

CHAPTER ONE

INTRODUCTION AND METHODOLOGY

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1.1 INTRODUCTION:

1.1.1 Brief History of Taxation on Income:

Taxation on income, in its modern form, was introduced in India for the first time in the year 1860 by the British Rulers to overcome the financial difficulties following the Sepoy Mutiny of 1857. Initially, it was considered only a temporary measure for raising the necessary revenues; but in 1886, it was imposed on permanent basis and since then, it has continued to occupy an important place in the Indian direct tax system.

The history of income-tax in India may be divided into four distinct periods, namely, (1) 1860 to 1885, (2) 1886 to 1914, (3) from First World War to 1950, and (4) from 1950 to date.

The first period was a period of experiments. The tax was twice introduced - in 1860 and 1869, and twice abandoned - in 1865 and 1873. 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 the income-tax law. The most important features that mark this period are the introduction of graduation in the tax. The Act of 1918, for the first time,

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

✓ The Income-tax Act of 1922 could cater to the taxation needs of the country well until the end of the Second World War. The stiff taxes during the war period, combined with colossal fortunes, particularly in black markets, and the failure of the Government to strengthen the administrative machinery adequately and in time, led to extensive evasion of taxes. During this period, it was also revealed that as a result of nearly forty amending Acts, the 1922 Act had become a much mutilated piece of legislation. It was this very Act that Independent India inherited from the British in 1947.

✓ The Sovereign Democratic Republic of India adopted a written Constitution for the governance of its affairs of State in the year 1950; and the power to enact laws for imposing taxes transferred to the Legislature. This is the beginning of the fourth period in the history of taxation of income in India.

Article 245(1) of the Constitution of India authorises 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 the Union List). List-I specifies Entry No.82 (which deals with the Income-tax Act and the Annual Finance Acts) as being the matters relating to the imposition of taxes.

✓ By the beginning of 1950's, the Income-tax Act, 1922, had become very complicated on account of innumerable amendments it had sustained. The Government of India, therefore, referred the matter to the Law Commission in 1956, with a view to simplify it and prevent the evasion of income tax. The Law Commission submitted its Report in September 1958; but in the meantime, the Government of India had appointed the Direct Taxes Administration Enquiry Committee to suggest appropriate measures to minimize the inconveniences to the assesseees and prevent evasion of tax. This Committee also submitted its Report in the year 1959. Side by side, the Central Board of Revenue had appointed a Committee of its senior officers to consider the reports of the Law Commission and the Direct Taxes Administration Enquiry Committee, which examined both the Reports in consultation with the Ministry of Law and finally, the Income-tax Bill, 1961, was introduced in the Parliament on 24th April, 1961. After passing through a Select Committee, the Bill was converted into the Income-tax Act, 1961, in September, 1961, to come into force with effect

from 1st April, 1962.

The Income-tax Act, 1961, applies to the whole of India (including Jammu and Kashmir). Since its inception, several amendments of far-reaching nature have been made in the Act through the Finance Acts every year. Besides these, amendments have also been made by various Amending Acts. As a matter of fact, the Income-tax Act, 1961, has been amended and re-amended more often and more drastically during the twentyeight years of its existence than the 1922 Act was amended during forty years of its existence.

The Direct Tax Laws Committee, headed by Shri.C.C. Chokshi, submitted its Final Report to the Government in October, 1978. The Committee's main recommendations laid emphasis on the simplification and rationalization of the laws relating to the direct taxes in a number of ways. The Committee also recommended the simplification of the law with regard to the settlement of cases, taxation of casual income, etc. Since 1978, the Government has gradually implemented some of the recommendations of the Chokshi Committee.

The Taxation Laws Amendment Act, 1984, extensively amended the Income-tax Act, 1961. The amendments made through this Act were intended mainly to streamline the procedures in the interest of better work management, avoiding inconvenience to the taxpayers, reducing litigations, removal of certain anomalies and rationalization of some of the provisions of the

Income-tax Act, 1961. Moreover, these amendments were also meant to counteract tax avoidance and tax evasion.

