Report of the Task Force on

Direct Taxes

December, 2002

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REPORT OF THE

TASK FORCE ON DIRECT TAXES

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PREFACE

The Task Force presented the Consultation Paper to the Government on 2nd November, 2002 with the request that the paper may be made available to all concerned for discussion and debate. The response received has been overwhelming and there has been universal appreciation of the Minister of Finance & Company Affairs for bringing in transparency in the formulation of tax policies.

An intense public debate was generated and tax professionals, tax officials and academicians, trade and industry associations and invididuals from all walks of life contributed to the debate by sending hundreds of emails, letters and through articles in the media. On its part, the Task Force interacted with a large number of trade and industry associations and individuals at Pune, Ahmedabad, Ludhiana, Chennai, Bangalore, Mumbai and Delhi. The Task Force has immensely benefited from these comments and suggestions and we thank them all. These consultations and discussions have also convinced the Task Force that the launching of growth promoting tax reforms is one idea whose time has come.

The Task Force would like to express its gratitude to the Chairman and Members of the Central Board of Direct Taxes and the officers of the Department of Revenue for their full cooperation and support. The Task Force is also grateful to the Ministries and Departments of the Government of India which commented on the Consultation Paper and made valuable suggestions, many of which have been included in the Report.

In many ways, the report of the Task Force is a continuation of the fiscal reforms initiated by the path breaking work of the Tax Reforms Committee under the chairmanship of Dr. Raja J. Chelliah in 1991. We also benefited from the outstanding work done by the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan under the chairmanship of Dr. Parthasarathi Shome in 2001 and the Expert Committee to Review the system of Administered Interest Rates and Other Related Issues under the chairmanship of Dr. Y.V. Reddy in September, 2001. Our report aims to meet the country's strategic needs of accelerating growth and the reduction of poverty.

The Task Force wishes to also place on record their deep appreciation of the outstanding contribution of Shri Arbind Modi, IRS in the preparation of the Report. But for his efforts, presentation of this report would not have been possible in such a short time. We also wish to thank Shri Rahul Naveen, Under Secretary, Department of Revenue for painstakingly estimating the revenue impact of the various recommendations, Ms. Vibha Bhalla, Deputy Director of Income Tax, Shri Bharatendu Dobriyal, Asstt. Director of Income Tax, Shri Om Prakash, Programmer, Directorate of Income Tax (Systems), Shri S. Ravi, Private Secretary to Chairman of the Task Force and Shri Santosh Kumar Gupta who assisted Shri Modi, for their valuable support.

The Task Force also wishes to thank CMIE for allowing the use of their database and ASSOCHAM, CII, FICCI and their affiliates for making excellent arrangements for the meetings of the Task Force in Delhi and other parts of the country.

(Vijay L. Kelkar)
Advisor to Minister of Finance & Company Affairs &
Chairman of the Task Force on Direct Taxes

New Delhi,

27th December, 2002

CHAPTER 1

REACTIONS TO THE CONSULTATION PAPER: RESPONSE OF THE TASK FORCE

1.1 The Consultation Paper of the Task Force on Direct Taxes was made available on the web site of the Ministry of Finance & Company Affairs (http://finmin.nic.in) on 2nd November 2002, inviting comments and suggestions of all concerned. The Task Force was overwhelmed by the response.

1.2 We received 1500 emails. There were more than 200 op-ed and other articles in English newspapers, and even more in regional newspapers. Almost 100 memoranda were received from various organisations. The Task Force visited major centres of trade and industry – Pune, Ludhiana, Ahmedabad, Chennai, Bangalore, New Delhi and Mumbai, thus supplementing the discussions in Mumbai, New Delhi and Kolkata which had taken place earlier.

1.3 There has been universal appreciation of the initiative by the Union Minister of Finance & Company Affairs for bringing transparency in the formulation of tax policy. The breadth and intensity of the responses clearly brought out the all-round desire to contribute to the country's Fiscal Policies.

1.4 Each one of the responses was constructive. Our discussions with trade and industry, tax professionals, income tax officials and scholars indicated considerable support to our basic proposals leading to simplification, reduction in tax burden of the salaried and non-salaried tax payers as well as of equity (risk) capital, greater usage of information technology in tax administration, outsourcing of non-core functions of the tax administration, improving services to tax payers and fundamental change in incentives and disincentives for tax compliance and against tax evasion. For instance, in a Web poll conducted by *India Today*, a majority of those who polled supported the implementation of our proposals. The support for establishing the Tax Information Network (TIN) – which will facilitate secure and seamless logistics of tax collection – was particularly enthusiastic. We also observed an interesting correlation: younger taxpayers were more likely to support our

proposals. Of course, there have been critical comments as well. Many of the reactions received contradicted each other since they offered conflicting suggestions, particularly regarding tax rates and tax exemptions. In this Chapter, we have attempted to distill the major themes that emerged from the reactions to the Consultation Paper. In addition, there are a number of individual proposals that have been addressed in the respective chapters. The Task Force wishes to express its appreciation to everyone who took time to prepare and send her or his responses and documents. We thank them all.

Approach for reformulation

1.5 One of the most perceptive reactions received by the Task Force is that while appreciating the thrust of our tax reforms proposals, the advice is that it must have a "human face". In other words, it must especially address the concerns of the vulnerable sections such as senior citizens. It was felt that the Consultation Paper was not sufficiently sensitive to the problems and requirements (such as housing and old age income security) of senior citizens and low-income groups. The Task Force accepts this thoughtful advice[1].

1.6 Hence, in reformulating our proposals, while maintaining their essential thrust and approach, we have accepted the principle that no vulnerable class of taxpayer shall be worse off because of our proposals. Keeping this principle in view, the Task Force has modified its Consultation Paper proposals so as to, *inter alia*, (i) provide additional tax reliefs to senior citizens, (ii) maintain fiscal support to the housing needs of low income groups, and (iii) strengthen old age income security by encouraging long term savings. We would however also like to add that, in addition to the proposed tax measures, the Government will need to formulate sooner rather than later a well functioning pension system based on contributions by individuals into personal pension accounts.

Benefits for salaried and non-salaried tax payers

1.7 A major underlying theme in the comments received was that the Task Force proposals are pro-corporate sector rather than pro-individual taxpayers. Fortunately, this perception is easy to rebut since it couldn't be further from the truth.

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[1] On a personal note, this was also the unanimous advice of the spouses of the Task Force members.

1.8 With the proposed personal tax rates, disposable income will be higher for every class of taxpayer, that is, the tax burden is lower for each income group as well as for senior citizens **(Table-1.1)**. This table is based on the actual taxpayer profile, computed on the basis of average for each income group using CBDT database of 9.25 lakh taxpayers spread over assessment years 1998-99 to 2001-02. This also means that the entire "middle class" will benefit from our proposals. It is estimated that the personal tax burden for the existing taxpayers will be reduced by as much as Rs.7,900 crores per annum.

1.9 Our proposals achieve overall revenue neutrality, and enhance buoyancy by widening the personal and corporate income tax bases. This is sought to be done by reducing tax rates, pruning tax exemptions, aligning taxable profits with book profits and improving compliance. Our proposals completely eliminate the dividend tax, and long term capital gains tax on listed equities in the hands of the investors. These have been recommended with the express purpose of reducing the exorbitant cost of equity capital in our country. These gains or benefits accrue entirely to individual shareholders.

1.10 Further, we have recommended that all individuals with an annual income below Rs.1 lakh will be fully exempted from income tax. This also helps reduce the tax burden on individuals, and particularly low-income groups. Currently, with per capita income in the country at about Rs.25,000 per year, our proposal implies that an "average" family of four would not pay any income tax and thus meet their needs better.

1.11 The proposed tax reforms leave the choice of deploying a taxpayer's income to the individual. In other words, choice regarding how much to save and in which asset is left to the individual rather than being "directed" by the tax code. Effectively, by moving away from a paternalistic tax system, the Task Force has sought to empower the individual taxpayer.

1.12 Our analysis of the existing tax framework shows that thanks to myriad, often contradictory tax exemptions, the system has become increasingly complex. In tax policy and tax administration, such complexity is inherently regressive and therefore favours the

Table – 1.1

IMPACT ON TAX INCIDENCE ACROSS INCOME GROUPS

Income Range (in Rs)	Salaried Taxpayers			Non-Salaried Taxpayers			Senior Citizens		
	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)
0-40,000	0	0	0	0	0	0	0	0	0
40,000-50,000	0	0	0	0	0	0	0	0	0
50,000-60,000	0	0	0	382	0	382	0	0	0
60,000-80,000	0	0	0	2196	0	2196	0	0	0
80,000-1,00,000	1587	363	1224	5452	0	5452	0	0	0
1,00,000-1,50,000	8901	6334	2567	10697	4057	6640	0	0	0
1,50,000-2,00,000	22897	15746	7151	23522	14369	9152	7772	4369	3402
2,00,000-3,00,000	43353	29058	14295	44830	30872	13959	29080	20872	8209
3,00,000-4,00,000	75600	49335	26265	76855	52576	24279	61105	42576	18529
4,00,000-5,00,000	106643	76662	29980	108923	82590	26334	93173	72590	20584
5,00,000-10,00,000	185415	140886	44528	188671	154168	34503	172921	144168	28753
Above 10,00,000	733666	664070	69597	1177511	1094566	82946	1161761	1084566	77196

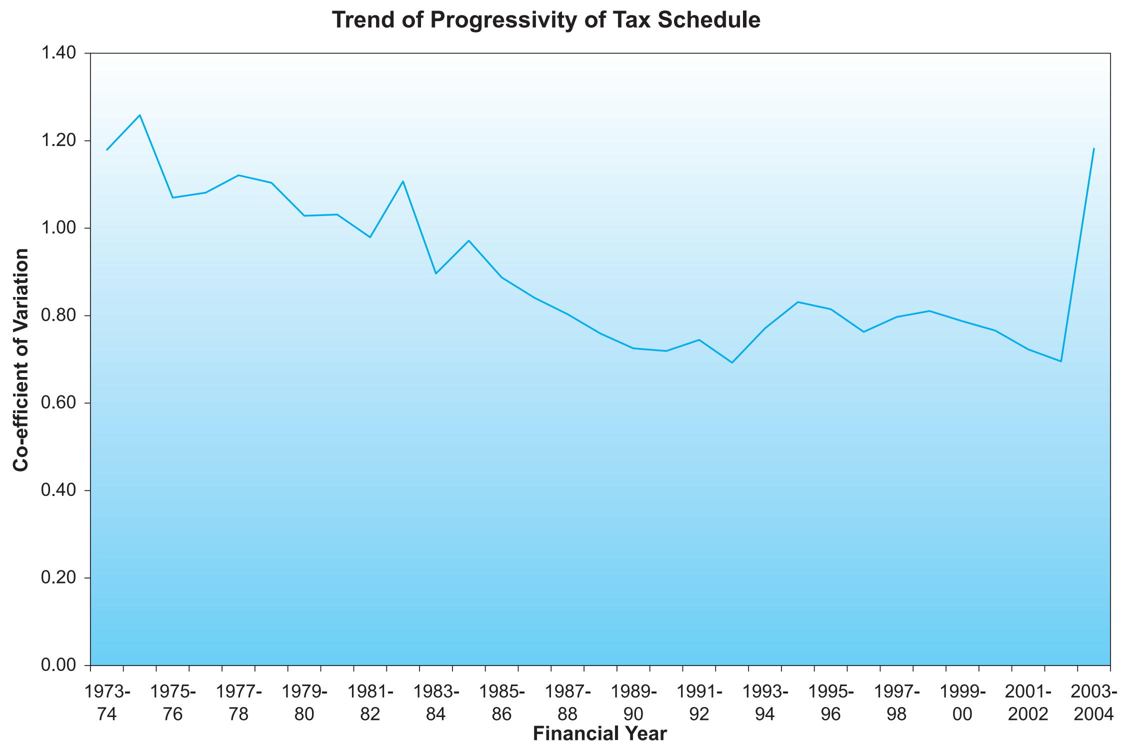
Note: This table is based on the actual taxpayer profile, computed on the basis of average for each income group using CBDT database of 9.25 lakh taxpayers spread over assessment years 1998-99 to 2001-02.

rich and the powerful[2]. Our proposals to simplify and enhance transparency of the tax system would thus in fact help individual taxpayers, by reducing their compliance costs, which have been estimated to be as high as **48 per cent** of taxes paid[3].

1.13 Thus, our tax proposals aimed at reducing the tax burden, lowering transaction costs and promoting transparency, are individual taxpayer-friendly proposals. With the consequent downward reduction in the compliance costs by even 10 percent, individual taxpayers will have further gains of Rs.4,000 crores per annum.

1.14 In addition, we would like to emphasise that our tax proposals will make the tax system the most equitable in the last two decades as is seen in the graph below.

1.15 This feature of enhanced equity or progressivity of our proposals is important to be recognised as some analysts have mentioned that our proposals are pro-rich because we have proposed removal of dividend and long-term capital gains tax. As we have argued, with the withdrawal of exemption and alignment of taxable profits with the book profits,



[2] This is due to the presence of information asymmetries, and the fixed costs of reorganising economic activities in a way that avoids taxes.

[3] These estimates are from a NIPFP Study (2002) prepared for the Planning Commission

the corporations will bear the full burden of the corporate taxation. Richer individuals generally own corporations and therefore our proposals will effectively increase the burden of such individuals. This means that our proposals are even more progressive than what is suggested in the graph since it does not "factor in" the incidence of the corporate tax liability. We may note that we have also recognised the need to maintain the dividend tax in Option – II where the elimination of tax exemptions is spread over a three-year period.

Treatment of housing

1.16 The Task Force received a very large number of comments with regard to our proposal for withdrawal of tax exemptions on interest payment on loans for self-occupied houses. The Task Force accepts the view that the housing sector is one of the key sectors of the Indian economy in terms of providing growth and employment and it is indeed a leading sector. However, our proposal was based essentially on the consideration of horizontal equity (equity between sectors) and vertical equity (equity amongst various income groups)[4].

1.17 The extant treatment also generates a tax distortion in the investments of a household among different classes of assets. For instance, a family that invests in the professional education of its children is putting resources into building human capital which can cost as much as many a small dwelling. This investment in human capital does not get tax benefits, while buying a house and living in it does. In other words, if a family wants to send a daughter/son to a medical, engineering or other professional college which can be an investment of around Rs.5 lakhs-Rs.6 lakhs, this investment gets no tax benefit, unlike the tax benefit given for owner occupied houses. This violates horizontal equity.

1.18 Currently, up to Rs.1,50,000 of interest payments are allowed as deductibles in taxable income, which implies a subsidy of Rs.45,000 per year for individuals who are living in their own house costing Rs.20 lakhs or more. This violates vertical equity. The

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[4] There is a basic inconsistency in the traditional tax treatment of housing, which recognises rental income as taxable income in the hands of a homeowner who does not live in a house, while ignoring the notional rental income in the hands of a homeowner who lives in his house.

richer sections of society are being "subsidised" to purchase their own dwellings, which can hardly be justified by a fiscally constrained economy, which is aiming to reduce subsidies on food and fuel. If a housing subsidy ought to be given, then it should be directed only to low-income households. Presently, a power loom worker whose taxable income is less than Rs.80,000 receives no tax subsidy for loan repayment for his own dwelling for the simple reason that he is not a tax payer.

1.19 It is for these reasons that the Task Force had initially recommended the elimination of this tax benefit. However, we have received almost universal reaction that this facility should not be eliminated for a number of reasons. In order to protect low-income groups, we suggest an interest subsidy of 2% for housing loans up to Rs.5,00,000 to all borrowers. This will help prospective homebuilders whose income is less than Rs.1 lakh. Until such time this proposal is adopted, we also recommend the continuation of interest deduction of up to Rs.50,000. According to the data provided by the National Housing Bank this would cover about 85 percent of total borrowers and all borrowers from low income groups **(Table – 1.2)**.

Table 1.2: Number of Loanees and Amount Dispersed by Housing Finance Companies during 2001-02.

Size of the Housing Loan (in Rs.)	No. of Loanees	Amount Disbursed (Rs. in crores)	Percentage		Average size of the loan (in Rs.)
			Loanees	Amount	
Up-to Rs. 5 lakh	376556	8761	85%	59%	232661
Rs. 5 lakhs to Rs. 10 lakh	48145	3442	11%	23%	714923
Above Rs. 10 lakh	16442	2608	4%	18%	1586182
Total	**441143**	**14811**	**100%**	**100%**	**335741**

Source : National Housing Bank.

Tax incentives for saving

1.20 As far as support to savings is concerned, the view of the Task Force is that the implicit costs of the present structure of tax incentives outweighs the benefits.

1.21 Firstly, the incentives are for gross savings, which has led to "round-tripping" of savings and, as pointed out by the Y.V. Reddy Committee, leads to very high implicit cost of borrowing for the exchequer. This has also been an important factor in reducing public savings. Consequently, the tax incentives for savings while changing the composition of household savings have perhaps led to a decline in total savings of the national economy.

1.22 A recent paper published in *Economic & Political Weekly* has shown how tax incentives for small savings increases the overall interest rate structure, including medium and long term rates[5] . In our view, this has been one of the factors that has led to a reduction in the investment, employment and growth momentum, thereby hurting the economy in the macro economic sense. In other words, showing that what may be "micro rational" for individuals has become "macro irrational" for the economy.

1.23 Our proposals will lead to lower tax outgo for all assessees and consequently set off any perceived increase in tax liability arising from the elimination of "directed" savings in specific instruments. It is noteworthy that there is no unambiguous international evidence that the overall savings rate of an economy is influenced by tax breaks on specific savings instruments.[6]

1.24 Furthermore, savings incentives are available to only certain savings instruments. This implies that presently the choice to taxpayers to deploy their savings is perforce circumscribed, e.g., there is an implicit disincentive for deploying savings into the equity market. It is for this reason that the Task Force has recommended removal of exemptions. However, the (social) objective of promoting genuine long-term savings for increasing old age economic security is undoubtedly important. To promote this, in Chapter 4 we have

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[5] Lal, Deepak, S. Bhide and D. Vasudevan, (2001), Financial Exuberance: Savings Deposits, Fiscal Deficits and Interest Rates in India, Economic and Political Weekly, Vol. XXXVI, No. 44, pp. 4196-4203, November 3, 2001

[6] See Report of the Expert Group to Review Existing Fiscal Incentives for Savings (Chairman: P. Shome) for a review of evidence in this regard.

proposed doubling of the ceiling on contributions to the pension plan under section 80CCC to Rs. 20,000/- that will be eligible for tax relief. These pension plan schemes are presently operated by Life Insurance Corporation of India and other insurance companies.

Enlarging the tax base

1.25 A concern has also been voiced in the comments on the Consultation Paper that by increasing the limit to Rs.1 lakh, a large number of taxpayers will escape from the tax net. These apprehensions are misplaced. For the wider goal of increasing the tax revenue-to-GDP ratio, the key question should be the total income that is being brought into the tax net, and not the number of taxpayers. Surely, a simple toll tax would bring more tax payers, but that would not give buoyancy to the tax-GDP ratio. Also, most taxpayers with incomes of up to Rs.1 lakh will continue to file returns on account of the one-by-six scheme and therefore the concern that they "drop out" of the tax net is misplaced.

1.26 Now we move to the implications of our proposals. First, by removal of the various exemptions, we are in fact enhancing transparency as well as increasing the quantum of income – corporate and personal – that will attract taxes, albeit at lower rates. Second, by reversing the trend over the last two decades of an increasing burden upon the income group between Rs.2 lakhs to Rs.5 lakhs, we would be bringing more income into the tax net due to improved compliance.

1.27 A recent study by Surjit Bhalla has shown how over time, due to increased tax rates, the tax compliance by tax payers with an income between Rs.2 lakhs-Rs.5 lakhs has steadily declined and is currently the lowest among all income groups[7] (in fact, the estimated compliance rate (in percentage terms) is in the single digit for this particular class) as shown in **Table-1.3** below. His study also shows that, congruent with international experience, tax compliance in India is tax rate responsive. Hence our proposals, by reducing the tax burden will capture this "missing middle" into the tax net due to greater compliance, which enlarges the tax base.

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[7] Surjit Bhalla, *Tax Compliance in India*, January 2002 (*mimeo*).

