CHAPTER TWO

CONCEPTUAL STRUCTURE

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2.1 INTRODUCTION:

Taxes are unrequited, compulsory payments collected primarily by the central government. Tax revenue is usually considered under two headings: direct taxes on individuals and firms, and indirect (commodity) taxes on goods and services. Direct taxes include taxes on personal income as well as other taxes consisting mainly of social security contributions, payroll taxes and taxes on property and wealth. In industrial countries, income and other direct taxes account for 69 percent of the total tax revenue. The weight placed on personal income (27 percent) and social security taxes (31 percent) in industrial countries is feasible because the necessary administrative apparatus exists. Personal taxes are hard to collect in the predominantly rural, agricultural economies, where people are widely dispersed. Taxes on company income present fewer administrative difficulties. Company taxes are, therefore, relatively more important in the revenue structure of the developing countries. Cultural and historical factors also influence tax composition in the developing countries.

Governments attempt to use tax systems to achieve many goals; raising revenue is only one of them. To facilitate compliance and collection, however, a tax system must be administratively feasible. For the same reason but also as an end in itself, it must spread its burden equitably. To avoid misallocating resources, it must not upset the patterns of production, trade, consumption, saving and investment. All these aims can rarely be satisfied simultaneously.

2.2 CANON'S OF TAXATION:

Adam Smith's gave four canons of taxation, which should be incorporated in any sound system of taxation:

1. Ability: All citizens should contribute towards the expenses of the government 'as nearly as possible in proportion to their relative abilities'.
2. Certainty: The amount to be paid, the time and the method of payment should all be clear to and certain for the taxpayer to adjust his income and expenditure accordingly. The state also should know how much revenue it could expect and when it would get it. The canon of certainty is meant to prevent exploitation of the taxpayer by the tax collector or the state.
3. Convenience: In Smith's own words, "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".
4. Economy: This means minimizing the cost of collection. The revenue from a tax should be very much more than the

cost of its collection.

Other canons propounded by the writers on public finance are:

5. Simplicity: The tax system should be easily comprehensible to the common man.
6. Productivity: The tax system should produce adequate revenue to meet the public expenditure.

Still other canons envisaged in a sound tax system are: elasticity, flexibility, diversity and neutrality.

2.3 APPROACHES OF TAXATION:

Over the years, certain theories of taxation have come to be developed that adopt certain basic approaches while levying taxes. Two of these approaches are:

1. Benefit approach: The government services confer certain benefits on the community and the cost of providing these benefits should be apportioned among individuals and private organizations on the basis of the relative benefits which they enjoy. The benefit approach has two implications; first, the benefit is used as a justification for taxation; and second, it serves as a standard for apportioning the tax burden.
2. Ability-to-Pay Approach: This approach is based on the broad assumption that those who possess income or wealth should contribute to the support of public functions

according to their relative abilities. The obligation to pay to the government is taken as a social or collective responsibility, though "who shall pay and in what amount" is necessarily individualized, that is, those who have not, need not pay.

2.4 DIRECT AND INDIRECT TAXES:

John Stuart Mill has differentiated between the direct and indirect taxes as follows:

> "A direct tax (which) is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another".

Thus, the taxes are 'direct' or 'indirect', depending upon the fact whether they are actually paid by the people on whom the burden fell or not.

In modern times, taxes are classified into direct and indirect taxes on the basis of assessment rather than on the point of assessment. Taxes, for instance, can be on the income received or on the expenditure incurred. Those taxes, which are imposed on the receipt of income, are called 'direct' and those which are imposed on the expenditure are regarded as 'indirect' taxes. This classification, however, involves two difficulties; firstly, it assumes that the income and expenditure are two separate items; in fact, one's income is the expenditure of another and vice-versa; secondly, it excludes those taxes which are based on the stock of capital, as different from those related to changes in the stock of capital. According to Dalton,

> "A direct tax is really paid by the person on whom it is legally imposed, while an indirect tax is imposed on one person but paid partly or wholly by another, owing to a consequent change in the terms of some contract or bargain between them".

According to some economists, a direct tax is the one that is levied when the income is earned. An indirect tax is the one that is levied when the income is spent. Some others are of the opinion that direct taxes are those which are levied on income and wealth, while indirect taxes are those which are levied on the commodities and servies. A number of efforts have been made to define the terms 'direct tax' and 'indirect tax', yet there is hardly any definition which is acceptable to all.

The tax structure in the developing countries depends on several factors connected with economic, social, cultural and political systems of these countries. The availability of tax bases, the administrative efficiency to collect the taxes and the policy objectives of the government affect the tax structure to a large extent. The tax structure is closely related to the current level of economic development, as various factors act at different stages of development differently.

As the society begins to break away from its old ways, indirect taxes become more important. As monetization and commercialization develop, old traditional forms of direct taxes give way to indirect forms of taxes; first on trade and transactions, and later on, on more sophisticated consumer goods and expenditure. Thus, as the structure of economy changes with the economic development, the nature of tax bases changes as well. The economic objectives of the tax policy vary with the stages of economic development, as do the economic criteria by which a good tax structure is to be judged.

2.5 COMPARISON OF DIRECT AND INDIRECT TAXES:

Direct and indirect taxes may be compared from their different angles - allocation of resources, administrative viewpoint and distributional effects.

