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THE CHALLENGES OF TAX COLLECTION IN DEVELOPING ECONOMIES

(WITH SPECIAL REFERENCE TO INDIA)

by

PRAMOD KUMAR RAI

(Under the Direction of Prof. Walter Hellerstein)

ABSTRACT

This paper gives an overview of the Indian tax system and discusses the challenges in tax collection faced by developing economies using India as a model. The paper discusses the ways and means to reduce the black economy and to improve tax compliance for better collection of revenue. The paper further proposes the establishment of a dispute resolution system in developing economies similar to that of the United States for speedy and fair settlement of taxation disputes.

INDEX WORDS: Tax Collection, Developing Economies, Challenge, Dispute Resolution System, India, Black Economy, Agricultural Income, Value Added Tax

THE CHALLENGES OF TAX COLLECTION IN DEVELOPING ECONOMIES

(WITH SPECIAL REFERENCE TO INDIA)

by

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of the Requirements for the Degree

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PRAMOD KUMAR RAI

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August 2004

DEDICATION

This paper is dedicated to my wife Jagriti and my parents Mr. Bageshwar Nath Rai and Mrs. Nirmala Rai who have always motivated me to achieve excellence in academic life.

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CHAPTER 1

INTRODUCTION

"It was only for the good of his subjects that he collected taxes from them, just as the sun draws moisture from earth to give it back a thousand-fold"

Kalidas eulogizing King Dalip in Raghuvansh[1]

All civilized countries need to collect taxes for several reasons, such as to finance developmental activities, to meet their day-to-day expenses related to maintenance of a free and fair society, to control the economy through fiscal measures, and to a certain extent, to change the economic behavior of people. This authority of national governments to collect monies from taxpayers must recognize a balance between the nations' authority to tax and taxpayers' rights. Thus, the real challenge for nations is to ensure that taxpayers are treated with fairness, justice, and equity, while national governments assert their jurisdiction as taxing authorities. Ideally this tax collection can be analogized to the extraction of honey from the abode of honeybees where honeybees are not disturbed and careful extraction of the honey results in a circular process

[1] An old Indian treatise in the *Sanskrit* language. Manu, the ancient sage and law giver, in his book '*Manusmriti*' has also expressed the similar opinion that the king could levy taxes according to *shashtras*, i.e., religious texts. The wise sage advised that taxes should be related to the income and expenditure of the subject. He, however, cautioned the king against excessive taxation and stated that both extremes should be avoided, namely, either the complete absence of taxes or exorbitant taxation. According to Manu, the king should arrange the collection of taxes in such a manner that the subjects did not feel the pinch of paying taxes.

where more honey is deposited by honeybees giving better opportunity to the extractor to get the honey in perpetuity.

A sound tax system should identify surpluses in the economy and should tax it in such a fashion as to cause minimal damage to productive activity. Tax collection should act as a catalyst for economic growth. Ideally a tax system should be neutral with respect to its effect on economic behavior. In the real world, however, it is impossible to achieve neutrality. Administrative feasibility and practicability are two important constraints on tax policy. These are also matters of convenience to varying degrees. A tax policy is administratively feasible when its enforcement does not cost too much. At the same time administrative feasibility should not be an excuse to compromise the original objective. Further, a tax structure should treat equally those individuals who are approximately in the same situation and account for differences among people who are in dissimilar situations. Finally, every tax should be collected at the time or in the manner in which it is the most convenient for the contributor to pay it, and every tax should be so contrived as both to take out and keep out of the pockets of people as little as possible over and above what it brings to the public treasury.[2]

Sneed, commenting on American tax policy, has suggested that while designing a tax system, the government must answer certain questions[3]. Does the tax base consist of stable and easily identifiable features of the social and economic order? Does the tax system cause substantial distortion of the base? Does allocation of the tax burden reflect the political, social, and ethical aspirations of dominant groups? Finally, does the tax system try to achieve some or all of the following purposes?

(i) To supply adequate revenue,

[2] David G. Davies, *United States Taxes and Tax Policy, 17-19 (1986) (*Quoting Adam Smith [1937:778])

(ii) To achieve a practical and workable tax system,

(iii) To establish horizontal and vertical equity,

(iv) To achieve economic stability,

(v) To reduce economic inequality,

(v) To avoid impairment of the market-oriented economy, and

(vi) To accomplish a high degree of harmony between the tax and the intended political order?

By and large, taxpayers of all countries do not want to pay taxes unless compelled by a situation where they are left with no option other than to pay the taxes. Therefore, for better tax compliance, a system should be designed that automatically extracts taxes rather than leaves the payment of taxes to the voluntary choice and morality of taxpayers. Penal provisions making tax evasion a costly affair should supplement this automatic extraction of taxes.

The tax administrators of developing countries face many challenges in the massive task of tax collection. Nevertheless the problem of tax evasion bothers tax administrators of developing countries and developed countries alike. In the real world, those who wish to reduce their tax liability have more choices than just tax evasion[4]. Smarter and more sophisticated taxpayers, who find the cost/risk of evasion greater than the benefit, practice risk-free legal ways of non-payment of taxes rather than blatant tax evasion, which is popularly known as tax avoidance. In many countries, there are perfectly legal tax avoidance strategies for minimizing tax liabilities. For the government, the results of tax evasion and tax avoidance are

---

[3] Sneed, *The Criteria of Federal Income Tax Policy, 17 Stan. L. Rev. 567 (1965).* Also *See Sneed, Taxation, 11 J. Pub. L. 3 (1962)*

[4] Paul Webly, Henry Robben, Henk Elffers & Dick Hessing, *Tax Evasion: An Experimental Approach ,135 (1991)*

the same; for the taxpayer, however, tax avoidance is preferable because there are less or no chances of getting caught and prosecuted. It is also believed that relatively less wealthy and consequently less well-advised people engage in tax evasion whereas relatively more wealthy and better-advised people practice tax avoidance. Therefore, the loss to government revenue on account of tax avoidance is much greater compared to tax evasion. For effective revenue collection, governments need to curb not only the tax evasion but also the tax avoidance. The tax collection system should be designed in such a way that not only the tax evasion but also the tax avoidance becomes difficult for the taxpayer.

Most developing and underdeveloped[5] countries, including India, are characterized by the existence, in greater degree of unutilized manpower on the one hand and of unexploited natural resources on the other, but they have aspirations to become developed countries. Developing countries are trying to fulfill the increasing developmental needs of their country and people by way of public expenditure within their limited resources. Indirect taxes are a major contributor of the revenue in developing economies. Central Excise Duty on goods manufactured/produced domestically and Customs Duties on imported goods constitute the two major sources of indirect taxes in India and represent more than 60% of central tax revenue (see Table 1 and Figure 1). But revenue receipts from Customs & Excise are on the decline due to World Trade Organization (WTO) commitments and rationalization of commodity duties. Therefore, governments of developing economies must find alternative sources of revenue and

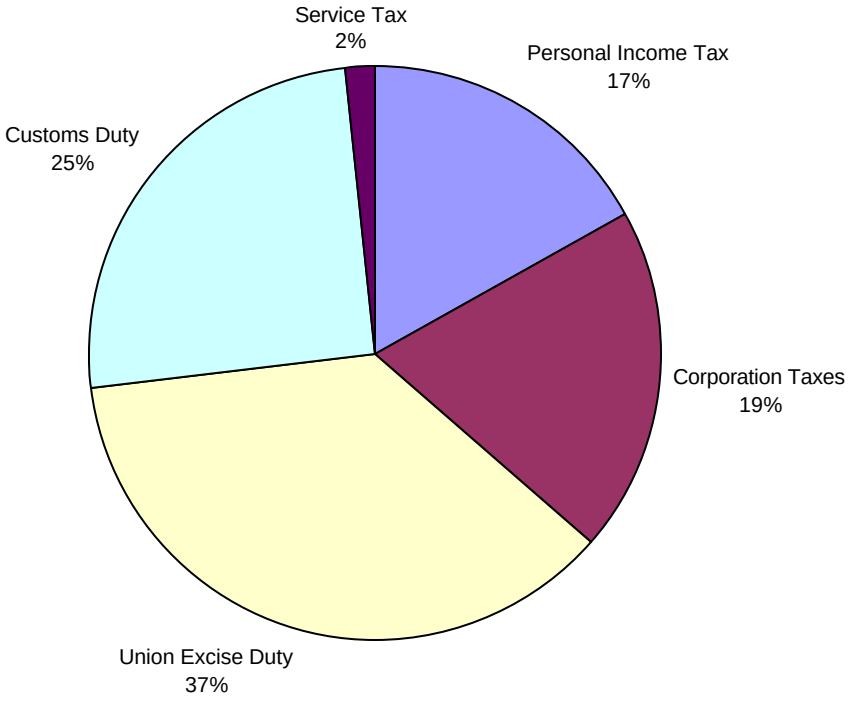
[5] United Nations, *Measures for the Economic Development of Underdeveloped Countries*, 3 (1951). The United Nation (UN) has defined 'underdeveloped country' as a country with real per capita income of less than a quarter of the per capita income of the United States. The definition thus is relative. The UN was not comfortable with the term 'underdeveloped' and suggested that an adequate synonym would be 'poor countries' rather than 'underdeveloped countries.'
More recently instead of referring to these economies as undeveloped the UN publication prefer to describe them as 'developing economies' to signify that though still underdeveloped, the process of development has been initiated in these countries.

Table 1: Share of Different Taxes in Central Tax Collection (In Million US$)

	1950-51	1980-81	2001-02 (% of Total Tax Revenue)
Personal Income Tax	31.1	335.5	7110.4 (16.88)
Corporation Taxes	8.8	291	8134.74 (19.31)
Other Direct Taxes (Wealth, Gift, Etc.)	0.88	39.5	137.76 (0.3)
Total Direct Taxes	**40.78**	**666**	**15382.9** (36.53)
Union Excise Duty	15.55	1444.3	15227.4 (36.16)
Customs Duty	35.5	757.7	10563.4 (25)
Service Tax			734.4 (1.74)
Other Commodity Taxes (State Level Taxes of Union Territory)	0.88	68.88	198.9 (0.47)
Total Indirect Taxes	**51.93**	**2270.88**	**26724.1** (63.47)
Total Tax Revenue	***92.71***	***2936.88***	***42107*** (100)

Source: Economic Survey of India (Various Issues)

Figure 1: Share of Different Taxes in Federal Tax Revenue in India
(For Financial Year 2001-02)



must pay more attention especially to direct taxes. The tax systems of these countries should be designed to reduce the risks of macroeconomic instability by improving the organization and operation of tax administration.

Although progressive income taxes are considered more fair because they are linked with an ability to pay while most indirect taxes are considered regressive, there are other important issues, such as effectiveness associated with these taxes, worth considering in the case of developing economies. A tax collected at the source of transactions (for example, excise duties) by a party other than the ultimate taxpayer will rank higher on the index of tax effectiveness than a tax, which depends on a declaration of liability by the taxpayer himself. Taxes with exemptions and deductions will be less effective than taxes that are imposed without exemptions and deductions on strictly defined bases. Taxes that are obtained from a few collection points, such as customs duties on imports and excise duties on manufactured items, will be more effective than taxes that have to be collected from widely diffused sources. For the same reason, taxes imposed on manufacturers or wholesale distributors may be expected to rank higher on the effectiveness index than single-stage retail sales taxes. In sum, it can be said that direct taxes are more prone to evasion compared to indirect taxes. That is why countries that are not able to enforce their tax laws more effectively rely more on commodity taxes at source. Alternatively, as long as other sources of revenue do not develop, commodity taxes will be compulsion rather than choice for developing economies.

To increase the effectiveness of commodity taxes and to reduce their cascading effect, introduction of VAT is a must in developing economies. Many observers hold the view that the trading community has been amongst the biggest offenders when it comes to

evading taxes[6]. Under the VAT system, no exemptions will be given and a tax will be levied at each stage from the manufacture of a product to its final sale. At each stage of value-addition, the tax levied on the inputs can be claimed back from tax authorities. If enforced properly, it forms part of the fiscal consolidation strategy for the country. It could, in fact, help address the fiscal deficit problem, and the revenues estimated to be collected could actually mean lowering of the fiscal deficit burden for governments of developing economies.

In the last twenty years, tax reform has become the main point on political agendas of governments around the world. In the United States, the Reagan administration, by the Tax Reform Act of 1986, reduced the top individual income tax rate to 28%. The labor government of New Zealand introduced the most radical tax reform in a western country by broadening the tax base, reducing rates of income tax, simplifying the rate structure, and imposing a new corporate tax system and comprehensive VAT. The Indian tax system also has undergone some major reforms since 1990. The Tax Reforms Committee headed by Dr. Raja Chelliah[7] recommended a new broad-based value-added service tax in the early 1990's. The Committee pointed out that indirect taxes should be broadly neutral, not only in relation to production and consumption of goods, but also in relation to services. The Committee recommended a move towards a full-fledged Value Added Tax (VAT) system covering services and commodities. The committee felt that the VAT mechanism would mitigate the burden of service taxes and eliminate the cascading effect on ultimate customers. Recently, two task forces under the chairmanship of Vijay Kelker, known as the 'Kelker Task Force',[8] were set up to

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[6] Salil Panchal, *What is VAT? And Why VAT?, April 12,2003 at* http://www.rediff.com/money/2003/apr/12vat.htm.

[7] *Tax Reforms Committee: Final Report, Part I & II; Government of India, Ministry of Finance, Department of Revenue, New Delhi, 1992 & 1993* (Chairman: Prof. Raja J. Chelliah)

[8] *Dr Kelkar's revised but unchanged report , January 6, 2003, Business Line(internet Ed.)* on http://www.thehindubusinessline.com/bline/2003/01/06/stories/2003010600590900.htm

demystify the powers of budget-making by bringing transparency, and to recommend measures for simplification and rationalization of direct and indirect taxes, and to facilitate an informed discussion on tax reforms. The Kelker Task Force submitted its report in December 2002. The Kelker Task Force with regard to indirect taxes has recommended widening of the tax base, removal of exemptions, expansion of the service tax base, and reduction of the multiplicity of customs duties. The task force also recommended that all excise duties should necessarily be VAT-based without exception. With regard to income taxes, the task force recommended an increase in the basic exemption limit from Rs[9] 50,000 to Rs 100,000, elimination of incentive schemes, and imposition of two rates of 20% and 30% with no further surcharge on payable taxes.

In Chapter 2, the Indian tax system and the nature and contribution of major federal and state taxes will be described. In Chapter 3, the major challenges in tax collection faced by developing countries will be discussed. The lists of challenges are illustrative and not exclusive. In Chapter 4, certain remedial measures are suggested for the reduction of the black economy and enhanced collection of taxes. Chapter 5 discusses exclusively the dispute resolution system in India in the tax arena and compares it with the United States dispute resolution system. The chapter discusses the problems of the present dispute resolution system and makes the suggestion to incorporate certain elements of the United States tax dispute resolution system for speedy and fair disposal of disputes. The last chapter is a summary of discussions done in this paper.

[9] Abbreviation for the Indian currency 'Rupees'. The present exchange rate is US$ 1 = Rs 45.

CHAPTER 2

THE INDIAN TAX SYSTEM

2.1 An Overview

The political organization of India is very similar to that of the United States except for one major difference: India has a parliamentary form of government whereas the United States has a presidential form of government. India is also a common law federal country, with separation of powers between the legislature, the judiciary and the executive. There is a division of legislative powers between states and the federation itself under article 246 of the Constitution[10]. Each state has its own executive government, which functions independently from the federal government. The judiciary in India also is independent, but unlike the United States,[11] India has a unified judicial set up common for state as well as federal subject matters. The seventh schedule under article 246 of the Constitution enumerates three lists of subject matters: (1) 'List I - Union List' on which the legislation can be done exclusively by the federal legislature (2) 'List II - State List' on which the legislation can be done exclusively by the state legislatures, and (3) 'List III -

[10] *India Const. Art 246.* Subject-matter of laws made by Parliament and by the Legislatures of States: -
(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the "Union List").
(2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the "Concurrent List").
(3) Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II in the Seventh Schedule (in this Constitution referred to as the "State List").
(4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included in a State notwithstanding that such matter is a matter enumerated in the State List.

Concurrent List' on which the legislation can be done concurrently by the federal legislature and the state legislature. In case of conflict on concurrent legislation federal law will prevail under the federal supremacy. Further residual powers of legislation belong to the federal legislature.

The federal government's power to levy taxes is covered under entry 82 to entry 92B of the union list of the seventh schedule[12]. More importantly, entry 82 covers taxes on income other than agricultural income, entry 83 covers duties of customs including export duties, entry 84 covers duties of excise on goods manufactured in India except alcoholic liquors and narcotic drugs, and entry 85 covers corporation tax. State governments' power to levy taxes is covered under entry 45 to entry 62 of the state list of the seventh schedule[13]. More importantly,

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[11] In the United States, each state has its own court system independent of the federal court system to deal with state subject matters. Federal courts have jurisdiction over federal subject matters alone unless they assert diversity jurisdiction.

[12] *India Const. Seventh Schedule, List I, Union List*

82. Taxes on income other than agricultural income.
83. Duties of customs including export duties.
84. Duties of excise on tobacco and other goods manufactured or produced in India except-
    (a) Alcoholic liquors for human consumption
    (b) Opium, Indian hemp and other narcotic drugs and narcotics,

but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
85. Corporation tax.
86. Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies.
87. Estate duty in respect of property other than agricultural land.
88. Duties in respect of succession to property other than agricultural land.
89. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.
90. Taxes other than stamp duties on transactions in stock exchanges and futures markets.
91. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.
92. Taxes on the sale or purchase of newspapers and on advertisements published therein.
92A. 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.
92B. Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.

[13] *India Const. Seventh Schedule, List II, State List*

45. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.
46. Taxes on agricultural income.

entry 46 covers taxes on the agricultural income, entry 51 covers duties of excise on alcoholic liquors and narcotic drugs, and entry 54 covers taxes on sale or purchase of goods. Further, Article 265 of the Constitution of India says that no tax shall be levied or collected except by the authority of law. [14]

The Department of Revenue is headed by a senior bureaucrat known as the revenue secretary who reports to the Finance Minister who in turn reports to the Prime Minister and as a part of the council of ministers answerable to the Union Parliament. The Department of Revenue exercises control in respect of revenue matters relating to Direct and Indirect Union Taxes through two statutory Boards[15], namely, the Central Board of Direct Taxes (CBDT) and

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47. Duties in respect of succession to agricultural land.
48. Estate duty in respect of agricultural land.
49. Taxes on lands and buildings.
50. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.
51. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:-
(a) Alcoholic liquors for human consumption;
(b) Opium, Indian hemp and other narcotic drugs and narcotics,
but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
52. Taxes on the entry of goods into a local area for consumption, use or sale therein.
53. Taxes on the consumption or sale of electricity.
54. Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.
55. Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television.
56. Taxes on goods and passengers carried by road or on inland waterways.
57. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III.
58. Taxes on animals and boats.
59. Tolls.
60. Taxes on professions, trades, callings and employments.
61. Capitation taxes.
62. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

[14] *India Const. Art 265*. Taxes not to be imposed save by authority of law.- No tax shall be levied or collected except by authority of law.

[15] The two Boards were constituted under the Central Board of Revenue Act (1963)(India).

the Central Board of Excise and Customs (CBEC)[16]. Each Board is composed of a Chairman and five to six members. These two boards are entrusted with the task of tax policy formulation of the country in their respective fields and are overall in charge of respective tax administrations. The field level set up is separate and independent, although similar, for direct taxes and indirect taxes. The highest-ranking field officer is known as 'The Chief Commissioner of Income Tax' or 'The Chief Commissioner of Central Excise and Customs' as the case may be and heads a zone of the size of a medium size Indian state. The jurisdiction of the chief commissioner is further divided into commissionrates (headed by commissioners), which in turn are divided into divisions (headed by Assistant or Deputy commissioners). There are further lower ranking officers heading smaller jurisdictions. A similar set up exists at the state level for the collection of state taxes[17]. Respective state governments control the employees of state tax departments.

2.2 Federal Taxes

The major sources of tax revenue for the federal government are duties of excise on manufactured commodities, duties of customs on imported goods, income taxes on corporate earnings and individual income, and newly levied service taxes. Other taxes, such as the wealth tax, the estate tax etc., though imposed does not contribute significantly to the national exchequer. The contribution of various taxes to the national exchequer is shown in Table 1 and Figure 1.

2.2.1 Central Excise: Central Excise is an indirect value-added tax levied by the central government on goods manufactured in India under the authority of Entry 84 of the Union List (List 1) under the Seventh Schedule read with Article 246 of the Constitution of India. The

[16] The CBEC deals with all union indirect taxes. Since customs and excise were the only union indirect taxes to start with, the board was known as the 'Central Board of Excise and Customs'. However, a third union indirect tax, namely the service tax has been added in 1994.

Central Excise duty is levied in terms of the Central Excise Act 1944,[18] and the rates of duty, ad-valorem[19] or specific, are prescribed under Schedule I and II of the Central Excise Tariff Act 1985[20]. The taxable event under the Central Excise law is 'manufacture' and the liability of Central Excise duty arises as soon as goods are manufactured. This central value-added tax is imposed at the rate of 16% on most commodities[21]. It is the single largest contributor to the central tax revenue and accounted for 36.16% of the central tax revenue in the financial year 2001-02[22]. It is also the tax with minimum cost of collection because it is collected at fewer points.