Table –1.3 : Compliance Ratios

Year	Range of Returned Income (in '000s of Rupees)							
	0-50	50-100	100-200	200-300	300-400	400-500	500-1000	above 1000
1988	1.2	13.2	11.1	21.6	112.6	10.2	24.1	42.9
1989	1.3	11.1	8.3	21.7	32.5	110.2	5.9	15.5
1990	1.1	17.9	4.8	10.0	39.4	136.5	5.0	22.6
1991	1.2	16.5	3.5	8.9	19.2	36.9	5.2	22.4
1992	1.3	13.1	4.8	9.2	26.9	55.5	9.2	28.4
1993	1.7	16.4	10.3	4.4	10.7	28.6	12.9	44.6
1994	1.7	12.9	9.0	3.8	7.9	20.7	26.9	17.7
1995	1.9	13.1	7.3	3.5	5.5	7.8	19.7	18.0
1996	1.7	17.2	12.0	4.5	7.0	10.2	27.2	33.4
1997	2.1	21.6	12.3	3.8	7.6	8.9	41.8	42.7
1998	2.9	28.0	14.6	4.2	5.5	8.4	32.9	35.7
1999	3.3	40.3	15.1	4.0	4.7	8.3	27.3	41.4
2000	4.4	41.4	23.2	3.7	6.7	9.0	23.7	33.6
2001	4.7	42.9	23.1	3.4	5.4	7.6	21.1	32.9

Source: Surjit Bhalla, *Tax Compliance in India*, January 2002 (*mimeo*).

1.28 Since the continuation of the one-by-six scheme is recommended, there would be a steady accretion to the number of tax returns filed, and with an improved tax information system, the tax base would be further enlarged.

1.29 We should also note that international comparisons regarding the minimum level of taxable income, against our proposed Rs.1 lakh, are not fair. This is because unlike other countries, Indian families with less than Rs.1 lakh in annual income pay much higher quantum of indirect taxes on the goods and services that they consume. In other words, the comparison of total tax burdens should incorporate direct *and* indirect taxes.

1.30 Regarding our proposals to tax agricultural income, there was considerable support as it promotes horizontal equity and captures agricultural income of non-agriculturists. However, a number of observers have made a point that it could result in considerable administrative difficulties and increase transaction costs for agriculturists. Given the proposed exemption level of Rs.1 lakh and other systemic reforms that have been recommended, the Task Force believes that administrative problems may not be insurmountable. However, it is entirely for State governments to consider our proposals in this area given the Constitutional provisions.

Tax as a tool of developmental policy

1.31 One of the important points made by some commentators is that our proposals imply a reduction in the developmental role of the State. According to them, tax exemptions are aimed to meet certain development objectives, and a policy of abstaining from tax exemption is synonymous with vitiating these objectives.

1.32 Our proposals in no way dilute the role of the State. The approach of the Task Force regarding the removal of tax incentives is no different from that proposed in the Tenth Five Year Plan – which embodies the development aspirations of the State – that was recently approved by the National Development Council[8]. Our approach seeks to improve the role of the State by making it more efficient, transparent, better targeted and more accountable.

1.33 Tax exemptions are opaque since their incidence as well as implicit cost is non-transparent. Further, the present "exemptions raj" promotes rent-seeking behaviour, and contributes to the complexity in tax laws. In terms of administration, exemptions more often than not lead to tax leakage and tax abuse thus increasingly making the system counter productive and dysfunctional. Consequently, it has increased tax rates for tax complying sectors, thereby leading to an all-round increase in the *ex-ante* costs of "risk" (equity) capital in the economy. This adversely affects investment, growth dynamics and employment generation. Today, full tax paying corporations, including small and medium enterprises pay almost 50 per cent tax *ex ante* on risk (equity) capital since they can avail

[8] Planning Commission : Tenth Five Year Plan 2002-2007, December 2002, see Box 3.1

of only few, if any, tax exemptions; on the other hand, certain classes of corporations that are privileged to "access" these exemptions pay much lower taxes. Clearly, there is cross-subsidisation. Moreover, such exemptions mean greater complexity, which burdens the tax authorities further and leads to an increasingly antagonistic relationship between the Revenue official and the taxpayer. This complexity is one of the major reasons for tax leakage and tax abuse.

1.34 Hence, the Task Force is of the view that this is not an efficient way of achieving the developmental objectives and that there are better and more efficient alternatives to achieve these goals. For instance, if we want to promote investment in economically backward regions, the government should give an up-front capital subsidy to a project in place of tax exemptions. Such an expenditure-based instrument will make the policy transparent and directly accountable – through the CAG audit – to Parliamentary oversight. More examples can be given. If the State wishes to encourage use of renewable energy, it can pay a direct subsidy of, say, 25% of the purchase price of a windmill instead of tax incentives.

1.35 One of the important objectives of our proposals is to increase the tax revenue-to-GDP ratio through better compliance, and a larger tax base. As a consequence, additional resources will become available to the State, which can be used to increase expenditures for producing public goods, particularly in the areas of health, education and other social infrastructure.

Going back on promises?

1.36 Yet another important set of comments received, particularly from the corporate sector, related to the need to observe the doctrine of *promissory estoppel*. According to this doctrine, a Government should maintain the promises that it has given even if these are not contractual. This doctrine was particularly referred to in the context of tax exemptions relating to 80IA & 80IB and 10A & 10B. We would like to make several observations in this regard:

1. It is important to recognise that it is individuals or citizens who pay taxes, and not "corporate buildings or plant & equipment". Promises can only be made to

individuals and our proposals do not lead to any diminution of the promises made to individual shareholders who own corporations.

In fact, our proposals improve the lot of the shareholders as for them we are eliminating not only dividend tax, but also capital gains tax. Consider what is being proposed: Currently, there are firms which pay no tax on profit, while their shareholders pay dividend tax at 30 percent and capital gains tax at 10 per cent, which are (indirectly) taxes on profits. Our proposal is to charge 30 percent tax on all corporations, and remove the dividend tax and capital gains tax (on listed equity). After all, corporations are only "vehicles" or instruments that are owned by shareholders. Therefore, there is no reduction in benefits enjoyed by shareholders if our proposals are implemented, and consequently all promises are being observed.

2. In important infrastructure sectors such as power generation and distribution, basic telephoning, major ports, toll roads etc the rate of return is regulated. This means that the tax incidence is effectively a pass through. Further, in our proposals, we have made provisions regarding the indefinite carry over of losses. This removes the financial constraints faced by the infrastructure sector, and obviates the need for complex rules relating to various sections in Chapter VIA.

3. There is also a legal perspective. A number of judgements of the Supreme Court have upheld that in the realm of tax policy, the principle of *promissory estoppel* does not hold and the State can change tax policies in the public interest.

4. An argument has been made that although our proposals imply equivalence for their shareholders, profit making firms may have transitional cash flow concerns regarding financing their investments. There are three comments in this regard: Firstly, such profit making firms will have little difficulty in financing investment as currently banks and financial institutions are looking for such opportunities. Secondly, there is adequate liquidity available to finance profit making firms and that too at declining interest rates. Hence, there shall be little transitional problems for profit making firms. Thirdly, reducing the cash flow problems of firms may aggravate the cash flow problems of shareholders as they currently have to pay dividend tax, i.e., what is really involved is the "shifting" of cash flow problems.

1.37 Regarding tax benefits available to computer software exports under section 10A, domestic as well as foreign firms with investments in India in this sector had made a detailed presentation pointing out the peculiar taxation problems faced by Indian firms on their on-site revenues and how section 10A is helpful. In light of the complexity of tax treatment for software exports, the Task Force would like to briefly flag some issues pertinent to compensating Indian software companies that provide services on-site in foreign countries (often involving the stationing of Indian employees abroad).

1.38 Exemption under sections 10A and 10B for software off-site exports (services provided from India to clients abroad) has implications for allocative efficiency and equity. From the point of view of the sector itself, the exemption is a "tax cross-subsidy" between on-site and off-site exports (the foreign tax burden on the former being mitigated by exempting from corporate-tax profits from the latter). Therefore, the exemption results in a distortion in the "relative value" signals of different activities. Equity is impacted on two grounds. First, it differentiates *between* service providers *within* the software sector: those that cater for the domestic segment and those that export. Secondly, inasmuch as the sector is treated differentially from other productive sectors of the Indian economy (including, but not limited to, exporters of both goods and non-software services). Exempting incomes of companies providing on-site software services from tax on considerations of avoiding double incidence is analogous to correcting the (price) disadvantage faced by exporters of goods arising from the imposition of customs duties by the importing country's government. Furthermore, the need for continuing monitoring of exemptions has adverse consequences for the effectiveness of the tax administration as well. Finally, the Indian treasury loses revenue to the foreign exchequer – a case of "transfer of resources" from a developing country to a developed country.

1.39 Since the Task Force could not reach unanimity regarding the treatment of profits of computer software exports, even after discussing these issues in depth, it has suggested two possible alternatives to mitigate the tax problems faced by the software sector. The first is the elimination of exemptions under sections 10A & 10B together with retention of an amended Section 91 (to partially offset the burden). The second is retention of these

exemptions until a totalisation agreement is ratified with trading partners, simultaneously with taxes being levied on dividend distribution and long-term capital gains.

Towards strengthening the financial system

1.40 There is one relatively unnoticed but important positive aspect of our proposals and this relates to the strengthening of India's financial system.

1.41 Our proposals on corporate taxes are based on real income[9]. This implies that with our proposals, banks that meet RBI prudential standards for NPA provisioning will get full tax credit for the same. This would encourage banks to clean their Balance Sheets, achieve improved capital adequacy ratio, and help us move towards a sound and robust banking system. Since Banks do not avail of any capital allowances the benefit from lower tax rates will increase retained profits of the financial sector, which will facilitate an increased supply of commercial credit.

1.42 There is another more profound relationship between the proposed tax rationalisation and modernisation of the financial sector, and this is from improved allocative efficiency. The decision to incur capital expenditure will now depend on return considerations rather than tax considerations. The recommendations of the report are aimed at greatly simplifying and rationalising the tax system. This will better focus investment decisions of households upon an evaluation of the underlying risk and return of alternative investment avenues, without distortions induced by tax considerations. It will hence help us obtain a system of financial market prices that reflect risk and return, as should prevail in a dynamic market economy.

Implementation options for corporate tax reforms

1.43 In the Consultation Paper, we proposed two options regarding changes in Corporate Income Tax. Option I is to implement the proposals at "one go". Option II suggests a

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[9] Real Income here refers to commercial profit.

phased implementation. Some commentators have argued that the second option of staggered implementation appears to be superior.

1.44 Our preference is clearly for Option I. It was unanimously agreed that it is rather difficult for any government to give a credible *ex-ante* time commitment. Such commitments are rarely sustainable. Past experience shows while tax rates were reduced, successive governments failed to implement measures for strengthening the tax base eg. phased withdrawal of incentives. As a result, we have reached a point where the corporate tax rates are close to their resting points and yet the statute continues to be riddled with exemptions and deductions. Any attempt to sequence the reduction in the corporate taxes and the withdrawal of exemptions and deductions could lead to disastrous impact on revenue flows, particularly taking into account the proposed reduction in the personal income tax rates. The two must necessarily be implemented simultaneously. Phasing also gives rise to uncertainty and "hope" that reforms could be reversed. There is an additional factor in favour of Option I. Given the present weak state of the international economy, the proposed package has the potential to impart a strong counter-cyclical boost to the Indian economy by promoting domestic demand – both consumer demand as well as investment demand. A number of influential economic analysts in India have argued that our industrial economy is facing a cyclical slow down and our package would meet this challenge. In other words, the timing for the immediate launching of the proposed fiscal reforms is most opportune.

Charitable organisations

1.45 There were also concerns expressed by a number of NGOs and charitable organisations. The concerns were regarding our proposal for the use of rating agencies. While NGOs accept the principle, they suggested that the details should be fully worked out before implementing it. We have modified our proposals in this regard, giving more time to all concerned to adapt to the new procedures.

1.46 Also, a number of organisations have argued in favour of setting up a National Charities Commission along the lines of the National Charities Commission, U.K., a body which both regulates and also helps in developing the sector. A number of States in India have the office of Charities Commissioner which regulates charity

organizations. Hence, it may be more appropriate to have, at the national level, a National Charities Board which will be an advisory and promotional organization. The Task Force recommends that the Ministry of Finance & Company Affairs may explore this in consultation with the Ministries concerned.

1.47 The Task Force fully recognises the important role played by charitable organisations and NGOs in our country in strengthening civil society. Our proposals are in fact aimed at strengthening these institutions through the provision of more efficient services by the tax authorities.

Taxpayer services and tax administration

1.48 On the subject of tax administration, the Report has sought to encourage rapid improvements in both administration and accountability, in the firm belief that tax policy is only as good as its administration. The responses the Task Force received during consultations has only served to validate these concerns. The four main areas of complaints consistently perceived by taxpayers regarding tax administration related to delays in refunds, high-pitched assessments, harassment and inordinate delays in the interface process and widespread corruption. The Task Force would like to reiterate here that the measures it has recommended will help address these concerns and will put *samman* for taxpayers back into the spotlight.

1.49 A general emphasis on computerisation of the entire tax system, the cornerstone of which is the recommended Tax Information Network (TIN), is designed to streamline tax administration. A particular benefit is felt to be a reduction in the personal interface. Process improvements, such as outsourcing the non-core functions of the administration, will mitigate the high pitch of assessments by freeing up administration time for making assessments more accurate. The recommendation to route refund and tax payment transactions through banks based on PAN will both cut delays and enforce compliance, a double benefit for a move to a wide-based and efficient tax administration. Our proposals in their entirety reduce the avenues for rent seeking behavior, which *ipso facto* mitigates scope for corruption.

1.50 Accountability and oversight of the tax administration have been relentlessly emphasised in the Report. The establishment of a tax Ombudsman, on the lines of a similar body for the banking sector, has been recommended. Tax information will have to be routinely and periodically supplied by each Commissioner, enabling evaluation of the deviations of the tax administration from a set of explicit performance parameters (that have been laid out in Chapter 3).

Combating tax evasion through more effective enforcement

1.51 A number of individuals have pointed out in their responses that the Consultation Paper has failed to evolve a comprehensive strategy for enforcement against tax evaders. This is far from reality.

1.52 The Task Force at the outset recognised the importance of evolving a strategy, which would considerably enhance the ability of the tax administration to detect and penalise non-compliance. We decided to first address various issues that impact on the effectiveness of tax administration. Tax policy issues, dealt in the later chapters, are essentially addressed to improve the core functions of the tax administration, i.e., to improve taxpayer services and to enhance deterrence against tax evasion.

1.53 The underlying philosophy of the report is to substantially alter the economics of tax evasion. The cost of compliance is proposed to be drastically reduced by simplifying the tax laws and reducing the tax rates. The emphasis on taxpayer service through extensive use of information technology will enable the department to promote voluntary compliance amongst the general class of taxpayers and identify the "hard core" tax evaders. Similarly, the cost of non-compliance is intended to be increased substantially by establishing the Tax Information Network (TIN) which will enhance the probability of identification of tax evaders as well as help in the detection of income evaded. It will also substantially improve the quality of evidence against tax evaders and enable successful prosecution. As a corollary, the current tendency of high pitched assessment based on presumptions and conjectures will be a thing of the past. In effect, the present Block Assessment policy operates as an "Amnesty Scheme" for tax evaders detected as a result of search. The proposal

of the Task Force to do away with Block Assessment in cases of search and seizure will provide further deterrence against tax evasion by levy of interest, penalty and prosecution of persons found guilty of tax evasion.

Concluding Remarks

1.54 A number of commentators have made the point that although the thrust of the Consultation Paper was broadly acceptable, the Paper could be criticised on two grounds:

1. There were drafting issues. For instance, the Consultation Paper should have made it clear that while deleting section 36(iii) all the relevant benefits would continue under section 37 and this fully takes into account the borrowing costs of the entrepreneur in determining the tax liability.

2. The Consultation Paper did not present adequate data. Consequently, commentators made their own assumptions and, in some cases, this led to incorrect conclusions.

1.55 We accept these shortcomings and, in this Report, we have endeavored to make our proposals as clear as possible and to provide necessary tables to support the recommendations. Further, we recommend that the Central Board of Direct Taxes should regularly make available data on CD-ROMs to scholars and analysts. This will help in encouraging in-depth research and analysis of the tax data and other economic trends. Such research will be of vital importance for improving our tax policies.

1.56 Penultimately, we would like to point out that our proposals should be seen as a continuum of the reform process which began in 1991. Various eminent committees, viz., the Chelliah Committee, the Y.V. Reddy Committee and the Parthasarathi Shome Committee have recommended an open, transparent tax system with low tax rates, minimal exemptions and effective tax administration. Since 1991, our fiscal policy has substantially reduced the corporate tax rate, from 51.75 per cent in 1991-92 to 36.75 per cent in 2002-03 and now proposed to be further reduced to 30 per cent in 2003-04. Similarly, the maximum

income tax rates have also been substantially reduced from 56 per cent to 31.5 per cent in 2002-03 and now proposed to be further reduced to 30 per cent in 2003-04. However, such reductions have been effected without reducing (indeed, enhancing) exemptions. This has adversely impacted potential tax revenues, and failed to impart the necessary buoyancy. In turn, this has constrained the ability of the economy to invest in the social sector and in physical infrastructure. Our proposals are aimed to correct this distortion by increasing the buoyancy of taxes and enhancing resources for investment and,hopefully, play a role in boosting economic growth to 8%, the target growth rate of the Tenth Five Year Plan.

1.57 Finally, our proposals should be seen as an integral part of the second generation of reforms, aimed to meet India's strategic needs, i.e., to accelerate the growth rate while meeting the challenges of globalisation. To achieve this, our fiscal policy should promote transparency, reward efficiency, provide economic security to employees, protect economic rights of shareholders and discourage rent seeking and crony capitalism. We believe that the proposals laid out in this Report will enable our country to reach this worthy objective.

CHAPTER 2

APPROACH TO TAX REFORM

2.1 The Government of India is emphasising, *inter alia*, enhanced fiscal transparency to improve budgetary management, which the impending passage of the Fiscal Responsibility and Budget Management Act will further reinforce. In this regard, the Government is convinced that rationalising and simplifying direct tax laws and redesigning procedures to bring them at par with practices of other dynamic economies is *sine qua non*. Accordingly, the Task Force was assigned the following Terms of Reference: (i) Rationalisation and simplification of the direct taxes with a view to minimising exemptions, removing anomalies and improving equity; (ii) Improvement in tax-payer services so as to reduce compliance cost, impart transparency and facilitate voluntary compliance; (iii) Redesigning procedures for strengthening enforcement so as to improve compliance of direct tax laws; and (iv) Any other matter related to the above points.

2.2 The Task Force was intended as the forum to deliberate upon and correct many of the existing anomalies in the Indian direct tax system. Towards fulfilling this mandate, an attempt has been made to outline steps required for initiating and expediting a requisite change in the *fiscal paradigm* of the country by way of a *process transformation* on the direct tax side. The Task Force deliberated on ways to reduce costs of tax administration, examined best tax practices in the world and extensively debated means of empowering Central Board of Direct Taxes (CBDT) to fulfill its function effectively. The approach of the Task Force has been influenced by the recognition that in the recent past, economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration. This Report contains the Task Force's considered judgement, melded from views culled from a diverse section of stakeholders. In conjunction with the reduction in the incidence of commodity taxes – which are by definition regressive – recommended by the Task Force on Indirect Taxes, the tax structure of the Indian fiscal system is sought to be made more progressive and to improve the functioning of markets.

2.3 Hitherto, tax policy, including exemptions, has been used in instances where other instruments at the disposal of the government are *prima facie* more suited to achieve stated objectives. There is a widespread perception that (frequent) changes in the tax code in the last decade or so have (unintentionally) been akin to substituting the erstwhile "license raj" with an "exemptions raj". Confusion in assigning instruments to objectives result in an inefficient allocation of resources and often defeat stated aims. Clearly demarcated distinctions among objectives to be achieved and increasing transparency in the use of expenditure and tax instruments for these objectives can be expected to yield better results. Old-age social security and pensions, for instance, can be better provided through transfers funded by *explicit* social security taxes (as is done elsewhere). A definitive separation of the two broad classes of instruments will have the secondary effect of reducing ambiguities in justification of expenditures and also impart greater effectiveness to parliamentary oversight of the government's fiscal decisions.

2.4 The Task Force has endeavored to ensure that the recommendations pertaining to the direct tax codes are congruent with generally accepted principles of taxation. The three principles relate to efficiency (minimising distortions in resource allocation), equity (which *inter alia* includes progressiveness of effective tax rates) and effectiveness (of tax administration). The Task Force recognized that the best means of advancing the three principles – thereby being one of the principal outcomes that was set of this Report – is an alignment of the objectives of the tax authorities with obligations of taxpayers; in other words, enhance the incentive compatibility of the two groups. The effects of most changes overlap all three principles; it is impossible (and artificial) to ascribe any particular desired principle as the sole motivator of a recommended change.

2.5 The design of tax policies has emerged as a concern of critical importance. The tax policy must be outcome oriented rather than input specific; for instance, many tax incentives reward higher usage of particular factors of production (inputs) or provide tax breaks for specific savings instruments. These incentives need to be re-engineered so that desired outcomes – viz., higher productivity of income taxpayers and increased returns to shareholders – are encouraged. This is the case with the most dynamic countries among the emerging markets. Additionally, in conformity with recent initiatives in other parts of the world, transparency & corporate governance has sought to be enhanced (by, among other things, aligning book and taxable profits).