1. Allocative aspect: Traditionally, economists have maintained that the allocative effects of indirect taxes are inferior to those of direct taxes, that is, if a certain amount of money is collected from the community by way of indirect taxes, the burden will be greater than if the same amount were to be collected by way

of a direct tax.

2. Administrative aspect: From this point of view, direct taxes are not levied on low incomes and suitable exemption limits are provided for income-tax. In other words, from the administrative point of view, indirect taxes are considered superior to the direct taxes. They are easy to collect, convenient to pay and difficult to evade. However, such a comparison between direct and indirect taxes does not hold good because of many factors, particularly:

   (i) those income groups which are exempt from the operation of direct taxes on he ground of equity and justice are not exempt from the payment of indirect taxes;

   (ii) the modern administrative machinery for tax assessment and tax collection has been revolutionized somuchso that the income-taxes and other direct taxes can be levied even on the lowest income groups.

   Again, there are certain circumstances when the administrative arguments in favour of indirect taxation becomes strong, e.g. in the underdeveloped countries, the factors such as small producers incapable of keeping accounts, barter and subsistence sections of the economy, etc., are responsible for the predominance of indirect taxation.

Thus, the comparison between direct and indirect taxes on the basis of administration in such a way that the former are inferior to the latter is defective.

3. Distributional aspect: It used to be held that direct taxes were pre-eminently suited to bring about a reduction in the inequality of income in the capitalist system and hence, these were considered very progressive. At the same time, indirect taxes fall on all incomes and were, therefore, regarded as generallY regressive.

It is difficult to speak of direct taxes as progressive and indirect taxes as regressive. In fact, if a direct tax is passed on to the customer, it will be regressive. Likewise, an indirect tax on luxury goods may shift factors of production from the industries to those lines of production which meet the demands of the common masses and thus an indirect tax can be regarded as progressive as a direct tax.

2.6 STRUCTURE OF DIRECT TAXES:

Direct taxes have been divided into five groups, they are:

1. taxes on income (personal and corporate, both),
2. social security contributions,
3. taxes on payroll or manpower,
4. property taxes,
5. other direct taxes.

The reliance on taxes on income under direct taxes in most of the developing countries are similar to those of the developed countries. These taxes are dominating the direct tax structure in most cases.

Social security taxes are frequently used in many of the developing countries, though the role of these taxes in low income countries is very limited. These taxes are popular in those countries which have attained a relatively high level of per capita income.

Reliance on property taxes is relatively high in the develloping countries whereas in the case of the developed countries, the contribution of these taxes has been very low.

It is evident that the structure of direct taxes in the developing countries is significantly different from that of the developed countries. Taxes on income are dominating in most of the developing countries, though the weak performance of income-taxes in some countries may be due to the predominance of either the social security taxes or the property taxes.

2.7 MERITS AND DEMERITS OF DIRECT TAXES:

Following are the **merits** of the direct taxes:

1. Direct taxes are based on the principle of ability-to-pay

They are amenable to fine gradation or progression.

2. Direct taxes satisfy the Canon of Certainty. The taxpayer is certain as to how much he is expected to pay and the state can estimate the yield from direct taxes fairly, accurately and adjust its income and expenditure.

3. Direct taxes are elastic. With the increase in income and wealth of the people, the yield of direct taxes also will increase. Elasticity also implies that the government's revenue can be increased simply by raising the rates of taxation.

4. Direct taxes create civic consciousness. The taxpayers are made to feel directly the burden of the taxes and hence, take an intelligent and keen interest in the way public income is spent. They are likely to be more mindful about their rights and responsibilities as citizens of the state.

5. Direct taxes are economical. The cost of collecting the direct taxes is rather low.

Following are the **demerits** of the direct taxes:

1. Direct taxes tend to be arbitrary. It is indeed difficult to have an objectively just basis of ability in the case of direct taxes. The rate of income-tax, for example, will depend upon the political complexion of the government.

2. Direct taxes are the taxes on honesty and they tempt

people to evade them. There is always the possibility of tax evasion in the case of direct taxes.

3. Direct taxes are inconvenient. The taxpayer has to prepare and supply income-tax returns of the sources of his income to the tax authorities. Accounting procedures are so numerous and difficult to comply with that in most cases, individual taxpayers have to get the help of the professional income-tax practitioners to prepare their returns.

4. Direct taxes are often regarded as expensive to collect, since each and every taxpayer will have to be separately contacted by the tax authorities which becomes very costly. Elaborate machinery has to be designed to contact and assess taxpayers and also to prevent tax evasion.

2.7.1 Progressivity of Direct Taxes:

In India, taxation has been used to promote multiple objectives such as to increase the rate of domestic savings, reduce inequalities of income and wealth and to maintain price stability. The first objective was attempted to be achieved through 'widening and deepening of the Indian tax system' so as to mobilize additional revenues for the purpose of investment in the public sector. Additional taxation measures were mainly intended to increase its public sector saving by diverting the increased income in the private sector from going to conspicuous consumption to the public sector saving and investment. But empirical studies have shown that this has not actually happened in India. In fact, both direct and circumstantial evidences go to prove that the additional taxation has encouraged the government to increase its consumption expenditure much more than government saving.

