TAXATION OF NOTIONAL INCOME: A COMPARISON OF TAX REGIMES

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Notional income is the flow of satisfactions from goods owned and used by the taxpayer. This paper explores the Indian and American approaches to taxation of notional income. It is argued that the Indian approach to taxation of notional income exhibits a distinct theoretical incoherence. Indian courts have refrained from allowing taxation of notional income, unless the same is expressly provided for in the Income Tax Act. This approach has resulted in divergent judicial reasoning which is not founded on the theoretical basis for inclusion of notional income. In contrast, the American law has progressed to an expansive conception of income that includes all economic gain. The focus on economic reality of transactions is clearly reflected in the economic substance doctrine of the American anti-avoidance law. This paper pre-empts that the introduction of General Anti Avoidance Rules in India hint at a gradual shift towards the broader conception of income adopted in American law.

I. INTRODUCTION

Notional income or imputed income has been defined as a flow of satisfactions from goods owned and used by the taxpayer, or from benefits arising out of the personal exertions of the taxpayer on his own behalf.[1] For example, farmers who consume their own produce save money which they would have spent on vegetables otherwise. These savings result in an economic gain to the farmer, on which he is not taxed.[2] Consequently, inequity in taxation develops as all other consumers must purchase their produce.[3] Since taxable income is based on the concept of realisation, an interesting issue that arises is whether notional income can be taxed. In this paper, I have sought to examine this question by comparatively analysing the taxation of notional income in India and United States.

This paper argues that the key distinction in the Indian and American law on taxation of notional income lies in the difference in their

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1 D.B. Marsh, *The Taxation of Imputed Income*, 58(4) Political Science Quarterly 514 (1943); G.G. Lieuallen, Basic Federal Income Tax 31 (2008); K. Holmes, The Concept of Income: A Multi-Disciplinary Analysis 522 (2001); H.J. Ault & B.J. Arnold, Comparative Income Taxation: A Structural Analysis 215 (2010).

2 Assuming that the cost of production of the consumed produce is negligible.

3 Ault & Arnold, *supra* note 1.

approaches in considering economic reality as a constituent of taxable income. However, the introduction of General Anti-Avoidance Rules ('GAAR') in India may dilute this distinction. I would like to clarify at the outset that an in-depth examination of the charging provisions allowing for taxation of notional income in the Indian and American law is beyond the scope of this paper.

II. TAXATION OF NOTIONAL INCOME IN INDIA

A. STATUTORY PROVISIONS

Under the Indian law, the taxation of income is scheduler in character. This implies that tax is imposed on only those heads of income which are specifically covered under the Income Tax Act, 1961 ('ITA'). Consequently, notional income is not taxable unless specifically provided for in the ITA.

1. Income from house property

The ITA provides for the taxation of several kinds of notional income, most notably the imputed income (rent) from owner-occupied houses under § 22. Previously, in case of property occupied by the owner for his own residence, a notional income was brought to tax on the rationale that the owner experienced a relative increase in wealth through rent savings. However, this position was changed *vide* the Finance Act, 1986.[4] Presently, such tax on notional income is levied where the owner has more than one property for self-occupation.[5] In such cases, the income from other house(s) is deemed to be the sum for which the property might reasonably be expected to be let from year to year.[6] In fact, the property is assessable on notional income even when it is occupied by a tenant, free of rent.[7]

2. Transfer of capital asset

§ 50C imbibes a policy for taxation of notional income to tackle the problem of understatement of actual consideration received or accrued for a transfer of capital asset. Under this provision, a notional value of consideration may be adopted for a transfer of a capital asset. Such an assessment would arise if the actual consideration is less than the value adopted or assessed or

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4 The amendment came into force on April 1, 1984. The amendment was explained by the Board in Circular No. 461, dated July 9, 1986: (1986) 161 ITR St 21.

5 Income Tax Act, 1961, § 23(2) read with § 23(4).

6 Income Tax Act, 1961, § 23(1).

7 CIT v. DLF Housing Construction Pvt. Ltd., (1981) 128 ITR 773 (Del); Sri Currimbhoy Ebrahim Baronetcy Trust v. CIT, (1963) 48 ITR 507 (Bom); Vakil (DM) v. CIT, (1946) 14 ITR 298 (Bom).

assessable by the stamp valuation authority for the payment of stamp duty in respect of such transfer.[8] The latter valuation will be deemed to be the full value of consideration for the transfer of the capital asset.