2.6 An equitable treatment of tax incidence is critical to the acceptability – and thereby the success – of any tax structure. Equity – both horizontal (similar tax treatment for similar classes of taxpayers) and vertical (progressive nature of tax incidence) – is consciously sought to be enhanced. The regime of a multitude of exemptions has been detrimental not only to tax efficiency but also equity by enabling a vocal (often rich and powerful) minority to enjoy rents arising from the resultant distortions (complexity) in the system, consequently undermining the postulate of equitable incidence (and thereby foster a regressive tax structure).

2.7 Optimal tax policy should be pursued in the general interest of the economy rather than for catering to sectional interests. Every exemption has a constituency and democratic systems tend to respond to constituencies – a tax break to one constituency inevitably spawns similar demand by others. The dynamic nature of economic activity in India, with changes in the relative share of industry, services and agriculture-value added, is moreover sure to continually shift the taxpayer profile. The recommendations of the Report are embedded in a forward-looking approach to taxation by imparting a sector-neutral flavour (including fiscal impartiality between those who produce for the domestic market and those catering to external markets). Therefore, it is recommended that income from all sources and asset classes – skilled and unskilled labour, human capital, physical capital and financial (risk) capital – should have equal tax incidence.

2.8 Often, the exemptions looked to be rational at the micro level, but were irrational at the macro level. For instance, tax breaks on specific savings/investment products did help in resource mobilisation of particular financial instruments with associated high rates of return to subscribers of these instruments. Selective exemptions did not only engender dichotomy of real returns on various instruments, they also helped to increase the cost of borrowing for everyone with debilitating consequences for investment and growth for the whole economy – in other words, the strategy was harmful at the macro level. If this wasn't bad enough, to make investments in specific assets affordable – given the high cost of borrowing brought about, in part, by the aforementioned tax breaks – tax incentives were conferred! Removal of tax breaks on specific savings vehicles will impart downward flexibility to the (implicit) floor on rates of return on these instruments and contribute towards further lowering the cost of debt capital. Furthermore, by the elimination of taxation on dividend and capital gains (on equity of listed companies),

shareholders are taxed only once, and therefore the cost of (equity) risk capital also comes down. A *systemic* beneficial outcome will be a reduction in the cost of capital, thereby helping to boost investment and growth.

2.9 As a macroeconomic coda to these arguments, it should also be pointed out that that cross-section and inter-temporal evidence points overwhelmingly towards *simultaneity* in savings and growth behaviour of economies rather than causality from the former to the latter[10]. In other words, there is little evidence that high savings have actually caused high growth; the two normally move together. Encouraging savings as an objective *per se*, with little regard for the damage it might cause by raising the cost of funds, is likely to defeat the purpose of growth. The Task Force does recognize, though, that long-term savings might need to be encouraged and explicitly does this by rewarding the fruits of such savings, at the time they mature.

2.10 In addition to enhancing horizontal equity, vertical equity will, moreover, also be served. The specific tax proposals outlined in subsequent chapters – if accepted as an integrated package – will constitute the most progressive tax changes in India in the last two decades.

2.11 The Task Force would like to explicitly point out that elimination of various (corporate level) tax holidays, concomitantly with removal of dividend and capital gains tax (on listed equity), will bring down a shareholder's *ex ante* tax liability from about 50 percent at present to 30 percent. On that account, viewed from the unexceptionable perspective of a shareholder, the government is not going back on its moral commitment regarding corporate level tax breaks that have already been granted (and availed of).

2.12 The series of *ad hoc* exemptions and other tinkering, in addition to distorting economic incentives, has also served to clutter the culture of compliance. Tax policy and tax administration is inter-linked: complex tax policy leads to complex tax legislation, which inevitably leads to cumbersome administration through a cascading effect on filings,

[10] See Report of the Expert Group to Review Existing Fiscal Incentives for Savings (Chairman: P. Shome) for a review of evidence in this regard.

compliance procedures and enforcement measures. Unsurprisingly, a weak and porous system has evolved, which by increasing transaction costs of participation dissuades potential taxpayers. Over the years, a number of perverse incentives have crept in: taxpaying is often punished (by harassment) and tax evasion is not sufficiently deterred. The recommendations are designed to change the economics of tax compliance, viz., reduce transaction costs of tax paying and increase the price of evasion. One of the tax department's biggest challenges will be to bring the "missing middle"– mainly urban, self-employed service sector professionals who, advertently or unwittingly, have dropped out of the tax base – into compliance, through the right mix of communication, education and enforcement. Presently, the compliance rate in percentage terms of this category of taxpayer is in the single digit. It is noteworthy that this undesirable outcome has occurred against the backdrop of considerable efforts in recent years by the tax authorities to fulfil its functions.

2.13 Just as the Task Force recommends that greater effort be expended on enlarging the taxpayer base, so must it emphasise that the quality of services extended to the taxpayer be improved. The tax department is no different than most businesses: world-class customer service is critical. Communication about taxes and tax policies is extremely important – taxpayer rights and obligations need to be clearly specified. The best tax systems in the world deal with taxpayers in a professional customer-relationship environment, which requires the system to be transparent, responsive and non-discriminatory. Furthermore, by increasing accountability of tax authorities, a durable welfare-improving social contract is established between taxpayers and tax administration.

2.14 A change in attitudes has distinctly and perceptibly emerged in a previously largely adversarial relationship between the tax collector and taxpayer, when neither was inclined to believe the other's integrity. Younger taxpayers are more willing to pay their dues to society. This bracket of young taxpayers, in line with global trends, constitutes the most dynamic and productive segment of India's population. Not only will they be the engine for higher growth, their contribution to the tax coffers will increase. At the same time, this willingness is conditional; based on their experience as customers for commercial services, they have come to expect a professional interaction with service providers.

Leveraging this segment for both higher growth and tax revenues will consequently have to tread the fine line between incentivising effort and enterprise while simultaneously co-opting them into the tax base. The Task Force reiterates that all possible measures are instituted to prevent an alienation of this increasingly important demographic segment and an attendant reversion to the tax cynicism of earlier generations.

2.15 The Task Force cannot over-emphasise that effective tax reform must harness Information Technology (IT). The CBDT has to be commended for the effort it has expended and the actions it has initiated for computerisation of taxpayer records. However, business processes, systems and facilities have not kept pace with the growing demands on tax administration. Simple and transparent business processes are at the core of any service organisation and this is also true for a tax administration. Raising the resources required for the targets envisaged by the Tenth Plan involves much more than adjusting rates and rationalizing exemptions – a fundamental process change which empowers the tax department in more effectively fulfilling its functions is needed. Apart from facilitating increased efficiency, IT can contribute to aligning the incentive compatibility of the department and taxpayers by its potential of enhancing transparency thereby contributing to mitigating rent seeking. The mandatory web-based logging of details & parameters of taxpayer complaints and action taken on these complaints is an example of the use of IT facilitation in this context.

2.16 Availability of IT expertise and the presence of world class (common carrier) network systems developed by the National Stock Depository Limited (NSDL) can be relatively quickly deployed to make a *systemic* improvement in processes to reduce transaction costs (for both CBDT and the taxpayer). Establishment of a Tax Information Network (TIN) can facilitate transactions, akin to securities markets, and establish *secure and seamless logistics of tax collection* through integration of primary information, record keeping, retrieval and enforcement. Centralised processing of TDS certificates, for example, has the potential to increase compliance and reduce fraud – false certificates result in increased costs of cross-checking and verification. Reciprocally, not only is there reduced potential for discretion and concomitant harassment, but it can also help to expedite refunds. Some of these activities, as well as systems for process automation, can be out-sourced in

conformity with procedures adopted by the best international tax administrations, thereby permitting the CBDT to pursue more effectively its core functions.

2.17 These broad recommendations are elaborated in subsequent chapters. In closing, however, the Task Force would like to strongly urge that these recommendations be adopted as a package. Deep organisational reform in the private sector occurs following the failure of discrete changes from preventing a threat to the viability of the enterprise; the same is true of the framework for direct taxes. The efficacy of the recommendations is likely to be seriously vitiated if individual components are selectively accepted or rejected and reforms continue in a piece-meal manner; success of tax reform efforts depends on their implementation as an integrated package.

CHAPTER 3

REFORM OF TAX ADMINISTRATION

3.1 It is widely accepted that a significant portion of potential tax revenue is not collected because of poor tax administration and high tax evasion in India. The question is whether the complexity of the tax structure or high tax rates have led to a high incidence of tax evasion, or if lax tax administration by itself has been unable to fulfill the revenue objectives implied by the tax structure. In practice, it is likely that both tax policy and tax administration have mutually affected each other.

3.2 It is widely recognized that tax policy and tax administrations are intrinsically linked. In this interrelationship, however, tax policy formulation is generally seen to precede tax administration. This is because only when a tax structure is legislated does tax administration come to play its role in the implementation of the law. In developing countries, however, the direction of the link may not be quite so apparent. Indeed, it is said that in developing countries tax administration is tax policy[11]. This would imply that, however fine the design of the tax structure might be in a representative developing country, it is the interpretation and implementation of the law that counts. These elements reflect the need for adequate capacity of the tax administration in place to implement the law[12].

3.3 At the same time, experience reveals that a particular tax administration mechanism could alter the original intention of tax policy and structure. Possible modes include large taxpayer units that continue to be emphasized in the long run at the cost of the overall universe of taxpayers, tax deduction at source used as a final withholding, purely financial, as opposed to physical, control as an administrative device in a rudimentary environment, and the use of distortionary or simplistic taxes purely on grounds of easy administration.

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[11] Bird, Richard M. and Milka Casanegra (1992), Improving Tax Reform in Developing Countries, International Monetary Fund, Washington D.C.

[12] Faria, Angelo and Zutu Yucelik (1995), 'The Interrelationship between Tax Policy and Tax Administration' in Parthasarathi Shome (ed.), Tax Policy Handbook, International Monetary Fund, Washington D.C.

3.4 In many developing countries, tax laws may be quite well designed and detailed. But unless the accompanying tax administration is able to handle those laws in terms of having the appropriate staff to interpret and implement them, the field-level reality of the actual incidence of the tax system may be quite different from the original objectives[13]. The taxes may be passed on to those on whom they are not meant to fall, and the distribution of the burden may turn out to be indiscriminate. Lawyers find it easy to litigate tax matters because of the difficulties in interpreting complex tax laws and, accountants, ploughing through a myriad pages of the tax code, successfully advise clients in careful tax planning such that their tax burden is minimized. This implies that, in the long run, it has to be ensured that tax administration instruments facilitate, rather than ignore or hinder, the implementation of tax policy goals.

Role of the Tax Administration

3.5 If "tax administration is tax policy", as is widely recognised, it is imperative to identify the role of the tax administration, so that responsibility and accountability is clearly established. The existence of a tax administration is a necessity, even in the most law-abiding society. Where there is full compliance, the role of the tax administration would be restricted to the provision of facilities for citizen to discharge their responsibility. In case there is non-compliance, it will have to play the role of a policeman. Since it cannot play the role of a policeman to all taxpayers, its action must provide sufficient deterrence so as to induce voluntary compliance.

3.6 Collection of taxes are merely transfer of resources from the large masses of taxpayers to the Government. The resources used in the collection of taxes are a dead-weight loss[14] unless the benefit flowing from the expenditure policy exceeds the dead-weight loss. Hence, it is necessary to use minimum resources in the collection of taxes. **Therefore, the fundamental role of tax administration is, in order of priority:**

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[13] Faria, Angelo and Zutu Yucelik (1995), 'The Interrelationship between Tax Policy and Tax Administration' in Parthasarathi Shome (ed.), Tax Policy Handbook, International Monetary Fund, Washington D.C.

[14] This is exclusive of the dead-weight loss on account of distortionary impact of taxes.

1. **To render quality taxpayer services to encourage voluntary compliance of tax laws; and**

2. **To detect and penalise non-compliance.**

The extent of success of the tax administration in its role would be reflected in higher revenue growth.

3.7 These functions of the tax administration comprise the following separable component activities:

1. Taxpayers' education and services
2. Collection of information
3. Collation of information
4. Dissemination of information
5. Storage and retrieval of information
6. Verification (appraisal/assessment of information)
7. Collection of taxes
8. Taxpayers' grievances redressal system
9. Accountability

Taxpayer Service

3.8 Traditionally, the role of the tax administration has been to enforce the tax laws and provide at least minimal taxpayer service. This was understandable in the context of a small potential taxpayer base and the then prevalent practice of administrative assessment. Over time, as the taxpayer base expanded and the scheme of self-assessment introduced, it became necessary for the tax administration to also facilitate compliance through the provision of quality taxpayer service. In most developing countries this shift in role focus is suspiciously viewed as abandonment of its traditional role of enforcement and softening of the tax administration. Most employees unable to reconcile to their new role continue to resist this shift in the role perception from an enforcement officer to a facilitator.

3.9 Tax evaders in most countries, particularly developing countries, can be classified into two categories. The first category relates to those who fail to comply because of

information asymmetry (lack of information) and the tax administration's failure to provide this information. Recourse to private sources (tax practitioners) for information entails a relatively high compliance burden. These evaders are sitting ducks for the tax administration and entail a high administrative burden if pursued individually. The second category relates to those who refuse to comply because of deficiencies in the taxpayers' information system and supporting institutional setup. Therefore, the latter, in effect, is also because of information asymmetry (lack of information with taxpayers). The compliance burden in this category is relatively low. The first category constitutes the majority of tax evaders but account for a relatively small proportion of taxes evaded. The existence of the first category of evaders creates a general climate of non-compliance. Tax evasion being contagious, spreads widely! Since the second category is hard to nab and the first category is a sitting duck, the tax administration tends to prey on the first category for easy success. The second category continues to thrive under the umbrella of the first category. It is, therefore, efficient for the tax administration to provide quality taxpayer service and reduce the size of the first category. The limited resources hitherto deployed in the pursuit of the first category could be substantially released and redeployed to the task of tackling the second category. Hence, taxpayer service must be seen as complimentary to enforcement and not a substitute as is commonly understood in most developing countries – the mind set amidst tax officials in India is no different. Provision of quality taxpayer service is an integral part of the enforcement strategy of any tax administration.

3.10 Taxpayer service typically refers to the provision of information and material by the tax administration to the general mass of taxpayers so as to facilitate compliance with the tax law. A cross-country survey of taxpayer service indicates that the relatively more successful tax administrations provide relatively high levels of taxpayer service. Inspite of the mindset in favour of enforcement, the Income Tax Department indeed provides a range of services to facilitate compliance. These services include pamphlets, brochures, booklets, web–based information and return forms. In some Metropoliton centres, an Interactive Voice Response System is operational. The recently introduced scheme of Suvidha and Sampark are all extensions of the taxpayer service programme. However, these are just beginnings and are clearly not enough. The present scope of taxpayer service in India is too narrow compared to the range of services offered by other tax administrations across countries (**Table – 3.1** below). The evolution of the package of taxpayer services in

India is accidental – the entire programme seems to have evolved in an ad hoc manner rather then as a strategy to promote voluntary compliance. The Task Force was informed that this was primarily due to inadequate financial resources for taxpayer service. The expenditure set aside for taxpayer service is woefully small (less than 2 per cent of its annual budget). The existing taxpayer service programme is also handicapped by the absence of professionals trained for planning and executing focused media campaigns.

Table 3.1 : Taxpayer Information Programs in Selected Countries

		Argentina	Canada	Chile	Colombia	Jamaica	Mexico	Trinidad	USA	India
A.	**Publications**									
1	Tax guides (instructions)	x	x	x	x	x	x	x	x	x
2	Pamphlets and bulletins	x	x		x	x	x	x	x	x
3	Technical publications		x		x	x	x	x	x	x
4	Audio cassettes for visually impaired		x							
5	Newspaper tax supplements			x	x	x	x	x	x	
6	Reminders in press			x						x
B.	**Media**									
1	Radio or television commercials	x	x	x	x	x	x	x	x	
2	Special television programs		x		x	x		x	x	
3	Video cassettes		x				x		x	
4	Press conferences			x			x		x	
C.	**Telephone contact**									
1	Telephone assistance	x	x	x	x	x	x	x	x	
2	Tele-refund		x				x		x	
3	Tele-info		x						x	
D.	**Personal contacts**									
1	Walk-in service		x	x	x	x	x	x	x	x
E.	**Correspondence**									
1	Individually drafted letters		x	x		x		x	x	
2	Standardized letters		x	x		x		x	x	
F.	**Other programs**									
1	Volunteers		x					x	x	
2	High school program	x	x	x		x	x	x	x	
3	Rural tax scene kits		x						x	
4	Native outreach		x						x	
5	Training for new business							x	x	
6	Participation in seminar and conferences		x		x		x		x	

3.11 Given the best international practice in the area of taxpayer service and the future programme for widening the tax base through voluntary compliance, **the Task Force recommends the following measures to expand the present scope of the taxpayer service programme:**

(i) The income tax department must expand, qualitatively and quantitatively, the present scope of taxpayer service. These should cover the range of taxpayer services indicated in Table–1 above and, inter alia, include the introduction of a telephonic system (by voice message) to remind taxpayers of important dates and the provision of pre-formatted programmed floppy diskettes through retail outlets.

(ii) The expenditure on taxpayer service must be increased from the present level of about one percent of the total expenditure on tax administration to at least five percent. In this regard, an important start should be made by the establishment of taxpayers' clinic in different parts of the country to enable taxpayers to walk in for assistance. The Task Force feels that better treatment of existing taxpayers has an important role in encouraging those outside the tax net to become taxpaying citizens.

(iii) The department should provide easy access to taxpayers through Internet and e-mail and extend facilities such as tele-filing and tele-refunds. It should design special programmes for retired people, low-income taxpayers and other such groups with special needs who cannot afford expensive services of tax consultants.

Taxpayer Identification and Registration

3.12 The process of tax enforcement begins with the identification of taxpayers. This is truly a formidable task particularly in an economy where the unorganized sector predominates. Only an effective taxpayer information system and monitoring can help to achieve this task. The establishment of an effective taxpayer information system is crucially dependent upon a unique identification numbering system such that the information relating to various indicators of wealth, expenditure and financial transactions can be collected and collated.

3.13 The Income tax Act[15] provides for allotment of a Permanent Account Number (having ten alphanumeric characters). Every person who fulfils any of the following conditions has to compulsorily apply to the Assessing Officer for the allotment of a permanent account number (PAN):

1) If his total income or the total income of any other person in respect of which he is assessable under this Act during any previous year exceeded the maximum amount which is not chargeable to income-tax; or
2) Carrying on any business or profession whose total sales, turnover or gross receipts are or is likely to exceed five lakh rupees in any previous year; or
3) A charitable trust or institution;
4) Any other person desiring to own a PAN ; and
5) Any other person by whom tax is payable.

3.14 The PAN is required to be quoted by a person:

(a) In all his return to, or correspondence with any income tax authority.

(b) In all challans for the payment of any sum due under the income tax act

(c) In all documents pertaining to foreign transactions ;

(d) Sale or purchase of any immovable property valued at five lakh rupees or more ;

(e) Sale or purchase of motor vehicle or vehicle(does not include two-wheeled vehicles);

(f) A time deposit exceeding fifty thousand rupees with a banking company;

(g) A deposit exceeding fifty thousand rupees in any account with post office savings bank;

(h) A contract of a value exceeding one lakh rupees for sale or purchase of securities;

(i) Opening an account with the bank;

(j) Making an application for a telephone connection including for a cellular (mobile) telephone;

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[15] Section 139A

(k) Payment of hotels and restaurants for an amount exceeding twenty five thousand at any one time;

(l) Payment in cash for purchase of bank drafts or pay orders or bankers cheque from a bank for an amount aggregating fifty thousand rupees or more during any one day;

(m) Deposit in cash aggregating fifty thousand Rupees or more with a bank during any one day; and

(n) Payment in connection with travel to any foreign country for an amount exceeding twenty five thousand rupees at any one time.

3.15 **Given the ongoing and new initiatives by the Ministry of Home Affairs for issuing a Citizen Identification Number and by the Ministry of Labour for issuing a Social Security Number, the Task Force feels that the use of PAN can effectively integrate, on the lines of the US Social Security Number system, multiple tasks of tax and commercial enforcement, targeting government subvention, improving governance and enhance national security, both at the Central and State level. We recommend that:**

(i) The PAN should be extended to cover all citizens and therefore serve as a Citizen identification number. This will obviate the need for the Home and Labour Ministries to issue new numbers.

(ii) Given the manifold increase in the coverage of PAN, the responsibility for issuing should be transferred to an independent agency outside the income tax department. However, the income tax department should have online access to the database for tax enforcement like any other agency.

(iii) The requirement of quoting PAN may be expanded to cover most financial transactions.

