CHAPTER I

HISTORY AND CONCEPT OF INCOME

Income tax is so entrenched in the life of the people that it is more convincing for one to believe income tax to exist from the time of Adam and Eve rather than to believe the fact that it is essentially a modern phenomenon. As a matter of fact, as democratic ideals gained popularity, there grew up a tendency to apply principles of justice to the realms of taxation. This tendency found concrete expression in the extensive use of income tax as an instrument of public finance.

Historically taxation, of which income tax is a part, seems to have germinated out of the benevolent act of voluntary contribution of all primitive societies. With the passage of time and with the development of private properties and commercial activities, the willingness on the part of the society to contribute to its welfare was recognised and appreciated. The then authorities conveniently made use of this benevolence by converting it into fees and charges of various kinds and later into levies on exchange and transport, and finally, into compulsory contribution which were apportioned among persons according to general standard of equity and upon such basis as property and income. With the advent of democratic and socialistic ideals, the role of income tax as an instrument of equity gathered momentum. Rapid industrialisation, widespread diffusion of money economy, and consequent emergence of new form
of wealth which could not be taxed by older form of taxation were some of the basic reasons behind the origin of income tax. Under the condition of modern industrial life property held by a person no longer sufficed as an indicator of his tax-paying ability. With merchants relying to an increasing extent upon the rate of turnover; entrepreneur being influenced by speculative gains; wages becoming the prime motivator of labour; salaried and other professional classes living on their earning; varying rate of return on investment affecting the investment decision of the wealthy; the test of ability to pay tax has shifted from property owned or capital owned to income earned by a person.

Income tax has a spasmodic history and was generally imposed to tide over crises during emergency. As a matter of fact the ancient Romans always regarded direct taxation of their citizens as humiliating and undignified. Direct tax was paid only in time of emergency and sometimes it was repaid after the emergency was over. Income tax was found for the first time in the commercial democracy of medieval Italy. In its modern form the tax only appeared at the end of the eighteenth century. Even after its emergence, before World War II it was a class tax, in the sense that wage earners, salaried employees and self-employed individuals were exempted from it. However, since that time countries have greatly withdrawn such exemption and today income tax has become more widespread.
As an instrument of national policy income tax has played different roles in different countries at different points of time. The modern income tax can be said to have transversed four stages, (i) as a sporadic resource in war, (ii) as a temporary addition to regular revenues, (iii) as a permanent source of revenue and (iv) as the chief reliance of the fiscal system.

British tax imposed by Pitt in 1798 which was withdrawn after the war in 1816 may be considered to be the earliest example of the first stage.

Income tax as a temporary addition to regular revenue or in other words, income tax in peace time dates from 1840 when it was introduced in Switzerland. In Britain it was Sir Robert Peel who reintroduced income tax in 1842 for three years not to raise fund for war but to overcome the total imbalance caused by custom dues and to compensate for the repeal of the corn laws. Austria followed in 1849 and Italy in 1864.

The third phase i.e. income tax as a permanent source of revenue can be traced to the year 1874 in Great Britain. Though 1874 had raised high hopes for its abolition in very near future it was in 1876 that Great Britain imposed income tax with the sole purpose to meet deficiency in ordinary expenditure. The third stage which was attained by England in 1874 spread to other countries within next twentyfive years. Democratic Australia was the first to follow. South Australia initiated income
tax in 1884, New Zealand in 1891, Tasmania in 1894, Japan 1887, German Commonwealth with Prussia in the lead, in 1891, the Netherlands in 1893. Income tax as a regular source of revenue in United States dates from the adoption of the 16th Amendment to the constitution in 1913. Though an attempt was made in 1890 to establish income tax but it was frustrated by the Supreme Court which in the famous case of Pullock vs. The Farmer's Loan and Trust Company, 1895, held income tax to be unconstitutional. The Canadian Government introduced an income tax in 1917, as an emergency measure to meet the cost of World War I, but the tax was retained and developed into a major source of the Canadian revenue system.

