CHAPTER II

ISSUES IN TAXATION OF INCOME

Introduction :

The government requires revenue for its functioning. As the government functions for the people, the cost involved in the discharge of these functions is necessarily borne by the people. The governments have been inherently delegated power to collect revenue from the people ever since the institution of the government came into existence. The magnitude of the revenue required by the government for the discharge of its responsibilities as well as the manner of raising and collecting that revenue have important implications for the efficiency, equity and welfare. Because "even a light load, if ill-distributed may prove too heavy to bear. So also a small amount of tax revenue, raised by means of ill-conceived taxes, proves a serious menace to national progress; nay, it may lead to popular resentment, and may ultimately drive people to revolt."[1]

So, the question of determining the amount of tax for each individual of the society equitably where everyone is

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1. Lakdawala, D.T., Justice in Taxation in India, The Popular Book Depot, Bombay, 1946, p.2.

different from each other in terms of ability, tastes and needs has been most disputed.[2] Accordingly, the basis of taxation and the mode of its collection have been matters of lively debates among the scholars. Before going into these aspects we first briefly trace the evolution of Income Tax.

1. Evolution of the Income Taxation :

First Phase :

The modern income tax system seems to have emerged to achieve mainly two fold objectives. First, to raise revenue for the government and second, to ensure an equitable distribution of the burden of taxation among various classes of the people. Government revenue needs for development purposes were relatively minor in the past in case of the developed countries unlike the developing countries of today. In fact, the governments in the past had hardly any role in the development. Main functions of the governments in the past were to maintain law and order inside the country and safeguard the country from outside aggression. So the need for revenue used to arise only when either the country had to face the external aggression or it had to cope with civil war or revolution inside the country. History of modern income taxation is full of evidences in this regard.

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2. Musgrave, R.A., and Musgrave, P.B., Public Finance in Theory and Practice (3rd. ed.) MacGraw Hill International Book Company, 1983, p.237; Pigou, A.C., A Study in Public Finance, MacMillan and Co.Ltd.,London, 1956,p.55.

England :

England seems to be the first country in the world to introduce the modern income tax and it was forced to introduce it when it had to face the gigantic struggle against France[3] which broke out in 1793. Before this war, England used to collect revenue mainly through customs, excises, stamp duty and some other minor direct taxes. But these sources of revenue could not meet the need of revenue to defray the war expenses. This necessitated the British government to introduce a bill in 1798 for the imposition of the direct tax on income which was finally enacted as a law on January 8, 1799 which is regarded as the first income tax law in the history. But when peace was restored after the battle of Waterloo, the tax was discontinued since 1816.

U.S.A. :

In the United States of America also, a similar necessity arose. Before the Civil War broke out the government used to get revenue only through some indirect taxes and the real estate taxes. But as the civil war broke out these sources could not produce the required amount of revenue. Income tax was naturally one additional source to be thought of. But the irony of the U.S. Constitution was that it had prohibited

3. Groves, Harold M., Financing the Government, Henry Holt and Company, New York, 1946, Appendix.

the imposition of any direct taxes on incomes or property. So in 1861 a bill was passed by the Congress authorizing the federal government to impose a tax on income under the name of 'Income Duty', which was considered an indirect tax. But this law could not be implemented due to the absence of the detailed work regarding mechanism of collection. So another law was passed in 1862 which was to be in force for three years beginning July 1863. The war was in its worst phase and the revenue need of the government increased enormously. So to meet this challenge, government passed another more detailed and comprehensive income tax law in June 1864 which served as the model upon which all subsequent laws were based. Since the tax was basically the war tax, it was abandoned in 1872.

<u>France</u> :

Although the first attempt at the introduction of the income tax in 1848 in France was made as a result of violent opposition against the abuses, inequalities and injustices caused by the old methods of taxation of aristocracy, the second attempt was the direct result of the Franco-Prussian (Germany) War of 1870. The first and second attempts could not succeed due to the fierce opposition in the house. It was only in 1887 that the income tax law was enacted in France but this also was not implemented due to the fall of the government which had laboured hard to get the bill passed in the house. As a result of this, income tax scheme in France was relegated into background for more than two decades. It was only in 1909, that the French Chamber of Deputies finally adopted a general income tax scheme.

