Taxation

Topics Covered

- ***Definitions***
- ***Cess and Surcharge***
- ***Classification of Taxes***
- ***Direct and Indirect Taxes***
- ***Different Taxes***
- ***Problems in Taxation***
- ***Problems related to Direct taxes***
- ***Problems related to Indirect Taxes***
- ***Cascading effect, Lack of Common Market***
- ***VAT and GST***
- ***Tax Avoidance and Tax Evasion***
- ***Reasons for low Tax to GDP Ratio in India***
- ***Other Important Taxes***

Taxes are levied by governments on their citizens to generate income for undertaking projects to boost the economy of the country and to raise the standard of living of its citizens.

The authority of the government to levy tax in India is derived from the Constitution of India, which allocates the power to levy taxes to the Central and State governments.

All taxes levied within India need to be backed by an accompanying law passed by the Parliament or the State Legislature. Taxes are the largest source of income for the government.

Difference between tax and fee

- A tax is a compulsory payment levied on the persons or companies, to meet the expenditure incurred on conferring common benefits upon the people of a country.
- Fee is also a compulsory payment made by a person, who receives in return, a particular benefit or service from the government.

Tax Base: A tax base is a total amount of assets or income that can be taxed by a taxing authority, usually by the government. The aggregate value of the financial streams or assets on which tax can be imposed. In the case of income tax, for instance, the tax base is determined by what the tax authorities state as the minimum amount of annual income that can be taxed (taxable income).

If this minimum amount (tax threshold) is lowered, this will automatically increase (widen) the tax base; if it is raised, the tax base will be narrowed.

Tax Incidence: It shows the entity or person on whom the tax is imposed.

Tax Burden: It means who actually pay taxes or from whom tax is collected.

Tax Incidence vs Tax Burden: Suppose if government increases service tax on restaurants, restaurants may absorb it if competition is intense or pass it on to consumers. Here incidence is on restaurants. If they absorb it and pays it then the burden is also on the restaurants. Or if the restaurants pass that additional tax burden on to consumers then the burden is the consumers.

Tax Expenditure: Tax Expenditures, as the word might indicate, does not relate to the expenditures incurred by the Government in the collection of taxes.
Rather it refers to the opportunity cost of taxing at concessional rates, or the opportunity cost of giving exemptions, deductions, rebates, deferrals credits etc. to the tax payers.
Tax expenditures indicate how much more revenue could have been collected by the Government if not for such measures. In other words, it shows the extent of indirect subsidy enjoyed by the tax payers in the country.

Tax Elasticity: It refers to changes in tax revenue in response to changes in tax rate. For example, how tax revenue changes if the government reduces corporate income tax from 30 per cent to 25 per cent indicate tax elasticity.

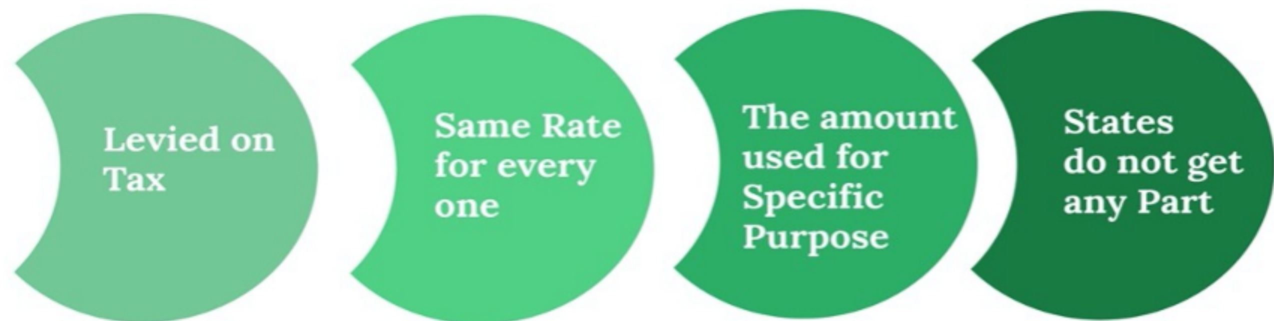
Tax Buoyancy: It explains this relationship between the changes in government's tax revenue growth and the changes in GDP. It refers to

the responsiveness of tax revenue growth to changes in GDP. When a tax is buoyant, its revenue increases without increasing the tax rate.

Cess and Surcharge

A **Cess** imposed by the central government is a tax on tax, levied by the government for a specific purpose. Generally, cess is expected to be levied till the time the government gets enough money for that purpose. It is different from the usual taxes like excise duty and personal income tax as it is imposed as an additional tax besides the existing tax (tax on tax).

For example, the education cess of 3% on personal income tax of 30% is imposed as a tax on the prevailing 30%. As a result, the total tax rate goes up to 30.9% (30% basic rate + 3% (cess) of the 30%).



Another difference between cess and the usual tax is the way in which tax revenue from cess is kept. Revenue from main taxes like Personal Income taxes are kept at Consolidated Fund of India (CFI). The government can use it for any purposes.

But the tax revenue from Cess are first credited to the CFI and the Central Government may, after due appropriation made by Parliament, utilise the money for the specified purposes.
For example, the proceeds are kept as Central Road Fund (CRF) in the case of fuel cess (on petrol and diesel). The revenue collected is initially credited to the CFI and after adjusting for the cost of collection, Parliament through its appropriation bill, credits such proceeds to the Central Road fund.

‘*Surcharge*’ is an additional charge or tax levied on an existing tax. Unlike a cess, which is meant to raise revenue for a temporary need, surcharge is usually permanent in nature. It is levied as a percentage on the income tax payable as per normal rates.

Currently, wealthy individuals and companies are liable to pay a surcharge on their tax outgo. Individuals earning a taxable income of over 1 crore have to shell out a surcharge amounting to 15 per cent of their tax outgo. So, if your taxable income is 1.2 crore, your income tax payable works out to 34.25 lakh. The 15 per cent surcharge will be computed on this amount, at 5.13 lakh. Thus, the total tax payable is 39.38 lakh without including cess.

Some Examples of Cess and Surcharge:

CESSES INDIA PAYS

Education cess on imported goods

Secondary and higher education cess on imported goods

Cess on crude petroleum oil

Road cess on petrol

Road cess on high speed diesel oil

Special Additional Duty of Excise on petrol

National Calamity Contingent Duty (NCCD) on tobacco and tobacco products and crude oil

Education Cess:

Education cess is a tax in India primarily introduced to help cover the cost of government-sponsored educational programs. This cess is collected independently of other taxes and is applicable to all Indian citizens, corporations, and other people living in the country. income.

Swachh Bharat Cess: This is a cess imposed by the government of India and was started from 15 November 2015. It is collected to the Consolidate Fund of India and will be used to funding and promoting any government campaigns concerning the Swachh Bharat initiatives.

Krishi Kalyan Cess: This is yet another cess brought about by the government of India since the June of 2016. It is basically introduced in

order to extend welfare to all the farmers and to the improvement of agricultural facilities in the country.

Infrastructure Cess: Infrastructure cess is another tax brought into effect from the 1st of June 2016. Under this tax, a cess of 1% is applicable on petrol/LPG/CNG-driven motor vehicles which are 4 meters or less in length and 1200cc or less in engine capacity.

SHE Cess: SHE Cess means Secondary and Higher Education Cess . The cess is levied in two parts, the first being the Primary Education Cess and the second being the Secondary and Higher Education Cess. This cess is a part of income tax and is governed by the IT Act. The rate of the education cess is announced by the government when the budget is announced for the year.
The rate at which education cess is calculated is actually a combination of the two types of cess applied on the taxable income. For the education cess the rate is 2% of the tax payable and for the Secondary and Higher Education Cess the rate is 1% of the tax payable. Together they form the education cess rate of 3% of the tax payable.

Tax Deduction at Source: TDS stands for 'Tax Deducted at Source'. It was introduced to collect tax at the source from where an individual's income is generated. The government uses TDS as a tool to collect tax in order to minimise tax evasion by taxing the income (partially or wholly) at the time it is generated rather than at a later date.
TDS is applicable on the various incomes such as salaries, interest received, commission received etc. TDS is not applicable to all incomes and persons for all transactions. TDS works on the concept that every person making specified type of payments to any person shall deduct tax at the rates prescribed in the Income Tax Act at source and deposit the same into the government's account.

The person who is making the payment is responsible for deducting the tax and depositing the same with government. This person is known as ‘deductor. On the other hand, the person who receives the payment after the tax deduction is called ‘deductee’.

Finance Commission:

Finance Commission is a constitutional body for the purpose of allocation of certain revenue resources between the Union and the State Governments. It was established under Article 280 of the Indian Constitution by the Indian President. It was created to define the financial relations between the Centre and the states. It was formed in 1951.

Article 280 of the Indian Constitution

- President after two years of the commencement of Indian Constitution and thereafter every 5 years, has to constitute a Finance Commission of India.
- It shall be the duty of the Commission to make recommendations to the President in relation to the:
    - The distribution between the Union and the States of the net proceeds of taxes which are to be, or maybe, divided between them and the allocation between the States of the respective shares of such proceeds;
    - The principles which should govern the grants in aid of the revenues of the States out of the Consolidated Fund of India;
    - Any other matter referred to the Commission by the President in the interests of sound finance
    - The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them

Note: President can also constitute Finance Commission before the expiry of five years as he considers necessary.

Q) With reference to the Finance Commission of India, which of the following statements is correct?

(a) It encourages the inflow of foreign capital for infrastructure development

(b) It facilitates the proper distribution of finances among the Public Sector Undertakings

(c) It ensures transparency in financial administration

(d) None of the statements (a), (b) and (c) given above is correct in his context

Q) With reference to the Fourteenth Finance Commission, which of the following statements is/ are correct?
1. It has increased the share of States in the central divisible pool from 32 percent to 42 percent.

2. It has made recommendations concerning sector specific grants.

Select the correct answer using the code given below.

(a) 1 only

(b) 2 only

(c) Both 1 and 2

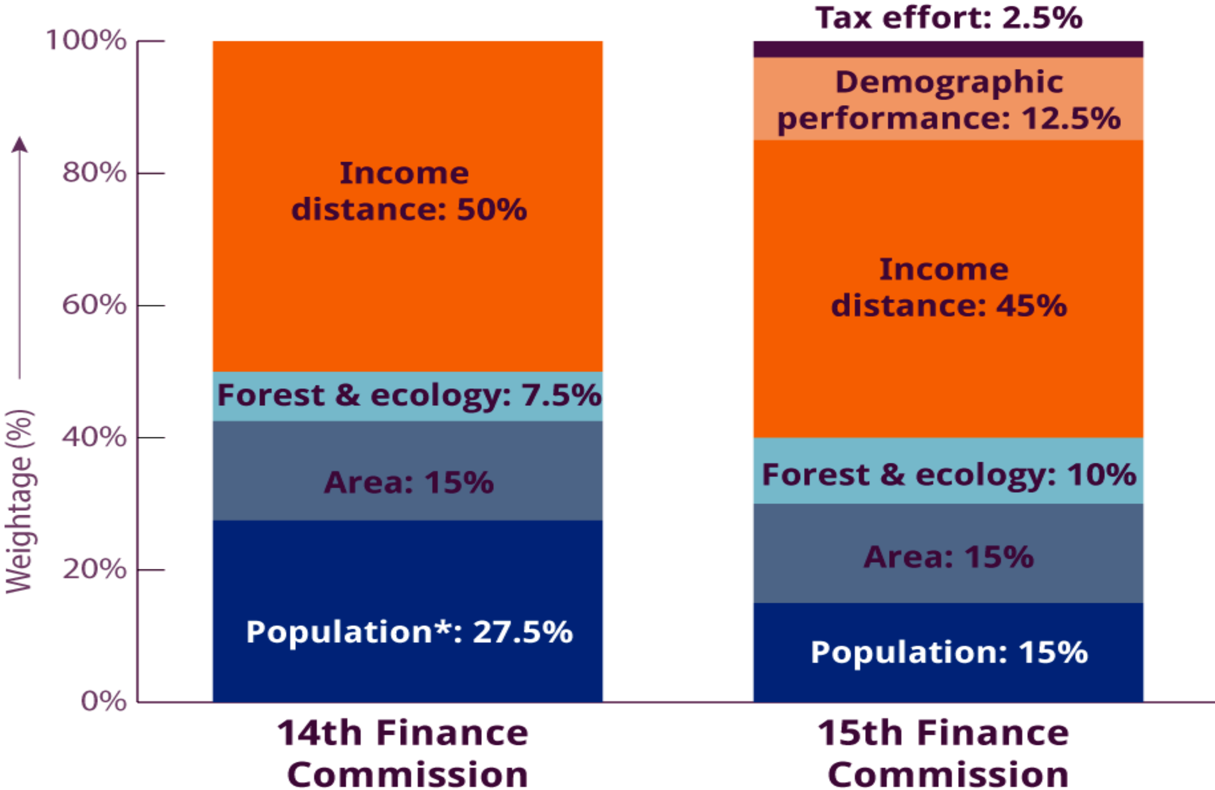
(d) Neither 1 nor 2

Devolution of Taxes:

Article 280 of the Constitution mandates that each FC make recommendations about the distribution of net proceeds of taxes between the Union and states (called vertical devolution) and also among states (called horizontal devolution). The FC has wide powers under the Constitution to (re)define financial relations between and among the Union and states.

