LAW OF TAXATION

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Introduction

Taxes have been the lifeblood for good governance. Contemporary ambitious developmental schemes for all round progress of the society rests on the revenue, generated through the medium of taxation. The power to levy taxes is vested with the sovereign. The tax proceeds go to the general revenues of the state and the taxpayer gets no return for his contribution, but only participates in the common benefits derived by all. However, the citizens of a democratic state have the advantage of being taxed only with the consent of their elected representatives.

Brief historical background

A brief knowledge of the history of tax laws in India is essential to understand the present tax system. The tax system of British India reflected characteristics of a traditional agricultural economy. Revenues of the Central Government were dominated by customs duties as domestic requirements for manufactured goods were met mostly by imports. Various customs and tariff enactments were passed from time to time. The most significant among them were Sea Customs Act, 1878 and the Tariff Act, 1934. These enactments were consolidated into a single legislation — the Customs Act, 1962. Excise taxation in its modern form dates back to 1894 when for the first time a duty @ 5% *advalorem* was imposed on cotton yarn of more than 20 counts. Apart from the indirect taxes, among the direct taxes, the chief source of revenue was the income tax introduced in India by the British in 1860 to overcome the financial difficulties created by the events of 1857. Till 1886 the income tax imposition remained irregular. Thereafter, it became systematic. The form of income tax has undergone a series of changes to meet the ever-changing requirements of finance and economic policy. The Act of 1886 levied tax on the income of both residents and non residents in India, keeping agricultural income beyond tax liability. The Act remained in force for 32 years till the new Act was passed in 1918. The legislation

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charged all receipts casual or non-recurring pertaining to business or profession. This Act was replaced by the Income Tax Act of 1922, in view of the reforms introduced by the Government of India Act, 1919. The significant change brought by this Act was the introduction of setoff of loss from one source against the income from other sources. It also introduced separate department for income tax administration. The slab rate system was introduced in 1939 on the recommendation of Income Tax Enquiry Committee 1935. The present law of income tax in India is governed by the Income Tax Act, 1961 which replaced the Act of 1922. It came into force on 1st April 1962 and since then it was amended. Tax rates are not given time and again in the Income Tax Act but in the Finance Act, which is passed by the Parliament along with the budget for the Central Government every year.

Indian taxation: the constitutional scheme

In India's federal Constitution the powers of the centre and the constituent units are well defined. The legislative powers of the Union are enumerated in list I of the seventh schedule and those of the states in list II, the concurrent powers being found in list III.

The powers of taxation exclusively conferred on the Union legislature are in respect of the following subjects: (1) Taxes on income other than agriculture income; (2) Duties of customs including export duties; (3) Duties of excise on tobacco and other goods manufactured or produced in India except alcoholic liquors and narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohols *etc.*, (4) Corporation tax; (5) Taxes on the capital value of assets exclusive of agriculture land, of individuals and companies; taxes on the capital of companies; (6) Estate duty in respect of property other than agricultural land; (7) Duties in respect of succession to property other than agricultural land; (8) Terminal taxes on goods or passengers carried by railway, sea or air: Taxes on railway fares and freights; (9) Taxes other than stamp duties on transaction in stock exchanges and futures markets; (10) Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letter of credit, policies of insurance, transfer of shares, debentures, proxies and receipts; (11) Taxes on the sale or purchase of newspapers and on advertisements published therein; (12) Taxes on the sale or purchase of goods other than newspapers where such sale or purchase takes place in the course of inter-state trade or commerce. (13) Taxes on the consignment of goods (whether consignment is to the person making it to any other person), where such consignment takes places in the course of inter state trade or commerce.

To enable the Parliament to formulate by law principles for determining the modalities of levying the Service Tax by the Central Government and collection of the proceeds thereof by the Central Government and the

States, the 95th Constitution Amendment Act was enacted in 2003. Consequently, new article 268 A has been inserted for levy of Service Tax by Union Government, collected and appropriated by the Union.[1]

The validity of Service tax has been challenged in various courts of India wherein the courts have upheld the legality of the levy. Some important decisions are –

- *Addition Advertising* v. *Union of India*[2] where it was held that levy of tax on advertising service is not unconstitutional. It was held that this is not a tax on any profession, trade, calling or employment, but in respect of service rendered. If there is no service, there is no tax. The Court further making a difference between 'advertisement service' and 'advertisement' held that 'the tax is not on advertisement' but on the services rendered with reference to the advertisement.
- *M/s Laghu Udyog Bharati* v. *UOI*[3] where the petitioners had challenged the Government's decision to shift the burden of duty/ liability to the service receivers in case of Goods Transport Operators and Clearing and Forwarding Agents. The Supreme Court upholding the contention of petitioners observed:

> The service tax is levied by reason of services, which are offered. The imposition is on the person rendering the service. Of course, it may be indirect tax, it may be possible that the same is passed on to the customer.

But as far as the levy and assessment is concerned, it is the person rendering the service who alone can be regarded as an assessee and not the customer. This is the only way in which the provision can be read harmoniously.

The Hon'ble Apex Court finding the imposition against the purpose of the Act further observed that:

> The charge of tax is on the value of services and it is only the person who is providing service can be regarded as an assessee. The rules, therefore, cannot be so framed which do not carry out the purpose of the Chapter (Statute) and cannot be in conflict with the same.

Challenges have also been made on the Union Government's power to impose tax on a state subject. A number of trade bodies and individual service providers have challenged the levy of service tax by the Union Government under the residuary entry No. 97, list I in VII Schedule of the

1. Amendment of seventh schedule to the Constitution, in list I-Union list after entry 92 B, entry 92 C has been inserted for taxes on services. See entry 92 C.
2. 1998 (98) ELT 14.
3. 1999 (89) ELT 247.