In India income tax was first introduced in 1860. It was withdrawn in 1873 and was reintroduced in 1886 and it exists to date. Development of Income Tax reached its peak during and after the World War II. To meet the increased fiscal burden of the war and post-war rebuilding period, almost all countries adopted income tax to raise additional revenue. With the setting in of democratic and socialistic sentiments, income tax began to be considered indispensable not only from the point of being a reliable source of revenue but also from the view of being a social instrument for bringing about equity. Thus World War and post-war brought about the fourth phase - income tax's
role as the primadonna of revenue system in most of the developed countries. India, like many other developing countries, is however, yet to enter this coveted stage. However, in the course of time, the concept of Income Tax has widened both from the standpoint of necessity of imposing it and from the definition.

The historical evolution of income tax and the popularity of democratic ideal in the present world in most countries these days promise income tax to persist in days to come. So without arguing on the issue that whether income tax is just or not, it would be better if we try to develop a system that strikes a balance between the economic point of view and the angle of taxpayer to suit a particular economy.

Concept of Income.

The legislation and implementation of income tax call for a precise definition of taxable income. The determination of an objective and an unambiguous method of measuring each person's ability to pay taxes mark the first step in the quest for achieving tax equality. Unfortunately the ideal way to arrive at this measure has always been elusive and there is no general agreement among the tax specialists in this regard. Diversity rather than unity characterizes discussions on this important and vexed problem. The controversy, is in regard to the choice between 'income' and 'expenditure' as the basis of levying tax on income.
The ideal theoretical income concept that has received general acceptance is that of Haig and Simons. According to Haig 'income is the money value of the net accretion to one's economic power between two points of time'. Simons advocates a concept similar to that of Haig and according to him 'income is the algebraic sum of consumption and change in net wealth'.

This idea, as can be seen, is to incorporate allincomingsof a person on accrual basis without regard to the form in which they are received or the source from which they accrue. Thus, not only all factor earnings such as wages, rents, interest and profits should be included in determining the tax base of taxpayers but also capital gains, gifts, bequests, windfalls, benefits received in kind, compensation of any kind, life insurance monies, gratuities and provident fund monies are also to be included to measure the tax paying ability, whether the earnings are consumed or saved.

There is, as stated earlier, another school of thought according to which an attempt is made to frame definition of income based on the disposition of accruals; or one can say of a definition of income based on consumption criteria. The supporters of consumption tax advocate exclusion of savings from the measure of taxable income and to use, as the tax base, of only what is spent on personal consumption during a given period of time. Thus, the basic difference between accrual-type personal income - tax and consumption type personal income - tax is
that while the former believes in taxing both the personal consumption and accumulation made, the latter concept advocates exclusion of accumulation from the tax-base.

Income Vrs. Expenditure tax.

The first objection that is directed by protagonists of consumption tax against accepting income as the tax base is taxing of 'savings'. They argue that acceptance of the accrual type income tax leads to double taxation of savings and so penalises thrift and inhibits investment and growth. The argument is that an income tax is imposed on both the income when it is first received, and any interest paid when the income is saved. The tax on expenditure, on the other hand only taxes the saving once - when they are spent. An expenditure tax therefore allows a more favourable return to saving, as interest can be received on the gross amount of any income saved. The Expenditure Tax therefore encourages savings. Prof. John Stewart Mills says ".... for when saved and invested .... it (income) thenceforth pay income tax on the interest or profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempt from income tax, the contributions are twice taxed on what they save and only once on what they spend".9

Another critical objection raised by those attracted to the disposition concept against the accrual concept relates to
taxation of capital gains. It is argued that capital gains are basically windfalls - and factors like rise in price level, decline in the market rate of interest result in capital gain which is more illusory than real and it does not lead to any improvement in the wellbeing of tax payer. Accrual concept, by taxing such gain not only speaks of injustice but also involves problem of defining and measuring such gain or loss. It also calls for adjustment of tax base for inflation. Thus tax specialists subscribing to expenditure tax say that adoption of expenditure tax will eradicate the problem of defining and measuring capital gains and losses for when shares, bonds, other securities, real estate and other assets are purchased, the price will be entirely deducted from the tax base and when they are sold later the tax would be paid on the entire amount realised and not just the gain. Similarly, as regards depreciation, the problem faced under the accrual concept to measure capital consumption can be avoided, for under expenditure tax the entire cost of the asset is in effect deducted at the time of purchase. Adjustment of tax base for inflation is also not required under consumption tax as consumption would be measured appropriately on current price. Thus most of the complexity that is unavoidable under the accrual basis will disappear as everything will be considered on cash flow basis. So, it is argued that on grounds of simplicity too, consumption tax is more desirable.