Along the lines of §50C, the recently introduced §50D also adopts deemed value as consideration in transfers of capital assets where the actual consideration cannot be determined or ascertained.[9] Here, the fair market value of the asset on the date of transfer is deemed to be the full value of consideration for taxation of capital gains.

3. Gifts from non-relatives

The taxation of gifts from non-relatives under §56 aims to curb the practice of bogus gifts intended to achieve tax avoidance. In computation of income received from gifts of movable property without consideration, § 56(vii)(c)(i) adopts a notional value equalling the aggregate fair market value of such property, if the same exceeds fifty thousand rupees. If the aggregate fair market value of the property exceeds the consideration by over fifty thousand rupees, the difference between the two amounts is taxed as notional income.[10] This fiction is also extended to firms and unlisted companies in case of gifts of shares by § 56(viia).[11]

B. JUDICIAL APPROACH: THEORETICAL INCOHERENCE?

As discussed in the previous section, the taxation of notional income is prescribed in several provisions of the ITA. This section explores the judicial approach to taxation of notional income which reveals a distinct theoretical incoherence.

The constitutional validity of a law primarily depends on the competence of the legislature to enact the same.[12] The authority of the legislature to tax income is derived from Entry 82 of List I, which empowers the Parliament to enact laws taxing income other than agricultural income.

The question of constitutional validity of taxation of notional income from self-owned houses under §23(2) arose through a writ petition before the Madhya Pradesh High Court in *Bhagwan Dass* v. *Union of India* ('Bhagwan Dass').[13] The Court rejected the petitioner's contention that the inclusion of

[8] Income Tax Act, 1961, § 50C(1).

[9] § 50D was introduced by the Finance Act, 2012 and entered into force on April 1, 2013.

[10] Income Tax Act, 1961, § 56 (vii)(c)(ii).

[11] Income Tax Act, 1961, § 56(viia).

[12] Jagannath Baksh Singh v. State of U.P., (1962) 46 ITR 169 (SC); Kanga et al, The Law and Practice of Income Tax 6 (D. Vyas ed., 2004).

[13] Bhagwan Dass Jain v. Union of India, (1981) 2 SCC 135: AIR 1981 SC 907, ¶14.

any amount under § 23(2) in his income was unconstitutional as there was no accrual of income in the true sense of the term. On appeal, the Supreme Court upheld the decision of the High Court. While supporting the constitutionality of § 23(2), the Apex Court imported a wide definition of 'income' in Entry 82 proclaimed in *Navinchandra Mafatlal* v. *CIT* ('Navinchandra Mafatlal'),[14] to hold that the definition of income not only includes what is received, but also "what one saves by using oneself".[15] Indeed, the Court observed that anything which can be *converted* into income can be reasonably regarded as giving rise to income. Therefore, the power to tax notional income was within legislative competence.

Significantly, this theoretical basis for taxing notional income has only been applied in cases where taxation of imputed income is *expressly* provided for in the ITA. On other occasions, courts have uniformly supported the stance that taxation of notional income is impermissible. As highlighted by the Supreme Court in *Poona Electric Supply*,[16] this reasoning postulates that "income-tax is a tax on the real income, i.e., the profits arrived at on commercial principles subject to the provisions of the Income-tax Act". Subsequently, the Orissa High Court in *Prafulla Kumar Malik*[17] emphasized that income tax is imposed only on "profits he actually receives and not on the profits he might have, but has not received".