Constitution. They contended that the service tax is nothing but a tax on professions, which is specifically listed, in the State list. Therefore, the Union Government is not empowered to levy service tax on professional services. Moreover, the levy has also been challenged on the grounds of hostile discrimination vis-à-vis other services and/or the service providers within the same category. However, constitutional validity of the service tax law provisions contained in the Chapter V of the Finance Act, 1994 and the Rules framed thereunder, was upheld by various high courts.

The state list has the following entries relating to taxation; (1) Land revenue, including the assessment and collection of revenue, the maintenance of land records *etc.*; (2) Taxes on agricultural income; (3) Duties in respect of succession to agricultural land; (4) Estate duty in respect of agricultural land; (5) Taxes on lands and buildings; (5A) Taxes on unusual rights subject to any legislations imposed by Parliament by law relating to mineral development (6) Duties of excise and countervailing duties on alcoholic liquor; narcotic drugs and narcotics excluding medicinal and toilet preparations; (7) Taxes on entry of goods into a local area for consumption, use or sale there; (8) Taxes on the consumption or sale of electricity; (9) Taxes on the sale or purchase of goods other than newspapers subject to the provisions of entry 92 A of list I; (10) Taxes on advertisements other than advertisements published in the newspapers; (11) Taxes on goods and passengers carried by road or on inland waterways; (12) Taxes on vehicles whether mechanically propelled or not suitable for use of roads, including tramears, subject to the provisions of entry 35 in list III; (13) Taxes on animal and boats (14) Tolls; (15) Taxes on professions, trades, callings and employments; (16) Capitation taxes; (17) Taxes on luxuries including taxes on entertainments, amusements, betting and gambling; (18) Rates of stamp duties in respect of documents other than those specified in the provision of list I with regard to the rates of stamp duty.

In the concurrent list the two entries relating to taxation are entry 35 and entry 44. The former relates to the principles on which taxes on mechanically propelled vehicles are to be levied. Entry 44 reads 'Stamp duties other than duties on fees collected by means of judicial stamps but not including rates of stamp duty. This means that the Union government and the states have concurrent power to legislate as to stamp duties on non-judicial documents except in regard to the rates of such duties which are to be levied according to entry 91 of list I or entry 63 of list II depending on the nature of the document.

The residuary power of legislation as to the subjects not covered by any of the legislating lists vests by virtue of entry 97 of list I with the central legislature. The Supreme Court has held that wealth tax is not covered by any of the entries in the lists and, therefore, under entry 97 of list I the

central legislature can levy wealth tax on all wealth including agriculture land.[4]

Article 285 (1) provides that the property of the Union shall, save in so far as Parliament may by law otherwise provide, be exempt from all taxes imposed by a State or by any authority within a state. Under sub-clause (2) of the article, property of the Union which was taxable immediately before the commencement of the Constitution would continue to be liable to taxation until Parliament by law otherwise provides.

Under article 289 the property and income of a state shall be exempt from Union taxation. The Union can, however, tax any trade or business carried on by the state government and the income thereof unless the trade or business is declared by Parliament to be incidental to the ordinary functions of government.

Article 301 of the Constitution provides that trade, commerce and intercourse throughout the territory of India shall be free. It has been held by the Supreme Court in *Nataraja Mudaliar's* case[5] that a tax on trade transactions does not *per se* affect freedom of trade. Restrictions on inter-state trade in public interest may, however, be imposed by Parliament.[6] Preference to one state or discrimination between one state and another by either Parliament or the state legislatures is not permitted except in a situation where in order to deal with scarcity conditions in India Parliament so provides.[7] A state may impose on goods imported from other states any tax to which similarly goods manufactured or produced in that state are subject, so however, as not to discriminate between the imported and the local goods.[8] The state may also impose reasonable restrictions on the freedom of trade, commerce or intercourse with or within that state as may be required in the public interest.[9] For the exercise of powers under article 304 (a) and (b), the previous sanction of the President is required.

It can be noticed that the Constitution does not expressly confer powers of taxation on local bodies like municipalities, district boards and panchayats. These bodies enjoy such powers of taxation as may be delegated to them by the state government for their needs.

Central taxes

Central taxation is direct as well as indirect. The principal direct taxes

4. *Union of India* v. *H.S. Dhillon* (1972) 2 SCR 33.
5. *State of Madras* v. *Nataraja Mudaliar* AIR 1969 SC 147 and *Atiabari Tea Co. Ltd* v. *State of Assam* AIR 1961 SC 232.
6. Article 302.
7. Article 303.
8. Article 304 (a). See also, *Indian Cement* v. *State of A.P.* AIR 1988 SC 567.
9. Article 304 (b). See also *Kalyani Stores* v. *State of Orissa* AIR 1966 SC 686.

include income tax and wealth-tax. The scheme of direct taxes is designed to lay a wide net so as to catch the tax-evader at some point or the other. If income tax is evaded the income will accumulate and show up as wealth liable to be taxed under the Wealth Tax Act.

Indirect taxation consists of duties of excise and customs, central sales tax and stamps duties. Excise duties are levied under the Central Excise Act, 1944 as amended from time to time. Duties of customs are governed by the Customs Act, 1962. The Central Sales Tax Act, 1956 levies tax on inter-state but the proceeds are collected and retained by the state in which the transaction commences. Stamp duties are levied under the Indian Stamp Act, 1899.

In this short study, it is hardly possible to describe the whole tax system. It is proposed, therefore, to examine in some detail the tax which arouses universal interest, namely, the tax on income and only briefly to refer to the others. Some provisions relating to the service tax will also be discussed as it has much significance today.

