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Abstract

Property, according to Hindu law, may be divided into two classes, namely, joint family property and separate property.

Anurag Sanyal '95 is a mathematics major minoring in economics. Anurag wrote the following paper in his Public Finance class with Dr. Leekley. Anurag has maintained an active role in the Economics Society and Journal for the past two years.

T h e H i n d u Undivided Family: Effects on the Indian Tax System

by Anurag Sanyal

*"To Tax and to please, no more than to love
and be wise, is not given to man"*

- Edmund Burke, 1774

The objective of taxation is to raise revenue for the purpose of maintaining the government both in developed and developing countries. India's primary objectives of taxation include redistribution, growth, and stability. Among the major tax powers vested by the constitution to both the Union and the States, the personal income tax is one of the most important sources of revenue. But the system has its flaws. The existence of the Hindu Undivided Family (HUF) and the superior treatment given to the HUF complicates the assessment and collection of income tax. This monograph intends to describe the characteristic features of the system of succession and inheritance that is typical to a

HUF and how the dexterous use of these features enables the members of a HUF to avoid their tax liabilities either partially or completely. However, it is not completely justified to shirk the entire responsibility on the HUF. Other structural deficiencies are also unveiled through the course of discussion and appropriate suggestions have been enumerated.

Indian income tax laws do not discriminate between different sources of income as would the case be under a "scheduler" type of income tax. Thus, the Indian system of personal taxation may be called "global" in principle and, for the most part, in practice also. In India the personal income tax is levied on the total income of all individuals, Hindu Undivided Families (HUF), unregistered firms, and other "associations of persons." Total income is said to be the sum of the tax payer's income under all categories, exclusive of certain exempt receipts which are not included in total income, and reduced by deduction of certain expenditures incurred in earning total income. In India, income tax is levied at progressive rates and the super tax, which was levied separately as a supplement to income tax, is now fully integrated with income tax.

Indian tax law provides for the collection of taxes from the tax payer through one or more of four different processes: first, deductions or withholding at source at the time of payment of income; second, advance payment of tax by the tax payer himself; third, provisional assessment and demand by the income tax officer; and fourth, regular assessment and final demand by the Income Tax officer (Cutt 1969, p. 87). The major obstacle that the tax authorities face is the problem of categorizing the tax paying unit and the resulting hindrances in the equitable and efficient assessment of income. This is primarily caused by the existence of the Hindu

Undivided family (HUF). Then what is the HUF and how does it complicate the Indian tax system?

The Hindu joint family, called the Hindu undivided family in the Income Tax Act (1961), is a type of extended family system. The joint and undivided family is the usual characteristic of Hindu society; it consists of all persons who are lineally descended from a common ancestor and includes their mother, wives, and unmarried daughters bound together by the fundamental principle of "*Spindaship*" or family relationship which is one of the distinguishing features of this institution (Chawla 1972, p. 103). The laws of inheritance when combined with the succession laws provide a number of avenues for the HUF to avoid income tax in some measure. Thus, the comprehension of both of these aspects will enable the reader to understand the efficacy of their usage by the HUF.

Property, according to Hindu law, may be divided into two classes, namely, joint family property and separate property.

Of the members of a joint family, those who acquire by birth an interest in the joint (coparcenary) property are called coparceners. Chawla very aptly says, "the conception of a joint family constituting a coparcenary (obviously, then, a narrower body than the joint family) is that of a common male ancestor with his lineal descendants in the male line with four degrees counting from and inclusive of such ancestor." [For example; if a person X is married with two sons ('P' and 'Q') and a

daughter ('D') and P and Q get married then the families of P and Q together with their unmarried sister D form the joint family but by the Hindu Successions Act only P and Q were treated as coparceners. Thus referring to Chawla's definition in the context of the above mentioned family, X is the common ancestor and P and Q are male lineal descendants. As P and Q's family extends there forms a smaller joint family within the parent one and with time there is even the formation of sub-coparcenaries as the families extend.]

Every coparcenary must have a common ancestor with which to start--normally the head of the joint family. The extant coparcenary is not limited to four degrees from the common ancestor; rather at any point in time, it is limited to four degrees from the last holder of the ancestral property which in most cases is the coparcener himself (Chawla, p. 103). Suppose after the death of an ancestor, his two sons acquire the ancestral property by partition. From then on the two coparceners have formed their individual coparcenaries bestowing rights in the property to their heirs. The heirs will now be counted not from the original ancestors but within four degrees of the two new coparceners. This eventually leads to the formation of smaller HUFs. However, the existence of a coparcenary is not a pre-requisite to the existence of a HUF, because the latter can consist of a sole surviving male member and female members (like mother, wife or unmarried daughters or sisters). But, in the case of a lone male coparcener, even though he might possess the joint family property, he cannot be considered as a HUF, because "a single man cannot constitute a family." (Chawla, p. 106).