The 15th Finance Commission report for 2020-21 was tabled in Parliament on February 1. Every finance commission decides the vertical distribution of divisible pool of taxes between GoI and state governments, and the horizontal distribution of the share between states.

For the latter, we are now used to the idea of a formula. For instance, the 2020-21 report gives 15% weight for population, 15% for geographical area, 10% for forest and ecology, 45% for income distance, 12.5% for demographic performance and 2.5% for tax effort. Population, area, and forest and ecology are described as being need-based, income distance as equity-based, and demographic performance and tax effort as performance-based.



Q) Which one of the following authorities makes recommendation to the Governor of a State as to the principles for determining the taxes and duties which may be appropriated by the Panchayats in that particular State?
(a) District Planning Committees
(b) State Finance Commission
(c) Finance ministry of that State
(d) Panchayati Raj Ministry of that State

Classification of Taxes

(a) Direct taxes and

(b) Indirect Taxes.

This distinction between taxes depends on

(1) The liability of payment of tax to government and

(2) The actual burden of tax.

In case of direct taxes, the liability of payment and the burden of the tax falls on the same person. For example, income tax is a direct tax because the person who is liable to pay it also bears the burden of the tax; The burden of the tax cannot be shifted on others.

Table 4 : Direct vs . Indirect Taxation		
	Advantages	***Disadvantages***
Direct Taxation	01 Relatively cheap and easy to collect.	01 Discourage hard work and enterprise
	02 Equitable in that it falls on those who can afford to pay.	02 Increase the time and resources spent on tax avoidance.
	03 Gives the government fairly direct control over people's spending.	03 The tax on company profits tends to reduce investment.
Indirect Taxation	01 Does not discourage effort.	01 Indirect taxes are regressive: as a proportion of income they fall more heavily on the poor.
	02 Can be used for specific social policies such as reducing smoking or gambling.	02 Can be difficult and costly to collect.
	03 People have a degree of choice on whether they will pay the tax.	03 The amount of revenue to be raised by excise duty or sales tax cannot easily be predicted.

Example of Direct Taxes

- Income tax: The tax on incomes of individuals
- Corporation tax: The tax on corporate profit
- Wealth tax: The tax on wealth of individuals
- Gift tax: The tax on gifts given

But this does not happen in case of indirect taxes. For example, in case of GST, although the liability to pay tax lies with the seller of a good, the actual burden of tax falls on the buyer.

The buyer and not the seller is the one who finally pays the sales tax. The seller only collects the tax from the buyer by increasing the price and pays it to the government. Thus, we find that in case of sales tax, the burden of tax is shifted from the seller to the buyer. All taxes on

production are indirect taxes because producers recover these taxes from buyers by increasing the price of the product.

Example of Indirect Taxes

- Value added tax
- Excise duty: The tax on goods manufactured in factories
- Customs duty: The tax on imports and exports
- Service tax: The tax on the services provided
- Goods and Service Tax (GST)

Types of Taxation:

Progressive Tax: In progressive taxation, the tax liability increases with individual or entity income. This is based on principle of "ability to pay". Under this system, lowest income people are generally exempted while highest income people pay highest taxes.

Example: Income Tax

Q) A redistribution of income in a country can be best brought about through:
(a) Progressive taxation combined with progressive expenditure
(b) Progressive taxation combined with regressive expenditure
(c) Regressive taxation combined with regressive expenditure
(d) Regressive taxation combined with progressive expenditure

Regressive Tax: A regressive tax is the one in which tax rate decreases as the amount subject to taxation increases, and the tax rate progresses from high to low. The lowest amount is subject to higher taxation and this leads to individuals with low income bear the highest burden of regressive taxes. Such tax does not take into account the ability to pay.

Proportional Tax: In this system, a flat tax is levied regardless of income of wealth.
Example: Corporation tax in India whereby government charges a flat rate of 25% on the income earned by the companies in India.

Specific Duty: Specific duty is a duty imposed on each unit of a commodity imported or exported. It is easy to calculate and administer as it can simply be calculated by multiplying the rate of duty with number of units imported or exported. It is levied on such goods whose quantification in terms of number of units is possible.
For example, number of T. V. sets and meters of cloth. In spite of advantages over advalorem duty, specific duty is not very popular as most of the countries use advalorem duties. In this case value of commodity is not taken into consideration.

Advalorem Duty: Advalorem duty is a duty imposed on the total value of commodity imported or exported. It is difficult to calculate as it requires a proper assessment of the value of goods imported or exported. It is levied on such goods whose quantification in terms of number of units is not possible. For example,' rare Pantene's and statues. Generally most of the countries charge duties on the basis of value of goods imported or exported, i.e., advalorem duties. In this case physical units of commodity are not taken into consideration.

Important Taxes:
1. Income Tax: The income, which this tax applies, can come from any source like a business, owning a house or property, gains received from investments and salaries, etc. It is the tax that is levied on your earning in a financial year. There are many facets to income tax, such as the tax slabs, taxable income, tax deducted at source (TDS), reduction of taxable income, etc. The tax is applicable to both individuals and companies.

Note: Tax on Agricultural income is levied by state government's but as of now it's zero percent across India.

Q) Agricultural income tax is assigned to the State Government by:
(a) Finance Commission
(b) National Development Council
(c) Inter-State Council
(d) The Constitution of India

Q) Which one of the following statements regarding the levying, collecting and distribution of Income Tax is correct?
(a) The Union levies, collects and distributes the proceeds of income tax between itself and the states
(b) The Union levies, collects and keeps all the proceeds of income tax to itself
(c) The Union levies and collects the tax but all the proceeds are distributed among the states
(d) Only the surcharge levied on income tax is shared between the Union and the states

2. Wealth Tax:

Wealth Tax was another tax levied by the government, which was charged based on the net wealth of the assessee. Wealth tax is chargeable with respect to the net wealth of a property. Net wealth is equal to all the assets an individual owns minus the cost of acquiring them (any loan taken to acquire them). Wealth tax is no longer operational as it was abolished during the Union Budget of 2015.

The wealth tax, governed by the Wealth Tax Act, allows the government to impose a tax on the net wealth of a person, an HUF or a company. This tax is set to be abolished in 2016 but until then the tax levied on the net wealth is about 1% of the wealth that exceeds Rs. 30 lakhs. There are exceptions to this tax which are organisations that don't have to pay

wealth tax. These organisations could be trusts, partnership firms, social clubs, political parties, etc.

Estate & Inheritance Tax:

Estate tax is a tax that is based on the net value of the property owned by the deceased. When the assets are transferred to the beneficiary, estate tax comes into play. This tax has nothing to do with the person who inherits the assets. Inheritance tax, on the other hand, is imposed by state governments and the tax rate depends on the person receiving the property, and in some jurisdictions, how much they receive.

Gift Tax

Amount exceeding Rs. 50000 received without consideration by an individual from any person is subjected to gift tax as income under "other sources". There are exemptions like money received from relatives is not taxable. Marriage gifts and money received through inheritance are also exempt from gift tax. Inheritance tax was earlier in practice but has been repealed by the government.

Capital Gains Tax: This is a tax that is payable whenever you receive a sizable amount of money. It could be from an investment or from the sale of a property.

It is usually of two types, short term capital gains from investments held for less than 24 months and long term capital gains from investments held for longer than 24 months. The tax applicable for each is also very different since the tax on short term gains is calculated based in the income bracket that you fall in and the tax on long term gains is 20%.

Q) Under which of the following circumstances may "capital gains' arise?
1. When there is an increase in the sales of a product
2. When there is a natural increase in the value of the property owned
3. When you purchase a painting and there is a growth in its value due to increase in its popularity
Select the correct answer using the codes given below:
(a) 1 only
(b) 2 and 3 only
(c) 2 only
(d) 1,2 and 3

Stamp Duty, Registration Fees, Transfer Tax:

Stamp duty, registration fees, and transfer taxes are collect as a supplement of property tax. For instance, when an individual purchases a property, they also have to pay for the cost of stamps (stamp duty), registration fees (fee charged by local registrar to legalize a property transaction), and transfer tax (tax paid to transfer the ownership of a commodity.

Perquisite Tax: Perquisites are all the perks or privileges that employers may extend to employees. These privileges may include a house provided by the company or a car for your use, given to you by the company. These perks are not just limited to big compensation like cars and houses, they can even include things like compensation for fuel or phone bills.

Fringe Benefit Tax:

Fringe Benefit Tax, or FBT, was a tax which applied to almost every fringe benefit an employer provided to their employees. In this tax, a number of aspects were covered. Some of them include:

- Employer's expense on travel (LTA), employee welfare, accommodation, and entertainment.

- Any regular commute or commute related expense provided by an employer. Employer's contribution to a certified retirement fund.
- Employer Stock Option Plans (ESOPs).

FBT was started under the Indian government's stewardship from April 1, 2005. However, the tax was later scrapped in 2009 by the-then Finance Minister Pranab Mukherjee during the 2009 Union Budget session.

Professional Tax:

Professional Tax, or employment tax, is another form of tax levied only by state governments in India. According to professional tax norms, individuals earning income or practicing a profession such as a doctor, lawyer, chartered accountant, or company secretary etc. are required to pay this tax. However, not all states levy professional tax and the rate differs across all the states that levy the tax.

Corporate Tax: Corporate tax is the income tax that is paid by companies from the revenue they earn. This tax also comes with a slab of its own that decides how much tax the company has to pay.

Q) Corporation tax:
(a) Is levied and appropriated by the States
(b) Is levied by the Union and collected and appropriated by the States
(c) Is levied by the Union and shared by the Union and the States
(d) Is levied by the Union and belongs to it exclusively

Dividend Distribution Tax: Dividend Distribution Tax was introduced after the end of 2007's Union Budget. It is basically a tax levied on companies based on the dividend they pay to their investors. This tax is applicable on the gross or net income an investor receives from their investment.

In the since FY 2018, Dividend is taxable in the hands of the shareholder.

Minimum Alternative Tax: Minimum Alternative Tax, or MAT, is basically a way for the Income Tax Department to get companies to pay a minimum tax, which currently stands at 18.5%. This form of tax was brought into effect through the introduction of Section 115JA of the Income Tax Act. However, companies involved in infrastructure and power sectors are exempt from paying MAT. Once a company pays the MAT, it can carry the payment forward and setoff (adjust) against regular tax payable during the subsequent five-year period subject to certain conditions.

