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Income Tax Act 2025 – What India's Most Significant Direct Tax Reform in 60 Years Means

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MAINS RELEVANCE:

GS Paper 3


INTERVIEW ANGLE

"The Income Tax Act 2025 replaces a 60-year-old law. What were the key deficiencies of the 1961 Act, what does the new Act address, and what challenges remain in India's direct tax system?"

WHY IN NEWS

CBDT invited public consultation on draft rules under the Income Tax Act 2025 — which replaces the Income Tax Act 1961 and is scheduled for implementation from April 1, 2026 — representing India's most consequential direct tax legislation in six decades.

WHY THE 1961 ACT NEEDED REPLACEMENT

The **Income Tax Act, 1961** is one of India's most heavily amended pieces of legislation. Originally comprising around **298 sections**, it has been amended over **3,000 times** through successive Finance Acts, special amendments, and court orders. By 2025, it had grown to over **1,900 pages** with layered cross-references, exceptions to exceptions, and provisions that experts describe as navigable only by specialists.

The practical consequences of this complexity were significant:

Tax litigation burden: India has one of the world's highest tax litigation loads. As of 2024, approximately **Rs 30–35 lakh crore** of disputed tax demands were pending across Income Tax Appellate Tribunals (ITATs), High Courts, and the Supreme Court. A significant portion of this stems from ambiguous provisions in the 1961 Act that different assesseees and assessing officers interpreted differently.

Compliance costs: India's **tax-to-GDP ratio** (~11% of GDP) is well below comparable economies (OECD average: ~33%). Part of the shortfall is structural — India's large informal economy and agricultural sector. But a non-trivial factor is that compliance is genuinely difficult for small businesses, self-employed

professionals, and individuals navigating complex rules for deductions, exemptions, and reporting requirements.

Outdated concepts: The 1961 Act was drafted for a paper-based, industrial economy. Digital income, cryptocurrency, platform-economy earnings, and international e-commerce were not contemplated. While the government has added provisions (e.g., Section 115BBH for VDAs — Virtual Digital Assets), they sit awkwardly within an analogue statutory framework.

WHAT THE INCOME TAX ACT 2025 AIMS TO DO

The new Act was drafted after a comprehensive review process involving the Central Board of Direct Taxes (CBDT), the Finance Ministry's Tax Policy Division, industry bodies, and tax professionals. Its core objectives:

Simplification: Reduce the Act's volume by eliminating redundant provisions, consolidating related sections, and rewriting in plain language. The goal is an Act that can be understood by an educated non-specialist without consulting a tax lawyer for every clause.

Reducing litigation: Incorporate settled judicial interpretations directly into the statute — converting years of case law into clear statutory provisions — reducing the scope for interpretive disputes.

Digital economy readiness: Address platform economy income, digital goods and services, cryptocurrency and digital asset taxation, and cross-border digital transactions more comprehensively than the 1961 Act could accommodate through amendments.

Taxpayer certainty: Establish clearer timelines for assessments, appeals, and refunds — reducing the discretionary power of assessing officers that has historically been a source of harassment and corruption.

THE CONSULTATION PROCESS — CBDT'S APPROACH

CBDT's decision to publish **draft rules and forms** for public consultation before the Act's April 1, 2026 implementation is significant — it represents a departure from the traditional practice of finalising rules behind closed doors. The **February 22, 2026 deadline** for stakeholder comments creates an opportunity for industry bodies, tax practitioners, and civil society to flag implementation concerns before they become compliance problems.

This consultative approach echoes the process used for the **GST (Goods and Services Tax)** implementation — where extensive industry consultation was held before the July 1, 2017 rollout — and for the **Companies Act, 2013** implementation rules. It acknowledges that even a well-drafted statute requires well-designed implementing rules to function effectively in practice.

WHAT THE ACT MAY NOT FULLY RESOLVE

Even a comprehensively drafted new Act cannot resolve certain structural features of India's direct tax system.

The informality problem: A significant share of India’s economic activity occurs in cash, outside the tax net. The 1961 Act’s complexity was not the primary reason for this; it reflects the structure of the economy and the enforcement capacity of the tax administration. The new Act, by itself, will not dramatically expand the tax base.