The HUF also manipulates the property rights to procure exemptions and yield other tax advantages. Property, according to Hindu law, may be divided into two classes, namely,

joint family property and separate property.

A Hindu who is a share holder of a joint family, can have his own separate property. However, not even his son acquires any interest in the separate property by birth. In his life time the coparcener may treat his separate property in any fashion--throw it in the hotchpot of the HUF, bequeath it by will or even sell it. However, on his death it passes by intestate succession to his heirs and not by survivorship to the surviving coparceners (now subject to the Hindu Succession Act, 1956). As a result of the fact that many individual members of the HUF may hold separate property there is the emergence of many branches and sub-branches of a main HUF which are in itself a HUF. This immediately results in the formation of small HUFs. Interpreted differently, it could be said that in practicality the creation of sub-HUFs results in the treatment of unit families as HUFs with an exemption limit close to twice of what it originally should have been.

An observation made by James Cutt in his book, Taxation And Economic Development in India, efficiently bolsters my argument: "There is one particular statutory area of avoidance--the privileged tax treatment of the Hindu Undivided Family--which has been recently shown to represent very substantial revenue loss to the exchequer." The HUF enjoys a basic exemption limit of Rs 7000 as against Rs 4000 for an individual. The revenue loss involved in such treatment is aggravated by the possibilities of complete or partial partition and transfer of assets open to the HUF, which permit the use of several exemption limits and lower rates on split incomes (Cutt 1969, p. 95)

The two main systems of inheritance under Hindu Law are the '*Mitakshara*' system and the '*Dayabhaga*' system. To understand the procedure for categorizing each HUF under a

particular system it is essential to comprehend section 64 of the Hindu Succession Act. This Act sets a candid set of criteria that need to be fulfilled by a HUF in question to subscribe to either of the two systems. These clauses do not affect the taxation procedures as it is only after the designation of the type that the characteristics come into play. The spirit of the *Mitakshara* coparcenary is the unity of ownership. The main incidents of joint family property under *Mitakshara* are (i) devolving by survivorship and not by succession and (ii) property in which the male issues of the coparceners acquire an interest by birth. According to the *Dayabhaga* law, the sons do not acquire any interest by birth in the ancestral property. It is only on the death of the father leaving two male issues that a coparcenary is first formed. However, in the absence of a male issue the heirs could be the deceased's widow or his daughters. A Hindu may dispose of his separate or self-acquired property by gift while a coparcener under the *Dayabhaga* law may dispose of his coparcenary interest by gift. A coparcener under *Mitakshara* cannot do so unless he is the sole surviving coparcener (Chawla, p. 105). This helps the coparcener under *Dayabhaga* to give any coparcenary property to his wife or minor son and thus tactfully avoid the liability that would have otherwise been incurred had the property been under his ownership. It is also important to discuss the flexibility of the two laws with respect to enabling the coparceners to gift and transfer property. This is important in the understanding of how HUFs extend exemption limits and in certain situations even avoid tax liabilities.

Now the questions that arise are how is all of this incorporated into the personal income tax and how does it affect the working of the system? The laws of succession and property

rights are primarily used by the HUF to file exemptions and transfers so as to reduce their tax liability partially or even completely. The difference in the exemption limit coupled by the partition and transfer of assets rights already puts the HUF at an advantageous platform compared to the individual tax payer. This cumulated with numerous other factors, benefits the HUF greatly and causes disparity between the two different units of tax payers. Then what is the rationale behind taxing the HUF as a separate tax unit?

The joint family differs from the unitary family for it is a multi generation unit. Its size may quite often be larger than that of an unitary family. On this consideration, a higher exemption limit is allowed to a HUF under the Income Tax Act provided it satisfies one of the following two conditions:

- (i) It has, at least, two members entitled to claim partition who are not less than 18 years of age.
- (ii) It has at least two members entitled to claim partition who are not lineally descended from any other living member of the family.

Another rationale behind allowing a higher exemption is that were the coparceners of the HUF to partition and set up as separate tax units, they would be entitled to separate tax exemptions. In reality, a family which satisfies either of these conditions need not be a 'big' family, while there also could be 'big' families which do not satisfy these conditions. It is obvious then that there is no rationale behind treating a HUF differently from a unitary family in the matter of fixing the exemption limit. Thus, the difference in sizes of the families call for differential family allowances and nothing else.

The acceptance of the Hindu family as an individual tax unit reaps distinct advantages for it. The following advantages are not just benefits to the HUF but also threats to overall

goals of equity and stability. Thus:

(i) Whatever the size of the HUF a higher exemption limit causes even unitary families to convert themselves into HUFs.

