

How Tax Avoidance by People Leads to an Imbalance in the Government Budget

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ABSTRACT

This study explores how avoidance of taxes affects public services, economic inequality, and the financial stability of the Indian government. The literature study explores the complicated nature of tax legislation in India, highlighting the necessity of a strong anti-tax avoidance framework. The technique sets forward goals include comprehending tax avoidance, determining its causes and effects, and examining strategies used. The scope includes a thorough analysis of the literature on tax avoidance, a look at the causes and consequences, and a study at the relationship between tax avoidance and government revenue. The data analysis focuses on the landmark decision of "McDowell & Company Limited vs. The Commercial Tax Officer," emphasizing the differentiation made by the court between legitimate tax planning and illegal tax avoidance. Findings emphasize the case has had a significant impact on tax jurisprudence, established limits for acceptable tax planning, and maintained the anti-avoidance concept in Indian tax law.

INTRODUCTION

Tax avoidance by individuals has a big effect on the Indian government's budget, causing an imbalance that is averse to the nation's fiscal health. In simple terms tax avoidance is the use of legal strategies by people to reduce their tax liabilities. Although tax avoidance is not unlawful as such itself, it may negatively impact public services, infrastructure development, and the nation's general economic health by limiting the government's capacity to collect taxes.

The Indian government is mostly dependent on tax income to pay for a number of basic services, such as infrastructure development and healthcare and education. People who avoid paying taxes lower the total amount collected in taxes, which limits the government's financial resources. The government budget becomes unbalanced as a result of the discrepancy between projected and actual revenue.

Taking advantage of tax law loopholes is a common way for people to avoid paying taxes. People may arrange their finances in a way that legally reduces their taxable income by taking advantage of not certain or outdated tax regulations. Some people may also utilize offshore accounts to avoid paying taxes on their

wealth. Even if these actions may be legal, they decrease the amount of money available for public expenditure, which adds to the budget imbalance in the government.

Moreover, tax avoidance has the potential to worsen economic disparities. Public services are primarily funded by those who cannot afford sophisticated tax preparation when a significant portion of the population uses strategies to reduce their tax planning. This increases pressure on those with lower incomes who may already be having difficulty making sufficient money to survive.

Tax avoidance has an effect on many different industries. Budget reductions in vital sectors like healthcare and education might result from insufficient income, making it more difficult for the government to offer its residents high-quality services. Due to a shortage of funds, infrastructure projects—which are essential for economic growth—may also experience delays or restrictions. When the government is restricted by a lack of funding, the country's overall development is hampered.

To address the problem of tax avoidance, a comprehensive approach is needed. The tax enforcement processes be strengthened, and that financial transactions be made transparent. In addition, promoting a tax compliance culture through public awareness and education may be extremely effective in reducing the negative consequences of tax avoidance.

LITERARTURE REVIEW

Arun Goyal and Manish Gupta in their article "Tax Avoidance in India: An Analysis," point to the intricate nature of India's tax laws, which provide numerous opportunities for tax planning and avoidance. They also highlight the challenges faced by the tax administration in effectively enforcing tax laws and identifying tax avoidance schemes.

Initially, the startups will face challenges regarding taxation they may have limited resources the financial management and taxation has become critical factor for them that influences their growth what is the purpose they started to utilize information technology as it helps streamline the processes and enhances the accuracy of maintaining accounts and taxation (Ferdiana, R. et al., 2019).

Neha Sharma and Ritu Mehta in their paper "Impact of Tax Avoidance on Indian Economy," said that tax avoidance leads to a loss of government revenue, which can be used for development projects and welfare schemes. They also highlight that tax avoidance erodes public trust in the tax system and encourages a culture of non-compliance.

The relationship between entrepreneurship has become a matter of interest among policymakers. So the author explores the relationship between venture capital-based entrepreneurship and the taxation policy. The study suggests that good taxation policies will help to encourage more entrepreneurial activities. The lower the tax rates the higher will be they will attract the starting of new ventures (Keuschnigg, C. et al., 2004).