In the case of price stability, taxation was justified on the basis of Keynesian macro-economic logic, namely, that taxation would reduce disposable income and hence, efffective demand and thus bring down the prices. But here again, some of the empirical studies have shown that the taxation particularly indirect taxation, instead of reducing the demand has simply added to the tax-pushed price rise and consequently, the additional tax measures in the past ten years or so, have only added to the price instability in the country.

With regard to the equity objective, the role of taxation in reducing inequalities of income and wealth has been rather over-emphasized. During the Second Five-Year Plan period, the big push strategy of industrialization emphasized the objective of growth and equity. Growth was attempted to be achieved through rapid industrial development, particularly by starting capital goods industries and equity was supposed to achieved through fiscal policy tools, particularly by levying steeply progressive rates of tax on income and wealth.

Accordingly, for the first time, a set of direct taxes was introduced based on the recommendations of Nicholas Kaldor, which came to be known as 'integrated direct tax system'. In addition to the then existing income-tax, capital gains-tax and estate-duty, wealth-tax, gift-tax and expenditure-tax were introduced during the Second Five-Year Plan period. Since then, these have continued to operate with various modifications and only the expenditure-tax has been removed.

Nicholas Kaldor provided a very appealing rationale for the equity objective of taxation in the following words:

> "An effective system of progressive direct taxation is vital to the survival of democratic institution in India. The need for this arises not only merely on financial ground - to raise adequate resources for purposes of accelerated economic development but in order to bring about the degree of social cohesion and cooperation that is essential for the successful functioning of a democratic system. In a community where there is such a wide gap between the position of a privileged minority of a well-to-do and the vast majority who live in dire poverty, social cohesion can only be achieved if economic inequality is effectively lessened and the tendency towards increasing concentration of wealth is effectively contained. This can only be done through the instrument of taxation. It is in any case inevitable that heavy burdens should be laid on the broad masses of the population of India

so as to attain a satisfactory rate of development in the coming decades. It will not be possible to carry through the programmes successfully with the consent and cooperation of the people if the privileged minority of the well-to-do are not made to bear their fair share of this burden. Moreover, in matters of taxation, like in administration of law, it is not enough that justice should be done - it must be seen to be done. If owing to defects in the tax laws or in the administration, highly progressive taxes of wealth and income have no visible effects on the prevailing economic inequality or in the standards of living of rich, the mere enactment of advanced tax legslation will prove fruitless".

2.7.2 Reasons for Inadequate Progressivity:

After establishing the negligible equalizing effect of direct taxes in India, it is necessary to search for the reasons for inadequacy of progressivity. Three reasons may be given to explain this phenomenon:

1. Though the legal tax rates have been steeply progressive, the effective tax rates have been mad lower owing to various exemptions, allowances and deductions. In other words, 'tax-expenditure' measures which are built into the direct tax structure system have distorted

the legal rate structure and made them either 'proportional' or 'regressive' in their actual operation;

2. Tax evasion seems to be evident as the average and marginal effective tax rates become lower at the higher levels of income and wealth;

3. The extent of tax avoidance under legal protection and the ever-increasing arrears of assessment and of collection do indicate that at the higher levels of income and wealth, people resort to legal remedies because of defective assessment and as a result, the actual tax liability becomes far less than the expected legal liability. Consequently, the originally designed tax loses its progressivity element over time, apart from the government losing the revenue. Thus, a combination of these factors have been operating in India which have made the direct taxes ineffective in their equalizing effect.

It is clear that the direct taxes in the country have not been effective in reducing inequalities of income and wealth. This is mainly because the coverage of these taxes is so small, that it is meaningless to think of using such taxes which cover a small proportion of the active population in the country, to reduce the inequality of income in the country as a whole. The actual operation of the tax laws have shown that the average and marginal effective tax rates have been quite different from the legal tax rates and as a result, the expected equity, even among those whose income and wealth are assessed for direct taxes, is not achieved. It would be better to recognize the fact that such defectively designed direct taxes cannot reduce inequalities of income and wealth in this country and, therefore, to justify these taxes only from the point of view of raising revenue. Otherwise, great hopes will be raised, and in fact, such hopes have been raised in the past, in the minds of the people in the name of achieving equity through steeply progressive taxation, which, in fact, has not been achieved. As such, instead of raising expectations and dashing them to the ground without achieving the intended objective, it would be better to concede the fact that the political and socio-economic institutional set-up in India does not allow direct taxes to be used for achieving the objective of reducing inequalities of income in the country.

However, if the political leaders are serious in using the direct taxes for reducing inequalities of income and wealth, then they should reform the direct tax structure in such a way as to cover more people, to plug legal loopholes, not only to prevent evasion of taxes but also to reduce tax avoidance through tax planning.

We now take a brief look at the mechanics of the operation of the three direct taxes, viz. (1) the Income-tax Act, 1961; (2) the Wealth-tax Act, 1958; and (iii) the Gift-tax Act, 1957.

Income-tax:

The present law of taxation of income is governed by the Income-tax Act, 1961, which is amended from time to time by the annual Finance Acts. In the case of a person 'resident' in India, all income derived from whatever source is within the scope of taxation; however, in the case of a 'non-resident', the tax liability extends only to the income which is received or accrues to the non-resident in India. It is evident that the income which accrues or arises outside India (i.e. foreign income) is beyond the scope of tax liability in India in the case of a non-resident. There are elaborate rules for ascertaining the residential status of an assessee.

