DEVELOPMENT OF TAX LAWS AND ADMINISTRATION IN INDIA – PAST, PRESENT AND FUTURE

JUSTICE R.V. EASWAR
Former Judge, Delhi High Court

In a brilliant introduction to his book, *The Law Book – 250 Milestones in the History of Law*, Michael H. Roffer begins with the statement: "*The Law surrounds us. It affects the food we eat, the water we drink, and the air we breathe. It travels with us. It defines our relationships with the people with whom we live, work, and share space. It affects our homes and schools, our offices and stores. The law touches every aspect of our lives and even our deaths.*" I am inclined to think, in a lighter vein, that the author had the tax law in his mind more than any other law, for the tax law (direct & indirect) touches every aspect of life which he has listed! That is perhaps why Oliver Wendell Holmes Jr., made the famous statement that "*Taxes are the price we pay for civilization. I like to pay my taxes*". But the question as to how the taxes are imposed and collected, and upon whom they are levied, and in what manner and how they are quantified – these questions seem to have always troubled the tax administrator, the tax payer, the tax lawyer and ultimately the government.

Taxes have been looked upon, traditionally, as the government's share in the prosperity of the breadwinner. That is one of the main reasons why income-tax paid is not allowed as a deductible expense; it has been held to be the "Crown's share in the profits", there being other reasons, too. It would appear that before the development of "money" as representing the purchasing power of a person, the taxes were collected in kind, through commodities, even hard work. Customs duty and taxes on owning of lands are said to be two of the earliest taxes netting huge revenues for the countries. Only in the year 1798, William Pitt the Younger, who was the Prime Minister of Great Britain those days, first proposed a legislation to tax the citizens *"upon all the leading branches of income"*. This law is generally believed to be the first formal income-tax in history. This tax is believed to have been imposed to replenish the treasury of that country which had been drained because of its war with Napoleon Bonaparte. The tax was known as "*The Triple Assessment*" because its measure was three times the expenditure which a person had incurred in the preceding year. There is good reason to believe that the levy succeeded, because it was followed up by a proposal that a general income-tax be charged on all leading branches of income. This resulted in a tax legislated for the first time in history in January, 1799, and it called for a progressive rate of tax on annual income above 60 pounds; the rate began with 1% and went up to 10% on incomes above 200 pounds. But it was a disaster, and the public protested strongly and resisted payment. It was criticised as a "monstrous law" and "an indiscriminate rapine"; experts claimed that the public received it with nothing but "disdain and distrust". Eventually the tax was repealed in 1802, after a short life of just three years, but the trend had set in, and the law had caught the eye of governments all over. In the very next year, England enacted a new income-tax law and this law became the basis for all subsequent enactments in that country and became the bedrock of that country's fiscal policy. Soon, Germany and America adapted the law, resulting in the passing of several enactments for the levy and collection of income-tax.

In America, several short-lived attempts had been made in this behalf and in the law passed in 1894, a tax of 2% was imposed on annual income over 4,000 dollars the object stated being "to address economic inequalities". But what happened was that in a decision of the Supreme Court of America, *Pollock vs. Farmers' Loan & Trust Co.*, this levy was struck down as unconstitutional; it was held that the taxes on real and personal property were direct taxes and in the absence of apportionment among the states they were unconstitutional. Chastened by this judgment, Howard Taft, the President of America, wanted to levy income-tax in 1908 after an amendment to the Constitution to expressly permit the levy. It was the sixteenth amendment and after being passed by the Senate and the House of Representatives and the required number of states, it became law in 1913. It was called the Revenue Act, 1913 and it imposed tax on net income at rates ranging from 1% to 6%.