More recently, the Direct Tax Laws (Amendment) Act, 1987, amended the Income-tax Act, 1961, still further. This amending Act is based on the recommendations of the Committee for Rationalization of Direct Taxes, whose report was laid before the Parliament on 14th August 1986. These amendments have been made to achieve the following objectives:

- (1) Simplification of the law and procedure relating to the direct taxes, in keeping with the policy of reposing trust in the taxpayers, so as to encourage voluntary compliances;
- ✓ (2) Rationalization of the scheme of taxation of income and ensuring that the income earned during the same period by the same category of the taxpayers is subject to tax at the same rate;
- (3) Ensuring that only the real income is taxed;
- (4) Increasing the cost of avoidance and providing effective deterrence against evasion by imposing a mandatory additional tax to the extent of 30% of the concealed income in the event of any concealment of income;
- (5) By removing uncertainties in the matter of assessment by cutting down areas of subjective decisions by tax authorities and reducing litigation;
- ✓ (6) Making tax laws effective by preventing leakage of revenue through instrumentalities of numerous taxable

entities by taxing certain entities at the maximum marginal rate;

- (7) Ensuring uniformity, to the extent possible, in the provisions of the three direct tax laws, to pave the way for the enactment of a single direct tax code.

Overall, over the years, the Income-tax Act, 1961, has undergone innumerable changes by way of amendments, substitutions, deletions and additions (as much as 3300 amendments, according to Mr.N.A.Palkhivala).

✓ 1.1.2 Scope of the Income-tax Act, 1961:

Tax on income plays a very important role in the national economy. It is one of the important sources of revenue to the national exchequer. Although the responsibility for the administration of tax policy and the collection of tax revenue lies with the Union Government, part of the proceeds go into a divisible pool and are shared by the State Governments. The tax on income is also looked upon as a tool for achieving the social and economic objectives, as laid down in the Constitution. The Income-tax has further been recognized as a good lever to narrow down the disparities of income.

The Income-tax Act, 1961, has been brought into force with effect from 1st April, 1962, and applies to the whole of India (including Jammu and Kashmir). The Act has

298 sections, numerous sub-sections and twelve Schedules. For its governance, the Department has framed 124 rules, called "The Income-tax Rules, 1962". The Act retains the structural characteristic features of the 1922 Act, but its provisions have been re-arranged in a more logical and convenient manner. The Act has also amplified several provisions and introduced many new provisions, with a view to simplify the taxation processes and to prevent tax avoidance and tax evasion.

1.1.3 The Income-tax Rules, 1962:

At the time of drafting of the Act, many situations and circumstances remained unforeseen. The Legislature, therefore, has left many things undecided and a mention to this effect has been made in the relevant sections of the Act. As the Central Board of Direct Taxes looks after the administration of all the direct taxes, it has framed various rules for the administration of the Act. These rules are called 'The Income-tax Rules, 1962' and are amended from time to time.

1.1.4 The Annual Finance Acts:

The Union Finance Minister presents the Annual Budget to the Parliament, generally on the last day of the month of February every year and also moves a Bill known as 'the Finance Bill' for that particular year. The Bill contains

proposals in the areas of direct and indirect taxes. The proposals for the rates of income-tax for that particular year are contained in the Finance Bill, because the tax-rates schedule does not form part of the Income-tax Act. The Annual Finance Act introduces amendments to the direct tax laws.

1.1.5 Circulars of the Central Board of Direct Taxes: ✓

The Central Board of Direct Taxes, from time to time, issues circulars (directives) to deal with certain specific problems brought to its notice. These circulars do not take the place of law but serve as guidelines for the administrative officers and the public. Under section 119 of the Income-tax Act, the circulars issued by the CBDT are binding on all the officers and the persons employed in the execution of the Act.

✓ 1.1.6 Place of Income-tax in the Tax System:

Taxes are as old as States and State Governments. India, being one of the oldest civilizations in the world, had a well-developed system of public finance since ancient times. Taxation has been well recognized as an instrument of public finance and administration in almost all ancient literature, including the Hindu Dharmashastras. During the days of the kings and feudal lords, taxes were imposed and collected much for their personal needs and also for the

maintenance of Army for keeping internal peace and protection from foreign aggression. After Independence, the Government took up, as a major task, various programmes for the country's social and economic development through Government-sponsored planning process. The resources required for such programmes were raised, besides other means, through taxation. The trend in the Government's total revenue receipts and the tax revenue receipts since Independence to the year 1987 is well reflected through Table 1.1 (on the following page).

Table 1.1 reveals that there has been an alround expansion in the size of the Government's revenue receipts and taxes have provided their full support to the Government finance. The share of the tax revenue in the revenue receipts has been of the order of more than 85% throughout the above period. The percentage of the revenues generated through direct taxes to the total tax revenue is, on an average, 15% during the last ten years. The share of income-tax in the direct-tax revenue is, on an average, 85 percent.

