Exemption from Tax in India: A Critical Analysis of the Need for Reform and Emerging Challenges

Mehul Solanki

Student, Law, Jagran Lakecity University

ABSTRACT

This research paper analyzes tax exemptions in India, focusing on the necessity for reform and the challenges that arise. Tax exemption in India is a significant matter that should not be ignored and must be examined thoroughly; it plays a vital role in fostering social welfare, stimulating economic growth, and supporting specific sectors like education, agriculture, and various charitable organizations. However, the abuse of these exemptions has resulted in substantial revenue losses, tax evasion, and unequal treatment among individuals. This paper closely investigates the concept of tax exemption in India and assesses its socio-economic rationale, while also highlighting emerging challenges and advocating for comprehensive reforms. By drawing on both the legal framework and practical realities, this paper proposes recommendations for establishing a more equitable, less biased, and more effective system of tax exemptions to enhance societal well-being.

Keywords: Tax exemption, Tax reform, emerging challenges, reforms.

INTRODUCTION

A tax exemption[1] is a legal reduction in the taxable income permitted by law. It serves as a lawful deduction from the income subject to taxation due to specific qualifying reasons. In India, particular sources of income are exempt from taxation under the Income Tax Act of 1961. These are referred to as tax-free incomes, meaning the Income Tax Department[2] is unable to levy taxes on these exempted incomes. As a result, individuals have the opportunity to reduce their tax liabilities by utilizing these exemptions when submitting their Income Tax Returns (ITRs). This document emphasizes the structure and implications of tax exemptions and advocates for essential reforms that align with both international standards and local requirements.

INTERPREATION AND SIGNIFICANCE OF TAX EXEMPTION

Tax exemption permits certain types of income to be disregarded for tax obligations in accordance with specific legal provisions in India. This can be observed in various laws, including the Income Tax Act of 1961, the Goods and Services Act, and other related legislation.

[1] Tax exemption | English meaning - cambridge dictionary. (n.d.). https://dictionary.cambridge.org/dictionary/english/tax-exemption

[2] BankBazaar. (n.d.). Income tax exemption rules - with limits. https://www.bankbazaar.com/tax/income-tax-exemption-rules.html

The aim of tax exemption are as follows –

- Foster economic growth and industrial advancement.
- Motivate investment in underdeveloped areas.
- Assist non-profit and faith-based organizations.
- Encourage growth in targeted sectors such as farming, education, and health services.
- Offer support to marginalized communities.

LEGAL FRAMEWORK FOR TAX EXEMPTIONS

The income tax act, 1961.

Sir James Wilson played a key role in the early implementation of taxation laws in India. As the finance minister before independence, he delivered the country's first "Union Budget" on April 7, 1860, and introduced the Indian Income Tax Act of 1860. This legislation included taxes on tobacco duty, licensing, and personal income. The Indian Income Tax Act of 1860 was established to offset the financial losses sustained by the government following the military uprising of 1857.

Income tax was categorized into four distinct types:

1. Revenue from landed property
2. Earnings from employment and trades
3. Income from securities
4. Salaries and pension income

The groundwork for India's tax regulations was laid down with the Indian Income Tax Act of 1860. However, this act underwent several revisions and eventually replacement over time. In 1918, a new Income Tax Act was introduced, succeeded by the Income Tax Act of 1922, which remained in effect until the fiscal year 1961-62. In 1962, the Ministry of Finance launched the Income Tax Act of 1962, which came into force on April 1, 1962, and was applicable throughout India, including Jammu and Kashmir and Sikkim. Since 1962, numerous amendments have been made to the Income Tax Act via the union budget.

Who is eligible to pay tax in India?[3]

According to the Indian Tax Department, individuals with a gross income exceeding 2.5 lakhs rupees annually are required to file their Income Tax Returns. For senior citizens, this threshold is set at 3 lakhs per year, while for super senior citizens, it is raised to 5 lakhs annually. Income tax must be paid by companies, corporate firms, bodies of individuals (BOIs), local authorities, associations of persons (AOPs), and Hindu Undivided Families (HUFs). Additionally, if your gross income surpasses 2.5 lakhs, you are obligated to file your Income Tax Returns each year.