2.2.2 Customs: Customs is another indirect tax levied by the central government on goods imported into India and exported from India under the authority of Entry 83 of the Union List (List 1) under the Seventh Schedule read with Article 246 of the Constitution of India. The Customs Act, 1962 is the basic Statute, effective February 1, 1963, which empowers, under Section 12[23], duties to be levied on goods imported into or exported from India. The categories of items and the rates of duties, which are leviable, have been specified in two schedules to the

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[17] Among various state taxes, sales tax also known as commercial tax in a few states, excise on liquor and narcotic drugs, land revenue, and profession tax etc. are the most important.

[18] *Central Excise Act 1944 (India) § 3.* Duties specified in the First Schedule and the Second Schedule to the Central Excise Tariff Act, 1985 to be levied.- (1) There shall be levied and collected in such manner as may be prescribed,—

(a) A duty of excise to be called the Central Value Added Tax (CENVAT), on all excisable goods which are produced or manufactured in India as, and at the rates, set forth in the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986);

(b) A special duty of excise, in addition to the duty of excise specified in clause (a) above, on excisable goods specified in the Second Schedule to the Central Excise Tariff Act, 1985 (5 of 1986) which are produced or manufactured in India, as, and at the rates, set forth in the said Second Schedule:

[19] Duties with reference to value are called ad-valorem duties.

[20] *Central Excise Tariff Act 1985 (India).*

[21] On few commodities of basic needs and life saving drugs it is 8% and few items of luxury it is 24%. There are few exempted items as well.

[22] *See* Table 1 and Figure 1

[23] *Customs Act 1962 (India) § 12.* Dutiable goods. –(1) Except as otherwise provided in this Act, or any other law for the time being in force, duties of customs shall be levied at such rates as may be specified

Customs Tariff Act 1975. The first Schedule to the said Act specifies the various categories of import items in a systematic and well-considered manner, in accordance with an international scheme of classification of the internationally traded goods – termed 'harmonized system of commodity classification'. The duties on imports range between 5% and 25%. The peak import duty is being reduced in a phased manner to achieve a final 5% level under GATT and WTO commitments. The Second Schedule to the Customs Tariff Act 1975 incorporates items subjected to export duties and rates thereof. However, as a policy matter, exports are not charged to any duty and any taxes suffered by exported items are refunded under various schemes in order to boost exports. Where ad-valorem duties (i.e., duties with reference to value) are collected, which are the predominant mode of levy, the value of the goods has to be determined for customs duty purposes as per provisions laid down under Section 14 of the Customs Act[24] and the Customs Valuation (determination of prices of imports goods) Rules 1988 issued thereunder. These provisions are essentially adoption of the GATT based valuation system (now termed WTO Valuation Agreement), which is followed internationally and was incorporated into the Indian law in 1988. The taxable event under the customs law in the case of imported goods is the landing of goods on Indian soil. Customs duty is the second largest contributor to the central tax revenue and accounted for 25% of the central tax revenue in the financial year 2001-02[25].

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under the Customs Tariff Act, 1975 (51 of 1975), or any other law for the time being in force, on goods imported into, or exported from, India.

[24] *Customs Act 1962 (India) § 14.* Valuation of goods for purposes of assessment: – (1) For the purposes of the Customs Tariff Act, 1975 (51 of 1975), or any other law for the time being in force where under a duty of customs is chargeable on any goods by reference to their value, the value of such goods shall be deemed to be the price at which such or like goods are ordinarily sold, or offered for sale, for delivery at the time and place of importation or exportation, as the case may be, in the course of international trade, where (a) the seller and the buyer have no interest in the business of each other ; or (b) one of them has no interest in the business of the other, and the price is the sole consideration for the sale or offer for sale

[25] *See* Table 1 and Figure 1

2.2.3 Income Taxes (Individual and Corporate): Income tax is charged under the Indian Income Tax Act, 1961[26]. It is an annual tax on income levied by the Central Government. Tax is charged in respect of the income of the financial year (known as the previous year) in the next financial year (known as the assessment year) at the rates fixed for such assessment year in the Finance Act passed each year by the Parliament. The normal accounting year in India begins on the first of April and ends on the 31st of March. The return of income for the previous financial year is due in the next financial year i.e. assessment year in which the proceedings for assessment commence, either by filing of a return voluntarily by the income earner or by the Income Tax Department initiating action for calling the return.

Generally, the word 'income' covers receipts in the form of money or equivalent of money that arise with certain regularity from a definite source. It is not all receipts that form the basis of taxation under the Act. A distinction is generally made between capital receipts and revenue receipts. Winnings from lotteries, crossword puzzles, races, and card games, etc., which do not arise from any definite source and do not have the element of regularity, have also been specifically clarified as 'income' under the Act.

It is not the gross receipts but only the net receipts arrived at after deducting the related expenses incurred in connection with earning such receipts, which are made the basis of taxation. Chapter IV of the act categorizes the income of a person under

[26] *Income Tax 1961 (India) § 4*.Charge Of Income-Tax.
(1) Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of, this Act in respect of the total income of the previous year of every person:
Provided that where by virtue of any provision of this Act income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly.
(2) In respect of income chargeable under sub-section (1), income-tax shall be deducted at the source or paid in advance, where it is so deductible or payable under any provision of this Act.

different heads and provides for the manner of computation of the taxable income of each head. These heads of income are Salaries, Income from real property (known as house property), Profits and gains from a business or profession, Capital gains, and Income from other sources.

All receipts having the character of income[27] are taxable unless they are specifically exempted from taxation, as enumerated and discussed in Chapter III of the Act. The total income under each head, as worked out in accordance with the provisions of the Act, is termed as the 'Gross Total Income'. The Act provides for certain deductions from the gross total income. These deductions, which are discussed in Chapter V, are not referable to any particular head of income, but are allowed from the aggregate of income under all of the heads and are in the nature of incentive provisions of different kinds. For example, deductions are allowed for the promotion of charitable activities, the promotion of exports and other activities resulting in the in flow of foreign exchange, the development of industries and other socio-economic objectives. Incentives for the promotion of savings are also provided in the form of a deduction in tax liability by grant of a rebate at a certain percentage on certain savings made out of the taxable income.

After reducing the 'gross total income' by the amount of incentive deductions, the remainder is the amount on which tax is to be calculated at the rates prescribed

[27] *Income Tax Act 1961 (India) § 5* Scope of total income. (1) Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which- (a) is received or is deemed to be received in India in such year by or on behalf of such person; or (b) accrues or arises or is deemed to accrue or arise to him in India during such year; or(c) accrues or arises to him outside India during such year:
Provided that, in the case of a person not ordinarily resident in India within the meaning of sub-section (6) of section 6, the income which accrues or arises to him outside India shall not be so included unless it is derived from a business controlled in or a profession set up in India.
(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which- (a) is received or is deemed to be received in India in such year by or on behalf of such person; or (b) accrues or arises or is deemed to accrue or arise to him in India during such year.

by the relevant Finance Act. This amount is termed as the 'Total Income' and is the base for taxation. For certain categories of taxpayers, a basic exemption limit is provided and the tax is calculated only on that part of the total income, which is in excess of such exemption limit. If such 'Total income' is below the basic exemption limit, no tax is chargeable and no return needs to be filed. For instance, under the Finance Act, 2000, no tax is payable by an individual if his total income is below Rs. 50,000/-. The rates of taxation and the exemption limit applicable to different categories of assesses are given in Chapter XIII.

The persons, who are liable to pay income tax and against whom proceedings for assessment are taken under the Act, can be natural persons or artificial juridical persons such as corporations, local authorities etc. For the purpose of assessment, two or more persons earning income jointly also form a separate entity such as 'firm' or 'association of persons'. The persons forming an assessable entity can be an individual, a Hindu Undivided Family[28], a corporation, a firm, an 'association or persons' or 'body of individuals', a local authority and any other artificial juridical person not falling into any of the above categories.

Different rules for the computation of income and tax exist for different types of persons under the Act. All persons are further categorized on the basis of their residence in the taxable territory, i.e. India. The residential status of a person is required, as the tax liability is dependent on such status. Based on the residence, a person can be a Resident or a Non-resident.

[28] Hindu Undivided Family (HUF) is a separate taxable entity in India independent of the members of the family. For availing benefits of HUF no registration/incorporation etc. is required. HUF and HUF members can be analogized to small family businesses and their shareholders respectively. This facility is available to members of the community following Hinduism.

Tax Slabs and Rates for the Financial Year Beginning on 1st April 2002 and ending on 31st March 2003, Relevant for the Assessment Year 2003-2004.

(i) The tax rate for companies and firms is 35% of total income with a surcharge of 5% on payable tax. Further, there is a minimum alternate tax (MAT) for companies that try to escape the income tax net by using the provisions of exemptions, deductions, and depreciation etc. In case the total income of a company as computed under the Income Tax Act, after availing all eligible deductions, is less than 30% of the book profits, the company shall be charged a minimum tax that works out to be 12% of the book profit. The taxes on corporate earnings are the third largest contributor to the central tax revenue with a share of 19.31% in the year 2001-02.[29]

(ii) The tax rates for Individuals, Hindu Undivided Family, Body of Individuals and Association of Persons are given in Table 2. Taxes on individual income are the fourth largest contributor to the central tax revenue with a share of 16.88% in the year 2001-02.[30]

(iii) The tax rates for Co-operative societies are given in Table 3.

(iv) The tax rate for Local authorities is 30% of total income with a surcharge of 5% on payable tax. Co-operative societies and local authorities do not contribute significantly to the national exchequer.

2.2.4 Service Tax: "Tax on services" was not specifically mentioned in any entry either in the Union List or in the State List or in the concurrent list of the Seventh Schedule of the Constitution. To mop up extra revenue in the budget of 1994, for the first time, the union

[29] *See* Table1 and Figure 1
[30] *See* Table1 and Figure 1

Table 2: Tax Rates for Individuals, Hindu Undivided Family, Body of Individuals and Association of Persons for Financial Year 2002-03

INCOME	TAX
For income up to Rs.50,000	No tax
For income from Rs 50,001 to Rs 60,000	Tax is 10% of income exceeding Rs 50,000
For income from Rs 60,001 to Rs 1,50,000	Tax is Rs 1,000 + 20% of the income exceeding Rs 60,000 with surcharge of 5% on payable tax
For income from Rs. 1,50,001 and above	Tax is Rs 19,000 + 30% of the income exceeding Rs 150,000 with surcharge of 5% on payable tax

Source: Finance Act 2002 (India)

Table 3: Tax Rates for Co-operative Societies for Financial Year 2002-03

INCOME	TAX
For income up to Rs. 10,000	Tax is 10% of income
For income from Rs 10,001 to Rs20,000	Tax is Rs 1,000 + 20% of the income exceeding Rs 10,000 with surcharge of 5% on payable tax
For income more than Rs 20,000	Tax is Rs 3,000 + 30% of the income exceeding Rs 20,000 with surcharge of 5% on payable tax

Source: Finance Act 2002 (India)

government under the authority of residual Entry 97[31] of the Union List (List 1) of the Seventh Schedule of the Constitution of India imposed a 5% service tax on selected services. It was an indirect tax to be collected from the provider of services, who would pass the burden to the recipient of services. In 1994, it was imposed on three services: telephones, non-life insurance, and stockbrokers. Today it covers more than 58 services with a flat non-creditable rate of duty of 8%. However it remains a poorly administered tax with very little share in the central tax revenue. The Constitution (Ninety-Fifth Amendment) Bill 2003, which was passed by the Indian parliament on May 8, 2003 specifically provides for levy of service tax by the central government and collection and appropriation of Service Tax by the Central and State Governments. The amendment has inserted a new article 268A[32] in the Constitution and a new entry 92C[33] in the union list of the seventh schedule. Service tax is the fifth largest contributor in the central tax revenue with a share of 1.74% in the financial year 2001-02.[34]

2.3 State Taxes

Because of the federal system of government in India, the states directly provide many public services. However, as a practical matter, states have very limited sources of revenue. States cannot impose any tax on services or on any income other than agricultural income, and for political reasons, the states have chosen not to impose tax on the agricultural income. Apart from

[31] *India Const. Seventh Schedule, Union List, Entry 97*, Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists. (This entry vests residual legislative powers to federal government)

[32] *India Const. Art 268A.* Service Tax levied by Union and collected and appropriated by the Union and the States: (1)Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States in the manner provided in clause (2).
(2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be— (a) Collected by the Government of India and the States (b) appropriated by the Government of India and the States in accordance with such principles of collection and appropriation as may be formulated by Parliament by law.

[33] *India Const. Seventh Schedule, Union List Entry 92C.* Taxes on services

[34] *See* Table 1 and Figure 1

the sales tax, the only other important tax levied by states is the excise on liquor. Other taxes such as land revenue, professional taxes, motor vehicle tax, arms tax etc though imposed by states do not contribute significantly to the state exchequer.

2.3.1 Sales Tax: State governments impose sales tax on the first sale[35] of a commodity under the power given to them under entry 54[36] of the state list of the seventh schedule of the Constitution of India. If the commodity is sold subsequently without further processing, it is exempt from the sales tax. State sales taxes that apply only on sales made within the state have rates that range from 4 to 15%. States have divided goods into various categories for charging different rates of sales tax. There is no uniform system and each state has its own categorization of goods. Exports and services are exempt from the sales tax. Further, a 4% central sales tax is imposed by central government on interstate sales under entry 92A[37] of the union list of the seventh schedule of the Constitution of India, and the entire proceeds are given to the state of the seller, i.e. the originating state of goods. Respective sales tax departments of states collect both state sales taxes and central sales taxes.

[35] It is a tax on the first sale, unlike the US system where states impose retail sales tax on the last stage of sale. This is done to reduce the number of taxpayers for better tax compliance. But in this case the value on which tax is charged is a wholesale value, which is much lower than the retail value. Further this wholesale value is very easy to manipulate on account of greater relation between the wholesaler and the supplier compared to the relation between a retailer and an individual consumer.

[36] *India Const. Seventh Schedule, State List, Entry No.54*.Taxes on the sale or purchase of goods other than newspapers

[37] *India Const. Seventh Schedule, Union List, Entry No.92A.* 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.

CHAPTER 3

THE CHALLENGES IN TAX COLLECTION

"The power of the government depends upon the strength of its treasury."

Kautilya[38]

3.1 Low Gross National Product and Low Rate of Capital Formation

According to Professor Nurkse, "The meaning of capital formation is that society does not apply the whole of its current productive activity to the needs and desires of immediate consumption but directs a part of it to the making of capital goods, tools and instruments, machines and transport facilities, plant and equipment- all the various forms of real capital that can so greatly increase the efficacy of the productive effort so as to make possible an expansion of consumable output in future."[39] In developing countries, however, the current productive activity is so low that it is not sufficient for the present consumption and therefore, capital formation is very slow. The requirement of funds in developing countries are huge on account of their under

[38] This well known treatise by Kautilya (advisor of the Mauryan Empire) on state crafts, written sometime in 300 B.C., when the Great Mauryan Empire of India was on its glorious upwards move, is truly amazing, for its in-depth study of the civilization of that time and the suggestions given, which should guide a king in running the State in a most efficient and fruitful manner. According to him, tax was not a compulsory contribution to be made by the subject to the State but the relationship was based on *Dharma* (religion) and it was the King's sacred duty to protect its citizens in view of the tax collected and if the King failed in his duty, the subject had a right to stop paying taxes, and even to demand refund of the taxes paid. During Mauryan period revenues were collected from all possible sources, however the underlying philosophy was not to exploit or over-tax people but to provide them as well as to the State and the King, immunity from external and internal danger. The revenues collected in this manner were spent on social services such as building of roads, setting up of educational institutions, setting up of new villages and such other activities beneficial to the community. The over all emphasis was on equity and justice in taxation. The affluent had to pay higher taxes as compared to the not so fortunate.

development but their GNP is so low that they cannot generate such funds by taxation. With low tax revenue and low capital formation, they cannot develop much-needed infrastructure necessary for higher production and growth in the economy. Consequently, they are trapped in a vicious cycle wherein their GNP will remain low and their dependency on foreign debt will be more.

The World Bank Development Report (2002) classified various countries on the basis of per capita Gross National Production (GNP) (see Table 4 and Figure 2). The classification groups countries into three categories: (a) low-income countries with per capita GNP of less than US$ 755, (b) middle-income countries with per capita GNP ranging between US$ 755 and US$ 9265, and (c) high-income countries that are mostly members of the Organization of Economic Cooperation and Development (OECD) and some others having per capita GNP of more than US$ 9265. From Table 4 it is clear that low-income countries comprise nearly 40.6 percent of the world population (2459 million), but account for only 3.3 percent of world GNP. Middle-income countries, which are less developed than the highly developed countries, but comparatively more developed than low-income countries, have 44.5 percent of the world population and account for 17 percent of the world GNP. These two groups together, which are popularly known as 'developing economies' or 'underdeveloped economies', account for 85 percent of the world population but account for only 20 percent of the world GNP. Most countries of Asia, Africa, Latin America and some countries of Europe are included in them. In contrast, the high-income economies, which comprise only 15% of the world population, account for 78 % of the world GNP.

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[39] R Nurkse, *Problems of Capital Formation in Underdeveloped Countries, 2*

Table 4: Distribution of World Population and GNP in 2000

(Exchange Rate Basis)

	GNP (Billion US $)	Population (In Millions)	GNP Per Capita (US $)
A) Low Income Economies Including India	1030 (3.3%)	2459 (40.6%)	420
B) Middle Income Economies Including China	5308 (17%)	2692 (44.5%)	1970
(A+B) Undeveloped/ Developing Economies	6338(20.3%)	5151(85.1%)	1230
C) High Income Economies (Mostly OECD Countries)	24829(79.7%)	903(14.9%)	27510
World Total	31167(100%)	6054(100%)	5148
China	1065(3.4%)	1261(20.8%)	840
India	471(1.5%)	1016(16.8%)	460

Source: World Bank, World Development Report (2002)

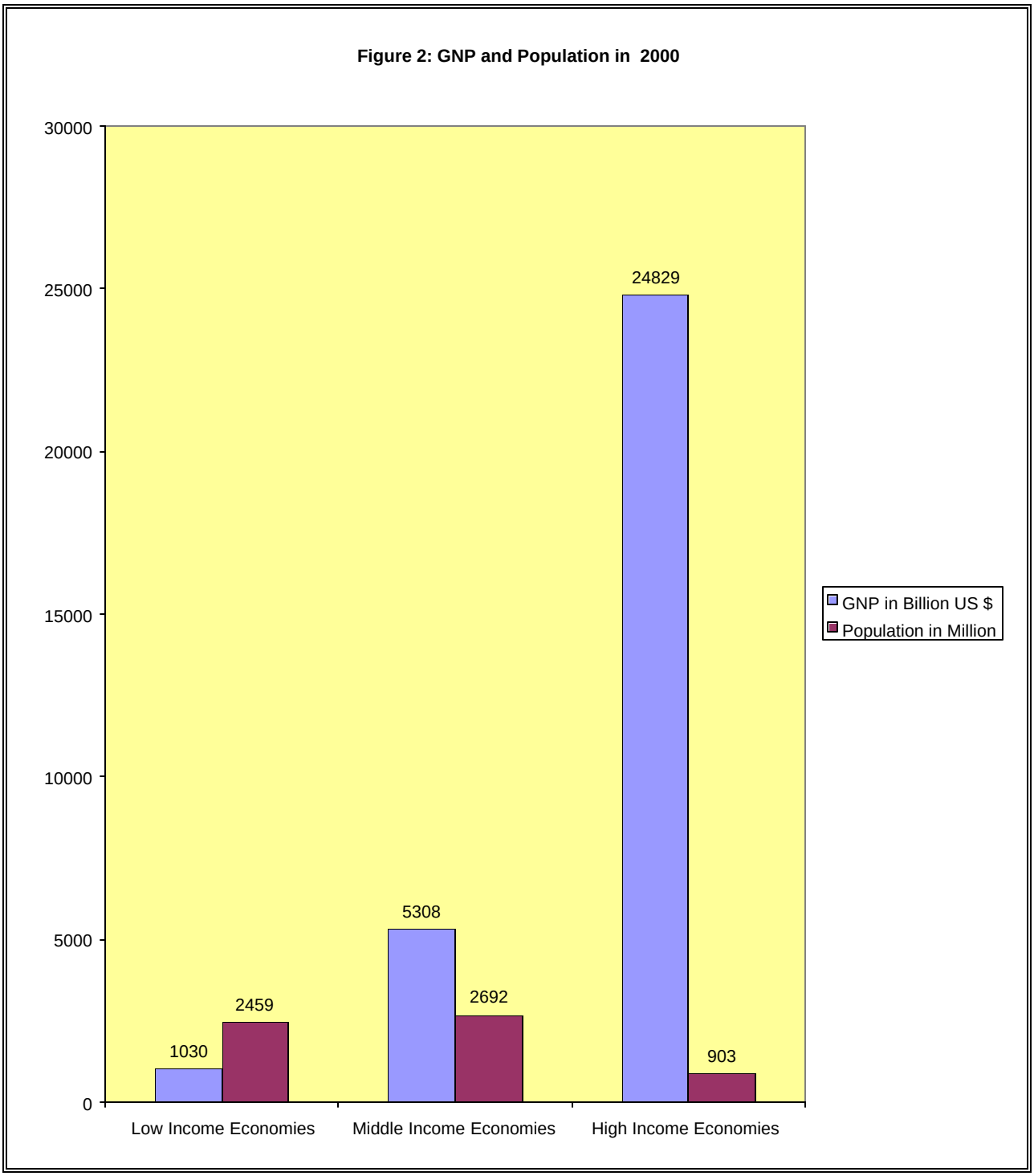
Figure 2: GNP and Population in 2000
30000
25000
20000
15000
10000
5000
0
1030
2459
5308
2692
24829
903
Low Income Economies
Middle Income Economies
High Income Economies
GNP in Billion US $
Population in Million

From the above analysis, it is evident that the bulk of poor people reside in low income and middle income developing countries[40] where the availability of resources is meager and less than sufficient. In order to raise revenue, it is necessary to identify surpluses in the economy. When the majority of people are living in scarcity, finding the surplus in the economy and taxing it becomes a real challenge. Unless revenue is generated from internal sources however, these countries cannot develop. On account of a huge population, the situation of India is the worst among developing economies barring some countries of Africa. India, with a population of approximately 1016 million in the year 2000 and with a per capita income of US$ 460, is among the poorest of the economies of the world. It has a share of 16.8% in the world population but accounts for only 1.5% of the world GNP.

