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**Study Material**

**19UCR408: INDIRECT TAX**

**UNIT – I: Introduction to Taxation**

Tax- Features – Canons – Objectives of Taxation – Tax Vs Duty - Direct Tax Vs Indirect Tax – Advantages and Disadvantages of indirect taxes - Various types of Indirect taxes.

**Meaning of TAX:**

Tax is a compulsory payment to be made by every resident of India. It is a charge or burden laid upon persons or the property for the support of a Government. Government decided the rates and the items on which tax will be charged, like income tax, GST, etc.

**Definition of tax:**

According to Hugh Dalton, "a tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return, and not imposed as penalty for any legal offence."

**Direct and Indirect Tax:**

**Direct Tax:** It is levied on income and activities conducted. The burden of tax cannot be shifted in case of direct tax. It is paid directly by person concerned. It is paid after the income reaches in the hands of the taxpayer. Tax collection is difficult. Example Income tax, wealth tax.

**Indirect Tax:** It is levied on product or services. The burden of tax shifted for indirect taxes. It is paid by one person but he recovers the same from another person i.e. person who actually bear the tax ultimate consumer. It is paid before goods/service reaches the taxpayer. Tax collection is relatively easier. Example GST, excise duty custom duty sale tax service tax

**OBJECTIVES OF TAXATION:**

**1. To raise revenue:** The principal objective of taxation is to raise revenue for the government, which is needed for the provision of essential services and execution of other activities of the government.

**2. To regulate the production of certain commodities:** In order to regulate the production of some certain harmful product, government imposes heavy tax on the production of such commodity.

**3. To control the consumption of certain commodities:** Government imposes tax on some commodities which are considered to be harmful or too luxurious, such tax is meant to increase the price of the commodities, hence a reduction in the demand and subsequent consumption.

**4. To control monopoly powers:** Certain taxes are levied in order to curb monopoly powers. Such taxes include excess profit tax.

To redistribute income: Taxation can be applied as a means of redistributing income. A progressive tax system takes away more money from the rich and the proceeds are used in providing goods and services whose marginal utilities are higher for the poor than the rich.

**5. To protect infant and domestic industries:** High import duties can be used to discourage the importation and consumption of foreign goods which usually out-compete the locally produced ones.

**6. To prevent dumping:** High import duties can be used to prevent dumping of relatively cheap products in the developing economies by the more technologically advanced countries.

**7. To maintain balance of payment:** Balance of payment deficit can be corrected by imposing taxes which discourages imports while taxes/tariffs that encourage exports are at the same time introduced.

**8. To curb inflation:** Certain forms of tax can be used to reduce the level of inflation. A high rate of taxation without corresponding increase in government expenditure will reduce disposable income of consumer. This will help to reduce prices.

**9. To regulate business activities:** The form and direction on business activities can be regulated through taxation. A tax may discourage or encourage a given line of business. A high rate of taxation will discourage a business activity while subsidy (negative tax) encourages same.

**Characteristics of tax:**

**1. Maximum Social Benefit:** According to Dr. Dalton, that system of taxation is the best which is based on the principle of maximum social advantage. To achieve this, the taxes should be on different sections of people in such a way that the marginal sacrifice of different taxes should be the same. Every tax system should promote the greatest good of the greatest number.

**2. Equality in the distribution of tax burden:** There are two aspects to the problem of the tax system equality. The first is the proper treatment of persons in like circumstances. The rate in this case is ‘equal treatment of equals’. All those persons who are placed in similar circumstances should bear the same burden of taxation. The second aspect of equality in taxation is the desirable relative treatment of persons in unlike circumstances. That is, those who are better off should pay more taxes and they should bear a great burden of taxation.

**3. Multi-taxation system or diversity system:** A multiple tax refers to the tax system in which taxes are levied on various items. The tax system should be diversified instead of being concentrated in one or two taxes. At the same time, care should be taken to avoid multiplicity of taxes.

**4. Productivity of the tax system:** The term ‘productivity’ is interpreted in two senses. First, the taxation system should be such as to provide adequate income to the government to meet its expenditure. As the needs of the public authorities increase continually of the tax system should yield increased revenues.