Income-tax

The governing Act is the Income-tax Act, 1961. It was supposed to simplify the law as it had developed under the Income-tax Act, 1922. Numerous amendments have, however, followed since its enactment, and simplicity seems an unattainable goal.

The charging section: The Act lays down in section 4 that income tax shall be charged in every assessment year from every person on the total income of the previous year at the rate or rates levied by the relevant finance Act. Section 4 provides:

> (1) where any Central Act enacts that income tax shall be charged for any assessment year at any rate or rates, income tax rate or those rates shall be charged for that year in accordance with and subject to provisions (including the provision for the levy of additional income tax) of this Act in respect of total income of the previous year of every person.
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> (2) In respect of the income chargeable under sub-section (1) income tax shall be deducted at source or paid in advance where it is so deductible or payable under any provisions of this Act.

Thus the Act itself does not levy the tax; it leaves it to be levied by the Finance Act. The central legislature, therefore, passes every year, a Finance Act in which the rates of tax on different kinds of assesses and incomes are laid down. The Finance Act is also used to make substantive amendments in the various taxing structure.

The income tax, according to Section 4, is leviable on every person. 'Person' is defined in Section 2 (31) to include an individual, a Hindu

undivided family, a company, a firm, an association of persons or a body or individuals, whether incorporated or not, a local authority and every artificial juridical person not falling within any of the above categories. This definition is inclusive not exhaustive. Therefore, any person not falling in the above categories may still fall in four corners of the term 'person' and accordingly may be liable to pay tax under section 4.

Next it will be noticed that under section 4, tax is to be levied in the assessment year (*i.e.*, the financial year in which the tax is leviable) on the income of the previous year. Previous year means the financial year immediately preceding the assessment year, *e.g.*, for the assessment year 2005-06 the previous year is the financial year 2004-05.

However, from the assessment year 1989-90 onwards all assesses are requested to follow financial year (*i.e.*, April to March, 31) as the previous years. This uniform previous year has to be followed for all sources of income.

What is income : Under the Act, income is taken in the widest sense. The definition of 'income' in section 2 (24) is inclusive and not exhaustive. Under Section 2 (24) income includes: (i) Profit and gains; (ii) Dividend; (iii) Voluntary contribution received by a trust and various other items. It includes those things which are included in section 2 (24) but also includes such things, which the term signifies according to its general and natural meaning.

Entry 82 of list 1 of Seventh Schedule to Constitution empowers Parliament to levy taxes on income other then agricultural income. Entries in the lists in Seventh schedule to the Constitution should not be read in a narrower or restricted sense as held in *Bhagwandas Jain* v. *Union of India.*[10] It, therefore, follows that in addition to receipts mentioned in Sec. 2 (24) which does not define the term income but merely describes the various receipts as income any other receipts is taxable under the Act; if it comes within the general and natural meaning of the term 'income'.

Though there are different concepts of 'income' for the purpose of taxation, income is broadly defined as the true increase in the amount of wealth, which comes to a person during a stated period of time.[11]

Total income

As per section 2 (45), 'total income' means the total amount of income referred to in section 5, computed in the manner laid down in the Act. The definition of total income in section 2 (45) has two ingredients: (i) the income must comprise the total amount of income mentioned in section 5

10. (1981) 5 Taxmann 7 SC.
11. *Comm. of Corporation and Taxation* v. *Filoon* 38 NE 2d 693, 700.

and, (ii) it must be computed in the manner laid down in the Act. In 'total income', certain incomings which fall within the ordinary meaning of income may be excluded by some provisions of the Act; equally some incomings which are outside the ordinary concept of income may be included. It is after giving effect to the various exclusions and exemptions and applying the rules as to computation of income that 'total income' is arrived at. The whole of 'total income' may again not be taxable as a result of certain deductions.

Residence and total income

Section 5 of the Act provides for what constitutes total income with reference to the residential status of the assessee concerned. Total income under the section is different for those who are "resident but not ordinarily resident", and those who are "non resident". What is to be seen is the residential status in the previous year. It becomes necessary at this stage to examine the concept of residence as envisaged under the Act.

An individual under section 6(1) is said to be resident in India in any previous year if he (a) is in India in that previous year for a period or periods amounting in all to one hundred and eighty-two days or more; or (b) having within the four years preceding that previous year has been in India for periods amounting in all to three hundred and sixty-five days or more, is in India for a period or periods amounting in all to sixty days or more in that previous year.

A firm or other association of persons is said to be resident in India in any previous year in every case except where during that year the control and management of its affairs is situated wholly outside India.

A company is said to be resident in India in any previous year if (i) it is an Indian company as defined in the Act, or (ii) during that year the control and management of its affairs is situated wholly in India.

A person who is a resident in India will be treated as not ordinarily resident in the previous year if such person is an individual who (a) has not been resident in India in eight out of the ten previous year preceding that year, or (b) has not during the seven previous years preceding that year been in India for a period of, or periods amounting in all to, seven hundred and thirty days or more. A Hindu undivided family is not ordinarily resident in India in the previous year if its manager or *karta* is not ordinarily resident in India according to the above definition.

The total income of persons who are resident and ordinarily resident and not ordinarily resident in the previous year consists under section 6 (5) of: (a) income received or deemed to be received in India, (b) income which accrues or arises or is deemed to accrue or arise in India, (c) income which accrues or arises outside India during the accounting year even if it is not

received or brought into India. Persons who are not ordinarily resident differ from those ordinarily resident in that their foreign income is taxed only if it is derived from a business controlled or a profession or vocation set up in India or it is deemed under the provisions of the Act to accrue in India or is received or deemed to be received in India. Non-residents are taxable only in respect of income, which accrues or arises in India or deemed to be so, and income, which is received or deemed to be received in India.