In order to compare resources in a real sense, it is important to consider the purchasing power of money in different economies. On a purchasing power basis also there is a huge difference between developed economies and developing economies, as shown in Table 5. Per capita GNP in the United States is roughly seventy-five times the per capita GNP in India on an exchange rate basis and roughly fifteen times on purchasing power parity basis. It simply means that even on purchasing power parity basis, the scope of taxation in India is one to fifteen that of the United States.

3.2 Poverty and Inequality

In the United States, the difference between the richest and poorest is not as high as it is in the case of developing economies. In the United States, by and large most people pay taxes and most people have access to basic facilities. In developing economies, however, the distribution of resources and income is highly uneven. Although official figures confirm that only 26% of the

[40] Cairncross A. K., *Factors In Economic Development*. (Underdeveloped economies represent slum of world economy.)

Table 5: Per Capita GNP at Market Prices

(In US $ in Year 2000)

Country	Exchange Rate Basis	Purchasing Parity Basis
USA	34260	34260
Switzerland	38120	30350
Japan	34210	26460
Germany	25050	25010
UK	24500	23550
China	840	3940
INDIA	460	2390

Source: World Bank, World Development Report (2002)

Table 6: Percentage of Population Living Below the Poverty Line in India

	1970	1983	1988
Below Poverty Line[41]	52.4	42.5	39.6
Below Ultra Poverty Line[42]	29.8	21.8	19.2

Source: World Bank, India: Poverty, Employment and Social Services (1989)

[41] Any person whose income is not sufficient to afford 2250 calories is living below the poverty line.
[42] A person whose income is less than 75% of the income required to afford 2250 calories is living below the ultra poverty line.

population lives below the poverty line (see Table 6), unofficial figures report that almost 50% of the population is living below the poverty line.[43] The population living below the poverty line is living in abject poverty and they cannot be taxed and should not be taxed by the government under any circumstances. However, they are also forced to pay taxes if not directly then indirectly in the form of indirect taxes on various commodities and services, which they consume.

Developing countries such as Brazil and Mexico have extreme inequality of income (see Table 7). Though the inequality in income distributions, inter alia the concentration of income in India is comparable to that in the United States, the phenomena of mass poverty makes these two distributions of income quite distinct. The lowest 20% in the United States population, accounting for 5.2% of the national income, may not contribute much, but the middle 60% of the United States population having 48.4% share in the national income, contributes a lot in national taxes. Forget about the lowest 20% of the Indian population having 8.1% share in the national income; even the middle 60% of the Indian population having 45.8 % share in the national income does not contribute anything directly in national taxes[44]. In fact the lowest 95 % of the Indian population do not file any income tax return and are not assessed on their tax liability at all.[45]

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[43] Poverty line: The concept of poverty is different in different countries. In developing countries, the generally accepted definition of poverty is based on the minimum level of living rather than a reasonable level of living because to talk about a reasonable level of living or good life may appear to be a wishful thinking at the present stage. This attitude is borne out of a realization that it would not be possible to provide even basic needs for some decades. In developing economies poverty line means an average calorie intake of 2250 per capita per day. The World Bank has adopted the same definition.

[44] Every person in India, however poor, contributes to the government exchequer through indirect taxation of commodities and services.

[45] *Tax base wider; but little change in mop-up: CAG, March 16, 2002, Business Line (Internet Ed.),* on http://www.thehindubusinessline.com/bline/2002/03/16/stories/2002031603080200.htm, Total assesses as on March 31, 2001 were 23.213 million, which included 23.002 million income tax and corporation tax assesses, registering an increase of 3.111 million (15.48 per cent) over the earlier year. So the population filing income tax returns is roughly 2% of the country population.

Table 7: Percentage Distribution of Income in Selected Countries

Country	Lowest 20% of Population	Middle 60% of Population	Highest 20% of Population	Highest 20% To Lowest 20% Ratio
Brazil (1996)	2.5	33.7	63.8	25.5
Mexico (1995)	3.6	38.2	58.2	16.2
USA (1997)	5.2	48.4	46.4	9
China (1998)	5.9	47.5	46.6	7.9
Switzerland (1992)	6.9	52.8	40.3	5.8
India (1997)	8.1	45.8	46.1	5.7
Sri Lanka (1995)	8	49.2	42.8	5.4
Pakistan (1997)	9.5	49.4	41.1	4.3

Source: Compiled From World Bank Development Report 2000-2001

Table 8: Sources of GDP in Selected Countries

Country	Agriculture	Industry	Services	Active Population In Agriculture
USA	2	27	71	2
UK	1	25	74	2
Japan	7	32	61	5
China	16	49	35	69
India	27	27	46	58

Source: World Bank, World Development Indicator (2002)

Figure 3: Sources of GDP in India
(World Bank Report 2002)

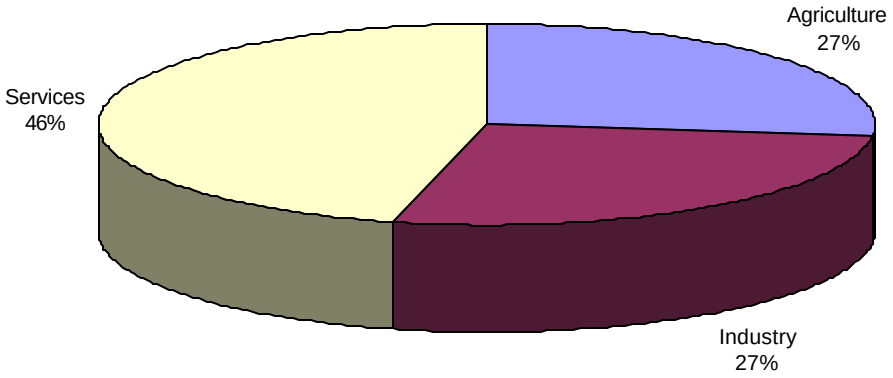
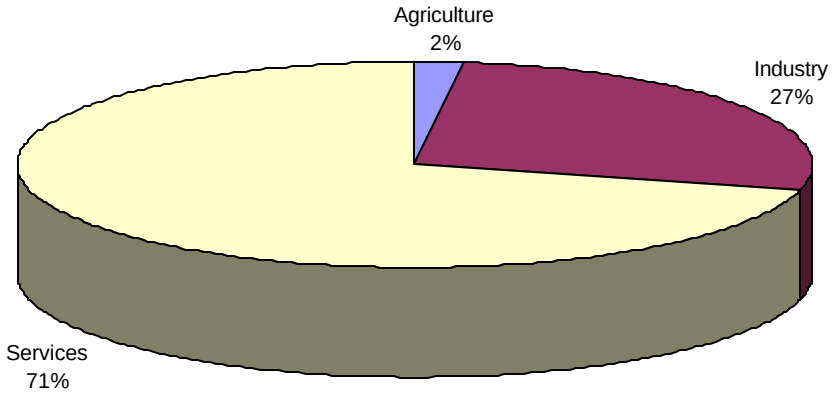


Figure 4: Sources of GDP in the United States
(World Bank Report 2002)



3.3 Occupational Pattern Unsuitable for Taxation

In developing economies, agriculture remains the main activity, which has a very low yield and less potential for taxation. Throughout the world there is a tendency to subsidize agriculture instead of taxing it[46]. Major tax revenue in developed economies comes from industry and services and from individuals employed in these sectors. In India, agriculture accounts for 27% of the Gross Domestic Production (GDP), employing 58% of the population[47](See Table 8). There is no tax on agricultural income, which is subject matter of the state legislation. However land revenue is collected by states on agricultural holdings, but it is highly insignificant when compared to the total tax revenue of states (see Table 9).

3.4 Large Population with Unemployment and Underemployment

India has a population density of roughly 2.5 times the population density of China and 11 times the population density of the United States (see Table 10 and Figure 5). The country is facing a massive problem of unemployment and underemployment[48]. It is extremely difficult to widen the tax base and to collect taxes from unemployed and underemployed people.

3.5 Abundance of Exemptions for Political Reasons

There are too many exemptions under direct taxes as well as indirect taxes based on the push and pull of various lobbying groups. The following two categories of exemptions are worth mentioning here.

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[46] Kate Campbell, *Agricultural trade issues spark disputes with Europe,* at http://www.cfbf.com/agalert/2001/aa-022101b.htm

[47] In fact it is wrong to say that agriculture employs 58% of the population. The population that cannot find alternative avenues of employment is just dependent on agriculture which is the most traditional form of employment and which is not concentrated at few places unlike the industries and services sector.

[48] Underemployment is a situation where a person is not employed to his fullest capacity. There is massive underemployment in family-based traditional sectors such as agriculture. For example, father and four sons are cultivating a farm that can be cultivated by one person because sons cannot find alternative employment.

3.5.1 Exemption on Agricultural Income: The biggest mistake of the Indian tax system is to exempt the agricultural income. Taxing powers on agricultural income are given to states under the state list of the seventh schedule[49] of the Constitution read with article 246 of the Constitution. Therefore the federal income tax exempts agricultural income from taxation[50]. However agricultural income has not been defined in the Income Tax Act of 1961. Taxpayers have tried to claim a variety of income under the heading of agricultural income.[51] At present none of the states impose an effective tax on agricultural income[52] for political reasons. More than 50% of population still depends on agriculture (see Table 8) and farmers are the most reliable vote banks for political parties. Nobody wants to annoy farmers. It is not that once a tax is imposed, farmers will start paying taxes. Farming in India is at the subsistence level. There is hardly any profit in agriculture. Therefore, imposing a tax on agricultural income will not affect most farmers because they will remain below the exemption limit. Nevertheless, there is a psychological and emotional fear among farmers as well as politicians. The ruling party thinks that the opposition will campaign and brand them as anti-farmer, a political party that wants to extract money from farmers and not from rich industrialists. Many farmers will buy this idea. The idea may be supported by even those farmers who would not have to pay taxes at all on a wishful and ambitious thinking that one day they may do well in agriculture and end up paying taxes on agricultural income in the future. Further all tax evaders, including politicians and

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[49] *India const. Seventh schedule, state list, entry no.46* Taxes on agricultural income.

[50] *Income Tax Act 1961(India) § 10*: In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included- (1) Agricultural income;

[51] *See Union of India v. S. Muthyam Reddy, 1999 SOL Case no. 596(Supreme Court of India), Singhai Rakesh Kumar v. Union of India, 2000 SOL Case no. 649(Supreme Court of India) and M/S Assam Co. Ltd v. State of Assam, 2001 SOL Case no. 199(Supreme Court of India)*
All these cases are available online at http://www.supremecourtonline.com

[52] Few states impose a tax on agricultural income when it arises from tea gardens etc. Tea gardens are owned by the corporate sector in India and are run like just any other business entity. In order to impose a tax on them, states do not have to struggle much on the political front.

Table 9: Share of Agricultural Taxes in States' Revenue

Year	Total agricultural taxes (in million US $)	Agriculture tax as a percentage of state tax revenue
1951-52	11.5	18.6
1970-71	27.5	5.4
1997-98	357.7	1.3*

Source: Reserve Bank of India, Report on finance and currency 1996-97

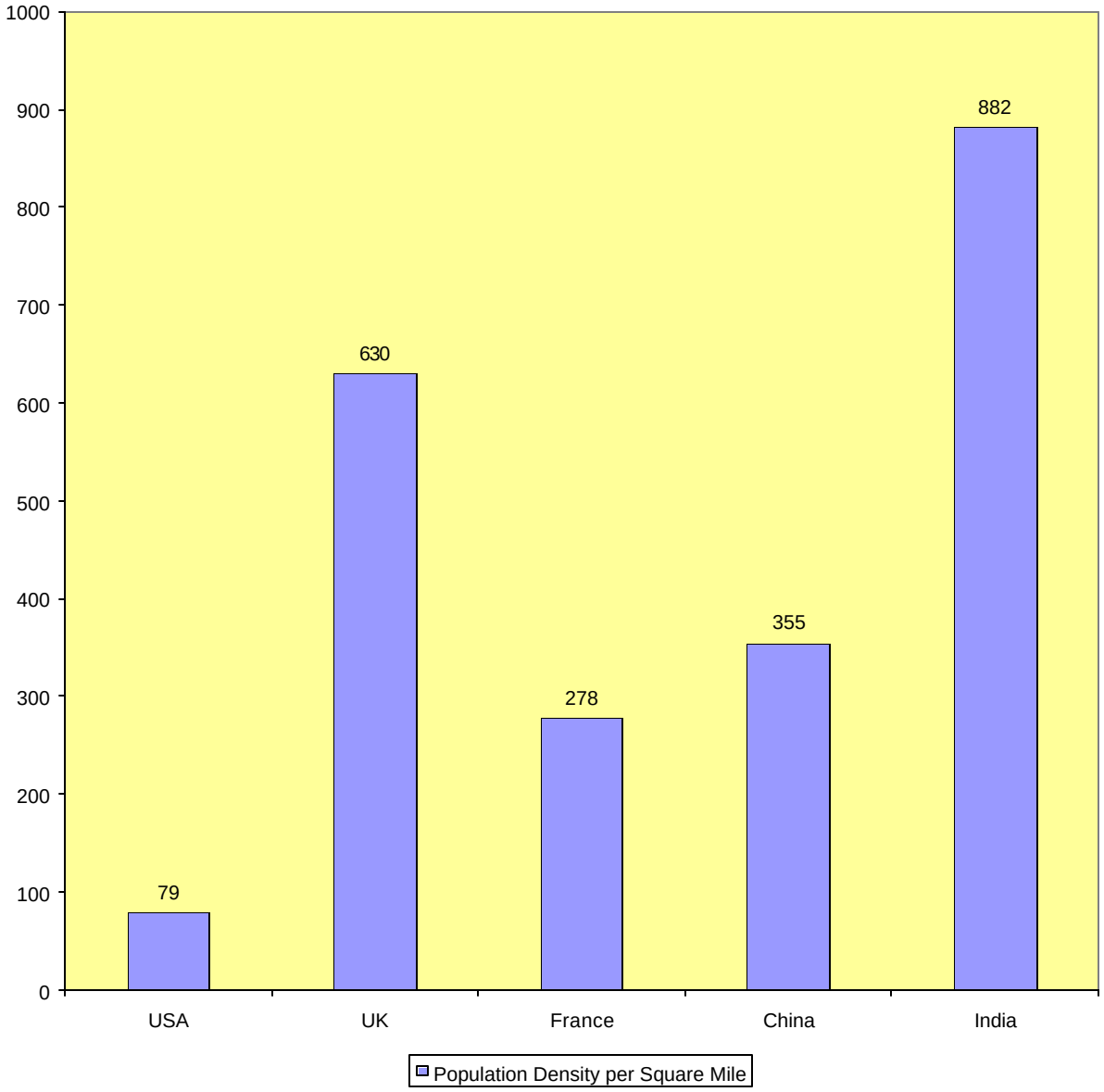
Table 10: Population Density in Selected Countries

Country	Population In Millions	Area In 1000 Sq Miles	Population Density Per Sq Mile
USA	278.4	3539.2	79
UK	58.8	93.3	630
France	59.1	212.4	278
China	1280	3600.9	355
India	1013	1147.9	882

Source: Atlas A-Z, First American Edition 2001

* It is just 0.4 % of total tax collection of the country.

Figure 5: Comparison of Population Density



bureaucrats misclassify their taxable income as agricultural income and they do not want it to become taxable. So any move to tax the agricultural income is being opposed within the ruling party itself. The result is that in the name of agricultural income billions of taxes are being evaded.

3.5.2 Ambiguous Exemptions on Commodities under VAT System: Similarly, on the indirect taxes side (which is a VAT at central level), the exemptions become ambiguous and do not serve any clear purpose. When a commodity is zero-rated, no tax applies to its sale and the seller of the zero-rated item receives a credit for the tax paid on the purchase of inputs used to produce it. By this procedure, a zero-rated commodity is freed from the entire tax burden. By contrast, if a commodity is exempted, then the sale is not subject to tax but the seller is also not entitled to credits of taxes suffered on inputs. Therefore there will be some incidence of tax on the product, which will be borne by the ultimate user. The exact incidence of tax depends on the value addition done by the manufacturer of exempted items. For a general VAT rate of 16%, for a value addition of 100% the incidence of tax will be 8%,[53] and for a value addition of only 25% the incidence of tax on the exempted item will be 12.8%. Thus the exact incidence of tax is not known in the case of exempted items. Thus Government policy is unclear in the case of exempted items: how much tax is the government willing to forgo on these products? It is also a violation of the principle of equity because the same product coming from two different channels is subjected to different level of taxes. The lower the value addition, the higher is the incidence of tax on the exempted item. Consequently, in the case of exempted items, decentralization of the economic activity is discouraged and business people go for the highly centralized activity whereby all the value addition occurs at one place. This creates distortion in the economy.

Therefore, governments should refrain from exemptions and instead impose a definite tax burden on the product. For example, when a fixed tax of 2% is imposed on a product, it is guaranteed that the incidence of tax on that product is exactly 2% and neither less nor more.

3.6 Predominance of Cash Transactions with No Trails

Cash transactions arise in three situations. Firstly, people having un-accounted money prefer to have cash transactions. Secondly, people desirous of evading taxes prefer to have cash transactions[54] and thus in the process generate unaccounted money. Cash transactions of these two categories are interlinked and dominate the Indian economy. The third category is the people who do not trust the banking and financial sector. They are very few in number in India. Indian banks have good credibility. People keep money in the bank and withdraw cash for their use. Only extremely poor people who do not have enough money do not have bank accounts. In India no body keeps cash at home except in the case of illegally earned money when it cannot be deposited in the bank and person fears that there will be accountability problem.

There is no reliable permanent record to trace these cash transactions. Therefore, in these countries it is extremely difficult to assess the income or expenditure of individuals and even of the corporate sector. Governments are deprived of billions of legitimate tax revenue. On the other hand billions of black market unaccounted money is generated which is utilized for funding terrorists, the narcotics trade, trafficking in human beings, and other illicit

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[53] For example inputs purchased in $100 with a tax incidence of $16 are being sold in $200 without payment of taxes on a value addition of 100%. Since no credit is available to the seller, the product which is being sold in $200 will have tax incidence of $16 i.e. 8%.

[54] Once I went to buy steel rods for construction of my house. The shopkeeper quoted the delivery price of Rs 1350 for 100 Kg of steel rods. When I started writing a check, he said I have to pay 13% of sales tax over and above Rs 1350 if I pay by check or if I insist for a written bill for the purchase. If I pay in cash and do not insist for receipt then he will not charge sales tax. The shopkeeper neither collects sales tax nor pays sales tax to the government but still shopkeeper saves income tax on the profit corresponding to unaccounted sales. If these cash transactions are somehow stopped then he will be forced to show sale of rods in his record to make his records comply with receipt of money through Check.

activities. It is very difficult to determine the extent of these cash transactions. The total tax evasion exceeds the total taxes collected for the available data for 1980-81, which indicates the existence of a huge black economy (see Table 11 and Table 12).

3.7 Huge Black Economy

In the preceding paragraphs, it has been emphasized that avenues of taxation in developing economies are much less when compared to developed economies. Further the prospects of taxation become bleaker on account of the presence of a rampant black economy. The size of the black economy in developed Organization of Economic Co-operation and Development (OECD) countries is much smaller compared to the size of the black economy in developing countries (see Table 13). An International Monetary Fund (IMF) survey on the unaccounted sector of the economy has estimated the black money in India to the tune of 50% of GNP[55]. The amount of black money is growing not only in absolute terms but also in relative terms as a percentage of GNP (see Table 14 and Figure 6). The rate of growth of the black economy income is faster than the rate of growth of the GNP itself. The political system talked to control it but did not take effective measures to curb the growth of unaccounted income. The result is that 50% of the GNP goes untaxed on account of the black economy, posing a very serious challenge for tax collectors and a threat to the stability of the economy. Generation of black income is by and large on the following accounts:

(i) Under reporting of income to avoid taxes.

(ii) Under invoicing of goods and services to avoid commodity taxes.

(iii) Real estate transfer at lower value to avoid taxes and to use black money earned elsewhere.