**5. Rights of tax-payers:** A sound tax system will have to safeguard the interests of the tax payers. In a democratic set-up, the rights of the tax payers have to be continuously kept in mind. Besides, the present level of taxation as well as the further prospects of taxation necessitate that the interest and rights of tax-payers should be given adequate recognition.

**6. Universal application of taxes:** Each individual should pay according to his ability to pay, and the individual possessing the same ability to pay should contribute the same amount by way of taxes without any discrimination. In India, income tax is lacking these characteristics because income from agriculture is not taxed to the extent the incomes have been taxed in the non-agriculture sector.

**7. Elasticity:** The taxation system should provide to the government increased income with the increase in the national income of the country. The taxation system should also yield more income when the government expenditure goes up. Two things are essential to bring about elasticity in the tax system. First there should be proper blending of direct and indirect taxes. Secondly, certain sources of income should be exclusively reserved for emergencies.

**8. Convenience:** The government should keep in view the convenience of the tax-payer while devising the taxation system of the country. Since the tax-payers make sacrifices when they pay the taxes, it is essential for the government to see that they are not put to any avoidable inconvenience

**Effects of Tax:**

#### 1. Effects of Taxation on Production:

(i) Effects on the ability to work, save and invest

(ii) Effects on the will to work, save and invest

(iii) Effects on the allocation of resources.

#### 2. Effects on the Ability to Work Save:

Imposition of taxes results in the reduction of disposable income of the taxpayers. This will reduce their expenditure on necessaries which are required to be consumed for the sake of improving efficiency. As efficiency suffers ability to work declines. This ultimately adversely affects savings and investment. However, this happens in the case of poor persons.

#### 3. Effects on the will to Work, Save and Invest:

The effects of taxation on the willingness to work, save and invest are partly the result of money burden of tax and partly the result of psychological burden of tax.

#### 4. Effects on the Allocation of Resources:

By diverting resources to the desired directions, taxation can influence the volume or the size of production as well as the pattern of production in the economy. It may, in the ultimate analysis, produce some beneficial effects on production. High taxation on harmful drugs and commodities will reduce their consumption.

#### 5. Effects of Taxation on Income Distribution:

Taxation has both favourable and unfavourable effects on the distribution of income and wealth. Whether taxes reduce or increase income inequality depends on the nature of taxes. A steeply progressive taxation system tends to reduce income inequality since the burden of such taxes falls heavily on the richer persons.

#### ****6. Other Effects of Taxation:****

If taxes produce favourable effects on the ability and the desire to work, save and invest, there will be a favourable effect on the employment situation of a country. Further, if resources collected via taxes are utilized for development projects, it will increase employment in the economy. If taxes affect the volume of savings and investment badly then recession and unemployment problem will be aggravated.

**Assessment and Previous year:**

According to the Income Tax Act, income earned by a person in a financial year is taxable in the following financial year. So, the financial year in which the person has received income is called as the **Previous Year**. On the other hand, the financial year in which the tax liability on the income of the person is assessed is known as **Assessment Year**.

### Comparison Chart:

| **BASIS FOR COMPARISON** | **PREVIOUS YEAR** | **ASSESSMENT YEAR** |
| --- | --- | --- |
| Meaning | Previous Year is the financial year, in which the assessee earns income. | Assessment Year is the financial year, in which the income of the assessee earned during the previous year is evaluated and taxed. |
| What is it? | The year to which income belongs. | The year in which income tax liability for the previous year arises. |
| Term | Its term is 12 months or less. | Its term is 12 months |

**Model of Impact, Shifting and Incidence of Tax:**

**1. Impact of Taxation:** it refers to the immediate burden of tax. The impact of tax is the immediate result of the imposition of tax on a person who pays it in the first instance.

**2. Shifting of Tax:** It is a process by which the money burden of a tax is transferred from one person to another.

**3. Incidence of taxation:** It refers to the final money burden of a tax on a person, who ultimately beats it. Whenever the money burden of a tax finally settles to rest of the ultimate tax payers, it is called the incidence of tax.