Alternate Minimum Tax:

Alternative Minimum Tax was designed to prevent taxpayers from escaping their fair share of tax liability through tax breaks. It is a supplemental income tax required in addition to baseline income tax for certain individuals, corporations, etc that have special circumstances that allow them for lower payments of standard income tax.

Alternate Minimum Tax means the amount of tax computed on the adjusted total income. AMT is a way to collect the minimum tax from the zero tax payers. Under it, the assessee is liable to pay tax at rate of 18.5%. It is not an additional tax levied on the taxpayers.

Q) Consider the following:
1. Fringe Benefit Tax
2. Interest Tax
3. Securities Transaction Tax

Which of the above is/are Direct Tax/Taxes?

(a) 1 only
(b) 1 and 3 only
(c) 2 and 3 only
(d) 1,2 and 3

Pigouvian Tax: Pigouvian Tax is a tax on economic activities that generate negative externalities, which create costs that are borne by

unrelated third parties. The costs arising from negative externalities are not reflected in the final cost of a product or service. Therefore, the market becomes inefficient. The main purpose of Pigouvian taxes is to oppose market inefficiencies by increasing the marginal private cost by the amount generated by the negative externality. In such a case, the final cost (original cost plus tax) will reflect the full social cost of the economic activity. Subsequently, the negative externality will be internalized. Pigouvian taxes can be imposed to challenge the following activities: Environmental pollution, Harmful substances (tobacco and alcohol), Congestion etc.,

Tobin Tax: An excise tax assessed on currency conversions. The tax is imposed to help stabilize currency and interest rates by penalizing currency speculation. Revenues from this tax are intended to be used for global priorities such as environmental and basic human needs. The tax is named after its proponent, Nobel laureate economist James Tobin. It is designed to deter only speculative flows of hot money—money that moves regularly between financial markets in search of high short-term interest rates. It is not meant to impact long-term investments. The shorter the investment cycle (i.e., the time between buying and selling a currency), the higher the effective rate of tax—thus providing market-based incentives for lengthening the term structure of investments.

Banking Cash Transaction Tax:

Banking Cash Transaction Tax is yet another form of tax that has been abandoned by the Indian government. This form of taxation was operation from 2005-2009 until the then FM Pranab Mukherjee nullified the tax. This tax suggested that every bank transaction (debit or credit) would be taxed at a rate of 0.1%.

Security Transaction Tax (STT)

STT is levied on transactions (sale/purchase) done through the stock exchanges. STT is applicable on purchase or sale of various financial products like stocks, derivatives, mutual funds etc.

Q) Consider the following statements:
In India, taxes on transactions in Stock Exchanges and Futures Markets are
1. Levied by the Union
2. Collected by the States
Which of the statements given above is/are correct?
(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2

Entry Tax:

Entry tax is a tax levied in select states across the country like Uttarakhand, Madhya Pradesh, Gujarat, Assam, and Delhi. Under this, all items entering the state ordered via e-commerce establishments are taxed. The rate for this tax varies between 5.5% to 10%.

In last 10-15 years, Indian taxation system has undergone tremendous reforms. The tax rates have been rationalised and tax laws have been simplified resulting in better compliance, ease of tax payment and better enforcement. The process of rationalisation of tax administration is ongoing in India.

Toll Tax & Road Tax:

Toll tax is a tax you often pay to use any form of infrastructure developed by the government, example roads and bridges. The tax amount levied is rather negligible which is used for maintenance and basic upkeep of a particular project.

Property Tax - Municipal Tax:

Also known as Property Tax or Real Estate Tax, this is one of the taxes levied by local municipal bodies of every city. These taxes are levied in order to provide and maintain the for basic civic services. All owners of residential or commercial properties are subject to Municipal Tax.

Entertainment Tax:

Entertainment Tax is yet another type of tax commonly seen in India. It is levied by the government on feature films, television series, exhibitions, amusement, and recreational parlours. This tax is collected taking into account a business entity's gross collection collected from earnings based on commercial shows, film festival earnings, and audience participation.

Q) Consider the following statements: In India, stamp duties on financial transactions are:
1. Levied and collected by the State Government
2. Appropriated by the Union Government
Which of these statements is/are correct?
(a) Only 1
(b) Only 2
(c) Both 1 and 2
(d) Neither 1 nor 2

Sales Tax: As the name suggests, sales tax is a tax that is levied on the sale of a product. This product can be something that was produced in India or imported and can even cover services rendered. This tax is levied on the seller of the product who then transfers it onto the person who buys said product with the sales tax added to the price of the product. The limitation of this tax is that it can be levied only ones for a particular product, which means that if the product is sold a second time, sales tax cannot be applied to it.

Q) The sales tax you pay while purchasing a toothpaste is a
(a) Tax imposed by the Central Government
(b) Tax imposed by the Central Government but collected by the State Government
(c) Tax imposed by the State Government but collected by the Central Government
(d) Tax imposed and collected by the State Government

Service Tax: Like sales tax is added to the price of goods sold in India, so is service tax added to services provided in India. It is not applicable on goods but on companies that provide services and is collected every month or once every quarter based on how the services are provided. If the establishment is an individual service provider then the service tax is paid only once the customer pays the bills however, for companies the service tax is payable the moment the invoice is raised, irrespective of the customer paying the bill.

An important thing to remember is that since the service at a restaurant is a combination of the food, the waiter and the premises themselves, it is difficult to pin point what qualifies for service tax. To remove any ambiguity, in this regard, it has been announced that the service tax in restaurants will be levied only on 40% of the total bill.

Custom duty: When you purchase anything that needs to be imported from another country, a charge is applied on it and that is the customs duty. It applies to all the products that come in via land, sea or air. Even if you bring in products bought in another country to India, a customs duty can be levied on it. The purpose of the customs duty is to ensure that all the goods entering the country are taxed and paid for.

Octroi: If tax is levied by the municipal corporation or Grama panchayat on the goods bought from other parts of the country by traders for sale into their jurisdiction limits, then it is known as octroi.

Excise Duty: This is a tax that is levied on all the goods manufactured or produced in India. It is different from customs duty because it is applicable only on things produced in India and is also known as the Central Value Added Tax or CENVAT. This tax is collected by the government from the manufacturer of the goods. It can also be collected from those entities that receive manufactured goods and employ people to transport the goods from the manufacturer to themselves.

Q) Consider the following taxes:
1. Corporation tax
2. Customs duty
3. Wealth tax
4. Excise duty

Which of these is/are indirect taxes?
(a) 1 only
(b) 2 and 4
(c) 1 and 3
(d) 2 and 3

Value Added Tax: VAT, also known as commercial tax is not applicable on commodities that are zero rated (eg. food and essential drugs) or those that fall under exports. This tax is levied at all the stages of the supply chain, right from the manufacturers, dealers and distributors to the end user.

The value added tax is a tax that is levied at the discretion of the state government and not all states implemented it when it was first announced. The tax is levied on various goods sold in the state and the amount of the tax is decided by the state itself.

Problems in Indian Taxation structure

Multiplicity of taxes: Taxes by Union Government, State Governments and the local governments have resulted in difficulties and harassment to the tax payer.

Dominance of Indirect taxes: Central government revenues from indirect and direct taxes were in the ratio of 65:35 respectively in 2015-16. It is well known that indirect taxes cause more pain to the poor than the wealthy.

Adhocism: Several taxes are imposed on 'adhoc' basis to meet deficits and they are withdrawn later on. Some taxes are introduced and withdrawn later for political reasons.

Bias in incidence of taxes: As per the indirect taxation enquiry committee, "The burden of the urban households was distinctly higher than the rural households in the corresponding expenditure class". Urban population is taxed far higher than the rural rich.

Complexity and corruption: A provoking feature of the Indian tax system is its complexity. Both direct and indirect tax laws are complex. This provides enough scope for avoiding and evading taxes. So when the system is complex, there will be good amount of discretion to the tax authority, which ultimately resulted in corruption.

Imbalance in tax system: Excessive emphasis on indirect taxes has resulted in the glaring imbalances of nearly 100% citizens affected by indirect taxes but hardly 1% of the population coming under the purview of direct taxation.

Lack of built-in elasticity: Income from taxation does not increase automatically in India in proportion to increase in National income. Hence, the government is compelled to increase taxes sometimes to maintain a constant tax income ratio.

Prior to the liberalization of Economy, India's tax regime suffered numerous problems. These problems which were in vogue in 1960s and 1970s were as follows:

- There was a high degree of progressiveness (rich needed to pay exorbitant taxes). On the other hand, tax collection efficiency was very low (rich were smart enough to evade tax).
- There was large number of exemptions, which eroded the already narrow tax base in the country.
- In terms of corporation tax, there were numerous discriminations between different kinds of the companies that discouraged the investments. Double taxation of dividends was also common in those days.
- In terms of Indirect taxes, the high rates of custom / excise duties were prevalent. There was no VAT; there was no service sector within the purview of tax.

The efforts to reform India's tax system began in mid 1980s when the government announced a Long Term Fiscal Policy, 1985. This policy recognized that the fiscal position of the country is going downhill and there was a need to make changes in the taxation system. In that decade, a technical group to review and rationalize the central excise duties was established and this led to introduction of Modified System of Value-Added Tax (MODVAT) in 1986. To rationalize the custom duties, the harmonized system (HS) of the classification of goods was introduced.

Raja Chelliah Committee

The Government appointed a Tax Reforms Committee under Prof Raja Chelliah to lay out agenda for reforming India's tax system. This TRC

came up with three reports in 1991, 1992 and 1993 with several measures, which can be summarized in these points:

1. Reforming the personal taxation system by reducing the marginal tax rates.
2. Reduction in the corporate tax rates.
3. Reducing the cost of imported inputs
4. By lowering the customs duties.
5. Reduction in the number of Customs tariff rates and its rationalization.
6. Simplifying the excise duties and its integration with a Value-Added Tax (VAT) system.
7. Bringing the services sector in the tax net within a VAT system.
8. Broadening of the tax base.
9. Building a tax information and computerization.
10. Improving the quality of tax administration.

The tax reforms that began with the Chelliah Committee recommendations are still going on. Later on, government appointed the Vijay Kelkar Committee in 2002 which further provided direction to the tax reforms in the country.

Vijay Kelkar Committee

The latest Impetus to direct tax reforms in India came with the recommendations of the Task Force on Direct & Indirect Taxes under the chairmanship of Vijay Kelkar in 2002. The main recommendations of this task force related to the direct taxes related to increasing the income tax exemption limit, rationalization of exemptions, abolition of long term capital gains tax, abolition of wealth tax etc. Its key recommendations were as follows:

Administration of Direct Tax

- The taxpayer services should be extended both in quality and quantity and taxpayers should get easy access through internet and email.
- PAN (Permanent Account Number) should be expanded and it should cover all citizens.
- Block assessment of search and seizure cases should be abolished.
- To clear the backlog, the department should outsource the data entry work.
- All returns and issue of refunds should be completed in a four month period.
- Dispatch of refunds should be outsourced.
- Government should establish a Tax Information Network to modernize, simplify and rationalize tax collection, particular TDS and TCS.
- Abolish the requirement of Tax Clearance Certificate on leaving the country. Empower CBDT with appropriate administrative and financial powers.

Personal income tax

- Increase in exemption limit to Rs.1 lakh for the general categories of tax payers and further exemption for senior citizens and widows.
- Rationalize income tax slabs, eliminate surcharge on personal income tax.
- Incentivise home loans by providing interest subsidy on home loans @2%.
- Increase deduction under Section 80C for contribution to pension funds.

Corporation Tax

- Reduce the Corporate tax to 30% for domestic companies and 35% for foreign companies.

- The listed companies should be exempted from tax on dividends and capital gains
- Increase rate of depreciation for plant and machinery.
- Abolish Minimum Alternate Tax.

