BASIC PRINCIPLES OF INCOME-TAX LAW

By: Justice R.K. Abichandani

1. Constitutional Provisions :

The Constitution of India vests the Parliament with plenary legislative powers to impose taxes on matters specifically enumerated in the Union List and all the power of making any law imposing a tax not mentioned in Concurrent or State Lists, as provided by Article 248(2). "Tax on income" is defined in an inclusive manner by Article 366(29) under which the expression includes a tax in the nature of an excess profits tax. "Corporation tax" is defined by Article 366(6) to mean any tax on income, so far as it is payable by Companies and is a tax in case of which the three conditions mentioned therein are fulfilled, namely, (*a) that it is not chargeable in respect of agricultural income; (b) that no deduction in respect of tax paid by Companies is, by any enactments which may apply to the tax, authorised to be made from dividends payable by the Companies to individuals; and (c) that no provision exists for taking the tax so paid into account in computing for the purposes of Indian income-tax, the total income of individuals receiving such dividends, or in computing the Indian income-tax payable by, or refundable to such individuals.* Under entry 82 of the Union List, the Parliament has exclusive power to make laws with respect to “Taxes on income other than agricultural income”. The expression “agricultural income” as defined under clause (1) of Article 366 means agricultural income as defined for the purposes of the enactments relating to Indian income-tax.

2. Tax Law :

The tax law of a nation is usually unique to it, although there may be similarities and common features in the laws of various countries. Tax law is,in general, concerned only with the legal aspects of taxation, and not with its financial, economic, or other aspects. The decisions to impose various kinds of taxes, their rates and sweep fall into the political domain and not into the domain of tax law. Tax law consists of a body of rules of public law that affect the activities and reciprocal interests of a political community and the members composing it - as distinguished from relationships between individuals in the sphere of private law. Tax law can be divided into substantial tax law, which is a body of the legal provisions giving rise to the charging of a tax; and procedural tax law, which consists of the rules laid down in the law as to assessment and enforcement procedure, coercive measures, administrative and judicial appeals and other similar matters.

3. Interpretation of tax law :

The tax laws mean what the words in them say, since it is presumed that the Parliament acts purposefully in the use of its language. The judiciary has the final authority to interpret the tax statute. The normal rules in the doctrine of precedent apply also to tax cases. One general qualification to the doctrine of precedent, which is particularly important in tax law, is that previous decisions are only of value in determining questions of law. It is, however, a common fallacy to use similarity of facts in a previous case to decide another question of fact in the same way, *(See G. & C. Kreglinger v. New Patogania Meat & Cold Storage Co. Ltd [1914] A.C. 25 at P.40).*

3.1 In addition to the general principles common to the interpretation of statutory provisions, there are some special rules which apply to the interpretation of tax laws. One such rule is the autonomy of tax law, meaning thereby that tax laws pursue aims that are different from other laws. The tax claim is a claim under public law. Principles applicable to relationships under private law such as law of contracts, therefore, cannot be invoked to interpret provisions of tax law. No tax shall be levied or collected save by the authority of law, as provided by Article 265 of the Constitution of India. Since a tax can only be imposed by law, the Courts or the administration do not have a "creative power" to make things or operations taxable through an analogical interpretation of the statute, in cases where it is not established that the legislature intended them to be taxable. By process of interpretation, the Court or taxing authority cannot introduce any attenuation or relaxation to its effect, even if justified by circumstances, except in cases where the Court or the administration are authorised to apply the rules of equity within the limits prescribed. Once enacted by the Legislature, a tax cannot be judicially restrained. There is no way of challenging a tax law on the ground of its being unreasonable or unjust, but the application of the law must be correct. The principle of *res judicata* does not apply for precluding an appeal in respect of subsequent year's assessment, and so far as the previous decision is not a binding precedent, the question may be litigated again. The better view would be that where there has been a binding decision of the Court on a question of law on a previous occasion, the point so concluded could not be litigated again either by the revenue or by the assessee.