As taxation registers an important impact on the economy of any country; a tax system, as a whole, should be designed to achieve the desired objectives, besides serving as a source of revenue. In general, it should ensure fairness, prompt savings and investments in the country and be capable of efficient administration. Taxation may be said to be fair, if it is based on the 'ability-to-pay' principle. On the ground of

Table No.1.1

Total revenue receipts, Tax revenue, Direct
tax revenue and Total income-tax

| Year | Total Revenue Receipts | Tax Revenue | Direct Tax Revenue | Total Income Tax | (Rs. in crores) | | |
|---------|------------------------------|----------------|--------------------------|------------------------|--|---|--|
| | | | | | Percentage of tax to total revenue | Percentage of direct tax to tax revenue | Percentage of income tax to direct taxes |
| 1960-61 | 1772.71 | 1350.41 | 402.07 | 278.43 | 76.18 | 29.77 | 69.24 |
| 1965-66 | 5703.68 | 2921.59 | 734.14 | 576.64 | 78.86 | 25.13 | 78.54 |
| 1970-71 | 5862.83 | 4752.41 | 1009.07 | 843.69 | 81.06 | 21.23 | 83.61 |
| 1975-76 | 13686.72 | 11181.73 | 2492.55 | 3076.06 | 81.70 | 29.29 | 83.90 |
| 1980-81 | 23834.90 | 19843.75 | 3268.28 | 2817.18 | 83.25 | 16.47 | 86.22 |
| 1981-82 | 28880.61 | 24142.41 | 4133.19 | 3445.47 | 83.59 | 17.12 | 83.36 |
| 1982-83 | 33085.70 | 27241.57 | 4491.96 | 3754.23 | 82.34 | 16.40 | 83.57 |
| 1983-84 | 36958.77 | 31523.45 | 4907.57 | 4191.87 | 85.30 | 15.57 | 85.41 |
| 1984-85 | 42933.21 | 55813.42 | 5329.49 | 4484.00 | 83.42 | 14.88 | 84.13 |
| 1985-86 | 50756.62 | 42827.92 | 6287.13 | 5374.00 | 84.38 | 14.68 | 90.24 |
| 1986-87 | 54952.77 | 47355.08 | 6435.65 | 8094.00 | 86.17 | 13.59 | 94.69 |

fairness, direct taxes are preferred to indirect taxes as they are more equitable, administratively effective and can be related to an individual's ability to pay. Income is considered to be the most satisfactory index of the ability to pay, which can be subject to progressive rate schedule. Therefore, all politically-advanced countries possess some form of progressive personal taxation, generally based on income.

Income-tax is the most important of all direct taxes and with the application of progressive rate schedule, provision of an exemption limit and incorporation of a number of incentive provisions, it can be made not only to satisfy all the canons of a sound tax system but may also go a long way in realizing a variety of socio-economic objectives set out by the economic system. Due to all these factors, taxes on income have assumed increasing importance in the overall structure of direct taxation in India.

1.1.7 Definition of 'Salary':

The term 'salary' has its root in the Latin word 'salarium', meaning "money given to soldiers for salt", as was practice in the Roman Armies two thousand years ago. After the decline and fall of the Roman Empire, the term continued in usage and came to signify "fixed compensation paid regularly for the services rendered, as by the year, quarter, month or week". During the course of time, it came to distinctly mean the

compensation paid to the white-collar workers (rather than the blue-collar workers, to whom 'wages' are paid). Ordinarily, 'salary' denotes payment for services of a non-manual type while 'wage' is used for payments for manual services.

Section 17(1) of the Income-tax Act, 1961, gives an inclusive definition to the term 'salary'. Thus, apart from what is commonly known as 'pay' or 'salary', it also includes:

- ✓ 1. wages,
2. any annuity or pension,
3. any gratuity,
4. any fees, commission, perquisites or profits in
lieu of or in addition to any salary or wages,
5. any advance of salary,
6. any payment received as leave encashment,
7. annual accretions to provident fund in
certain circumstances,
8. transferred balances in certain cases.

A detailed description of each of these terms is given in Chapter Three of this Dissertation.

✓ 1.2 STATEMENT OF THE PROBLEM:

Section 14 of the Income-tax Act, 1961, lays down that "for the purpose of charge of income-tax and computation of total income", 'salaries' shall be included in an individual's total income. The provisions for computation of income are

spread throughout the Act and hence, the computation and assessment of income from salary have become a complicated process. Here, it should be borne in mind that the assessee tries to evade the tax not because he wishes to escape his tax liability, but being apprehensive about the complexities involved and the harassment he is likely to suffer, he tries to keep himself out of the tax net even by dishonest means. The Income-tax Act, 1961, which replaced the entire Act of the period of the British Rule in India, is not much different from the predecessor Act and does not reflect the requirements of the Indian situation. Mostly, the assessment prescribed under the Act is not understood by a common taxpayer and, therefore, he avoids to file a tax return. Also, the forms prescribed for filing a tax return is not common and simple to fill in.