Collection of Information

3.16 For administrative purposes, information for taxpayer for identification can be grouped broadly in three heads : (i) Taxpayer's Declaration, (ii) Information Returns and (iii) Field Survey

(i) Taxpayer's Declaration : Under the system of self-assessment, the taxpayer forms the basic source of information. The taxpayer provides information to the tax administration through returns and accompanying documents. These returns contain valuable information on the taxpayer and his activities. All this information can potentially be used to help gauge the taxes due from the taxpayer. However, the Task Force was apprised that tax administration was unable to digitize the information since the staff in the income tax department, despite training in computer skills, is at the lower end of the learning curve. More than 2.5 crores of tax returns were pending for processing for lack of adequate skilled manpower.

(ii) Information Returns: This is a more widely used device to collect information. Information returns are declarations filed with a tax administration by persons required to report details of their financial dealings with other taxpayers. Information returns often require listing of all transactions of a certain kind, e.g., payments of corporate dividends or transactions of other kinds beyond a level with other taxpayers during a certain period. A wide variety of sources of information can be imagined which could be garnered by the tax administration through the device of information returns. Such returns also include information returns relating to tax deduction at source.

Under the extant procedure, the Central Information Branch (CIB) functioning under the Director-General (Investigation) within the Directorate of Income Tax (Investigation), spread all over the country, collects from predetermined sources information relating to financial transactions from various external and internal sources. Sources of information to be tapped in a financial year, are laid down by CBDT in its instruction No. 1943 dated August 22, 1997. The Director-General of Income Tax (Investigation) is empowered to revise the ceilings of the monetary limits fixed by the Board for collection of information. Currently, about 37 broad categories of external and internal sources are listed in the long-term action plan for information collection, formulated by CBDT. Section 133B (power to call for information) and 131 (power regarding discovery, production of evidence, etc.) constitute the main legal base for the process. Under Section 133(6) of the Income Tax Act, firms, companies, dealers, brokers, agents, banks, etc., can be called upon to provide the name and address of persons engaged in transactions

with them. The information so collected is collated and then disseminated by the CIB to the assessing officers for verification in the respective cases.

The process starts with the collection of information, mainly from external sources. However, there are several hurdles in this area. First, the flow of information is not automatic in the sense that the CIB first issues letters to various agencies, calling for information under sub-section (6) of Section 133 of the Income Tax Act. Although the instruction identifies the broad sources of information to be tapped during the year, the specific identity of these sources, viz., the specific firms, dealers, brokers, banks, companies, etc., required to be tapped for this purpose are left to the discretion of the officer in the field formation, with the result that the coverage of sources is usually incomplete. Secondly, even where information is called for under Section 133(6), not all agencies respond promptly. In such cases summons under Section 131 are issued. Even then, many agencies try to stall or even resist communication of information. Refusal to part with information by banks and some other financial institutions is a case in point. This strains CIB's resources and delays verification and dissemination of information. Thirdly, because of limited manpower and infrastructure – including, importantly, the lack of automation and also the long delays in furnishing information, the CIB is not able to collect information from even the major external sources every year. The inability to collect annually comprehensive information from all or at least the major sources dilutes the efficacy of CIB verifications

Under the Income tax Act, deduction at source is required to be made from specified categories of payment like salaries, interest, commission etc. The deductor is required to file with the TDS circle in the Department annual returns relating to deduction of tax at source. These information returns are also an important source of information.

(iii) **Information and evidence collected by the Department during the course of investigation :** In addition to information from taxpayer's return and other information returns, a large volume of information also gets collected during assessment, searches and seizures and survey operations.

3.17 In view of the extant method of collection of information and constraints in digitising the volume of information received by the tax administration, **the Task Force recommends:**

1. **Income Tax Act should be amended to provide for submission of 'annual information return' by third parties in respect of various transactions as may be prescribed. For this purpose, a proper format of the return also needs to be prescribed. Consequently, the flow of information will be continuous and the discretionary power with the CIB to collect information will be eliminated.**

2. **Such annual return of information (including returns relating to tax deducted at source) should be mandatorily required to be submitted on electronic format.**

3. **Many of the Departments involved in transactions specified in Rule 114B do not have any mechanism for obtaining the PAN of the concerned person. It is, therefore, necessary that the pro forma used by them for their departmental purposes, e.g., the application form for transfer of motor license, should have the necessary column requiring the applicant to disclose his Permanent Account Number (PAN).**

4. **The Department should set up a structure for Electronic Data Interchange (EDI) with some of the major departments and organisations involved in the transactions specified in Rule 114B, such as, Banks, Stock Exchanges, Telephone Companies, Regional Transport Authority etc.**

Search and Seizure

3.18 In the public perception, the Income tax department is identified with 'raids'. That is its identity. That is its most visible enforcement activity. Raids are conducted with the help and in the presence of the police force. The search and seizure activity is immediately reported in the press, highlighting "big names" and large amounts of undisclosed income. It also provides publicity to the concerned officer.

3.19 The objective of the search is to ascertain facts and collect evidence of concealed income and to give a message that tax evasion will not go undetected or unpunished. But, in the course of the search as they are conducted, the main objective of the search team is to obtain a declaration of undisclosed income from the person searched. It confirms success of the raid. Further investigations are slowed down or abandoned. Often such declarations are obtained under pressure. They are retracted in subsequent proceedings. After the raid, the officers of the investigation in charge of the raid, call to their office the persons searched to understand from them the seized accounts and documents. They record further statements.

3.20 The officer, in charge of the raid, prepares a report on the seized material in about 60 days, giving an (own) appraisal of the search and seizure, without any accountability for what he discloses (or omits) to put down in the report. This report is the basis for assessment in the searched case. The assessing officer does not independently investigate the case. He neither has time nor inclination to do so. The assessment is one sided, high pitched, completed in a hurry when it is close to getting barred by limitation, ignoring the contentions of the assessee. About half the arrears are accounted for by Search & Seizure assessments. When the case goes through first and second appeal, the additions are deleted.

3.21 In a search case, there is no "real" investigation. As a result, the assessment does not stand the test of judicial scrutiny in appeals. There is nominal revenue gain from the searched case. Overall, the contribution of searched cases to total revenue collection is less than one per cent.

3.22 In view of the scheme of block assessment and settlement by Settlement Commission, the person searched is not required to pay any interest or penalty and is never subjected to prosecution in respect of the income he had concealed and which was detected as a result of search and seizure action by the department. He gets away by paying tax at the rate of 60 per cent as against normal rate of 30 per cent or 35 per cent. As a result, the deterrence effect of a search is also doubtful.

3.23 Today, in the income tax department the most sought after posting for most of the officers in any grade is to the search and seizure wing (officers deploy all sorts of "strategies" to obtain a posting to the search and seizure wing) . The reason is not that the search and

seizure work provides high visibility with a sense of being in power without accountability for acts or omissions, but the main reason is that it is profitable. The department gives handsome rewards to members of search team based on seizures and revenue realisations. A substantial proportion of the rewards have been received only by officers posted to search and seizure wing. This practice has contributed to obtaining forced confessions of undisclosed income and seizure of money, jewellery, stock or other assets recorded in accounts or acquired from disclosed sources of income.

3.24 To sum up, income tax raids in India are the most visible activity of the department. In public perception, the identity of the Income tax department is 'raids'. Search and seizure has become a substitute for all investigations and an end in itself. Search and seizure does not serve as deterrence against tax evasion. It has become a routine exercise. There is no meaningful investigation prior to, during, or after the search. The concealed income declared as a result of search is widely publicized, but in judicial proceedings the additions made on that basis are not sustained. Search and seizure cases contribute less than one per cent to total revenue realizations and search and seizure cases do not suffer interest, penalty or prosecution. Nevertheless, the social and economic cost of search and seizure activity is very high.

3.25 Search and seizure has a limited role, in the income tax proceedings. Search and seizure is not a substitute for investigation. It is only a tool for investigation. It is not an end in itself. Search and seizure cannot be a way of life for any civilized society. Search and seizure should be used in rarest of rare cases, when it is a must and where alternative measures of investigation have failed. And once it is used, it should have its full impact as a deterrent. The tax evader should suffer the penal consequences of interest, penalty and prosecution in respect of the concealed income detected as a result of the search.

3.26 Based on the aforesaid considerations, **the Task Force recommends the following :-**

a) Special procedure for assessment of search cases in chapter XIV B (Block Assessment) which provides for tax at the rate of 60 per cent, be omitted. As and when concealment is detected and established, it should suffer full penal consequences of interest, penalty and prosecution.

b) **Power of Settlement Commission to grant immunity from interest, penalty and prosecution may be restricted to cases other than those where the assessee admits of tax evasion consequent to search and seizure action taken by the department in his case.**

c) **The scheme of rewarding officers engaged in search and seizure activity be abolished.**

d) **Often in the course of search and seizure, stocks are either seized, deemed seized or put under order of attachment or prohibition. This hampers business, without any gain to revenue. Commerce Ministry has unveiled new export-Import Policy (2002-2007). At para 2.42.1 it states "No seizure of stock shall be made by any agency so as to disrupt the manufacturing activity and delivery schedule of export goods. In exception cases, the concerned agency may seize the stock on the basis of prima facie evidence. However, such seizure should be lifted within 7 days.". In line with this policy of the government, the stocks found during the course of search and seizure operation under the Income Tax Act may only be inventorised but not seized. This can be done by issuing administrative instruction.**

3.27 A cross section of people cutting across trade and industry complained of a high handed behaviour of raiding parties particularly while recording a statement. It was pointed out that over enthusiastic raiding parties would often coerce a "surrender". As a result all follow up investigations are distracted and generally brought to a stand still. Since, the surrender is not backed by adequate evidence, the tax evader invariably retracts from the statement of surrender, by which time it is too late for the department to resume investigations. Similarly, where adequate evidence is indeed found, a surrender is not necessary to establish tax evasion. **Therefore, the Task Force recommends that the Central Board of Direct Taxes must issue immediate instructions to the effect that no raiding party should obtain any surrender whatsoever. Where, a taxpayer desires to voluntarily make a disclosure, he should be advised to make so after the search. As a result, the taxpayer will not be able to allege coercion and successfully distract investigations. All cases where surrender is obtained during the course of the search in violation of the instructions of the CBDT, the leader of the raiding party should**

be subjected to vigilance enquiry. Further, the Task Force also recommends that all statements recorded during the search should be video recorded. This will, indeed, add to the confidence of the taxpayer in the impartiality of the system.

Survey Operations

3.28 Section 133A empowers an Income Tax Authority to enter any business premises to inspect books of accounts, stocks or other valuable articles or seek information. The income tax authority is also empowered to place marks of identification on the books of accounts or documents inspected by him or take extracts or copies therefrom, make inventory of cash, stock or other valuable articles verified by him or record statement of any person present at the business premises. The Finance Act, 2002 has now empowered the income tax authority to also impound and retain in custody the books of accounts or documents after recording the reasons for so doing. Furthermore, she/he is also required to obtain the approval of the Chief Commissioner or Director General or Commissioner or Director to retain such books after a period of fifteen days. It was represented before the Task Force that consequent to the amendment by the Finance Act, 2002 the survey, which was a routine field verification exercise, has been upgraded to that of a search and seizure. Further, unlike the search and seizure where reasons for conducting the search must be recorded in writing and the warrant issued by a senior officer in the rank of Commissioner, there is no such requirement in the case of a survey. A junior officer at the assessing officer level can authorise a survey without assigning any reason. The public at large was very apprehensive about the possible misuse of such unbridled power. **Accordingly, we recommend the following:-**

1. **A survey should be authorised after recording the reasons in writing and the power of authorization should not be vested in any officer below the rank of a Joint Commissioner of Income Tax.**

2. **The books of accounts impounded by the survey team should not be retained beyond a period of seven days since it has the potential of disrupting the business of a taxpayer. Where it is felt that the books need to be retained beyond the period of seven days, the department may obtain photocopies duly attested by the taxpayer for further investigation.**

Verification of Tax Returns

3.29 The Income tax assessment system in India comprises of 'Intimation' of tax/refund on returned income (Section 143(1)(a)); 'limited scrutiny' (Section 143) introduced by the Finance Act, 2002 with effect from 1st June, 2002 to disallow inadmissible loss, exemption, deduction, allowance, or relief claimed in the turn; and 'full scrutiny' (section 143).

3.30 'Intimation' of tax or refund on the basis of returned income is to be routinely generated and sent to the taxpayer once computerisation is in place. Processing of the return of income by the integrated computerised system will ensure that the refund generated is after adjustment of the outstanding arrears if any against the assessee. Till then, manual verification and adjustment of the outstanding demand against the assessee will be necessary before the refund is issued to him. Unfortunately, despite training in computer skills, the staff in the income tax department is at the lower end of the learning curve and in-house clearing of the backlog in a short period is not possible. As a result, more than 2.5 crores of tax returns remain unprocessed. A large number of these would be refund cases contributing to the grievance against non-issue of refunds. Against this background, **the Task Force recommends that:-**

1. **In line with our view that the tax department should concentrate on its core functions, the department should be allowed to outsource data entry work and clear the backlog of returns (which number 2.8 crores as on 30th September, 2002) by end February 2003.**

2. **All returns must be processed within four months of receipt. For this purpose, it would be necessary for the department to either hire additional personnel on a temporary basis during the peak period for filing returns, or, outsource data entry work, as is done routinely by national tax administrations all over the world. Further, we must emphasis that outsourcing of such data entry work relating to processing of returns should be done only to supplement the efforts of the departmental staff and officers and not as a substitute.**

The cost of hiring additional personnel or outsourcing data entry work would be far less in comparison to the benefit from reduced interest burden on refunds and taxpayer satisfaction.

3.31 The audit (scrutiny) programme is the most important element of the enforcement strategy of any tax administration. The overriding aim of such a programme is to provide a credible deterrence to protect the tax yield[16]. Such deterrence is established through the process of selective verification of the volume of information received by the tax administration. The success of this process is greatly influenced by the method used for selecting the returns.

3.32 The Task Force was appraised about the negative aspects of the existing discretion-based system of selection of returns. We also received large-scale complaints about rent seeking by officials engaged in this discretion-based system of selection of returns. **Therefore, we recommend the immediate abolition of the existing discretion based system of selection of returns. The department should progressively develop an audit selection system for risk analysis and assessment, which forms a scientific (and, therefore, objective) basis for identifying cases of potential tax evasion for in-depth scrutiny.**

3.33 **Risk Analysis is by definition the process carried out by a computer program using data where there are proven statistical relationships, whereas risk assessment is a cognitive process. However, before an audit selection system can be driven by risk analysis good quality data has to be obtained over a number of years. Risk analysis will help to rank taxpayers and any local knowledge and intelligence must be factored to make a risk assessment. This will provide the most efficient and effective means of targeting tax officials to arrears of greatest risk. It is important that cases for audit are selected on the basis of perceived risk and not simply by intelligence or speculation since intelligence would be available for only a few taxpayers. Further, selection of cases based on risk analysis and assessment must be combined with a certain small**

[16] The other objectives of an audit programme are to (i) protect the expected yield from the tax; (ii) identify the true amount of tax, and bring errors to account; (iii) seek value for money in the deployment of audit resources; and (iv) maintain social acceptance of the tax.

percentage of random audit, and carrying out issue- specific audits, such as refund audits.

3.34 **In the interim, we recommend the identification of cases through a random non-discretionary centralised method deploying the PAN database. The current practice of issuing guidelines for selection of cases for scrutiny, which eventually finds its way to the public, must be given up.**

3.35 **Once a case is selected for scrutiny, it should be fully investigated, covering investments, accretion to assets, expenses incurred, savings, transactions entered and profits made, turnover etc. The scrutiny assessment will then serve its purpose of deterrence against tax evasion and contribute to revenue realisation. The present practice in scrutiny assessments is mostly to make statutory disallowances of exemptions, deductions and other claims made in the return to achieve zero error assessments from the point of audit objections. 100 per cent policing is not possible. Therefore, the number of cases selected for effective scrutiny should be on the basis of available manpower, their number and capability.**

3.36 Penalty proceedings for concealment of income are required to be initiated in the course of assessment proceedings (Section 271(1) of the IT Act). The order imposing the penalty can be passed within six months from the end of the month in which the order of the Appellate Tribunal against the order of the assessment is received. It takes about seven years on an average before the order of the second appellate authority against the order of assessment is received. Therefore, the order of penalty for concealment of income is passed only after seven years and thereafter it goes through the process of appeals, which takes another five to seven years. Hence, given the judicial process, any order that imposes penalty for concealment takes more than a decade to fructify. Consequently, the deterrence effect is considerably diluted. This is so, because penalty proceedings are treated as separate from assessment proceedings, though the same material is considered in both the proceedings. One possible solution is to pass the order of penalty for concealment along with the order of assessment. This would indeed have positive impact on the deterrence of scrutiny assessment and penalty on tax evasion. It would also reduce multiple proceedings and litigation.

3.37 However, during the process of consultation it was pointed out that the simultaneous passing of both assessment and penalty orders would result in very high tax demands from the taxpayers who would then be pressed for payment. This will result in considerable harassment. In the alternative, if the demand is stayed, the department would invite severe criticism for lack of performance. The Task Force was also informed that with the increase in the number of first appellate authorities, the pendency of appeals at this level has reduced substantially and decisions would now be forthcoming within one year. This being so, **we recommend that Section 275 of the Income Tax Act should be suitably amended to provide that the penalty order should be passed within one year from the end of the financial year in which the first appellate order is received. Consequently, the delay in passing the order-levying penalty for concealment would be considerably reduced to about two years.**

Computerisation of the Tax Administration

3.38 The assessment of most modern taxes requires the ability to marshal the numerous pieces of information needed to determine the base of the tax and the rate to be applied. With many taxpayers, the level of information that needs to be processed and – for tasks that need centralised coordination – the magnitude of the coordination problem increase rapidly and possibly faster than the number of taxpayers. Either taxes requiring less information must be adopted or the information processing and coordination capacity of the tax administration must be improved.

3.39 Radical improvement in tax administration calls for a transformation of organisation and methods. Modern information technology greatly facilitates such transformation. The availability, cost, and accessibility of modern computers make them ideal for the large-scale information processing and coordination problems facing tax administrations. Benefits to taxpayers from computerisation, through such systems as electronic filing, electronic data interchange and computerised taxpayer assistance can also be immense in terms of lower compliance costs and time saving. Nonetheless, it is critical to have a clear strategy and to consider a number of important aspects of the problem when considering the introduction of technology to upgrade the information handling capacity of any tax administration.

3.40 The Task Force cannot over emphasise that effective tax reform must harness Information Technology (IT). The tax department is no different from most businesses. World-class customer service is critical when "all of India is its customer and Parliament its Board of Directors". While the CBDT has to be commended for the effort it has expended and the action it has initiated for computerisation of taxpayer records, the business processes, systems and facilities have not kept pace with the growing demand on tax administration. The Task Force firmly believes that the tax department should be allowed to concentrate on its core functions – an increasing emphasis on assessment and enforcement duties, rather than logistics and support services – which will surely lead to increased effectiveness of the tax administration. In this context, rapid and progressive outsourcing of many tasks of the tax department is not only feasible, given the significant pool of talent in the Indian software industry, but it is also desirable. In order to make IT infrastructure commensurate with the requisite processing tasks, the Task Force would like to explicitly put on record that implementation of this enhanced integration-software requires considerable investment in upgrading associated IT hardware and sufficient access to high-capacity bandwidth for implementing the network.

3.41 The process of systemic modernisation of tax administration cannot be further delayed. To empower the tax administration in executing its core function, the Task Force studied the existing depository system of the National Stock Depository Limited (NSDL) and concluded that it offered a scalable system to meet the requirements stated above. As this proven and tested infrastructure already exists, it can readily be adapted to offer a world-class, state-of-the-art IT architecture to rapidly empower the tax administration. Our study suggests that the system could be operational and available on-line by the beginning of the 2003-04 fiscal year.

3.42 **To speed up the process of modernisation, the Task Force therefore recommends the following:**

(a) The Government should establish a national Tax Information Network (TIN) on a build, operate and transfer basis. This will comprise of a world class (common carrier) network system and have access to state-

of-the-art IT infrastructure. A requisite in-built feature of the system is that it should be scalable to offer ease of access across tax administration and taxpayers. The network that is envisaged will facilitate transactions, akin to securities markets, and establish secure and seamless logistics of tax collection through integration of primary information, record keeping, dissemination and retrieval. It should be a repository of information, with a database of all tax payments and refunds. Data mining software associated with such relational databases will allow a quick and systematic identification of non-compliance and abuses, thereby helping to improve compliance. The existing facilities of the National Securities Depository Ltd. (NSDL) can be relatively quickly deployed to make a systemic improvement in processes and reduce transaction cost.

