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ANALYSIS**

TOPIC

**Reforming India's Income
Tax Law**

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REFORMING INDIA'S INCOME TAX LAW

Context

- The government has announced its intent to review the Income Tax Act (1961) aiming to fundamentally resolve the contentious sections of the Act be carefully redrafted, tax structure simplified.

About

- India's income tax system, governed by the **Income-tax Act of 1961**, governing the taxation of income earned by individuals, businesses, and other entities, has long been a subject of debate for its complexity and the burden it places on both individuals and businesses.

Key Aspects To Consider

- **Rising Share of Personal Income Tax over Corporate Tax:** Over the years, the share of corporate tax in gross tax revenue has been on a decreasing trend, while personal income tax's share has been increasing.
 - ♦ As of February 2024, income tax formed 28% of the gross tax revenue—a new peak. The decline in corporate tax collections after FY19 can be attributed to the significant corporate tax cuts introduced in September 2019.
- **Rising Share of Indirect Tax over Direct Taxes:** The share of direct taxes (levied directly on incomes) has been decreasing, while that of indirect taxes (such as GST) has been increasing.
 - ♦ Direct taxes are considered “progressive” because they tax higher earners more. However, concerns arise when the burden disproportionately falls on the middle class.
- **Complexity and Ambiguity:** India's Income Tax Act, 1961, along with numerous amendments and circulars, creates a convoluted legal framework. Taxpayers often struggle with its complexity and ambiguity. Simplification and clarity are essential to ensure fair compliance and reduce disputes.
- **Tax Evasion and Black Money:** Efforts to curb tax evasion remain critical. The government has taken steps like demonetization and promoting digital payments to bring unaccounted wealth into the formal economy. However, challenges persist, and addressing black money remains a priority.
- **Parallel Economy and Informal Sector:** The informal sector—comprising unorganised businesses and self-employed individuals—poses challenges. Many transactions occur outside the formal tax net.
 - ♦ Encouraging formalisation and widening the tax base are ongoing goals.
- **Capital Gains Tax and Investment Behavior:** The treatment of capital gains tax affects investment decisions. Balancing revenue collection with incentivizing investment is crucial.
 - ♦ Recent budget changes have impacted long-term capital gains tax on assets like stocks and real estate.
- **Reassessment Notices and Compliance:** Tax officials are increasingly scrutinising returns. The reassessment law aims to catch discrepancies and ensure compliance. However, taxpayers need clarity on the process to avoid undue stress.

Effective and Efficient Income Tax System in India

- To make the tax system more efficient, equitable, and growth-oriented, various reforms have been suggested. These reforms aim to simplify tax structures, broaden the tax base, and improve compliance.
- **Simplification and Clarity:** The complexity of the Income Tax Act can be overwhelming for taxpayers. Simplification is essential to enhance compliance and reduce disputes.
 - ♦ **Redrafting Contentious Sections:** The government should carefully review and redraft contentious sections of the Income Tax Act. By doing so, we can address ambiguities and reduce the scope for disputes.
 - ♦ **Clearer Definitions:** Providing precise definitions for terms like “income,” “capital gains,” and “exemptions” would minimise confusion and ensure uniform interpretation.
- **Rationalizing Tax Rates:** India's tax rates have evolved over time, leading to a convoluted structure. Rationalising tax rates can simplify compliance and encourage voluntary tax payments:
 - ♦ **Progressive Taxation:** While progressive taxation is essential for equity, striking the right balance between tax rates and revenue collection is crucial. Gradual reductions in tax rates for different income slabs could incentivize compliance.

- **Broadening the Tax Base By Inclusion of More Taxpayers:** Despite having a large population, India's tax base remains narrow, with only a small percentage of people paying income tax. Reforms that encourage more individuals and businesses to enter the formal tax net are crucial. This could involve lowering the threshold for taxable income or incentivizing voluntary compliance through reduced penalties for past evasion.
- **Digital Transformation:** Leveraging technology can revolutionise tax administration:
 - ◆ **E-filing and Digital Payments:** Encouraging e-filing and digital payment options simplifies the process for taxpayers and reduces paperwork.
 - ◆ **Real-time Data Sharing:** Implementing real-time data sharing across departments can help detect tax frauds and improve compliance.
- **Dispute Resolution Mechanisms:** taxpayers and the government:
 - ◆ **Vivad Se Vishwas Scheme:** It aims to settle direct tax disputes. It provides an opportunity for taxpayers to resolve pending appeals and avoid prolonged litigation.
 - ◆ **Faceless Assessment and Appeals:** Expanding faceless assessment and appeals processes can enhance transparency and reduce subjectivity.
- **Progressive Taxation:** Reforms that ensure a more progressive tax structure, where higher earners pay a proportionately higher tax, could enhance equity in the tax system. This might involve increasing the tax rates for the highest income brackets or introducing a wealth tax.
- **Addressing Corporate Taxation:** Aligning corporate tax rates with global standards while ensuring that large corporations pay their fair share is another important area. This could involve closing loopholes that allow for profit shifting and tax avoidance by multinational corporations.
- **Combating Tax Evasion:** Strengthening measures against tax evasion through stricter enforcement and enhanced use of technology, such as data analytics and AI, could help identify non-compliance and bring more individuals into the tax fold.
- **Encouraging Investment and Job Creation:** Tax reforms should align with economic growth and job creation:
 - ◆ **Startup Ecosystem:** Supporting startups by abolishing the angel tax and providing tax incentives can foster innovation and entrepreneurship.
 - ◆ **Employment-linked Incentives:** The government's focus on employment and skilling is commendable. Incentives tied to EPFO-linked schemes can encourage job creation.

Challenges to Reform

- While these reforms have the potential to significantly improve India's income tax system, they are not without challenges. Political will is crucial, as tax reforms can be unpopular among certain segments of the population. Additionally, the transition to a new system must be managed carefully to avoid disruptions.

Conclusion and Way Forward

- India's income tax system is evolving, with efforts to simplify, formalise, and address legacy issues.
- Reforming India's income tax law requires a holistic approach. By simplifying provisions, rationalising rates, embracing technology, and promoting fairness, we can create a tax system that benefits all stakeholders.
- Balancing revenue needs, fairness, and economic growth remains a delicate task. As taxpayers, understanding our obligations and rights within this framework is essential.
- A comprehensive review of the Income Tax Act leads to meaningful changes and a more taxpayer-friendly regime.

Source: IE



Mains Practice Question

[Q] Do you think it is necessary to reform India's Income Tax law? Highlights the major steps for effective and efficient Income Tax System in India.