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ETHICAL NAVIGATION IN THE WORLD OF TAXATION

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ABSTRACT

‘Ethics’ is a term derived from a Greek word, ‘ethos’ which means ‘character’, and a Latin term ‘mores’ which means ‘custom’. Ethics are what bounds an individual in a professional, fiduciary or domestic relationship with others. In every relationship, ethics plays an important role for its long and strong going. This research paper aims to present ethics in taxation. I’ll discuss that how ethics binds the parties involved in the transaction of taxes to perform their part in it. This paper will also deal with non-compliance of ethics and its effects afterwards on the nation and the economy. Increasing crimes of Tax Evasion and Tax Avoidance are result of non-compliance of ethics in taxation. This being said, there are many other straightforward acts like, money laundering, corruption, bribery, etc which are also causes of unethical behaviour by citizens. This disorder further points out the loopholes in Tax Administrations and Tax-compliance regulations, it is also an alarming clock to strengthen the Tax authorities in a large nation like India.

Keywords: Ethics, Tax literacy, Tax evasion, Tax Avoidance, Tax Planning.

INTRODUCTION

The primary source of revenue for government is ‘Tax’, which is required to stimulate economic growth of the society, to fulfil socio-economic objectives for the betterment and development of the society. In other words, Taxes helps the government to boost up the social infrastructure. The government levy taxes in many forms on the incomes of individuals and companies. As per the Constitution of India, the Indian Taxation system is such that, Central Government and State Government are empowered to levy taxes on citizens and enterprises, which is guaranteed by Article 270.

Before understanding ethics in taxation, and idea of what tax is, is to be considered. In simple words, Tax is an amount of money required by the government for public welfare, but certain

characteristics regarding imposition of tax must be understood first. Several Economists and Judges have defined about the liability and payment of taxes. As per *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 offense.'

As per *Latham C.J.*, 'Tax is a compulsory exaction of money by public authority for public purposes enforceable by law and is not payment for services rendered.' Both of these definitions emphasize more on paying tax as a compulsion, it further justifies that payment of taxes as a '*sine qua non*' concept.

Ethics, on the other hand are the moral and rational principles of an individual to act in circumstances, which showcases professionalism, grace, courtesy and social behaviour of the person with others. Ethical behaviour is an important aspect in mapping a character of an individual which further promotes the strong relationship in the society. As per a known philosopher *Aristotle*, ethical behaviour meant 'keeping the knowledge that actions are done for the betterment of common good.'

ETHICS IN TAXATION

Ethics and Ethical behaviour in Taxation is a multi-faceted issue, because it binds the taxpayers to pay taxes to the government, similarly, it also binds and obliges the tax imposers (government) to entertain these taxes in order to bring good to the public. It is to be understood by both the parties in this transaction that it is a 'bonafide contract', and that they must perform their part in this contract because if either of the party defaults, it will harm everybody in the nation or society as a whole.

India is one of the largest rapidly growing nation with some of the very highly rigorous tax compliance regulations but even after that citizens exercise unfair practices like 'Tax Evasion' and 'Tax Avoidance'. India has a hybrid taxation system: Direct Taxes and Indirect Taxes.

TAXATION SYSTEM IN INDIA

In India, Central Board of Revenue governs the payment of different types of taxes imposed by the government on citizens. It was formed by the Central Board of Revenue Act, 1963. It further is divided into two sub-bodies; Central Board of Direct Taxes (responsible for the collection of direct taxes and formulation of policies) and Central Board of Indirect Taxes and Customs (responsible for formulation of policies and collection sales tax, custom and excise duties).

1. **Direct Taxes:** They are imposed on Individuals and Organizations. These taxes are paid by the same person on whom it was imposed and thus, only two parties are involved in such transaction; Taxpayers and Tax imposers. Example of such taxes are Income Tax, Capital Gain Tax, Property Tax, etc.

For instance, Mahesh is employed at 60,000 per annum in a company, and he qualifies to pay tax as per the respective governments' tax slab system, therefore, income tax can be imposed on Mahesh, wherein, the tax is borne on Mahesh and has to be paid by him.