Beginning with William Pitt's levy in 1798, taxes have been imposed to recover monies lost on account of warfare, impliedly as a fee for protecting the citizens against external aggression. In India, the Sepoy Mutiny in 1857 saw the British rulers imposing a tax in 1860 as a temporary measure for 5 years. In 1867, a licence tax on all trades and professions was imposed. In 1868, it became a 'certificate tax' and in both licence tax and certificate tax, agricultural income was excluded. From 1869 to 1873, for a period of 4 years, there was an income-tax including agricultural income. The tax got revived due to famine and other reasons in 1877, but it was the Act of 1886 which saw the first landmark of income-tax law of India. It remained in force till 1918, in which year a comprehensive recasting of the income-tax law was attempted with a measure of success. Inequalities and inconsistencies in the earlier law were sought to be redressed. The heads of income such as property, salaries, business earnings and professional income, other sources of income were introduced in this law. It applied to income under these heads which arose in British India.

The recommendations of the All India Tax Committee formed the basis of the Indian Income-Tax Act, 1922 which tax lawyers of repute commend as a well-drafted, precise legislation with about 60 sections. In this law, the tax rates were not prescribed in a schedule as was done previously, and the rates were left to be prescribed by the annual Finance Acts. This has endured till now. Notable features of the Act were the adjustment of past losses and inter-head and intra-head losses, liability of the successor to the business to pay taxes of the predecessor, etc. The Act received wholesale amendments by the 1939 Amendment Act. Notable features of this amending Act were: introduction of a category of "resident, but not ordinarily resident", taxation of income accruing outside British India even if it is not brought into British India, introduction of provisions to prevent avoidance of tax by creating trusts, transferring property to relatives (spouse, minor children), dividend-stripping, bond-washing, introduction of closely-held companies to avoid dividend income, etc.

The working of the 1922 Act led to certain situations which were thought by the government to be not in the interests of the growth and development of income-tax law in India, and a series of recommendations were sought with a view to bringing about a legislation with more teeth and which was more comprehensive. Substantial changes were made in the 1947 Taxation of Income (Investigation Commission) Act, in 1952, 1953 and 1955 (Dr. John Mathai Committee). More importantly, the Act was referred to the Law Commission in 1956 in order to make it "on logical lines and to make it intelligible and simple, without at the same time affecting the basic structure". The recommendations of the Law Commission and the committee headed by Mahavir Tyagi set up in the meantime formed the basis of the present 1961 Act.

The Income Tax Act, 1961 today is a maze no doubt, but to call it "*a national disgrace*" (Nani Palkhivala, preface to the 8th edition of his treatise on income-tax law) would be unfair, in my humble opinion. Government has the right to set right distortions practised by the tax payers to "evade" (not avoid or mitigate or plan) income-tax, and it is also well established that this can be done even retrospectively. This is particularly so in modern days when multi-national enterprises indulge in multi-layering and multi-structuring of the corporate entity, and locate them in different places around the world and in different tax jurisdictions. The government of the day must be conceded the right to combat such moves if it feels due taxes are not being paid and the right to plug the loopholes, if necessary, by making the amendments retrospective. It cannot be lost sight of that it is always a running battle between the government and the tax payers, particularly the multi-national juggernauts, and each side tries its best to outdo the other! But to be fair to the tax payers, it must also be said that some of the amendments in the recent past, say in about 10-12 years, have been startling, upsetting the traditional and well-accepted notions of what is "income". A different concept of "*taxation of benefits*" has come to stay, where the notional difference between the market value of an asset, movable or immovable, and the price paid is roped in as income.

It is hard to believe that a provision in the Act which was read down to make it workable, equitable and fair to both the citizen and the government, by the Supreme Court in *K.P. Varghese (131 ITR 597) (SC)* has been introduced through "the back door", giving a go-by to the acclaimed principles of taxation vis-à-vis the power under the Constitution of India explained lucidly and forcefully, if I may say so with respect, in the judgment. There are also recent instances of what is not income or even a receipt, being taxed under some pretext or the other. We have all so far understood the pay-out of dividend by a company as its expense (though not tax-deductible in the company's hands, being appropriation of profits), but we are now told that it will be taxed as the income of the company, a proposition which is baffling. The constitutional validity of this tax has undoubtedly been upheld by the Supreme Court in the recent Tata Tea case and therefore the levy has come to stay. But one shudders to think of the consequences that may follow in the coming days. A citizen can be mulcted with taxes both on his income and his expense, to put it crudely, taking umbrage under the ever-elastic Entry 82 of List I (Union List) which permits the central government to levy "taxes on income other than agricultural income".