(b) TIN will receive, on behalf of the tax administration, all TDS returns and other information returns for digitisation. The information would be received either online, or through magnetic media or in printed format. The digitised information will be downloaded by the National Computer Centre / Regional Computer Centres of the income tax department for further processing.

(c) TIN will also receive online information about collection of taxes from the banks. The information could be downloaded by the income tax department as and when required.

(d) The taxpayer will have the facility of accessing the TIN system through a secure and confidential Permanent Account Number (PAN)-based identification to ascertain tax payments credited to his/her account and the status of returns and refunds.

The TIN will therefore serve as a gateway to the National Computer Centre of the Income Tax Department. It will help overcome the paucity of technical manpower and inadequate technical infrastructure.

3.43 The Income tax Act provides for collection of taxes on a pay-as-you-earn basis. Some form/sources of income are subjected to withholding tax (known as "tax deduction at source" in the Income Tax Act and commonly referred to as TDS). To the extent, the tax liability is in excess of the amount of TDS, the same is required to be paid as advance tax in installments during the financial year. The shortfall, if any, is required to be paid at the time of filing the tax return.

3.44 The system of collection of taxes through TDS is justified on the ground that it helps identify those who are liable to pay taxes and once identified, a taxpayer is induced to even declare incomes which he would not have otherwise declared. It is also perceived as a **"costless"** method of collection of taxes. Therefore, the coverage of TDS has been expanded over time; a significantly large proportion of the direct tax revenues is collected through this mechanism.

3.45 Our interaction with trade, industry and a cross-section of taxpayers across the country revealed considerable resistance to TDS. Their complaint was essentially against the high private cost to discharge what was essentially a government function. In a recent study on compliance cost estimates of income tax commissioned by the Planning Commission, such private compliance costs (for TDS) have been estimated to be as high as 11.8 percent of revenues. Generally, compliance costs are regressive; smaller the payer, larger is the compliance cost of TDS. Such costs essentially relate to issuing of TDS certificates to the payee, payment of TDS to the Government account and filing of TDS returns (information returns) with the tax authorities. If there are compliance deficiencies, there is an additional cost of compliance. Given the relatively high levels of compliance cost estimates, **the Task Force recommends that firms and individuals whose total sales, gross receipts or turnover from the business or profession carried on by it is less than the monetary limits specified under clause (a) or clause (b) of section 44AB should continue to be exempted from the liability of deducting tax at source.**[16a] **However, once the TIN, which has been recommended by this Task Force, is fully**

[16a.] A suggestion was made that companies with a turnover of less than Rs.40 lakhs should also be exempted from the requirement to deduct tax at source. Since such incorporated bodies are organized institutions with adequate infrastructural facilities, we are not inclined to accept this suggestion.

operationalised, the requirement to issue TDS certificates to the payee can be dispensed and the scheme can be extended to the smaller taxpayers.

3.46 As indicated above, TDS serves as a mechanism to counteract tax evasion through third party matching of information. However, such matching is constrained in the absence of PAN of the payee. Since we have recommended in the earlier section of this report the decentralisation of allotment of PAN, **we also recommend that where a payee receiving salary fails to furnish his PAN, tax should be deducted at a flat rate of 30 percent. In all other cases of such failure, tax should be deducted at twice the normal rate or 30 percent, which ever is lower.**

3.47 Under the existing system payee can claim exemption from TDS:

1. She/he can apply to an assessing officer u/s 197, for a certificate for deduction of income tax at a lower rate or no deduction of income tax. If the assessing officer is satisfied she/he shall issue a certificate as may be appropriate.

2. She/he can make a self-declaration (u/s 197A) to the effect that the tax on her/his estimated total income in which income is to be included will be NIL.

3. Where the income received by the payee is below a specified limit, no tax is required to be deducted at source irrespective of the level of income of the payee.

4. All interest payments by cooperative banks and other cooperative societies must be subjected to TDS so that the cooperatives do not develop into institutions for parking of black money. This will also ensure that there is a level playing field for all agencies competing for deposits.

3.48 However, various options are not available in respect of all categories of payments; in most cases, only the first and third options are available. Given the procedure for issue of certificates for exemption from TDS, the Task Force observed considerable dissatisfaction amongst a large number of taxpayers, particularly those at relatively low income levels and senior citizens, about the efficiency of the procedure. Most complained about having to visit the tax office repeatedly and also being subjected to fishing and roving inquiries.

Some taxpayers also complained of unethical behaviour in this regard. If the tax administration has to take recourse to TDS as an efficient system of tax collection, it must necessarily design procedures where non-taxpayers do not have to shoulder the same burden of compliance cost as other taxpayers. Concerned with the lack of such procedures, **the Task Force recommends the following:-**

1. **Tax should be required to be deducted at source irrespective of the amount of payment.**

2. **A payee should be allowed to claim exemption from TDS if she/he furnishes a self declaration to the payer that the tax on her/his estimated total income in which the income is to be included will be NIL and quotes her/his Permanent Account Number (PAN) on such.**

3. **The present system of obtaining a certificate from the assessing officer for deduction at lower rate should be abolished so as to minimize the interface between the taxpayer and tax authorities.**

3.49 Currently, payment of taxes can be made only at the specified branches of designated public sector banks in a given city. The taxpayer is required to fill up the right challan depending upon the major and minor head of the payment, i.e., whether it is a payment against Corporation-tax or Income-tax and whether it is by way of self assessment tax, advance tax, regular tax or TDS etc. The challan together with the corresponding amount of cash or cheque is presented before the authorised branch of the designated bank. In case of a cheque payment, the banks give the receipted copy of challan only after the cheque is cleared, which usually takes 2-3 days. Branches of designated banks send the challans of their various branches in a city/region to a Nodal branch from where these come together with a scroll to the Computer Centre/Central Treasury Units (CTUs) while another set goes to concerned Zonal Account Office (ZAO). The banks are entitled to a service charge of 11.18 paise per hundred rupees of tax deposited with them. Besides, they enjoy a float period of 15 days after which they transfer the tax deposited with them to the Reserve Bank of India (RBI). The procedure of reconciliation of taxes paid between Banks, Department's Computer Centres, Central Treasury Units and the Zonal Account Office is, entirely manual-based on paper copies of the challans and scrolls.

3.50 Since only a limited number of public sector banks are designated for collection of taxes and these, in turn, have authorised only a few of their branches for giving this facility, the choice before a taxpayer is very limited. In a very large number of cases, the taxpayers have to deposit taxes in a bank/branch in which they do not have their own bank account. This entails an extra period of 2-3 days for clearance of the cheques and thus the taxpayer has to visit the bank again (after 2-3 days) for collecting the paid copy of the challan.

3.51 The service charge of 11.18 paise per hundred rupees is not related to the cost of service or the cost of transaction but is related to the amount of tax paid in one challan. This is a historical legacy and, entirely, illogical. In addition, since the banks are simply collecting together the counterfoils of challans under a daily/weekly scroll and forwarding them to the Central Treasury Unit (CTU) / Zonal Account Office (ZAO) via their nodal banks, there is hardly any value added to justify the service charges of 11.18 paise per hundred rupees, in addition to the benefit of retaining the tax money for 15 days.

3.52 There are numerous instances of mistakes in challans and scrolls. There are even cases where the name of the taxpayer is not mentioned on the challan!

3.53 Since the Tax Accounting System in the Department has been fully computerised, it becomes necessary to transcribe the data on the challans after they are received in the Department. This involves huge (and increasing) data work. A delay in this affects reporting of tax collection and makes forecasting of the budget revenue collection to the Government more difficult.

3.54 **In view of our recommendation for the establishment of TIN, we recommend a revised procedure for collection of taxes and their accounting. The new procedure will be as follows:**

(a) A taxpayer will be required to fill up only one copy of the challan while making payment of taxes in the bank. The present requirement of filling up four copies of challan for payment of any tax will be given up.

(b) The banks will be networked to the TIN and receive payments online. The banks will be required to issue a computerised receipt to the taxpayer instantaneously. The date of presentation of a cheque will be treated as the date of payment. If a cheque bounces, the bank will reverse the receipt online, and the department would then be expected to prosecute the delinquent taxpayer.

(c) With instant accounting of tax collection, the requirement of enclosing a copy of the challan as evidence of tax payment, along with the annual return of income could be done away.

(d) Since the TIN will digitise all TDS returns, the requirement to file TDS certificates along with the return of income will also be dispensed with.

(e) At present, taxes are collected through approximately 10,500 bank branches. Since the proposed procedure requires banks to receive online payment, those banks that do not have adequate infrastructure for establishing online connectivity will be debarred from collecting taxes. Accordingly, the Government, in consultation with the Reserve Bank of India, should also consider paying higher charges for services rendered by banks.

The process outlined above will facilitate real-time accounting of TDS, Advance Tax and Self-Assessment Tax, and help the tax administration to swiftly identify non-compliance. Furthermore, the new procedure of tax accounting will facilitate electronic filing of tax returns.

Refund

3.55 The failure of the tax administration to issue refunds continues to be a major source of public grievance. This is partly due to its inability to promptly process the

returns, whose numbers have increased substantially in the last three years, and partly due to the cumbersome process for issuing of refunds[17]. **Therefore, we recommend the following:**

(a) **The existing cumbersome and manually-operated procedures for issue of refunds must be replaced by a more efficient IT-based system. Under the new system the department will prepare a separate file of all refunds daily which will be downloaded by a payment intermediary, i.e., a designated bank.**

(b) **The designated bank will be authorised to issue computerised refunds as is the current practice for issuing dividend and interest warrants by companies.**

(c) **The designated bank will be required to transmit the information relating to the issue of refunds to the TIN, which will also allow a taxpayer to verify the status of his/her refund claim.**

Income tax Clearance Certificates

3.56 A person leaving India by land, sea or air is required to obtain from the Competent Authority a certificate that he has no liabilities under the direct tax laws or that he has made satisfactory arrangement for payment of his existing liabilities as also for payment of the tax that may become payable by him. The persons requiring income tax clearance are those:

(i) not domiciled in India provided they have stayed in India over a period of 120 days. Generally, a person holding a foreign passport is considered as not domiciled in India;

[17] For detail procedure for Issue of Refund, reference may be made to DOMS Circular No.:54, dated 16/12/87 and Circular No.: 58, dated 08/02/98.

(ii) domiciled in India at the time of departure but-

(a) intends to leave India as an Emigrant; or

(b) intends to leave India on a work permit for employment or occupation abroad; or

(c) in respect of whom income tax authority considers that a clearance is necessary.

3.57 Case 1 was intended to facilitate collection of taxes from foreigners in respect of income that they may have earned during their stay in India. Case 2 was also intended to ensure that residents do not leave India without discharging their tax liabilities. However, over time the machinery for issuing such clearances has degenerated often leading to complaints of harassment and unethical behavior. In fact, international travel guides advice foreign tourist to budget for a certain sum to obtain such clearances. This is indeed an inhibiting factor for foreign tourists to visit India and stay long periods. It is also learnt from a cross section of officers and staff in the Department that they have yet to come across any case where such a clearance has facilitated recovery of taxes.

3.58 India has a network of treaties for avoidance of double taxation. These treaties do not provide for any bilateral arrangement for assistance in tax recovery by one country from the residents of another country. It is now learnt that OECD has proposed the incorporation of such an arrangement in all treaties and therefore India will have to renegotiate for this purpose.

3.59 The Group on Tax Policy and Tax Administration set up by the Planning Commission under the chairmanship of Dr. Parthasarathi Shome has recommended that the requirement to obtain tax clearance by foreign tourists must be dispensed with immediately. The Task Force also discussed this issue and endorsed the view of the Group.

3.60 **It is therefore recommended that the present requirement of obtaining a tax clearance certificate before leaving the country must be abolished. However in order to protect the interest of revenue, we can continue to allow the income tax authorities to notify the immigration/custom authorities to prevent any particular person from leaving the country if such person is considered to be a proclaimed offender. As a**

result only a handful of notified persons will be subjected to the process of tax clearance as against the present practice of requiring all and sundry to comply with the requirement of obtaining tax clearance before leaving the country.

3.61 In terms of the policy of the Government of India, patronage in the form of grant of license, government contracts, permits, etc should be extended only to honest taxpayers. All the Ministries, their attached and subordinate offices, public sector undertakings, ordnance factories, Directorate-General of Supplies and Disposals and Central Public Works Department strictly ensure that those who fail to discharge their tax obligations do not get any patronage from them. The concerned Department/Agencies, before granting the contract insist on the production of Income Tax clearance certificate from the Assessing officer to the effect that the concerned person has paid his taxes unless stayed by the competent authority; he has cooperated with the department in the completion of assessments by filing return of income and complying with the notices and in the past three years, she/he has not been penalized or prosecuted for tax defaults. It is also learnt that some banks have also been insisting on income tax clearance certificate before granting loans.

3.62 Application for the tax clearance is required to be made to the Assessing officer having jurisdiction over his case in a specific form. This form brings out the state of tax compliance by the concerned person. On receipt of the form, the Assessing Officer verifies from his records the facts stated therein. He looks into the position regarding payment of taxes, assessee's cooperation in completing assessment and whether he was penalised or prosecuted. Thereafter, the certificate of tax clearance is recorded by the Assessing Officer on the Application form.

3.63 The certificate is valid for one year. Application for fresh certificate can be made one month prior to the date on which the validity of the previous certificate is due to expire. Those firms of repute who have clean tax records are by Government notification exempted from the production of income tax clearance certificate. Such exemption certificate is issued on the recommendation of the Commissioner.

3.64 The existing system of issuing income tax clearance certificate has become a source of harassment and encourages rent-seeking behavior. A taxpayer is required to visit the

income tax office a number of times, thereby increasing the interface with the department, which must be avoided to the extent possible. It is not necessary that we should enforce compliance with the tax laws by denying "patronage". The tax laws provide for adequate penalties and prosecution for this purpose.

3.65 **In view of the above, it is recommended that the system of issuing Income Tax Clearance Certificates to contractors and others should be eliminated forthwith. However, to help in enhancing effective tax enforcement, all government agencies should be required to obtain the PAN of entities participating in tenders, being designated as vendors to the government, etc., and periodically submit (pre– specified) relevant information to the tax administration.**

Dispute Resolution

3.66 Under the current scheme of dispute resolution, the taxpayer has the option to either seek administrative redressal or judicial remedy. The Income tax Act specifies the categories of orders in respect of which a judicial remedy can be availed. There are several orders for which there is no judicial remedy and the administrative redressal mechanism is ineffective. This results in considerable dissatisfaction amongst taxpayers. **The Task Force therefore recommends that the Income tax Act should be amended to provide that all orders/intimation imposing any additional burden should be made appealable.**

3.67 A cross section of taxpayers lamented the absence of administrative response to their grievances particularly to those relating to issue of refunds (mostly women and senior citizens), rectification appeal effects etc. It was suggested that the office of Ombudsman along the lines in the banking sector may be setup which will help redress taxpayer grievances. **Accordingly, the Task Force recommends creating the institution of Ombudsman in the top ten-taxpaying cities and all state capitals along the lines of that in the banking sector. This institution will provide an independent system to assure that tax problems, which have not been resolved through normal channels, are promptly and fairly handled. It will also identify issues that increase burden or create problem for taxpayers, and bring those issues to the attention of the Central Board of Direct Taxes (CBDT). The Ombudsman will also enquire into, should a complaint be filed, the practices and performance of all classes of tax professionals.**

Where necessary, it will also make appropriate legislative proposals. This institution will be independent of the local tax office. Its goal will be to protect individual taxpayer rights and to reduce taxpayer burden. A consolidated annual report of the Ombudsman system will be tabled in Parliament.

Accountability

3.68 The ability of the tax administration to perform its role effectively and efficiently is in turn determined by its ability to coordinate and adapt over time the organisational structure and its resources. The organisational structure should follow from the organisations' objectives and conditions prevailing in the country. Until recently, the organisational structures of many tax administrations were not based on any overarching rationale, but instead had either emerged as a result of historical accident & bureaucratic inertia or had evolved in an ad-hoc manner. In the last few years, however, there has been a worldwide interest in reforming the organisational structure of tax departments.

3.69 One of the important general organisational issues relate to the placement of the tax administration in relation to the Ministry of Finance. While traditionally the tax administration has been placed within the Ministry of Finance, tax administrations are increasingly attracted to the Canadian model where the tax administration is placed outside the Ministry of Finance with full autonomy. Since the Finance Ministry is responsible for the preparation and execution of the government budget, it must necessarily continue to have authority over both revenue collection and expenditure to fulfill that responsibility. **Analogously, CBDT, which is responsible for administering the direct tax laws, should be given the requisite autonomy so that it is made more accountable.**

3.70 **Deeply concerned about the lack of any meaningful accountability of the tax administration, the Task Force recommends the following:**

- **(a) The control of the Central Government over the tax administration be exercised through a Memorandum of Understanding (MOU) between the Central Board of Direct Taxes and the Central Government (we understand that there is already a Cabinet decision to this effect). The Central Board of Revenue Act provides that the two boards (CBDT**

and CBEC) must function subject to the control of the Central Government, but the mechanism and the extent of control still remains unspecified.

(b) **The MOU should, inter alia, specify the financial commitment of the Central Government for tax administration.**

(c) **The MOU to provide for full financial autonomy and control over deployment of human resources to the CBDT. The Central Government should only specify the general guidelines for financial expenditure and deployment of human resources.**

(d) **The MoU should be for a period of five years specifying observable performance indicators for CBDT and the financial resources that would be made available to CBDT on a year-to-year basis.**

(e) **The CBDT should have exclusive power for designing the enforcement strategy, subject to the condition that it is non-discriminatory and transparent.**

3.71 The Task Force also observed that the turnover of Members and Chairman of the Board was too high. **The Task Force recommends that the rules for appointment of Members should provide for selection on criteria of merit-cum-seniority from amongst those who have a minimum period of two years of service before retirement as on the date on which the vacancy arises. Further, an officer once appointed as member of the Board should be debarred from any appointment either in the ITAT or Settlement Commission. Similarly, the Chairman, CBDT should be selected on criterion of merit cum seniority and once appointed should have a minimum tenure of two years.**

3.72 The Task Force also noted that the standards of accountability at the field formation level were considerably diluted since, *inter alia,* the performance targets, particularly those related to revenue collection, were unrealistic and thrust upon them. The field formations were either resigned to the failure of the targets or resorted to questionable practices to

meet revenue targets divorced from underlying economic trends. The Task Force was informed that very often officers were (informally) directed to hold back refunds to boost revenue collection. Accordingly, it is strongly recommended that the revenue targets should be based on underlying economic trends.

3.73 Regrettably, the Task Force received large number of complaints from taxpayers across the country about lack of accountability of any tax administrator for actions that were sometimes *malafide*. While our recommendations on systemic improvement and policy changes would certainly enhance transparency and reduce discretion, thereby reducing opportunities for rent seeking, nevertheless it is necessary for the tax administration to be even handed both with the taxpayers and its officials and staff. We are informed that a set of Conduct Rules exists to regulate the conduct of officers and staff. Inspite of this **we consider it necessary to reiterate the direction by the Honorable Supreme Court18 that disciplinary action must be taken in the following cases:**

1. **Where the officer had acted in a manner as would reflect on his reputation for integrity or good faith or devotion to duty;**

2. **If there is prima facie material to show recklessness or misconduct in the discharge of his duty;**

3. **If the officer has acted in a manner which is unbecoming of a Government servant;**

4. **If the officer has acted negligently or that he omitted the prescribed conditions which are essential for the exercise of the statutory powers;**

5. **If the officer has acted in order to unduly favour a party;**

6. **If the officer has been actuated by corrupt motive, however small the bribe may be because Lord Coke said long ago 'through the bribe may be small, yet the fault is great'.**

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[18] Union of India and Others Vs. Upendra Singh (207ITR-782, SC)

3.74 **Further, as a confidence building measure, the Task Force recommends that the Central Board of Direct Taxes should release annual information (giving Chief Commissioner-wise break-up) of number of complaints received from the public or acts of omission or commission identified through internal mechanism or by external agencies and the result of official enquiry into such complaints. The information must be provided separately for officers and staff. Such information may relate to tax payer profiles, returns received, headwise breakup of income, number of appeals filed and disposed of, penalty orders, rectification applications, reopening of assessment, refund orders, refunds issued, returns selected for scrutiny assessment and their results, break up of collection, etc.**

3.75 The ultimate accountability of the tax administration is to the citizens. **With a view to enhancing accountability of (and transparency in) tax administration, it is important that the CBDT publishes an annual report of its own, along the lines of the UPSC / CVC, that is tabled in Parliament and put on its web site. The annual report must separately provide for performance achievements of each Chief Commissioner / Commissioner. In addition, the quarterly progress of achievement must be displayed on the web site, so that taxpayers have an opportunity to respond. While defining a stricter accountability structure, however, care must be taken to eschew an excessive and regimented accountability system which over-burdens AOs with onerous and fragmented oversight that ultimately only serves to reduce its overall effectiveness.**

Delegation of Financial Powers

3.76 The Central Board of Direct Taxes was created out of the Central Board of Revenue in the early Sixties. Ever since it has functioned as a part of the Department of Revenue.