Wealth Tax

- Abolition of wealth tax.

The above recommendations were made 13 years ago. Today, we see that many of them have been implemented. The DTC and GST have been so far biggest reforms initiated by the Government in direct and indirect tax regime respectively. However, DTC has never arrived and government does not seem to go seriously after it because most of its provisions are already incorporated in the Income Tax Act. GST has come into force from July 1, 2017.

Q) Which of the following is not a recommendation of the task force on direct taxes under the chairmanship of Dr. Vijay L Kelkar in the year 2002?
(a) Abolition of Wealth Tax
(b) Increase in the exemption limit of personal income to Rs. 1.20 lakh for widows
(c) Elimination of standard deduction
(d) Exemption from tax on dividends and capital gains from the listed equity.

Key Direct Tax Reforms

Tax Information Network (TIN): On behalf of the Income Tax Department, the National Securities Depository Limited (NSDL) established Tax Information Network (TIN). This is a source of the countrywide tax related data. The basic idea behind establishing TIN was to modernise collection, processing, monitoring and accounting of

direct taxes using information technology. TIN has three subsystems viz. ERACS, OLTAS and CPLGS.

Electronic Return Acceptance And Consolidation System (ERACS)

ERACS consists of a system for interface with the taxpayers (TIN Facilitation Centres that is TIN-FC) and an internet supported system for upload of electronic returns of Tax Deduction at Source (TDS) and Tax Collection at Source (TCS) and Annual Information Return (AIR) to the central system of TIN.

Online Tax Accounting System (OLTAS)

Online Tax Accounting System (OLTAS) OLTAS is used for upload to the central system the details of tax deposited in numerous tax collecting branches across the country every day.

Central PAN Ledger Generation System (CPLGS): It is the central system that merges the details of TDS/TCS and advance tax into the PAN.

e-TDS & e-TCS

TDS refers to Tax Deduction at Source. The third parties deduct tax at source and then deposits it at pre-determined bank branches. Since 2004–2005, it has been made mandatory to file TDS returns electronically for both the operators, the Government as well as corporate sector. Further, the Income Tax Act, 1961 states that when tax is collected at source by the seller from the buyer, it is named TCS (Tax Collected at Source). Under the scheme named 'Electronic Filing of Returns of Tax Collected at Source Scheme, 2005', the corporate and Government deductors have to pay electronically or physically to NSDL.

Other Initiatives in Direct Taxation

eSahyog initiative : Paperless Assessments

Information Technology has made the life of tax payers easy as they don't need physically go to banks to deposit bank challans and present the case and documents to assessing officers. To make further simple, the CBDT recently came up with a proposal paperless income tax assessment over emails. This would save the taxpayer to pay a visit to IT office, particularly in case of small amounts. Pilot projects in this direction have been launched in Mumbai, Delhi, Chennai, Bengaluru and Ahmedabad.

Sevottam: Efficient grievance redressal

To bring new life to the sluggish grievance redressal system, the department is using 'Sevottam' platform that connects all income tax offices in the country. The idea is to address the queries and grievances in real time.

Faster refunds

The IT department is working towards processing and sending tax refunds within 10working days. The initiative to verify Income Tax Return (ITR) by Aadhaar or bank database has been taken.

Pre-filled ITR forms

Despite of online forms, many people still use offline downloaded forms for tax purpose. The Department is now taking an initiative to offer pre-filled forms which automatically populated with user / tax payer data and are downloaded with most information filled already.

PAN camps

To increase coverage of the PAN, the government has been conducting PAN camps across India. There is also a proposals to launch Income Tax Business Application-Permanent Account Number (ITBA-PAN) portal,

through which anyone can apply for PAN online and get it within 48 hours.

Indirect Tax Reforms

First Indirect Tax Reform occurred in India when the Modified Value Added Tax-(MODVAT) was introduced for selected commodities in 1986 to replace the Central Excise Duty. It was gradually extended to all commodities through Central Value Added Tax (CENVAT). The states also followed the suit and enacted the VAT acts to replace the sales tax with Value Added Tax. Following are the key indirect tax reforms done.

Reduction in Custom Duties

In 1990, the custom duty on non-agricultural products was around 128%.It was brought down gradually. Currently, the average custom duties are 11-12%, however, they range from 0 to 150%.

Central Excise

Central Excise duties were first replaced with MODVAT and now CENVAT is applicable. The number of different types of duties was cut down.

Service Tax

Tax Service tax was first introduced on some limited services in 1994-95 at 7%. The rate was gradually increased and so was the number of taxable services. Currently, we pay 14% service tax on around 100 services.

Q) Which one of the following is the correct statement? Service tax is a/an:
(a) Direct tax levied by the Central Government
(b) Indirect tax levied by the Central Government.
(c) Direct tax levied by the State Government.
(d) Indirect tax levied by the State Government.

Q) In India, the tax proceeds of which one of the following as a percentage of gross tax revenue has significantly declined in the last five years?
(a) Service tax
(b) Personal income tax
(c) Excise duty
(d) Corporation tax

Keeping in focus the problems in taxation system, at least from the point of view of multiplicity of taxes and, complexity involved in understanding and complying with, reforms have been bringing in for the last couple years. And this process is still going on with the latest reform in Indirect tax structure in the name of Goods and Service Tax (GST). Of all the reforms proposed, if not implemented, two reforms worth discussion:

1. Direct Tax Code (DTC)
2. Goods and Service Tax (GST)

The Draft Direct Taxes Code Bill, 2009

The Direct Taxes Code Bill seeks to consolidate and amend the law relating to all direct taxes and will replace the Income Tax Act, 1961. The Bill removes tax exemptions, and lowers income, corporate, and wealth tax rates. The draft Bill was released for public discussion on August 12th, 2009 by the Finance Minister Shri Pranab Mukherjee. The Ministry released a revised discussion paper for feedback on June 15, 2010.

Highlights of the Bill:

- The Bill replaces the Income Tax Act, 1961.
- The Bill widens income tax slabs for individuals. Income between Rs 1.6 lakh to Rs 10 lakh will be taxed at 10%, between Rs 10 lakh and Rs 25 lakh at 20%, and that over Rs 25 lakh at 30%.

- The Bill removes several tax deductions currently allowed such as those on investments in life insurance or provident funds. Interest paid on housing loans shall no longer be tax deductible.
- Companies will be taxed at 25% of business income. The Bill also imposes a minimum alternate tax of 2% on the assets of companies and a dividend distribution tax of 15% on domestic companies. Foreign companies shall pay an additional branch profits tax of 15%.
- Unincorporated bodies are taxed at 30% of income while non profit organisations are taxed at 15% of any surplus of income over expenditure.
- The Bill raises the wealth tax exemption limit from Rs 15 lakh to Rs 50 crore and widens the ambit of wealth tax to include financial assets.

Q) What is/are the most likely advantages of implementing 'Goods and Services Tax (GST)"?
1. It will replace multiple taxes collected by multiple authorities and will thus create a single market in India.
2. It will drastically reduce the 'Current Account Deficit' of India and will enable it to increase its foreign exchange reserves.
3. It will enormously increase the growth and size of economy of India and will enable it to overtake China in the near future.
Select the correct answer using the code given below:
(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1,2 and 3

Goods And Services Tax

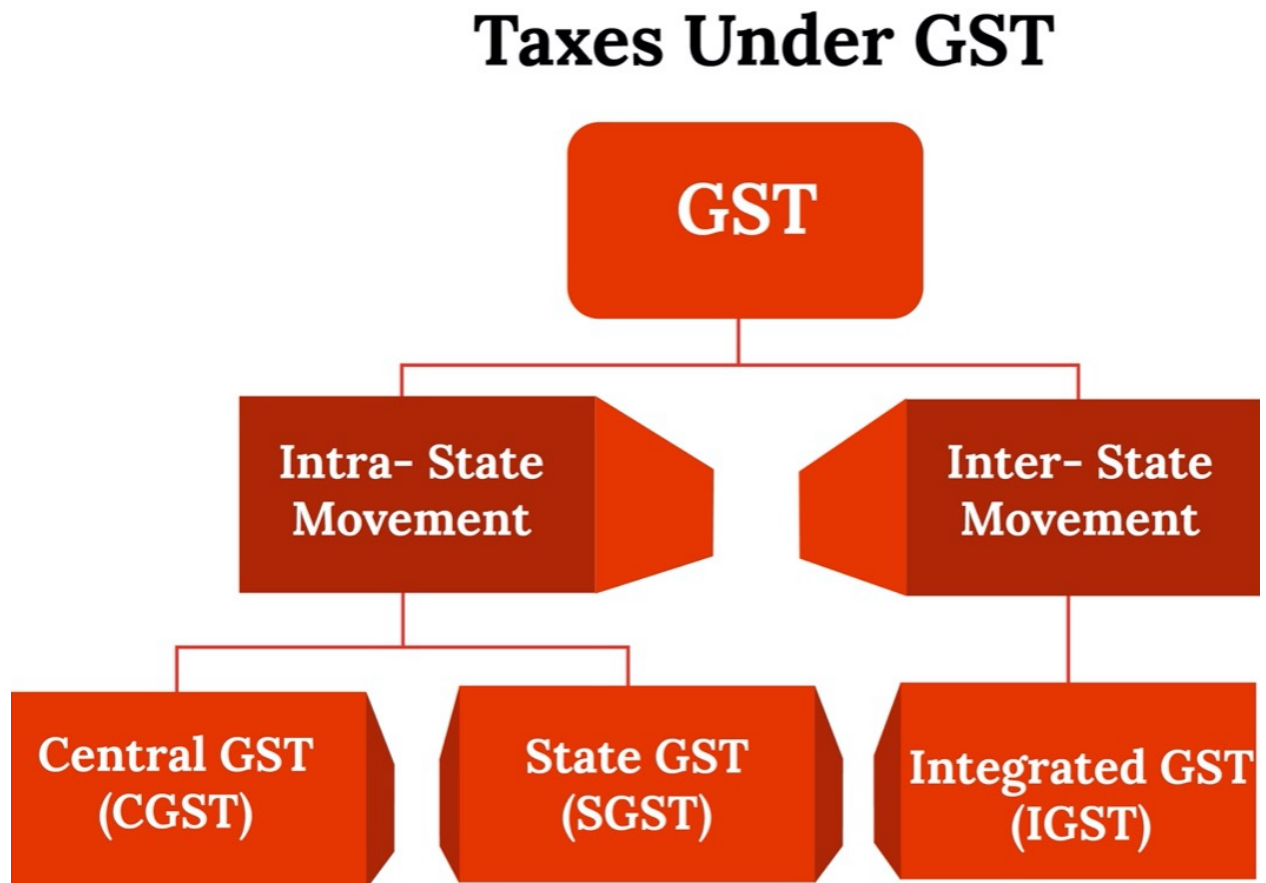
The Goods and Services Tax (GST) is so far the biggest tax reform in the country. At present, the GST-Bills have been passed and it is expected to come into force from July 1, 2017.

In India, these indirect taxes were collected in around 15 different ways.

It was very cumbersome to calculate so many taxes. Moreover, the tax on tax under the previous system made the goods and services very costly.
With this in mind, the government brought in the GST. This would also help in moving ahead in the ease of doing business rankings.

Three types of GST in India

- CGST
- SGST
- IGST



Why 3 taxes - CGST, SGST, IGST?

India is a federal country where both the Centre and the States have been assigned the powers to levy and collect taxes. Both the levels of Government have distinct responsibilities to perform, as per the Constitution, for which they need to raise resources.

A dual GST will, therefore, be keeping with the Constitutional requirement of fiscal federalism.

The Centre and States will be simultaneously levying GST.
3 taxes will be implemented to help tax-payers to take credit against each other thus ensuring "One nation one tax".

How Does GST Work?