The computation of Income

Receipts which fall within the definition of income are not *ipso facto* treated as part of total income under the Act for Section 10 excludes certain categories of income from consideration. Some of the important items so excluded in computation of total income are shown below:

Sections	Items excluded
10(1)	Agricultural income
10(2A)	Share of income from a partnership firm
10(6)	Exemptions for foreigners
	(a) Passage money
	(b) Remunerations of officials of foreign embassies, high commissions, legations, commissions, consultants or trade representatives
	(c) Remunerations of employees of certain foreign rnterprises
	(d) Remunerations of employees of foreign philanthropic institution
	(e) Salaries of technicians on scientific research of the government, local authorities of special corporations
	(f) Salaries to non-residents employed on a foreign ship
	(g) Salaries to non-resident teachers
	(h) Income of individual engaged in research work in certain cases
	(i) Remuneration to certain trainee foreigners
10(10)	Death cum retirement gratuity
10 (10C)	Payments on voluntary retirement of employees of public sector company, any other company, authorities of government local authority or co-operative society, Specific university, IIT, notified institute of management
10 (10D)	Sums received under a life insurance policy

10(11,12,13)	Payment received from provident funds and super-annuation fund
10 (13A)	House rent allowance
10(16)	Scholarships for education
10(17)	Allowance to members of parliament and state legislatures
10(19A)	Annual value of palace of ruler
10(20)	Income of local authority
10(21)	Income of an approved scientific research association
10(22B)	Income of notified news agency
10(23A)	Income of professional association for encouragement to the profession of law and medicines
10(23B)	Income of khadi and village industries
10(23D)	Income of notified mutual funds
10(23F)	Income of from dividend and long term capital gain, venture capital fund or venture capital company
10(24)	Income of a registered trade union
10(26)	Income of a member of a scheduled tribe residing in specified area
10(26A)	Income of person resident in district of Ladakh in certain cases
10(27)	Income of co-operative societies formed to promote interest of scheduled caste and scheduled sribes
10(32)	Income of minor child upto Rs.1500/- per child subject to maximum of two child in parent income
10(34)	Dividend exempt in the hands of shareholders
10(37)	Capital gains on compensation received on compulsory acquisition on transfer of agriculture land
10(38)	Capital gain arising from sale of shares and units
10A	Exemption in respect of profits of newly industrial undertakings in free trade zones and units producing electronic hardware technology park or software technology park
10B	Income from newly established export oriented Undertaking

Income heads for computation of income

The Act divides income into five categories or heads namely, salaries, income from house property, profits and gains of business or profession,

capital gains, and income from other sources. There are different rules for computation of income under each of these heads.

Salaries

For a payment to be treated as salary it must be due or paid by an employer to an employee. A regular payment for services received by an agent is not salary, neither is the remuneration received by the director of a company unless the terms of the contract create a relationship of master and servant.

Salary includes not only the payment received in cash as wages from the employer but also the value of perquisites like rent-free house or other amenities or concessions. It also includes any commission, gratuity, amenity or advance of salary. Profit in lieu of salary like compensation in connection with termination of services and the employer's contribution to the provident fund (not exempted under section 10) are also salary within the definition.

Salary is taxable in the previous year when it falls due though not paid, and also in the year when it is paid though not due. Arrears of salary of an earlier year if not charged when they fell due are liable to be taxed when paid. If on account of such payments of arrears, hardship is caused to the employee, *i.e.*, by rise in rate of tax, relief can be claimed by the assessee under section 89(1).

The employer of a salaried employee is under a duty to deduct the tax due on the aggregate amount of salary paid or due during a previous year. The rate at which salary is taxed is the rate laid down in the Finance Act of the previous year itself. The previous year for salaries and all other income is always the financial year preceding the assessment year and the assessee has no choice in the matter.

Up to the assessment year 2005-06 standard deduction at prescribed percentage of gross salary was allowed under section 16 (i) but by the Finance Act 2005 relevant for assessment year 2006-07 standard deduction has been deleted in view of enhancement of the basic exemption limit of total income from Rs.50,000 to Rs.100,000.

Income from house property

Under this head the annual value of house-property of which the assessee is the owner but which is not occupied by him for the purpose of any business or profession carried on by him is chargeable as income from house property. The term annual value means the rent for which the property might reasonably be expected to let from year to year, or the rent actually received if it is higher.

Standard deductions under section 24(a) are consolidated 30% of the net annual value for various expenses like repair, insurance, collection

charges, land revenue or other tax levied by State Government; annual value; local taxes and ground rent paid by owner. Besides this, deduction is available in respect of interest on borrowed capital.

Concessions are given to owners occupying their own house, (one house) or part of a house which is in the occupation of the owner for his own residence or which cannot be actually occupied by the owner owing to his employment, business or profession carried on at any other place and he has to reside at that other place in a building not belonging to him, then the annual value shall be taken to be nil *i.e.*, no income from such house or part of a house will be included in the taxable income. This incentive is available only in respect of one house or part of a house which is self occupied and not let out.

Persons who own house property as co-owners in definitely ascertainable shares have to pay tax only in respect of their own separate shares.

Profits and gains of business or profession

The income under this head consists of: (a) the profits and gains of any business or profession carried on by the assessee at any time during the previous year, (b) compensation for termination of services by a person managing whole or substantially the whole affairs of a company or as agent of another person, (c) income of a trade, profession or similar association from specific services performed for its members, (d) value of any benefit or perquisite whether convertible into money or not arising from business or the exercise of a profession (e) profit on sale of import license and (f) drawbacks to any person against duty of excise or customs.