Germany :

Income tax in Germany was the combined result of the widening of the gap of income distribution due to heavy excise duties during 18th century and democratic upheaval in the first half of the 19th century. Class tax was adopted first in 1811 and again in 1820 as an alternative to the exhorbitant excise duties. But this tax also could not prove itself an adequate alternative to excise either in terms of revenue or in terms of lessening the inequalities. And the internal political upheaval of 1848, reintroduction of income tax in England and mass discontent against the excise duties led finally to the reintroduction of income tax in Germany in 1848. But it was repealed in 1856. Since then several experiments were done in different German States to find out the viable alternative to the excise duty. It was finally in 1891 that a comprehensive income tax law was passed in Germany.

After the introduction of income tax in major countries in Europe, England and the United States, other adjoining countries also were motivated to adopt similar laws to impose this tax. England's successful experiment with income tax had subsequently encouraged many countries to introduce direct tax on income. From the above accounts it may be safely inferred that the first phase of the introduction of the income tax system was a direct result of the financial exigencies created by either war against other countries or by political unheavals within the country.

Second Phase :

The second phase of the income tax seems to have started on equity grounds than on the grounds of revenue needs. After the repeal of the income tax in 1816 in England indirect taxes on almost everything were levied to maintain the level of public revenue. These taxes had well-nigh reached the limit. At the sametime budget deficits were enormous and increasing. Articles appeared saying..."the present fiscal system compels the labourers, a dwarf in wealth to carry the load of the lord who is a giant in affluence."[4] This kind of wave of mass discontent against the existing indirect taxes began to surface. And consequently the government could do no better than reintroduce the income tax. Finally, law was passed in 1842 which was popularly known as the "Property and Income Tax Act." Since then, this

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4. Seligman, E.R.A., The Income Tax: A Study of the History Theory and Practice of Income Taxation at Home and Abroad, The MacMillan Company, Newyork, 1914, p.117.

tax has remained a permanent and important source of public revenue in England despite the fierce opposition by prominent figures like J.S.Mill. But it is said "the country as a whole supported (this tax), not because it loved income tax more but because it loved the indirect taxes less."[5]

In U.S.A. also income tax was scrapped in 1872 after the civil war was over because it was not needed for revenue purposes anymore. But after the abandonment of income tax for nearly two decades, conditions appeared leading to the reintroduction of income tax there also. Rich urban investors in securities, the wealthy businessmen, and the well-to-do professional classes were escaping taxes almost entirely[6] which gave rise to mass discontent against the existing fiscal system. In this context some of the most pinching as well as articulate portions of speeches delivered in the U.S.Congress by Mr. Macmillan are worth-quoting - "We do not come here in any spirit of antagonism to wealth. It is not a proposition to put an undue embargo upon wealth, but it is to make the wealth that is accumulated in this country pay some share of the expenses of government...My friends, are we going to put all of this burden on the things men eat and wear and leave out those vast accumulations of wealth."

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5. Quoted in Seligman, E.R.A., Op.cit., p.138.

6. Ibid., p.495.

"And yet, when it is proposed to shift this burden from those who cannot bear it to those who can; to divide it between consumption and wealth; to shift it from the labourer who has nothing but his power to toil and sweat, to the man who has a fortune made or inherited, we hear a hue and cry raised.... I would be most reluctant to use the power of government to tax wealth unjustly. But I am also unwilling to let wealth escape all government taxation."[7] At other place he said "As you have prospered, so pay. As you have received the blessings of the government, contribute to its support. As you have been enabled to accumulate this wealth by the blessings of free institutions contribute something to perpetuate them."[8]

After such appealing discussions the new law was passed to be effective from 1895 onwards.[9] But as the direct tax on income was prohibited by the constitution, this law was declared invalid by the U.S. Supreme Court. But the campaign for the reintroduction of income tax upon the wealthier classes still intensified. So constitution was so amended as to authorize the federal government to levy income tax. Consequently a new income tax law was passed and became effective in 1913.