Exponents of the consumption tax claim that as disposition
concept is based on 'how much a person takes out from the economy' and not on 'how much a person contributes', as advocated under the accrual concept, it is a fair and equitable basis to judge a person's ability to pay. It is further advocated that perspective of income tax based on accrual concept is relatively short run - a year or several years to allow for short run fluctuations. Consumption is more stable than income and so a better measure of long term wellbeing. It is argued that, if one makes some simple assumptions like perfect capital market, constant discount rates that apply equally to all people under all circumstance, constant and proportional tax rates, no gifts and bequests, then the base of taxes on the discounted present value of income and expenditure will be the same over a lifetime regardless of when the incomes are consumed.\(^{10}\)

Though the disposition concept, which at one time was confined to a few distinguished persons like John Stewart Mill, Irving Fisher, Nicholas Kaldor and James Meade and which now-a-days is picking up an ardent support among many economists, no country in the world is yet planning to abandon the income tax based basically on the accrual concept. The objection that the accrual concept goes on to tax savings twice does not hold good, for 'interest' is not a part of the amount saved. It is in fact an accrual on the amount saved - it is not a part of capital but an earning on capital employed. Further, if savings and investments are totally exempted from being taxed without taking
into consideration the forms of such savings and investments, it will greatly increase the concentration of wealth. People belonging to the higher income bracket carry the bulk of the savings and investments and therefore leaving out saving and investment from the tax net will automatically imply leaving out this section from the tax net to a large extent. On the other hand people belonging to the lower income bracket do not have enough capability to save out of their earnings and consequently it will be this section who will have to bear the brunt of the tax burden. Equality will thus suffer. Hence there is a belief, that a consumption tax is 'nothing but a wage tax in tuxedo' and it is rejected as an 'insufficient compromise of the various legitimate objectives of a basic tax system'.

Coming to taxation of capital gain the arguments put forward for exclusion of capital gain from tax base by those advocating for expenditure type personal income tax are not weighty. Objections, such as capital gain are windfalls and are only illusory and are the product of inflation overlook the appreciation of capital value of a capital asset, due to other factors like, accumulation of interest, revaluation or revision of prospects, etc. Since in actual practice it is difficult to isolate the contribution of each of these factors to capital appreciation, controversy will always be there, as some will support exclusion of such gain from tax base while some others will oppose such exclusion. Taxing capital gain is more justified, for a failure
to include capital gain in the tax base would give some taxpayers a gift as this will entail more tax burden upon the rest of the community of taxpayers who will be compelled to make up the revenue loss suffered due to exclusion of capital gain from the taxnet. Capital gain can accrue only to people who possess wealth and it is generally seen that such gain accrues mainly to the wealthy minority in a community. Further, possession of wealth, even if it yields no income, increases the taxable capacity of the taxpayer. So, exempting such gain over and above the high incomes that this minority enjoys will mean additional tax concessions to this minority at the expense of the rest of the community. Exemption of capital gain will not only favour well-to-do taxpayers having higher taxable capacity and discriminate against the lower income groups, but would also discriminate against the taxpayers having the same income, for one who earns no or only a small element of capital gain will be taxed at a higher sum than the other who has the same income but which comprise of large amount of capital gain. Thus, the accrual concept, which goes on to tax capital gain, is much more acceptable even though it may involve problem of defining and measuring of such gains.

