

# Trust-Based Tax Administration: Rationalizing Penalty and Prosecution

## BUDGET PROPOSAL

Pursuant to an ongoing decriminalization initiative, the Finance Bill, 2026, has proposed the following key changes:

- Certain **procedural lapses**, such as non-production of books of account, documents, etc., are proposed to be **decriminalized**.
- **Minor offences** will now be subject only to **fines**, rather than imprisonment.
- For more significant offences, punishment will be commensurate with the quantum of the default. The nature of imprisonment has also been restricted to **simple imprisonment**. The maximum term of imprisonment has been reduced to **2 years** for initial offences and 3 years for subsequent offences.
- For **technical and compliance-related defaults** such as failure to get accounts audited, non-furnishing of transfer pricing audit reports, and default in filing statements of financial transactions, the existing penalties are proposed to be **replaced with fees**.
- Penalty for **misreporting** of income is also eligible for **immunity**, subject to payment of 100% additional income-tax. In cases of unexplained credits, investments, or assets, the same have been subsumed under misreporting of income and are also eligible for immunity, subject to payment of 120% additional tax.

## IMPACT

These proposals signal a shift away from a system that relies only on strict punishment towards one that balances enforcement with fairness and trust. By decriminalizing procedural mistakes, doing away with rigorous imprisonment, reducing maximum jail terms, and replacing some penalties with fixed fees, the changes aim to reduce the fear of being harshly prosecuted for genuine or technical errors.

This, in turn, is expected to encourage taxpayers to comply voluntarily and on time, while allowing tax authorities to focus their efforts on serious tax evasion rather than minor or technical lapses.

## ELP's INSIGHTS

For taxpayers, particularly businesses with complex reporting obligations, the proposed decriminalisation and rationalisation of offences should materially reduce the fear and stigma attached to inadvertent or technical non-compliance. Taken together, these measures signal a clearer distinction between **genuine error and wilful non-compliance** and are likely to create a more predictable compliance environment that lowers perceived personal risk for directors, officers, and professionals acting in good faith.

Publicly available data on tax prosecutions underscores why this shift is timely. Over the past decade, the Income-tax Department has **filed 13,877 prosecution cases but secured only 522 convictions**, against 963 acquittals and 3,345 withdrawals.<sup>1</sup> The high incidence of acquittals and withdrawals points to structural challenges in taking routine tax cases to conviction.

Against this backdrop, moving towards decriminalisation of procedural lapses and a more calibrated penalty framework is not only taxpayer-friendly but also a pragmatic realignment of enforcement tools with actual prosecutorial outcomes.

At the level of the exchequer, experience from other jurisdictions suggests that focusing criminal law on wilful, high-value evasion while using civil and administrative tools for other cases tends to improve overall revenue outcomes. These moves will enable tax authorities to redeploy investigative and prosecutorial resources toward large, organised or repeat evasion instead of routine lapses. Over time, this is expected to enhance deterrence where it matters most, reduce litigation backlogs, and support a culture of co-operative compliance that **broadens and stabilises the tax base**.

1. Answer dated December 08, 2025 by the Ministry of Finance to Lok Sabha- Unstarred Question No. 1310.