Tarun Jain in his book "Tax Avoidance in India: A Study of Legal Strategies" delves into the intricacies of tax avoidance in India, analysing its various forms and examining the loopholes in the tax system that enable tax avoidance practices. He emphasizes the need for a robust anti-tax avoidance regime to safeguard the country's tax base and ensure fairness in taxation.

The study examines the impact of tax regimes on the initial startup costs and how it affects the decisions of an individual entering into entrepreneurship. If the tax burdens are lower then the individuals will be encouraged to innovate new ventures. Innovative entrepreneurship is basically a riskier one. So the burden of the risk can be reduced by getting a deduction for research and development expenses, innovation-related investments or tax credits (Darnihamedani, P. et al., 2018).

S.K. Gupta in his article "Tax Avoidance: A Conceptual Analysis" highlights the inefficiency of the Indian tax administration as a significant factor in tax avoidance. He asserts that the lack of resources, outdated technology, and ineffective enforcement mechanisms enable individuals and corporations to evade taxes without facing significant repercussions.

Startup financing has an internal link to taxation related to capital gain. The study is made on the impact of capital gain taxation on the funding of startups. It highlights the implication of initial funding for the startups. Capital gain taxation will impact the behavior of the investor because it affects the return they get from the investments. If the higher tax rate levied on the capital gains, the investor will get a lesser return (Edwards, A. et al., 2020).

R.C. Bhargava in his paper "Impact of Tax Avoidance on Indian Economy" highlights the erosion of the tax base as a major consequence of tax avoidance. He argues that the reduction in tax revenues due to avoidance practices deprives the government of funds essential for providing public services and infrastructure.

The study highlights the lock-in effect, a means by which investors are not encouraged to sell their assets due to the liability of taxes. This lock-in effect is created by capital gain taxation. The individuals will exit

from their venture due to heavy tax levied on their business. The author explores the impact of tax policies on the willingness of business startups (Chari, V. V. et al.,2005).

Ashwani Kumar Mishra in his book "Tax Avoidance and Evasion in India: Issues and Challenges" identifies the complex and intricate nature of India's tax laws as a major contributor to tax avoidance. He argues that the labyrinthine structure of tax provisions provides ample opportunities for individuals and corporations to exploit loopholes and engage in tax-planning strategies.

METHODOLOGY

OBJECTIVES OF THE STUDY

- ❖ To understand the concept of tax avoidance.
- ❖ To identify the potential causes behind tax avoidance and how it affects the government's revenue.
- ❖ Analyse the effects of tax avoidance on government revenue.
- ❖ Analyse the consequences of tax avoidance
- ❖ Identify the tricks or strategies people use to avoid paying taxes, such as using certain laws or moving money to different places.

SCOPE OF THE STUDY

- ❖ A comprehensive review of tax avoidance literature.
- ❖ Understanding the underlying causes of tax avoidance.
- ❖ Gain a clear understanding of what tax avoidance is and how it happens,
- ❖ Assessing the impact on government revenue.
- ❖ The relationship between tax avoidance and government revenue.

DATA ANALYSIS AND INTERPRETATION

In Indian tax law, the case "McDowell & Company Limited vs. The Commercial Tax Officer" is a landmark judgment that is frequently brought up in conversations about tax planning, avoidance, and the limits of legitimate tax reduction strategies. The Supreme Court of India heard the matter, and judgment was delivered on February 4,1985.

Background and Case Details:Tax Planning Scheme

The liquor manufacturer McDowell & Company Limited used a tax planning scheme to lower its tax liability.

Artificial Losses

By manipulating its accounting through a series of transactions, including the transfer of specific rights and privileges, the corporation created artificial losses.

Avoidance of Tax liability

These transactions were made in an effort to reduce or eliminate the tax liability that the company would have otherwise been responsible for paying.