3.77 In those days, the Income tax department had only a few offices and not a very large number of employees. Decision making was relatively less complicated and the tax laws were simple and remained unchanged for long periods of time. This situation continued for almost three decades, with only incremental changes.

3.78 Things, however, began to change very rapidly in early nineties. The number of taxpayers increased sharply. Induction of technology was no longer a choice but a necessity.

3.79 Decision making has now ceased to be simple since speedy decisions are necessary on all issues of tax policy as well as management. Most decisions today have to be in hard real time as even soft real time may be late. Delays in decision making impose a great burden on the effectiveness of the tax administration.

3.80 In the context of the rapidly changing environment, CBDT has to attend to several functions critical to efficient functioning of Income Tax Department. It has to get ready about 55,000 personnel for induction of technology and provide world class services to more than 2 crore taxpayers. The technology induction initiative involves reorientation of the entire staff and also training them in new skills, extensive communication with taxpayers and public at large and constant review and updating of technology. It is only appropriate that at this critical juncture the CBDT is given necessary and sufficient authority to manage the affairs of the Income Tax department. Powers over the use of resources (both financial and human) must be commensurate with responsibility. A comprehensive technology induction initiative requires comprehensive authority for its implementation.

3.81 In this backdrop, it will not be out of place to mention that it is a declared policy of the Government to encourage Ministries to delegate powers to subordinate offices. As a matter of fact, Government of India decision number 7 under Rule 13 of Delegation of Financial Rules, 1978 mentions not only suitable delegation to match requirements of subordinate offices, it also stipulates a three-yearly review of the delegated powers. Unfortunately, CBDT has continued to function without any financial authority to guide and control affairs of Income Tax offices across the country. **The Task Force is of the view that the position should be immediately rectified through adequate delegation of powers to bring in synergy and effectiveness in management functions.**

Human Resource Management

3.82 **The absence of control over human resources has further undermined accountability. Therefore, we recommend that the Central Government should delegate to CBDT full authority and responsibility regarding staff of the income tax**

department and its secretariat. The CBDT should, however, exercise such delegated powers in a transparent manner within the framework of rules and guidelines framed for this purpose. Such rules and guidelines should be framed with the approval of the government.

Infrastructure

3.83 The Task Force was aghast at the physical environment prevailing in most tax offices. We were also told by professionals that office space, work conditions and basic conveniences for staff, as well as storage facilities for tax records, are grossly inadequate. Facilities for taxpayers are even worse. The existing office layout is inimical to modernisation and induction of information technology. **To institute these changes, the Task Force recommends the following:**

(a) Based on the report of the Task Force set up by the CBDT in pursuant to our recommendation in the Consultation Paper, the CBDT should request Chief Commissioners to identify the shortcomings in their offices by 1st April 2003 and send forward a proposal to CBDT.

(b) By 1st August 2003 a model Commissionerate including the offices at the range, circle and ward levels should be established in each zone.

(c) CBDT should seek the requisite financial sanction to replicate the model offices by either upgrading existing offices or, where necessary, by purchasing new premises, etc. The entire exercise should be time bound so that by January 2005 modern offices are in place in all Commissionerates.

CHAPTER 4

PERSONAL INCOME TAX REFORM

Ramifications of Tax Policy for Tax Administration[19]

4.1 By the late 1960s and early 1970s, Scandinavia, the United Kingdom and other developed countries, as well as many developing nations, had legislated multiple and high individual income tax rates. Among the highest was India's, where it was well over 95 per cent. Such high and multiple rates not only made tax administration very difficult, but also led to a state, especially in developed countries, where income tax evasion became widely accepted as standard behaviour. During this era, corporate income tax rates were also very high — with most countries legislating rates between 50 per cent and 60 per cent.

4.2 The expected negative ramification of such high marginal tax rates was that income tax became replete with exemptions, allowances, deductions and incentives. What started as sectoral and specific reliefs from high taxes were soon extended to facilitate and accommodate social or development goals. It was rarely analysed whether such tax exemptions actually achieved the desired objectives. But these developed lives of their own and, in most countries, inevitably multiplied over time — driven by interests of specific power groups at different points of time. India was no exception.

4.3 Thus, over and above the personal exemption or threshold, the individual income tax base became eroded by explicit deductions for household size (which has been used both as an allowance in some countries and as a disincentive in others), education expenses and loans (as social objective), life insurance (both for social security and saving objectives), and particular saving instruments such as government securities or small banks such as post-office saving banks. It also excluded implicit income from owner occupied housing, sometimes pecuniary income from second homes, agriculture income and so on, across the world. In some Asian and Latin American countries, certain sources of income such as interest, dividends, and gains from capital were exempted altogether. Understandably,

[19] This section is heavily drawn from Parthasarathi Shome, *India's Fiscal Matters*, Oxford University Press, New Delhi (2002).

in not a few countries including some developed ones, individual income tax came to be popularly known as a 'voluntary tax'.

4.4 The corporate income tax base also became analogously eroded. Accelerated depreciation for select activities, tax incentives for employment generation or capital equipment, tax holidays for export-oriented industry, breaks for backward region development, small-scale industry and environmental investment, and the like — all these became a part of the fiscal landscape of India. Often, these exemptions led to inequitable taxation. For example, the jewellery industry produced very large incomes, but contributed to little revenue. In other instances, it led to excessive imports of unused accessories such as windmills or solar energy panels. Such examples can be multiplied.

4.5 While some countries attempted to narrow the scope of incentives over time, many failed to carry out comprehensive reform in tax policy and concomitant tax administration. In most part, this reflected the power of lobbies and political economy constraints associated with removing a vast spectrum of incentives in one go. However, the incremental approach to reform is also fraught with dangers. The electoral cycle of democracies make it very difficult for even reformist governments to credibly pre-commit to a time-table and schedule of reforms. More often than not, this has resulted in the original objectives being diluted — only to recreate new opacity in the 'reformed' tax system.

4.6 A few facts need to be stated at this stage — facts that are common knowledge to most experts in fiscal policy.

- First, there is hardly any evidence to prove that tax incentives have, *per se*, increased investment or saving — for which these incentives were devised.

- Second, the corollary has been proven very often — namely, that scaling back of tax incentives and exemptions have almost always had a positive effect on tax policy, tax revenue, tax compliance and tax administration.

- Third, decreasing the intensity of tax incentives automatically translates to a tax expenditure. Thus, even if gross tax revenues remained the same, the net tax revenue would necessarily be higher.

- Fourth, the other important implication of "exemption raj" tax regime is the loss of effective parliamentary oversight as the resultant "tax expenditure" are not transparent and not amenable to the C&AG audit ; a clear loss to democratic governance.

- Fifth, the tax incentives create antagonistic tension between the tax administrator and the taxpayer as the tax system is being asked to meet multiple objectives such as support to R&D, development of backward area etc. This becomes a source of litigation.

- Sixth, fewer the tax incentives, the less is the discretionary space available to tax administrators to interpret the law or executive statutes. It has been repeatedly emphasised to this Task Force that the 'control over the provision of tax incentives to a particular investor' by 'government officials' is a 'major instrument that makes corruption possible' — which often results in unwarranted discretion in the hands of officials, and militates against arm's length transactions.

4.7 The results of the income tax laws due to the "exemption raj", comprising of complex, allowance and exemption, are two-fold. For honest taxpayers, on the one hand, filing the income tax return continues to be an annual exercise in complexity, and an uncomfortable fear of the assessment by the tax administrator that is to follow. On the other, a direct result of the complexity in the tax structure is the difficulty faced by tax administrators in carrying out initial assessments, as well as to execute selective audit functions.

4.8 By the beginning of the 1980s, things had begun to change — starting with developed countries and then spreading to globalising developing nations. By the mid-1990s, the structure, design and enforcement of both individual and corporate income taxes underwent major changes. Earlier ideological objectives were substituted by considerations of incentive compatibility, reasonableness, administrative feasibility, stability and the credibility of fair enforcement.

4.9 The first step in reforming the income tax structure was reducing the number of as well as the level of rates. By the mid-1990s, many developing countries had emerged from the reform process having legislated individual income tax structures with significantly

lower and fewer rates — typically 15-25-35 per cent. Even India legislated comparable rates in 1997. Similarly the corporate income tax rates were slashed — sometimes halved from the prevailing rate — driven by the twin objectives of administrative feasibility and better tax compliance.

4.10 Forces of globalisation also played a major role in the international convergence of tax rates and structures. In a world on increasingly mobile and frictionless international flow of capital, outward looking national governments soon realised that getting a share of competitive global capital necessitated keeping the tax rates low and tax rules simple — in line with global trends.

4.11 The global experience is with lower tax rates and fewer opaque exemptions, the administration of income tax became much simpler. The administration's resources was better spent on alternative investments — such as modernising the tax administration through widespread computerisation, including electronic filing, better data processing and mining, and production of far better statistical output. These resources and inputs, in turn, were more usefully employed both in formulating future tax policy, as well as in better enforcement, through more transparent and finer tax audit selection.

4.12 **At the beginning of the 21st century, some truths about taxation have become self-evident. Even so, they bear repetition.**

- **First, the design of tax policy is of paramount importance for tax administration.**

- **Second, if the objective is to have a transparent, efficient and feasible tax administration, then the structure of all taxes should comprise common elements. These are low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges, few temporary measures. And in the rare instances where there are exceptions, there should be clear guidelines.**

4.13 **The Task Force is unanimously in favour of these overarching fiscal principles. And the recommendations that follow in this chapter and the next derive from these objectives.**

Personal Income Tax Rates

4.14 It is well recognised that the rates of tax affect economic behaviour of taxpayers i.e. choice between work and leisure, the choice between consumption and savings, and also the compliance behaviour of taxpayers. The design of a personal income tax rate schedule must therefore be equitable and efficient — which are potentially conflicting objectives. A highly progressive tax rate schedule, while meeting the ends of vertical equity, causes higher distortion in the economic behaviour of taxpayers and therefore promotes inefficiency. Further, high rates of taxes induce tax evasion, thereby undermining the effective impact on equity. **The Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan has enumerated the following principles for designing the rate schedule:**

- **The basic exemption limit must be at a moderate level — an appropriate balance between the tax liability at the lowest levels, administrative cost of collection and compliance burden of the smallest taxpayers. The ability of the tax administration to render quality services to taxpayers will also significantly affect the choice of the exemption limit.**

- **The number of tax slabs should be few and their ranges fairly large to minimise distortions arising out of bracket creep.**

- **The maximum marginal rate of tax should be moderate, so that the distortions in the economic behaviour of taxpayers and incentive to evade tax payment are minimised.**

This Task Force endorses these principles.

4.15 Personal income tax rates in India were at their peak in 1973-74 — with the exemption limit at Rs.5,000, the minimum marginal rates of tax at 10 per cent, and the maximum marginal rate of tax rising to 85 per cent spread over eleven tax slabs. Additionally, there was also a surcharge of 10 per cent where the total income was below Rs.15,000, and a rate of 15 per cent in other cases. Therefore the "effective" maximum marginal statutory

rate was 97.75 per cent. The progressivity of the tax system was very high.[20] The large number of tax slabs, also distorted the progressivity of the tax system due to bracket creep. The design of the tax rate schedule was neither economically efficient nor equitable, nor amenable to voluntary compliance.

4.16 Since those days, there has been a steady increase in the exemption limit, decrease in the maximum marginal rate of tax, and reduction in the number of tax slabs. As a result, the design of the tax rate schedule has been made relatively more efficient. Since the number of tax slabs has been reduced substantially, the distortion in the equity of the schedule arising due to bracket creep has also been considerably minimised. However, there has been a steady decline in the progressivity due to the sharp reduction in the maximum marginal rate of tax and failure to adjust the tax slabs to inflation.

4.17 The exemption limit of Rs.5,000 in 1973-74 is equivalent to Rs.50,000 at current prices in 2001-2002. However, the exemption limit was increased to Rs.50,000 in 1998-99 itself i.e. 3 years in advance. Therefore, the increase in the exemption limit has outpaced inflation. Further, a survey of the effective exemption levels across countries indicate that the exemption level in India is relatively high — thereby keeping out a relatively larger number of people outside the tax net. If the share of direct taxes to GDP has to be increased to internationally prevalent levels, it is equally necessary that the tax system is as broad based as in other countries.

4.18 At present, there are three tax slabs. Most countries have three to five slabs. As mentioned, greater the number of tax slabs, larger is the distortion due to bracket creep. The fairest (in terms of horizontal equity in the broadest sense), the simplest and the most easily administrable form of income tax is a moderately progressive flat, or single marginal rate, income tax levied on a comprehensive base[21] . With a flat rate income tax, most of the defects in, and the problems caused by, an income tax with a progressive rate schedule virtually disappears[22] . With a moderate single rate, almost all the deductions and tax-preferences could be eliminated making the task of administration easy. All those with

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[20] The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan has measured the variation of tax liability for different levels of taxable income and estimated the coefficient of variation in 1973-74 was then at a high of 1.06. Since then the progressivity of the tax rate schedule has declined substantially to 0.64.

[21] Government of India,(December 1991), Interim Report of the Tax Reforms Committee.

[22] Ibid.

taxable incomes can opt for tax deduction at source to the maximum extent possible — thus making tax deduction at source can become an important way of collecting tax.

4.19 Full integration of personal and corporate income taxes can be achieved by applying the same single rate to both incomes and exempting dividends in the hands of the shareholders. With a single rate, the inequality in the treatment between steady and fluctuating incomes as well as between incomes that are concentrated during a short period in life and those that are spread over a long period will be greatly reduced. All capital gains can be taxed as ordinary income, with long-term gains being suitably indexed for inflation. With a single rate, "bunching" does not cause any serious problem. There will be need only for the indexation of the exemption level; there will be no bracket creep. Inflation will still create problems, but the interaction of inflation and income taxation will produce much less iniquitous effects than under a progressive schedule.

4.20 However, a single rate cannot be pitched at a high level. Therefore, the rate of progression that can be achieved will inevitably be moderate. By many, this is considered to be the single most significant demerit of the system. In the Indian context, since a single rate would have to be around 30 per cent, the exemption level would also have to be fairly high. That, in turn, would leave out some people who could reasonably be brought within the income tax net with a lower tax rate.

4.21 **The Task Force, therefore, decided to reject the imposition of a single individual income tax rate, and instead opt for a reformed system of personal income tax with more than one rate. The Task Force believes that the alternative lies in a multiple rate schedule, but with very little spread.**

4.22 An opinion was expressed in some quarters that the entry tax rate in personal income tax should be relatively low so that it does not frighten potential taxpayers from being in the tax net. However, with a low entry rate, the number of rates inevitably multiplies, and the tax administration ends up at square one — all the problems associated with a progressive rate schedule.

4.23 The Task Force's aim is precisely to minimise these problems. Our perception is that potential taxpayers at the lower end of the scale are frightened not by the entry rate of

tax (since the average tax continues to be very low) but more by the compliance and enforcement procedures. The Task Force, therefore, believes that it is not necessary to lower the entry rate of tax. **Further, in view of the distortionary impact of multiple slabs, the Task Force recommends a two rate schedule for personal income tax.23 But before outlining the slabs and their rates, it is necessary to explain the empirical reasons for arriving at such a conclusion.**

4.24 In 1973-74, the tax rates of 10 per cent and 20 per cent were applicable for incomes up to Rs.10,000 and Rs.20,000 respectively. The corresponding inflation adjusted income levels are Rs.1,00,000 and Rs.2,00,000 in 2001-2002. Thus, the existing corresponding income levels of Rs.60,000 and Rs.1,50,000 are substantially lower than the inflation-indexed levels — thereby resulting in an increase in the real tax liability. Historically, while the top marginal rates of tax have been reduced, the tax liability at the middle has indeed increased. This has, not surprisingly though, has given rise to the problem of "the missing middle". **If the full effect of lower tax rates has to be realised, it is not only necessary to have an optimal enforcement strategy but also ensure that the benefits of a tax cut apply to all class of taxpayers — rather than be restricted to a handful of taxpayers at the top end. This is possibly achieved by broad basing the tax slabs and we recommend accordingly.**

4.25 **In view of the above, we had recommended in the Consultation Paper for public debate that the personal income tax rate schedule should be revised along the lines indicated in Table 4.1.**

Table 4.1 : Proposed Personal Income Tax Structure.

Income level	Tax rates
Below Rs. 1,00,000	Nil
Rs. 1,00,000-4,00,000	20 percent of the Income in excess of Rs. 1,00,000/-
Above Rs. 4,00,000	Rs.60,000/- plus 30 percent of the Income in excess of Rs. 4,00,000\-

[23] This is consistent with the recommendations in the Interim Report of The Tax Reforms Committee (Chairman : Professor Raja J. Chelliah)

4.26 **Further, the revenue gain from levy of surcharge is generally illusory since such a levy has the effect of increasing the marginal rate of tax, which adversely affect compliance. Therefore, we had also recommended that the present surcharge of 5 per cent on taxpayers with incomes above Rs. 60,000/- must be eliminated.**

4.27 Reacting to the rate schedule proposed in **Table 4.1**, some section of the public (including tax administrators) have expressed apprehension at the possibility of a large number of taxpayers dropping out of the tax net consequent to the sharp increase in the exemption limit. It was felt that if indeed this happened, the programme for widening the tax base would suffer a serious set back. However, given the package of administrative and policy reforms and empirical evidence, the apprehension is misplaced.

4.28 A substantial part of the proposed increase in the exemption limit will be neutralized by our recommendations in the subsequent sections for the withdrawal/elimination of standard deduction, saving incentives u/s 80-L, and conversion of income based deduction into rebates. Therefore, the effective increase in the exemption limit is substantially less.

4.29 The recent sharp increase in the number of taxpayers is attributed to the one by six scheme, which provides for filing of returns by any person who owns the specified assets or has incurred specified expenditure. This scheme has had a direct effect on increase in the number of non-taxpayer filers. However, it appears that this scheme has also had a deterrent effect[24]; taxpayers who would not have otherwise filed their tax returns and disclose their income, have been induced to file their return for fear of identification through the one by six scheme. Since there is no recommendation by us to abolish this scheme, we believe that it would not be possible for existing filers to escape their filing liability.

4.30 We recognise that there could be filers who are not covered by the one by six scheme but have taxable income in the range of Rs. 50,000/- to Rs. 1,00,000/-. Consequent to the increase in the exemption limit, such filers would drop out of the tax net. This is possible only in a static condition. With annual increase in taxpayers income, such filers would be pushed back into the tax net. Empirical evidence suggests that increase in exemption limits have never resulted in the fall in the number of taxpayers **(Table 4.2)**.

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[24] However, this needs to be proved empirically.

Table 4.2 : Trend of Exemption Limit for Personal Income Tax and the Growth of Taxpayers Base

Financial year	Number of taxpayers (as on 1st April of the year)	Exemption limit (at current prices)	Financial year	Number of taxpayers (as on 1st April of the year)	Exemption limit (at current prices)
1965-66	2126398	3000	**1984-85**	4932094	15000
1966-67	N A	3500	**1985-86**	4937657	18000
1967-68	2696407	3500	**1986-87**	5502142	18000
1968-69	2708464	3500	**1987-88**	6261465	18000
1969-70	N A	3500	**1988-89**	7883247	18000
1970-71	3230000	5000	**1989-90**	8583690	18000
1971-72	3012570	5000	**1990-91**	8934442	22000
1972-73	3208516	5000	**1991-92**	9391172	22000
1973-74	3388259	5000	**1992-93**	9671289	28000
1974-75	3460843	6000	**1993-94**	10450677	30000
1975-76	3637434	6000	**1994-95**	11668075	35000
1976-77	3796258	8000	**1995-96**	13208781	40000
1977-78	3778724	10000	**1996-97**	14094644	40000
1978-79	3955244	10000	**1997-98**	15979205	40000
1979-80	3969965	10000	**1998-99**	17578326	50000
1980-81	4175615	12000	**1999-2000**	21744508	50000
1981-82	4594425	15000	**2000-01**	25052380	50000
1982-83	4660865	15000	**2001-02**	28681380	50000
1983-84	4797260	15000	**2002-03**	34407380	50000

Sources : 1. Annual Reports of the Ministry of Finance (different years) 2. Comptroller and Auditor General of India, reports for various years. 3. Performace Statistics of the Income Tax Department (different years). 4. CAP statement of Income Tax Department(different years)

Note : The number of taxpayers as on 1st April, 2002 indicated is based on the above sources. The CBDT has informed that the number of taxpayers as on 1st April, 2002 is 300.02 lakhs. This needs to be reconciled. However, this difference does not in any way effect the point that the Task Force intends to make

4.31 Our recommendation relating to broad basing of the tax slabs will reduce the marginal rate of tax for most taxpayers. This in turn, at existing enforcement levels, will induce a large number of taxpayers (particularly businessman / professionals) to disclose higher incomes. Increase in voluntary compliance will therefore contain the potential damage to the tax base.