This real accrual of income test was elaborated by the Supreme Court in *Godhra Electricity Company*.[18] In this case, a government circular entitled the assessee to recover consumption charges from its customers at enhanced rates. As this order was the subject matter of protracted litigation, the assessee was unable to recover the enhanced charges. Consequently, it challenged the inclusion of such amount within its assessable income on the ground that no real income had accrued. Reiterating its earlier decision in *Morvi Industries Ltd.* v. *CIT*[19] and *CIT* v. *Birla Gwalior*[20], the Court held that tax cannot be imposed on hypothetical accrual of income. It was observed that the question of real accrual of income must be considered by taking the probability of realisation in a realistic manner.[21]

Applying this principle, courts have consistently refrained from allowing taxation of notional profits and interest that is not expressly allowed in the ITA. This approach was adopted by the Bombay High Court in *Smidth*.[22]

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14 Navinchandra Mafatlal v. CIT, AIR 1955 SC 58.
15 *Id*., ¶834.
16 Poona Electric Supply Co. Ltd. v. CIT, (1965) 3 SCR 818, ¶20.
17 CIT v. Prafulla Kumar Malik, AIR 1969 Ori 187, ¶10.
18 Godhra Electricity Co. Ltd. v. CIT, (1997) 4 SCC 530: (1997) 225 ITR 746.
19 (1972) 4 SCC 451: (1971) 82 ITR 835.
20 (1974) 3 SCC 196: (1973) 89 ITR 266.
21 Godhra Electricity Co. Ltd. v. CIT, (1997) 4 SCC 530: (1997) 225 ITR 746, ¶15.
22 CIT v. F.L. Smidth & Co., (1959) 35 ITR 183 (Bom). *See also* Bipin Chandra Maganlal v. CIT, (1955) 28 ITR 1 (Bom).

Although the inclusion of notional income under § 42(2) of the 1922 Act was affirmed, the Court held that such income does not constitute profits under the second part of § 23A (1), in the absence of express legislative sanction.[23]

In *Asian Hotels*,[24] the Delhi High Court considered the issue of notional income from interest free loans received by the petitioner in respect of shops given on rent. The Assessing Officer computed tax of 18 percent per annum on the notional interest on the basis that they resulted in benefit to the petitioner. Rejecting this contention, the Court held that the notional income from the interest free loans is not taxable in the absence of a specific provision in the ITA.[25]

A similar question of taxation of notional income from interest free loans given by the company to its managing director arose in *Highways Construction*.[26] The Gauhati High Court did not uphold the taxation of notional income, noting that, "if the assessee had not bargained for interest, or had not collected interest, we fail to see how the Income Tax authorities can fix a notional interest as due, or collected by the assessee".[27]

Therefore, the judicial approach does not support taxation of notional income, unless provided in the ITA. In Bhagwan Dass, the constitutionality of taxation of notional rent under Article 23(2) was upheld on the ground that legislative competence extends to income "save[d] by using oneself". However, this rationale was not adopted in other cases concerning notional income that was not taxed by the ITA. On those occasions, courts have reiterated that tax can only be imposed on *real* income accrued to the assessee. The dual justifications exemplify the lack of a clear theoretical basis regarding taxation of notional income under Indian law.

III. TAXATION OF NOTIONAL INCOME IN THE UNITED STATES

Unlike the scheduler model followed in India, the US follows the global model on taxation of income. Under this system, one schedule of tax rates is applied to the aggregate income comprising all types of income, irrespective of its source or nature.[28] The Sixteenth Amendment to the US Constitution states that the Congress shall have the power "to lay and collect

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[23] CIT v. F.L. Smidth & Co., (1959) 35 ITR 183 (Bom), ¶5.

[24] CIT v. Asian Hotels Ltd., (2010) 323 ITR 490 (Delhi), ¶9.

[25] *See also* CIT v. Vijay Singh, (2010) 323 ITR 446, ¶6 (Delhi) (where this principle was reiterated in respect of interest free loans from employer to employee).

[26] Highways Construction Co. Pvt. Ltd. v. CIT, (1993) 199 ITR 702 (Gauhati).

[27] *Id*., ¶ 7.

[28] Ault & Arnold, *supra* note 1, 197; C. Brown & I. Valodia, Taxation and Gender Equity 23 (2010).

taxes on incomes, from whatever sources derived".[29] The amendment, however, does not define the meaning of 'income'. This section analyses the judicial interpretation of 'income' to explore whether it can include notional income within its fold.