Benefits of Tax Exemption

- Tax exemptions result in numerous economic incentives, drawing in both domestic and foreign investments.
- social services including education, healthcare, housing, and public assistance. Different parts of the Income Tax Act, including Sections 11 and 12, state that income utilized for charitable and religious

[3] Understanding income tax eligibility in India: Bajaj Finance. www.bajajfinserv.in. (2025, January 20). https://www.bajajfinserv.in/understand-income-tax-eligibility

purposes is not subject to taxation. Additionally, donations made to registered organizations are also exempt from taxes.

- Support for Primary sector - Earnings from agricultural activities are completely exempt under section 10(1), providing relief to farmers and contributing to a rise in agricultural production.
- The reduction of tax burden for individuals, along with the exemptions and deductions offered from section 80C to section 80U, offers relief to the middle segment of society.

EMERGING CHALLENGES

Tax systems can be perceived as inequitable[4]: There is also considerable discretion in the specifics of a country's tax legislation.

Depending on whom you consult, you may receive vastly different perspectives on who ought to be taxed more heavily and who should receive tax exemptions.

As a result, it is impossible to satisfy everyone with a single tax code, leading to ongoing debates among individuals who believe they are being treated unjustly by the local tax system.

Individuals may attempt to evade tax obligations: Many individuals might even seek ways to circumvent tax payments. With skilled tax advisors, you might discover loopholes in local tax regulations, allowing you to save considerable amounts of money. This is particularly applicable to those with substantial wealth, as they might choose to change their residency to nations with lower tax rates. Consequently, this type of tax avoidance could result in a scenario where the diligent general population shoulders the majority of the tax burden while the affluent find ways to sidestep tax payments, ultimately leading to significant frustration among the public.

People's Apathy: One downside of direct taxation is that it fails to cultivate a sense of civic responsibility among those who do not pay these taxes. In the case of income tax, individuals with incomes below a certain threshold are exempt from paying taxes. In a low-income country such as India, the majority of the population is not obligated to pay income tax. When a person directly experiences the burden of a tax, they tend to inquire about how the government utilizes that revenue. Those who do not directly shoulder the tax burden remain apathetic regarding the allocation of public funds.

Politicians may behave in an opportunistic manner: They might frequently assert that they represent the desires and preferences of the broader public. Nevertheless, their actions may not always align with this commitment. For example, many politicians might prioritize the interests of small groups over initiatives that would be advantageous for the general population.

Inflationary: Since indirect taxes raise the prices of goods, they are viewed as inflationary. When the government relies more heavily on indirect taxes, inflation is likely to continue rising.

CASE LAWS

Commissioner Of Income-Tax vs Pulikkal Medical Foundation Pvt. Ltd. on 5 August, 1993[5]

K. Vinod Chandran, J.: The matter originates from an order of the Tribunal concerning the assessment year 1991-92. The Tribunal determined that the assessee qualifies for the exemption under Section 10(22A) of the Income Tax Act, 1961 [hereinafter referred to as "the Act"], citing the decision of a

[4] k, *Dr. Shamala. (2022, May). ISSUES AND CHALLENGES: PRESENT TAX POLICIES IN INDIA. International Journal of Research and Analytical Review. https://ijrar.org/papers/IJRAR22B2346.pdf

[5] Commissioner of income tax v. Pulickal Medical Foundation, Kerala High Court, judgment, law, Casemine.com. https://www.casemine.com. (n.d.). https://www.casemine.com/judgement/in/5d919939714d587fe94c3a44

Division Bench of this Court in C.I.T. v. Pulikkal Medical Foundation P. Ltd. [(1994) 210 ITR 299 (Ker.)]. The legal questions presented for our review and determination are as follows:

