

Do you think the income tax penalties in India are a bit too harsh?



istock4 min read . Updated: 28 Jan 2022, 01:00 AM IST **Gautam Nayak**

Tax officials often say the penalty for filing late tax returns is fairly low in India

Listen to this article

We often hear from tax officials that the penalties in India for not filing tax returns in time are fairly low, being just ₹5,000, and going up to ₹10,000 if the tax return is not filed by 31 March following the taxable financial year. This is, of course, in addition to interest payable at 1% per month on the unpaid taxes. Is this fact of penalties being low really true or are there other far more severe consequences?

The most severe consequence of not filing a tax return in time is that you lose the benefit of carry forward of any losses that you may have incurred, which could not be set off against the same year's income. For most individuals, these losses are in the nature of capital losses; for those carrying on business or profession (including derivatives trading), there could be a loss incurred in the business or profession. Effectively, you lose the tax shield that you would have got when you would have recouped these losses to your portfolio through gains in subsequent years. The taxes that you end up paying in the subsequent years on the gains is the real penalty in such a case.

Further, if you were entitled to a tax refund, normally you would have got 6% per annum interest on the refund from 1 April before the due date, till the issue of the refund. If you file the return late, you lose the interest for the period from April till the month in which you filed the return.

If you have earned foreign income and have paid foreign taxes on such income, as a resident of India, your foreign income is also taxed in India, but you are entitled to deduct the foreign taxes paid against your Indian income tax liability.

Unfortunately, the law requires you to file a form before you file the return, claiming credit of such foreign taxes. If you forget to file that form in time, you may not get credit for the foreign taxes paid by you, though the foreign income is taxed in your hands, and by law, you are entitled to a deduction from your Indian taxes.

Charitable entities have to bear much harsher penalties for such delays in filing their returns. A charitable entity is entitled to exemption on its income (including donations received) if it spends such income on charity. However, if it does not file either its audit report or its income tax return in time, it has to pay tax on its gross income, without any deduction for the spending on charity.

Even if it has already spent its entire income on charity, it ends up having to pay income tax over and above that.

Businesses which are entitled to tax holidays also suffer severe consequences if they do not file relevant audit reports in time. They lose the benefit of the tax holiday or deduction for the year if they do not file the relevant audit reports in time.

These consequences are therefore much more harsh than a mere penalty. Are such harsh consequences really warranted? In the past, the high courts have reduced the impact of such harsh consequences in relation to filing of audit reports, by holding that what is important is the availability of the audit report, even though it is obtained late, and that so long as the audit report is filed, the benefit of the tax holiday or deduction cannot be denied. Unfortunately, in relation to the late filing of tax returns, there has been no such relief granted by the courts.

However, a just and fair tax law should ensure that the punishment matches the magnitude of the offence. Can a taxpayer who files his return late by a day or two be equated with another who files it much later, or does not file it at all? Today, both face the same punishment of losing the benefit of carry forward of the entire loss. In some countries, such as the USA, the penalty depends upon the period of delay and is capped.

The tax authorities should seriously consider replacing the existing provision on total prohibition of set-off of losses by one which provides a graded denial of carry forward of losses, linked to the quantum of delay, with a cap on the total denial of loss. For instance, a taxpayer could lose the benefit of carry forward of 5% of his capital losses or business losses for every month of delay, subject to an overall cap of 25% or 50% of such losses.

Similarly, charitable entities can face graded denial of exemption linked to the quantum of delay, instead of complete denial of exemption for even a day's delay. In case of delay in filing of audit reports also, such a graded approach should be considered, which will be less harsh on small misdemeanours.

Such graded denial of benefits will provide some relief to the hassled taxpayers, who already have to face so much compliance, and at times, have to really struggle to meet their compliance requirements for no fault of theirs.

Gautam Nayak is partner, CNK & Associates LLP