2. **Indirect Taxes:** These taxes are imposed on services. There are three parties involved in such transaction; Taxpayers, Tax-imposers (government) and Intermediaries (Retailers). Such taxes are borne by different person and paid by different person to the government for the services claimed.

For instance, Mahesh owns a Hotel. Suresh, a customer claims the services of hotel, while paying for the services, some tax is paid (borne on Suresh only) by him, which is collected by Mahesh (Intermediary) and further paid to the government. Some examples are Service Tax, Value-Added Tax (VAT), Goods and Services Tax, etc.

TAX EVASION

It is an illegal activity where a person or corporate entity intentionally underpays or hides a certain part of their revenue to reduce their Tax liability. Whenever an individual with a malice fails to disclose their taxable income by either manipulation of financial statements or claiming unauthorized deductions. Tax evasion is a white-collar crime and includes: Forging of income tax returns, sham companies, money laundering, clubbing of incomes, etc.

Various studies and surveys has found out that Tax evasion occurs due to weak tax laws (regulations and norms), incompetent tax authority personnel, substandard tax administration and corruption in tax collecting procedures. These were the obvious factors which lead to an offense of Tax evasion, but morality of Taxpayers also plays an important role as to why such crime is rising.

Through time there have been many cases of Tax evasion, but most famous among them all are the two tax evasion cases of Cadbury India Ltd, during 2009-10 and 2012-13 financial years. Both of them were related to evasion of excise duties and services tax, respectively. *In Re: Sir Dinshaw Maneckjee Petit Bari vs Unknown*¹, is a very famous case of lifting of Corporate Veil, wherein,

¹ [1927] 29 BOMLR 447 ('Sir Dinshaw').

an issue was raised that whether the companies formed by Sir Dinshaw Manockji were a separate legal entity. Court in its interpretation stated that the companies formed by him were sham and the purpose of their formation was to evade taxes. Another relevant case law would be *Workmen vs Associated Rubber Industries Ltd.*², wherein a sub company INARCO Ltd. was created by Associated Rubber Industries Ltd., which prevented the workmen of the parent company to get bonuses. The apex court in this case stated that INARCO holdings was nothing but just a sham company formed to evade from tax liabilities and prevent the company to pay respective bonuses to the workmen.

TAX AVOIDANCE

Tax avoidance is the practice within the legal limits for dodging tax, but it is not advisable to exercise as it takes undue advantages of legal loopholes and ambiguities. It doesn't directly infringes any legal ground but if the courts deem fit thinks it to be punishable as per the facts and circumstances of the case, then the taxpayer can be penalized with fine as well. It promotes immorality in taxpayers to use the functionaries and tools against the tax authorities in a way which is not advisable by law. It is not defined under Income Tax Act, 1961, but it can be understood with reference to Tax shelter and Tax Havens, which are a type of legal tax avoidance practices. The former states about the methods, within the local or international laws, to reduce taxable income and the latter defines the jurisdictions or areas which have reduced tax rates.

A famous case of Tax Avoidance is *Vodafone International Holding vs Union of India*³, wherein, the apex court, to prevent cases of Tax avoidance and describe the legal ground for saving oneself from payment of excessive taxes, recognized the principles of Tax Planning.

TAX PLANNING

Tax Planning is a legal way to reduce tax burden and liabilities from an individual's assets and income by using the exemptions and deduction provided under the Income Tax Act, 1961. It is a legitimate practice of saving taxes which is permissible by the Tax authorities. Tax Planning serves for various purposes like,

To litigate tax disputes with local, federal, state, or foreign tax authorities. There is often friction between tax collectors and taxpayers as the former attempts to extract the maximum amount possible while the latter desires to keep their tax liability to a minimum. Minimizing litigation

² AIR 1986 SC 1 ('*Workmen*').

³ Civil Appeal No. 733 of 2012 ('*Vodafone*').

saves the taxpayer from legal liabilities.

To reduce tax liabilities. Every taxpayer wishes to reduce their tax burden and save money for their future. You can reduce your payable tax by arranging your investments within the various benefits offered under the Income Tax Act, 1961. The Act offers many tax planning investment schemes that can significantly reduce your tax liability.