In India, income-tax is a composite tax on the aggregate of incomes from various sources. However, taxable income is first computed under different heads of income and then aggregated. From the aggregated amount, certain deductions are made to arrive at the taxable income. Section 14 of the Act prescribes five broad heads under which the income of an assessee is classified for the purpose of computation of the total income and the charge of income-tax. These are: (1) salaries, (2) income from the house property, (3) profits and gains of business or profession, (4) capital gains, and (5) income from other sources.

The method of computing income and the permissible deductions differ with each head of income and sections 15 and

59 of the Act are devoted to deal separately with different heads of income. The heads of income are intended to indicate the classes of income to which different rules of computation are applied. According to Section 2(45), the total income of an assessee means the income for which he is chargeable to tax on the basis of his residence. It is computed in the following manner:

(a) ascertain the residential status of the assessee and find out which income is chargeable in his hands. For a residential assessee, the whole of his world income is chargeable to tax, while for a non-resident assessee, his Indian incomes only are taxable;

(b) Compute such incomes under different heads of income after allowing deductions, relevant to each head of income and then total them up;

(c) Add others' incomes with the assessee's income, wherever applicable;

(d) Allow set-off and carry-forward of losses. The resultant figure is known as 'gross total income' of the assessee;

(e) From the 'gross total income', make the deduction allowed by the law on account of certain payments and in respect of certain incomes (sections 80C to 80V). The balance is called 'total income', i.e. the base for charging the income-tax.

There are seven categories of 'persons' (i.e. units of assessment) chargeable to tax under the Act. According to section 2(31) of the Act, the word 'person' includes: (i) an Individual, (ii) a Hindu undivided family, (iii) a Company, (iv) a Firm; (v) an Association of persons, or a body of individuals, whether incorporated or not, (vi) a local authority, (vii) every Artificial juridical person, not falling within any of the preceding categories.

Broadly speaking, the system of income-tax is 'global' in nature and in that it does not discriminate between different sources of income. In other words, income from various sources is pooled together for determining tax liability. Basic exemption is allowed to permit a minimum standard of living or some level of income which does not reflect the taxpaying capacity of a person. The present level of basic exemption is Rs.28,000 for individual taxpayers.

Income-tax revenue originates mainly from two tax-paying entities, viz. companies and individuals. Although the concept of taxable income and the procedure for its computation is the same, except for minor differences for all taxable entities, the income-tax rates vary among the different entities. From the standpoint of differential tax treatment, the tax on companies (also referred to as the 'corporation tax') is essentially a proportional tax while the tax on non-corporate entities (also referred to as the 'personal income-tax') is basically a progressive income-tax.

Likewise, the rate of tax on the corporate entities differs depending on whether a company is 'domestic' or 'foreign', 'widely-held' or 'closely-held', 'industrial' or 'trading'. In general, a domestic company is taxed at a lower rate than a foreign company. Among the domestic companies, widely-held companies bear lower rates as compared to the closely-held companies. Among the domestic companies, the industrial companies are taxed at a lower rate than the non-industrial companies. It may be noted that a company is liable to income-tax, however small its income may be, while a basic exemption is allowed to the individual taxpayers.

Though the regular assessment in respect of any income is made in the latter assessment year, the tax on such income is payable by way of advance payment or deduction at-source. Section 208 of the Act makes it obligatory to pay advance-tax in every case where the advance tax payable is Rs.1500 or more. Similarly, there are provisions under section 192 regarding the deduction at-source as, for example, deduction of tax from salaries.

Wealth-tax, Gift-tax and Estate-Duty:

An annual tax on the net wealth has been in operation in India since April 1, 1957. It was introduced as part of the integrated system of direct taxation recommended by the British Economist Professor Nicholas Kaldor in 1956. The rationale behind the imposition of wealth-tax lies essentially in furthering the equity objective of the tax policy. Since the owneeship of wealth is the main source of economic inequalities in Inda, a tax on wealth is intended to reduce its concentration in few hands. Unfortunately, the underlying objective of this tax has not been achieved. In the case of an individual, no wealth-tax is levied if the 'net wealth' does not exceed Rs.2,50,000.

Estate duty was abolished with effect from March 16, 1985. Yields represented collections on estate passing on death occuring before the abolition.

A tax on inter-vivos gifts was imposed in India under the Gift-tax Act, 1958. The statute was enacted as part of an integrated scheme of taxation of income, wealth, expenditure and gifts. The legislation was intended also to supplement the imposition of the estate duty with effect from October 15, 1953. In this sense, the objective of gift-tax is to ensure that transfers of wealth which are effected during the lifetime of a person bear tax liability similar to the levy of estate duty on property passing on the death of a person. Gifts from one person to another provide a convenient device to avoid or reduce liability under income-tax, wealth-tax and estate-duty.

2.8 UNACCOUNTED MONEY AND PROGRESSIVITY OF TAXATION:

The tax system prevailing in India suffers from various deficiencies; foremost amongst which is represented by unaccounted money. The prevalence of unaccounted money makes an intense impact on the theory of progressive taxation. In fact, tax evasion and tax avoidance transform the progressive taxation into a regressive state. Because the portion of the unaccounted money in the hands of the affluent people escapes tax burden. The consequence of this is that the very canon of minimizing inequality is defeated and on the contrary, rich become richer.