**Assessee and its types:**

An Assessee may be **any individual liable to pay taxes for himself or to pay tax on behalf of somebody else**. The Income Tax Act, 1961 has classified Assessee in different categories. An Assessee may either be a normal Assessee, a Representative Assessee, a Deemed Assessee or an Assessee in Default.

**1. Normal Assessee:** An individual who is liable to pay taxes for the income earned during a financial year is known as a normal assessee. Every individual who has earned any income earned or losses incurred during the previous financial years are liable to pay taxes to the government in the current financial year. All individuals who pay interest/penalty or who are supposed to get a refund from the government are categorised as normal assesses.

**2. Representative Assessee:** There may be a case in which a person is liable to pay taxes for the income or losses incurred by a third party. Such a person is known as a representative assessee. Representatives come into the picture when the person liable for taxes is a non-resident, minor, or lunatic. Such people will not be able to file taxes by themselves. The people representing them can either be an agent or guardian.

**3. Assessee-in-default:** Assessee-in-default is a person who has failed to fulfill his statutory obligations as per the income tax act such as not paying taxes to the government or not file his income tax return. For example, an employer is supposed to deduct taxes from the salary of his employees before disbursing the salary. He is, then, required to pay the deducted taxes to the government by the specified due date. If the employer fails to deposit the tax deducted, he will be considered as an assessee-in-default.

**4. Deemed Assessee:** An individual might be assigned the responsibility of paying taxes by the legal authorities and such individuals are called deemed assesses. Deemed assesses can be:

* The eldest son or a legal heir of a deceased person who has expired without writing a will.
* The executor or a legal heir of the property of a deceased person who has passed on his property to the executor in writing.
* The guardian of a lunatic, an idiot, or a minor.
* The agent of a non-resident Indian receiving income from India.

**Distribution of revenue between central and states:**

The Constitution of India contains provisions for the distribution of revenue s between central and state is explained below:

**1. Taxes and duties which are levied, collected and wholly retained by the union government:** Corporation tax, taxes on the capital value of assets of industries and companies, duties on bills of exchange and promissory notes.

**2. Taxes and duties levied by the union but collected and appropriated by the state government (Article 268):** Stamp duties, excise duties on medicinal and toilet preparations mentioned in the union list.

**3. Taxes and duties levied and collected by union but proceeds entirely given to state government (Article 269):** Succession and estate duty other than on agricultural land, terminal taxes on goods and passengers carried by sea or air, taxes on railway fares and freights, taxes other than stamp duties on transactions in stock exchange and future markets, taxes on sale and purchase of news paper and their advertisement, taxes on sale or purchase of goods other than newspaper where the sale taken place in the course of interstate trade or commerce.

**4. Taxes and duties levied and collected by the union but distributed between the union and states (Article 270):** Income tax other than agricultural income, union duties of excise other than those mentioned in Article 268.

**5. Surcharge on certain duties and taxes for union government (Article 271):** The surcharge provided in this article is an additional tax or duty on duties and taxes mentioned in Article 269 and 270 above. The entire proceeds from the surcharge are to be credited to the consolidated fund of India for the usage of union and they will not be distributed to the states.

**6. Taxes and duties which are levied and collected by the union and may be distributed between the union and states (Article 272):** Central excise duties are to be levied, collected and fully retained by the union. Some are to be distributed among the states in accordance with such principles of distribution as may be formulated by such Act of parliament.

The constitution of India does not merely mark out channels for the flow of resources from centre to states but also provides machinery for regulating the flow which is called “Finance Commission”.

**Canon of Taxation:**

**Meaning of Canons of Taxation:**

By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. In fact, canons of taxation are related to the administrative part of a tax. Adam Smith first devised the principles or canons of taxation in 1776. Even in the 21st century, Smithian canons of taxation are applied by the modern governments while imposing and collecting taxes.