To ensure economic stability, as Taxpayers' money is devoted to the betterment of the country. Effective tax planning and management provide a healthy inflow of white money that results in the sound progress of the economy. This benefits both the citizens and the economy.

To leverage productivity: One of the core tax planning objectives is channelizing funds from taxable sources to different income-generating plans. This ensures optimal utilization of funds for productive causes.

Steps to Avoid Tax Evasion and Tax Avoidance

Increasing awareness about taxes and making people learn about the importance of Tax must be the prior step by the Tax administrations and the government to stop such malice practices. There are various studies and global studies, which has showed that more the ethical value and morality in a citizens, more is the compliance of regulations in the society. Tax education can now be easily provided to the taxpayers through media and public conferences by getting them know of their liabilities, their benefit of paying taxes and the growth of the living standard of their society. Some other steps include -

- Change in the traditional tax penalty provisions, the mild penalties of evading taxes was the major reason in the increasing of such practices in the first place. Severe penalties will increase the risk of evading taxes in future, which will further help in compliance of tax regulations.
- Reducing tax rates, it will help in taking other demands in consideration, which will help in increasing productivity of indigenous businesses and products and this will wholly benefit the nation's economic growth.
- Strengthening Anti-Corruption policies and considering the grants-in-aid to the government will help in minimizing corruption exercises.
- Amiable policies and schemes for taxpayer's benefit will also encourage them to comply with tax ethics.

- Relief provisions for the taxpayers, in cases of mishap or several other unforeseen circumstances.
- Tax administrators must include provisions to audit of accounts, details regarding collection and deposition of incomes by taxpayers themselves.
- Introduction of a more stable and just Taxation system.

IMPACT OF BUDGET 2024-25 ON TAXPAYER’S BEHAVIOR

The Indian Budget 2024-25 also carry the focus of interim budget, which are on 4 castes; *Garib* (Poor), *Mahilayen* (Women), *Yuva* (Youth) and *Annadata* (Farmer). Furthermore, this year, it aims on Employment, Skilling MSMEs and Middle Class. It introduced several new tax policies aimed at enhancing compliance and encouraging ethical tax practices Understanding the impact of these policies on taxpayer behavior is crucial for evaluating their effectiveness and identifying areas for further improvement.⁴

Tax Compliance Measures

The Budget for FY 2024-25 includes a range of measures designed to improve tax compliance among individuals and businesses. Key initiatives include:

- **Simplified Tax Filing Procedures:** Streamlining the tax filing process to make it more user-friendly and accessible, reducing the compliance burden on taxpayers.
- **Enhanced Digital Infrastructure:** Expanding the use of digital platforms for tax filing, payments, and record-keeping to ensure transparency and ease of access.
- **Incentives for Timely Filing:** Introducing incentives such as tax rebates and reduced interest on overdue taxes for taxpayers who file their returns on time.

Litigation and other incentives

This year’s Budget, alongwith simplifying taxes, also aims in enhancing taxpayer services and reducing litigation⁵.

- **Digitalization of Income Tax and Customs services:** All services, concerning Income Tax and Customs, including rectification processes and Appellate orders will be digitalized over the period of next two years.

⁴ Minister of Finance, *Budget 2024-25 Speech*, IndiaBudget, <
https://www.indiabudget.gov.in/doc/Budget_Speech.pdf>, accessed on July 31st, 2024.

⁵ *Infra*, Note 10.

- **Appeals and Litigation:** For resolution of Income Tax disputes pending in appeal, 'Vivad se Vishwas' scheme is introduced. Also, the monetary limits for filing cases in Tax Tribunals, High Courts and Supreme Court has increased simultaneously.