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7. Quoted in Seligmman, E.R.A. op.cit., p.498.

8. Ibid, p.499.

9. Ibid, p.508.

In France, Germany, Italy and other adjoining countries also redressing the inequalities among the people created by the growth of the modern industries and commerce was one of the main reasons along with the need of the revenue for the popular demand and the success of the income taxation.

So even if wars had not occured, income tax would have come in due cource of time in England, U.S.A., France, Germany etc. through natural and evolutionary processes of industrialization which gave rise to vast needs of government and vast inequalities of wealth and income. But wars brought it rather earlier. In present times, there is hardly any country in the world which does not have income tax system though the degree of success in terms of revenue and equity might be different depending upon the level of their economic development, political will and administrative competence.

2. Theoretical Basis of the Income Taxation :

Introduction :

Taxes at different times have been levied on the basis of the nature of the economy prevailing in the respective country. In the primitive community where inequalities were negligible, productivity very low and organization rudimentary, poll tax was the simplest and the most effective method of taxation. But when, gradually agriculture, handicrafts and commerce appeared, the system of the ownership of property developed and economic inequalities started emerging with social organization becoming more complex, property, as a basis of taxation replaced people as a basis (land tax). As the economy developed further, salary earning class, professionals and investors appeared, property tax could not reach these newly emerging classes.

So to bring them into the tax net as also to meet the growing needs of the state, expenditure was taken as a basis of taxation thinking that no one could escape the expenditure on consumption (indirect taxes). But in course of time, it appeared that the poor people had to spend all of their incomes for consumption whereas the expenditures of the rich people used to be only a small part of their incomes resulting thus in great inequalities among the people. So this basis was also found inadequate.

Then 'produce' was taken as the norm of taxation. But in practice, this also could not bring all the earnings within the tax net. So, finally income was taken as the basis of taxation that would reflect the real ability to pay of the people. Once it was considered that income tax could replace all other taxes and duties for the revenue requirements of the government. But this remained only a hope.

Theories of Taxation :

The fiscal economists, on the otherhand, were busy to find out the theoretical basis of taxation on which the payment of taxes by the people could be justified. The first of these theories is the Cost of Service Theory under which the basis of tax payment is the services of the state to the individual. So the amount of tax that every individual should pay should be determined on the basis of the expenses incurred by the government in protecting him.[10] But the immediate objection to this theory was that most of the state services are so general that it is impossible to determine the specific costs to each individual. Many of the government services such as defence, justice, police protection etc. are in the nature of public goods. Further the poor often use more services from the public schools, public hospitals, public transports etc. than the rich. So if the cost-of-service principle was to be accepted as the basis of taxation, it would lead to regressive taxation, causing more unequal distribution of the tax burden.

Then emerged the Benefit Principle or Give and Take Theory of Taxation according to which an equitable tax system would be one under which each tax payer contributes in line with the benefits which a person receives from the government.[11]

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10. Lakdawala, D.T., op.cit., p.3.

11. Masgrave, R.A., and Musgrave, P.B., op.cit., p.238.

The benefit theory assumes that the benefits enjoyed by the society from the state exceed the tax paid by it.[12]

Here also the same reason that the poor often use more public services than the rich, rejects the benefit principle as the basis of taxation. Because tax varies inversely with wealth and income under this principle leading thereby to the regressive taxation.

Moreover, "for a tax, by definition, is a payment, in return for which no direct and specific *quid pro quo* is rendered to the tax payers."[13] So this principle also could not be taken as the basis for tax payment.

Ability-to-Pay Principle :

Although the ability-to-pay principle was discussed even earlier than the benefit principle, it received prominence afterwards only when redistributive aspect of taxation came to acquire greater emphasis. However, according to the ability-to-pay principle people with equal ability should pay similar amount of tax, this is horizontal equity. Whereas the people with greater ability should pay more, this is

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12. Lakdawala, D.T., *op.cit.*, p.4.