**Types of Canons of Taxation:**

In this sense, his canons of taxation are, indeed, ‘classic’. His four canons of taxation are:

(i) Canon of equality or equity

(ii) Canon of certainty

(iii) Canon of economy

iv) Canon of convenience.

Modern economists have added more in the list of canons of taxation.

(v) Canon of productivity

vi) Canon of elasticity

(vii) Canon of simplicity

(viii) Canon of diversity.

**i. Canon of Equality:**

Canon of equality states that the burden of taxation must be distributed equally or equitably among the taxpayers. However, this sort of equality robs of justice because not all taxpayers have the same ability to pay taxes. Rich people are capable of paying more taxes than poor people. Thus, justice demands that a person having greater ability to pay must pay large taxes.

**ii. Canon of Certainty:**

The tax which an individual has to pay should be certain and not arbitrary. According to A. Smith, the time of payment, the manner of payment, the quantity to be paid, i.e., tax liability, ought all to be clear and plain to the contributor and to everyone. Thus, canon of certainty embraces a lot of things. It must be certain to the taxpayer as well as to the tax-levying authority.

**iii. Canon of Economy:**

This canon implies that the cost of collecting a tax should be as minimum as possible. Any tax that involves high administrative cost and unusual delay in assessment and high collection of taxes should be avoided altogether.

**iV. Canon of Convenience:**

Taxes should be levied and collected in such a manner that it provides the greatest convenience not only to the taxpayer but also to the government.

**V. Canon of Productivity:**

According to a well-known classical economist in the field of public finance, Charles F. Bastable, taxes must be productive or cost-effective. This implies that the revenue yield from any tax must be a sizable one. Further, this canon states that only those taxes should be imposed that do not hamper productive effort of the community. A tax is said to be a productive one only when it acts as an incentive to production.

**ii. Canon of Elasticit**y:

Modern econo­mists attach great importance to the canon of elasticity. This canon implies that a tax should be flexible or elastic in yield.

`It should be levied in such a way that the rate of taxes can be changed according to exigencies of the situation. Whenever the government needs money, it must be able to extract as much income as possible without generating any harmful consequences through raising tax rates. Income tax satisfies this canon.

**iii. Canon of Simplicity:**

Every tax must be simple and intelligible to the people so that the taxpayer is able to calculate it without taking the help of tax consultants. A complex as well as a complicated tax is bound to yield undesirable side-effects. It may encourage taxpayers to evade taxes if the tax system is found to be complicated.

**iv. Canon of Diversity:**

Taxation must be dynamic. This means that a country’s tax structure ought to be dynamic or diverse in nature rather than having a single or two taxes. Diversification in a tax structure will demand involvement of the majority of the sectors of the population.

**Different Types of Indirect Tax**

There are different types of indirect tax in India. However, after the implementation of GST, all these indirect taxes were bundled into one singular tax for the citizens of India. We will have a look at the different types of indirect tax in India:

**1. Service tax:** This tax is levied by an entity in return for the service provided by them. The service tax is collected by the Government of India and deposited with them.

**2. Excise duty:** When any product or good is manufactured by a company in India, then the tax levied on those goods is called the Excise Duty. The manufacturing company pays the tax on the goods and in turn recover the amount from their customers.

**3. Value Added Tax:** Also known as VAT, this type of tax is levied on any product sold directly to customer and are movable. VAT consists of Central Sales Tax which is paid to the Government of India State Central Sales Tax which is paid to the respective State Government.

**4. Custom Duty:** This a tax levied on the goods imported to India. Sometimes, Custome Duty is also levied on products which are exported out of India.

**5. Stamp Duty:** This is a tax levied on the transfer of any immovable property in a state of India. The state government in whose state the property is located charges this type of tax. Stamp tax is also applicable on all legal documents too.

**6. Entertainment Tax:**

This tax is charged by the state government and is applicable on any products or transactions related to entertainment. Purchasing of any video games, movie shows, sports activities, arcades, amusement parks, etc. are some of the products on which Entertainment Tax is charged.

**7. Securities Transaction Tax:**

This tax is levied during the trading of securities through Indian Stock Exchange.