Simplification and Rationalization of Capital Gains

This year's Budget has implemented significant changes to simplify and rationalize capital gains taxation, aiming to make the tax system more equitable:

1. **Short-term Capital Gains (STCG):** The tax rate for short-term capital gains on certain financial assets has been increased from 15% to 20%. This change is expected to standardize the tax treatment of different asset classes and reduce arbitrage opportunities that arise from varying tax rates.^{[6][7]}
2. **Long-term Capital Gains (LTCG):** Long-term gains on both financial and non-financial assets will now attract a tax rate of 12.5%, up from the previous 10%. Additionally, the exemption limit for capital gains on certain financial assets has been raised to ₹1.25 lakh per year. This measure aims to ease the tax burden on small investors while ensuring that higher income from capital gains is taxed appropriately.^{[8][9]}
3. **Rationalization Efforts:** These reforms aim to create a more streamlined tax system, making it easier for taxpayers to comply with the rules and for the authorities to administer them. The government's intent is to reduce the complexity that often leads to disputes and confusion among taxpayers.¹⁰

This simplification will influence Taxpayers' behavior by influencing:

- **Ethical Implications of Simplified Tax Regimes:** The simplification of capital gains tax rates influences taxpayer behavior, compliance, and ethics. Simplified tax systems can reduce opportunities for tax avoidance and evasion, leading to higher ethical standards in taxation practices.
- **Equity and Fairness:** Analyze whether the new capital gains tax rates are perceived as fair and equitable among different taxpayer groups. This involves studying the impact on

⁶ Pranati Deva, *Budget 2024 Key Highlights*, mint, <<https://www.livemint.com/economy/budget-2024-key-highlights-from-major-capital-gains-income-tax-changes-to-job-creation-initiatives-key-takeaways-11721713404102.html>> accessed on July 30th, 2024.

⁷ *Infra*, Note 10.

⁸ PwC India, *Union Budget 2024*, pwc, <<https://www.pwc.in/budget/union-budget-2024.html>>, accessed on July 30th, 2024.

⁹ *Infra*, Note 10.

¹⁰ Ministry of Finance, *Highlights of the Union Budget 2024-25*, Press Information Bureau, <<https://pib.gov.in/PressReleaseIframePage.aspx?PRID=2035609>>, accessed on July 30th, 2024.

both small investors, who benefit from higher exemption limits, and high-net-worth individuals, who face higher tax rates.

Employment and Investment

The Budget 2024-25 has also introduced several measures to stimulate job creation and boost investment across various sectors:

1. **Employment-linked Incentives:** The budget has launched three new schemes offering direct benefit transfers (DBTs) of up to ₹15,000 for new hires. These schemes aim to support the creation of approximately 50 lakh new jobs, benefiting 30 lakh youths. Employers will receive reimbursements of up to ₹3,000 per month for two years for each new employee hired under these schemes.^{[11][12]}
2. **Internship and Housing Programs:** A major initiative involves providing internships to one crore youth over the next five years, helping them gain valuable work experience. Additionally, the budget facilitates rental housing for industrial workers through public-private partnerships (PPP), aiming to improve living conditions for workers and stimulate economic activity.¹³
3. **Angel Tax Abolition:** To further support the startup ecosystem, the budget has abolished the angel tax for all classes of investors. This measure is intended to attract more investments into startups, fostering innovation and entrepreneurship in India.¹⁴
4. **Infrastructure Investment:** The budget allocates ₹11.11 lakh crore to infrastructure development, which constitutes 3.4% of GDP. This investment focuses on enhancing urban and rural connectivity through transport-oriented development and industrial parks, promoting economic growth and job creation.^{[15][16]}

This will further motivate and influence Taxpayers' behavior to comply with Taxation, by:

- **Ethical Considerations in Employment-linked Incentives:** Evaluate the ethical implications of government incentives for employment. Assess how direct benefit transfers and employer reimbursements for new hires promote ethical business practices and fair labor standards.

¹¹ *Supra*, Note 6.

¹² *Supra*, Note 8.

¹³ EY India, *Union Budget 2024*, EY, <https://www.ey.com/en_in/tax/union-budget-2024>, accessed on July 30th, 2024.

¹⁴ *Supra*, Note 10.

¹⁵ *Supra*, Note 8.

¹⁶ *Supra*, Note 13.