Realizing the importance of a simplified assessment procedure of salary income, the present topic, namely, "Assessment of Income from Salary under the Income-tax Act, 1961" has been taken for a critical study.

✓ 1.3 OBJECTIVES OF THE STUDY:

The present research work has been undertaken to study the procedure of assessment of income from salary under the Income-tax Act, 1961, and also:

- (1) To critically examine the statutory provisions under the Income-tax Act, 1961, relating to the income from salary;
- (2) To examine the relevant case-law in respect of the assessment of income from salary;
- (3) To study the amendments made in the provisions regarding the assessment of income;
- (4) To formulate definitive conclusions and to put forward meaningful suggestions relating to the assessment of income from salary.

1.4 METHOD OF DATA COLLECTION:

The data required for a research study are usually collected from two sources, namely, primary sources and secondary sources. The primary sources provide the data gathered at firsthand by the researcher himself. The secondary data, however, is the data collected by someone else and made available to others through published statistics, reports, etc.

For the present research work, it is practically impossible to collect any primary data as the information that would be sought to be collected is of confidential nature and as such, neither the Income-tax Department nor the individual taxpayers would willingly tender any significant information or statistics. The present research work, therefore, relies entirely on the secondary data, mainly the legislative provisions contained in the Income-tax Act, 1961; relevant portions of

the Income-tax Rules, 1962; various circulars issued by the Central Board of Direct Taxes; case-law as pronounced by various High Courts and the Supreme Court of the country; and finally, on the contributions made by eminent writers in reputed journals, periodicals, books, etc.

While using the available secondary data, its format has been changed to meet the requirements of the present work as also care has been taken to ensure the reliability of the data used.

✓ 1.5 SCOPE OF THE STUDY:

It is quite easy to define income-tax in just three sentences:

Income-tax is an annual tax levied in every assessment-year, at the prescribed rates, on every person, in respect of his total income for the relevant previous year. The total income is determined with reference to the person's residential status and the place of accrual or receipt of income. It is the aggregate of the income computed under different heads of income, after allowing for permissible exemptions and deductions.

The problem arises only when one seeks to understand the expressions underlined. These expressions have been assigned specific connotation under the Income-tax Act, 1961.

In the succeeding Chapters, it is the endeavour of the researcher to interpret these expressions as they are relevant to the salaried taxpayers and through this exercise, critically evaluate the procedure of assessment of income from salary under the Income-tax Act, 1961.

1.6 LIMITATIONS OF THE STUDY:

✓ The Income-tax Act, 1961, identifies a separate head of income for salaries, vide section 14 and also devotes three distinct sections (15, 16 and 17) to define 'salary', 'deductions' allowable from salary and 'perquisites' and 'profits in lieu of salary'. Also, there are a substantial number of rules and forms prescribed under the Act for the assessment of salary income. Moreover, over the years, the Central Board of Direct Taxes (CBDT) has issued a number of circulars as guidelines for the administrative staff as well as the Supreme Court's intervention has been sought for interpreting various statutory provisions. It is beyond the scope of this Dissertation to conduct an in-depth analysis of the overall administrative procedures, correlate them with individual governing rules, check the law and proceed with drawing specific conclusions. The study is, therefore, kept limited to the evaluation of the statutory provisions and to offer meaningful suggestions, so as to simplify the procedure for assessment of income from salary.

1.7 CHAPTER SCHEME:

The Dissertation has been divided into Five Chapters. **Chapter One** introduces the topic under study and also deals with the framework aspects like statement of the problem, objectives of the study, methodology adopted, significance, scope and limitations of the study. **Chapter Two** records the statutory provisions and the governing rules relating to the assessment of income from salary, together with the legislative history of their amendments. **Chapter Three** defines the conceptual and procedural aspects of the topic, together with their tentative interpretation in simplified language as also their relationship with the relevant provisions contained elsewhere in the statute book. **Chapter Four** concentrates on the analysis and interpretation, together with a critical evaluation, of the statutory provisions with the help of the case law. The exercise is concentrated mainly on judging the spirit of the provisions rather than investigating their technical finesse. **Chapter Five** presents the researcher's conclusions about the problem taken up for study and also offers certain meaningful suggestions aimed at improving and simplifying the procedure as it pertains to the assessment of income from salary under the Income-tax Act, 1961. A comprehensive **Bibliography** concludes the Dissertation.