(ii) The life insurance premium deduction from gross total income for a HUF is twice that of an individual tax payer irrespective of the size of the HUF or the age of the family members.

(iii) The members of the HUF are, on the principle that there should be no double taxation, exempt from tax in respect of sums which they receive out of the income of the family.

(iv) The joint family may be partitioned, fully or partially, into a number of joint families.

(v) The joint family may be partially partitioned as to property which means that while the joint family continues, some property is shared among some or all of the coparceners.

(vi) A coparcener governed by Dayabhaga may give any property of the family to his wife/minor son, while a coparcener under Mitakshara can do so only if he is the sole surviving coparcener.

(vii) A Hindu at any time may throw his self acquired property into the common stock of a HUF; thus, creating a new HUF where non existed before. This normally occurs when the HUF consists only of the individual and his immediate family, for in the case of a larger HUF the other members would also be holders of the individuals' property. This enables the individual to transfer part of his property to his wife and children and consequently circumvent the income tax act (section 64). This may be repeated by a person any number of times.

With the influx of modernization, the number of HUFs was expected to decrease. But this is not so. Although sociological studies and surveys have indicated a decline in the joint family system, I.S. Gulati and K.S. Gulati in their study have shown that the HUF

as a tax payer, "is not only not a vanishing entity but one which is likely to hold its part of the ground in the foreseeable future" (Gulati, p. 23). Though the principles of *Spindaship* (ie. sharing the same house, food and place of worship) are not followed yet, on paper, these families stand to be HUFs. Why so? The prime reason being that the beneficiaries can then save a greater proportion of their income by protecting it under the cover of high exemptions and transfer facilities available to an original HUF. These benefits get multiplied even more because of the small size of these families.

As mentioned earlier, the intelligent use of the exemptions available to the HUF can cause immense losses to the exchequer. James Cutt in his book, Taxation and Economic Development in India, says, "A calculation made of the maximum tax avoidance available to a HUF, through varied combinations of complete partition, partial partition and transfers by gifts shows that by dextrous employment of avoidance techniques a HUF can earn up to Rs 58000 (8 times the actual exemption limit) without incurring any income tax liability. An aggregate computation of annual loss to the exchequer on account of avoidance action of HUF provides an average figure of Rs 800 million (\$27 million) and Rs 1500 million (\$50million)."

I think treating HUFs as a separate entity threatens the basic essence of secularity that has been embodied in the spirit of India.

With the cons related to the existence of the HUF already discussed, I find it

appropriate to raise a question that has been boggling my mind ever since I have started writing this paper. It is true that India is described as a "Sovereign, Socialist, Secular, Democratic, Republic." I think treating HUFs as a separate entity threatens the basic essence of secularity that has been embodied in the spirit of India. It is certainly not true that only the Hindus have "big" families. With a minority of Muslims (12%), Christians, Zoroastrians, Jains, and Buddhists, it is implicitly discriminatory for Hindus to have a separate option enabling them to exempt themselves from their tax liabilities. However, the existence of the HUF can be understood by the circumstances at the time of its origin.

The origin of the HUF lies essentially in the 1937 amendment of the Hindu Succession Act which was a decade before independence and the existence of other religions at that time was a negligible minority except for the Muslims (who too were relatively small in number). Thus, among other economic reasons the creation of the HUF was primarily done by the British to pamper the Hindu feudal families and earn their loyalty by creating an ameliorated position for them over the common Indian. With the support of the elite Hindu feudals it was possible for the British to thwart the relentless efforts of the Indians to free themselves from the "British Raj." I feel the existence of the HUF and the superior treatment of assessing their tax liabilities are not in accordance with secularity and not in the spirit of democracy.

But it is not entirely justified to say that the problems of inequity, inefficiency, avoidance, and evasion--some of the major hurdles that the Indian personal income tax faces--are solely due to the existence of the HUF. There are other factors too, that find their moorings in some of the basic principles of taxation that India follows. The Indian

definition of income causes many problems emerging out of the narrow and convergent nature of the definition. Professor Kaldor argued in 1956 to introduce a wider definition of income in India and to embrace all beneficial receipts which increase the tax payers spending power and not merely the conventional forms of income included in the tax base. This advocacy of a wider base strikes a common chord with the definition proposed earlier by Haig and Simon. Though this broad definition is gaining strength among most fiscal theorists, until the early seventies, only the classification of the short term capital gains as ordinary income was the only step towards broadening the base (Budget 1967-68). Since then, no significant step has been taken to broaden the tax base. It has always been an important concern of most fiscal theorists to include the agriculture tax into the personal income tax as it holds a major share of revenue resource for the government but not many steps have been taken towards the matter. Broadening of the tax base shall definitely solve many problems, and incorporating the agriculture income into the base is an advisable first step.