- **Impact of Abolition of Angel Tax:** Study the ethical dimensions of abolishing the angel tax on startup investments. Consider how this change encourages ethical investments and supports innovation and entrepreneurship.

CRITICISMS AND CONCERNS OF BUDGET 2024-25

1. Fairness of Penalties:

- a) While the overall perception of the tax reforms is positive but there are concerns about the fairness of increased penalties for tax evasion. Some taxpayers feel that the penalties are too harsh, especially for minor infractions, and could lead to a disproportionate impact on small taxpayers.
- b) Critics argue that while enforcement is necessary, the government should ensure that penalties are applied equitably and do not disproportionately affect those who may inadvertently fall afoul of the rules.

2. Implementation Challenges: There are apprehensions about the practical implementation of some of the new measures, particularly in rural areas where digital infrastructure might be lacking. The public perception is that while the reforms are well-intentioned, their success will depend on effective execution across diverse regions and demographics.

3. Complex Incentive Structures: The complexity of some of the incentive structures introduced in the budget has led to confusion among taxpayers. There is a sentiment that while the incentives are beneficial, the government needs to provide clearer guidance on how to access them, to ensure that all eligible taxpayers can take full advantage of these benefits.¹⁷

GOOD TAX SYSTEM

A good tax system¹⁸ is the root of a stronger economy of a nation. Tax helps to build a higher living standard for citizens of the nation; therefore, a good and reliable tax system must be the call for every developing and under-developing nation today. In 1776, Scottish economist and philosopher, Adam Smith, published a book titled *The Wealth of Nations*, wherein he talked about a 'good tax system' by introducing the 'Canons of Taxation' to the world. These Canons of taxation were nothing but a set of principles and rules to build a better tax system. In his book, Mr

¹⁷ *Supra*, Note 13.

¹⁸ Gaurav Akrani, *What is Tax? Definition - Adam Smith's Canon of Taxation* (February 12, 2010), <<https://kalyan-city.blogspot.com/2010/12/what-is-tax-definition-adam-smith.html>>, accessed on June 13th, 2023

Smith, introduced four such canons which was further increased by other renowned economists as per the changing times. These four Canons of Taxation were -

1. Canon of Equity: This canon talks about providing social and economic justice to the people. Adam Smith under this principle states that every person should pay tax as per their ability to pay, i.e. an individual should pay tax in proportion to the revenue he/she generates and enjoy. It is because revenue of every citizen is protected and appreciated by the state, as the state entertains their demands and provide them with corresponding opportunities, it provides them Banks to preserve their money, Police departments to counter any anarchy and courts to further interpret justice.
2. Canon of Certainty: According to this principle, Adam smith states that taxes must be certain and not ambiguous in nature. This canon talks about certainty in taxes, in their payment, in their collecting authorities and their regulating administrations. It further states that to remove arbitrariness and disputes with taxpayers, the government must make the individuals well aware of the tax system of the society, wherein, it can be understood by the taxpayers that upto what cap or bar every individual is needed to pay tax to the government and that it should not come as a surprise to them.
3. Canon of Convenience: This principle states that the method and timing of payment of tax must be made as per the convenience of taxpayer. It is important to increase tax ethics and compliance in the taxpayers and this canon will help in developing morality in them. For instance, Income Tax is deducted at source, land tax is collected at the time of harvest, etc.
4. Canon of Economy: This canon states that there must be economy in tax administration. It is to say that cost of tax collection must be lower than the amount of tax collected, because it would not be feasible to collect tax, which is widespread and is not schematic to administer.

Additional Canons of Taxation

After Adam smith's time, various other functions and activities were increased and implemented. Government was expected to maintain economic stability, full employment, reduce income inequality & promote growth and development. Therefore, it was need of the hour that tax system should be created that it meets the requirements of growing state's activities.