4. Rationale of income taxation :

Whether or not income is an accurate measure of tax paying ability, depends on how it is defined. An individual's income is the best single index of his ability to contribute to the public revenue. To the extent that a person's ability to pay taxes is affected by other circumstances, such as, the number of dependents he supports or extraordinary medical expenses, it is easier to make adjustments for such circumstances by changes in the personal income-tax than by changes in other types of taxes.

5. Economic and Social impact :

Income-tax applies generally to all types of persons, whether individual, bodies of individuals, corporate bodies or other juridical persons. Levy of income-tax has substantial fiscal, economic and social consequences to the community, and the way it operates is of vital significance to particular individuals or companies. Imposition of income tax directly affects the sum available for spending by the private sector of the economy, and, raising or lowering of the general rates of tax even marginally, can have marked deflationary or inflationary effect. The tax may encourage, or discourage, particular types of activity in the private sector, by treating a particular type of activity more, or less favourably for tax purposes compared with other available activities. This is, at times, deliberately done when the government provides for some special relief, such as investment allowances on new ship, aircraft, machinery or plant. *(See 32A of the Income Tax Act, 1961).* Every proposed transaction of substance is required to be studied from the tax angle to find out what tax savings can be effected, if any, by reframing such transaction. The professional men have to be well equipped to correctly and effectively advise taxpayers as to their potential liability to tax, and their work, though not productive to the nation, is necessary to ensure smooth working of the tax system.

5.1 Levy of income-tax has social effects too, besides its effect on economic life of the community. Highly progressive rates of tax on individuals which provide the money for various welfare functions of the State have significant social consequences. Numerous types of tax reliefs given for charities, the provisions of various types of pensions etc. affect the social structure of the community to a substantial extent, though these factors cannot be evaluated in exact terms.

6. Principles of a good tax system :

The following principles are said to underlie a good tax system :

(i) **Equity :** There must be an element of re-distribution of resources between high and low income people as well as similar tax burden for taxpayers with similar means.

(ii) **Economic efficiency :** Taxation must impact neutrally on various taxpayer groups and economic sectors, and commercial decision making must not get distorted by the tax considerations.

(iii) **Adequacy :** The system should have nexus between the revenue proposed to be raised and the public expenditure needs.

(iv) **Simplicity :** Taxpayers must be able to clearly understand the nature and extent of their obligation and consequences of non-compliance.

(v) **Transparency :** Taxpayers must know how and when they are paying tax, and how much tax they are paying.

(vi) **Cost :** Compliance and collection costs must be minimised.

(vii) **<u>Anti-avoidance :</u>** The tax scheme should be so framed that there would be minimal incentive and potential for avoidance of taxation.

6.1 Equity in taxation has two concepts "vertical" and "horizontal" equity. Vertical equity refers to taxation on the basis of ability to pay. This has the element of re-distribution. In an income tax, ability to pay is measured by the calculation of a person's income. Therefore, the definition of "income" becomes crucial. On the footing that income is worth more to those who earn less, and that those with higher incomes should bear more of the tax burden, vertical equity implies a progressive tax, as a result of which, high income earners should pay a higher portion of their income in tax than low income earners. The marginal rate structure of our current income tax, with a tax-free threshold and increasing rates in the higher slabs of income is progressive. A flat rate tax would be regressive, because, it would cast a higher burden on the income of low income-earners than on the income of high income-earners in context of their total earnings. This would amount to treating unequals as equals.

6.2 Horizontal equity in taxation underlies the basic principle of equality so that like people are treated alike by imposing similar tax burdens on taxpayers with similar means. What must be borne in mind when considering horizontal equity is who is being compared and under what circumstances. Do we want individuals to be treated like individuals, or families, with a "house-wife" like families with a "working wife", or married couples like single people, or men like women, or senior citizens like the young, or partnerships like trusts or corporations? Comparision of tax units is often unclear in discussions of horizontal equity.

7. <u>Tax unit & tax base :</u>

The tax unit is the person or entity whose income is calculated and who is to pay the tax. The basic tax unit is the individual - corporations and other legal entities are also tax units. The tax base, in an income tax, is "income". A broad based income tax will cover all kinds of income, gains, and accretions to wealth. Thus, fringe benefits and capital gains are included in a broad based income tax. The broader the tax base, as a general principle, the lower the tax rates required to raise the same amount of revenue and the less easy it is to avoid the tax by converting one type of income into another. A broad tax base satisfies several of the tax policy criteria. The effective tax rate, as opposed to the marginal rate, may differ widely between tax payers as the result of the tax base and the provisions relating to the tax rebates, exemptions and deductions.