In terms of horizontal equity and revenue productivity, income must be defined as net accretion, or change in the spending power of the taxable unit over a specified period of time. The change in the taxable units spending power can be measured by the sum of the consumption, gifts, and change in net worth of assets (Cutt, p. 94). Such a base includes all additions to spending over a period without regard to source, form, or whether consumed or saved. This is yet another means of creating an ideal tax base. But, the implementation of this action needs to take into consideration the administrative feasibility of this kind of a proposal. Among other problems, this kind of a scheme involves the

problem of full disclosure on the tax payers' part. But with a strong administration and an honest constituency this issue could be dealt with.

The discriminatory treatment accorded to fluctuating incomes is the standard argument used to condemn progressive tax rates. Under a procedure of yearly assessment a tax payer whose income fluctuates from year to year will pay a greater proportion of his income in tax than a taxpayer having the same average income more evenly distributed from year to year. This is a violation of the principle of horizontal equity. This can be avoided by introducing the process of averaging, but the problem that comes up is to decide what will be the most appropriate tool. A suggestion could be to imitate the 60's methods used by Wisconsin and Australia, i.e. the five year average method (Vickrey 1947, p.169).

Among other built in problems that the Indian Personal Taxation system has is the relatively high level of exemption. In 1965 an exemption of Rs. 4,000 was ten times the per capita income of Rs. 421.50. This consequently resulted in the exclusion of 60% of the urban income, which provides for almost all of Union non-corporation income tax revenue, from taxation (Planning Commission Report 1965, p.70). The Planning Commission continued to report that with a reduction in exemption levels to Rs 2,000 it would bring 23% of income into the taxation network and would result in an immediate increase of Rs 1000 million to (\$30 million) the exchequer.

With issues like the discriminatory treatment of the HUF and the individual tax payer, avoidance and evasion of the personal income tax, problems related to progressivity, relatively high levels of exemptions, an exclusive definition of income resulting in a narrow tax base and adverse incentives to tax

payers overshadowing the Indian personal Income Tax; it definitely calls for redemption. To complement all the measures already discussed implicitly while investigating the problems there are a few more suggestions that directly aim to ensure horizontal equity especially when treating the HUF. Thus:

(i) the family should be treated as the tax unit; a scheme of adequate family allowances should be incorporated with it.

(ii) the HUF should not be accorded any distinct treatment; some of its aspects would have to be ignored for tax purposes; others can be fitted into the scheme of family taxation.

(iii) Intra-family gifts should be ignored; those made to individuals outside the family household should be treated as the recipients income.

I personally believe that among all the problems related to personal taxation in India, the problem of avoidance and evasion call for immediate attention. With 36% of the Indian currency revolving in a parallel black market economy, it is not to be too demanding to ask for a more resilient tax system. (India Today, June 1993). The T.E.C. defined the concept of avoidance and evasion unequivocally:

"Leakage in revenue may occur either through a deliberate distortion of facts relating to an assessment after the liability has been incurred, or by so arranging one's affairs before the liability is incurred as to prevent its occurrence or to reduce the incidence of the tax within the framework of the existing legislation. The former set of transactions is usually referred to as 'evasion' and the latter as 'avoidance,'.... Both avoidance and evasion result in the loss of revenue to the government, but the former has the color of legality about it. In the net result, the burden on the honest citizen increases protanto" (T.E.C. Vol 2, pp. 189-190).

I personally believe that among all the problems related to personal taxation in India, the problem of avoidance and evasion call for immediate action.

It is clear that the difference between avoidance and evasion is only of degree; both offend the spirit of the law although the former may technically conform to its letter. However, evasion is a more serious problem. Avoidance may be dealt with by defining the tax base in a more concrete manner and also meticulously drafting new legislation so as to patch up the existing loopholes in the law. Evasion too needs to be prevented by the use of the aforementioned techniques combined with the use of a variety of techniques to promote accurate disclosure and through severe punishment of offenders. I believe with the opening of the economy and a more liberal tax atmosphere the urge and need to avoid and evade will definitely decline.

In the past two years, Dr. Man Mohan Singh, the present Finance Minister of India has been working towards liberalizing the country's economy and is simultaneously trying to sew the loopholes in the system. The Personal Income Tax is also awaiting major reforms. With a discrete and intelligent handling of the HUF as well as the other discrepancies discussed in this paper, India should definitely be able to strike a positive balance between equity and efficiency. The results of the trade off shall greatly be in favor of the nation's growth and overall stability. With the corporate taxation reduced from 40%

to a low of 20% in certain industries, the future of the personal income tax seems to be encouraging for the payer and shall definitely help India step into the twenty-first century with a strong infrastructure.

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