The power to tax income, and the general power to levy taxes, is traceable to Article 246 of the Constitution of India which says that Parliament has exclusive power to make laws with respect to any of the matters specified in List I of the 7th Schedule to the Constitution. It is also necessary to note Article 248 which reiterates that Parliament has exclusive power to make any law with respect to any matter not enumerated in the State List or the Concurrent List and such power shall include the power to legislate for the levy of tax not mentioned in either of these Lists. It is in this background that we need to now look at Article 265, which occurs in the Chapter titled "Finance, Property, Contracts and Suits". It is a single-liner, and one of the most powerful one-liners; one cannot also help noticing that the marginal head of the article consists of 10 words, and the article itself contains 12 words, only 2 more than the marginal head!

"ARTICLE 265. Taxes not to be imposed save by authority of law.—No tax shall be levied or collected except by authority of law".

The government therefore requires the authority of law not only to "levy" taxes but also to "collect" them. The consequence is that a collection machinery which is tyrannical or arbitrary or out of proportion with the gravity of the situation or circumstances can also be held to be unconstitutional, being in violation of the article. Since an entry includes all subsidiary and ancillary matters, the power to tax would include the power to enact law for the effective implementation and collection/recovery of the tax levied. It can determine the procedure to collect the tax and provide for a machinery and also make provision for evasion of taxation: *Orient Paper Mills Ltd. vs. State of Orissa (AIR 1961 SC 1438)*. It was, however, held that the power to seize and confiscate the goods moving from one state to another, which were not meant for sale, and also levy penalty was not incidental to the power to levy tax under Article 265 (*C.P. Officer vs. K.P. Abdulla, (1970) 3 SCC 355*).

In a federal set-up like ours, the inter-relationship between the government at the centre and the state governments is very critical. According to M.P. Jain, the author, inter-governmental financial relationship "*touches the very heart of modern federalism, as the way in which this relationship functions affects the whole content and working of a federal polity*". Since taxation is part – a very substantial and significant part – of the finances, the allocation of the taxing powers is considered important in Constitutions. The scheme of allocation of taxing powers is broadly based on the principle that *the taxes which are of a local nature are legislated upon by the states and taxes which have a tax-base extending over more than one state, or which should be taxed uniformly throughout India, or which can be more conveniently collected by the centre, are allocated to the centre.* The drawing up of a Union List, State List and Concurrent List has by and large said to have prevented the problem arising out of overlapping taxes being levied causing hardship to citizens, though the Concurrent List has now and then caused some problem or the other. There are some other federations in the world where this problem (of overlapping taxes) has manifested itself more acutely.

I had earlier referred to the entries in the three Lists in the 7th Schedule to the Constitution being "elastic" and being the subject of a wide interpretation. Here, there is a clear distinction between a tax entry and a non-tax entry. A tax entry, it has been held in several judgments of the Supreme Court, has to be construed or interpreted broadly and liberally. In *Tata Iron & Steel Co. vs. St. of Bihar (AIR 1958 SC 452)*, this principle of broad and liberal interpretation of the tax-entries was extended to include the power to tax retrospectively. An important principle in this context is the doctrine of "pith and substance" which means this: the true character of the legislation in question has to be ascertained by having regard to it as a whole, to its objects and to the scope and effect of its provisions, and if according to its "true nature and character" the law substantially relates to a topic assigned to the legislature, which enacted it, then it is not invalid merely because it incidentally trenches or encroaches on matters assigned to another legislature. The fact of incidental encroachment does not affect the *vires* of the law even as regards the area of encroachment; incidental encroachments are not forbidden. The law in question has to be read as an organic whole and not as a mere collection of sections; it should not be disintegrated into pieces and each piece examined whether it fits into the Constitutional scheme or division of legislative powers. The classic observations of the Supreme Court in *State of Bombay vs. Balsara (AIR 1951 SC 318)* are these:

"It is well-settled that the validity of an Act is not affected if

it incidentally trenches on matters outside the authorised field and, therefore, it is necessary to enquire in each case what is the pith and substance of the Act impugned. If the Act, when so viewed, substantially falls within the powers expressly conferred upon the legislature which enacted it, then it cannot be held to be invalid merely because it incidentally encroaches on matters which have been assigned to another legislature".