Legal Issues

Whether McDowell & Company Limited's tax planning scheme amounted to tax avoidance using artificial and colorable devices or was a lawful use of its right to minimize tax liabilities was the main legal question in this case.

Decision of the Supreme Court

The Supreme Court, in its judgment, made several important observations and rulings:

Doctrine of Tax Avoidance

The distinction between tax planning and tax avoidance was recognized by the court. Although it is reasonable and expected of taxpayers to plan ahead for taxes, it was decided that utilizing artificial and colorable devices to avoid taxes was illegal.

Substance Over Form

The concept that the substance of a transaction should take priority over its form in tax considerations has been emphasized by the court. This implies that, for taxation matters, the true nature and purpose of a transaction should be taken into account.

Legitimate Tax Planning vs. Tax Avoidance

The court made it clear that although taxpayers might arrange their affairs to minimize their tax liability within legal bounds, they are not permitted to use dubious methods, artificial devices, or colorable transactions solely as a means of avoiding tax.

Significance

The McDowell case is significant because it established the principle that tax planning is permissible as long as it is carried out lawfully. However, it is illegal to utilize colorable and artificial devices to avoid paying taxes. The tax jurisprudence (law) in India has been significantly impacted by this ruling, which has also affected other rulings and amendments to legislation aiming to reduce aggressive tax planning.

FINDINGS

Differentiating Tax Planning and Tax Avoidance

The distinction between lawful tax planning and illegal tax avoidance using artificial and colorable devices was recognized and emphasized by the court.

Substance Over Form

The court decided that the substance of a transaction should take priority over its formal structure when it comes to taxes. This implies that, for taxation purposes, the true nature and purpose of a transaction should be taken into consideration.

Abuse of Law

The court observed that although taxpayers are allowed to arrange their affairs in a way that minimizes their tax burden, they are not permitted to utilize dubious methods or artificial devices that lead to an abuse of the law.

Influence on Tax Jurisprudence

The case changed the way that tax avoidance is seen in India and had a major influence on the country's tax law. It had an impact on later rulings and changes to laws meant to restrain aggressive tax planning.

Boundaries of Legitimate Tax Planning

The McDowell case's conclusions contributed to a better definition of the permitted limits between lawful tax planning and illegal tax avoidance using artificial and colorable devices.

Anti-Avoidance Principle

The court's decision upheld the anti-avoidance concept in tax law, which discourages actions conducted primarily to avoid paying taxes, even when they may be lawful in theory.

CONCLUSION

In conclusion, tax avoidance in India has significant adverse effects on public services, infrastructure development, and economic inequality. It also presents serious obstacles to the government's ability to manage its finances. It is crucial to take an integrated approach to addressing the issue because important services are funded mostly by income taxes.

The literature study emphasizes how complex India's tax rules are, offering many options for tax planning and avoidance. Scholars highlight the difficulties that tax authorities encounter in implementing rules and identifying avoidance strategies. There is a lot of evidence of the detrimental effects of tax avoidance on public trust, government revenue, and economic inequality. It is frequently emphasized that the tax code has to be updated and a strong anti-tax avoidance system is required.

The legal differences between tax planning and avoidance are emphasized in the case study of McDowell & Company Limited vs. The Commercial Tax Officer. According to the Supreme Court's decision, it is illegal to use artificial and colorable devices for avoiding taxes, even when reasonable tax planning is permitted. This landmark case strengthened the anti-avoidance concept and established guidelines for legitimate tax planning, greatly impacting tax jurisprudence in India.

The objectives of this study are to understand tax avoidance, identify its origins and consequences, assess how it affects public funds, and look at its strategies employed. The results highlight the significance of defining specific limits for legal tax planning, prioritizing substance over form, and differentiating between legal tax planning and illegal avoidance. An important case that shaped India's approach for preventing tax avoidance and encouraging fiscal responsibility is the McDowell case.

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