of this tax, the integrated tax structure, which the government, have been aiming at will be completed.[8]

The operation of the Act extends to whole of India, excluding Jammu and Kashmir. The Act is deemed to have come into effect on 1st April 1958. The Act was extended with modification to Dadra and Nagar Haveli, Goa, Daman and Diu and Pondicherry by regulation 3 of 1963 with effect from 1.4.1963.

The Gift-tax Act 1958 is framed on the basis of the New Zealand Gift Duties Act, 1955. The gift-tax legislations are in vogue in the United States, Canada, Australia, New Zealand, Sri Lanka and other countries.

1.7 OBJECTIVES OF THE STUDY:

The present research work has been undertaken to study the penalties and prosecutions under the direct tax laws. Following are the broad objectivs of the study:

(1) To critically examine the existing provisions for penalties

and prosecutions under the direct tax laws;

(2) To study the amendments/changes made in the provisions regarding the penalties and prosecutions;

(3) To arrive at definite conclusions and offer meaningful suggestions, as may be appropriate.

1.8 METHODOLOGY OF THE STUDY:

The present research work is based exclusively on the **secondary data**, that is, published sources. The study has drawn extensively from the reports of various tax reform and investigation committees set up by the government and other published sources like authoritative books; journals of repute have also been referred to wherever necessary.

1.9 SIGNIFICANCE OF THE STUDY:

In the fiscal system of a developing country like India, revenue generation through direct taxes occupies a prominent place. In a developing economy, it becomes essential to collect and realize tax dues as expeditiously as possible.

With the increase in the number of taxpayers, it is essential that the tax administration must be honest, consistent and expeditious, in case it is desired that the tax laws are observed voluntarily. Every taxpayer tries to minimize his tax liability and if wilfull evasion is allowed to succeed, it will not only lead to revenue loss, but will bring general

disrespect for the law. As such, it becomes necessary that the State should provide for appropriate penalties and prosecution to discourage such tendencies.

Various penalties and prosecution provisions have been incorporated under the direct tax laws, viz. the Wealth-tax Act, 1957; the Gift-tax Act, 1958; and the Income-tax Act, 1961. These penalties have been incorporated in order to make the implementation of the tax laws more effective.

The present study is an an attempt to examine the existing provisions for penalties and prosecutions under the direct tax laws and to offer meaningful suggestions.

1.10 SCOPE AND LIMIATIONS OF THE STUDY:

The present study attempts to examine the existing provisions relating to the penalties and prosecutions under the direct tax laws, viz. the Income-tax Act, the Wealth-tax Act and the Gift-tax Act. Besides, over the years, innumerable amendments to these provisions (sections) have been brought into force in addition to various case-law laid down by the High Courts and the Supreme Court of India. It is, however, beyond the scope of this Dissertation to take an exhaustive review of each and every amendment and the caselaw.

1.11 CHAPTER SCHEME:

The Dissertation is divided into five Chapters. Chapter-1 deals with the introduction of the Income-tax Act, the Wealth-tax Act and the Gift-tax Act and also deals with the framework aspects of the present research work, such as objectives, methodology, significance and limitations of the study. Chapter-2 presents the meaning of penalty, objects of prosecution and also the statutory provisions relating to the penalties and prosecution under the direct tax laws. Chapter-3 focuses on the analysis and interpretation, together with a critical evaluation of the statutory provisions presented in Chapter-2. Chapter-4 presents the Committee Reports and Supreme Court and High Court cases. Chapter-5 presents the conclusions arrived at at the end of the study and offers certain suggestions aimed at improving and simplifying the penalties and prosecution procedure. A comprehensive Bibliography concludes the Dissertation.

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