13. Dalton, Hugh, *Principles of Public Finance*, Ruttedge and Kegan Paul Ltd., London, 1961, p.61.

vertical equity.[14] There is no difficulty in realising the horizontal equity through taxation because in this case only determining the tax for people with certain ability is enough. Then the same amount of tax applies to the people belonging to the same group. But it has been a serious problem in the theory of taxation to determine the tax liability for the people with different ability-to-pay so that equal burden of a tax is assured.

Diminishing Marginal Utility of Money :

Although it is obvious that the richer people possess greater ability-to-pay than the relatively poorer people, by how much the tax burden should differ for the people with different ability is the crucial problem in distributing the tax burden equitably among the people. To solve this problem, the law of diminishing marginal utility has been invoked as the theoretical basis for determining the tax liability for the people with different ability. This law while applied to income requires that the schedule of marginal utility of income should exhibit a decline with every increase in income.

Here it is to be noted that since tax payment involves sacrifice this sacrifice is to be distributed equitably among the people with different ability to pay. Then does the equal

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14. Musgrave, R.A., and Musgrave, P.B., op.cit., p.242

sacrifice theory based on the law of diminishing marginal utility ensure the distribution of tax burden according to the ability-to-pay? The answer depends upon the way the term 'equal' is interpreted. Because there are three sacrifice principles such as equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice and answer turns out to be different under each of these principles.[15]

a. Equal Absolute Sacrifice :

If we interpret equal sacrifice in terms of absolute amount then the amount of tax to be paid by the people with different ability will depend upon the nature of marginal utility schedule of income. If this schedule is assumed to be constant for the people of different income level then the principle of equal absolute sacrifice demands the same amount of tax from all. And if the marginal utility of income is assumed to be declining with each addition in income, then the principle of equal absolute sacrifice demands the increase in the amount of tax to be paid with each increase in income. Because the people with larger incomes should sacrifice more income to equate the sacrifice of utility of income of the people with relatively lower income. Because the people with lower income have more utility from their income than the people with higher income. But it does not necessarily mean

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15. Musgrave, R.A., and Musgrave, P.B., op.cit., p.250.

that increase in tax burden with each increase in income calls for any specific types of taxation either proportional or progressive. Because higher absolute amount of tax from the people with higher income might be associated with regressive or proportional tax. Since the distribution of the tax liability depends upon the marginal utility schedule of income, tax liability might increase progressively, proportionally or regressively depending upon the elasticity of the marginal utility of income. If the elasticity of the marginal utility with respect to income is greater than unity, it calls for a progressive distribution of tax burden. If the elasticity is equal to unity, proportional distribution of tax burden is required and finally if this elasticity is less than unity, then it requires regressive distribution of tax burden. So according to these three forms of equal absolute sacrifice principle progressive distribution of tax burden is justified only when the marginal utility schedule of income is elastic. While one can say that the marginal utility of income tends to decline, nothing definite can be said about the rate of decline and therefore the equal absolute sacrifice principle does not provide a conclusive basis for progressive taxation.

b. Equal Proportional Sacrifice :

If we interpret the principle of equal sacrifice in terms of proportional amount then the amount of tax to be paid

Ever since the tax on income has been contemplated, defining the income for tax purposes has remained one of the most controversial and complicated problems. As Wickrey says, the definition of the base for an income tax is difficult and has aroused much controvery.[17] Seligman says that the problem of defining income with such precision, and completely to avoid any net impairment of capital is one that baffles the student; and certainly no such precision can be attained for purposes of taxation.[18] Prest also opines that the definition of income in an advanced country gives rise to all sorts of conundra which can hardly be said to have been solved to every one's satisfaction.[19]

Even in the United States of America where personal income taxation is said to have been most successful, the controversy regarding the definition of income still persists and it is far from settled. As Musgrave and Musgrave put it - "one must keep in mind that the tax base itself reflects the statutory definition of taxable income with all its imperfections."[20]

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17. Vickrey, William, Agenda for Progressive Taxation, The Ronald Press Company, New York, 1947, p.198.