The first case in which the scope of the constitutional definition of 'income' was considered was the decision of the US Supreme Court in *Eisner* v. *Macomber* ('Macomber').[30] Qualifying the all-encompassing construction of the Sixteenth Amendment, the Court pronounced the 'realisation' theory, whereby income was defined as "the gain derived from capital, from labour, provided it be understood to include the profit gained through a sale or conversion of capital assets, and… a gain, a profit, something of exchangeable value, proceeding from the property, severed from capital".[31] The case concerned the issue of whether stock dividends were to be treated as being *separated* from the capital stock from which the dividend was paid. In this context, the Court stated that unless severed by mode of payment, stock dividend were not realised by the tax payer.[32] In any case, the antecedent increase in profits caused by stock dividend indicated an increase in capital, and not the receipt of any income.[33] While considering the Government's contention that the new stock dividend certificates measure the extent to which the gains accumulated by the corporation have made the tax payer *richer*, the Court stated that enrichment through increase in capital investment does not amount to income.[34] Hence, the definition of income was qualified by *first*, its source and *second*, the requirement of realisation by severance. Under the application of this definition, taxation of imputed rent from owner-occupied housing was held to be unconstitutional.[35]

The cases decided after Macomber indicate a presumption in favour of taxing any *economic gain*, if it is objectively measurable.[36] In *Helvering* v. *Bruun* ('Bruun'),[37] the Court relaxed the realisation requirement by holding that it does not require a strict severance of gain from capital. The case involved a lease deed, under which the lessee constructed a new building, whose useful life was as long as the lease. Upon default by the lessee, the new building became the property of the taxpayer upon termination of the lease. The Court emphasized that the taxpayer received back his land with the addition of an

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[29] Amendment XVI, United States Constitution. It reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration".

[30] 252 U.S. 189 (1919).

[31] *Id*., ¶21.

[32] *Id*., ¶33.

[33] *Id*., ¶31.

[34] *Id.*

[35] Helvering v. Independent Life Insurance Co., 292 U.S. 371 (1934).

[36] *Symmetry of the Realisation Requirement and its Application to the "Mortgage Swap" Requirement*, 9(1) VANDERBILT TAX REVIEW, 359, 372 (1989-1990).

[37] 309 U.S. 461 (1940).

ascertainable value.[38] It asserted that such *shifts in economic benefits* which alter a taxpayer's future anticipated earnings or *fixes an economic gain* will be taxed as income.[39] This line of thought was further advanced in *Helvering* v. *Horst* ('Horst'),[40] when the Court noted that realisation is not only characterised by receipt in cash or property, but also when the taxpayer obtains *fruition of the economic gain* which has already accrued to him.[41]

The most significant development after Macomber occurred over three decades later, in the Supreme Court's decision in Glenshaw Glass.[42] The Court, while considering the determination of whether money received as exemplary damages is included within income, held that income includes all instances of "undeniable accessions to wealth, clearly realised, and over which the taxpayers have complete dominion".[43] The legal progression from Macomber to Glenshaw Glass clearly indicates a gradual movement to an approach which looks at the economic reality of a transaction. As a result, all economic gain is included within the definition of income.[44]

The Supreme Court is yet to give a specific ruling on the constitutionality of taxation of notional income. It is submitted that in theory, notional income satisfies the test of taxable income laid down in Glenshaw Glass. Although qualified by the realisation requirement, this test is co-extensive with the seminal Haig-Simmons definition of income,[45] which includes notional income within its fold.[46] Although the facts in Glenshaw Glass do not relate to accumulation of savings, there is nothing to indicate that accessions to wealth may only result from positive monetary inflow.[47] For instance, rent-savings accumulated by resident home-owners would result in substantial financial gain.[48] In fact, the prevalent academic opinion against taxation of notional income is primarily centred on the *practical* difficulties involved in computation.[49] This

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38 *Id*.

39 *Id*.

40 311 U.S. 112 (1940).

41 *Id*., ¶6.

42 Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426 (1955).

43 *Id*., ¶10.

44 *See also* James v. United States, 366 U.S. 213 (1961) (affirmed the accessions to wealth test laid down in Glenshaw Glass).