Taxes, direct or indirect, are based on coercive transferrence backed by the state authority and power. The taxpayer, either actual or potential, therefore, devises several ways, to keep the intensity of transferrence as low as possible. Tax evasion, tax avoidance and tax planning are some of these devices. In common parlance, all these signify the general reluctance to pay the taxes. Yet, for the purpose of discussion to proceed, these should be described rather in detail.

2.9 TAX EVASION, TAX AVOIDANCE AND TAX PLANNING:

2.9.1 Tax Evasion:

It is a method of evading tax liability by dishonest means like suppression of sales, inflating expenses, etc. This form of tax planning is deplorable. It is also a rather dubious way of attempting to solve one's tax problems and should be condemned.

The chief limitation of income-tax is that the incomes of certain groups of people and the allowances and deductions claimed by them cannot be checked with a high degree of accuracy. Certain incomes are paid from sources which can be easily checked, for example, wages and salaries, interests and dividends, where the chances of evasion are slight, but when incomes are received from the sale of goods or through personal services, accurate checking is impossible, for example, farmers, small businessmen and professional men.

While people are able to evade the provisions of the income-tax to which they should logically be subject, through under-reporting and hiding of income (concealment of income), the income-tax system itself may contain so many loopholes or avenues of avoidance. The taxpayer is able to avoid being taxed under the general scope of the tax, somuchso that the actual burden is very much less severe than it appears to be from the income-tax schedule. Some of the obvious avenues of tax-avoidance are as follows:

a. The absence of a clear and comprehensive definition of income for tax purpose is a very important area of tax avoidance. In some countries, capital gains are exempted and in some, they are treated lightly. As a result, capital gains pave the way for substantial tax avoidance through the conversion of other incomes, especially earnings of closely-held business units into capital gains. Attempts are made to check the mcre important abuses, but considerable avoidance is inevitable so long as capital gains receive favourable treatment.

b. The definition of expenses as permissible deduction is elastic. Besides, there is over-generous provision for the relief of 'losses'. Consequently, the businessmen claim all types of deductions and sometimes, 'manufacturing losses' for tax purposes.

c. Failure to secure the true aggregate of a person's (or his family's) total property or income for tax purposes, due partly to defective provisions concerning the compulsory aggregation of family income, is another source of tax avoidance.

d. Division of property among members of the family is a familiar technique adopted everywhere to escape the effects of progression. It is almost impossible to prevent tax avoidance on this ground.

e. The government may exempt the purchase of government bonds or atleast the income thereof from the scope of the income-tax. This offers a safe method of avoidance for persons with relatively large incomes. The rich may prefer the low interest rates of these bonds tc the payment of high income-tax to the public authorities.

f. Judicious use of trusts may reduce tax liability. This is so because the income of trusts are either completely exempt or are taxed lightly. Accordingly, a rich taxpayer wishing to avoid income-tax, may convert his property into a trust, make himself a trustee and enjoy the usual benefits, but without paying taxes or by paying them at considerably low rates.

g. Authorities may fail to secure the full reporting of income or of property for various reasons such as:

   i. absence of any automatic reporting system for property income and property transactions similar to the one for income from the employment;

   ii. the failure to get comprehensive returns from the taxpayers;

   iii. facilities provided for the concealment of income and property through the registration of property in bogus names or through anonymous holdings like bearer-bonds or the system of blank transfers in the case of shares, etc.

As a result of all the above, tax avoidance of an illegal nature takes place, and a tax-evader generally escapes with considerable understatement of income and overstatement of expenses. The difficulty of accurate checking enables these people to evade the tax. The different sources of tax evasion are:

a. understatement of receipts;

b. under-reporting of adjusted gross income;

c. deduction of essentially personal expenditure as business expenses; and

d. failing to report miscellaneous casual income from irregular sources, etc.

It is true that tax-evasion takes place commonly in all the countries, but it is difficult to assess its magnitude.

2.9.2 Tax-avoidance:

According to G.S.A.Wheatcraft, it is an "art of dodging the tax without actually breaking the law". It is a method of reducing tax liability by taking advantage of certain loopholes in the law. Tax avoidance involves: (i) a transaction entered into to avoid tax and with full legal backing; and (ii) a transaction which the legislature would not intend to encourage.

2.9.3 Tax-planning:

This is a method of planning corporate affairs by availing of the incentives and benefits provided by the Legislature and thus promoting the spirit behind the provisions made in the law. Tax planning is neither 'tax-evasion' nor 'tax-avoidance'.

Obviously, tax evasion stands apart from tax-avoidance and tax-planning and again tax-avoidance and tax-planning are not conceptually the same thing. Following discussion clarifies these fundamental differences in a comparative analysis.

Tax-evasion and Tax-avoidance:

On the subject of tax-evasion and tax-avoidance, the Wanchoo Committee observes:

> "The distinction between 'evasion' and 'avoidance' is largely dependent on the difference in the methods of escape resorted to. Some are instances of merely availing, strictly in accordance with law, the tax exemptions or tax privileges offfered by the government, Others are manoeuvres involving an element of deceit, misrepresentation of facts, falsification of accounts, including downright fraud. The first represents what is truly tax-planning, the latter tax-evasion. But, between these two extremes, there lies a vast domain for selecting a variety of methods, which, though technically satisfying the requirements of law, in fact, circumvent it with a view to eliminate or reduce tax burden. It is these methods that constitute tax-avoidance.