The income under this head is computed by deducting the various allowances granted under the Act. The deductible items stated in broad terms are; (a) rent and repairs of business premises, (b) land revenue, local rates and municipal taxes, (c) premium paid for insurance of premises, (d) current repairs to machinery and insurance thereof, (e) depreciation as allowable, (f) development allowance as provided for and development rebate where still allowable, (g) other development allowances, (h) rehabilitation allowance where due, (i) expenditure on scientific research to the extent allowable, (j) expenditure on acquisition of patent rights or copyrights, (k) expenditure for obtaining license for telecomm business, (l) expenditure on eligible projects or schemes and (m) agricultural development allowances. Further deductions are permissible on account of (i) premium paid in respect of insurance of stock, (ii) sums paid towards bonus or commission, (iii) interest paid on capital borrowed, (iv) employer's contributions to recognized employee's provident funds, (v) contributions to any approved gratuity fund, (vi) loss on animals which have been used for

the purpose of business, (vii) bad debts, (viii) expenditure on family planning among employees and (ix) any other expenditure not of a capital nature which can be justified as having been laid out wholly and exclusively for the business or profession.

The Act contains provisions for setting off of losses in one business against gains of other business as also for setting off of loss against other heads of income. The loss in business which remains after setting it off against other business or other heads in the manner permissible, can be carried forward for a maximum of eight years. Speculation business is, however, to be treated as a separate business for this purpose and loss in speculation business can be set off only against similar business. It can be carried forward and set-off in succeeding eight years against speculation business only from Assessment Year 2006-2007. One time limit was eight years upto Assessment Year 2005-2006.

Capital gains

Profits of gains arising from the sale, exchange, relinquishment or transfer of a capital asset as defined in the Act are deemed to be income of the previous year in which, they took place and are taxable under the head capital gains. Such gains do not fall within the ordinary concept of income but have been made chargeable by specific provision. The levy has been held by the Supreme Court as *intra vires* on the reasoning that the word 'income' in Entry 54 of List I of the Seventh Schedule must be interpreted in the widest sense and cannot be limited to the meaning given to it under the income-tax statutes.[12]

It includes any money or other assets under an insurance from an insurer on account of damage or destruction of any capital asset as a result of flood, typhoon, hurricane, earthquake, riot, fire or explosion then any profit or gain arising out from receipt of such money shall be chargable to income tax under this head. It also includes profit or gain from sale of a capital asset from conversion of this capital asset into a stock in trade of a business carried on by him and profit or gain from the transfer of capital asset by way of distribution on the dissolution of the firm or AOP or BOI.

The income chargeable under this head is worked out by deducting expenditure incurred wholly and exclusively in connection with such transfer plus the cost of acquisition of the asset and the cost of any improvement thereto from the full value of the consideration received or accruing as a result of the transfer of capital asset. The following chart presents the cost of inflation index in order to ascertain capital gains.

12. *Navinchandra Mafatlal* 26 I.T.R. 758.

Cost of Inflation Index

Sl. No.	Financial Year	Cost Inflation Index
1	1981-82	100
2.	1982-83	109
3.	1983-84	116
4.	1984-85	125
5.	1985-86	133
6.	1986-87	140
7.	1987-88	150
8.	1988-89	161
9.	1989-90	172
10.	1990-91	182
11.	1991-92	199
12.	1992-93	223
13.	1993-94	244
14.	1994-95	259
15.	1995-96	281
16.	1996-97	305
17.	1997-98	331
18.	1998-99	351
19.	1999-2000	389
20.	2000-2001	406
21.	2001-2002	426
22.	2002-2003	447
23.	2003-2004	463
24.	2004-2005	480
25.	2005-2006	497

Taxation of Different Kinds of Assesses

Individuals

An Individual is liable to pay tax if his income exceeds the prescribed maximum limit. However, income from assets transferred by a male assessee to his wife or minor child is taxed in his hands. The income of a trust created by the assessee which is not revocable for the life-time of the

beneficiary or the transferee will not be taxed in the hands of the assesee. However, trustees of a discretionary trust are to be assessed in the status of an individual.[13]

Hindu undivided families

Because of the peculiar features of Hindu undivided families the Income-tax Act makes special provisions for their taxation. A joint family consists of all male Hindus descended in the male line from a common ancestor, their wives and their unmarried daughters. Usually the eldest male member of the family manages its affairs and is called the *karta*. He enjoys wide powers to manage and dispose of property under Hindu law. Members of the undivided family are entitled to a partition of the family assets and to enjoy their separate shares of the property.

The income of Hindu undivided family is assessed on the family as a whole with the *Karta* as the assessee. The individual members of the family are not taxed on any amount distributed to them from the family income. Any income earned by an individual member of the family by his own exertion is taxable in his own hands. Where a person receives a salary from a partnership concern in which the family is represented by one or more of its members as partners the question arises whether such salary is the income of the family or of the individual. A similar question has arisen in cases when a member of the family is in receipt of salary as manager or director of a company in which the family has holdings. The principle laid down by the Supreme Court in such cases is that the salary would be income of the family if it is not so much a return for the individual's services as for the money invested by the family in the partnership or the company.

Partnership firms

A partnership is not a separate juristic entity like a company but an aggregation of the individuals composing it. Persons who have entered into partnership are called individual partners and collectively a firm under a firm name.

The firm is taxed as a separate entity. There is no distinction between registered and unregistered firms. The income of the firm is taxed at a flat rate, *i.e.*, 30% plus surcharge of 10%+2% Education Cess on tax for the assessment year 2006-07. Under Section 184 (1) (*i*) A firm must be evidenced by an instrument, *i.e.*, a partnership deed, should accompany the first return of the firm.