7.1 Tax laws like other laws raise issues of gender, race and sexuality which get ignored in the mainstream debate. A regressive tax will hit most women harder than most men; most special tax deductions will benefit men more than women; even tax benefits for savings will benefit women less than men, as fewer women have disposable income for saving, because, they spend more of their income on necessities for their families and themselves. Women suffer proportionately more from cuts in public expenditure on housing, education and welfare. *("Reforming Tax for Social Justice" article by Miranda Stewart - teaching comparative tax policy at New York University School of Law; see also Women, Tax and Poverty, (1995) 27 Ottowa Law Review 99).*

8. <u>Charging and machinery sections :</u>

A section in the Income Tax Act which imposes a charge is referred to as a charging section and a section merely providing rules for working out the charge so imposed is referred to as a machinery section. In applying the provisions of the Income Tax Act, it is necessary to bear in mind that a machinery section is intended merely to provide rules for assessment or collection of the tax and not to increase or vary it. A machinery section will not be so construed as to defeat a charge which is clearly imposed. If what appears to be a machinery section in fact imposes a charge or increases or varies a charge made in another section, the Courts must give effect to it. It is, therefore, necessary in the first instance to determine which is the charging and which is the machinery provision. It is only when it is determined that a provision is only machinery that it will not be allowed to operate as a charge.

9. **<u>Income :</u>**

The Income Tax Act does not attempt to provide any comprehensive definition of "income" for tax purposes; but gives an inclusive definition in Section 2(24). Income - tax is a tax on income from various sources, estimated according to sets of rules which vary according to the source of income from which it flows. Most type of income can be broadly classified into three main categories*; (a) income derived by a person by rendering personal service; (b) income from* *property, and (c) income from the profits of a trade, profession or vocation.* In economic terms, the first category represents income from "labour" alone, the second represents income from "capital" alone whilst the third category combines both "capital" and "labour". Though the methods of assessing income under these different heads are distinct, income for tax purposes must be money or something capable of being turned into money. The income tax, whatever way it is charged is, however, one tax. In every case, the tax is a tax on income, whatever may be the standard by which the income is measured under different heads.

10. **<u>Income and Capital :</u>**

Income is, generally, contrasted with capital by treating receipt as "income" if it cannot be classified as capital. Underlying many of the decisions as to what is, and what is not, taxable income from property or profits is the broad concept that capital corresponds to a tree and income to its fruit. This figure of speech would be apposite in regard to money invested in an income producing form, such as, capital sum which bears interest. An accretion to capital is not income, although income does not escape tax merely because it is used, to increase or recoup capital, nor is it any the less "income" because its production involves wastage of capital. (British Tax Encyclopaedia - G.S.A.. Wheatcroft).

10.1 Pitney J., in Eisner v. Macomber 252 US 189 at pp 206, 207, defined "income from property" in following terms :

> *"Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invested or employed, and coming in, being derived, that is, received or drawn by the recipient (the tax payer) for his separate use, benefit, and disposal; that is income derived from property. Nothing else answers this description."*

These general propositions would, however, be of assistance only when there is no specific relevant provision in the Income Tax Act, under which some items which normally be classified as capital are deemed to be income and taxable whilst other items which are clearly income are exempted from tax.

10.2 Capital and income are not purely legal conceptions. They arise in trade and business and in all borrowings and lendings. What may be capital item in the accounts of one taxpayer might, in the particular circumstances of another, bear an income character. Thus, land though capable of producing income to be taxed as income from property, is itself usually capital in the hands of a non-trader. This holds good for a trader or a trading company if the trade is not that of a builder or land developer. If that is the trade, the land forms part of stock-in-trade and its cost counts as a trading expense. *(Macnaghten J. in Johnson (Inspector of Taxes) v. Try (W.S.) Ltd. [1946] All ER. 165, affirmed in [1946] 1 All ER. 532).* The intrinsic characteristics of capital sums and revenue items respectively are essentially the same for receipts as for expenditure. *(See Simon's Income Tax, Vol.1 Pr.44).* There is, however, no single infallible test for settling the vexed question whether a receipt is of an income or capital nature and each case must depend on its particular facts since mere use of words "income" and "capital" are not necessarily conclusive. However, there are some factors such as "recurrence" or, acquisition of fixed assets which may throw light on the character of an item.