The perennial argument put forth in favour of expenditure tax has little merit. In this world of ever changing tax rates, economic and political changes and when nothing is certain, taxation of lifetime consumption (or income) does not
seem to be appropriate. 'Simplicity' of consumption tax vis-à-vis 'complexity' envisaged under the accrual concept as an argument for switching over to a disposition type of personal income tax overlooks transition problems. Transition from accrual basis to cash-flow type of income tax will not only be troublesome but will also involve various complexities. Taxpayer who would draw upon assets, some of which had been previously taxed under the income tax, to finance current consumption would be taxed yet again. To introduce consumption tax, some method must be designed to identify consumption from previously taxed accumulation so as to do justice to the taxpayer. Whatever method may be adopted to segregate previously taxed accumulations from consumption tax will leave big loopholes specially for people with large amount of untaxed accrued capital gain, to evade tax. Transition to cash-flow concept will not only increase greatly concentration of wealth but will be a boon to people who practise tax evasion skilfully. Administration of consumption tax will be very difficult as identification of consumption is much more difficult than identification of income. Further, people who do not furnish proper accounts of their income cannot be expected to change their attitude overnight to give proper accounts of the consumption made during a period. From cost point also, maintaining account of the amount that people save or consume each year will be high and tedious. Moreover, it should be remembered that the public in general are now used to regard income, not expenditure, as the
best index of the ability to pay, and it would be unwise to
discontinue this familiar and widely approved basis of taxa-
tion. Thus, theoretically accrual concept as addressed by
Haig and Simons is much more acceptable than the disposition
concept of income tax. In actual practice however, no country comes close to
the use of a general accrual concept in the legislation of
taxation. Many items, which strictly speaking should be in-
cluded in the tax base, if the accrual concept is followed,
like unrealised accretion to economic power, imputed income
arising from the use of leisure time devoted in one's kitchen gar-
den, are excluded on administrative ground as valuation of
such income and maintenance of its account is not only very
difficult but is also not beneficial if one considers the cost
involved to administer such income vis-a-vis the additional
revenue that can be earned from such type of accrual. Again,
exempting of savings made in the approved manner, provision
for retirement annuities, tax free superannuation funds, pension
funds, etc. are features, basically advocated by exponents of
consumption type are found to be incorporated in the legisla-
tion of taxes on income in almost all countries. Over and above,
the inherent tendency of the tax payer to avoid the taxnet cast
by the tax gatherers in the never-ending game of the former
detecting loopholes in the tax legislation and the latter en-
deavouring to plug it, makes the practical situation much more
complex to allow a definition that could serve the tax administration as an unfailing guide. Thus, in practice, no attempt is usually made for a general definition of income and instead fiscal provisions believe in enumerating items that are to be included, excluded, or deducted to compute taxable income. Even this approach, as adopted by almost all countries, is not free from practical difficulty. Problems crop-up basically from the fact that, the approach adopted in defining income in economic theory is different from that in Accountancy. An accountant is more concerned with the net result over a period and, therefore, lays more stress on the outgoings rather than incomings. He also looks upon the source of income — primarily a business enterprise — as existing separately from the owner of it. On the other hand, an economist is more interested in the incomings of the recipient himself and in his case the outgoings are predominantly of the nature of personal consumption and as such the question of deducting them from the incomings does not arise. Secondly, an economist speaks in terms of accretion to one's economic power — this power may be derived not only from the realised accretion but even from realisable accretion. To an accountant, on the other hand, profit (income) is the realised increment in the value of the whole amount invested in an undertaking. The tax-gatherer, appreciating this difference in approach, tries his best to exploit the situation to his advantage — he accepts the accounting concept in general, but
where he is faced with the problem of defining a particular income following the economist's concept of accrual, like defining of capital gain — he is quick enough to switch over to the realisation concept as the Accountant advocates.

This tendency of the tax-gatherer to have the best of both worlds involves a situation where neither the economist nor the accountant nor even the tax-gatherers but the judiciary has the last word on the issue.