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13. *CIT* v. *Deepak Family Trust (No. 1) and others (Guj.)* (1995) 211 ITR 575.

Association of persons

When a number of persons or individuals, whether incorporated or not, join together in income-producing activity and they do not in law constitute a partnership they are assessable as an "association of persons". Co-owners of property are to be separately taxed in respect of their respective shares if the shares are definite and ascertainable. If not, they are liable to be assessed as an association of persons. The income of the association is taxed as a unit whether incorporated or not. An association of persons may have companies, firms, as its members. Illegality of an association does not affect its liability to be taxed as such; therefore a partnership which is otherwise void may be taxed as an association of persons.

Company

Under Section 2(17) company is defined. It is broadly categorized as domestic companies and foreign companies. Domestic companies are those which are registered in India and foreign companies are those body corporate which are incorporated under the laws of a foreign country. Although the income of a company is determined in the same manner as that of an individual there is no minimum taxable limit with the result that the whole profit is taxable. The tax is levied at a flat rate. A company is under a legal duty to deduct tax on the dividend paid to its shareholders.

Income-tax authorities

The key-figure is the assessing officer as far as assessment is concerned. He issues notices to file return, examines accounts, determines the income of the assessee and recovers tax. He is aided in his work by Inspectors of Income-tax who are subordinate to him. They perform such duties as survey, or examination of accounts as the assessing officer may assign to them. The work of Assessing Officers is supervised by Joint Commissioner or Additional Commissioner, who in turn are within the jurisdiction of Commissioner of Income Tax (CIT). CIT (Appeals) deals appeals against the assessment made by Assessing Officer. The Commissioner of Income Tax is supervised by the Chief Commissioner of Income Tax. There are Director/ Director General of Income Tax for conducting enquiry and investigation of concealment and to discharge other duties. The final authority at the top is the Central Board of Direct Taxes, the functions of which are regulated by the Central Board of Revenue Act, 1963.

The Central Board of Direct Taxes has power to issue such orders, instructions and directions to the various departmental authorities as it deem fit for the proper administration of the Act. But it cannot give instructions to any officer to decide a question in a particular case in a particular way or

so as to interfere with the direction of the CIT (Appeals) in the exercise of his appellate functions.

Appeals and revision

Assessees who are aggrieved by orders of assessing officers may appeal to the DCIT (Appeals) or CIT (Appeals). Appeals against the orders of the Commissioners may be filed by the assessee as well as the Income tax Department before the Income tax Appellate Tribunal which is an authority independent of the Income tax Department, its members being appointed by the Ministry of Law and Justice. The working of the Tribunal is regulated by the Income tax Appellate Tribunal Rules, 1963. On a question of law arising out of the order of the Tribunal a reference can be made at the instance of the assessee or the Commissioner of Income-tax to the High Court. An appeal shall lie to the Supreme Court from any judgment of the high court delivered on a reference made under section 256 in any case which the high court certifies to be a fit one for appeal to the Supreme Court.

Assessment procedure

Every assessee whose income in the previous year is above the maximum exemption limit is under a legal duty to file his return of income. However, every firm and company has to file the return of income tax. Every company, firm or any other assessee whose accounts are being subject to Audit under Income tax law or any other law or any working partner of a firm whose accounts are required to be audited under Income tax Act or any other law for the time being in force or a person referred in first proviso to section 139(1) shall file the return by October 31 of the assessment year. In case of any other asseessee the return shall be paid by July 31 of the assessment year.

For the purpose of making an assessment the assessing officer can ask the assessee to produce such accounts and documents and to give such information as necessary. With the previous approval of the Commissioner, the Income-tax officer/assessing officer can ask the assessee to give a full account of his assets and liabilities. The assessee, however, cannot be asked to produce accounts for a period more than six years prior to the previous year. If the assessing officer has as a result of his enquiries collected any material which he proposes to use for the purpose of the assessment he must give the assessee an opportunity to be heard in respect of it.

When the assessee fails to file a return or fails to comply with notices issued to him the Income-tax officer may make what is called a 'best judgment assessment'. This must be a guesswork to a certain extent but it must be honest guesswork. The assessee can ask for such an assessment to

be re-opened on showing sufficient cause for not filing return on complying with notices.

Where income has escaped assessment in past years the Income-tax officer can issue notice under section 148 to the assessee for the purpose of showing cause as to why assessment or reassessment should not be made. Where an assessment order has been passed under section 143(3) or section 147 notice can be issued upto 4 years from the end of relevant assessment year for any amount by the assessing officer authorized. Beyond 4 years upto 6 years from the end of relevant assessment year notice can only be issued, if the income which has escaped is likely to be Rs.1,00,000 or more for that year with the prior approval of Commissioner or Chief Commissioner where no assessment order has been passed under section 143(3) or 147, notice can be issued for any amount upto 4 years by any assessing officer and from 4 years upto 6 years, only if the amount likely to escape assessment is Rs.1,00,000 or more with the prior approval of Joint Commissioner.

Remedies outside the Act

Section 293 of the Act lays down that no suit shall be brought in any civil court to set aside or modify any assessment made under the Act. A suit, however, is permitted if the provision under which the income-tax authority is acting is *ultra vires,* or the authority abuses its power and acts not under the Act but in violation of its provisions. A writ petition under article 226 of the Constitution lies if the authority is acting outside its powers and jurisdiction, *e.g.*, when the conditions prior to the issue of a notice for re-assessment are not satisfied. A writ petition under article 226 also lies if the action taken is *mala fide,* against natural justice or patently erroneous. A writ petition to the Supreme Court under article 32 of the Constitution lies only if there is an infringement of a fundamental right. The mere fact that an assessment is made on a wrong interpretation of valid provisions of the Act does not amount to contravention of any fundamental right. A tax can be levied under article 265 of the Constitution only under a valid law, and the validity of the law can be tested in the light of the fundamental right provisions in Part III of the Constitution.