Another aspect of Article 265 is that it is open to the legislature to pass a validating Act to remove the infirmity in the law pointed out by the judgment, and make the law effective from the date of its enactment and retain the collections of the taxes under the law invalidated by the court. The important condition, however, is that the government must have the power to levy the tax, for in the absence of the power the tax must ever remain invalid: *M.P. Cement Manufacturers Association vs. State of M.P. (2004) 2 SCC 249*. The validation by a validating Act can however be done only by removing the grounds of illegality (*Rai Ramkrishna vs. State of Bihar*) (*AIR 1963 SC 1967*), or by removing the basis of the decision and not merely by disregarding or disobeying or "reversing" the judgment: *Ahmedabad Municipality vs. New Shorrock Spg. & Wvg. Co: (1970) 2 SCC 280*.

Legislative competence (in addition to Constitutional validity) is the deciding factor in examining the validity of a tax. In judging the legislative competence – which has to be adjudicated at the threshold before any other challenge is examined – the nature and character of the tax constitute a significant element. The following aspects are irrelevant: (a) motive in imposing the tax; (b) wrong reasons given in the statement of objects and reasons; (c) the form and manner in which the power is exercised; (d) nomenclature of the tax. In *Jullundur Rubber Goods Manufacturers Association vs. UoI (1969) 2 SCC 280*, it was held that so long as the doctrine of "pith and substance" is satisfied and the "real nature and character of the levy" test is answered in the affirmative, with reference to the taxable event and the incidence of the levy, the law imposing tax cannot be invalidated. It cannot also be argued that the tax under a particular entry shall be levied in a particular manner; it is open to the legislature to adopt such method of levy as it chooses so long as the character of the levy falls within the four corners of the particular entry: T*wyford Tea Co. vs. State of Kerala (1970) 1 SCC 189*. The pithy observations of the Supreme Court in Rai Ramkrishna (*supra*) are noteworthy:

"The objects to be taxed, so long as they happen to be within the legislative competence of the legislature can be taxed by the legislature according to the exigencies of its needs. ……..the quantum of the tax levied by the taxing statute, the condition subject to which it is levied, the manner in which it is sought to be recovered are all matters within the competence of the legislature".

In *Jain Bros. vs. UoI (1969) 3 SCC 311* and *Avinder Singh vs. State of Punjab (1979) 1 SCC 137*, it was held that Art. 265 does not prohibit double taxation of the same person twice over if the legislature evinces a clear intention to do so and that the vice of double-taxation cannot be spun out of the said article. But without an express provision in the law to impose tax twice over on the same subject, there can be no double-taxation by implication.

The question of sharing the revenues between the centre and the states is crucial, not the least due to political reasons. In the USA, there is no provision in their Constitution for sharing revenues between the centre and the states, but in actual practice a system of conditional grants has come to be under which the centre financially supports the states. Moreover, in that country the power of the states to impose taxes is vast. The situation in Australia and Canada is more or less the same, and there is a system of tax-sharing. The Constitution of India also contains provisions to ensure financial equilibrium in the distribution of collection by way of taxes. It may be noted that most of the lucrative tax levies, such as corporation tax, income-tax, goods and services tax, customs duty are within the domain of the centre. On the other hand, the states require plenty of money for their welfare and development schemes and they are mostly left with taxes by way of octroi, entry tax, land revenues, etc. There are, however, political compulsions in imposing land revenues, as well as considerations such as hardships to the agriculturists to be taken note of. The makers of the Constitution did recognise that the revenues of the states were thus inadequate to fulfill their needs. In the Report of the Expert Committee on Financial Provisions, this was highlighted. The Constitution therefore provided for sharing of the finances between the centre and the states.