1. CGST and SGST

GST is a consumption based tax i.e. the tax should be received by the state in which the goods or services are consumed and not by the state in which such goods are manufactured. IGST is designed to ensure seamless flow of input tax credit from one state to another. One state has to deal only with the Centre government to settle the tax amounts and not with every other state, thus making the process easier.

For e.g.: – Rajesh, a dealer in Maharashtra sold goods to Anand in Maharashtra worth Rs. 10,000. The GST rate is 18% comprising of CGST rate of 9% and SGST rate of 9%, in such case the dealer collects Rs. 1800 and Rs. 900 will go to the central government and Rs. 900 will go to the Maharashtra government.

2. IGST

Now, if Rajesh in Maharashtra had sold goods to Anand in Gujarat worth Rs. 1,00,000. The GST rate is 18% .In such case the dealer has to charge Rs. 18,000 as IGST. This whole 18000 as IGST will go to the Centre alone. This is the reason why many states were opposing the GST.

What is Input Tax Credit?

Input credit means at the time of paying tax on output, you can reduce the tax you have already paid on inputs.
Say, you are a manufacturer –
Tax payable on output (Final Product) is Rs 450
Tax paid on input (Purchases/Raw Material) is Rs 300
You can claim input credit of Rs 300 and you only need to deposit Rs 150 in taxes.

Comparison of working of indirect tax in the previous system (Before GST) and now under GST:

Old Tax System

- A Manufacturer paid Rs.100 (including 10% i.e. Rs.10 as tax) for raw material.
- Now he makes a nice shirt using the raw material (thereby adding value to the raw material) and adds his profit of Rs.30. The cost price of the shirt is Rs. 130 now. The manufacturer has to pay 10% tax on Rs.130,that is Rs.13, before he sells to the wholesaler. Therefore the rate at which the manufacturer sells to the wholesaler is Rs.130+13=Rs.143.
- Now the wholesaler adds his profit margin of Rs.30 to the shirt. So the Cost price of the shirt is Rs.173. He pays a tax of 10% on 173 that is 17.3. Therefore the wholesaler sells to the retailer at Rs. 190.3(143+30+17.3).
- The retailer adds his profit margin of Rs.30. The cost price is Rs. 220.3 and pays a tax of 10% on 220.3 which is 22.03. Therefore the rate at which the retailer sells to the customer is 220.3+22.03=242.33.

The total tax paid under the old system was 10+13+17.3+22.03=62.33

New Tax System

- A manufacturer paid Rs. 100 (including 10% i.e.Rs.10 as tax) for raw material. Now he makes a nice shirt using the raw material (thereby adding value to the raw material) and adds his profit of Rs.30. The cost price of the shirt is Rs. 130 now. The manufacturer has to pay 10% tax on Rs.130,that is Rs.13, before he sells to the wholesaler. However, under GST, he gets an input tax credit of 10 which he already paid on purchase of raw material. So he pays only Rs.3 as tax. So he sells the shirt to the wholesaler at Rs.130+3=133.
- Now the wholesaler adds his profit margin of Rs.30 to the shirt. So the Cost price of the shirt is Rs.163. Tax of 10% on 163, is 16.3. However, he gets an input tax credit of 13 rupees already paid. So he pays only Rs.3.3 as tax. Therefore the wholesaler sells to the retailer at Rs. 166.3(163+3.3).
- The retailer adds his profit margin of Rs.30. The cost price is Rs. 196.3 and tax of 10% on 196.3 is 19.63. However, he gets credit of 16.3 Therefore he pays only Rs.3.33 as tax. So the rate at which the retailer sells to the customer is 199.63.

The total tax paid under the new system is 10+3+3.3+3.33=19.63.

The price the customer paid for the shirt was Rs.242.33 under the old system and Rs.199.63 under the new system.

We can clearly see how the tax on tax under the old system lead to an increase in the final cost of the product which was a burden to the customer. The GST system is going to curb the tax on tax (also called cascading effect).

What are the advantages of GST?

For Business and Industry

- Easy compliance: A robust and comprehensive IT system would be the foundation of the GST regime in India. Therefore, all tax payer services such as registrations, returns, payments, etc. would be available to the taxpayers online, which would make compliance easy and transparent.
- Uniformity of tax rates and structures: GST will ensure that indirect tax rates and structures are common across the country, thereby increasing certainty and ease of doing business. In other words, GST would make doing business in the country tax neutral, irrespective of the choice of place of doing business.
- Removal of cascading: A system of seamless tax-credits throughout the value-chain, and across boundaries of States, would ensure that there is minimal cascading of taxes. This would reduce hidden costs of doing business.
- Improved competitiveness: Checks at state borders causes slow movement of trucks. In India, they travel 280 km a day compared with 800 km in the US .Reduction in transaction time leads to reduced costs of doing business, which would eventually lead to improved competitiveness for the trade and industry.
- Gain to manufacturers and exporters: The subsuming of major Central and State taxes in GST, complete and comprehensive set-off of input goods and services and phasing out of Central Sales Tax (CST) would reduce the cost of locally manufactured goods and services. This will increase the competitiveness of Indian goods and services in the international market and give boost to Indian exports. The uniformity in tax rates and procedures across the country will also go a long way in reducing the compliance cost.

For Central and State Governments

- Simple and easy to administer: Multiple indirect taxes at the Central and State levels are being replaced by GST. Backed with a robust end-to-end IT system, GST would be simpler and easier to administer than all other indirect taxes of the Centre and State levied so far.
- Better controls on leakage: GST will result in better tax compliance due to a robust IT infrastructure. Due to the seamless transfer of input tax credit from one stage to another in the chain of value addition, there is an in-built mechanism in the design of GST that would incentivize tax compliance by traders.
- Higher revenue efficiency: GST is expected to decrease the cost of collection of tax revenues of the Government, and will therefore, lead to higher revenue efficiency.

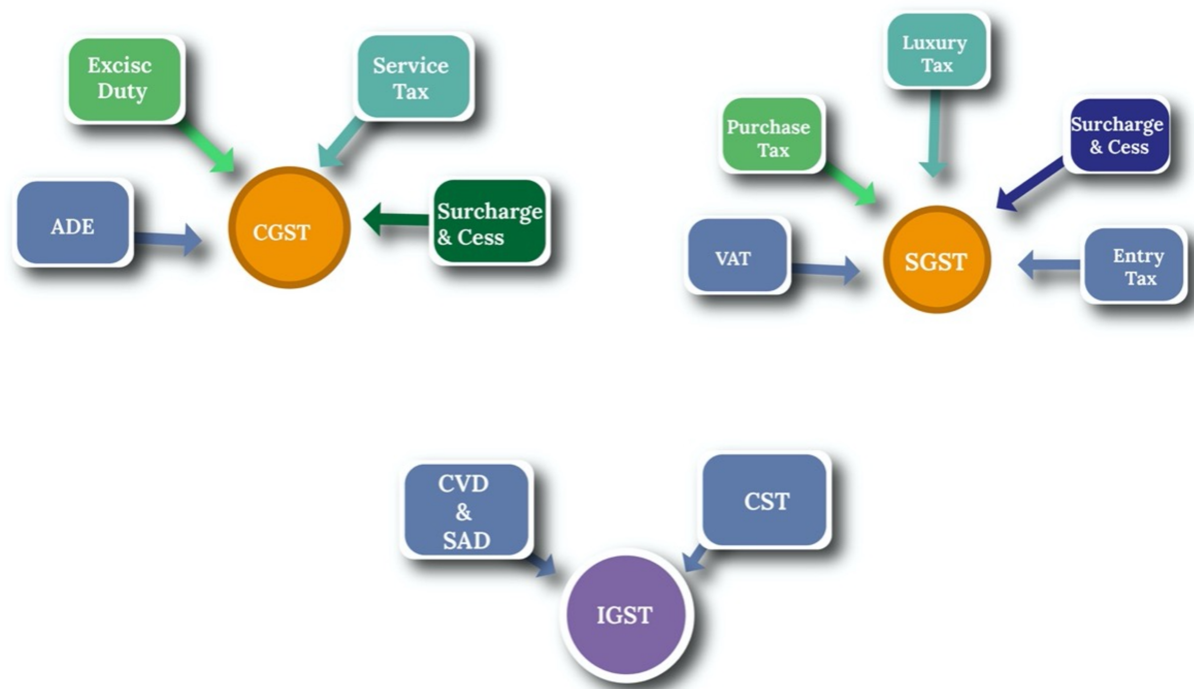
For the consumer

- Single and transparent tax proportionate to the value of goods and services: Due to multiple indirect taxes being levied by the Centre and State, with incomplete or no input tax credits available at progressive stages of value addition, the cost of most goods and services in the country today are laden with many hidden taxes. Under GST, there would be only one tax from the manufacturer to the consumer, leading to transparency of taxes paid to the final consumer.
- Relief in overall tax burden: Because of efficiency gains and prevention of leakages, the overall tax burden on most commodities will come down, thereby leading to cheaper goods and services, which will benefit consumers.

What are the different Tax rates under GST?

Though GST is touted as **ONE NATION ONE TAX**, in reality there are more than one rate (5,12,18,28,3,0). This is because India being such a

large nation, bringing so many states and UT's to agree was no simple task. Moreover, there are thousands of goods and services traded in the country with crores of people involved. There are many sections/classes of people and levying the same rate on the goods and services used by the poor and the rich alike is not justified. Therefore, as a first step, let's make the GST in its current form a success and further hope that in future all these various slabs will unify into a truly single tax.



What do not fall under GST?

Alcoholic liquor for human consumption, petroleum crude, high speed diesel, motor spirit (petrol), natural gas and aviation turbine fuel — GST Council will decide until when.

Merits and Demerits of taxation:

Merits of direct taxes:

1. Equity: A direct tax is an equitable tax. Through it the rich can be made to pay more than the poor. In case of necessity, the poor people can be granted exemption from payment of such taxes.

2. Certainty: A direct tax satisfies the canon of certainty. For instance, a person liable to pay income tax knows how much he will be required to pay; for that purpose he can appropriate steps beforehand.

3. Elasticity: A direct tax has elasticity. It can be varied according to the needs of the government and changes in the income of the people. When the income of the people goes up, the rate of income tax can also be increased. If the income of the people falls, the rate of income tax can also be lowered.

4. Productivity: Direct taxes constitute an important source of government revenue. Their collection charges are also low. Therefore, direct taxes are productive.

5. People's Consciousness: A direct tax increases the civic sense of the people. When people are fully aware of the payment of taxes, they are also conscious of the way the government spends the money. They resent unproductive or wasteful expenditure.
As a result, the government becomes careful in its expenditure.

Demerits of direct taxes:

1. Lack of Popularity: First, such taxes are not very popular, because people have to bear the burden of such taxes directly.

2. Evasion: The second disadvantages of a direct tax is that it is liable to be evaded. By submitting false returns, many people try to evade income tax. Unless the civic sense of the people is well developed and there is spread of education among them, the administration of direct taxes is very difficult.

3. People's Indifference: The third disadvantage of a direct tax is that it does not develop civic sense of those who do not pay such taxes. In the case of income tax, people with incomes below a certain level are not liable to pay tax. In a low-income country like India, the majority of the people are not required to pay income tax. When a man directly bears the burden of a tax, he tries to know how the government spends that money. Those who are not directly affected by the burden of taxation remain indifferent as to the way the public expenditure is incurred.

4. Disincentive to Work and Save: Another disadvantage of direct taxes is that they reduce the desire to work and save. When the rate of direct taxes is high. Many business ventures are not undertaken on the ground that a large part of the income earned will have to be given to the government in the form of taxes. Thus, direct taxes reduce incentives to work hard and save.

Merits of Indirect taxes:

1. Wide Coverage: The main merit of an indirect tax is that it touches all income groups. Indirect taxes, such as sales tax or excise duty, are imposed on all consumers or purchasers irrespective of their incomes.