If a tax cannot be administered with a high degree of efficiency and if a person can escape the tax either by legal or illegal means, the tax cannot conform to the accepted standards of equity and justice. Income-tax is generally considered as a tax on honesty. It expects a large number of assessees to declare their incomes. It is possible for many to escape the tax either by not declaring their income or to escape lightly by hiding part of their incomes. As such, the theoretical equity of the tax may be lost to a large extent if it cannot be administed with a high degree of effectiveness.

The question normally raised is how far tax avoidance is valid. Over the years, various judicial forums have clarified the position in this behalf. Some of the decisions are cited below.

(1) Learned Hand, J., observed in the Helvering v. Greggory, 69 7 2d 809, 810 (1934) that:

> "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to chose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes".

(2) Lord Clyde said in Ayrshire Pullman Motor Services v. Inland Revenue Commissioners (1929) 14 JC 745, 763, that:

> "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing statute for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in a like manner, entitled to be astute to prevent, so far

as he honestly can, depletion of his means by the Revenue".

(3) Lord Atkin observed in Inland Revenue Commissioner v. Duke of Westminster (1936) AC 1, that:

> "... for it has to be recognized that the subject, whether poor and humble or wealthy and noble, has the legal right so as to dispose of his capital and income as to attract upon himself the least amount of tax".

In the same case, Lord Tomlin observed that:

> "Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than what it otherwise would be. If he succeeds in ordering them so as to secure the result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax".

(4) Lord Summer observed in Inland Revenue Commissioners v. Fisher's Executors (1926) AC 395, 412, that:

> "My Lord, the highest authorities have always recognized that the subject is entitled to so arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and he can legitimately claim the advantage of any express term or of any omissions that he can find in his favour in the taxing Acts. In so doing, he neither comes under liability nor incurs blame".

(5) Viscount Summer again observed in Levene v. Inland Revenue Commissioners (1928) AC 217, 227, that:

> "It is trite law that His Majesty's subjects are free, if they can, to make their own arrangements so that their cases fall outside the scope of the taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure, if having considered the lines drawn by the Legislature for the imposition of taxes, they make it their business to walk outside them".

(6) Viscount Simon in Latilla v. Commissioners of Inland Revenue, 25 TC 107, 117, observed that:

> "My Lords, of recent years, much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who are prepared to adopt them might enjoy the income, without sharing the appropriate burden of British taxation, Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are 'entitled to do so'. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts or those of the professional gentlemen who assist them in the matter, should be regarded as commendable exercise of ingenuity or as discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase

pro-tanto the load of tax on the shoulders of the great body of good citizens - who do not desire, or do not know how to adopt these manoeuvres. Another consequence is that the legislature has made amendments to our Income-tax Code, which aim at nullifying the effectiveness of such schemes".

(7) Lord Greene, M.R., observed in Lord Howard D.Walen v. Commissioners of Inland Land Revenue, 25 TC 121, 134, that:

"For years, a battle for manoeuvre has been waged between the legislature and those who are minded to throw the burden of their fellow subjects. In that battle, the legislature has often been worsted by the skill, determination and resourcefulness of its opponents, of whom the present appellant has not been the least successful. It would not shock us in the least to find that legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers".

(8) It is found that the Supreme Court of India has not earlier on looked down upon tax avoidance practised by any assessee adopting legal means as a reprehensible act. In CIT v. A.Raman and Co. (1968) 67 ITR 11, 17, it pronounced:

"Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully circumvented".

Also refer CIT v. Calcutta Discount Co.Ltd. (1973), 91 ITR 8.

(9) In Jiyajee Rao Cotton Mills Ltd. v. CIT (1958) 34 ITR 888, 897, the Supreme Court had earlier observed:

"Earlier person is entitled so to arrange his affairs as to avoid taxation but the arrangement must be real and not a sham or make-believe".

(10) In CIT v. Keshavlal Patel (1965) 55 ITR 637, 642, the Supreme Court observed that:

"For taxing the assessees, legal position cannot be ignored and the substance of the transaction" (Re: CIT v. Provident Investment Co.Ltd., (1957) 32 ITR 190 (SC) regarded).

(11) In CIT v. Sakerlal Balabhai (1972) 86 ITR 2 (SC), the following general principles have been evolved regarding tax avoidance as understood under section 94 of the Income-tax Act, 1961:

- "Avoidance involves receipt of certain amount as income by the assessee being taxable in his hands, but on which he avoids tax by 'some artifice or device';

- "Avoidance of tax must be the end and intended to be achieved by the assessee by entering into the transaction". It must be a deliberate act with a set purpose (76 ITR 436, 445). Thus, a mere reduction of tax liability may not amount to tax avoidance;
- "The avoidance of tax must be exceptional, that is, by way of exception to the normal practice of the assesse and it should not be systematic, i.e. part of a regular reprehensible practice carried on by the assessee". It would be exceptional if it involved a single avoidance even though it may be schemed or devised and may be carried out simultaneously. (See also: Gurdial Singh v. CIT (1972) 85 ITR 238).