[55] R. Datt and K.P.M Sundharam, *Indian Economy,385 (2003)*

Table 11: Estimate of Tax Evasion in India (In Million US $)

Type	1980-81	1983-84	1987-88
Income Tax Evasion	3258.8	4959.7	7628.6
Corporation Tax Evasion	87.3	165	228.8
Excise Duty Evasion	962.9	1514.5	2433.5
Custom Duty Evasion	325.1	538.6	1322.9
State Taxes Evasion	1260.9	1877.1	3584.6
Total	5895	9054.9	15198.4

Source: Suraj B. Gupta, Black Income in India (1992)

Table 12: Taxes in India (Federal and State Taxes Combined)

Year	Direct Taxes In Million US $ (% in Total Tax Revenue)	Indirect Taxes In Million US $ (% in Total Tax Revenue)	Total Tax In Million US $	Total Tax As Percentage Of GDP
1950-51	51(34.8)	95.5(65.2)	146.5	6
1960-61	93.3(28.77)	231(71.23)	324.3	10
1970-71	244.4(23.5)	797.7(76.5)	1042.1	14
1980-81	819.9(18.65)	3577.4(81.35)	4397.3	17
2002-03	22435.5(25.85)	64362.4(74.15)	86797.9	17

Source: Economic Survey Of India (Various Issues)

Table 13: Frey and Weck-Hanneman's Ranking of Black Economies

of OECD Countries in 1978

Rank (Largest To Smallest)	Country	Black Economy As A % Of GNP
1	Sweden	13.2
2	Belgium	12.1
3	Denmark	11.8
4	Italy	11.4
5	Netherlands	9.6
6	France	9.4
7	Norway	9.2
8	Austria	8.9
9	Canada	8.7
10	West Germany	8.6
11	USA	8.3
12	UK	8
13	Finland	7.6
14	Ireland	7.2
15	Spain	6.5
16	Switzerland	4.3
17	Japan	4.1

Source: Pyle David J., Tax Evasion and Black Economy (1989)

(iv) Funding related to terrorism and insurgency.

(v) Bribes, kick backs, and cuts from supplies and contracts.

(vi) Over and under invoicing of imports and exports.

(vii) Narcotics and drugs trade, human trafficking, and other illicit activities.

(viii) High marginal tax rates.[56]

(ix) Licensing system of the controlled economy in pre 1990 era.

(x) Ineffective enforcement of tax laws.

(xi) Penalties imposed under tax laws are not deterrent enough.

(xii) Tax officials do not have the political support to deal with tax evaders and the black economy. (In 1975, during the declaration of emergency in India, with political support and will power, the income tax revenue grew by roughly 40%.[57])

(xiii) Tax evasion amnesty schemes such as the Voluntary Disclosure of Income Scheme (VDIS) for direct taxes and the Tax Dispute Settlement Scheme (*Kar Vivad Samadhan Scheme* KVSS) for indirect taxes.[58]

The presence of a large black economy in these countries results in loss of revenue to governments as a consequence of tax evasion, loss of useful productive activity on account of non-utilization of black money in a useful economy, and the

[56] At times India's marginal income tax rate was as high as 97.25%, confiscating the marginal income, but today India has a moderate rate of 30-35%, which is at par with income tax rates in developed countries.

[57] Ruddar Datt and K.P.M. Sundharam, *Indian Economy (2003*). The emergency was imposed during the tenure of the first Indian women Prime Minister Smt. Indira Gandhi in 1975 and many of the fundamental rights were suspended. There was a fear of government officials during emergency which resulted in better tax compliance.

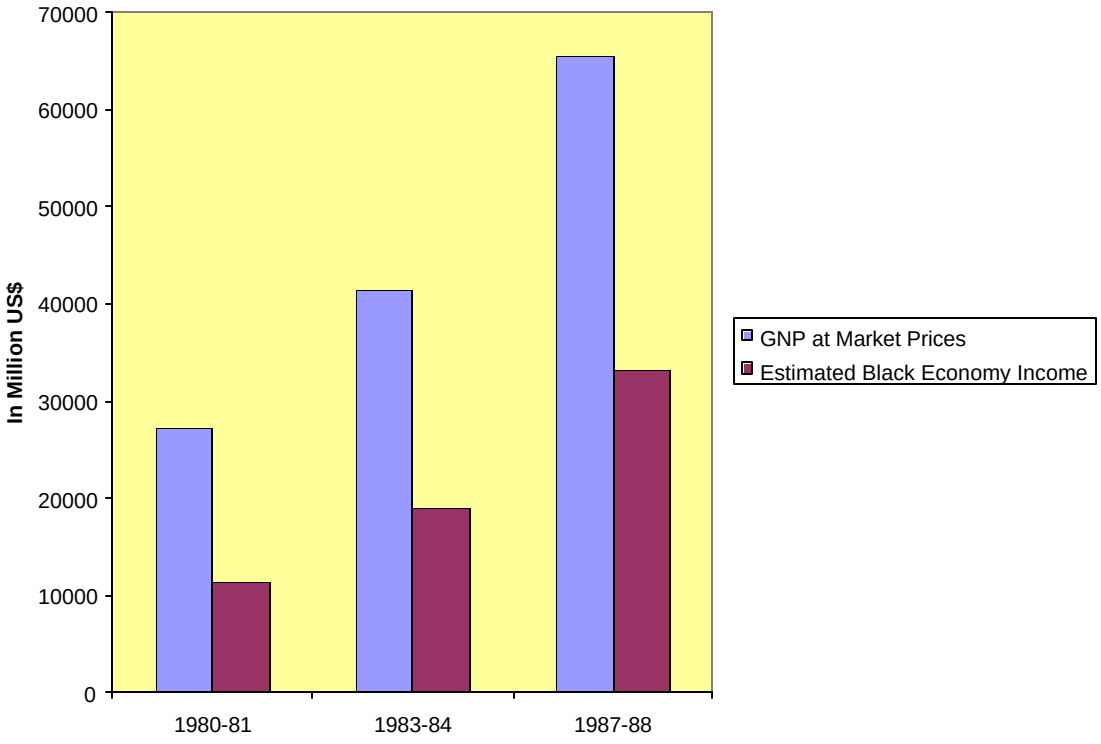
[58] These two schemes of ministry of finance in 1998, allowed tax evaders to free themselves from all tax liabilities by paying less than 50% of their tax liability and getting complete waiver from interest, penalty and prosecution. But by these schemes honest taxpayers felt cheated because they paid 100% of their tax liability on time and did not play fraud. The scheme rewarded the evaders. So there was a general feeling that one should evade taxes and generate black money and wait for amnesty scheme in future to make it white at a much lower payment of taxes.

Table 14: Estimate of the Black Economy Income in India

Year	GNP at Market Prices (In Million US $)	Estimated Black Economy Income (In Million US $)	Black Economy Income As A % of GNP
1980-81	27161	11327	41.7
1983-84	41327	18933	45.8
1987-88	65417	33173	50.7

Source: Suraj B. Gupta, Black Income in India (1992)

Figure 6: Growth of GNP and Black Economy Income in India



development of a plethora of problems on account of illegal economic activities such as drug trafficking, terrorist attacks, and human trafficking. Because Governments are unable to stop leakages of revenue, they impose more taxes on commodities and services to fulfill their revenue needs. The result is a regressive tax structure putting more pressure on honest taxpayers and promoting inequality in the society. Further it leads to transfer of funds from developing countries to abroad – a situation paradoxical for countries where foreign exchange and capital is scarce.

3.8 Extremely Narrow Tax Base and Heavy Burden on the Corporate Sector

The present tax base in India is lopsided, putting maximum pressure on the corporate sector. The major share of tax collection, whether it is excise, customs, sales tax, or income tax, comes from the corporate sector. It is the corporate sector, which is paying 80 % of the federal tax revenue in a country like India[59]. 95% of indirect taxes come from the corporate sector mainly manufacturing units[60]. The industrial development in these countries is already showing very sluggish growth, and incidence of the higher tax burden makes their viability even more difficult. Though it is argued that corporations never pay taxes, whether it is direct or indirect tax[61], as long as they are used as a conduit for tax collection their viability is affected. When a major portion of taxes is collected through the corporate structure, the subsequent passing of this burden by corporations is on a very narrow base of taxpayers (either shareholders or customers buying their products and services), which is not desirable for healthy economic growth.

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[59] *See* Table 1, the only significant revenue coming from non-corporate sources is tax on individual income, which has contributed only 16.88% in the central tax revenue in the year 2001-02.

[60] Entire excise duty is paid by the manufacturing sector. Similarly entire sales tax is also paid by manufacturing sector because in India sales tax is on first sale of goods and there is no sales tax on services. Since sales tax at present is not a value added tax, wholesalers and retailers who are involved in subsequent sales don't have to pay taxes. Again manufacturing sector on the imports of raw material etc pays most of the custom duties.

[61] Joseph A. Pechman, *Federal Tax Policy, 135-154 (5th ed. 1987*)

On the individual income tax side, it is the salary class, which is compelled to file tax returns and to pay taxes on its income. The actual base is much narrower. The total number of taxpayers in India (including corporate taxpayers) is only 23.21 million, which is roughly 2% of the country's population[62]. To widen the tax base, the Government of India recently introduced 'one-by-six' scheme for income taxes[63], which increased the number of returns but did not increase the tax collection.

3.9 Predominance of Regressive Indirect Taxes

The share of indirect taxes in developed economies is very low and the share of progressive direct taxes is very high (see Table 15 and Figure 8). But in developing economies including India, the share of indirect taxes is very high, which are by and large regressive because they are not linked with an ability to pay (see Figure 7). With regard to income taxes, there is a threshold of the income that is exempt from tax while all expenditure, however small, is vulnerable to commodity taxation. On the income tax side, the average tax rate is much lower than the marginal rate on account of this threshold exemption and preferential rates of taxation, but on indirect taxes side, there is little difference between the average and marginal rates of taxation. For the same item of consumption, taxes collected from a poor person and from a rich person are the same in monetary terms. But the level of sacrifice is different because personal value of

[62] *Tax base wider; but little change in mop-up: CAG, March 16, 2002, Business Line (Internet Ed.),* on http://www.thehindubusinessline.com/bline/2002/03/16/stories/2002031603080200.htm

[63] In order to expand the tax base, residents satisfying one or more of following criteria are required to file tax return irrespective of their income since 1997.
(1) Occupation of an Immovable property exceeding a specified floor area in select cities. (2) Owner or the lessee of a motor vehicle (3) subscriber to a telephone (4) incurring expenditure for himself or for any other person on travel to any foreign country (5) holder of the credit card, not being an "add-on" card, issued by any bank or institution (6) member of a club where entrance fee charged is twenty five thousand rupees or more

Table 15: Sources of Tax Revenue in Developed Economies in 1985

(As % of Total Tax Revenue)

	USA	UK	Canada	France	W. Germany	Sweden	Japan
Individual Income	35.7	26	35.5	12.7	28.7	38.5	24.8
Corporate Income	7.1	12.9	8.2	4.3	6.1	3.5	21
Total Income	42.8	38.9	44.3	17	34.8	42	45.8
Social Security Contributions	29.4	17.4	13.3	46.6	36.5	29.1	30.2
Goods & Services	17.7	31.6	31.5	28.7	25.6	26.4	14
Death & Gift	0.8	0.6	0.0	0.6	0.2	0.3	1.1
Property Taxes	9.3	11.4	9.5	3.9	2.8	2.0	8.6
Other	0	0	1.3	3.3	0	0.1	0.3
Total	100	100	100	100	100	100	100

Source: Hiromitsu Ishi, The Japanese Tax System, 6 (1989)

Figure 7: Share of Direct and Indirect Taxes in Total Revenue in India (For Financial Year 2002-03)

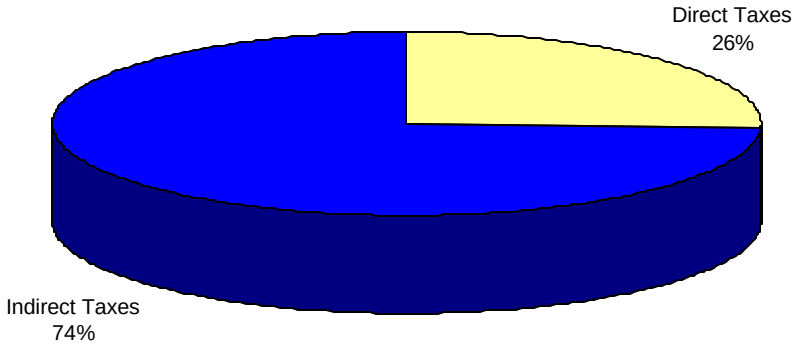
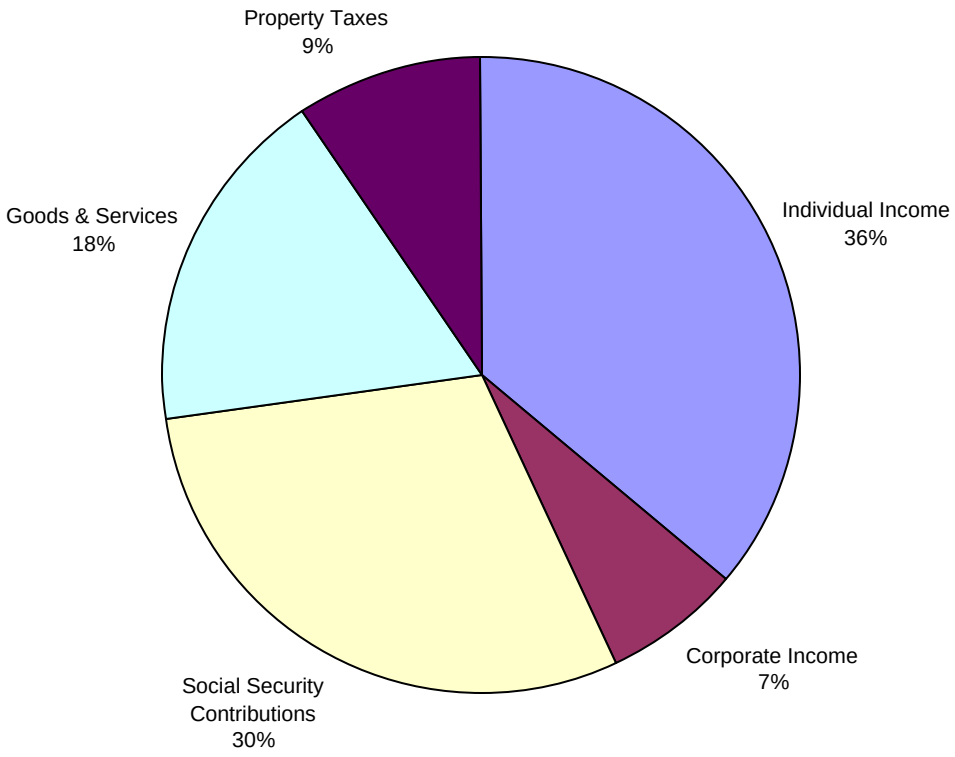


Figure 8: Share of Various Taxes in the United States in 1985



money sacrificed in tax is different for a rich person and a poor person.[64] Further, the proportion of income taken in taxes is more for poor people compared to rich people[65]. This results in a situation, which is not desirable in the tax policy of any country throughout the world.

To some extent, however, there is some progressivism in totality. For example, poor people pay nothing in income taxes whereas rich people do pay some income tax. The amount of consumption of goods and services are much less for poor people, consequently, tax payment is also low. Further, luxury items, which are by and large used by rich people, are charged to higher rates of taxes. Further, regressivity has two facets: the absolute burden of the tax on those who are below the poverty level and the regressive effect on those who are above poverty level. For those above poverty level and subject to income tax, adjusting income tax rates can offset the regressivity of indirect taxes. For those who are below poverty level and not subject to income tax, however, this approach is not helpful.

3.10 Rampant Tax Evasion

Tax evasion can be defined as fraudulent underpayment of taxes whereas tax avoidance is the attempt to decrease tax liability within the four corners of law. Relatively poor people evade taxes illegally while relatively rich people who are better advised try to diminish their tax liability by legal tax avoidance.[66] The exact quantum of tax evasion cannot be measured on

[64] For example on a $1000 purchase a poor man pays a tax of $ 160 at the rate of 16% and a billionaire also pays $ 160. In this case $ 160 means nothing for the billionaire, but it means a lot for poor man. It means for enjoying same product the sacrifice of poor man is much more compared to sacrifice of billionaire.

[65] Presuming that there is only one tax, which is an indirect tax on goods and services at the rate of 16%. A common person who earns $ 11600 in a year and spends all amount lands up paying $ 1600 in taxes on the purchase of $ 10000, which is 13.79 % of his income ($1600 out of $11600). A rich man earning $116,000 i.e. 10 times of the income of this person and spending only $58000 and saving $58000 pays $8000 in taxes which is 6.89% of his income ($8000 out of $ 116000).

[66] J.A.Kay and M.A.King, *The British Tax System,59 (5th ed. 1990)*

Table 16: Tax Revenues in Selected OECD Countries

(As a Percentage of GDP in Selected Years)

COUNTRY	1985	1980	1975	1965
SWEDEN	50.4	49.1	48.2	35.4
DENMARK	46.4	43.5	41.4	29.9
NORWAY	47.6	47.1	46.2	33.3
FRANCE	44.5	41.7	38.7	34.5
NETHERLANDS	45.9	45.8	43.2	33.2
AUSTRIA	43.1	41.2	38.6	34.7
UK	38	35.4	35.5	30.4
GERMANY	38	38	38.6	31.6
IRELAND	38.3	34	35	26
CANADA	33.1	31.6	32.4	25.4
USA	29.2	29.9	28.3	25.9
SPAIN	28.8	24.1	19.6	14.5
JAPAN	28	25.5	21.8	18.3
UNWEIGHTED AVERAGE	37		33	27

Source: B. Guy Peters, The Politics Of Taxation: A Comparative Perspective 1991 P.27

account of its very hidden nature. What behavior can be called tax evasion and how can we determine whether or not it takes place?[67] Only an estimate can be made about the tax evasion.

3.10.1 Very Low Percentage of GDP is Collected in Taxes: A comparison of tax collection in OECD countries and in India as a percentage of the GDP shows wide disparity (see Table 16). In developed countries like Sweden, the tax collection was as high as 50% of the GDP in the year 1985. The extreme difference in tax collection figures as a percentage of the GDP between developed and developing economies in spite of comparable, even higher rates of taxes in developing economies indicates a very high level of tax evasion and the presence of a huge black economy in developing countries. For example in India, income tax rates are comparable to that of the United States but the incidence of indirect taxes is much higher in India compared to the United States. Nevertheless, the tax collection in India was only 17 % of the GDP in the year 1980-81 as well as in the year 2002-03 in comparison to 29% of the GDP in the United States in the year 1985 (See Table 12 and Table 16). It simply means that the Indian economy has not contributed significantly to the national exchequer. It also shows that there is enough potential to mop up extra revenue in taxation by careful planning of the tax policy.

3.10.2 An Example of Tax Evasion in India: The manufacturers of steel ingots and rods in city A[68] are required to discharge 16 % excise duty and 13 % sales tax at the time of selling their products to retailers. The assessment is a self-assessment whereby the seller is required to raise an invoice showing taxes payable on the consignment. The duty is to be paid in the government account at the beginning of next month for the sales made in current month. The retailers are having a nexus with manufacturers for tax evasion. Assume that the manufacturer received an

[67] Paul Webly, Henry Robben, Henk Elffers and Dick Hessing, *Tax Evasion: An Experimental Approach ,29-54,(1991)*

[68] It is a real story but narrated with fictitious city name.

order for a supply of 100 MT[69] of steel products from the retailer R in January. The manufacturer will raise an invoice for 100 MT and send the consignment to R, for which he will receive payments in check or draft through banking channels. He will also reflect this sale in his record and pay taxes in the government account on this part of sale. But retailer R while selling the product will not raise any invoice to his customers, and receive payments in cash. Any customer insisting for invoice will be made to pay higher prices than a customer who pays in cash and does not insist for an invoice. When the retailer is left with less than 10 MT of stock he again orders 90 MT in February. This time the manufacturer will raise an invoice, one copy of which will accompany the goods, but the moment the consignment reaches to the retailer, all copies of invoices will be destroyed. The result is that this sale of 90 MT will be reflected neither in the records of the manufacturer nor in the records of the retailer and no tax will be paid. If any tax authority visits the retailer, the retailer will say that the stock in his possession pertains to the purchase of 100 MT made in the month of January. He will say that the market has been dull and he is unable to sell the product. The manufacturer will also refuse to have sold any item to the retailer after January. The manufacturer also receives his inputs in cash without an invoice in similar fashion. So the input-output ratio cannot be challenged. There is a perception that out of ten sales, one sale is reflected in records by this sector to justify their existence. The tax evasion does not stop here. Once a transaction is unrecorded, it is unrecorded forever. Having evaded indirect commodity taxes, both the manufacturer and the retailer and everybody else in the chain evades income taxes as well on the income associated with the sale and purchase of this product. To keep track of their payments from their retailers, the manufacturers maintain a raw account at

[69] One Metric Tone (MT) = 1000 Kilograms

a distant place over phone (most of the time out of state, sometimes out of the country – Nepal[70] is a favorite choice for this purpose) beyond the reach of taxing authorities.