2. Consumption Control: By imposing an indirect tax, the consumption of an undesirable thing can be discouraged. For example, by imposing excise duties on wine and cigarettes, the government discourages the consumption of such harmful products.

3. Popularity: People are not always conscious of indirect taxes because, in most cases, it is combined with the price. When people purchase cinema tickets they may well remain un-ware of the fact that the price of a ticket also includes the amusement tax. He is not, therefore,

consciously affected by the indirect tax and so he does not resent it much.

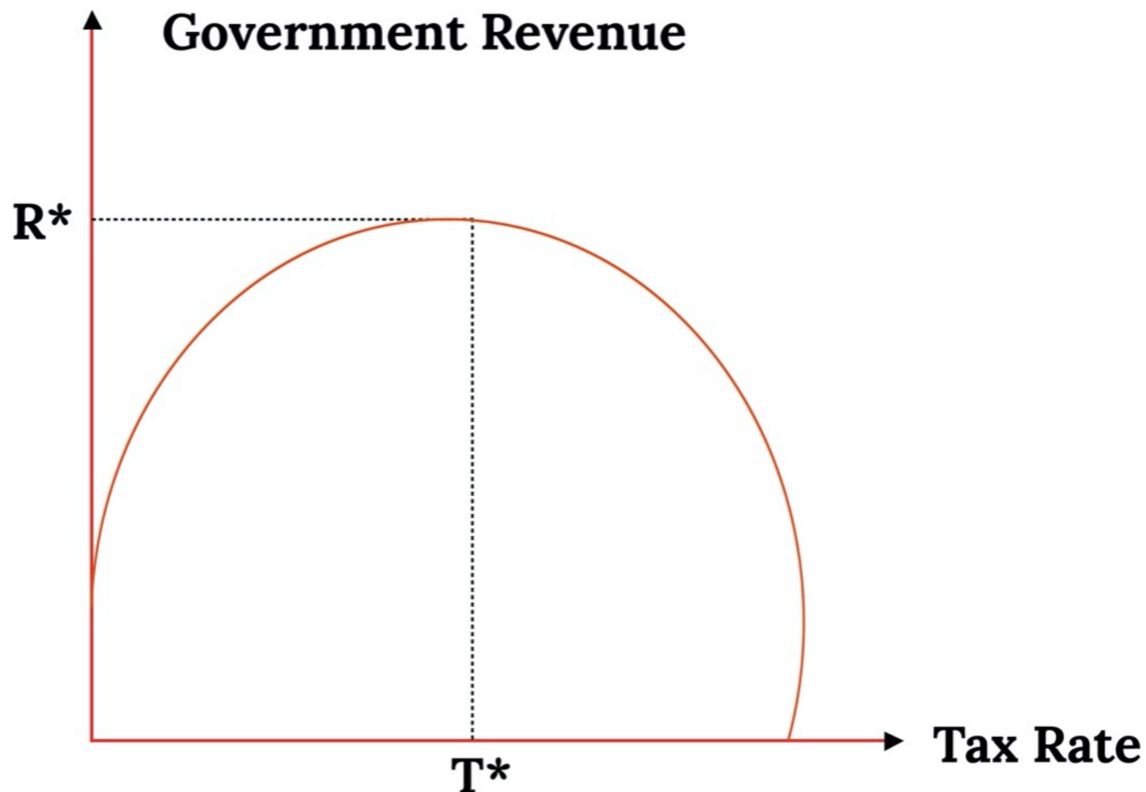
4. Productivity: Like a direct tax, an indirect tax also enlarges the revenue receipts of the government. By the levy of indirect taxes, the tax net is cast wider and all people are made to contribute to the national fund.

Demerits of Indirect taxes:

1. Regressive Character: The main drawback of an indirect tax is that it is not an equitable tax. It is regressive in nature. It affects the poorer section more than the rich. A commodity tax imposed on food stuff will affect a poorer family in a much greater degree than a rich family.

2. Administrative Difficulties: Indirect taxes create various administrative problems. The collection of an indirect tax like customs duty often involves large expenses. There is also the possibility of evasion. In India, it is well known that dealers evade the payment of sales tax to the government, although they realise it from their customers.

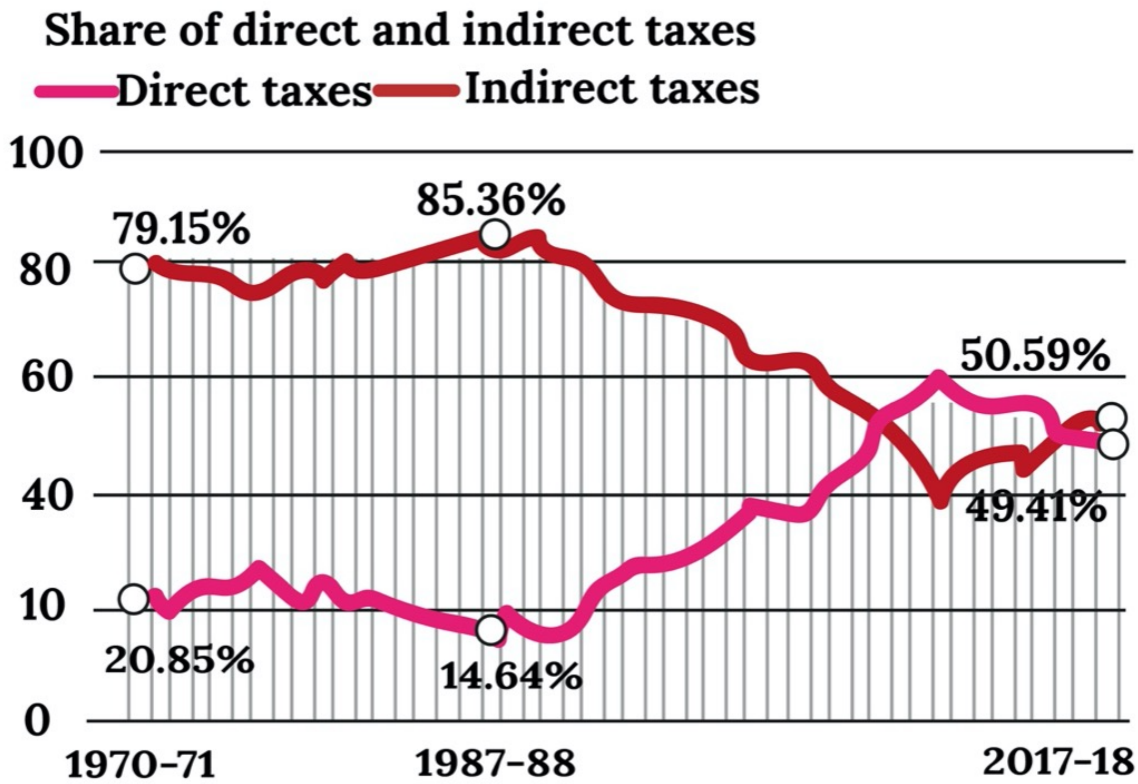
Laffer Curve



The Laffer curve is a graphic representation of the relationship between an increasing tax rate and a government's total revenues. The relationship suggests that revenues decline beyond a peak tax rate.

The shape of the Laffer curve suggests that government revenues diminish with tax rate increases beyond an optimal level denoted as T*. This is based on the theory that beyond a certain tax rate, a country's taxpayers will have a decreasing incentive to work knowing that more and more of their money is being taken by the government. In other words, according to this model, at tax rates approaching 100%, taxpayers will work little, if at all.

Changing scenario of Direct and Indirect taxes:



Tax Avoidance and Evasion

Tax avoidance is the legitimate minimizing of taxes, using methods included in the tax code. Businesses avoid taxes by taking all legitimate deductions and by sheltering income from taxes by setting up employee retirement plans and other means, all legal and under the Internal Revenue Code or state tax codes.

You may have heard of “tax shields” These shields are for protection against higher taxes, and they are the strategies that make up tax avoidance.

Tax evasion, on the other hand, is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by

not paying taxes owed. In this situation, the phrase “ignorance of the law is no excuse” comes to mind.

Tax evasion is most commonly thought of in relation to income taxes, but tax evasion can be practiced by businesses on state sales taxes and on employment taxes.

Tax-To-GDP Ratio

Definition: The tax-to-GDP ratio is the ratio of tax collected compared to national gross domestic product (GDP). In a simpler language, it would be Tax contribution towards GDP.

The tax-to-GDP ratio gives policymakers and analysts a metric that they can use to compare tax receipts from year to year. In most cases, because taxes are related to economic activity, the ratio should stay relatively consistent. Essentially, as the GDP grows, tax revenue should grow as well. Tax and GDP are related, since a higher GDP will automatically lead to a higher tax collection.
When tax revenues grow at a slower rate than the GDP of a country, then tax-to-GDP ratio drops. When tax revenue grows faster than GDP, the ratio increases.

Comparison of India’s Tax – to – GDP Ratio:

1. India’s tax to GDP increased from 10.4% in 1965 to 16.6% in 2015-16, the corresponding tax-to-GDP ratio of OECD countries increased from 21% in 1965 to 33% in 2015.
2. Even compared to OECD nations with lower GDP (Korea, Turkey, Mexico, Chile, Portugal, Greece, Slovenia and Poland) is still lower at 16.6% versus average of 24% of these nations.

3. Among the G-20 Countries, India had the third lowest tax-base, just above Mexico and Indonesia.
4. A high tax-to-GDP ratio is also a common feature of countries with high level of social security measures such as Belgium, Denmark etc.

What are the reasons for India's low tax-to-GDP ratio: Following reasons can be attributed to the low tax (both direct and indirect) to GDP ratio in India.

1. **High tax evasions**-Tax compliance in India is extremely low.
2. **Low per capita Income:** Low average incomes and a high poverty rate result in a very small portion of the labor force being eligible to pay personnel income tax.
3. **Unorganized sector:** India has relatively large informal/unorganized sector, and tax evasion is more rampant in informal sector compare to organized sector.
4. **Small Tax Base and its adverse effect tax buoyancy:** In India, only 3% people pay income tax. This is because a large population is still poor and hence don't earn enough to be in taxable income bracket, but also because even those who fall under the tax bracket, either don't pay or pay very little taxes. A small tax base unnecessary burdens the honest tax payer. According to Shome Panel, in the last 10 years though the direct tax collection has increased by more than 700%, the number of tax payers has merely grown by 35%.
5. **Lingering of contentious, adversarial tax issues:** India has one of highest number of disputes between tax administration and taxpayers, with lowest proportion of recovery of tax arrears. For example: the Vodafone tax dispute involving RS 20 K crore lingering since 2008.
6. **Tax exemption and subsidy policies:** The exemptions in the taxable income have grown at a much faster rate than the income. As a result,

there is less tax buoyancy. Similarly tax expenditure in the form of tax subsidies and exemptions was more than 6 lakh crore in 2015-16.

7. **Loop-holes in double tax avoidance treaties:** Provisions for tax exemptions from short term capital gains are often misused by companies to re-route their investments from such countries (called round tripping of funds). Similarly issues related to tax-evasion, double non-taxation and transfer pricing need to be fixed.
8. **Flourishing informal market ecosystem:** Informal sectors like paying guest accommodations, Kirana stores, Stationary shops, etc. Evade taxation.

Measures to Improve Tax-to-GDP ratio:

- **Widening tax base:** This can be done by implementing GST. GST will be a game changer as it will radically improve collection efficiency, will phase out a number of exemptions in a phased manner; lowers tax rates, increase the compliance level and generate more revenues from indirect taxes. GST will widen the tax base and generate additional revenues.
- **Improving compliance rate of tax laws:** GAAR (General Anti-avoidance rules) provisions may be useful in dealing with tax evasions where tax benefits exceed certain limit.
- **Efficient targeting of subsidies and phasing out of tax exemptions:** Subsidies to the well-off need to be scaled back, similarly tax exemptions to be reviewed and phased out, reasonable taxation of the better off regardless of where they get their income from like industry, services, real estate or agriculture.
- **Fast racking of disputes:** Fast tracking of tax disputes, reducing discretion of taxman and creating a predictable dispute resolution mechanism.