**Features of Indirect Tax**

**1. Tax liability:** The service provider or seller pays indirect taxes to the government, and the liability is transferred to the consumer.

**2. Payment of tax:** The seller pays indirect taxes to the government and the same is transferred to the consumer.

**3. Nature:** Indirect taxes were initially regressive in nature, but thanks to the implementation of the Goods and Services Tax, they are now pretty progressive.

Saving and investment: Indirect taxes are generally growth-oriented considering the fact that they encourage consumers to save and invest.

#### Key differences between Direct and Indirect Tax:

|  |  |  |
| --- | --- | --- |
| **Key difference** | **Direct Tax** | **Indirect Tax** |
| Levy of Tax | Direct tax is levied and paid for by individuals, Hindu undivided Families (HUF), firms, companies etc. | Indirect tax is ultimately paid for by the end-consumer of goods and services. |
| Burden of Tax | The burden of tax cannot be shifted. | Burden can be shifted |
| Administration | Lack of administration in collection of direct taxes can make tax evasion possible. | taxes cannot be evaded as the taxes are charged on goods and services |
| Inflation | Direct tax can help in reducing inflation. | Indirect tax may enhance inflation. |
| inequality | Direct taxes help in reducing inequalities and are considered to be progressive | 1. Indirect taxes enhance inequalities and are considered to be regressive. |
| Administrative cost | 1. Direct taxes have many exemptions and involve higher administrative costs. | Indirect taxes involve lesser administrative costs due to convenient and stable collections. |
| Investment | It reduce savings and discourage investments | Oriented more towards growth as they discourage consumption and help enhance savings. |
| Additional Tax | No additional cost | Additional indirect taxes levied on harmful commodities such as cigarettes, alcohol etc. |
| Coverage | Direct taxes are collected only from people in respective tax brackets. | Indirect taxes have a wider coverage as all members of the society are taxed through the sale of goods and services. |

**Advantages of Indirect Tax**

* **Convenience:** Indirect taxes do not burden the taxpayer and are convenient as they are paid only at the time of making a purchase. Moreover, state authorities find it convenient to levy indirect taxes because they are collected directly at the stores/factories which helps in saving a lot of time and effort.
* **Ease of collection:** Indirect taxes are easy to collect in comparison with direct taxes. Since indirect taxes are only collected at the time of making purchases, the authorities need not worry about their collection.
* **Collection from the poor:** Those who earn less than Rs.2.5 lakh p.a. are exempt from [income tax](https://www.bankbazaar.com/income-tax.html), which means that they do not contribute to the government. Since indirect taxes are charged at the point of sale, all individuals, regardless of the [income tax slab](https://www.bankbazaar.com/tax/income-tax-slabs.html) under which they fall, contribute towards the growth of the economy.
* **Equitable contributions:** Indirect taxes are directly related to the costs of products and services. What this essentially means that the basic necessities attract lower rates of tax while luxury items are charged at higher tax rates, thereby ensuring that contributions are equitable.

**Disadvantages of Indirect Tax**

Some of the disadvantages of Indirect Tax are given below:

* Indirect Tax charged sometimes are cumulative. This means that in a point-based transaction system, middlemen involved are likely to charge their own service tax which may result in the overall price of the product increasing.
* Indirect Tax can be regressive in nature. For example, salt tax remains the same for both poor and rich, However, if a rich person defaults the payment, then the penalties imposed will be higher as well.
* Indirect Tax are not industry friendly. Taxes are levied on raw materials and goods which in turn increases the cost of production, thus not allowing industries to expand as their competitive capacity is restricted.

**Tax Versus Duty:**

| **Tax** | **Duty** |
| --- | --- |
| * It is the compulsory amount paid to the government. * It is charged on income, wealth, service, sales etc. * Direct tax and indirect tax are types of taxes. * Wide scope. * Central/state governments will impose tax. | * It is an amount charged by government on imports/exports and manufacture of goods. * It is charged on goods and financial transactions. * Custom duty and excise duty are types of duty. * Narrow scope. * Central government will impose duty. |