For all practical purposes, it is seen that the tax-gatherers are found not interested in the question — What is income ? They are more interested in the question: Whether a particular item in a specified set of circumstances attracts tax on income or not? The answer to such type of questions necessarily depends upon the test to be applied by the person to whom it is put. An economist will test it by asking another question: Does it or does it not increase the economic power of the recipient to command satisfaction — yielding goals or services? The affirmative answer makes it 'income', the negative not. This answer again, is not necessarily popular and pragmatic to an Accountant. An Accountant is not much concerned with answering it as such, his interest lies more in the treatment of the item according to the accepted principles of accountancy, after its nature is determined. In the absence of any specific provision in the taxation law in specific circumstance, the tax-gatherer, has necessarily to fall back upon the
general principles that govern the issue and they lie embedded either in the guidelines generally provided by the scheme of a taxation law or else lie scattered in judicial pronouncements. Thus in any dispute between the tax-gatherer and the tax payer as to the true nature of a particular receipt, the courts have the ultimate answer which binds both of them.

Concept of Taxable Income in India.

At no time, the Income-Tax Acts of India did provide an exhaustive definition of Income. In fact, between 1860 and 1922 there was basically no definition, not even an inclusive definition, of the term 'Income', the subject matter of taxation. Frequently, what did not come into the pocket of a tax payer, was converted into 'income' for tax purpose by the incorporation of special provisions. For example, in 1923 the right of an employee to occupy free of rent a place of residence provided by his employer, was considered to be a taxable perquisite for the purpose of section 7 of the 1922 Act. From then onwards, this principle has been extended time and again to charge to tax many a benefit in kind, perquisite and amenity given to employees, businessmen and professional persons. Again, occasionally what the court held to be a receipt on capital Account was converted into an income by special definition or provisions (e.g. the definition of 'Dividend' in section 2 (6A) of the 1922 Act, compensation received on termination of employment or loss of managing agency etc). In the year 1939, it was for the
first time that an inclusive definition of the word *Income* was provided by the Act of 1922 in Sec. 2 (6C) and since then it has been amended, reamended and substituted till it assumed the form as given in Section 2 (24) of the Income-Tax Act of 1961. Even the last mentioned section has been amended a number of times, the latest being the incorporation of Clause (iiib) in Sec. 2 (24) by the Direct Tax Laws (Amendment) Act, 1989 with retrospective effect from 1-4-1962.

The income concept adopted by the Income Tax legislation of India is essentially an 'accrual concept'. However, accrual like capital gains is not included in the tax base of individuals until realised by the individual. Also self-produced income are excluded from the scope of income taxation in India. In India, 'global' concept of taxing income is followed — a 'resident' individual in India pays tax on his total World Income while the "non-resident" individuals pay tax only on "income accruing or deem to accrue or received or deemed to be received to them within India". Initially, casual and irregular items were not taxable in India, but at present, specially after the changes brought about with effect from the assessment years 1973-74 and 1987-88, it will be more appropriate to say that casual income is taxable in India, but is entitled to get a basic exemption of Rs.5,000/- in aggregate. As far as 'capital gain' is concerned, such gains are treated as regular income if it is realised within 36 months (12 months in case of shares)
Long-term capital gain (gain earned for asset held for over 36 months) gets a favourable tax treatment in India.

In the past, earned income (income from Salary, Profession, Vocation and Business) was treated favourably compared to 'unearned income' (income from land, building, securities, bullion etc.) through difference in rate of Sur-charges on the incomes, but at present, since April 1, 1968, this discrimination has been done away with.

Though accrual concept of income is followed in India, selective saving used to be exempted fully or partially to provide incentive to save and invest. But, from the assessment year 1990-91 such incentive has been greatly reduced. Present saving in certain instruments allows assessee to defer their tax payment on the income saved from the current year to some future financial year and saving in certain other instruments (Public Provident Fund, Life Insurance Policy etc.) entitles the assessee to get a tax rebate instead of allowing such saving to be excluded from the tax base.

To conclude, it can be said that the present system of income tax in India is a hybrid personal income tax which is consistent with neither the economic nor the accounting concept. It includes many aspects of accretion ideal but some aspects of consumption ideal too.