Double Taxation Avoidance Agreement

Double Taxation Avoidance Agreement (DTAA) is a tax agreement signed between India and other countries so that taxpayers can avoid paying double taxes on their income earned from the source country as well as the residence country. At present, India has double tax avoidance treaties with more than 80 nations around the world. Main purpose of DTAA between two countries is avoidance of double taxation, on income earned in any of these countries. Generally under such agreements credit is allowed and taxed by the country in which the taxpayer resides, for taxes levied in the other treaty country. It results the taxpayer pays no more than the higher of the two tax rates.

India has Double Taxation Avoidance Agreements with several countries. India is said to provide tax relief from double taxation to its residents, to some extent. DTAA agreements and other agreements for sharing tax information between governments is an ongoing affair. Under the IT Act 1961 of India Section 90, relief is provided for taxpayers who have paid tax to a country, with which India has signed a DTAA.

Q) A great deal of Foreign Direct Investment (FDI) to India comes from Mauritius than from many major and mature economies like UK and France. Why?
(a) India has preference for certain countries as regards receiving FDI
(b) India has double taxation avoidance agreement with Mauritius
(c) Most citizens of Mauritius have ethnic identity with India and so they feel secure to invest in India
(d) Impending dangers of global climatic change prompt Mauritius to make huge investments in India

Rates and rules of DTAA vary from country to country depending on the particular signed between both parties. The need for DTAA arises because of conflicting rules in two different countries about chargeability of income on basis of receipt and accrual, residential status etc. As there is no clear definition of income and taxability thereof, which is approved internationally, an income may become liable to tax in two countries. Double taxation occurs when an individual is forced to pay two or more taxes for the same income, asset, or financial transaction in different countries.

Double taxation occurs mainly due to overlapping tax laws and regulations of the countries where an individual operates his business.

- The income is taxable only in one country.
- The income is exempt in both countries.
- The income is taxable in both countries, but credit for tax paid in one country is given against tax payable in the other country.

Types of DTAA

- Comprehensive DTAA: Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time a treaty covers wealth tax, gift tax, surtax etc. too.

- Limited DTAA: Limited DTAAs are those which are limited to certain types of incomes only, e.g. DTAA between India and Pakistan is limited to shipping and aircraft profits only.

Foreign nationals of several countries such as USA, Canada and UK are required to declare and pay taxes on their worldwide income. Double taxation avoidance treaties, actually help in either minimizing the tax payable to your home country or in some cases even eliminating further tax liabilities, depending on the tax rates applicable. There can be double income and double taxation but don't hope for double avoidance!.

Tax Havens

A country, state or territory that offers foreign individuals and businesses little or no tax liability in a politically and economically stable environment. Tax havens also provide little or no financial information

to foreign tax authorities. Individuals and businesses that do not reside a tax haven can take advantage of these countries tax regimes to avoid paying taxes in their home countries. Tax havens do not require that an individual reside in or a business operate out of that country in order to benefit from its tax policies.

In 1998, the Organization for Economic Cooperation and Development (OECD) gave a number of factors to identify tax havens. Some of the most common factors are given below:

- No or nominal tax on relevant income
- Lack of effective exchange of information
- Lack of transparency
- No substantial activities

In general, tax havens can be classified in three types:

- **Primary tax havens:** The location where financial capital winds up. Subsidiary there have obtained rights to collect profits from corporate Intellectual Property Rights by transfers from their parent.
- **Semi-tax havens:** Locations that produce goods for sale primarily outside of their territorial boundaries and have flexible regulations to encourage job growth, such as free trade zones, territorial-only taxation, and similar inducements.
- **Conduit tax havens:** Locations where income from sales, primarily made outside their boundaries, is collected, and then distributed. Semi-tax havens are reimbursed for actual product costs, perhaps with a commodity mark-up. The remaining profits are transferred to the primary tax haven, because it holds rights to profits due to the corporate IP. By matching outflow to income they do not retain capital and their role, while crucial, remains invisible.

Large multinational corporations may have dozen of such tax haven entities interacting with each other. Each haven can claim that it does

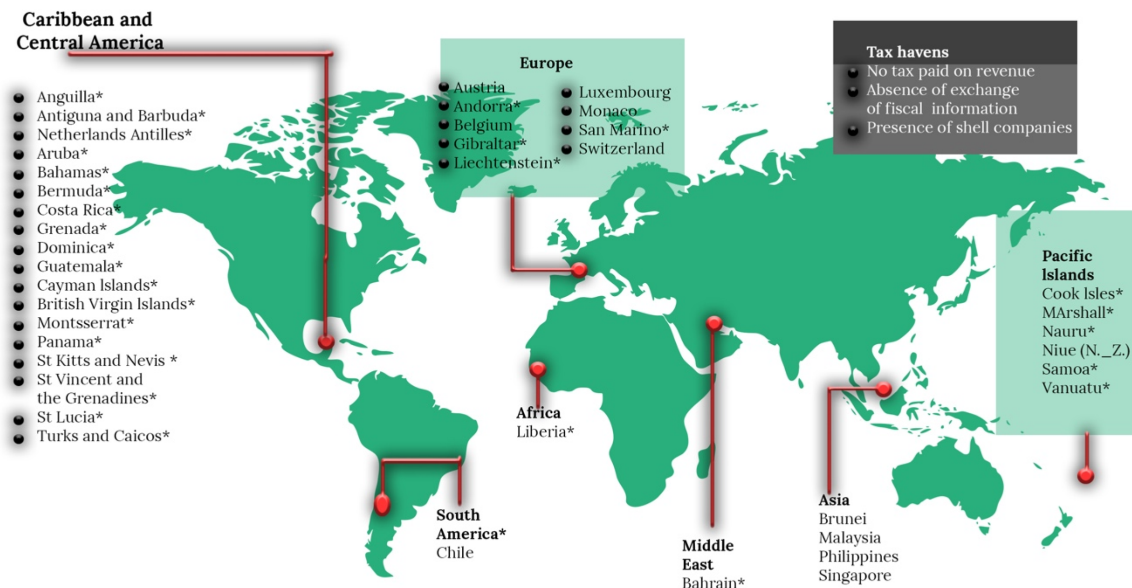
not satisfy definitions that attempt to place all tax havens into a single class. Even increased transparency does not change the effectiveness of corporate tax avoidance.

How Governments Earn Money from Tax Havens?

- Tax havens are not completely tax-free. They charge a lower tax rate than other countries. Low tax jurisdictions generally charge high customs or import duties to cover the losses in tax revenues.
- Tax havens may charge a fee for new registration of companies and renewal charges to be paid every year. Additional fees may also be charged such as license fees. Such fees and charges would add up to a recurring fixed income for the tax havens.
- By attracting foreign individuals or businesses, even if they are only charged a nominal tax rate, the country may earn substantially more in tax revenues than it would otherwise. Also, the country may benefit from corporate investments in business operations that offer jobs to the country's residents.

Benefits to a Tax Haven:

- To Tax Haven Countries – The countries benefit by way of attracting capital to their banks and financial institutions, which can then be used to build a thriving financial sector.
- To Individuals or Businesses – The individuals and businesses benefit by saving tax, which in tax haven countries may range from zero to low single digits compared to high taxes in their country of citizenship or domicile.

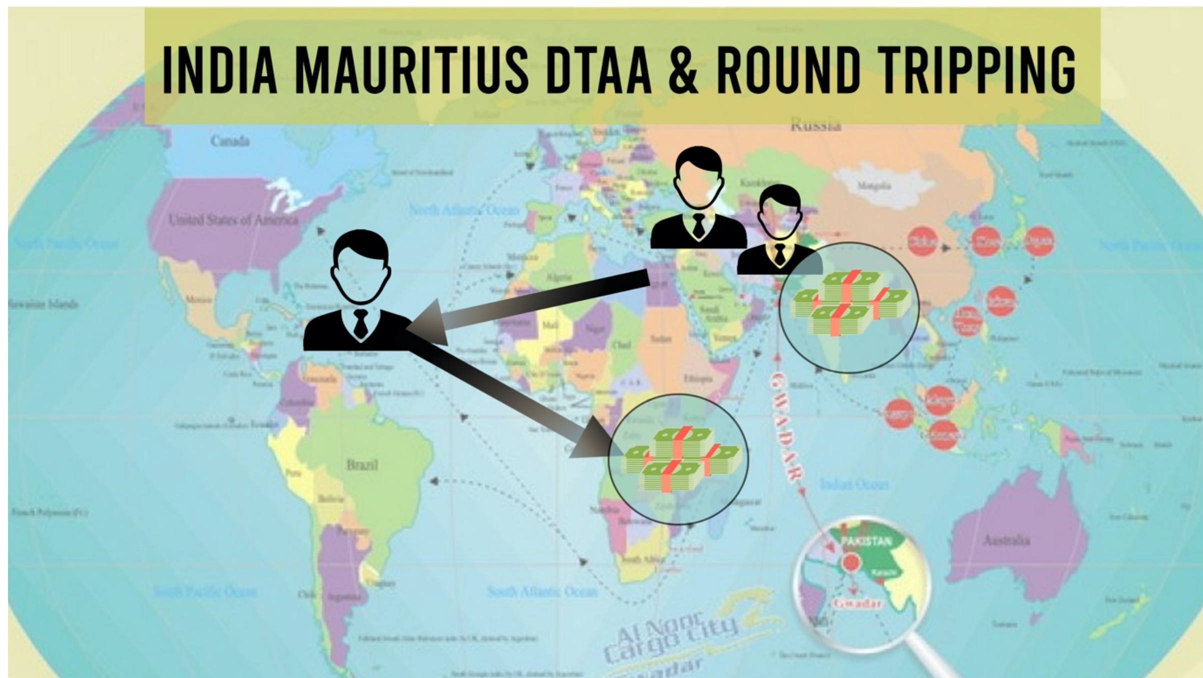


Round-tripping:

Round-tripping, also known as round-trip transactions or "Lazy Susans", is defined by The Wall Street Journal, as a form of barter that involves a company selling "an unused asset to another company, while at the same time agreeing to buy back the same or similar assets at about the same price."

- Another form of round tripping is the round-tripping of FDI. Under this form, the money from a country (India) flows to a foreign country (Mauritius) and comes back as Foreign Direct Investment (FDI) to India. In international scenarios, round tripping is used for tax evasion and money laundering.
- Round-trip trading artificially inflates volume and revenues, but in reality, adds no profit. There are a number of factors that promote roundtripping. The tax concessions provided in the foreign countries encourage the individuals to park money there. The money will be invested in a bogus company formed there (any tax haven change example - Mauritius) and later this company will be taking back the money as the foreign direct investment into the home country (let's say India). Another factor is black money from the home country is

transferred to foreign countries and returned to the home country as FDI.



Under the India-Mauritius tax treaty, a Mauritius based company that made the investment in India has to pay its tax in Mauritius. An advantage for the India Inc. boss parking his money in the Mauritius formed company is that the tax there is significantly low.