11. <u>Capital expenditure and income expenditure:</u>

In a rough way, the criterion of what is capital expenditure as against what is income expenditure would be to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year. *(Lord Dunedin in Vallambrosa Rubber Co. Ltd. v. Farmer (Surveyor of Taxes) [1910] SC 579, 5T.C. 529 - See Simon's Income Tax Vol.I, pr.45).* The contrasting phrase used by Lord Dunedin - "expenditure once for all" - is illustrated by the decision in Ounsworth v. Vickers Ltd. [1995] 3 KB 267, where the cost to a shipbuilding company of dredging a channel and providing a deep water berth for the construction and delivery of a ship was held to be capital expenditure. On the other hand, expenditure on stock in trade or other circulating capital is recurrent, and is accordingly a revenue item.

11.1 Furthermore, a payment made for acquiring or creating a fixed asset or an amount received on its realization is usually a capital sum. The most obvious instance is that of the price received or paid on the sale or purchase of a capital asset of a physical or transferable kind, provided that the thing sold or acquired is not something in which it is the business of the particular taxpayer to deal. When an expenditure is made, not once and for all, but with a view to bringing into existence an asset or advantage for "enduring benefit" of a trade, then, in absence of indication to the contrary, such an expenditure is properly attributable to capital and not to revenue. The benefit should endure in the way that a fixed capital endures; but "enduring" does not mean "everlasting". Moreover, the advantage need not be of a positive character. It may consist in getting rid of an item of fixed capital that is onerous.

12. <u>Evasion and avoidance of tax :</u>

A sharp distinction must be made between evasion and avoidance of tax. Illegal methods of reducing tax liability, by misstating or omitting items from the returns, are known as "tax evasion", which creates a statutory liability to substantial monetary penalties and to a criminal prosecution in serious cases such as of fraud. Aiders and abettors are similarly liable. "Tax avoidance", however, denotes adoption of lawful means for reducing tax liability. Full use is made of loopholes in the tax system particularly when the rates imposed are very high. When loopholes become too well known, the yield of the tax will be less. A simple device is discovered which gradually gets into common use and then the legislation stops it. A more refined device is then adopted which again is plugged by legislation, and so on, a seesaw process goes on between a well-advised tax payer on one side and the Legislature and the Revenue on the other. The result is frequent amendments in the law of income-tax, making it a complicated branch of the laws.

13. Method of Accounting :

The income chargeable under the head "profits and gains of business or profession" or "income from other sources" is required to be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. The Central Government is empowered to notify in the official gazette accounting standards to be followed by any class of assessees or in respect of any class of income. *(Sec. 145 Income*

Tax Act, 1961). The question whether one method of accounting or another should be employed in assessing taxable income derived from a given pursuit is a question which must be decided according to legal principles. But, it would be a mistake to treat such a question as depending upon a search for an answer in the provisions of the legislation, a search for some expression of direct intention to be extracted from the text of the enactment in which it may be hidden.

13.1 The words income, profit, and gain are conceptions of the world of business affairs and they cover infinite variety of activities. Every recurrent accrual of advantages that can be expressed in terms of money is capable of inclusion under these conceptions. No single formula could be devised which would effectively reduce to a just expression of a net money sum, the annual result of every kind of pursuit or activity by which the members of a community seek livelihood or wealth. But, nearly in every department of enterprise and employment, the course of affairs and the practice of business have developed method of estimating or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual, or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible, in a great measure, for the conceptions of income, profit and gain, and, therefore, may be said to enter into the determination or definition of the subject which the legislature has undertaken to tax. The Courts have always viewed the ascertainment of income as governed by the principles recognised or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question, such as method of accounting in certain cases as provided under section 145-A of the Income Tax Act, 1961.