Other direct taxes

Wealth tax is levied under the Wealth Tax Act, 1957. It is levied on individuals, companies and Hindu undivided families. The tax is annually levied on the net wealth of a tax payer as on the valuation date. That valuation date in relation to any year for which an assessment is to be made under the Wealth Tax Act means the last day of the previous year as defined in the Income-tax Act. The Valuation date for an assessment year shall be March 31 of the financial year. The value of an assets for the purpose of the

Act is the market value as on the valuation date. Assets up to Rs.15,00,000 are exempted in the case of individuals as well as Hindu undivided families and companies.

Indirect Taxes

Some of the important aspect of indirect taxes are given below:

Service tax

The service tax is an indirect tax levied on certain services provided by certain categories of persons/ firms/ agencies. It was first introduced in 1994. It gains its authority from Item No. 97 in the Union List of the seventh Schedule to the Constitution of India. Section 64 to 96 of the Finance Act, 1994, as amended from time to time, provide the legal basis for the levy and collection of tax. Section 66 of the Act authorizes the charging of service tax.

Rationale for service tax

Service sector which had represented nearly 35-40% of GDP had remained untapped as a source of revenue in India for a considerably long time. For the first time, the services came to be taxed by 1994 Budget through Chapter V of the Finance Act, 1994. It then covered just three services and came into force with effect from the 1st day of July 1994. Today, services cover wide range of activities such as management, banking, insurance, hospitality, administration, communication, entertainment, wholesale distribution and retailing including Research and Development (R& D). Service sector is now occupying the center stage of the economy.

Introduction of service tax in India

Service tax was levied on the recommendations made in early 1990's by the Tax Reforms Committee headed by Dr. Raja Chelliah. Dr. Manmohan Singh, the then Union Finance Minister, in his Budget for the year 1994-95 introduced the new concept of Service Tax and stated that:

> There is no sound reason for exempting services from taxation, therefore, I propose to make a modest effort in this direction by imposing a tax on services of telephones, non-life insurance and stock brokers.

By subsequent amendments other services had been added to the list. The Finance Act (2), 1996 enlarged the scope of levy of service tax covering three more services, *viz.*, (i) advertising agencies; (ii) courier agencies; (iii) radio pager services.

But tax on these services was made applicable from 1st November 1996. The Finance Acts of 1997 and 1998 further extended the scope of service tax to cover a larger number of services rendered by the following service providers, from the dates indicated against each of them:

(i)	Consulting engineers	7th July, 1997
(ii)	Custom house agents	15th June, 1997
(iii)	Steamer agents	15th June, 1997
(iv)	Clearing and forwarding agents	16th July, 1997
(v)	Air travel agents	1st July, 1997
(vi)	Tour operators	exempted upto 31.3.2000. Notification No. 52/98, 8th July, 1998, reintroduced w.e.f. 1.4.2000
(vii)	Rent-a-cab operators	exempted upto 31.3.2000 Vide Notification No. 3/99 dt. 28.2.99, reintroduced w.e.f. 1.4.2000
(viii)	Manpower recruitment agency	1st July, 1997
(ix)	Mandap keepers	1st July, 1997

The services provided by goods transport operators, out doors caterers and pandal shamiana contractors were brought under the tax net in the budget 1997-98, but abolished vide Notification No. 49/98 2nd June 1998. The Service Tax is leviable on the 'gross amount' charged by the service provider from the client, from the dates as notified and indicated above. Government of India has notified imposition of service tax on twelve new services in 1998-99 union Budget. The services listed below were notified on 7th October, 1998 and were subjected to levy of service tax w.e.f. 16th October, 1998. These include: (i) architects; (ii) interior decorators; (iii) management consultants; (iv) practicing chartered accountants; (v) practicing company secretaries; (vi) practicing cost accountants (vii) real estates agents/ consultants (viii) credit rating agencies; (ix) private security agencies; (x) market research agencies and (xi) underwriters agencies.

In case of mechanized slaughter houses, since exempted, vide Notification No. 58/98 dated 07.10.1998, the rate of service tax was used to be a specific rate based on per animal slaughtered. In the Finance Act, 2001, the levy of service tax has been extended to 14 more services and this levy is effective from 16.07.2001.[14]

In the Budget 2002-2003, 10 more services have been added to the tax. This levy is effective from 16.08.2002.[15] It is expected that in view of more

14. See Finance Act, 2001-02.
15. See Finance Act, 2002-03.

and more services brought under the service tax net, the service tax revenue would now form a major part in government's revenue earnings. In the Budget 2003-04 seven more services along with extension to three existing service have been added to the tax net. The levy of service tax on these services is effective from 1st July 2003.[16]

The rate of service tax has been enhanced to 10% from 8 %. Besides this, 2% Education Cess on the amount of service tax has also been introduced. Thus, the effective service tax rate is now 10.2% including Education Cess. The later Finance Acts added more services to tax net by way of amendments to Finance Act, 1994.

The rate of service tax was increased from 5% to 8% on all the taxable services w.e.f. 14.5.2003. In the Budget 2004-05, ten more services have been introduced in the service tax net along with reintroduction of three existing services.[17] In the Budget 2005-06, nine more services have been introduced in the service tax net as follows with effect from 16.06.2005, namely, (i) intellectual property services; (ii) opinion poll services; (iii) TV or radio programme services; (iv) survey and exploration of minerals services; (v) travel agent's services other than rail and air travel agents; (vi) forward contract services; (vii) transport of goods through pipe line or other conduit services; (viii) site preparation and clearance services; (ix) dredging services; (x) survey and mapmaking services; (xi) cleaning services; (xii) membership of clubs and associations; (xiii) packaging services; (xiv) mailing list compilation and mailing services; and (xv) construction services in relation to residential complexes.