There are two major methods by which the finances are shared: Tax-sharing and Grants-in-aid.There are detailed provisions in our Constitution in Article 268 onwards and it is beyond the scope of this article to dive deep into them. The most important aspect of tax-sharing is the establishment of a Finance Commission which can devise its own formula for the splitting of the revenues between the centre and the states in a flexible manner and without being rigid. The Commission is a non-political body and consists of a president and four members appointed by the President of India. Article 280 makes elaborate provisions for the powers and functions of the Commission. The functions include (a) the distribution between the Union and the States of the taxes can be divided; (b) to lay down the principles to govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India; (c) to lay down the measures to augment the Consolidated Fund of the States in order to supplement the resources of the panchayats on the basis of the recommendations of the State Finance Commission; and (d) to lay down measures to augment the State Consolidated Fund to supplement the resources of the municipalities on the basis of the recommendations of the State Finance Commission.

A burning question which has exercised the minds of tax experts, economists, jurists, tax lawyers and persons of eminence is *whether there should be justice in taxation*. N.T. Wright, an author who wrote several books on religion, remarked: "A *sense of justice comes with the kit of being human. We know about it, as we say, in our bones*". John Rawls, in his book *A Theory of Justice* says that the ultimate purpose of a State is justice. James Madison, the celebrated President of the USA, said "*Justice is the end of government. It is the end of civil society. It ever has been and ever will be pursued until it be obtained*". It is believed that taxation and economic or fiscal policy, which are subsidiary features of a government, do aim to do justice first and foremost. Thomas Piketty, in his book *The Economics of Inequality* says that a primary factor for the persistence of economic injustice in this world is tax and fiscal policy, though there may be other reasons, too. Injustice in taxation has many facets, the main facet being complexity due to lack of systematic theories which provide general guidance as to how taxation does function in society, and the difficulty in reasoning it out; according to David F. Bradford who wrote *Untangling the Income Tax*, taxation "*can be understood (if at all) by only a tiny priesthood of lawyers and accountants*"! Judge Learned Hand scathingly described tax law as a "meaningless procession of cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of….". Moreover, taxation or tax law takes note of and incorporates other disciplines in it, such as economics, philosophy, at times even politics. In India, if one has to understand the Income-Tax Act, one has to have more than a working knowledge of other branches of law – Civil and Criminal Law, Partnership Law, Hindu Law or Mohammedan Law, Company Law, Intellectual Property Law and so on. This certainly makes the tax law more interesting, but also complex. In contemporary tax jurisprudence, we often hear of *horizontal* and *vertical* equity. Horizontal equity requires two persons similarly situated to be treated similarly. Vertical equity requires two persons differently situated to be treated differentially to a degree. These are probably different names given to what is basically understood as fairness. Fairness in tax law, as presently advised, seems to be a distant goal. Adam Smith must be turning in his grave!

Is there morality in taxation? This question has troubled many tax jurists and lawyers over the years. We have a fascinating jurisprudence in India on the subject. The debate will go on forever and jurists will keep on saying that the two are poles apart, and that everything is fair in war, love and taxation. The morality aspect is relevant not only in the means which the tax payer adopts in "arranging his affairs in such a manner that he pays the least amount of tax", but it also applies to governments, particularly in the matter of retrospective taxation. How moral is it to tax the results of a transaction which, when it was put through, did not attract taxation but which has been made subject to tax at a future point of time with back-effect? People may have arranged their monetary affairs on the basis of the earlier law, and if they are told after ten years that the earlier law is being withdrawn retrospectively, it does cause enormous financial strain, mental agony and leads to distrust or mistrust on the government of the day. Today's world of globalisation of business and inter-country commerce and investment suffers most because of retrospective taxation, as we have seen recently in our country. The debate will go on, and ways and means will be found to tide over such difficult situations.

A stable tax policy may be a dream, but that should not prevent governments from adopting a rational and informed view of taxation principles to be adopted to serve the needs of the country. For a long time we did not have a "tax policy unit" in the administration of the Income-Tax Act, and if tax pundits are to be believed, this has resulted in several skewed situations which benefit neither the government nor the tax payer. Fortunately, we now have a Tax Policy Unit which carries out a lot of research, both of local and overseas conditions, and keeps advising the government which can input the advice to shape its fiscal policy.