4.32 The creation of the Tax Information Network (TIN), would enable the department to continue to keep a watch on non-taxpayers at the margin and also identify non-filers. This will, in-fact, provide an impetus to the ongoing programme for widening of tax base. Further, we are also guided by the consideration that an average family[25] need not necessarily be subjected to a progressivity tax in the form of income tax and its compliance burden. Their contribution to the national exchequer through consumption tax should be adequate.

4.33 A large number of individuals file their returns to claim refund because their income has been subjected to TDS even though their aggregate income is below the exemption limit. Since income will continue to be subject to TDS, such returns will continue to be filed. **In the light of the above, the Task Force is of the view that the current initiatives to widen the tax base would not be jeopardised in anyway.**

4.34 A section of the public (including some in the government) expressed a view that a two rate structure is not progressive enough. It was also argued that as in most other countries, we should continue to have a three rate structure with a lower entry point of tax.

4.35 The Task Force has estimated the progressivity of the tax schedule as measured by the coefficient of variation of tax liability at assumed levels of taxable income (Table – 4.3 and Chart – 1). The progressivity of the tax schedule has registered a steady decline since 1973-74 from a high of 1.18 to 0.7 in 2002-03[26]. The progressivity will increase from 0.7 to 1.04 consequent to the reduction in the number of slabs. The intuitive logic for this increase in progressivity is simple. Under the existing three slab rate schedule, the maximum marginal rate of 30 per cent is applicable to incomes above Rs. 1,50,000/-. Therefore, most

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[25] Given the per-capita income of Rs. 18,000/- in 2001-02, the average family income in most cases would be Rs. 1 lakh in 2003-04.

[26] It increased to 1.26 in 1974-75 before beginning to decline steadily.

taxpayers are subjected to tax at the same higher rate. Under the rate schedule proposed by us, most taxpayers would be taxable at the lower rate of 20 per cent and about 2 per cent of the taxpayers at the upper end only will be liable to tax at 30 per cent.

4.36 Most countries across the world have three to five rates, not because of the virtues, if any, of a multiple rates structure. Infact, multiple rate structures enhance problems of bracket creep and income smoothening. These countries have such a structure because of a low exemption limit with virtually no other exemptions / incentives. As a result, it is necessary to have low rates at the entry point to maintain the average rates at reasonable levels. If you have a low entry point of tax, then it becomes necessary to have multiple rates to reach a specified maximum rate. In India, the general exemption limit is at a moderate level coupled with large number of tax exemptions. Reform of such a system is possible only by substituting specific incentives by a generalized deduction in the form of an increase in exemption limit[27]. If the general exemption limit has to be raised, the rate of tax at the entry point cannot be relatively low since it will result in significant revenue loss without any design improvement.

4.37 **In view of the above, we do not consider necessary to alter the personal income tax rate schedule contained in Table-4.1 and accordingly endorse the same.**

Personal Income Tax Base

4.38 A negative effect of the early high marginal tax rates was that the income tax became replete with exemptions, allowances, deductions and incentives. Various exemptions and deductions still continue — in spite of significant reduction in personal income tax rates. As a result, the personal income tax law remains riddled with complexity, which inhibits voluntary compliance. Further, these benefit only a class of privileged taxpayers[28] and to the extent base is eroded, the large mass of general taxpayers have to bear the entire burden of a target revenue mobilisation effort. The consequential effect is the increase in marginal rates of tax — which in turn distorts economic efficiency and incentivises tax

[27] The tax reform proposals are generally designed to be arithmetically revenue neutral and therefore withdrawal of incentives must necessarily be compensated by increase in the general exemption limit and/ or reduction/rationalisation in tax rates.

[28] This is further restricted due to information asymmetry.

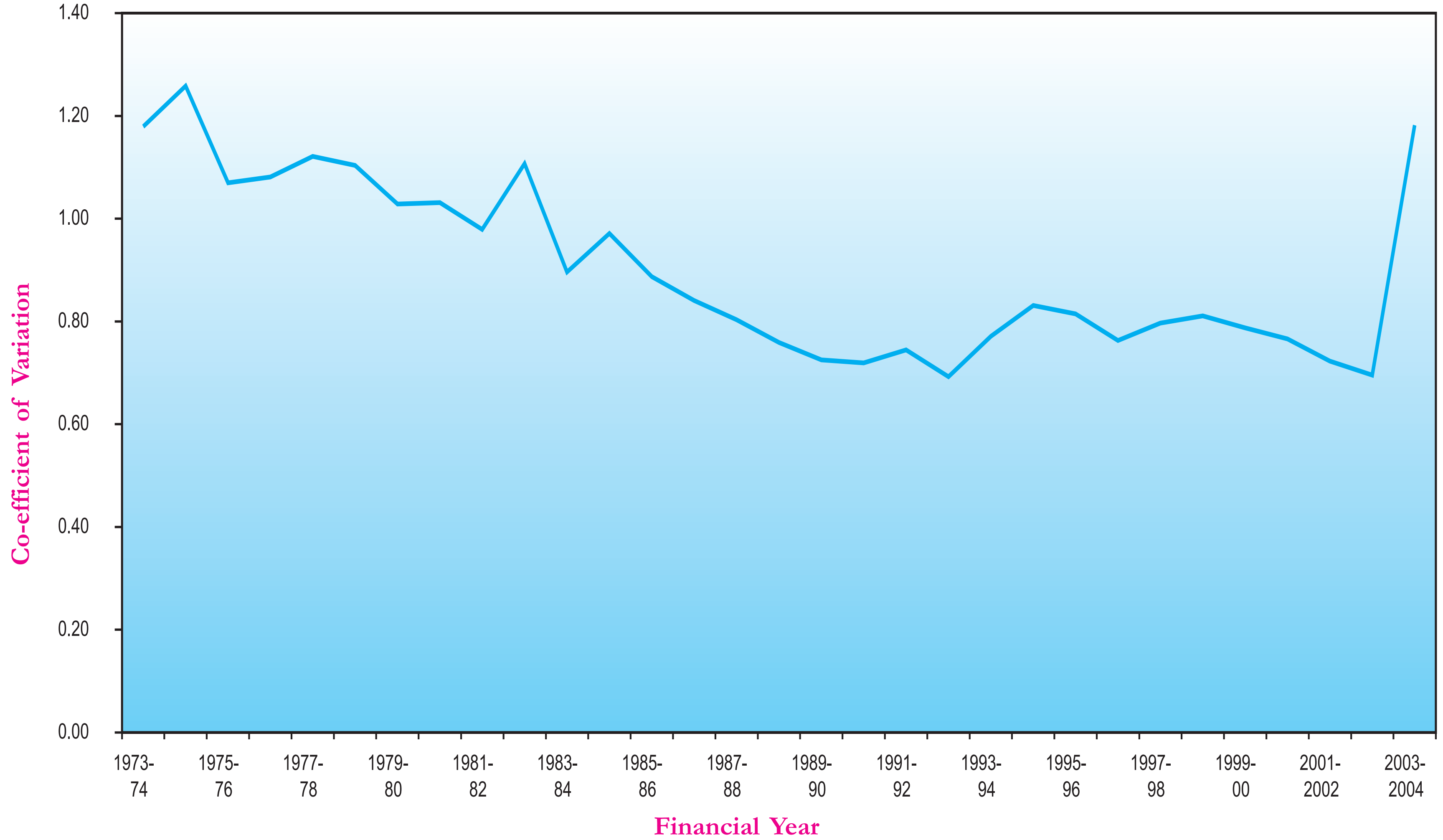
Table – 4.3

PROGRESSIVITY OF THE PERSONAL INCOME TAX SCHEDULE

Fin. Year	Income Levels	Average tax Liability for Assumed Level of taxable Income at 2003-2004 prices												Coefficient of Variation
		50000	60000	75000	100000	120000	150000	175000	200000	300000	500000	1000000	2000000	
1973-74		0.00	1.47	3.37	5.28	7.26	9.55	12.10	13.89	22.08	37.91	58.51	75.26	**1.18**
1974-75		0.00	1.96	4.21	6.95	8.54	10.95	12.83	15.35	26.07	0.00	57.08	67.04	**1.26**
1975-76		0.00	0.00	2.15	6.29	8.36	10.99	20.95	22.46	34.28	61.78	70.33	73.66	**1.07**
1976-77		0.00	0.00	1.90	5.55	7.37	9.76	11.59	13.58	21.79	32.55	47.02	56.51	**1.08**
1977-78		0.00	0.00	0.00	6.54	6.19	9.09	11.66	13.96	23.38	35.00	50.16	59.58	**1.12**
1978-79		0.00	0.00	0.00	6.89	6.66	9.47	12.22	14.63	24.12	35.73	50.78	59.89	**1.10**
1979-80		0.00	0.00	4.63	7.97	8.02	11.34	14.03	16.78	26.83	39.09	54.37	63.18	**1.03**
1980-81		0.00	0.00	5.54	4.38	6.95	10.83	13.82	16.94	25.96	38.03	51.34	58.67	**1.03**
1981-82		0.00	0.00	0.00	5.45	10.05	14.96	18.47	21.66	29.90	41.16	53.27	59.63	**0.98**
1982-83		0.00	0.00	0.00	7.49	11.74	16.62	20.36	23.31	31.76	0.00	54.56	60.28	**1.11**
1983-84		0.00	0.00	1.85	8.79	13.10	18.72	22.48	25.29	34.54	46.09	56.79	62.15	**0.90**
1984-85		0.00	0.00	3.06	8.69	12.49	17.51	9.59	14.02	32.40	42.68	52.28	57.08	**0.97**
1985-86		0.00	0.00	0.78	6.83	10.65	14.52	16.73	18.39	25.53	33.24	41.62	45.81	**0.89**
1986-87		0.00	0.00	2.46	8.40	12.00	15.60	17.66	19.81	26.54	34.41	42.21	46.10	**0.84**
1987-88		0.00	0.00	4.43	10.29	13.57	16.86	19.89	22.65	29.10	37.56	45.03	48.77	**0.80**
1988-89		0.00	1.18	5.94	11.74	14.78	17.82	21.51	24.07	30.05	38.66	45.58	49.04	**0.76**
1989-90		0.00	2.66	7.16	12.87	15.72	20.14	23.43	25.91	31.74	40.65	47.32	50.66	**0.73**
1990-91		0.68	3.90	8.18	13.63	16.36	20.14	22.98	25.11	34.86	43.32	49.66	52.83	**0.72**
1991-92		0.00	2.69	6.71	12.53	15.61	20.49	23.27	28.41	36.26	44.16	50.08	53.04	**0.74**
1992-93		1.18	4.32	8.90	14.17	17.90	22.32	24.85	26.74	38.12	45.27	50.63	53.32	**0.69**
1993-94		0.00	1.33	5.07	8.80	12.33	15.87	17.89	21.73	29.42	35.57	40.19	42.49	**0.77**
1994-95		0.00	0.00	2.62	6.97	9.83	13.86	16.17	17.90	29.45	33.67	36.83	38.42	**0.83**
1995-96		0.00	0.00	2.21	6.66	10.54	14.43	16.66	18.32	25.54	31.33	35.66	37.83	**0.81**
1996-97		0.00	0.00	3.72	8.63	12.19	15.75	17.79	20.16	26.77	32.06	36.03	38.02	**0.76**
1997-98		0.00	0.46	2.37	5.70	8.08	10.46	11.83	12.85	18.08	22.85	26.42	28.21	**0.80**
1998-99		0.00	0.00	1.45	5.90	8.25	10.60	11.94	13.34	18.89	23.33	26.67	28.33	**0.81**
1999-00		0.00	0.00	2.20	7.15	9.63	12.10	13.51	15.45	21.30	25.98	29.49	31.25	**0.79**
2000-2001		0.00	0.30	3.21	7.91	10.26	12.61	14.61	17.09	22.89	27.54	31.02	32.76	**0.77**
2001-2002		0.00	0.77	3.83	7.97	10.04	12.11	13.81	15.91	20.81	24.72	27.66	29.13	**0.72**
2002-2003		0.00	1.22	4.77	8.83	10.86	12.89	15.06	17.12	21.91	25.75	28.62	30.06	**0.70**
2003-2004		0.00	0.00	0.00	0.00	3.33	6.67	8.57	10.00	13.33	18.00	24.00	27.00	**1.04**

Chart - 1

Trend of Progressivity of Tax Schedule



evasion. The very objective of reduction in tax rates is, therefore, only partially achieved. **If compliance is to be fostered and nurtured and economic incentive sustained, it is necessary to review the various exemptions, deductions and rebates.**

Exemption Based on Residential Status

4.39 Under the Income Tax Law in India, the tax base of a taxpayer is effected by the residential status enjoyed by him. A taxpayer could have one of the following three residential status:-

- **Resident :** A taxpayer is treated as a resident if he is:
  - (a) Resident in India for 182 days or more during the financial year;
  - (b) In India for a period of 60 days or more during the financial year and resident in India for at least 365 days in aggregate during the preceding four financial years.
- **Resident but Not Ordinarily Resident :** A taxpayer is treated as resident but nor ordinarily resident if he is:
  - (a) Resident in India for less then 9 years out of the preceding 10 financial years ; or
  - (b) Resident in India for a period or periods amounting in all to less then 730 days during the preceding 7 financial years.
- **Non Resident :** A taxpayer is treated as non resident if he is neither a resident or resident but not ordinarily resident.

4.40 Residents are subject to tax on their world-wide income. Persons who are resident but not ordinarily resident are taxed only on Indian-sourced income[29], Non-residents are taxed only on Indian-sourced income and on income received, accruing or arising in India[30].

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[29] This includes income deemed to accrue or arise in India, income received in India or income received outside India arising from either a business controlled, or a profession established, in India.

[30] Nonresidents may also be taxed on income deemed to accrue or arise in India through a business connection, through or from any asset or source of income in India, or through the transfer of a capital asset situated in India (including a share in a company incorporated in India).

4.41 Persons who are resident but not ordinarily resident, enjoy exemption in respect of their foreign sourced income, even though in qualitative terms they are no different from residents. To the extent that most double taxation avoidance agreements provide for taxation of interest income in the country of residence, persons who are residents but not ordinarily residents enjoy exemption from foreign tax by claiming to be residents in India for the purpose of a treaty. Thanks to this peculiar category, therefore, a large number of such taxpayers end up paying no tax on their foreign sourced income, either in India or in any other part of the world. Further, most countries across the world provide for only two status: Residents and Non-residents.

4.42 **Accordingly, the Task Force recommends that residents but not ordinarily residents must be subjected to tax on their global / world-wide income at par with residents. To do so, this unusual category of resident but not ordinarily resident taxpayers must be deleted.**

4.43 **This will not only enhance the income tax base, but also remove an antiquated anomaly and simplify the law.**

Standard Deduction for Employees

4.44 Under the Income Tax Act, a taxpayer is allowed a deduction of a certain percentage of his salary income subject to a maximum amount as standard deduction in the computation of his salary income chargeable to income tax. At present standard deduction is allowed from the gross salary of the taxpayer, according to the following schedule:-

1. For gross salary below Rs.1.5 Lakh the amount is restricted to 1/3rd of the gross salary or Rs.30,000, whichever is less.

2. For gross salary between Rs.1.5 Lakh and Rs.3 Lakh, the amount is restricted to Rs.25,000.

3. For gross salary between Rs.3 Lakh and Rs.5 Lakh, the amount is restricted to Rs.20,000.

4. For gross salary above Rs.5 Lakh, no standard deduction is allowed.

In addition to the above, salaried employees are also eligible for a deduction up-to a maximum of Rs.9,600 towards conveyance allowance received from their employer.

4.45 The standard deduction allowed against salaried income is ostensibly to compensate, on an estimated basis, for the expenditure incidental to the employment of the taxpayer. The existing high level is often justified on the ground that unlike in the case of a self-employed taxpayer, a salaried employee does not have opportunities to evade taxes[31]. As a result, the effective tax burden on salaried employee is greater then those deriving income from self-employment/business and that the bulk of the personal income tax revenues flow from salaried employees. Therefore, the standard deduction should be seen as compensating for loss of such 'privilege' and mitigating the effective tax burden.

4.46 It is indeed true that a self-employed taxpayer has greater opportunities to evade taxes by lumping there personal expense with other expenses which are tax deductible. However, such lumping is often investigated and in most cases disallowed. Further, it is not uncommon amongst salaried employees both in the private and public sector to evade taxes (like self-employed taxpayers) on their illegitimate incomes through rent seeking and voucher payments.

4.47 Similarly, the perception that the effective tax burden on salaried employee is greater than those deriving income from self-employment/business is also not borne by the tax treatment of perquisites received by a salaried employee. The tax treatment of various forms of income in the hands of a salaried employee and a self-employed is summarised in **Table 4.4**. A large number of perquisites which are available to salaried employees is either concessionally treated or fully exempt, thereby substantially reducing the effective tax burden on a salaried employee. In the case of a self-employed all such benefits have to be paid for out of the post tax income. Hence, the justification of standard deduction on the count that the effective tax burden on salaried taxpayers is relatively higher then self-employed taxpayers is extremely weak.

4.48 The argument that the bulk of the income tax revenues are contributed by the salaried taxpayers is driven by perception rather than facts. On estimate, salaried taxpayers

[31] Self-employed taxpayers have the opportunity of lumping their personal expenses with other business expenses which are tax deductible.

Table 4.4 : Treatment of benefits/expenditures across salaried and self-employed taxpayers.

Nature of benefit/ expenditure	Treatment in the hands of the salaried employee	Treatment in the hands of the self-employed	Remarks
Expenditure on travelling from home to work place.	Almost, all salaried employees in the organised sector are granted a conveyance allowance, which is **exempt** from tax, subject to a ceiling of Rs. 9,600/-.	No deduction available.	
Expenditure incidental to the employment of the taxpayer.	A standard deduction restricted to 1/3rd of the gross salary or Rs. 30,000/- whichever is less for taxpayers with gross salary below Rs. 1.5 lakh. However, the standard deduction is restricted to Rs. 25,000/- and Rs. 20,000/- for taxpayer with gross salary between Rs. 1.5 lakh to 3 lakh and between Rs. 3 lakh to 5 lakh respectively. No standard deduction is available to a taxpayer whose gross salary exceeds Rs. 5 lakh.	No such deduction is allowed.	Lumping of any such personnel expenses with business expenses is disallowable.
Valuation of residential accommodation provided by the employer	Concessional tax treatment.	No such perquisite is available.	A self-employed can avail of the benefits of a residential accommodation can only be availed from post tax income.
Value of furnished accommodation.	Concessional tax treatment.	No such perquisite is available.	A self-employed can avail of the benefits of a residential accommodation can only be availed from post tax income.
Perquisite value of motor car used for personnel purposes.	Concessional tax treatment.	Fully taxed.	

Contd… Table IV.4

Nature of benefit/ expenditure	Treatment in the hands of the salaried employee	Treatment in the hands of the self-employed	Remarks
Provision of medical facilities (proviso to Sec. 17(2).	➢ Fully exempt, if the medical treatment is in specified hospitals ➢ Medical reimbursement other than above is exempt up-to Rs. 15,000/-	Fully taxed	
Interest free/concessional loans for medical treatment of specified diseases	Fully exempt	Fully taxed	
Expenses on employee's telephone including mobile phone	Fully exempt	Fully taxed	
House rent allowance	Concessional tax treatment	Fully taxed	
Leave travel allowance	Fully exempt	Fully taxed	

contribute only about 35 per cent of the personal tax revenues; the balance 65 per cent is contributed by the self-employed.

4.49 The levels of standard deduction have increased substantially over the years both in terms of the percentage and the overall ceiling — almost out of sync with the actual employment related expenses. The level of Rs.500 in 1974-75 allowable as standard deduction would now be equivalent to approximately Rs.5,000 in current terms. Once conveyance expenditure is separately exempted from taxation, it is difficult to visualise any other employment related expenditure other than personal in nature. This is particularly so when most employers provide for books and periodicals in the work place[32].

4.50 Unfortunately over the years, the increase in the standard deduction is an outcome of periodic demand for increase in the exemption limit by the salaried employees. Further the provision of a standard deduction to salaried taxpayers over and above the basic exemption limit is iniquitous in as much as it discriminates against self-employment. The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan strongly recommended downward adjustment of this benefit.

4.51 Since then, the Task Force has also collected information across countries on the allowability of employment related expenses **(Table 4.5)**. In most countries, no deduction is allowed for employee related expenses. Where such expenses are allowed, these are either based on actuals supported by documentation or on a presumptive basis with a cap at a very low level both in percentage and absolute terms (except Thailand). Therefore, the scale of the deduction for employee related expenses in the form of standard deduction is not in line with the best international practice.