[70] India and Nepal have an open border. Neither VISA nor Passport is required for entry from one side to other side. For a businessman entering Nepal is very easy but for tax authorities it is very difficult even if they are having proper information because it requires diplomatic permissions for searching premises in another country.

CHAPTER 4

THE REMEDIES

"The most serious defect in the Indian tax system is the failure of the income tax to tax agricultural income."

4.1 Wider Tax Base with Moderate Tax Rates

Irrespective of the form of activity on which tax is imposed, a broad-based tax imposed at a lower rate is likely to achieve a higher score on an index of tax effectiveness than a selective tax imposed at a higher rate. It is now widely accepted that moderate rates of income taxes encourage saving, foster growth, and motivate voluntary compliance. In the case of higher tax rates, incentive for evasion is very high. Tax rates should be lower with stricter penal provisions for evasion. On account of lower tax rates, most taxpayers will not be attracted towards evasion and the few who will still be attracted towards evasion will be prevented from doing so on account of stringent penal provisions. The system should try to cover every aspect of the economy with lower tax rates. A broader tax base will be able to result in good revenue to governments even with lower tax rates.

Incentive economists reason that to obtain an increase in real income, production must rise, and for the growth in production, overall incidence of taxes must be reduced[71]. Higher marginal tax rates encourage individuals to decrease their productive efforts in

[71] The incidence of both direct and indirect taxes discourage the production. For example with heavy commodity taxes on television sets fewer televisions will be sold. On the other hand with lower tax more

favor of leisure. Further higher marginal rates cause distortion in the economy because they inhibit or eliminate both specialization and exchange.[72] The high tax rates on corporate earnings create a strong incentive for owner and managers to spend company funds for tax deductibles, business-related goods and services that also yield personal satisfaction to individuals. That is why we see helicopters, swimming pools, luxurious guesthouses, country club memberships, chauffer driven limousines and business related meetings and vacations in exotic locations. Because at present the cost of such facilities is only 60% to the corporate and the balance 40 % of expenses is indirectly paid by governments in the form of non-collection of taxes.[73] The effective cost to the individual shareholder is much smaller because they have to pay taxes on dividends received.[74] In the 1970s, the peak tax rate was more than 70% in many countries and cost to corporate was less than 30%.[75] In 1978, in the United Kingdom, the peak tax rate on investment income was 98%, virtually confiscating the entire income and leaving no incentive to the investor for seeking investment income.[76] In developing economies, there is no effective social security system like United States for common people, and therefore, governments must

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number of television sets will be sold on account of lower purchase price for consumers resulting in more profit for owners, more salary for employees and based on higher volume may be more revenue to the government.

[72] David G. Davies, *United States Taxes and Tax Policy,7, 1986*

[73] For example, non-spending of $ 100 by a company at present will increase its taxable income by $100 on which it will pay a tax of $40 (assuming 40% corporate income tax) and effectively after taxes company will retain only $60. So when companies spend $ 100, practically they assume that they are spending only $60 and $40 is a subsidy from the government.

[74] In the above example a 25% shareholder will receive $ 15 (25% of $ 60) as dividend out of retained earnings of $60, on which he will pay individual income tax of $ 4.5 (assuming a 30% individual income tax). So money left for his personal enjoyment is only $ 15 - $ 4.5 = $ 11.5, where as in case of direct expenditure by corporate he is able to enjoy $ 25 (assuming he enjoys 25% of facilities). So his effective cost for a $ 25 utility is only $ 11.5 i.e. 46% of expenses. Further shareholders in controlling position use a lot of corporate money to satisfy their personal needs depriving government of taxes and minority shareholders of dividends. So their effective cost of these expenses is further lowered because they enjoy almost 100% of these facilities.

[75] In India in 1975 the peak income tax rate was as high as 97.25%. See Ruddar Datt and K.P.M. Sundharam, *Indian Economy, 916 (2003*).

[76] J.A.Kay and M.A.King, *The British Tax System, 103 (5th ed. 1990)*

encourage saving for future exigencies. Changes in effective tax rates play a crucial role in altering relative prices between consumptions and savings. Moderate tax rates will encourage saving behavior among people.

4.1.1 Expansion of the Service Tax Base: On selected services, just one central service tax is imposed at the rate of 8%. No tax is imposed on services by state governments. At present the contribution of services sector in GDP is around 50%[77], however their contribution in central tax revenue was only 1.74% in the year 2001-02.[78] 'Services' constitute a very heterogeneous spectrum of economic activities. Over a period of time, the definition of 'service' has also undergone change. In the olden days, it was difficult to separate 'services' from the service provider and recipient. Today services cover a wide range of activities such as management, banking, insurance, hospitality, administration, communication, entertainment, wholesale distribution and retailing including Research & Development activities. The service sector is now occupying the center stage of the economy so much so that in the contemporary world, the development of service sector has become synonymous with the advancement of the economy. The share of services sector in real GDP in India has surpassed that of the agriculture and industry at a relatively faster pace as compared to other industrialized nations. It is also well known that services constitute a larger proportion of the consumption of the rich rather than of the poor, as the demand for services is highly income-elastic.

Depending on socio-economic compulsions, each country evolved a taxation system on services, adopting either a comprehensive approach or a selective approach. While most developed countries tax all of the services with very few and limited exemptions, developing countries, including India, tax select services only. The service tax, which was

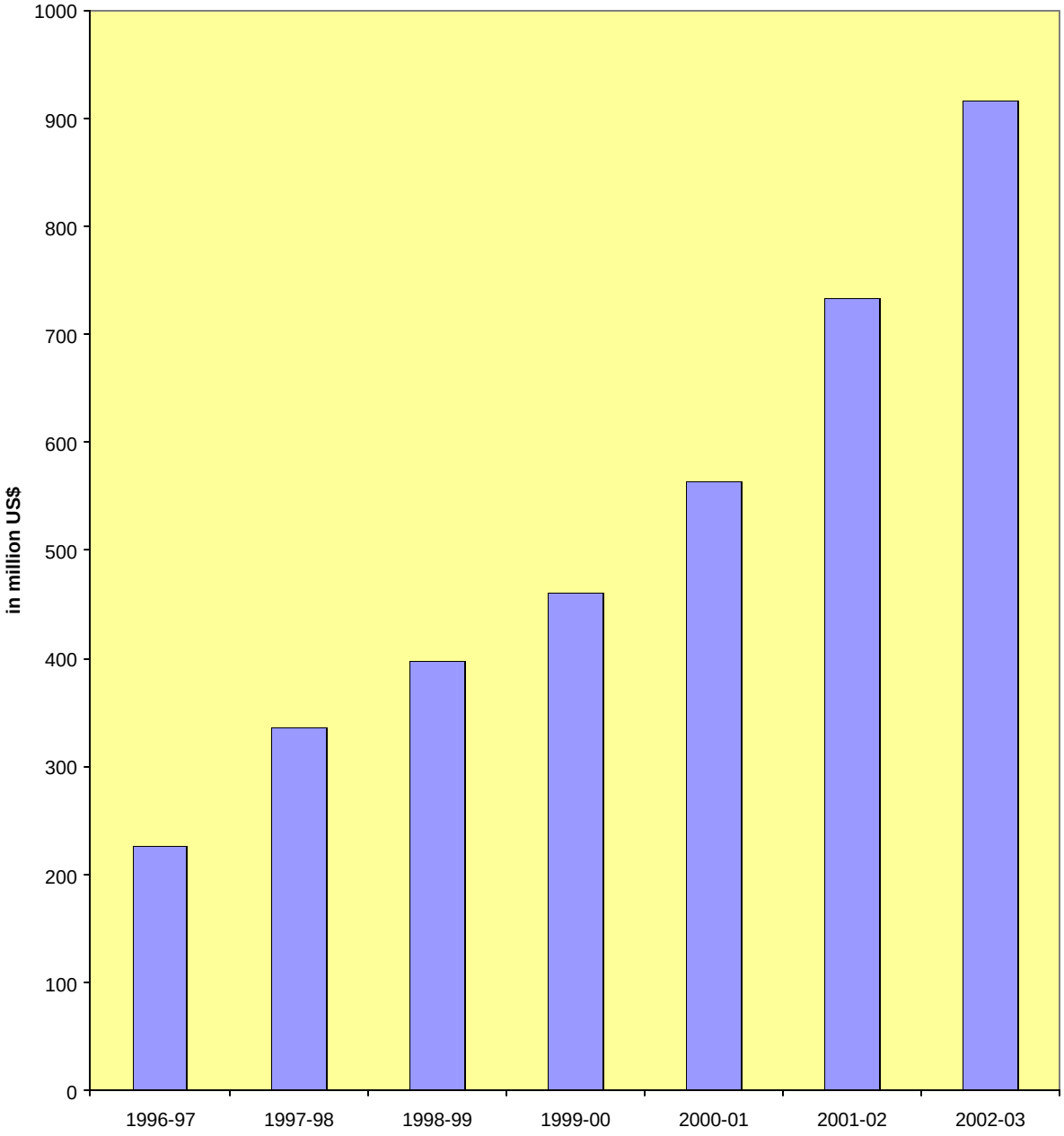
[77] *See* Table 8, in year 2002, the contribution of services sector was 46%.
[78] *See* Table 1

Table 17: Collection of Service Tax in India

Financial year	Revenue (In million US$)	%Growth	No. of Services taxed	No. of taxpayers	%Growth
1994-95	91.11	Base year	3	3,943	Base year
1995-96	188	101	3	4,866	19
1996-97	227.11	24	6	13,982	187
1997-98	336.67	49	18	45,991	228
1998-99	397.11	18	30	1,07,479	133
1999-00	460.44	16	27	1,15,495	7.45
2000-01	564.44	23	26	1,22,326	5.91
2001-02	734.44	26	41	1,87,577	53
2002-03	916.67	25	51	2,32,048	24

Source: Website of Directorate of Service Tax at http://www.servicetax.gov.in

Figure 9: Growth of Service Tax Revenue in India



introduced in India for the first time in the financial year 1994-95, has shown consistent growth and has potential to compensate loss in other indirect taxes such as customs (see Table 17 and Figure 9). Now it is high time to expand the service tax base to cover all services and to make it a tax based on value addition. The Tax Reforms Committee headed by Dr. Raja Chelliah[79] recommended a broad based value-added service tax in the early 1990s. The committee felt that the VAT mechanism would mitigate the burden of the service tax and take care of the cascading effect on the ultimate customers. The broadening of the Service Tax base will augment revenue collection and ensure greater participation by greater number of citizens[80] in the economic development of the nation. The 11th finance commission also recommended in its report that, as services are the fastest growing sector of the economy and constitutes over 50% of GDP, they should be increasingly brought into the tax net to improve the buoyancy of indirect tax collection.[81]

4.1.2 Expansion of the Income Tax Base: The evasion of taxes is extreme in the case of individual income tax compared to other taxes (see Figure 10). The evasion of individual income taxes accounts for 49% of the total evasion of taxes. Income tax, which is a more fair tax because it is a progressive tax and linked with an ability to pay, has a very narrow base in India. In order to expand the individual income tax base, government came with a scheme called 'one by six scheme',[82] effective August 1, 1998 that required the filing of return of income by

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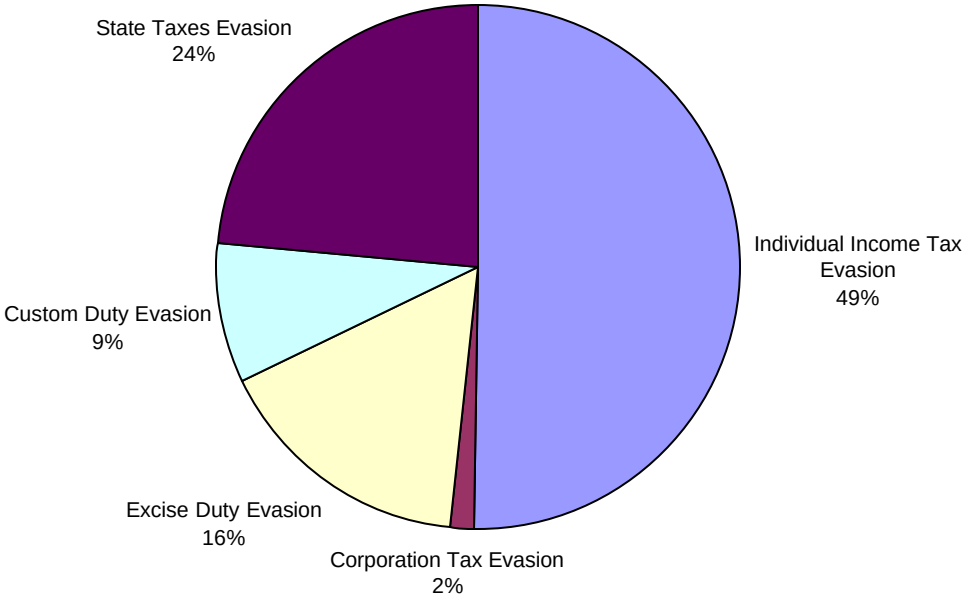
[79] *Tax Reforms Committee: Final Report, Part I & II; Government of India, Ministry of Finance, Department of Revenue, New Delhi, 1992 & 1993* (Chairman: Prof. Raja J. Chelliah)

[80] The present income tax base covers only 2% of the Indian citizens.

[81] *The report of 'The 11th finance commission of India' (constituted under article 280 of Constitution of India) for 2000-2005, issued in June 2000(paragraph 14.6).*
Also available online at http://fincomindia.nic.in/11threport.pdf

[82] Details of the scheme are available on national website of Income Tax Department of India at http://incometaxindia.gov.in

Figure 10: Proportion of Various Tax Evasions in the Indian Economy
(For Financial Year 1987-88)
(Based on the Estimate of Suraj B. Gupta)



persons even if their income is below the basic exemption limit if they satisfy one of the six criteria. The criteria are as follows:

(i) In occupation of an Immovable property exceeding a specified floor area, whether by way of ownership, tenancy or otherwise in selected large cities of India.

(ii) Owner or the lessee of a motor vehicle.

(iii) Subscriber to a telephone.

(iv) Incurring expenditure for himself or for any other person on travel to any foreign country.

(v) Holder of the credit card, not being an "add-on" card, issued by any bank or institution.

(vi) Member of a club where entrance fee charged is twenty five thousand rupees or more.

The presumption behind the scheme was that the categories of people mentioned above are well-to-do people of the economy and are having income in excess of the basic exemption limit. Once they are forced to file a return and once their individual information are on the tax department's records, they will be induced to pay taxes by declaring the income on account of a perceived fear of getting caught. But the speculations of income tax department went wrong. A large number of persons filed return, but declared their income below the basic exemption limit and did not pay taxes. As long as a long-term plan is not made with a view to discourage black income[83] and unearth undeclared income, the tax base cannot expand. In order to expand the tax base, income excluded in Chapter III of the Indian Income Tax Act 1961, and

[83] Some of the methods, which will be helpful in reduction of black economy, have been suggested in section 4.5 to 4.7 of this paper.

more importantly, agricultural income must be brought within the tax net.[84] Further, the plethora of incentive schemes in the form of deductions, exemptions, and exclusions incorporated in Chapter VI A, Chapter VII, and Chapter VIII of the Indian Income Tax Act 1961 needs to be restricted.

4.2 Deterrence Against Tax Evasion

The penal provisions in the Indian tax laws are not stringent enough to have a deterrent effect. Further, they allow too much discretion in the hands of tax officials, which leads to corruption. Discretions are not utilized in a free and fair manner. In the United States, the penalty for non-filing of a return is greater compared to the penalty for non-payment of the taxes itself. Moreover, in the United States, the amount of penalty is fixed by law and is not subject to the discretion of tax department officials. For example, under Internal Revenue Code (IRC) 6651(a)(1)[85], the assessable penalty for failure to file a return by a prescribed date is 5% of the tax to be shown on the return per month to a maximum of 25% in the aggregate. Whereas under IRC 6651(a)(2)[86], the assessable penalty for the failure to pay the tax by a prescribed date is only 0.5% of the tax shown on the return per month to a maximum of 25% in the aggregate. Similarly,

[84] Taxation of agricultural income has been covered in detail in section 4.7 of this paper

[85] *26 USCS § 6651(a)(1)* in case of failure to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed there for (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

[86] *26 USCS § 6651(a)(2)* in case of failure to pay the amount shown as tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

under IRC 6651(a)(3)[87], the assessable penalty for the failure to pay the tax required to be shown on the return but not shown on the return within ten days of notice and demand of payment is 0.5% of the tax to be paid per month to a maximum of 25% in the aggregate. Though there is a reasonable cause defense to these penalties but again what could be considered as reasonable cause has been elaborated under IRC 6664(c)[88]. When a return is filed the tax department is aware of the tax liability. There is a presumption that the taxpayer who has filed the return will pay the tax one day unless he becomes insolvent. There is no ill intention on the part of the taxpayer to hide the income or not to pay taxes. On the other hand, when no return is filed, the department is clueless. The taxpayer may not have paid the tax on account of financial hardship; but failure to file a return generally shows his/her bad intentions of not paying the tax. That is why the United States tax laws take non-filing of a return more seriously compared to non-payment of taxes. Imposition of greater penalties in the case of non-filing of a return ensures better compliance with tax laws. In India there are no separate provisions in law for the imposition of penalty for the failure to file a return and for the failure to pay taxes. Further, the amount of penalty for the failure to pay taxes, as well as the failure to file a return, is dependent

[87] *26 USCS § 6651(a)(3)* in case of failure to pay any amount in respect of any tax required to be shown on a return specified in paragraph (1) which is not so shown (including an assessment made pursuant to section 6213(b)) within 21 calendar days from the date of notice and demand there for (10 business days if the amount for which such notice and demand is made equals or exceeds $ 100,000), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount of tax stated in such notice and demand 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

[88] *26 USCS § 6664(c)* Reasonable cause exception:

(1) In general. No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(2) Special rule for certain valuation overstatements. In the case of any underpayment attributable to a substantial or gross valuation overstatement under chapter 1 with respect to charitable deduction property, paragraph (1) shall not apply unless-- (A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and (B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

on the discretion of tax department officials.[89] Tax officials also have broad powers to refrain from imposing any penalty on being satisfied that there was reasonable cause[90] for the failure; but what could be reasonable cause has not been elaborated in the act or in the accompanying rules and regulations. The requirement of satisfaction by tax officials has been misused over and over again and is a primary source of corruption in the tax department. Under the Indian law, no penalty can be imposed without issuance of notice[91], giving the taxpayer an opportunity to explain his case. There are also statutory time limits within which penalty proceedings must be initiated.[92] The Indian law should spell the quantum of penalty in clear terms in each case and any reasonable cause exceptions should be clearly defined to have transparency in the tax administration. Further, failure to file a return should be taken more seriously in order to expand the income tax base, which is extremely narrow at present.

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[89] *Income Tax Act 1961(India) § 271.* Failure to furnish returns, comply with notices, concealment of income, etc. (1) If the Assessing Officer or the Commissioner (Appeals) or the Commissioner in the course of any proceedings under this Act, is satisfied that any person- (b) has failed to comply with a notice under sub-section (1) of section 142 or sub-section (2) of section 143 or fails to comply with a direction issued under sub-section (2A) of section 142, or(c) has concealed the particulars of his income or furnished inaccurate particulars of such income, he may direct that such person shall pay by way of penalty,- (ii) in the cases referred to in clause (b), in addition to any tax payable by him, a sum of ten thousand rupees for each such failure; (iii) in the cases referred to in clause (c), in addition to any tax payable by him, a sum which shall not be less than, but which shall not exceed three times, the amount of tax sought to be evaded by reason of the concealment of particulars of his income or the furnishing of inaccurate particulars of such income.
Central Excise Rules 2002(India) Rule 26: Any person who acquires possession of, or is in any way concerned in transporting, removing, depositing, keeping, concealing, selling or purchasing, or in any other manner deals with, any excisable goods which he knows or has reason to believe are liable to confiscation under the Act or these rules, shall be liable to a penalty not exceeding the duty on such goods or rupees ten thousand, whichever is greater.

[90] *Income Tax Act 1961(India) § 273B.*Notwithstanding anything contained in the provisions of clause (b) of sub-section (1) of section 271, section 271A, section 271AA, section 271B, section 271BA, section 271BB, section 271C, section 271D, section 271E, section 271F, section 271G, clause (c) or clause (d) of sub-section (1) or sub-section (2) of section 272A, sub-section (1) of section 272AA or section 272B or sub-section (1) of section 272BB or sub-section (1) of section 272BBB clause (b) of sub-section (1) or clause (b) or clause (c) of sub-section (2) of section 273, no penalty shall be imposable on the person or the assessee, as the case may be, for any failure referred to in the said provisions if he proves that there was reasonable cause for the said failure.

[91] *Income Tax Act 1961(India) § 274(1)* No order imposing a penalty under this Chapter shall be made unless the assessee has been heard, or has been given a reasonable opportunity of being heard.

In the United States, the statutory time limit for assessment is three years in normal cases under section 6501(a)[93] and six years in case of 25% or more omission of an item of income from the gross income under section 6501(e)[94]. There is no statute of limitation in cases of fraud under section 6501(c) and cases of frauds can be opened at any time[95]. But in India, there is a statute of limitation for all cases including cases of frauds. For example, under the Central Excise Act of India, the statutory time limit for opening normal cases is one year, and in cases of fraud, the time limit is five years[96]. There is a similar provision under the Indian Income Tax Act 1961[97] and other taxation acts of India. The result is that tax evaders are not

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[92] *Income Tax Act 1961(India) § 275*

[93] *26 USCS § 6501(a)* General rule. Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed.