In 1980, however, the Supreme Court of India, obliterated the thin line of distinction between the 'tax-avoidance' and 'tax evasion'. The Court observed:

"We think that time has come for us to depart from the Westminster Principle as emphatically as the British Courts have done and to dissociate ourselves from the observations of Justice Shah (in the case of CIT v. Raman and Co.) and similar observations made elsewhere. The evil consequences of tax avoidance are manifold ... Surely, it is high time for the judiciary in India too to part its ways from the principle of Westminster and its alluring logic of tax avoidance. We now live in a welfare state whose financial needs, if backed by the law, have to be respected and met. We must recognize that there is as much moral sanction behind taxation laws as any other welfare legislation and it is a pretense to say that avoidance of taxation is not unethical... In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether provisions could be construed literally or liberally, but whether the transaction is a device to avoid tax ... It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is upto the Court ... to expose devices for what they really are and to refuse to give judicial benediction (McDowell Co. v. CTO (1980) 22 Taxmann 11 (SC)).

Tax-avoidance and Tax-Planning:

The razor-thin distinction between tax-avoidance and tax-planning can be understood from the following distinct features pointed out by E.A.Srinivas in his "Handbook of Corporate Tax Planning". Even though 'tax-avoidance' is legally justified, one should not practice it because tax-avoidance carries with it many disadvantages and the following points are worth mentioning:

1. Tax-avoidance involves taking advantage of loopholes in law but does not help in any long-range financial planning. This is because, as and when the loopholes

in the law are made public or even earlier, the legislature steps in to plug them. Laws are not drafted with divine purity and the thankless job of amending the laws every year - leaving an element of uncertainty among assessees - is being mainly attributed to the tax avoidance methods followed by the assessees. It must be pointed out that frequent tinkering with the laws for achieving little material benefit to the government and economy is causing uncertainty and crumbling the corporate planning process. A moratorium on tax laws (excepting exceptional cases) of atleast five years' duration would definitely be a welcome measure.

2. By the time, knowledge of the loopholes in the law is known to the public, the particular loophole ism being plugged. Thus, how many of the large body of tax subjects are able to derive any benefit from such loopholes?

3. Tax planning should not be just a legal exercise but should form an integral part of the management. If the finance managers are armed with tax planning methods, i.e. methods that have a relatively long-term utility, they can effectively evolve policies of lasting value. Howeverr, this is generally lacking in our corporate environment today.

4. By attempting to evolve a tax planning method, an assessee will also be armed with the knowledge of other allied

laws and policies and their effects on their financial decisions. But tax-avoidance narrows down the scope for this. Also, the evolving of consistent policies is not only demanded by the standard accounting practices but also insisted on by prudent tax authorities. Unstable financial policies resulting from tax avoidance are unwelcome.

5. Corporations have a social responsibility to promote activities and programmes of public interest. They are provided with incentives in tax laws which have been designed with a special social purpose. For this, tax planning involving proper understanding of the tax laws and related aspects, rather than tax avoidance, would be relevant.

6. Introduction of the Companies' Act and other allied laws have narrowed down the scope for tax evasion and tax avoidance. Tax evasion and tax avoidance only drive an assessee to the penal provisions of the tax laws. Penalty is often more severe than tax. So, only a tax planning exercise is more reliable.

7. Out of every rupee of profit earned, the corporate tax share goes on increasing and this factor calls for more careful planning in tax affairs than the plan.

8. High taxation leaves an assessee with less money. Proper application of intelligence, consistent with legislative intentions is the need of the hour.

9. In these days of credit squeeze and dear money conditions, even a rupee of tax decently saved in an interest-free loan from the government, which an assessee need not perhaps repay. This is more than true because the money paid in the form of direct taxes is inadmissible for tax computations in the assessment of the company.

10. The need for capital formation in the corporate sector need not be over-emphasized. But taxation controls the inflow of corporate funds, thereby influencing the capital formation.

11. With the existence of indirect taxation, increasing costs and controlled prices, only proper tax planning would enable companies to endure the burden of taxation.

12. Tax iiability forms part of preference creditors and hence, a special attempt should be seriously made to reduce it.

13. Controversy being the undercurrent of tax laws, large expenditure is incurred by companies on tax proceedings which demand the time and energy of the corporate executive. Of course, such expenditure may be claimed as a deduction for taxation purposes. But the time and energy spent can be avoided by proper tax planning.

14. Tax planning enables companies to make proper expense planning, capital-budget planning, sales promotion planning, etc.

The subtle **distinction** between tax-avoidance and tax-planning can be seen from the following examples.

EXAMPLE-1:

This is a classic example of tax-avoidance taken from the case: CIT v.Provident Investment Co.Ltd., (1957), 32 ITR 190 (SC).

The assessee in this case were the managing agents of other companies who were desirous of giving up the managing agency in favour of another party for a large consideration. In those days, a managing agency was transferrable. If they sold the managing agency to the intending purchaser, there would be a considerable amount of taxx to pay. So, they arrnaged the affairs in such a manner as to pay no tax. They relinquished their managing agency by resignation. On their resignatioN, the other party was formally appointed to fill up the void. In consideration for such relinquishment, the other party paid a total sum of Rs.50.0 lakhs to the assessee. The question arose as to whether any taxable capital gains were made. The Supreme Court held that the definition of 'transfer' for the purpose of taxing capital gains was not wide enough to include a case of relinquishment as in the instant case. The result was that the transaction did not attract any tax. Merely by changing the form of the transaction, but achieving the same object as contemplated, viz. obtaining a very large sum of money, the assessees kept themselves outside the net of taxation.