13.2 There is a tendency to place increasing reliance upon the concepts as understood in the realm of business and the principles and practices of commercial accountancy. The judicial process of recognizing principles and practices evolved in business or general affairs while deciding the questions presented before the Court inevitably leads to a development in the law itself. A decision of Court adopting or resorting to any given accounting principle or application of such principle would, ordinarily, settle for the future the rule to be observed, and the rule thus assumes the character of a proposition of law. However, in some areas like the distribution of expenditure between capital and income, it is difficult to formulate a principle as an induction from commercial practice and the matter rests in the realm of facts or discretionary judgement. In considering what is the true balance of profits and gains, the ordinary principles of commercial accountancy must be allowed to prevail where these are not invaded by statute.

14. Tax Payer's dual personality :

In the traditional analysis, taxpayers have two personalities - a business personality and personal personality, which are concerned, respectively, with profit-seeking and pleasure-seeking. Sometimes, the efforts to analyse payment of income taxes and payments related to income taxes from a two personality approach works very poorly. This has led to the thinking that the taxpayers have a third personality concerned with re-distribution of wealth which has its own criteria for deductibility, and payment of income- tax falls in this third category.

14.1 Usually, it is easy to attribute expenses between the two personalities. Just look and see whether the tax payer's purpose in incurring the expenses is to obtain business receipts or reduce costs needed to acquire those receipts, if so, it is deductible business expense. This "origin" test characterizes the expense by looking at whether it is incurred in business activity or personal activity. Thus, when a horse is transferred from the stud farm, to the owner's personal account, there is a disposition of trading stock.

14.2 When explicit statutory rules do not resolve specific income-tax issues of general interest, e.g. whether or not income-tax on business income and payments related to such taxes, (such as, interest on overdue taxes, litigation costs, and insurance premiums paid to cover such obligations) are deductible business expenses, they are required to be resolved by basic income tax principles. "The origin test has always had a mechanically reassuring surface attraction. It sounds as though, you can look back in time, to see whether the events which gave rise to the expense were personal or business. The trouble is, that nothing in the origin test tells you when to stop running the clock backwards, to decide, what prior event characterizes a later expense to which, it can be traced. Is a commuting expense, traceable to the job decision or to a personal decision about where to live; is child care the result of a decision to work or a personal decision to have a child; are education expenses the result of a work choice or a personal choice about how to spend one's life? These are difficult questions which take the business versus personal distinction to its limits" - *("The Tax Payer's Third Personality" - Comment on Redlark v. Commissioner" by William D. Popkin Indiana Law Journal Volume 72, Issue1).* Professor Popkin argues that the two-personality approach fails to provide any guidance in some settings and some expenses are expressions of a "third personality" - derived from shared membership in a group and resulting in wealth re-distribution within that group. When payments are group re-distributions of wealth, the dominant consideration is whether there is overall gain to the group, and not characterization as a business or personal expense. Absent such gain, the total income of the group should be zero. Whether the payer should deduct or the payee should report income to record the overall net zero, result remains important for reasons of revenue and economic efficiency, but the issue cannot be resolved within the confines of the traditional two personality approach" (ibid). The group re-distribution perspective insists that there is yet another way to think about taxpayers, recognising that people not only seek pleasure or profit, but also share wealth in the social and political community especially in a modern welfare state. Community sharing of wealth is an aspect of an individual's political personality and the tax law, according to Professor Popkin, should recognize this as something different from the kind of personal consumption that is routinely subject to income tax. Income-tax payments are involuntary, and, according to him, the involuntary nature of payment makes it less plausible to argue that it provides personal satisfaction to the payer, unlike insurance. Such tax payments are the price we pay for civilization, rather than for personal consumption. The tax payments are contributions by which, the group re-distributes wealth within the political family. In his paper, Professor Popkin suggests criteria to be applied to determine whether the deduction of income taxes and related expenses such as tax audit insurance, interest related to unpaid income tax, litigation expenses related to the income tax, are business deductions in light of such expenses having understood as group re-distribution expenses.

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