Agricultural income exemption: India’s Constitution (Article 265 and the Seventh Schedule) places agricultural income outside the central government’s taxing authority — it is a state subject. The complete exemption of agricultural income (regardless of quantum) from income tax has created well-known avoidance mechanisms for high-income earners who reclassify income as agricultural. The new Act cannot change this without a constitutional amendment — a politically impossible step.

Transfer pricing and international tax: India’s transfer pricing disputes with multinationals — involving billions of dollars in contested demands — reflect the complexity of international tax. While the new Act can incorporate OECD/G20 BEPS (Base Erosion and Profit Shifting) guidelines more cleanly, the underlying disputes arise from genuine ambiguity in how to value intragroup transactions.

THE LARGER FISCAL REFORM CONTEXT

The Income Tax Act 2025 sits within a broader fiscal reform arc: GST (2017) rationalized indirect taxes; the new Act rationalizes direct taxes; and India’s Fiscal Responsibility and Budget Management (FRBM) framework governs deficit management. Together, these represent India’s attempt to build a modern fiscal architecture adequate for a USD 5 trillion economy.

The measure of success will be in outcomes: a rising direct tax-to-GDP ratio (currently ~6% of GDP for income tax), reduced litigation backlog, and lower compliance costs. These will be visible only over a 3–5 year horizon after implementation.

UPSC RELEVANCE

Income Tax Act 2025 (replaces IT Act 1961; Presidential assent August 2025; implementation April 1, 2026), CBDT (Central Board of Direct Taxes), draft consultation deadline (February 22, 2026), India’s tax-to-GDP ratio (~11%), direct tax-to-GDP (~6%), agricultural income exemption (Seventh Schedule), VDA (Virtual Digital Asset) — Section 115BBH of old Act, BEPS (Base Erosion and Profit Shifting), ITAT (Income Tax Appellate Tribunal).

Fiscal policy; direct tax reform; India’s tax-to-GDP ratio gap; challenges in tax base expansion; GST and direct tax reform comparison; international tax and BEPS; tackling the black economy.

★ FACTS CORNER — KNOWLEDGEPEDIA

INCOME TAX ACT 2025:

Replaces: **Income Tax Act, 1961** (60-year-old legislation)

Presidential assent: **August 2025**; Implementation: **April 1, 2026**

CBDT consultation deadline: **February 22, 2026**

Original IT Act 1961: **~298 sections**; amended **3,000+ times**; grew to **1,900+ pages**

INDIA'S DIRECT TAX SYSTEM:

Tax-to-GDP ratio: **~11% of GDP** (OECD average: **~33%**)

Direct tax (income tax) to GDP: **~6%** of GDP

Pending tax litigation: **~Rs 30–35 lakh crore** (across ITAT, High Courts, Supreme Court)

Agricultural income: **Exempt** from central income tax (Seventh Schedule; state subject)

KEY TAX BODIES:

CBDT (Central Board of Direct Taxes): Apex body for income/corporate tax administration; under MoF

CBIC (Central Board of Indirect Taxes and Customs): GST, customs; under MoF

ITAT (Income Tax Appellate Tribunal): First appellate body for income tax disputes

RECENT TAX REFORMS:

GST: Implemented **July 1, 2017** (replaced VAT, Service Tax, Excise); 101st Constitutional Amendment

VDA Taxation: Virtual Digital Assets (crypto) taxed at **30%** under Section 115BBH (IT Act 1961, inserted 2022)

BEPS (Base Erosion and Profit Shifting): OECD/G20 framework (2015); India implementing Pillars One and Two

Faceless Assessment: Introduced 2020 — removes human interface between taxpayer and assessing officer

OTHER RELEVANT FACTS:

India's total tax collection (FY25): **~Rs 38 lakh crore** (direct + indirect)

Number of ITRs filed (FY25): **~8.5 crore**

FRBM Act (Fiscal Responsibility and Budget Management): Targets fiscal deficit at **3%** of GDP

Agricultural income exemption: Article 265 (no tax without law); Entry 46 of State List (7th Schedule) covers agricultural income tax

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