18. Seligman, E.R.A., op.cit., p.117.

19. Prest, A.R., Public Finance in Developing Countries, (3rd ed) English Language Book Society, London, 1985, p.30.

20. Musgrave, R.A., and Musgrave, P.B., op.cit., p.342.

Problems in Defining the Taxable Income :

The principal problem in determining the perfect definition of income that can fully reflect the ability-to-pay of all persons is that there are almost innumerable forms of income and gains which enhance the economic power of the people but can hardly be brought and ascertained for tax purposes. For example, a person's economic power might be enhanced by receiving gifts, inheritance, gains in all kinds of capital, farm product, owner-occupied houses, speculative gains, lottery, fringe-benefits provided by the employers, gratuities, remittances, rent, interest, dividend, profits, wages, salaries, pension, charges, fees and so on and so forth. All these forms of incomes and gains add to the economic power of the recipients. They may be earned or unearned incomes, accrued or realised incomes, in the form of imputed income, in the form of direct earnings or transfer, in the form of regular or irregular incomes and in the form of cash or kinds or services. So the problem is how can all these sources of economic power be brought to tax base so that horizontal equity could be taken care of.

In this context the definition of income propounded and practised in the U.S.A. may be instructive. The American definition of taxable income is greatly influenced by the theory of Haig and Simons. Haig defines the taxable income as -

"net accretion to economic power."[21] This definition has become a standard quotation in the American literature on the concept of the taxable income. Henry Simons has defined personal income, "as the algebric sum of (i) the market value of rights exercised in consumption, and (ii) the change in the value of the store of property rights between the beginning and end of the period."[22]

Musgrave and Musgrave also are of the opinion that income, as an index of tax paying capacity, should be defined broadly as total accretion to a person's wealth. All accretions should be included, whether they are regular or fluctuating, expected or unexpected, realised or unrealised. No consideration should be given to how the income is used, i.e. whether it is saved or consumed. They further say that incomes from all sources thus defined should be treated uniformly and be combined in a global income total to which tax rates are applied. Without globality, the application of a progressive rate schedule can not serve its purpose of adapting the tax to the tax payer's ability-to-pay.[23]

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21. Haig, R.M., The Federal Income Tax, Columbia University Press, New York, 1921, Chap.1.

22. Simons, Henry, Personal Income Taxation, University of Chicago Press, 1937, p.50.

23. Musgrave, R.A., and Musgrave, P.B., op.cit., p.344.

These definitions would necessarily help tax system to attain horizontal equity.[24] But in practice the definition of taxable income is quite conservative as realised income is being taxed rather than accrued income, cash income is being taxed rather than imputed income or fringe-benefits and only direct income is taxed excluding transfer and so on.

In England also current flow of cash has been taken as the definition of the taxable income.

Thus, even in advanced countries where tax system as well as tax administration are considered to be well-developed and efficient, the theoretical definition of income has been modified in practice, mainly on administrative ground. This is, by no means, conducive to the attainment of the horizontal equity as the theory demands. In developing countries there is further erosion of the horizontal equity as agricultural incomes which constitute about half of the national income are exempted from income tax.

Moreover, various kinds of deductions which are being granted to the tax payers for different purposes under all tax systems have further eroded the already shrunk tax base. In advanced countries the deductions are granted mainly on

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24. Kaldor, Nicholas, Indian Tax Reform: Report of a Survey, Government of India, Ministry of Finance, 1956, pp.14-15.

equity ground such as medical expenses, educational expenses, child care expenses, etc. The old age and blindness allowances have also been granted in some of these countries. The exemption limits are also determined taking the number of dependents into consideration.

But in developing countries incentive considerations have been given greater importance than equity considerations while determining the deductions. Certain kinds of savings and investments are allowed to be deducted in developing countries to increase the aggregate saving and investment for economic growth rather than the child care expenses, old age and blindness allowance.

So the attainment of horizontal equity in income taxation has been considerably restricted due to conservative definition of taxable income on the one hand, and due to erosion of tax base by way of various deductions on the other.