45 R. Haig, *The Concept of Income – Economic and Legal Aspects* in The Federal Income Tax 1, 27 (R.M. Haig ed., 1921); H.C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50 (1938).

46 D.G. Guff, *Rethinking the Concept of Income in Tax Law and Policy*, available at http://taxprof.typepad.com/taxprof_blog/files/Duff.pdf. (Last visited on February 2, 2014).

47 *The Constitutionality of the Taxation of Imputed Income*, 9(1) Valaparaiso University Law Review 221, 242 (1974); A. G. Abreu and R.K.Greenstein, *Defining Income*, 11(5) Florida Tax Review 295, 297 (2011).

48 W.M. Barker, *Statutory Interpretation, Comparative Law, and Economic Theory: Discovering the Grund of Income Taxation*, 40 San Diego Law Review 821, 846 (2003).

49 Homer P. Morris v. Commissioner, 9 B.T.A. 1273, 1278 (1928); Abreu & Greenstein, *supra* note 47 at 312; *Interest Free Loans After Hardee and Dickman*, 31 University of Kansas Law

does not take away from constitutionality of taxation of notional income under the prevailing Glenshaw Glass test.

Notably, the legislative and executive approach also indicates a presumption that notional income is included in the conception of income under Internal Revenue Code. For instance, the original Civil War Income Tax Act, 1861 adopted the global economic substance approach by taxing income from listed sources or from *any* other source whatsoever.[50] In order to equalise the economic benefit enjoyed by owners of self-occupied houses, the Revenue Act, 1863 permitted other tax payers to avail deduction for house rent.[51] With this objective, the Revenue Act, 1864 also allowed the following exemption to notional income from ownership of self-occupied houses: "[T]he rental value of any homestead used or occupied by any person, or by his family, in his own right or in the right of his wife, shall not be included and assessed as part of the income of such person".[52] At present, the Congress has chosen to explicitly exempt certain economic gains from taxation,[53] while taxing others such as interest-free loans, bargain purchases and payment of taxes by others.[54]

Indeed, the IRS has also taken conflicting stands taxing imputed income from interest free loans. In 1955, it issued a revenue ruling that interest free loans did not result in income to the borrower.[55] However, it later sought to tax the imputed income resultant from an interest free loan given by a corporation to its shareholder.[56]

IV. DIFFERENCE BETWEEN THE INDIAN AND AMERICAN APPROACHES

The primary difference between the Indian and American approaches to taxation of notional income lies in the different concepts of income adopted in their tax policies. The definition of income adopted by the US Supreme Court in Macomber was similar to the present day Indian approach. By limiting the definition of income to gain derived from capital or labour realised by severance from capital, the Court implicitly created a high threshold for realisation. However, subsequent cases such as Bruun and Horst expanded the definition of income to include objectively realised economic gains. Such

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REVIEW 625, 644 (1982-83); L.M. Rapp, *Some Recent Developments in Taxation of Notional Income*, 11 TAX LAW REVIEW 329, 268 (1955-56).

50 Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 292, 309 (repealed 1862) as cited in Barker, *supra* note 48, 821, 847 (2003).

51 Act of Mar. 3, 1863, ch. 74, § I1, 12 Stat. 713, 723 (repealed 1864) as cited in *Id.*

52 Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281 (repealed 1872) as cited in *Id.*

53 *See* Internal Revenue Code, § 1031.

54 K.E. MURPHY and M. HIGGINS, CONCEPTS IN FEDERAL TAXATION 3-20 – 3-24 (2012).

55 Rev. Rul. 55-173, 1955-2 C.B. 23 as cited in Abreu and Greenstein, *supra* note 47, 295, 316 (2011).

56 Dean v. Commissioner, 35 T.C. 1083 (1961), non-acq, 1973-2 C.B. 4.

inclusion of economic gains potentially allows for taxation of notional income, particularly in cases of imputed rent from self-owned houses where an objective determination of economic gain is possible. By including all 'accessions to wealth' within income, Glenshaw Glass effectively orchestrated the shift to a policy which considered economic substance.