[94] *26 USCS § 6501(e)(1) (A)* General rule. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

[95] *26 USCS § 6501(c) (1)* False return. In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time. (2) Willful attempt to evade tax. In case of a willful attempt in any manner to defeat or evade tax imposed by this title (other than tax imposed by subtitle A or B), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time. (3) No return. In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

[96] *Central Excise Act 1944(India) § 11A(1).* When any duty of excise has not been levied or paid or has been short-levied or short-paid or erroneously refunded, whether or not such non-levy or non-payment, short levy or short payment or erroneous refund, as the case may be, was on the basis of any approval, acceptance or assessment relating to the rate of duty on or valuation of excisable goods under any other provisions of this Act or the rules made there under, a Central Excise Officer may, within one year from the relevant date, serve notice on the person chargeable with the duty which has not been levied or paid or which has been short-levied or short-paid or to whom the refund has erroneously been made, requiring him to show cause why he should not pay the amount specified in the notice:
Provided that where any duty of excise has not been levied or paid or has been short-levied or short-paid or erroneously refunded by reason of fraud, collusion or any willful mis-statement or suppression of facts, or contravention of any of the provisions of this Act or of the rules made there under with intent to evade payment of duty, by such person or his agent, the provisions of this sub-section shall have effect, as if, for the words "one year", the words "five years" were substituted.

[97] *Income Tax Act 1961(India) § 153(1)(a)* Under normal circumstances, no order of assessment shall be made under section 143 or section 144 at any time after the expiry of two years from the end of the assessment year in which the income was first assessable.

afraid of taxation law. They think that if fraud is hidden for five years, then the game is won and the tax department can do nothing. If the taxpayer has declared all of the information and the tax department is not able to act within one year, then again nothing can be done. With paper returns in India and the lethargy of general government departments, one year is a very short period, and in many cases, before the tax department notices any discrepancy in returns, the one year period is over. On the other hand, in the United States, the taxpayer playing fraud can never sleep in peace. With no statutory time limit on the assessment in case of fraud, the fraudulent taxpayer can be caught anytime. So the provisions of tax law discourage taxpayers from committing fraud. It is not the law, but the fear of the law that ensures compliance in societies. All developing countries, including India, should incorporate statutes of limitation similar to the one prevailing in the United States.

4.3 Higher Standards of Tax Compliance for Certain Individuals

On account of taxpayers' grievances,[98] the Clinton administration restructured the Internal Revenue Service (IRS) of the United States by the IRS Restructuring and Reform Act of 1998.[99] The act placed the IRS on a higher standard of conduct. The ten infractions introduced by the Act of 1998, violation of any one of which will result in mandatory dismissal of an IRS employee, are known informally as 'the ten deadly sins'. One of the most draconian provisions of the reform act is that employees filing late tax returns must be dismissed automatically. In similar

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Income Tax Act 1961(India) § 149. (1) No notice for cases of fraud shall be issued for the relevant assessment year, - (a) if four years have elapsed from the end of the relevant assessment year, unless the case falls under clause (b);
(b) if four years, but not more than six years, have elapsed from the end of the relevant assessment year unless the income chargeable to tax which has escaped assessment amounts to or is likely to amount to one lakh (100,000) rupees or more for that year.

[98] *Elaine S. Povich, Vote For Respect/Congress Passes IRS Overhaul Bill To Add taxpayers Rights, A05, Newsday(NY),July10,1998* "There is little doubt that the IRS needs reforming when one out of two Americans say they would rather be mugged than be audited by IRS"

[99] *Pub L. No. 105-206, 112 Stat 685(1998*) Reflected in various sections of Internal Revenue Code

fashion, employees of tax departments in developing countries should be placed to stricter standards in order to set examples for the taxpaying public. In developing economies, tax officials, bureaucrats, and politicians are the biggest evaders of taxes. Similarly, tax practitioners such as Charter Accountants, Cost accountants, and lawyers, should also be placed to higher standards for the simple reason that if they cannot maintain a higher standards for their tax affairs, they cannot help others in maintaining a good standard of tax compliance. Tax practitioners, if found in collusion with a taxpayer in a tax fraud case, should be debarred from practicing. Similarly, certain other people holding high public posts such as senior bureaucrats and politicians should be placed to higher standards and made to resign if found guilty in a tax fraud case.

4.4 Universal Identification Number

In India there is no all-purpose unique identification number for citizens. In general, passports are held by only those who travel abroad. The Election Commission of India tried to issue a 'Voter Identity Card' to all eligible voters, but to date is not able to issue it to all voters. These cards are not mandatory for casting votes even today, and they are rarely used for any other purpose. Recently, the income tax department has started issuing Permanent Account Number (PAN) to taxpayers[100]. Even this number is not universal in nature, because it is issued only to taxpayers and at present it is used for tax purposes alone like the tax identification number in the

[100] *Income Tax Act 1961(India) § 139A.* Permanent account number:
(1) Every person,--
(i) if his total income or the total income of any other person in respect of which he is assessable under this Act during any previous year exceeded the maximum amount which is not chargeable to income tax; or
(ii) carrying on any business or profession whose total sales, turnover or gross receipts are or is likely to exceed five lakh rupees in any previous year; or
(iii) who is required to furnish a return of income under sub-section (4A) of section 139,
and who has not been allotted a permanent account number shall, within such time, as may be prescribed, apply to the Assessing Officer for the allotment of a permanent account number.

United States. Therefore, it is very difficult to track the income of a person, who neither files a return nor acquires a PAN, even if he has taxable income. Absence of an all-purpose identification number makes it easier for people to evade taxes. Their incomes at different places cannot be correlated. There are cases when a person claims a benefit meant for extremely poor people, and next year, a benefit meant for middle income people, without declaring his previous benefits. In the absence of an all-purpose identification number, it is extremely difficult for government officials to find about the previous history of the person. Therefore, an all-purpose identification number much like the United States Social Security Number, which will be used for tax purposes as well, should be issued to each person, irrespective of his/her income. To keep track of events, birth and death should be compulsorily registered,[101] and each child should be given a universal identification number at the time of his/her birth.

4.5 Reduction of the Black Economy

In order to reduce the black economy (apart from taxing agriculture, which is dealt with in the succeeding section), the following two measures are suggested. In the opinion of the author, on account of these two changes, without any efforts of law enforcing agencies, there will be drastic reduction in the black economy on its own.

4.5.1 Checks on Real Estate Transfers: In most developing economies, real estate transfers are a favorite source as well as a destination of black money. All real estate transfers take place at a paper price much lower than its market value. This allows a buyer to utilize his black money and a seller to evade the income tax on the resulting gain. The transaction consumes black money of the buyer and generates black money for the seller. There is also evasion of stamp duty, which is proportional to the value of transferred property. In India it is believed that real estate

[101] At present registration of birth, death, marriages etc are voluntary and not compulsory. The result is a very low registration of these events.

transactions take place at 40% to 60% of the fair market value.[102] To eliminate the black money from this sector of economy, all real estate transfers should be registered in a national database accessible to the public. Government or private individuals should have the option to purchase the property within six months[103] of the transaction at a price 25% more than the paper transaction value. This will discourage people to understate the price. There may be a chance that some one bought the property at genuine value and out of non commercial considerations like jealousy or all of a sudden appreciation of property there is a buyer who is ready to offer more than 25% and the original buyer wants to retain the property for genuine reasons. To deal with this kind of situation and to safeguard the property rights of individuals, some protection is needed in above-mentioned scheme. It could be one of the following:

(a) The person desirous of purchasing the property has to prove that there was under valuation in the original transaction, which can be proved by quoting transaction value of similar properties near about same time or based on facts and circumstances apart from his readiness to offer at least 25% more than the paper transaction value. Since buyer has to show his genuine readiness by offering 25% more price, he will not file frivolous claim.

(b) Alternatively the original buyer may be given an option to give a rebuttal evidence that original transaction was not undervalued again based on transaction value of similar properties near about same time or based on facts and circumstances and in case he succeeds in this attempt, he will retain the property.

Whatever options are chosen definitely it will reduce the under valuation of real property and thus reduce the black economy. First option is more rationale and should be liked by more

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[102] *See* T. C. A. Ramanujam *Shady money in `real' deals, Nov 16, 2002 business Line (internet edition)* at http://www.blonnet.com/2002/11/16/stories/2002111600320900.htm

[103] This is a mere suggestion and the exact time frame within which such option can be exercised can be fixed after an open debate.

number of people. Second option will be more drastic because it places burden of proof on original buyer that he bought it at genuine price. The second problem associated with real estate transfer is unlimited use of power of attorney to avoid stamp duties on property transfers. Persons dealing in real estate get power of attorney executed in their favor and when they get a customer they sell the property using that power of attorney. In this process they avoid the stamp duty on first transaction because execution of power of attorney requires a nominal stamp duty, irrespective of the value of property in respect of which power of attorney is executed. Either no stamp duty should be imposed on transfer of property or when it is imposed its avoidance should not be allowed by use of power of attorney. This can be done by the amendment of the Indian Transfer of Property Act 1882 that person holding power of attorney can do everything with the property except disposing off the property.

4.5.2 Discouraging Cash Transactions: Why is the incidence of black economy much less and tax compliance much better in the United States? (See Table 13 and Table 14) Why in all stores of the United States whether it is Wal-Mart or Bi-Lo or bookstore are customers charged state sales tax? In India the tax compliance is very poor and the size of the black economy is very large. One of the reasons is the predominance of cash transactions that has already been discussed. If some policy changes are made so that cash transactions becomes infeasible, then people will be forced to use banking channels, checks, credit cards etc. Once banking channels are used, the system will have records of income and expenditure, and the black economy would get minimized automatically in due course of time. Further, the universal identification number associated with persons will help in correlating their all financial transactions.

One way of achieving this target is to remove the currency of higher denominations from the circulation. If only currencies of lower denomination are in circulation,

it will be extremely difficult to have large transaction by cash. Poor people, who have low income, will be able to transact with the currency of lower denominations because they do not have to engage in large transactions. The maximum evasion of taxes is by extremely rich people who indulge in large transactions. This will increase the government tax revenue apart from reducing the black money from the world and bringing peace in the society.

If a transaction is unrecorded at one place, all subsequent transactions are also unrecorded. Therefore tax evasion leads into a vicious cycle and thereby all subsequent transaction also remain untaxed. If one transaction is recorded, then there is a strong likelihood that all subsequent transactions are recorded. At present in India, currency notes of denominations of Rs 1000 (US$ 22) are in circulation, which is a very big amount where per capita GNP is only US$ 460 (see Table 1). Ten million rupees (equivalent to more than US$ 200000) can be carried in a small suitcase. People are making unrecorded cash transactions of millions of dollars/rupees. If all currencies of denomination of more than Rs 20 in India are withdrawn from circulation, huge cash transactions will become infeasible and people will be forced to use banking channels.

4.6 Modifying the Small-Scale Exemption Scheme

In India small-scale industries are given a variety of tax exemptions, from income taxes to commodity taxes. The turnover limit for qualifying for small-scale exemption is fairly high. The result is mushrooming of small-scale units in the economy mainly for the purposes of tax avoidance and tax evasion by diverting income and production of other sources as income and production of small-scale units. The exemption from commodity taxes to this sector distorts the VAT system of taxation. Further in a market-oriented economy, business firms should be motivated by competitive forces to use the most efficient production techniques. In this way

goods and services demanded by consumers will be produced at the lowest possible cost. If a tax system interferes with these production decisions, resources are used less efficiently and less output is available to satisfy consumer demand, which is not desirable. These small-scale units apply crude technology, consume more electricity in their production of goods and services, and are technically less efficient, yet they compete with efficient tax-paying units on account of their saving by non-payment of taxes. The nation loses not only revenue but also valuable scarce resources such as electricity and fuel by their non-efficient functioning. The idea behind the exemption was that they need some protection during their period of infancy. On account of their protection in the initial period, they will be able to compete with bigger units and will grow at a faster rate and start paying taxes in future. But the fact is that they intentionally never cross the eligibility threshold turnover for a small-scale unit benefit. Further, these small scale units, are not liable to pay taxes, and are also not required to maintain statutory records for their production, and under the Indian law whatever records are maintained by them has to be accepted by the officials of tax departments. The result is that these units actually reach a turnover many times the threshold turnover but in their paper records they never cross that threshold and thus they remain eligible for the small-scale exemption in perpetuity. On account of unaccounted production they generate a lot of black income escaping the tax system. The commodity taxes exemption schemes to this sector must be withdrawn and they should be brought under VAT system without any exception. Their record-keeping requirements should be made at par with other units. Their small nature can be taken care of by progressive income taxes. This will ensure efficient utilization of national resources, reduction in the black economy and more collection of tax revenue.

4.7 Taxing Agricultural Income

The economic well being of a person, who derives his income from agricultural sources does not differ from that of a person, who derives his income from other sources. Why should a poor clerk earning US$ 2000 a year pay taxes while a rich farmer earning US$ 100,000 from agriculture pays no taxes? The principle of equity dictates that they should be taxed in a similar fashion. At present, however, there is no tax on the agricultural income in India and even the filing of a return is not necessary in most of the cases[104]. The agricultural income must be taxed nonetheless for the following reasons:

(a) First, the lack of tax on agricultural income leads to evasion of taxes in other sectors. In India, incomes from other taxable sources are being disguised as agricultural income. For disguised agricultural income, one does not need to find even a fake employer. Only thing they need to have is some agricultural land. Diversion of income from other sectors to the agricultural sector thus is very easy. On the other hand, if the government imposes a tax on agricultural income, tax collection from other sectors will increase. All developing countries should tax income from all sources the way that the United States taxes income from all sources. The Direct Taxes Enquiry Committee of India has also suggested that uniform and progressive taxation should be introduced for agricultural income to ensure that the agricultural sector no longer offers scope for tax evasions.

(b) Secondly, the traditional system of agricultural taxation is outdated, inadequate and irrelevant, and a system of progressive taxation of agricultural income is urgently called for.

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[104] *Income Tax Act 1961(India) § 139. (1)* Every person,- (a) being a company; or (b) being a person other than a company, if his total income or the total income of any other person in respect of which he is assessable under this Act during the previous year exceeded the maximum amount which is not chargeable to income-tax; shall, on or before the due date, furnish a return of his income or the income of such other person during the previous year, in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed:

(c) Thirdly, manufacturing and trading sectors have surrendered more of their earnings in the past to the government. It is high time to tax agriculture, which contributes 27% of the GDP. Income from livestock fisheries, poultry, dairy farming etc. should be subjected to tax.

(d) Fourthly, the government has invested large amounts in agriculture, and therefore those who are able to make profits in the agricultural sector must pay to the government in the form of taxes on grounds of equity and distributive justice. It is also argued that a progressive income tax will induce farmers to increase production by modernizing their farming to meet the tax liability.

4.7.1 Treatment of Agricultural Income by Other Countries: In the United States, income from all sources, including agriculture, is taxed.[105] In China, however, agricultural income is treated differently, nevertheless, it is taxed at an average rate of 15% and the tax is paid mainly in kind[106]. Further, there is a concealed agricultural tax in China in the form of sales to the state at a price lower than the fair market value.[107] Developing countries need an agricultural tax similar to that of the United States. The Chinese agricultural tax system is out of date and not suitable for present times. There is a talk even in Chinese circles to replace the existing agricultural tax, which is outdated by a modern tax.[108]

4.7.2 Problems in Taxing Agriculture: Taxing agricultural income has assumed great significance in view of staggering fiscal deficit, which is at present to the tune of 10% of the

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[105] *26 USCS §* 61*(a)* General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;(2) Gross income derived from business;(3) Gains derived from dealings in property;(4) Interest;(5) Rents;(6) Royalties;(7) Dividends;(8) Alimony and separate maintenance payments;(9) Annuities;(10) Income from life insurance and endowment contracts;(11) Pensions;(12) Income from discharge of indebtedness;(13) Distributive share of partnership gross income;(14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust.

[106] Jiyan Li, *Taxation in People's Republic of China, 19-21 (1990)*

[107] *Id. at 132*

[108] *Id. at 171*

GDP[109]. Revenue collections have been falling short of targets for the last three years. Taxing agricultural income is a long-standing demand of revenue experts and tax professionals, but no government has made any serious effort in this direction so far. This is partly because of political reasons[110] and partly because of constitutional hurdles. Irrespective of the merits of taxing agricultural income, its implementation still seems to be a far from reality. Article 246(3) of the Constitution confers powers on states for raising revenue by taxing agricultural income, in which none of states are interested at the moment. For taxation by federal government, agricultural income would have to be moved from the State List to either the Concurrent List[111] or the Union List of the seventh schedule of the Constitution. Moving it from the State List to the Concurrent List or the Union List requires a constitutional amendment[112] for which support of more than two-third of members of Parliament and ratification by more than 50% of state legislatures are required, which is virtually impossible in present situation for this politically sensitive and controversial move.

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[109] The International Monetary Fund, *The World Economic Outlook: Prospects and Policy Issues, semi-annual publication released on April 9,2003.* The IMF publication expressed concern over India's large fiscal deficit, which is at 10 per cent of the GDP

[110] *See* section 3.5.1 of this paper.

[111] Under concurrent list both state governments and federal governments can legislate simultaneously. However under federal supremacy in case of conflict federal law will prevail. The basic idea behind the constitutional provision for a concurrent list is that if and when a particular matter assumes importance, the Center should have freedom to step in and enact laws in order to secure uniformity in the law throughout the country or guide and encourage a state effort, or provide remedies for mischief arising in the state sphere.

[112] *India const. Art. 368(2)* An amendment of this Constitution may be initiated only by the introduction of a Bill for the purpose in either House of Parliament, and when the Bill is passed in each House by a majority of the total membership of that House and by a majority of not less than two-thirds of the members of that House present and voting it, shall be presented to the President who shall give his assent to the Bill and thereupon the Constitution shall stand amended in accordance with the terms of the Bill: Provided that if such amendment seeks to make any change in- (a) Article 54, article 55, article 73, article 162 or article 241, or (b) Chapter IV of Part V, Chapter V of Part VI, or Chapter I of Part XI, or (c) any of the Lists in the Seventh Schedule, or (d) the representation of States in Parliament, or (e) the provisions of this article; the amendment shall also require to be ratified by the Legislatures of not less than one-half of the States by resolutions to that effect passed by those Legislatures before the Bill making provision for such amendment is presented to the President for assent.

4.8 Setting Large Taxpayer Units

The top 20% of taxpayers pays almost 80% of taxes. Non-compliance or evasion by this sector will have a very bad impact on the economy. The Fiscal Affairs Department (FAD) of the International Monetary Fund (IMF) has analyzed the requirements for and impact of tax administration reform in developing countries. There is a growing focus on different segments of the taxpayer population, including large taxpayers, as a way to encourage greater stability in public revenue flows. Beginning in the 1980s, the IMF has recommended that member countries facing revenue crisis and looking to strengthen the tax administration should establish Large Taxpayer Units (LTUs) to increase control over the largest taxpayers[113] in the short and medium run.[114] By a staff team led by Katherine Baer,[115] the IMF has made a case study of forty countries in terms of the organization, systems, and procedures used by tax administrators to monitor the compliance of the large taxpayers and their effectiveness and efficiency.[116] Case analysis indicates that countries may gain significantly from setting up special operations to control the largest taxpayers.

The trend to establish LTUs or organizational arrangements based on large taxpayers in developing countries is similar to efforts in developed countries (e.g., Australia, France, the Netherlands, New Zealand, the United Kingdom, and the United States). Tax administrators in these countries are rearranging their operations around segments of the

[113] Taxpayers that make significant tax payments and that account for a large % of total tax collection, 50% or more.

[114] Operations to control the compliance of large taxpayers vary according to the type of organizational structure of each tax administration and may be referred to as Large Taxpayer Units, Large Taxpayer Departments (LTDs), Large Taxpayer Offices (LTOs) and so forth.

[115] International Monetary Fund, *Improving large taxpayers' compliance: a review of country experience, (2002)*

[116] Effectiveness of tax administration is measured by the degree of taxpayers compliance with the tax laws e.g. the tax administration's capacity to enforce tax laws while efficiency reflects the actual cost of tax administration.

taxpayer population because different sections require different strategies to manage their tax compliance and also because these different segments present different revenue risks. However there is an associated risk of over emphasizing the administration of larger taxpayer units and ignoring the medium size and small size taxpayers. Assigning too many taxpayers to LTUs, thereby rendering compliance management ineffective is another area of concern.

For the LTU to be effective, the government must be committed to setting up the LTU and providing it with the necessary resources and infrastructure. The long term effectiveness and creditability of the LTU depends on the government's ability to incorporate the LTU experience in a broader tax reform to improve the tax compliance of all classes of taxpayers. The LTU can work as a pilot model for broader tax reforms. The LTUs need to be upgraded and modernized continuously to remain effective and updated with changes in the technology, economy and the taxpaying population. The LTUs must be supported by a sound and fair legal framework in the country.[117] There should be simple and transparent criteria for selecting large taxpayers for LTUs. The choice of units should not be motivated by politics. The case study has shown that a positive relationship exists between the successful implementation of an LTU and progress in macro utilization and other structural reforms including tax policy reforms. The most effective LTU operations are based on a high level of centralized operations and a limited number of units to be supervised. By contrast the least effective LTUs seem to be those, which have a highly decentralized structure. All developing economies should learn from successful LTUs of developed economies.