The Indian government came out with proposals in 2016 to make use of e-assessment procedures with the objective of transparency and speed, in consonance with the "digital India" initiative. Measures are being taken to showcase the Indian tax administration as an intelligent, sensitive and non-combative system which will deal with overseas investors in India fairly and honestly. The recent amendment to introduce a pilot-scheme where assessments will be made without any interface between the tax officer and the assessee is a step taken with the right intention and its success will drive future amendments with a similar purpose. At the same time, the concern of the tax payers about the unnecessarily aggressive and at times vengeful attitude of the tax authorities cannot be said to be without basis and must be addressed. It is very easy to make a deliberately excessive and high-pitched assessment, create a demand and harass the assessees who will be forced to run from pillar to post, spend huge amounts as legal expenses, suffer mental agony, run the risk of assets and bank accounts being attached with consequent stoppage of business, and so on and so forth. Tax compliance cannot be expected without showing tax-sensitivity; to tax and to please is impossible, hence the need today for a friendly and polite and at the same time objective approach, with only the requirements of the law in mind. Collection of targeted amounts of tax cannot be the sole objective and setting of targets must also be realistic; assessments must be rooted to the law and should be in conformity with the judicial precedents and not merely target-oriented. A target-oriented approach tends to result in aggression and a flouting of the rule of law. Judicial review of the assessments and decisions of the tax authorities should be viewed as a corrective and not as criticism. What is required from the tax administration is a broad-minded, professional and impersonal approach. Computerisation has its place in the procedural aspects of administering the law, but computers cannot be allowed to make assessments!

Protracted and interminable tax disputes serve no purpose. The Act provides for an excellent system of appellate and revisional remedies but of late murmurs are being heard whether the appellate tiers, both the first and the second, are discharging their duties impartially and without being influenced by "oblique" considerations. There was a time when the Appellate Assistant Commissioners used to write orders which were, quality and learning wise, no less than those of judgments of High Courts or even the Supreme Court. It is unfortunate that one does not get to see such orders these days. The tax tribunal has always done an excellent job but of late one wonders if it can be said to be immune to the "winds of change" sweeping the country and the mindset of its people. Innovation and improvisation in the decision-making process is welcome, but it should be within the framework of the judicial norms and discipline. The decisions should be informed by objectivity and absence of bias – against the Department of Income-Tax, against the tax payer and also against the counsel! – and care should be taken to ensure that judicial adventurism does not masquerade as judicial innovation or judicial creativity. I will say no more.

A word about the emerging trends and issues in international taxation, which has turned out to be a fascinating branch of the income-tax law. These are mostly issues arising out of interpretation of tax treaties and transfer-pricing issues. In both, the stakes are mind-boggling. The jurisprudence is marvellous and provides excellent fodder for intellectual acrobatics. The IRS has mastered these two branches of tax law; the tax lawyers, with some unmatched original thinking, have made a huge contribution to the growth of this branch of the tax law, supplemented by the learning exhibited by the Tribunal in dealing with those issues. It is a matter of pride for the profession that the highest number of decisions in this branch has emerged from our country and it is believed that they are treated with great respect in judicial forums across the world. This is a very good augury for the tax administration of the country. It is further believed that this branch of tax jurisprudence will govern the future tax litigation in our country.

To conclude, I can do no better than quote the learned author, Padamchand Khincha, from his preface to the book *Emerging issues in International taxation*: *"Rightful tax is the price of social order. Tax is that portion of a citizen's property which he/she yields to the Government in return for the benefits enjoyed from the society. Citizens feel that taxes are (un)wantonly levied, that the pervasiveness of taxes is stifling. Governments feel that the tax payers are short in discharging their obligations……………..In this interaction of granting the benefits and demanding the exaction, the equation is hardly ever balanced."* Well, very pithily put. The goal of every tax administration is to find that ever-elusive balance!

JAI HIND!!! ■