There was an immediate sequel to this case. The law was promptly amended so as to include within the definition of transfer for the purpose of capital gains, a case of relinquishment. It may be noted that the dividing line between tax-avoidance by legal means and tax evasion by illegal methods is very thin. Also, it has been our experience that many intelligent assessees adopting tax avoidance methods have, at some point, slipped and unconsciously adopted tax evasion to solve their tax problems. These people realized this only when the same law which was protecting them pointed this out to them at the peril of penalty. We agree with Lord Greene when he observes, "It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers".

EXAMPLE-2:

Section-80 has been recast with effect from 1.4.1964, to provide that if a contract for deferred annuity contains any provision for the exercise by the insured of an option to receive a cash payment in lieu of the payment of annuity, the premium paid will not be an eligible deduction. The consequences of such an amendment are, with retrospective effect, altering the tax position of the existing contracts taken before this amendment. The amendment has been introducd to plug a loophole in the law. This loophole was that an assessee having a large amount of total income takes out such a contract for deferred annuity towards the fag-end of the previous year and then immediately after the close of the said year, has exercised the option to get back the premium paid after a minimal deduction. Now whereas premium paid has guarded him against the income from being taxed, the right for option helped him to get back the premium paid almost in-tact. A simple amendment in the law altered the whole picture.

Having understood the implications of tax avoidance, it can be said that if such methods succeed, the result is an increase in the burden of tax on the shoulders of the great body of 'good' citizens. Thus, tax avoidance would amount to digging our own grave, since, to the extent, we have not exploited the loopholes, we are inclined to be 'good' citizens. This is because one cannot exploit all the loopholes all the time. It may be difficult to distinguish a loophole from an intended benefit though perhaps an interpretation beneficial to a single assessee may turn out to be a loophole, in general. Tax avoidance is but tax dodging, if it defeats a clear objective of law. For example, it was held by the Supreme Court in CIT v. B.N.Kharwar (1969) 72 ITR 603, that where a partnership firm was converted into a limited company, there was as taxable transaction. This decision, however, does not hold any special objective of law. Hence, even if it may be coloured as 'tax-avoidance', a proper device adopted to reduce the rigours of taxation must nevertheless be welcomed. But even such a device should not defeat any other objective of law.

An authoritative comment comes from 'Prajnan', the Journal of the National Institute of Bank Management (Vol.XXI, April-June 1992, pp.44-49):

> "In recent times, the World Bank and IMF have very rigorously pursued the structural adjustment programmes of different countries that are trapped into various economic crises ... In case of India, the economic reforms have been introduced since 1990-91 onwards ... (Still), there is a need to embark upon tax reforms which would ultimately result in greater tax revenues through wide tax-net as well as lesser tax leakages as well as evaporation of revenues through unaccounted money".

2.10 RESOURCE MOBILIZATION AND CURBING OF BLACK MONEY GENERATION:

The concluding remarks of the present Chapter are taken from the recommendations of 'Seminar on Fiscal Policy for Growth' organized by the Associated Chambers of Commerce and Industry on 13.4.1990. Tax experts like Mr.Nani Palkhivala and industry-doyens like Mr.Viren Shah were in attendance. The seminar, after lengthy deliberations, indeed made some positive and concrete suggestions towards resource mobilization and curbing the generation of black money. A gist of these recommendations is presented below:

The exercise in this direction has to be multi-dimensional. The first and the foremost to combat blackmoney is to discourage further generation and proliferation through appropriate measures. The second is to lower the tax rates and widen the tax base. The third is to promote proper understanding and cordiality in relationship between the assessee and the assessing officers. The fourth is to simplify the law and procedures and allow normal business expenditure as deductions:

(i) The primary reason for the generation of black money is the high rate of taxation and the high cost economy. If evasion is made uneconomic by reducing the taxes, it will tend to discourage further generation of black money.

(ii) The next exercise should be a proper and closer survey of the self-employed persons in trade, business and professions, who have taxable income but are escaping the liability, amounting to evasion in a large way, which could be curbed by bringing all these income earners within the tax net.

(iii) There should be an attitudinal change in the assessing officers. They should take the taxpayer into confidence and accord him a fair and equitable treatment.

(iv) The tax laws and procedures should be streamlined and simplified so that it leaves little room for the administration to resort to differing interpretations, leading to harassment of assessees and consequent litigation.

(v) There is a large amount of blackmoney generated in transfer of property and other assets. These could be brought under control, if the consideration for the exchange of property or assets is allowed to be invested in other instruments which bring in a higher return instead of the same assets or property. In short, the capital gains should have larger options for investment purposes. Both government and private sector should be allowed to issue bearer bonds. By this, a substantial investment out of the blackmoney could be expected.

The then Union Finance Minister Prof.Madhu Dandavate in his Budget Speech, had said that there is a case for introducing a time-bound scheme which would permit undeclared incomes and hidden wealth to be used for one or more social purposes, such as slum-clearance, building of houses for lower and middle-income groups and setting up of specified agro-based industries in rural/backwards areas. Further, subject to certain conditions, the sources of moneys declared under this scheme will not be questioned. The scheme should be attractive enough to mop up a large amount of black money.

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