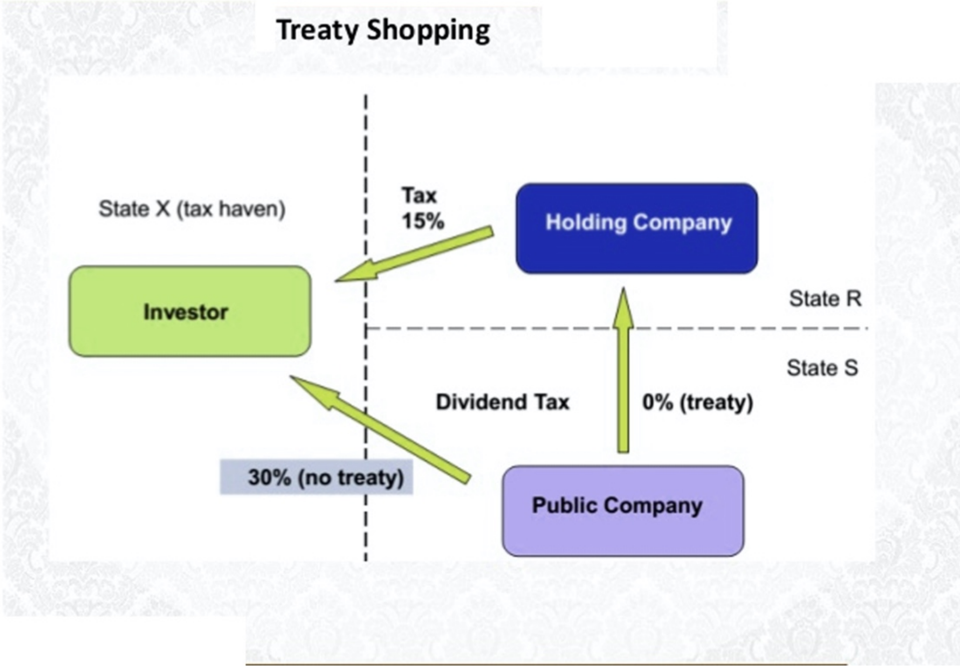
Treaty Shopping:

In Treaty shopping, a resident of a third country invests by taking advantage of a fiscal treaty between India and another contracting state. This has greatly contributed in encouraging FDI in the country but has been a medium of tax evasion. The Supreme Court has also noted in the Azadi Bachao Andolan case that treaty shopping opportunities could be an additional factor to attract such investments.

The roots of the Treaty shopping are in the inconsistencies among international tax regimes. If there is a dissimilarity of tax systems, it can

lead to distortion of investment flows. The underlying principle of bilateral tax treaties, i.e. the principle of reciprocity is impeded when a third-country resident derives benefits from a treaty intended to serve only the interests of residents of the two treaty partners.

Treaty shopping can be controlled by introduction of a limitation of benefit clause (LOB) and other clauses which limit the benefits to the residents of the two countries only. For instance, in the India-Singapore treaty, pursuant to a Protocol in 2005, India provided for capital gains tax exemption to a Singapore resident who sells shares of an Indian company.



However, at the same time the introduction of a limitation of benefit clause (LOB) deters treaty abuse. With this, a Singapore resident will not be entitled to capital gains exemption.

General Anti Avoidance Rules (GAAR)

GAAR is an Anti-avoidance rule framed by Department of Revenue under ministry of finance to identify and restrict arrangements and transactions that are specifically incurred with a motive of tax evasion. The Vodafone case, the biggest sensation of Indian Taxation history is one of the main reasons for the framework of GAAR. Many of us have a misconception about GAAR that it deals with Tax evasion and Tax Planning. But, GAAR will come into the picture in the case of "Impermissible avoidance arrangement", that too only when the tax benefit from such arrangement exceeds Rs. 3 crore. GAAR provisions applicable to "Impermissible avoidance arrangement". Now let's get in detail. What are "Impermissible avoidance arrangement"?

The concept of impermissible avoidance arrangement is defined under section 124 (15) of DTC which puts the responsibility of proving that main purpose of particular transaction was not obtaining a tax benefit on the tax payer.

Major Features of GAAR

- Threshold of Rs. 3 crores in respect of tax benefit to be breached for applicability of GAAR provisions.
- GAAR not to apply to Foreign Institutional Investors ("FII") subject to satisfaction of certain conditions. Where a part of an arrangement is an impermissible avoidance arrangement, the consequences in relation to tax are determined with reference to such part only.
- Investments made before April, 2010, the date of introduction of the Direct Taxes Code, Bill, 2010, would be grandfathered (from GAAR).

How GAAR work?

The provision of GAAR is to codify the doctrine of 'substance over form' where the real intention of the parties and purpose of an arrangement is taken into account for determining the tax consequences, irrespective of the legal structure of the concerned transaction or arrangement. It essentially comes into effect where an arrangement is entered into with the main purpose or one of the main purposes of obtaining a tax benefit and which also satisfies at least one of the following four tests:

- The arrangement creates rights and obligations that are not at arm's length,
- It results in misuse or abuse of provisions of tax laws,
- Lacks commercial substance or is deemed to lack commercial substance, or
- It is not carried out in a bona fide manner.

Hence we can say, if the tax officer believes that the main purpose or one of the main purposes of an arrangement is to obtain a tax benefit and even if one of the above four tests are satisfied, he has powers to declare it as an impermissible avoidance arrangement and re-characterise the entire transaction in a manner that is more conducive to maximising tax revenues.

There are many troubling aspects of this provision that will make doing business in India even more challenging, than what it already is from a tax perspective –

- It is presumed that obtaining tax benefit is the main purpose of the arrangement unless otherwise proved by the taxpayer. This is an onerous burden that under a fair rule of law should be discharged by revenue collector and not the taxpayer.
- An arrangement will be deemed to lack commercial substance under GAAR if it involves the location of an asset or of a transaction or of the place of residence of any party that would not have been so located

for any substantial commercial purpose other than obtaining tax benefit.

- GAAR allows tax authorities to call a business arrangement or a transaction 'impermissible avoidance arrangement' if they feel it has been primarily entered into to avoid taxes. Once an arrangement is ruled 'impermissible' then the tax authorities can deny tax benefits. Most aggressive tax avoidance arrangements would be under the risk of being termed impermissible.
- GAAR is a very broad based provision and can easily be applied to most tax-saving arrangements. Many experts feel that the provision would give unbridled powers to tax officers, allowing them to question any tax saving deal. Foreign institutional investors are worried that their investments routed through Mauritius could be denied tax benefits enjoyed by them under the Indo-Mauritius Tax Treaty.

P. Shome Panel Recommendations-

- The Shome Committee has recommended the postponement of the controversial tax provision by three years to 2016-17. In effect, GAAR would apply from assessment year 2017-18. GAAR was aimed at firms and investors routing money through tax havens.
- The committee has recommended that GAAR be applicable only if the monetary threshold of tax benefit is Rs 3 crore and more. The draft report has sought comments from the stake holders by September 15.
- The Committee has recommended abolition of capital gains tax on sale of listed securities by both resident and non-resident investors. Currently, there are no long-term capital gains on listed securities in India while short term gains are taxed at 10-30 per cent depending on the class of investors The panel has suggested an increase in securities transaction tax (STT) to make good the tax revenue loss that may arise from abolition of tax on gains from transfer of listed securities.

- As a step towards reassuring global investors, the Committee in its draft report suggested that GAAR provisions should not be invoked to examine the genuineness of the residency of entities in Mauritius. Mauritius is the most preferred route for foreign investments because of the liberal taxation regime in the island country. India has a double taxation avoidance treaty with Mauritius.
- The "investment climate in the country has suffered (a) serious setback and investors' confidence has been hit mainly because of the concerns over the impact of retrospective tax laws and GAAR.
- The panel wrote in a report posted on the Finance Ministry website, suggesting the government does not begin enforcing the rules until 2016-17 because "GAAR is an extremely advanced instrument of tax administration Taxation system in — one of deterrence, rather than for revenue generation.
- The general anti-avoidance rules (GAAR), first proposed in the budget in March, was meant to target tax evaders, partly by stopping Indian companies and investors from routing investments through Mauritius or other tax havens for the sole purpose of avoiding taxes.

Criticism of GAAR

Many provisions of GAAR have been criticised by various thinkers. However, the basic criticism of GAAR provisions is that it is considered to be too harsh in nature and there was a fear (considering poor record of IT authorities in India) that tax authorities will apply these provisions regularly (or read misuse) and torture the general honest tax payer too.

Two Examples to Understand GAAR provisions: (Source GAAR Committee)

Case A: A business sets up an undertaking in an under developed area by putting in substantial investment of capital, carries out manufacturing

activities therein and claims a tax deduction on sale of such production/manufacturing.
Is GAAR applicable in this case?

Explanation: There is an arrangement and one of the main purposes is a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by submitting to the conditions and economic consequences of the provisions in the legislation e.g., setting up the business only in the under developed area. Revenue would not invoke GAAR as regards this arrangement.

Case B: A business sets up a factory for manufacturing in an under developed tax exempt area. It then diverts its production from other connected manufacturing units and shows the same as manufactured in the tax exempt unit (while doing only process of packaging there). Is GAAR applicable in this case?

Explanation: There is an arrangement and there is a tax benefit, the main purpose or one of the main purposes of this arrangement is to obtain a tax benefit. The transaction misses commercial nature and there is misuse of the tax provisions. Revenue would invoke GAAR as regards this arrangement.

Base Erosion and Profit Shifting (BEPS)

Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.

What is Base erosion?

Base erosion is the use of financial measures and tax planning to reduce the size of a company's taxable profits in a country. It is often achieved

by structuring income to have more favourable tax treatment or by finding ways to write off certain expenditure against taxable income. This has effect of reducing a company's tax bill below what it would otherwise be expected to pay.

What is Profit Shifting?

Profit Shifting involves making payments to other group companies in order to move profits from high tax jurisdiction to low tax regimes. This serves to increase the overall profits available to group shareholders. Often, this intra-group payments (transfer pricing) take the form of royalties and interest payments, as these expenses can be deducted from pre-tax profits. Another advantage of these type of payment is that some jurisdiction have lower tax rates on these kinds of income.

Q) The term 'Base Erosion and Profit Shifting' is sometimes seen in the news in the context of
(a) Mining operation by multinational companies in resource-rich but backward areas
(b) Curbing of the tax evasion by multinational companies
(c) Exploitation of genetic resources of a country by multinational companies
(d) Lack of consideration of environmental costs in the planning and implementation of developmental projects

BEPS is a technique used by multinationals companies to avoid paying taxes in a country by under-stating the taxable profit, thus ending up paying less taxes on the profit than it should have been. The BEPS Project is OCED sponsored endeavour to address the tax-avoidance practices of multinational corporations. In July 2013, a BEPS Action Plan was endorsed by the G20 which identified 15 key areas to be addressed by 2015. The OECD work related to BEPS is based on this action plan to equip governments with domestic and international instruments to address the challenge

The 15 key areas ranges from preventing treaty abuse , re-examination of various aspects of transfer pricing texts to developing a multilateral instrument to tackle the issue .
It covers following aspects of global trade.

- Shift of profit from country of Permanent Establishment of firm, by either changing functions there or manipulating finances to avoid jurisdiction of host country.
- Review of business models in Global trade which has led to growth and promotion of E-commerce so that appropriate taxation framework can be introduced for cross-border e-commerce.
- Taxation review for Transfer pricing gains and Capital Gains, as recently it had led to many litigations in countries actively involved in world trade.
- Review of different Double Taxation Avoidance Agreements on case by case basis.
- Global chains of industries often remains hidden from jurisdiction of taxing country. Draft proposed to allow a broader view of such chains, so that transparency can be brought in taxation.
- Hybrid instruments which either comprises of debt and equity in some proportion or treated as debt in one country and equity in other, may lead to unintended tax avoidance in both onshore and offshore country. Considering this scenario OECD proposed to neutralise it.
- Dispute resolution and curbing harmful tax practices found its place in the draft proposal.

Implications for India:

- Tax avoidance is a major issue to India. There are several loopholes in domestic tax rules which are used to evade taxes.

- A large portion of the domestic income are diverted to tax heaven countries like Singapore - Mauritius and brought back to India in disguise of FDI to avoid taxes on the amounts .
- Participating in BEPS project would be a huge interest for India. It would enable it to deal with tax-avoidance challenges effectively by inculcating some of the best practices followed internationally to tackle such challenges.