Formation and function of DGST

Considering the increasing workload due to the expanding coverage of service tax, it has been decided to centralize all the work and entrust the same to a separate unit supervised by a very senior official. Accordingly, the office of Director General (Service Tax) has been formed in the year 1997. It is headed by the Director General (Service Tax). Some of the functions and powers of Director General (Service Tax) include: (i) to ensure that proper establishment and infrastructure has been created under different central excise commissioners to monitor the collection and assessment of service tax; (ii) to study the staff requirement at field level for proper and effective implementation of service tax; (iii) to study as to how the various service taxes are being implemented in the field and to suggest measures as may be necessary to increase revenue collection or to streamline procedures; and (iv) to undertake study of law and procedures in relation to service tax

16. See Finance Act, 2003-04.
17. See Finance Act, 2004-05.

with a view to simplify the service tax collection and assessment and make suggestions thereon *etc.*

Levy and assessment

Service tax is levied on specified taxable services and the responsibility of payment of the tax is cast on the service provider. System of self-assessment of service returns by service tax assesses has been introduced w.e.f. 01.04.2001. The jurisdictional Superintendent of Central Excise is authorized to cross verify the correctness of self assessed returns. Tax returns are expected to be filed half yearly. Central Excise officers are authorized to conduct surveys to bring the prospective services tax assesses under the tax net. Directorate of Service Tax at Mumbai oversees the activities at the field level for technical and policy level coordination.

Administrative mechanism

Service tax is administered by the Central Excise Commissionerate working under the Central Board of Excise and Customs, Department of Revenue, Ministry of Finance, Government of India. The unique feature of Service Tax is reliance on collection of tax, primarily through voluntary compliance. Government has from the very beginning adopted a flexible approach concerning service tax administration so that the assesses and the general public gain faith and trust in the tax measure so that voluntary tax compliance, one of the avowed objectives of the Citizens' Charter, is achieved. Substantive and procedural liberalization measures, adopted over the years for this purpose, are clear manifestations of the above approach.

VAT and its utility

VAT is a multi-point tax on value addition which is collected at different stages of sale with a provision for set off for tax paid at previous stage/ tax paid on inputs. VAT eliminates cascading by providing for set off of taxes paid on inputs and only taxing value addition. VAT has been introduced to replace state sales taxes and all other taxes like turnover tax, surcharge on sales tax, *etc.*, have been abolished. Further, under VAT regime, central sales tax is proposed to be phased out over the next few years.

Levy of VAT

It is levied on all commercial activities involved manufacture and trading of goods and services. The value added at each entity in the business transaction is determined by the difference in the sale prices of that entity and purchase values of bought out items of that entity. VAT is charged at a uniform rate as a percentage of prices at which the goods are transacted and it is imposed at each stage of transaction in the production and distribution

chain. It is charged as a percentage of prices, which means that the actual tax burden is visible at each stage in the production and distribution chain. As it is a consumption tax it is borne ultimately by the final consumer.The basic calculation procedure of VAT is the difference between tax liability and input tax credit at each stage of transaction. It is significant to note that though globally VAT also includes taxation of services, present system of VAT in India covers only tax on sale of goods within the state and services are not included in India.

VAT is one of the most radical reforms that have been implemented for the Indian economy after years of political and economic debate. In implementing VAT, the biggest benefit perhaps is that it could unite India into a large common market. It is more efficient tax mechanism in the sense that it avoids cascading of taxes and renders self-policing easy thereby problems of double taxation can be removed. At the same time, it can breed sophisticated attempts at evasion, since evidence of tax paid on inputs is virtually a gateway to VAT refunds. Persons who specialize in tax avoidance can still manipulate such evidence. However, the government perception is that VAT would help common people, traders, industrialist and also the government. According to it, VAT is indeed a move towards more efficiency, equal competition and fairness in the taxation system. The tax structure, in fact will become simple and more transparent and this will improve tax compliance and also augment revenue growth.

Problem of Tax Evasion

Under the Income Tax Act, an assessee is entitled to organize his business and is allowed to plan his business. Most of the time this planning leads to the incidents of tax avoidance through various modes and means. There is a difference between a pretence and a transaction which is real. In *Mc Dowell's* case[18] the Supreme Court took the view that transaction was a sham where a scheme formulated by an assessee as a tax planning measure is termed as tax avoidance scheme. To the same effect is the ratio of the judgment of the Supreme Court in the case of *Union of India* v. *Azadi Bachao Andolan.*[19]

Apart from tax avoidance, there is rampant practice of tax evasion across the board. Businessmen, traders, lawyers, film artists, doctors and politicians with high income are often opt in evading payment of tax by manipulation of records. Seldom there is complete and fair declaration of income. These malpractices lead to generation and accumulation of black money which circulates in the economy to the disadvantage of one and all.

18. (1985) 3 SCC 230.
19. (2003) 263 ITR 706.

Misra, J., in *McDowell* case[20] has rightly observed:

> Tax planning may be legitimate provided it is within the framework of law. Colorable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid the payment of tax by restoring to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resting to subterfuges.

Finally we may submit that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization. Unless wastes and ostentatiousness in governments' spending are avoided or eschewed, no amount of moral sermons would change peoples' attitude to tax avoidance. 'Black money' has become a fact of economic life. No solution seems in sight except a drastic change of outlook on the part of both taxpayer and tax collector. The common man can only wait wishfully for such a miracle to happen.

Suggested Readings

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20. *Supra* note 18.