As a result of which modern economists provided some more canons of taxation in addition of the Adam Smith's one. One of the main proponents for these canons were Charles Francis Bastable,

an Irish economist. These Additional canons¹⁹ were:

1. Canon of Productivity: This canon talks about Fiscal Adequacy. As per this principle, the tax system should be such that it is able to generate enough revenue for the treasury of the state. It states that it will not be healthy for a nation's economy that its government declare "Deficit Financing" in a fiscal year, because it will depreciate the tax system by the government and may cause inflation in prices. It is a helpful canon for growing economies in the world.
2. Canon of Elasticity: This principle talks about flexibility in the tax system of the state. As per this canon, taxes imposed by the government must be elastic in nature, so that the government can resort to a feasible system in different circumstances. For instance, in a depreciating economy, a government can impose high tax rates so, to deal with the crisis situations, also it can be reverted back to the original when the conditions are normal.
3. Canon of Flexibility: According to this principle, an economy must have a flexible tax structure and not rigid. This canon states that the tax structure be so developed that it can be changed by the tax authorities with changing time. It should be easy for the administration to revise the tax structure with respect to both its coverage and rates.
4. Canon of Simplicity: This canon talks of the simplicity in Tax system, it states that the tax system should not be complicated and must be so made that it is easy to understand, administer and interpret in case of disputes. It also helps build confidence of taxpayers for the respective tax system of the nation.
5. Canon of Diversity: This principle talks that the government should collect taxes from various sources rather than focusing only on a single source of tax. This is because concentrating only on several sources for collection of tax will result in increase in higher tax rates, less consideration of demands and as a result less productivity and growth. It is also not advisable to government to limit only to certain sources for collection of taxes as it will create inequity in society. If the tax revenue comes from diversified source, then any reduction in tax revenue on account of any one cause is bound to be small.

CONCLUSION

According to the literature study, there is a substantial and direct link between individual taxpayer ethics and morals and their tax compliance. Better tax compliance will result from a more excellent ethical value. Furthermore, tax literacy is a significant determinant of compliance. Tax education

¹⁹ *Canons of Taxation*, JNCollegeOnline, < <https://jncollegeonline.co.in/attendance/classnotes/files/1621226869.pdf> >, accessed on July 31st, 2024.

and knowledge contribute to improved planning on the side of taxpayers, which leads to increased compliance.

The research looked at whether tax ethics and social norms have a role in taxpayers adhering to all tax rules and regulations or if they are simply a rationalization for their self-interested behavior. Over 1000 Australians were included in this investigation. There were three outcomes. First, there was a link between tax ethics and compliance, and the amount of compliance fluctuated depending on the taxpayer's ethics and morals. Second, individual taxpayer beliefs were influenced by societal conceptions and conventions, which affected their level of compliance. Finally, these perceived standards had a minor impact on tax compliance. Hence it can be concluded that we cannot ignore the role of ethics and morality in shaping individual taxpayer behavior.

Although, the 2024-25 Budget has simplified tax processes, encouraging higher compliance through easier filing and digital tools, also, changes to capital gains taxes, with increased rates, are expected to reduce tax avoidance while promoting ethical compliance. However, higher rates may also drive some towards more aggressive tax strategies, making government enforcement crucial to maintain trust. The public views the new tax measures positively, appreciating the focus on fairness and transparency. The abolition of the angel tax and incentives for ethical investments are seen as steps that align tax policy with societal goals. Concerns remain about the fairness of penalties, especially for small taxpayers, highlighting the need for equitable enforcement.

The deterrence principle of punishment has traditionally been used to decrease tax evasion. This is inflicting a severe penalty or other consequence on the offender to make an example of them, therefore deterring other prospective offenders. However, when the danger of being detected is low, severe punishment may not be enough to dissuade people. This demands the development of a new method of guaranteeing tax compliance. While conventional penalties are vital, the government should consider how it might utilize ethics and morals to persuade taxpayers to report their actual earnings and follow other rules voluntarily. Personal moral views have a significant role in tax compliance decisions, and ethics is an essential element of Indian society. Individuals who believe that tax evasion is immoral are less inclined to do it, regardless of their financial situation. The vast majority of respondents agreed that everyone should pay their taxes without complaint and disagreed with the assertion that tax evasion is justifiable since it only harms the government and protects individual interests. In summary, most people's moral compass tells them that evading taxes is not the best approach to reduce one's tax liability.