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Income tax compliance: Gains and gaps

Despite mandatory compliance provisions, the share of nil returns remains high for both individuals and companies

One of the primary concerns of the income-tax regime is to expand the coverage — have a larger number of taxpayers within the scope of the regime. A broad-based tax regime is expected to be more stable and serve as a buoyant source of revenue. Income tax statistics provide information on the number of taxpayers as a part of the time series data dissemination. This is a superset of PAN holders who either paid tax or filed a return in a given assessment year. Income-tax return statistics, on the other hand, provide information on the total number of individuals or PAN holders filing returns during a given financial year as well as their distribution according to various parameters, including the amount of tax paid.

From these different data series, it is possible to define three categories of interactions between the income-tax system and taxpayers: Those who pay taxes and file return, those who pay taxes but do not file returns, and those who file nil returns, implying no tax is payable. In this piece, we explore the trends in these three categories for three classes of taxpayers: Individuals, firms, and companies.

The Indian income-tax regime has an extensive system of tax deductions at source (TDS) and tax collections at source (TCS). These provisions were introduced to improve tax collection and compliance in return filing. These provisions have had a significant impact on revenue collections — TDS as a percentage of total revenue collections increased from 32 per cent in 2013-14 to 41 per cent in 2022-23. To understand the impact of such deductions on compliance behaviour, we look at the share of taxpayers who haven't filed a return. During the period 2013-14 to 2023-24, the share of this category has declined for all three classes of taxpayers. For individuals, it has dropped from 32 per cent to 23 per cent. A similar decline is evident for firms —

from 15 per cent to 9 per cent. For companies, in 2013-14, the share was 11 per cent but in subsequent years, it fluctuated around 6 per cent. These trends are heartening, but the levels might need some attention.

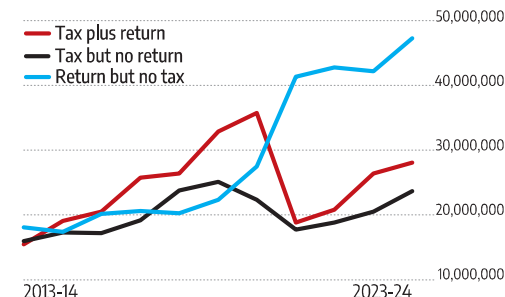
Turning to the other two categories, the first point to note is that for firms, nil returns account for a smaller share of total returns filed — 28 per cent. In contrast, the share of nil returns for both individuals and companies is significantly higher. The following figures show the evolution of different categories of taxpayers across these three categories. For firms, the predominance of tax-paying returns is evident.

For Individuals, the trends are quite dramatic. About 20 million taxpayers on average, pay taxes but do not file returns. This level has not changed much over the years. Nil returns have surged sharply since 2016-17 and have sustained the higher level with some increase observed even in 2023-24. This could be partly attributed to changes in compliance requirements, where the rules require filing of returns if certain high-value transactions are undertaken. In contrast, the number of returns with positive tax liability peaked in AY 2019-20, i.e., for FY 2018-19, after which there is a sharp fall. Gradual increases in subsequent years have brought it back to pre-demonetisation levels. Tweaks in tax policy, like exemption thresholds, and in rebate regimes do not seem to account for these changes. These divergent trends need some attention. The introduction of the mandatory compliance provisions does not seem to be translating into higher tax payments.

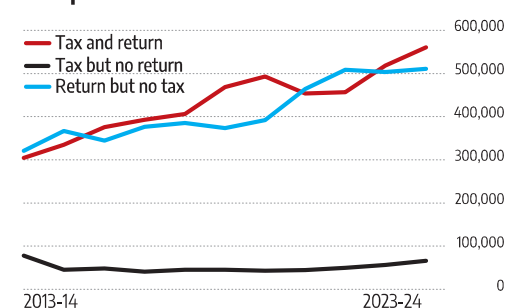
Turning to companies, the trends are significantly different. Demonetisation and the introduction of goods and services tax (GST) seem to have pushed up the number of tax-paying returns, with a moderation

Tax Trends

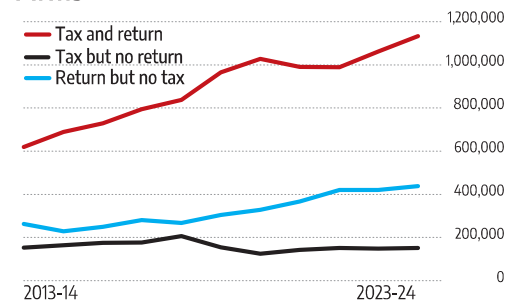
Individuals



Companies



Firms



Source: Income Tax Department's time series data

in the number of nil returns. As expected, the Covid crisis flipped this trend. It was only in 2023-24 that tax-paying returns began to command a larger share. What is noteworthy, however, is that both these series are trending upwards with nil returns moderately below 50 per cent. Policy changes like the introduction of the new income-tax regime with reduced tax rates don't seem to have changed this composition. Whether this is the normal course of evolution of tax systems needs to be examined. In particular, it would be interesting to explore whether companies evolve from a nil-return status to a tax-paying status over the lifecycle, with adjustments made for changing economic conditions. It could throw light on the drivers of the persistence and growth of nil-return companies, even when the tax regime shifts from a regime with significant incentive provisions to one with fewer built-in incentives.

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