1. "1. In light of the facts and circumstances of the case, is the Tribunal correct in both law and fact in concluding that the assessee is eligible for the exemption under Section 10(22A) of the Income Tax Act, 1961?
2. Considering the facts and circumstances of the case, and also in light of the High Court's finding in 210 ITR 299 at 312 that 'the assessee is operating the hospital on commercial lines'; and 'the assessee may engage in any activity for profit', is the Tribunal justified in affirming the CIT (Appeals) order and granting the exemption under Section 10(22A) of the Income Tax Act, 1961?"
3. The esteemed Senior Counsel for the Government of India (Taxes) cites Aditanar Educational Institution v. Addl. C.I.T. [(1997) 224 ITR 310 (SC)] to argue that the eligibility for the exemption under Section 10(22) of the Act can be evaluated by the Department each year when the assessment is presented to the Officer. Notable mention is made of the following statement:
4. We do not contest this principle; however, we note that the Assessing Officer did not perform such an assessment for the year 1991-92, which is the focus here. The order recorded as Annexure-A from the Assessing Officer merely indicates that although the High Court had acknowledged the claim in past years, the Department has pursued a Special Leave Petition with the Supreme Court. Thus, even the Assessing Officer operated under the presumption that if the Supreme Court ruled in favor of the Department, a denial of exemption could occur for the current year. We recognize the previously quoted principle wherein the Supreme Court stated that the exemption under Section 10(22) must be reviewed each year it is claimed, and approval of that exemption in a preceding year does not automatically benefit the assessee in the following years. Nonetheless, this issue does not emerge from the Tribunal's order since the Assessing Officer did not examine any factual considerations that would lead to a denial of the exemption for that specific year. Moreover, we find that the Hon'ble Supreme Court has upheld the High Court's ruling in Pulikkal Medical Foundation P. Ltd. in Civil Appeal No. 6098-99/1994, as per the order dated 25.02.1999.
5. Under these circumstances, the reference is concluded without addressing the legal question posed, as it does not pertain to the specific year in question.

REFORMS AND SCHEMES

1. THE NEW TAX SYSTEM: which provides reduced tax rates and a certain minimum exemption amount that taxpayers can choose to apply.
2. Impartial evaluation systems that limit discretion and also help decrease the instances of misuse that currently arise from exemptions.

ANALYSIS

Tax exemptions in India are primarily linked to social welfare and development, but they have become a significant issue due to their unintended consequences. While they can enhance investment and support charitable activities, they also provide advantages to high-income individuals and large corporations. This creates bias within the tax system and undermines its progressiveness. Misuse by charitable organizations and similar entities has turned into a critical problem, as these tax exemptions can often be driven by political motives or profit benefits. Additionally, sector-specific exemptions create artificial incentives rather than promoting merit-based growth. Although some exemptions contribute to public welfare, like those for agriculture and education, there is still a pressing need for fairness, accountability, and transparency within the tax system. A tax environment with fewer exemptions would enhance efficiency and equity, thereby aligning better with India's tax framework and improving overall effectiveness.

CONCLUSION

Tax exemption in India is not a recent phenomenon; it has historically been a significant aspect of the Indian economy. Nonetheless, the political implications and favoritism towards the affluent have contributed to undermining its effectiveness, rendering it unequal for a large segment of society. The rising challenges, including revenue loss, inequality, bias, and a lack of transparency, underscore the pressing need for reform. By enhancing accountability, promoting transparency, and aligning it with contemporary economic objectives, India can progress towards a more transparent, equitable, and efficient tax system. The future of tax policy should rely on surveys, be principle-driven, and focus on fairness and equity, ultimately fostering societal growth.

BIBLIOGRAPHY

1. SILLECK, W. F. (1921). TAX EXEMPTION. Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association, 14, 523–524. http://www.jstor.org/stable/23400187
2. https://www.drishtiias.com/daily-updates/daily-news-analysis/challenges-and-reforms-in-indias-taxation-system
3. Ajay. (2016, December 28). *Taxation system in India*. iPleaders. https://blog.ipleaders.in/taxation-system-india/ https://www.drishtiias.com/daily-updates/daily-news-analysis/challenges-and-reforms-in-indias-taxation-system
4. https://www.drishtiias.com/daily-updates/daily-news-analysis/challenges-and-reforms-in-indias-taxation-system