Vertical equity depends not only on the rate structure but also on the type of income tax followed. If the tax system is unitary or global underwhich incomes of a tax payer from all sources are integrated and form a single tax base, the progressiveness of the tax system becomes effective in attaining vertical equity. But if the tax system is schedular underwhich incomes of a tax payer from different sources are taxed separately as different taxes, the progressiveness of the tax structure loses its effectiveness in attaining equity even though all types of incomes are taxed. In developing countries, income tax system is far from being unitary. Agriculture incomes are exempted almost everywhere. Non-resident income is not taxed. Capital gains are separately treated. Interest income is being taxed separately in some countries and in some others rent or anyother incomes are taxed separately.[25]

Rate Structure of the Income Taxation :

It has been discussed in the earlier section that the modern income tax system is based upon the ability-to-pay principle. According to it, the ability of a person to pay tax is measured on the basis of the law of diminishing utility of money. It means that marginal utility of money diminishes with every additional unit of money after reaching certain level of income as mentioned earlier. Since the payment of tax imposes sacrifice on the tax payers, ability-to-pay principle demands equal sacrifice. But the rate structure depends upon the interpretation of the term 'equal' as discussed in earlier section. If the marginal utility of income is assumed to decline more than proportionately as the income increases, the principle of equal sacrifice leads to progressive taxation. If we assume that the marginal utility

25. Nepal itself is a case in point.

of income declines at a rate less than that of income it might require a proportional or a regressive tax. Since marginal utility of income can not be said to be declining at some specific rate, the rate structure of income taxation also can not be formulated in any specific form. However, the taxation on income and profits have been made progressive all over the world on the assumption that marginal utility of income declines at the rate higher than that of income. The rate of progression is always arbitrarily fixed.

In terms of rates, marginal or bracket rates are always higher than average rates under progressive taxation, marginal and average rates are always equal under proportional taxation and marginal rates are lower than average rates under regressive taxation. In terms of tax liability, the ratio of tax liability to income rises when moving up the income scale under progressive taxation, the ratio remains constant under proportional taxation and the ratio declines under regressive taxation.

But the problem here is to determine how progressive a tax should be at different levels of income. This difficulty arises from the fact that the rate of diminishing marginal utility of income is immeasurable. So the degree of progression in tax structure is being determined everywhere arbitrarily taking the basic features of the principle into account as to exempting the income level required for subsistence and making marginal rates higher at every subsequent income level.

In the same way, the degree of progression differs at different levels of income. The degree of progression is generally found to be higher in low and middle income levels than in the upper income levels and beyond certain level of income the degree of progression ends. Then the whole tax structure becomes degressive.

<u>Measurement of the Progression</u> :

The degree of progression is measured in the following manner:

i. The progression can be measured by the ratio of change in effective rate to change in income which is called the average rate progression. The value of the coefficient is zero for a proportional tax and positive for progressive tax. The effective rate curve tends to flatten out and progression tends to decline as we move up the income level. The process can be expressed in the following formula :

$$P = \frac{T_1/Y_1 - Y_0/Y_1}{Y_1 - Y_0}$$

ii. The progression can also be measured by the rate of percentage change in tax liability to percentage change in income which is called the liability progression. The coefficient 1 indicates the proportional tax and the coefficient above 1 indicates progression. This can be expressed by the following formula:

$$P = \left(\frac{T_1 - T_0}{T_0}\right) \div \left(\frac{Y_1 - Y_0}{Y_0}\right)$$

iii. Another method of measuring the degree of progression is the ratio of percentage change in disposable income to percentage change in income before tax. This is known as the disposable income progression. This is the elasticity of disposable income in relation to income before tax. Here elasticity 1 indicates the proportional taxation and elasticity less than 1 indicates the progression. The formula for this measurement is as follows:

$$P = \frac{(Y_1 - T_1) - (Y_0 - T_0)}{(Y_0 - T_0)} \div \frac{Y_1 - Y_o}{Y_o}$$

where P stands for Progression, Y_0 and Y_1 stand for lower and higher level of income respectively and T_0 and T_1 stand for corresponding amount of tax liabilities.[26]

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26. Musgrave, R.A., and Tun,Thin, "Income Tax Progression 1928-48", Journal of Political Economy, December 1948, pp.498-514; Musgrave, R.A. and Musgrave, P.B., op.cit. p.376.