In contrast, the Indian approach to taxation being scheduler in character, tax is only imposed in cases strictly covered under the charging provisions in the ITA. Therefore, courts are strictly bound by the legal fiction of income created by the ITA, irrespective of the economic reality. This is indicative from the divergent rationales adopted by the courts with respect to taxation of notional income. In Bhagwan Dass, the Supreme Court defended the taxation of notional rent under § 22 by stressing on the legislative competence to tax a broad definition of income that includes economic gain incurred due to savings. However, a similar inclusive definition of income was not relied upon in cases where the legislation did not tax the notional income specifically in dispute. For instance, in *Sohan Singh* v. *CIT*,[57] the Court refused to tax an interest-free loan received by a director from his company, even though it would result in an increase in savings. Indeed, courts have acknowledged that notional income is taxable only if specifically provided in the ITA.[58] Therefore, the taxation of notional income in Indian law is not based on a uniform policy of including or excluding economic gain within the definition of taxable income, but is solely determined by the legal fiction created by the exercise of legislative discretion.

V. PRE-EMPTING A CHANGE IN THE INDIAN APPROACH?

Although Indian courts have refrained from allowing taxation of notional income on the ground that it does not amount to 'real' income, with the advent of GAAR, Indian tax policy is likely to undergo a theoretical shift towards the American approach.

The introduction of GAAR will significantly overhaul the law governing tax avoidance by inducting different tests from multiple jurisdictions to filter out impermissible transactions.[59] The 'economic-substance test', imported from American law, requires an examination of the tax-payers' transactions by analysing any potential for profit, other than tax mitigation, or any meaningful change in the economic position of the tax payer.[60] A transaction lacking economic substance is considered problematic.[61] Further, GAAR also

[57] Sohan Singh v. CIT, (2001) 170 CTR 215 (Del).
[58] CIT v. F.L. Smidth & Co., (1959) 35 ITR 183 (Bom); Poona Electric supply Co. Ltd. v. CIT, (1965) 3 SCR 818.
[59] Income Tax Act, 1961 (as amended by Finance Act, 2012), § 96.
[60] Gregory v. Helvering, 293 U.S. 465 (1935).
[61] Income Tax Act, 1961 (as amended by Finance Act, 2012), § 97.

recognises the possibility of sham transactions and arrangements which satisfy all legal requirements, but do not achieve any commercial purpose besides tax savings.[62] The resultant emphasis on economic and commercial reality of legal arrangements leads to a theoretical shift towards the American approach which, post-Glenshaw Glass, accounts for economic gain by including all accessions to wealth within the definition of income.

By widening the net of taxable transactions through the prescription of multiple wide tests to catch tax avoidance, GAAR has initiated a gradual policy shift which stresses on economic substance of the transaction. From the lens of economic substance, the computation of income would include all economic gains. Upon expansion, this theoretical convergence with the American approach may streamline the taxation of notional income, consistent with the changing conception of taxable transactions.

VI. CONCLUSION

Indian courts have refrained from allowing taxation of notional income, unless the same is expressly provided for in the legislation. The reasoning for defending taxation of imputed income under some provisions of ITA pertains to a wide definition of income propounded in Navinchandra Mafatlal. It is significant to note that this reasoning has not been logically extended to other cases of notional income not taxed under the Act. This anomaly leaves Indian law in dire need for jurisprudential clarity on its definition of income.

On the other hand, American law has witnessed a steady progression from a conservative definition of income which did not allow taxation of notional income, to an expansive conception which includes all accessions to wealth. This emphasis on economic reality of transactions while computing income is also reflected in the anti-avoidance law where the economic-substance doctrine is clearly established.

The introduction of GAAR in India will allow courts to consider the economic reality of legal arrangements in order to determine tax avoidance. The induction of commercial substance and step transaction doctrines from American law also serves to widen the ambit of taxable transactions. The consideration of economic reality in determining taxable transactions is expanded, which makes a case for a policy shift towards taxation of notional income that usually involves latent economic gain. Thus, Indian law is gradually progressing towards the broader conception of income adopted in American law.

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[62] Income Tax Act, 1961 (as amended by Finance Act, 2012), §§ 96 and 97; PWC, *Removing the Fences: Looking through GAAR*, February 2012, available at http://www.pwc.com/in/en/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf (Last visited on February 2, 2014).