[117] International Monetary Fund, *Improving large taxpayers' compliance: a review of country experience, 38* (2002) In several countries large taxpayers have welcomed the establishment of LTUs as a way to increase the degree of transparency in tax administration and to improve the quality of taxpayer services.

4.9 Simplification and Transparency Based on Mutual Trust

Power corrupts a system and absolute power corrupts absolutely. On account of too much discretion vested in tax officials, complicated tax laws, and ignorance of taxpayers, the tax officials of developing economies become even more powerful. Taxation procedure in these countries needs to be simplified to remove corruption and to increase voluntary tax compliance. Governments must realize that complicated tax procedure cannot give good revenue to the treasury. It will lead to corruption in government offices and increased practice and earning for lawyers. The 'IRS Restructuring and Reform Act 1998' called for an about face in the work culture of American IRS from tax collection to an emphasis on taxpayer service. American IRS maintains twenty-four customer service centers with telephonic assistance. Further, under "The Omnibus Taxpayers' Bill of Rights 1988 and Taxpayers' Bill of Right II 1996" taxpayers of the United States are conferred the following important rights to ensure fairness in proceedings:

(i) Examination must be conducted at a reasonable time and place.

(ii) The service must explain the examination process and taxpayers' rights in the process.

(iii) If at any time during the examination, the taxpayer wishes to consult an attorney or accountant the examination must be suspended until the taxpayer has time to do so.

(iv) If a taxpayer has not received summons, then he may elect to be represented by an authorized representative instead of attending it personally.

(v) Either the taxpayer or the service, upon advance notice, can have an audio recording of the audit interview or any in-person interview concerning determination and collection of tax at the requester's expense, and the other party can get a copy of this at his or her expense.

But in India and most of the developing countries, recording of proceedings are not permitted. Taxpayers are interrogated at odd times and treated badly. Though written laws do not allow mistreatment of taxpayers and require that taxpayers be informed of their rights and legal provisions, these instructions are often not followed. Further, under IRC 6404(f)[118], if an IRS agent acting in official capacity responds to a taxpayer in writing, the taxpayer may rely on such written advice and the service must abate a portion of the penalty or any addition to the tax attributable to any erroneous advice. However, the abatement is granted only if the written advice was reasonably relied upon by the taxpayer, and the portion of the penalty or the addition to the tax did not result from the taxpayer's failure to provide adequate or accurate information. In India, the taxpayer cannot take help of bad advice of tax officials in general. Under IRC 6501(c)(4)(A)[119], taxpayer and service may agree to extend the period of assessment, provided that the agreement is executed before the expiration of the statutory period of assessment. Further, IRC 6501(c)(4)(B)[120] requires the service to inform the taxpayer of the right to refuse to extend the period of limitation and the right to restrict any agreed extensions to specific issues.

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[118] *26 USCS § 6404 (f)* Abatement of any penalty or addition to tax attributable to erroneous written advice by the Internal Revenue Service.
(1) In general. The Secretary shall abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the Internal Revenue Service, acting in such officer's or employee's official capacity.
(2) Limitations. Paragraph (1) shall apply only if--
(A) the written advice was reasonably relied upon by the taxpayer and was in response to a specific written request of the taxpayer, and
(B) the portion of the penalty or addition to tax did not result from a failure by the taxpayer to provide adequate or accurate information.

[119] *26 USCS § 6501(c)(4)(A)* In general. Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

[120] *26 USCS § 6501(c)(4)(B)* Notice to taxpayer of right to refuse or limit extension. The Secretary shall notify the taxpayer of the taxpayer's right to refuse to extend the period of limitations, or to limit such

In India, the statute of limitations cannot be extended at all. Therefore, in cases where the statute of limitations starts running out of time, the tax department issues a demand notice. Once the demand notice is issued, it cannot be withdrawn without going into the rigors of the adjudication process. Similar provisions to extend the statute of limitations by mutual agreement should be incorporated in Indian law. This will reduce litigation. Taxpayers of developing countries should be conferred certain rights to ensure fairness in the proceedings on lines of the American 'Taxpayers' Bill of Rights 1988 and Taxpayers' Bill of Right II 1996'.

4.10 Implementing True VAT and Single VAT

As recently as twenty-five years ago, the VAT existed only in France in a very rudimentary form[121]. But today adoption of VAT has been made a prerequisite for membership in the European community (EC), and it has been adopted in many third-world countries, including India, in some form or other. One of the benefits of VAT is its ability to link forward and backward. If one person in the chain from manufacturing to final consumption stage accounts for the goods any nonpayment of taxes at other stages can be found because it leaves sufficient paper trail. Further under VAT system for evasion of taxes everybody has to be an evader in the chain up to the consumption stage. If a buyer wants an invoice for getting credit then the seller cannot evade taxes. If a seller refuses to raise invoice, the buyer will negotiate with other sellers of the similar goods and services. The VAT System compels people to record transactions because the risk involved in not recording a transaction is much greater.[122] The invoice-method VAT has

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extension to particular issues or to a particular period of time, on each occasion when the taxpayer is requested to provide such consent.

[121] George R. Zodrow And Charles E. Mcclure, Jr.,*Direct Consumption Taxes, 46 Tax L. Rev. 407*

[122] Presume a purchase of $ 100 by a trader with a tax of $16 is being sold after value addition of $50 at a price of $150 where tax liability will be $24. If the trader records the purchase he has to pay tax on final sale. After getting the credit of $16 he has to pay a tax of $8. On the other hand if he does not record the receipt and if he is successful in the evasion, he will be benefited by the evasion of $8. But if he is caught

more revenue advantage than the single-stage retail sales tax (RST) in the sense that, if the final seller does not pay the tax or evade the tax, the revenue is lost, but in the case of VAT, revenue is collected in stages all along the way and therefore non-collection at one stage does not greatly impact revenue.[123] Non-collection of revenue at any stage prior to the last sale stage will lead to more payment of taxes at a subsequent stage. Thus, there is no loss of revenue except the delay in realization. If there is non-collection at the last stage itself, then there is some revenue loss corresponding to value addition at the last stage.

It is now well-established that 'invoice credit VAT'[124] is the best compared to any other form of commodity taxation.[125] It eliminates the cascading effect of taxes by allowing credit for taxes paid earlier, increases tax compliance, which is a great advantage in developing countries,[126] and reduces economic distortion. Therefore complete VAT in its true spirit must be introduced to avoid the cascading effect of taxes and to increase tax compliance.

The Government of India has already introduced VAT for central excise duties (known as CENVAT) but state governments still impose non-VAT sales tax on commodities. Recently, there is a proposal to introduce invoice credit type state VAT at a suggested rate of 12.5% for state sales taxes allowing credit for taxes paid on inputs as well as on

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he has to pay $24 because credit will not be available. So risk involved is three times more in terms of duty apart from imposition of the penalty.

[123] For example trader A sells goods in $100 without paying a VAT of $16 (16%) to trader B who in turn sells it to final consumer C in $150 on which there is a tax liability of $24(16%). Since A has not paid any taxes, B will not get any credit and he will land up paying $24. Had A paid $16, B would have got credit for $16 and paid only $8. In both cases government gets $24 with the difference that when A does not pay taxes, $16 is delayed until B sells the goods. If A pays tax and B does not pay taxes then $8 is lost and government gets only $16.

[124] For a complete analysis of various forms VAT, *see Tax Reform for Fairness, Simplicity, and Economic Growth [Treasury I] United States of Department of the Treasury Vol.3, 5-42(1984)*

[125] *See* Philips D. Oliver, *Tax Policy, 321-389(2nd ed, 2004)*

[126] One view is that countries, which cannot achieve a level of high income tax compliance, depend on the VAT because it is much easier to achieve compliance with the VAT. As it is already discussed the level of compliance in developing economies is very bad and therefore VAT will be a boon in meeting their revenue requirements.

capital goods. Central sales tax will continue at a lower rate of 2% (the present rate is 4%). However, none of the states are agreeing to allow credit on procurements from out-of-state sources, and thus in recent proposals, such taxes are not creditable. But again non-allowing credit for out of state taxes will create distortion in the economy. It will discourage inter-state trade. Further, the proposed state VAT will co-exist with the central VAT, central sales tax on interstate sale, and other local commodities taxes.

The introduction of even proposed VAT is being opposed by states for several reasons. Few states that have high tax rates fear that they will lose revenue if they implement VAT at the suggested rate of 12.5 per cent. At the same time, states with low tax rates apprehend that VAT would raise prices, thereby antagonizing consumers and reducing the popularity of incumbent governments. States with sales tax exemption zones fear loss of investments and widespread litigation on account of the imposition of VAT. The trading community, which is the biggest evader of taxes,[127] is opposing introduction of VAT tooth and nail. Though, introduction of VAT means less tax evasion, and more earning for the states, no political party is showing firm support for VAT due to the powerful lobby of the trading community. The following changes are necessary for an effective and efficient VAT system:

4.10.1 Merging All Commodity Taxes: If VAT co-exists with all other commodity taxes, there would be a cascading 'tax on tax' effect, and the very purpose of imposing VAT would be drastically diluted if not completely negated. . All commodity-based taxes should be merged into one and should be collected by one agency because they have one common base. Taxpayers are not comfortable in dealing with too many tax departments and filing too many returns. After its collection it can be distributed between federal, state, or local bodies the way it is already done in

[127] *Salil Panchal, What is VAT? And why VAT, April 12, 2003,* on http://www.rediff.com/money/2003/apr/12vat.htm,.

the case of duties of excise and income taxes. Alternatively, three creditable taxes can be imposed: 'VAT 1' for central commodity tax, 'VAT 2' for state taxes, and 'VAT 3' for any other local[128] commodity taxes. However, the credit earned on account of these three taxes will be utilized for the discharge of respective categories of VAT.[129]

4.10.2 Uniformity in the Tax Regime: VAT can be successful if, and only if, all of the states adopt uniform laws instead of their individual Acts that treat different product categories differently. There can be a common legislation by the federal government making a provision that the proceeds of state VAT will go directly to the account of jurisdictional states. Without uniformity in the tax regimes, there would be 'cross border' inter-state smuggling from lesser-taxed states to the relatively higher-taxed ones, and the whole concept of neutrality would be lost.

4.10.3 Creditability of Taxes Should Be Unconditional: All commodity taxes, irrespective of their place of payment, should be made creditable. But the states are not comfortable in allowing credit for taxes which were not paid in their jurisdiction, and which has not gone into their treasury. But if they agree for unconditional credit, somewhere they will loose revenue, but somewhere they will gain revenue, and in the long run, it will even out. Nevertheless, if they are not ready for out-of-jurisdiction credit, then out-of-jurisdiction sales or transfers should be treated as an export for state VAT purposes and should be zero-rated[130] because the states have primary jurisdiction to impose tax on sales made within their own jurisdiction. This zero-rating

[128] Federal and state level taxes exist throughout the country and local taxes also exist in most of the cities of India.

[129] Taxpayer will maintain three different credit accounts for VAT 1, VAT 2 and VAT3 and will take credit of input taxes in respective account. The credits in VAT1 account will be utilized for payment of VAT 1 taxes only. Similarly credits in VAT2 account will be utilized for payment of VAT 2 taxes and credits in VAT3 account will be utilized for payment of VAT 3 taxes.

[130] No tax will be charged on out of jurisdiction sale but credit earned on inputs contained in those sales will be available to taxpayers for discharging their tax liability on other products.

system will also not work, because in this situation, buyers will try to buy everything from out-of-state sources to avoid the state VAT, which will lead to distortion of the economy. Out-of-state sale cannot be compared with out-of-country sale for two reasons. First, out-of-country sale gives the home country foreign exchange, which is absent in the case of out-of-state sale; and second; procurement from out-of-country is subjected to import duty,[131] nullifying the zero levy of exporting countries. The import duty cannot be levied on interstate sale or transfer because it will hinder free trade within the country. The import duty also cannot be levied on interstate sale for administrative reasons because state boundaries are not administered in the same way in which national boundaries are administered.

4.10.4 What is the Solution? A better solution would be to allow credit on all procurements of all commodity taxes. Credits can be utilized for discharge of duty liability in the same jurisdiction. While making a sale outside the state, duty in cash (not from credit earned) should be paid in the account head of destination state[132]. In the destination state, the buyer can take credit for this out-of-state procurement, and the state will not have any objection because the tax for which credit is claimed has been paid into the treasury of that state. The state of the seller does not get revenue because consumption is taking place outside its boundaries and at the same time, the state of the seller allows credit on inputs that went into this out-of-state sale, which will be utilized by the seller on other sales in the state. This is also logical because those inputs are contained in products, which are not consumed in the state, and therefore the state is not entitled to taxes on those inputs and any tax paid earlier should be either refunded or allowed as a credit.

[131] Almost in all countries the effective import duty is more than the incidence of domestic duties on similar items manufactured in the home country. For the same source price net of taxes the final price for imported goods are more on account of higher freight and higher taxes. Imported goods compete in domestic market either on account of better quality or lower source price or both.

In the event any seller is not able to utilize the credit earned[133], he should be given a refund of the credit accumulated but not utilized. Existing state sales taxes on sale within the state and central sales tax on interstate sale should be replaced by uniform state VAT throughout the country. In this system there is no incentive for cross-border smuggling or cross-border sale, and thus there is no distortion of the economy.

4.11 Systematic Publication of Codes and Regulations

In the United States, all codes and regulations are published in a systematic way. There is a common citation format for all acts. Acts are divided into titles, and sections are embedded in each title. For example, the Internal Revenue Code is under Title 26. The regulation number reflects the corresponding section under which it is issued.[134] In India, there is no title number for the code. The regulations known as 'notifications and circulars' in India have their own numbering system, from which it is difficult to find the corresponding section under which they have been issued. If a person wanted to know whether there is a regulation issued under a particular section, he would have to search independently through all available material and still could not be sure whether he missed some regulation, because regulations are listed in chronological order. Since there is no official publication of combined regulations, it is especially difficult to know (especially with old regulations) which regulations are in force, and which have been repealed. The codes and regulations should be numbered and published the way that United States codes and regulations are published for better clarity.

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[132] In India at present all taxes are deposited in banks on treasury vouchers. State governments as well as federal government have got their own account. Within the account they have got different account heads for different type of taxes.

[133] For example, a seller who sells only to out of state buyers will not be able to utilize the credits and should be given refund for credit earned.

[134] For example regulation issued under 26 *USCS § 1245* of the code will be numbered as *Reg. § 1.1245*

4.12 Fixed Tenure of Tax Officials

Under the Internal Revenue Service (IRS) Restructuring and Reform Acts 1998, the Commissioner, the head of the American IRS was given a fixed term of five years with a possibility of extension for another five years to provide continuity and to minimize political interference. Earlier commissioner was having a term of four years which was extended to five years so that commissioner would not be threatened by a new US president coming into office. But in India, the head of the Indian Revenue Service (IRS) has no fixed tenure, and at times, it is as low as three months. In such a scenario, the head of service is hardly able to contribute anything. In order to allow senior tax officials time to understand the organization and operations of the department, and to master mammoth requirements of the job, the government must give them fixed tenure. Especially the three senior-most officers of the tax department, namely, the Revenue Secretary and Chairmen of the Central Board of Direct Taxes (CBDT) and the Central Board of Excise and Customs (CBEC) should have a minimum tenure of five years to allow them to work on a long-term vision for the department.

CHAPTER 5

REVAMPING THE DISPUTE RESOLUTION SYSTEM

"Justice delayed is justice denied."

5.1 The Present System

In the interest of simplicity, this paper will focus on the dispute resolution system of central excise cases. The dispute resolution systems of other taxes are the same with minor variations. Cases involving non-payment or short payment of taxes are investigated by jurisdictional officers who have the power to issue summons for appearance and production of documents, as well as authority to record statements.[135] After the enquiry, if the officers conclude that duty has been short-paid or not paid, they issue a demand notice[136] to the taxpayer, requiring him to explain his case to an adjudicating authority. The officer or group of officers in charge of the investigation determines whether a demand notice will be issued. The statutory limit for issuing a demand notice is one year in normal cases and five years in cases involving fraud.[137] Once a demand

[135] *Central Excise Act 1944 (India),* chapter III deals with powers of central excise officers.

[136] A demand notice is a statutory document which starts proceedings for the assessment of deficiency, much like the US notice of deficiency under *26 USCS § 6212.*

[137] *Central Excise Act 1944 (India), § 11A.* Recovery of duties not levied or not paid or short-levied or short-paid or erroneously refunded.- (1) When any duty of excise has not been levied or paid or has been short-levied or short-paid or erroneously refunded, whether or not such non-levy or non-payment, short levy or short payment or erroneous refund, as the case may be, was on the basis of any approval, acceptance or assessment relating to the rate of duty on or valuation of excisable goods under any other provisions of this Act or the rules made there under, a Central Excise Officer may, within one year from the relevant date, serve notice on the person chargeable with the duty which has not been levied or paid or which has been short-levied or short-paid or to whom the refund has erroneously been made, requiring him to show cause why he should not pay the amount specified in the notice:
Provided that where any duty of excise has not been levied or paid or has been short-levied or short-paid or erroneously refunded by reason of fraud, collusion or any willful mis-statement or suppression of facts, or contravention of any of the provisions of this Act or of the rules made there under with intent to evade

notice is issued, it will be adjudicated by departmental officers (see Table 18). Most of the time, the officers are the same who investigated the case[138]. Further, during the same period, these officers are entrusted with the executive task of revenue collection as well as the adjudication of disputes in their jurisdiction. This appears to be a violation of the principle of natural justice, which advises that no person should be a judge in his own case but the department has taken a stand that when these officers adjudicate, at that point of time, they do not act as executive revenue officers, rather they act as quasi-judicial authorities, and thus the principle of natural justice is not violated. The Supreme Court of India has upheld this argument in numerous decisions[139].

These departmental officers, after receiving written submissions from the taxpayer and giving the taxpayer an opportunity for a personal hearing, pass a reasoned, speaking and appealable order. The orders of all officers below the rank of Commissioner may be appealed with the Commissioner (appeals)[140]. The Commissioner (appeals), with no executive functions related to revenue, is a departmental officer, who is assigned the task to decide cases in appeals. However, very frequently Commissioners (appeals) are transferred to executive

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payment of duty, by such person or his agent, the provisions of this sub-section shall have effect, as if, for the words "one year", the words "five years" were substituted.

[138] When the officer who booked the case gets transferred, then the new person who takes charge, decides the case. Further, there is a directorate for investigation only. After issuing demand notices by this directorate, the cases are transferred to different authorities for adjudication.

[139] The adjudication orders of departmental officers are judged by the reasoning given in orders and at present are not challenged on the ground that they are decided by the same departmental officers who issued the demand notice. See *M/s. G.T.C. Industries Limited, Bombay v. Union of India, 2003, SOL Case No. 232 (Supreme Court of India)*

[140] *Central Excise Act 1944 (India) § 35*. Appeals to Commissioner (Appeals): - (1) Any person aggrieved by any decision or order passed under this Act by a Central Excise Officer, lower in rank than a Commissioner of Central Excise, may appeal to the Commissioner of Central Excise (Appeals) hereafter in this Chapter referred to as the Commissioner (Appeals) within sixty days from the date of the communication to him of such decision or order:

Provided that the Commissioner (Appeals) may, if he is satisfied that the appellant was prevented by sufficient cause from presenting the appeal within the aforesaid period of sixty days, allow it to be presented within a further period of thirty days.

Table 18: Adjudication Powers of Central Excise Officers in India
(US $ 1= Rs 45)

<table>
<tr><td>(A)</td><td>All cases involving fraud, collusion, any willful misstatement, suppression of facts, or contravention of Central Excise Act/ Rules made there under-with intent to evade payment of duty and / or where extended period has been invoked in show-cause-notices, (including CENVAT cases, will be adjudicated by:-</td></tr>
<tr><td></td><td><table>
<tr><th>Central Excise Officers</th><th>Powers of Adjudication
(Amount of duty involved)</th></tr>
<tr><td>Commissioners</td><td>Without limit</td></tr>
<tr><td>Additional Commissioners</td><td>Up to Rs. 2000 thousands</td></tr>
<tr><td>Joint Commissioners</td><td>Up to Rs. 1000 thousands</td></tr>
</table></td></tr>
<tr><td>(B)</td><td>Cases which do not fall under the category (A) above, will be adjudicated as follows:-</td></tr>
<tr><td></td><td><table>
<tr><th>Central Excise Officers</th><th>Powers of Adjudication
(Amount of duty involved)</th></tr>
<tr><td>Commissioners</td><td>Without limit</td></tr>
<tr><td>Additional /Joint Commissioners</td><td>Above Rs. 200 thousands and
up to Rs. 2000 thousands</td></tr>
<tr><td>Deputy/Assistant
Commissioners</td><td>Up to Rs. 200 thousands.</td></tr>
</table></td></tr>
<tr><td>(C)</td><td>Cases related to issues mentioned under first proviso to Section 35B(1) of Central Excise Act, 1944 would be adjudicated by the Addl. Commissioners/ Joint Commissioners without any monetary limit.</td></tr>
<tr><td>(D)</td><td>The Deputy/Assistant Commissioner of Central Excise without any monetary limit will adjudicate all cases relating to determination of classification and valuation.</td></tr>
</table>

Source: Central Excise Manual, Chapter 13, Part II, Paragraph 2.1

positions in the revenue department. The Commissioner (appeals) and other departmental officers are quasi-judicial authorities who have to follow principles of natural justice, but they are not strictly bound by the Civil Procedure Code[141] and the Evidence Act[142] in their proceedings. Any person, who is authorized by the taxpayer,[143] may appear before these officers; and as such no specific qualifications are required. However, appearance by lawyers, charter accountants, cost accountants, and retired departmental officers is most common. The aggrieved parties, taxpayer or department, may file an appeal against the orders of executive commissioner as well as commissioner (appeals) in the Customs, Excise and Service Tax Appellate Tribunal (CESTAT),[144] which is a statutory body established by an act of parliament. [145] The CESTAT has various benches comprising of technical members drawn from the revenue service and judicial members drawn from regular judicial services. Technical members must resign from the revenue service before joining CESTAT. The functioning of CESTAT is independent of the revenue department, much like American Tax Courts. If a question of law is involved, then a reference application[146] may be made to a jurisdictional High Court by CESTAT itself, before deciding the

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[141] *Code of Civil Procedure 1908 (India)*

[142] *Indian Evidence Act 1962 (India)*

[143] *Central Excise Act 1944 (India) § 35Q.* Appearance by authorized representative.- (1) Any person who is entitled or required to appear before a Central Excise Officer or the Appellate Tribunal in connection with any proceedings under this Act, otherwise than when required under this Act to appear personally for examination on oath or affirmation, may, subject to the other provisions of this section, appear by an authorized representative.