Application of the Tax Rates :

The progressive tax rates are applied in two ways. First, rates are applied on income class which is called the step system and, second, on income brackets which is called the slab system.

Under the step system, the same tax rate is applied to the entire taxable income of the tax payer whereas under the slab system the tax base is broken into different income slabs or brackets and different tax rates are applied to the corresponding income brackets.

The step system is the earliest method of the application of tax rates which is almost out of practice in modern times. Today the tax rates are commonly applied according to the slab system. The tax law quotes the marginal rates applicable to different income slabs under the slab system. So the actual effective tax rates are generally lower than the apparent marginal rates.[27]

But the problem here is that the theory does not guide us about determining the width and number of income slabs, and the progression in the marginal rates of corresponding income slabs. So these important issues contained in income tax structure are generally decided arbitrarily depending upon the social policy of the state. If the tax system is to be made more progressive to attain vertical equity, the width of

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27. Vickrey, Williams, op.cit., pp.367-368.

the different income slabs is made narrower and the number of the slabs is increased given the marginal tax rates and vice versa. So the progression is different in different tax structure.

Tax Paying Units

Income tax is of two types: personal and corporate. Corporate bodies pay corporate tax on their profits. The equity and the subsistence issues are not involved in corporation tax. So this tax is neither made progressive nor exemption limit is provided in it. They are generally taxed at flat rate on their entire profits.

But there are various tax paying units under personal income taxation. Generally, partnership firms, registered or unregistered firms, association of the persons and individuals pay personal income tax. Among them individuals are the most important component. The equity and subsistence issues are involved in individual taxation. So the exemption limit and the progressive rate structure are mainly involved while taxation of individuals is concerned. There is no uniformity in the treatment of firms and individuals in personal income tax structures of different countries. In some countries all of them are treated alike and in some others they are treated differently. In some countries the partnership firms are even treated like corporations.

There are two types of tax paying units under individual income taxation also: individual and family. Under individual as a tax paying unit system, the different members of a family who have taxable income are taxed separately. Each of them enjoys the exemption limit and allowances, if any, separately. The number of the dependents are not taken care of with respect to exemption limit. Though the rate structure is the same for both types of tax paying units, progressiveness, hence equity suffers under individuals as tax paying units because the tax base is substantially reduced due to separate treatment of each member of the family.[28]

Whereas under family as a tax paying unit system whole income of the family is clubbed in and is made a single tax base. The whole family enjoys only one exemption limit and single set of allowances, if any. But the case of Hindu-undivided family in India is different from this.

Exemption limits are determined taking the number of the dependents of the tax payer into consideration. As for example the limit is less for unattached individuals, little.

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28. Sunderam, K., and Pandit, V. "Direct Tax Reform:Family As Tax Paying Unit and other Issues", Economic and Political Weekly; April, 1979, p.776.

more for married couples without children and highest for married couples with dependent children. So the ability-to-pay principle is observed where family is adopted as tax paying unit.

Besides these there is yet another type of tax paying unit, that is, non-resident. Although there might be some difference, this type of tax paying unit is generally defined as follows:

a. A person who has resided in a country for a period not more than 180 days in any financial year; or

b. A person who is residing outside the country but acquiring or earning income from his original country, or

c. A firm or a company operating as a branch or sub-branch of a foreign firm or company or controlled or managed by such firm or company.

4. Assessment of the Tax :

Assessment of income tax is another most complicated issue involved in actual administration of the tax because it is natural for the tax payers to have the temptation to pay as little tax as possible. This being so, fraud, avoidance and evasion have emerged simultaneously with this tax. It was as early as in 1904 that a committee was instituted in England to examine the problem of fraud and evasion of income tax.[29]

29. Seligman, E.R.A., op.cit., p.185.

In Italy also this tax was almost doomed to failure due to wide spread fraud and evasion even in the initial stage of this tax.[30] Such fraud and evasion do not occur only due to lax administration of the tax but also due to the type of procedures followed in the assessment of tax. Defective methods followed in the assessment of tax give scope to fraud and evasion. Assessment of tax is considered to be the most vulnerable part of the income tax system while translating the theoretical principles of a good tax system into practice. So here we examine the methods of assessment.

Methods of the Income Tax Assessment :

There are generally three methods of assessment of the income tax as follows:

a. Presumptive Assessment Method;
b. Lump-sum or Self-declaration Method, and ;
c. Stoppage-at-Source Method;

a. Presumptive Assessment Method :

Under this method the tax authorities determine the taxable income of the tax payers on the basis of their outward signs. This method presumes that the people with large incomes usually give evidence of the fact in several ways, such as the amount of rent paid for the residence, the general standard of living as evidenced by the use of automobiles and consumer durables, the mode of dress etc.

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30. *Ibid.*, p.352.

In case of small firms, hotels, retail traders, handicrafts, workshops etc. the presumptive assessment method is applied by the tax authorities basing their judgement on location of the unit, use of some key inputs or number of customers or on the basis of known income of similarly placed business.

This method is applied when the tax payers are either not legally required to maintain books of accounts of their transactions or whatever accounts have been maintained are rejected by the tax authorities due to the lack of reliability. This method is also applied in cases when either the tax payers do not file the returns at all or whatever returns have been filed are far from being valid. This method is regarded as the most rudimentary method of assessment of the income tax on the ground that the taxable incomes determined through this method hardly reflect the real ability-to-pay of the tax payers.[31] It also gives rise to the tendency for arbitrary determination of the taxable income and also to the possibility of collusion between the tax payers and the tax authorities. It also discourages the tax payers from maintaining the books of accounts and encourages fraud and evasion. But in developing countries this method is still being practised to a not insignificant extent. This is why the fraud, avoidance and evasion have been the rules of the game in the income tax system in these countries. Income from self-employment are generally assessed on the basis of this method.

31. Morag, Amotz, "Some Economic Aspects of Two Administrative Methods of Estimating Taxable Income", National Tax Journal, June, 1957, p.184.

b. Lump-Sum or Self-declaration Method :

Under this method the tax payers declare their income on the basis of books of accounts maintained by them and furnish them to the tax authorities within the stipulated time. Lump-sum declaration is the old name of this method. The tax officers assess the tax on the basis of returns so furnished. This is a most commonly practised method of assessment of income tax. There have been further developments over this method. One of them is the self-assessment method under which the tax payers assess their incomes themselves, compute the tax to be paid and pay tax before the filing of the returns. And the evidence of payment of tax accompanies the return. Further, development in this method is the pay As you Earn(PAYE) method which has been applied in advanced as well as some of the developing countries. Under this method, the tax payers pay the tax in several instalments within the year of income in the interval of some months on the income earned during that period and file the returns after the close of the year of income for the final assessment. This method can be useful in countries where the tax administration has achieved considerable efficiency on the one hand, and tax compliance ratio of the people is high on the other.

c. Stoppage-at-Source Method :

Stoppage at source, withholding-at-source, collection-at-source, taxing or charging at source indicate the same method of tax assessment. If the income is acquired from the institutions whether government or private in the form of wages, salaries, interests, rents or dividends, the tax liable to such incomes is deducted by the person who makes such payments, at the time of payment and deposits the deducted tax to the credit of the government.

This method was for the first time introduced in England in 1803 and it is believed that this method is in the main responsible for the early success of this tax in England. In the U.S.A. and Italy also this method was applied from the very beginning but it did not cover as many types of income as it did in England. This method is regarded as the back-bone of the individual income tax. In the U.S.A. 81.71 per cent of total individual income tax in 1963 and more than 90 per cent during 1970s was collected through this method.[32]

Regarding the merits of this method, Musgrave and Musgrave say that by linking tax payments to the current level of income, rather than by having them lag behind one year, the responsiveness of tax payment to changes in the level of personal income is greatly increased. This method also assures fuller compliance since the declaration of income is not left entirely to the income earners.[33]

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32. Pechman, J.A., Federal Tax Policy, The Brookings Institution, Washington D.C., 1967, p.67.

33. Musgrave, R.A., and Musgrave, P.B., op.cit., p.338.