[144] *Central Excise Act 1944 (India) § 35B.* Appeals to the Appellate Tribunal.- (1) Any person aggrieved by any of the following orders may appeal to the Appellate Tribunal against such order—
(a) a decision or order passed by the Commissioner of Central Excise as an adjudicating authority;
(b) an order passed by the Commissioner (Appeals) under section 35A;

[145] In the case of income tax, the appellate tribunal is known as the Income Tax Appellate Tribunal (ITAT), which is also a statutory body, established by an act of parliament.

[146] *Central Excise Act 1944 (India) § 35H.* Application to High Court. - (1) The Commissioner of Central Excise or the other party may, within one hundred and eighty days of the date upon which he is served with notice of an order under section 35C passed on or after the 1st day of July, 1999 (not being an order relating, among other things, to the determination of any question having a relation to the rate of duty of

case. After receiving the determination on the legal point by the High Court, CESTAT will decide the case. Aggrieved parties may also make a reference application to a High Court on a question of law after receipt of CESTAT order. In this case, CESTAT will modify its order if the High Court reaches a different conclusion on the question of law, than the one taken by CESTAT. In all other cases, appeals lies to the Supreme Court of India by special leave.[147]

Taxpayers also may file a writ petition to a High Court under article 226[148] of the Constitution for violation of their fundamental rights as well as legal rights; and under article 32[149] they may file a writ petition to the Supreme Court of India for violation of their fundamental rights alone. Taxpayers have increasingly utilized article 226 and filed writ petitions in High Courts on the grounds of violation of their legal rights at all stages of disputes, including

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excise or to the value of goods for purposes of assessment), by application in the prescribed form, accompanied, where the application is made by the other party, by a fee of two hundred rupees, apply to the High Court to direct the Appellate Tribunal to refer to the High Court any question of law arising from such order of the Tribunal.

[147] *Central Excise Act 1944 (India) § 35L.* Appeal to the Supreme Court. An appeal shall lie to the Supreme Court from—

(a) any judgment of the High Court delivered on a reference made under section 35G or section 35H in any case which, on its own motion or on an oral application made by or on behalf of the party aggrieved, immediately after the passing of the judgment, the High Court certifies to be a fit one for appeal to the Supreme Court; or

(b) any order passed by the Appellate Tribunal relating, among other things, to the determination of any question having a relation to the rate of duty of excise or to the value of goods for purposes of assessment.

[148] *India Const. Art. 226*. Power of High Courts to issue certain writs. - (1)

Notwithstanding anything in article 32 every High Court shall have power, throughout the territories in relation to which it exercises jurisdiction, to issue to any person or authority, including in appropriate cases, any Government, within those territories directions, orders or writs, including writs in the nature of habeas corpus, mandamus, prohibition, quo warranto and certiorari, or any of them, for the enforcement of any of the rights conferred by Part III and for any other purpose.

[149] *India Const. Art. 32.* Remedies for enforcement of rights conferred by this Part. - (1) The right to move the Supreme Court by appropriate proceedings for the enforcement of the rights conferred by this Part is guaranteed.

(2) The Supreme Court shall have power to issue directions or orders

or writs, including writs in the nature of habeas corpus, mandamus, Prohibition, quo warranto and certiorari, whichever may be

Appropriate, for the enforcement of any of the rights conferred by this Part.

the stage prior to issuance of demand notice. The jurisdiction of civil courts lower than the High Courts is barred in taxation disputes[150].

To reduce the burden of the High Courts, the government introduced the National Tax Tribunal (NTT) Bill in the parliament on December 8, 2003, for the establishment of the NTT, which will hear cases involving 'substantial questions of law' arising from orders passed in appeal by the Income-Tax Appellate Tribunals (ITAT) and the Customs, Excise and Service Tax Appellate Tribunals (CESTAT)[151]. The Bill proposes to set up fifteen NTT benches for direct tax issues and ten benches for indirect tax matters, which, the government felt, would be enough to ensure rapid disposal of cases transferred from the High Courts. A Chairperson, who had held the post of a Supreme Court Judge or High Court Chief Justice, would head the NTT. Each NTT bench would have a judicial member and a technical member.

[150] All taxation statutes provide for special departmental procedures and appellate tribunals. The courts which can be approached are mentioned very clearly in these taxation statutes.

[151] *Tax tribunal Bill tabled in Lok Sabha, December 9,2003 Business Line (internet edition)* at http://www.blonnet.com/2003/12/09/stories/2003120902450300.htm

5.2 The Problems of the Present System

5.2.1 Huge Arrears of Revenue: Under the Central Excise Act 1944[152], taxpayers desirous of filing an appeal must deposit the duty or penalty imposed with the department before filing the appeal. The deposit may be claimed as a refund under section 11B[153] of the Central Excise Act if the appellate authority decides in favor of the taxpayer. However, the Tax Department has never insisted on conditions of deposit, and appellate authorities have very liberally granted stays on deposition of duty, penalty etc. Probably this was on account of an indirect acceptance of the fact by the department that departmental officers are confirming demands, which should not have been confirmed. This system of stays on confirmed demands has resulted in huge uncollected arrears of revenue. There are long delays in dispute resolution. No time limits for the disposal of disputes are fixed either for the departmental adjudicating officers or for the courts. Recently, however, the revenue department issued guidelines to departmental officers to adjudicate cases

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[152] *Central Excise Act 1944 (India) § 35F.* Deposit, pending appeal, of duty demanded or penalty levied.- Where in any appeal under this Chapter, the decision or order appealed against relates to any duty demanded in respect of goods which are not under the control of central excise authorities or any penalty levied under this Act, the person desirous of appealing against such decision or order shall, pending the appeal, deposit with the adjudicating authority the duty demanded or the penalty levied:
Provided that where in any particular case, the Commissioner (Appeals) or the Appellate Tribunal is of opinion that the deposit of duty demanded or penalty levied would cause undue hardship to such person, the Commissioner (Appeals) or, as the case may be, the Appellate Tribunal, may dispense with such deposit subject to such conditions as he or it may deem fit to impose so as to safeguard the interests of revenue.
Provided further that where an application is filed before the Commissioner (Appeals) for dispensing with the deposit of duty demanded or penalty levied under the first proviso, the Commissioner (Appeals) shall, where it is possible to do so, decide such application within thirty days from the date of its filing.
Central Excise Act 1944 (India) § 35N. Sums due to be paid notwithstanding reference, etc.- Notwithstanding that a reference had been made to the High Court or the Supreme Court or an appeal has been preferred to the Supreme Court, sums due to the Government as a result of an order passed under subsection (1) of section 35C shall be payable in accordance with the order so passed.

[153] *Central Excise Act 1944 (India) § 11B.* Claim for refund of duty.-
(1) Any person claiming refund of any duty of excise may make an application for refund of such duty to the Assistant Commissioner of Central Excise or Deputy Commissioner of Central Excise before the expiry of one year from the relevant date in such form and manner as may be prescribed and the application shall be accompanied by such documentary or other evidence (including the documents referred to in section 12A) as the applicant may furnish to establish that the amount of duty of excise in

within one year as far as possible. Similarly the commissioner (appeals) should decide each appeal within a period of six month.[154] The incorporation of the words 'where it is possible to do so' and 'as far as possible' nevertheless negate the entire guidelines and the time limits are never followed. In the Indian court system, it takes an average of ten to twelve years before a judgment reaches finality. In many cases, it has taken more than twenty years. The result is that, when an arrear is ripe for collection in the absence of stays, the taxpayer becomes non-traceable or insolvent, and in the case of corporations, the corporation closes or becomes insolvent, and collection becomes impossible.

5.2.2 Huge Number of Litigation and Question of Fairness: The dispute resolution system at the lower level is not fair at all. Revenue officers adjudicating the cases are biased in favor of the tax department. By the time a case reaches an impartial authority, it is too late. Revenue officers confirm most of the demand notices because of one or several of the following reasons:

(i) To meet revenue targets.

(ii) To show that the taxpayer was at fault, and they are not at fault. If they drop a demand on the grounds that there are no significant charges, or tax department officials were at fault, or the investigation was improper, then enquiry will be started against them. It is to be noted here that the same officer who is adjudicating the case, often investigated the case.

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relation to which such refund is claimed was collected from, or paid by, him and the incidence of such duty had not been passed on by him to any other person:

[154] *Central Excise Act 1944 (India), § 35A(4A)* The Commissioner (Appeals) shall, where it is possible to do so, hear and decide every appeal within a period of six months from the date on which it is filed.(the use of word 'every' is rendered meaningless by the use of phrase 'where it is possible to do so')

(iii) They are also human beings. They are the officers who have issued the demand notice, and it is very difficult for them to conclude that they were wrong at the time of issuance of the demand notice.

(iv) To save their skin: Many officers think that if they decide in favor of the department, no enquiry will be initiated against them, irrespective of the quality of the order. If they decide against the government, however, their order will be scrutinized in terms of their knowledge, and also there may be an allegation of bribery and bias for the taxpayer.

(v) The officers also have some indirect and informal pressure from their superiors to confirm the notices. The orders of departmental officers are reviewed administratively by their superiors, who decide whether department is aggrieved by the order. The task of superior officers becomes very easy, if adjudicating officer decides in favor of tax department.

The result is unnecessary litigation and a waste of time for the taxpayer as well as for the tax department. Superior appellate authorities moreover reverse 90% of the orders of departmental officers. The whole process costs time and money, as well as other hassles and torture.

5.3 The Needed Changes

5.3.1 Resolving Disputes within the Tax Department (Administrative Settlement): In the United States, the tax department and the taxpayer try to resolve the dispute administratively. Before issuing any notice of deficiency, a non-statutory letter known as the 30-day letter or preliminary notice of deficiency is issued. This 30-day letter does not stop the running of the statute of limitations and is not required by the Internal Revenue Code (IRC). It gives a fair idea of the grounds on which extra tax is being demanded. It gives the following options to taxpayers:

(i) If they agree to the IRS proposed changes in their assessment, they should sign Form 870, agreeing to the tax liability. Either on their own or with the help of an IRS officer, they can calculate the liability and pay the entire amount at once or work out various payment options.

(ii) In case they do not agree to the contents of 30-day letter, they can schedule an appointment and discuss their case with a pre-assigned officer of the examination department who has scrutinized their case.

(iii) If a taxpayer does not come to a conclusion even after discussing the case with an officer of the examination department, then he can schedule an appeal with the appeal office of the IRS, which functions independently of the examination department. In appeal, an officer who was not involved with the examination of the case considers the case. This ensures an impartial discussion and fairness in the proceedings.

(iv) If the taxpayer and department do not reach a conclusion or the taxpayer is not interested in an administrative procedure, a statutory notice of deficiency will be issued which will toll the statute of limitations and vest jurisdiction in the Tax Court.

The result of this independent appeal process is a settlement rate of 85% to 95% in appeals. Unlike the United States, in India before issuance of the notice of deficiency, independent officers do not discuss the case. Officers who took the objection first are always biased and the result is issuance of a demand notice in most cases where objections are taken, which leads to unnecessary litigation. In order to reduce litigation and encourage informal settlement of cases without resorting to courts, a similar administrative appeal process should be established in India.

5.3.2 Resolving Disputes outside the Tax Department (Tax Court[155]): In the United States, if the issue is not resolved administratively, a notice of deficiency is issued and the case is decided by the Tax Court which is a specialized court to deal with the tax related matters. The Tax Court primarily has a deficiency jurisdiction and incidental refund jurisdiction. Therefore, in order to go to Tax Court, a taxpayer need not pay the deficiency amount. A taxpayer may go to Tax Court soon after the receipt of a notice of deficiency under section 6212 of the code and within a period of ninety days. The Tax Court functions as a quasi-judicial authority independent from the tax department and decides cases in a free and fair manner. In India, even after issuance of the notice of deficiency, the next two stages are presided over by the departmental officers, who function more like revenue officers and less like judicial authorities. Like the United States, adjudication of cases after issuance of the demand notice should be made independent from the tax department.

5.3.3 Access to Courts Other Than the Tax Court: In the United States, a taxpayer may approach the Tax Courts without depositing the deficiency amount. However, access to other courts is conditioned upon full payment of the deficiency assessed[156], because courts other than the Tax Court have refund jurisdiction. The taxpayer must pay the tax demanded, and if he or she feels that taxes have been overpaid, he should first seek refund with the tax department,[157] and on refusal, he may file a case for refund in a United States District Court or a United States Court of

[155] The United States Tax Court was created under the Revenue Act of 1924 as an independent agency of the Executive Branch. In 1969 it was made an Article I legislative court of record within the federal judicial system.

[156] *Flora v. United States, 362 U.S. 145*

[157] *26 USCS § 7422 (a)* No suit prior to filing claims for refund. No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

Federal Claims. American courts have held that there is no hardship exception to the full payment requirement.[158] In China, a taxpayer has to pay the entire tax before litigating in a court of law[159]. Though in India access to regular courts is somewhat restricted and lower courts cannot entertain cases of tax evasion, taxpayers frequently approach the High Courts in their writ jurisdiction the moment the demand notice is issued, sometimes even before the issuance of the demand notice as a preemptive measure. Since High Courts are not comfortable with tax matters, in order to dispose the matter without going into the merits of the case, they grant stays, remand cases to the tax authorities and further complicate the matter. In the process, cases and consequently the amount involved in dispute remain pending for years. Many times, cases reach the Supreme Court without payment of the taxes involved.

Once Tax Courts are made independent, then on the United States pattern, access to other courts can be made conditional upon full payment of the disputed amount without any exception. This will reduce the arrears of revenue blocked in litigation and will make recovery possible.

5.3.4 Provisions for Recovery of the Cost: United States law provides recovery of costs in three different ways in a Tax Court proceeding. First, a payment to the United States by the taxpayer if the taxpayer's position in such proceedings is found frivolous or groundless and the taxpayer failed to pursue available administrative remedies[160]. Second, a payment by counsel

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[158] *Curry v. United States, 774 F.2d 852 (U.S. App., 1985)*

[159] Jiyan Li, *Taxation in People's Republic of China (1990)*

[160] *26 USCS § 6673(a)(1)* Procedures instituted primarily for delay, etc. Whenever it appears to the Tax Court that—

(A) proceedings before it have been instituted or maintained by the taxpayer primarily for delay,

(B) the taxpayer's position in such proceeding is frivolous or groundless, or

(C) the taxpayer unreasonably failed to pursue available administrative remedies,

the Tax Court, in its decision, may require the taxpayer to pay to the United States a penalty not in excess of $ 25,000.

appearing on behalf of a taxpayer, in his personal capacity, if it appears to the Tax Court that the attorney or other person admitted to practice has multiplied the proceedings unreasonably[161]. Third, by United States government in case of an attorney appearing on behalf of the Commissioner of the Internal Revenue Service, if it appears to the Tax Court that the attorney or other person admitted to practice has multiplied the proceedings unreasonably[162]. In courts other than the Tax Court a payment not in excess of US$ 10,000 may be awarded to the United States by the taxpayer if the taxpayer's position in such proceeding is found frivolous or groundless[163].

Further, under section 7430 of the code, the prevailing party may be awarded reasonable administrative costs incurred in connection with the administrative proceedings within the Internal Revenue Service and reasonable litigation costs incurred in connection with court proceedings[164]. However, the taxpayer's recovery of the cost is subject to a

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[161] *26 USCS § 6673(a)(2)* Counsel's liability for excessive costs. Whenever it appears to the Tax Court that any attorney or other person admitted to practice before the Tax Court has multiplied the proceedings in any case unreasonably and vexatiously, the Tax Court may require--
(A) that such attorney or other person pay personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct

[162] *26 USCS § 6673(a)(2)* (2) Counsel's liability for excessive costs. Whenever it appears to the Tax Court that any attorney or other person admitted to practice before the Tax Court has multiplied the proceedings in any case unreasonably and vexatiously, the Tax Court may require-
(B) if such attorney is appearing on behalf of the Commissioner of Internal Revenue, that the United States pay such excess costs, expenses, and attorneys' fees in the same manner as such an award by a district court.

[163] *26 USCS § 6673(b)(1)* Claims under section 7433. Whenever it appears to the court that the taxpayer's position in the proceedings before the court instituted or maintained by such taxpayer under section 7433 is frivolous or groundless, the court may require the taxpayer to pay to the United States a penalty not in excess of $ 10,000.

[164] *26 USCS § 7430(a)* In general. In any administrative or court proceeding which is brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, the prevailing party may be awarded a judgment or a settlement for—
reasonable administrative costs incurred in connection with such administrative proceeding within the Internal Revenue Service, and
(2) reasonable litigation costs incurred in connection with such court proceeding.

further condition that the taxpayer has exhausted the administrative remedies available within the IRS[165].

This system of cost recovery puts sufficient pressure on the IRS, taxpayers, and practitioners alike for not going in unnecessary litigation. In India, the recovery of costs from the government is extremely rare. The recovery of costs from practitioners is impossible. The revenue department in India goes for a lot of unnecessary litigation. Sometimes officers of the revenue department for their personal ego issue demand notices and file appeal against orders entered in favor of taxpayers. The similar recovery provisions should be incorporated in the laws of all developing countries to promote better accountability of tax officials, taxpayers, and tax practitioners. This will discourage officers from going into unnecessary litigation.

[165] *26 USCS § 7430(b)(1)* Requirement that administrative remedies be exhausted. A judgment for reasonable litigation costs shall not be awarded under subsection (a) in any court proceeding unless the court determines that the prevailing party has exhausted the administrative remedies available to such party within the Internal Revenue Service. Any failure to agree to an extension of the time for the assessment of any tax shall not be taken into account for purposes of determining whether the prevailing party meets the requirements of the preceding sentence.

CHAPTER 6

CONCLUSION

Developing countries face many kinds of problems and challenges in the colossal task of tax collection. First, these countries have difficulties in identifying surpluses in the economy on account of their low GNP, low rate of capital formation, poverty, unemployment, higher population density, etc. Second, their chances of tax collection is further diminished on account of predominantly cash transactions with no trails, a huge black economy, and rampant tax evasion. Third, there is a lack of political will power to collect revenues that results in a narrow tax base on account of a number of politically motivated tax exemptions and deductions.

Citizens and taxpayers in developing countries also suffer in many ways. First, there is less development because of a paucity of funds with the government and corruption in higher places. Second, with the predominance of regressive indirect taxes, the poorer section of society has to sacrifice a bigger share of income in taxes compared to richer persons of society. Further, taxpayers suffer greatly on account of absence of a fair dispute resolution system.

To deal with this situation, governments of these countries must take steps to widen their tax base and to reduce the black economy, thereby reducing tax avoidance and tax evasion. In order to reduce the black economy and tax evasion, all citizens of these countries must be issued a universal identification number, much like the United States social security number, to keep track of their transactions. Currency of higher denominations must be withdrawn and income from all sources should be made taxable. The governments must show

will power to collect taxes by withdrawing all popular and politically motivated exemptions. Larger taxpayers and their tax avoidance motives need to be closely monitored. The officers of the tax department and other senior politicians and officials should be held to higher standards of tax compliance. Codes and regulations must be simplified to permit better understanding and better tax compliance by taxpayers. A single comprehensive VAT should replace all commodity taxes. Officials of the tax department should be given fixed tenure in every charge, during their good behavior and their frequent transfers (at times in less than three months) should be done away with.

Last, but not least, the dispute resolution system in these countries must be modernized, and structural changes must be made for fair and speedy disposal of disputes. Taxpayers who contribute to the nation, must be treated fairly, and must be conferred certain basic rights in investigation of cases of tax evasion against them, following procedures established in the United States Taxpayer Bill of Rights 1988 and 1996. Taxpayers as well as government should be awarded the cost of litigation in case of frivolous and groundless claims of the other party.

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