4.52 The loss in revenue on account of standard deduction is substantial — more so because conveyance allowance is exempt from tax. Also, standard deduction of this relative scale are not in line with the best international practice and our recommendation on enhancing the general exemption limit.

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[32] In fact in the government, the expenditure by senior officers on newspapers is reimbursed. In the case of the corporate sector, the expenditure on newspapers and periodicals is an allowable business deduction without being treated as a perquisite in the hands of the employee.

Table 4.5 : Tax treatment of Employee related expenses@

Country	Whether any deduction is allowed for employee related expenses@?	Remarks
Bangladesh	No	
Singapore	No	
Italy	No	
New Zealand	No	
Sri Lanka	No	
Malaysia	Yes	Actuals supported by documentation.
Indonesia	Yes	5 per cent up-to a limit of Rp 1296 a year.
Philippines	No	
Germany	Yes	A lump-sum amount of Euro 1044 is deductible.
Netherlands	No	
Argentina	No	
Peru	No	
United Kingdom	Yes	Actuals
Japan	Yes	Standard deduction
Australia	No	
France	Yes	10 per cent of the salary subject to a limit of Euro 12229.
Thailand	Yes	40 per cent subject to a limit of Baht 60000.
United States	No	
Canada	No	
India	Yes	Standard deduction of 33.3 per cent subject to a limit of Rs. 30000.

@ Employee related expenses are those, which are equivalent to the expenses, represented by the standard deduction u/s 16(1) of the Income Tax Act 1961 of India. Such expenses are wholly and exclusively incurred by the employee in the performance of the duty of employment, otherwise than those, which are reimbursed by the employer.

4.53 **The Task Force, therefore, recommends that standard deduction under Section 16(1) of the Income Tax Act should be eliminated. However, the exemption of conveyance allowance subject to a ceiling of Rs. 9,600/- should be continued. This should serve as a reasonable deduction for employment related expenses. The additional liability of a taxpayer on this account will be more than met by the reduction in rates of personal income tax proposed by the Task Force.**

Treatment of Imputed Income from Owner Occupied House Property

4.54 Up to assessment year 1986-87, a notional annual value subject to a maximum of 10 per cent of the adjusted total income was imputed to the benefit flowing from the self-occupation of the house property. Accordingly full allowance by way of deduction was made for ground rent, repair and maintenance, interest on borrowed capital and similar other items of expenditure.

4.55 However, from assessment year 1987-88, the notional annual value imputed to the benefit flowing from self-occupation of the house property was deemed to be nil. Accordingly, it was provided that no deduction for the various items of expenditure would be allowed except a small amount of Rs.5,000 towards interest on borrowed capital. While non-deductibility of the various items of expenditure is consistent with the matching principle that expenditure relating to a particular item/source of income should be allowed only if the income is liable to tax in the economic/accounting sense, the allowability of interest expenditure up-to Rs.5,000/- is a deviation from this principle. The problem has been further compounded by increasing the ceiling from Rs.5,000 to 1,00,000 in assessment year 2001-02, and further to Rs.1,50,000 for assessment year 2002-03 and subsequent years. The increase far exceeds the inflation during this period.

4.56 This incentive is in the nature of tax subsidy. Such a tax subsidy is both iniquitous and inefficient. To the extent income from owner occupied dwelling is not imputed for tax purposes, it encourages owners to keep the dwelling premises vacant rather than rent. Similarly, the incentive is inequitous between non-taxpayer owners and taxpayer owners – a housing subsidy for owners with higher income. Even amongst taxpayer owners, it confers relatively higher tax relief to those with higher income since they are subjected to a higher marginal rate of tax.

4.57 **Table- 4.6** below indicates that during 2001-02, an amount of Rs. 14,811 crores was disbursed by all the housing finance companies to 4,41,143 loanees[33]. Of this, there were 3,76,556 new loanees who availed of loans below Rs. 5 lakhs constituting 85 per cent of the new loanees. The share of this category of loanees in the total amount disbursed is only 59 per cent. The average size of the loan to these 85 per cent of the loanees is Rs. 2,32,661/-. The annual interest burden on such average loans would be around Rs. 25,000/-[34]. A large number of the new loanees in this category are likely to be non-taxpayers and therefore do not enjoy any kind of subsidy. Equally large number would be those who would be taxpayer owners, of which a significant proportion would have rented out their houses while a small proportion would be under owner occupation. Hence, a very small proportion of this category of loanees benefit from the tax treatment of mortgage interest on owner occupied dwelling.

4.58 Similarly, there were 48,145 and 16,442 new loanees during 2001-02 who availed of loans between Rs. 5 lakhs to Rs. 10 lakhs and above Rs. 10 lakhs, respectively. They constitute 11 per cent and 4 per cent of the new loanees, respectively. There share in the total amount disbursed is 23 per cent and 18 per cent respectively. The annual interest burden on the average loan in the two categories is estimated to be Rs. 75,000/- and Rs. 1,60,000/- respectively. Given the size of the EMI payment for loanees in these two categories, it would be reasonable to assume that the average income of such loanees would be above Rs. 3 lakhs per year. Loanees in these categories will benefit substantially from our proposal to reduce tax rates and broaden the tax slabs. Additional relief by continuing with the tax subsidy for owner occupied dwelling for taxpayers with such high levels of income only helps to undermine vertical equity.

4.59 A conventional case for continuing housing incentive is based on the argument that it will adversely affect housing activities which has a multiplier affect on many other industries. It is also argued that the housing sector has been the engine of growth in the last two years driven mostly by the tax incentive for mortgage interest for owner occupied dwelling.

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[33] National Housing Bank has also informed that an equal amount with similar loan profiles can be estimated to have been disbursed as housing loans by the various commercial banks.

[34] This would be so for a repayment period of 10 to 15 years.

Table 4.6 : Number of Loanees and Amount Dispersed by Housing Finance Companies during 2001-02.

Size of the Housing Loan	No. of Loanees (Rs. in crs.)	Amount Disbursed loan	Percentage		Average size of the
			Loanees	Amount	
Up-to Rs. 5 lakhs	376556	8761	85%	59%	232661
Rs. 5 lakhs to Rs. 10 lakhs	48145	3442	11%	23%	714923
Above Rs. 10 lakhs	16442	2608	4%	18%	1586182
Total	**441143**	**14811**	**100%**	**100%**	**335741**

Source : National Housing Bank.

4.60 During the last two years the financial markets have witnessed instability due to scams etc. resulting in the erosion of investor confidence. This has compelled people to look for alternative forms of investment in the real sector like housing. Simultaneously during this period, the cost of housing has plummeted to its lowest; hence an attractive opportunity for people disillusioned with the performance in the financial market to invest in a house. While the opportunity is available, one of the factors affecting the decision to invest in a house would obviously be the effective cost of borrowing. Since this is, in turn, determined by the tax treatment of the nominal cost of borrowing, the tax incentive induces investment in housing. The prevailing nominal cost of borrowing was 12.5 per cent on housing loans for a period of 11 to 15 years[35]. The effective cost of borrowing for a taxpayer with a 20 and 30 per cent marginal rate of tax was 10 per cent and 8.75 per cent, respectively. The nominal cost of borrowing for similar loans have since reduced to 10.25 per cent. *Prima facie*, all the developments enumerated above are expected to have a positive effect on investment in housing. As yet, there is no study, which has disagreegated the impact of the various factors on the housing sector. It is therefore fallacious to argue that the withdrawal of the limited tax incentive will have any serious impact on housing. In any case, with the expected reduction in the interest rate for housing loans in the immediate future, the increased burden on account of withdrawal of the incentive would be substantially neutralised, if not eliminated.

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[35] This was so when the incentive was increased to Rs. 1,50,000 in the Union Budget 2001,

4.61 Further, incentives for savings in financial instruments are proposed to be eliminated across the board. The relative attractiveness of investment in housing will therefore continue. Since most taxpayers with capacity to pay annual interest of Rs. 1,50,000 will benefit substantially[36] from reduction in tax rates due to broad basing of the tax slabs, they will have relatively larger amount of equity fund to invest in a house. The weighted average effective cost of borrowing will in most cases remain unchanged. It will also enable the taxpayer to accelerate the repayment thereby benefiting from reduced interest outgo[37]. Such investors in house will also benefit from our proposal to abolish wealth tax.

4.62 The proposal to reduce corporate tax rates in the subsequent sections of this report will substantially benefit the housing finance companies since they would be unaffected by the simultaneous withdrawal of a large number of tax preferences[38]. These companies should be expected to shift this benefit forward to the borrowers by way of reduced interest.

4.63 Our recommendations on capital gains restricting the exemption for rollover of capital gains, to investments in housing and the bonds of the National Highway Authority should divert more than Rs.1,000 crores to housing. This in itself should spur housing and other allied activities.

4.64 Further the deduction for mortgage interest for owner occupied dwelling is also inconsistent with international practice. In most countries, the mortgage interest in respect of loans for acquiring owner occupied dwelling is not deductible, as **Table 4.7** shows.

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[36] We estimate tax savings of more than Rs. 35,000.

[37] The interest on home loans with shorter maturity period are relatively less than those with longer maturity period.

[38] There post tax profit can be expected to increase by as much as 10 per cent.

Table 4.7 : Tax Treatment of Mortgage Interest for Owner Occupied Dwelling

Country	Is the Imputed Income from Owner Occupied dwelling subjected to personal income tax?	Is Mortgage Interest Deductible for Tax Purposes?
Bangladesh	No	No
Singapore	Yes	Yes
Italy	Yes	Yes, A credit up to 19% of the interest paid, up to a maximum credit Italian 392.51 is granted to the loan drawn up before the year 1993.
New Zealand	No	No
Sri Lanka	No	Yes, No limit
Malaysia	No	No
Indonesia	No	No
Philippines	Not Available	No
Germany	No	No
Netherlands	Yes	Yes
Argentina	No	Yes, limited to ARS 20000
Peru	No	No
United Kingdom	No	No
Japan	No	Yes, subject to limit of Yen 5,00,000/-.
Australia	No	No
France	Not Available	No
Thailand	No	Yes, limited to Baht 50000
United States	No	Yes, subject to limits
Canada	Not Available	No
Sweden	Not Available	Yes
India	No	Yes, up to a maximum of Rs.1,50,000/-

4.65 It was argued before the Task Force that many of the smaller taxpayers, particularly in the working class, if left to them to fend for their old age, would end up requiring state support due to their individual myopia and destitution. Thus what is optimal at individual level may be socially sub-optimal. The aggregate of individual savings for old age income security, old age medical security and housing may not be adequate to generate socially optimal levels of such social security assets[39]. Therefore, such individuals should either be coerced or given adequate incentives to overcome their myopia. The Task Force recognises the potency of this argument even though there may not be any empirical evidence in support of the existence of individual myopia to the detriment of social needs.

4.66 In view of the aforesaid considerations, **the Task Force recommends continued support to loanees of home loans. Since the existing scheme of tax treatment of mortgage interest for owner occupied dwelling is targeted to taxpayers alone, the problem of individual myopia may not be fully resolved. Infact, individual myopia is most likely to exist only amongst the lower category of taxpayers and non-taxpayers. Therefore, the first best policy option would be to incentivise borrowings for housing by providing 2 per cent interest subsidy on all loans below Rs. 5 lakhs. This subsidy should be granted by the Government through the National Housing Bank. This will indeed target such loanees who suffer from individual myopia. The second best policy measure for this purpose would be to continue with the tax treatment of mortgage interest for owner occupied houses. However, given the average size of the home loan (around Rs. 3.5 lakhs), we recommend that the ceiling on the amount of mortgage interest deductible for taxable income purposes should be reduced from the existing level of Rs. 1,50,000/- to Rs. 50,000/- only.**

Tax Treatment of Agricultural Income

4.67 The continued exemption of agricultural income from the scope of income tax continues to be a sore point with all taxpayers. For the sake of brevity, this Task Force

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[39] Our decision to retain section 80CCC of the Income Tax Act which provides for tax relief for contributions to a pension scheme is primarily intended to provide old age income security. Similarly, our decisions to retain 80D of the Income Tax Act which provides tax reliefs for contribution to a medical insurance policy (mediclaim) and modify section 80DD to provide tax relief for medical expenses incurred by senior citizens, are intended to provide old age health security.

does not consider it necessary to repeat/reproduce the various arguments advanced by experts. Briefly, the arguments in support of an income tax on agriculture are the following:

1. It distorts both horizontal and vertical equity ;

2. It encourages laundering of non-agricultural income as agricultural income i.e. it has become a conduit for tax evasion.

Both the arguments are empirically verifiable. A close look at the tax returns of a large number of taxpayers in Mumbai by the Task Force revealed the following:

- A number of taxpayers had claimed large amount of income from agricultural operations. Since such income enjoyed exemption from the central income tax and there was no such tax effectively in place in the States, such taxpayers enjoyed favourable treatment vis-a-vis those earning equivalent level of income from non-agricultural activities. To this extent horizontal equity was distorted. Similarly, the favourable treatment of agricultural income also adversely affected vertical equity.

- *Prima facie* the claims for income from agricultural operations appeared to be doubtful to most officers since the agricultural operations are claimed to have been carried out in areas which are known to be infertile. Large-scale investigations against such claims are under progress. The department is expecting that most of these claims are likely to be withdrawn by the taxpayers.

4.68 Based on the sample in Mumbai, the revenue loss from laundering of non-agricultural income as agricultural income is estimated to be Rs.1,000 crores. Given the distortionary impact of continued exemption of agricultural income and the tax assignment under the Constitution, **the Task Force recommends the following:-**

(a) A tax rental arrangement should be designed whereby States should pass a resolution under Article 252 of the Constitution authorising the Central Government to impose income tax on agricultural income. The taxes collected by the Centre would however be assigned to the States.

(b) Tax from agricultural income for the purposes of allocation between States will be the difference between the tax on total income (including agricultural income) and the tax on total income net of agricultural income.

(c) Where a taxpayer derives agricultural income from different States, the revenues attributable to a State will be in the ratio of the income derived from a particular State to the total agricultural income.

(d) A separate tax return form should be prescribed for taxpayers deriving income from agriculture.

These recommendations will help mobilise additional resources for the States without the attendant problem of administering the agricultural income tax. Further, given our recommendations on increasing the exemption limit to Rs.1,00,000 per individual, most agricultural farmers would continue to remain out of the tax net. The proposed rental arrangement with the States could be packaged with the rental arrangement for taxation of services.

Rationalising income tax exemptions on savings instruments

4.69 Tax exemptions for savings instruments have earlier been extensively analysed by various committees and expert groups in the course of their deliberations relating to other fiscal and financial issues. The most comprehensive of these reports have been those of the Committees chaired by Dr. Raja J Chelliah, Dr. Parthasarathi Shome[40] and Dr. Y.V. Reddy[41] . Given their sensible and comprehensive treatment of tax exemptions relating to savings, this Committee is of the view that the best way to proceed is a judicious adoption of the best recommendations culled from these Reports, with only some slight modifications designed to enhance consistency and ease of implementation, rather than an elaborate "re-invention of the wheel", as it were.

4.70 Consumption expenditure rather than income serves as the most efficient form of tax base under an ideal tax system. Inspite of this, no country in the world has been able to successfully implement expenditure tax due to serious administrative problems. Almost all countries have relied upon income as a tax base. However, a tax on income is inherently

[40] Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, Planning Commission, May 2001.

[41] Expert Committee to Review the System of Administered Interest Rates and Other Related Issues, September 2001.

biased against savings. There are two alternative ways of devising an income tax which neutralises this bias and therefore effectively uses consumption as a tax base :-

(a) **Exempt Exempt Taxed (EET) Method :** Under this method, the contributions to a saving plan / scheme are deductible from the gross income, the income (accumulations) of the plan / scheme is exempt from tax and the withdrawal of the contribution along with benefits in the form of interest, dividend etc. is subjected to tax.

(b) **Taxed Exempt Exempt (TEE) Method :** Under this method, the contribution to a saving plan /scheme are out of post tax income (i.e. contributions are taxable), the income accumulation is exempt from tax and the withdrawal of the contribution along with benefits in the form of interest, dividend etc. is exempt from tax.

4.71 In order to neutralise the bias against savings, most countries design their income tax structure, so as to provide for exemption / concessional tax treatment of the various savings instruments by following one of the two methods[42]. Some experts are also of the view that the distortion arising out of the inherent bias against savings could be tolerated by adopting a simple income tax structure with reasonable rates and a comprehensive base.

4.72 The theory of tax incidence on financial instruments indicates no reasons for differential treatment for those of long-term maturity from those of short and medium-term maturity, taking the view that the term structure of interest rates would ensure efficient allocation of savings. In particular, the demands of fiscal neutrality that imposition of tax should not distort the choice between (a) different forms of saving, and (b) between consumption and saving are ensured under a non-discriminating tax treatment of savings irrespective of the maturity period. No strong empirical evidence exists, moreover, to support a hypothesis that tax incentives facilitate increased financial savings (by the private sector) at a macro level[43]. There is, therefore, a strong justification for taking an integrated view of fiscal concessions for financial instruments of all maturities.

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[42] The psychological impact of EET, however, providing tax benefits at the contribution stage, would be greater in promoting financial accumulation (Reddy Committee, 2001). *It may be noted that approximately two thirds of OECD countries follow the EET system, with some variations, for taxation of savings.*

[43] Report of the Expert Group to Review Existing Fiscal Incentives for Savings (Chairman: P. Shome), May 1997.

Box 4.1 : Tax Treatment of Savings in Select Countries

In the USA, a section 401(k) plan is a type of deferred compensation plan in which an employee can elect to have his employer contribute a portion of his wages to the plan on a pre–tax basis. These deferred wages are not included in the taxable wages but they are subject to social security, Medicare, and federal unemployment taxes. The amount that an employee may elect to defer to a 401(k) plan is limited. During 2001, an employee cannot elect to defer more than $10,500 for all 401(k) plans in which the employee participates. But if the employee participates in a SIMPLE 401(k) plan, the limit for 2001 is $6,500. Both of these limits are indexed for inflation. Generally, all deferred compensation plans in which the employee participates must be considered to determine if the $10,500 limit is exceeded. All contributions to retirement plans (including deferred compensation plans) are subject to additional limits.

Housing, pensions and Individual Savings Accounts (ISAs) now cover the saving activity of the bulk of the population in the UK. Over the last two decades the UK has moved from an incoherent tax regime for savings to a seemingly more satisfactory one[44]. The four main schemes designed to encourage savings, keeping in mind an ageing population, had been the Business Expansion Scheme (BES), Private Personal Pensions (PPP), Personal Equity Plans (PEP) and Tax Exempt Special Savings Accounts (TESSA)[45]. Personal Equity Plans were announced in the 1986 Budget, implemented in 1987 but substantially reformed in later years. TESSA was announced in the budget of March 1990 and became available from January 1991. PEPs were a vehicle for investment in equities, with tax-free income. Contributions to PEPs were not tax deductible, but any income or capital gains accrued within a PEP are tax free, and there is no tax on withdrawals. TESSAs gave the same tax treatment as a PEP for funds in designated schemes with annual contribution limits; saving were out of taxed income but interest earned is tax free and there is no tax on withdrawals. This

[44] Individual Savings Accounts (ISAs) have superseded PEP and TESSA (see text) since April 2001. ISAs are similar to the older schemes in most important respects and are designed to integrate the tax treatments for savings of disparate schemes. Existing subscribers to PEPs and TESSAs can continue with the schemes or migrate to ISAs.

[45] The Institute for Fiscal Studies, UK, Briefing Note No. 9, "A Survey of the UK Tax System", November 2001.

led to a situation of disparate tax treatment of different instruments used for similar purposes as well as for short- and long-term savings instruments. For example, for housing, equities and cash saving, saving was out of taxed income and there was no tax on returns and no tax on withdrawals, while, for pensions, saving is out of untaxed income, their fund income is untaxed but withdrawals are taxed. These two regimes produced the same effective tax rate of zero on the real return to saving. The one obvious exception is the existence of the tax-free lump sum in pensions, which makes the effective tax rate on the return to pensions saving negative.

In a bid to encourage personal saving, reforms introduced in November 2001 in Chile[46] allow new tax incentives to both salaried workers and the self-employed to encourage voluntary contributions to private pension funds. These will allow voluntary contributions to be deducted from an individual's taxable income. In order to qualify as deductible, they must, however, be invested in certain assets, such as mutual and other investment funds and life insurance, duly authorized by the appropriate regulatory authority. In addition, the new regulations allow individuals to withdraw part or all of their voluntary pension savings before reaching retirement age. However, in order to guard against excessive use of this prerogative, an exit tax will be levied on withdrawals, which will be treated as taxable income. Before the reform, only the AFPs (pension fund administrators) were allowed to offer tax-deductible savings schemes.

The Supplemental Retirement Scheme (SRS)[47] in Singapore, effective April 2001, is designed to encourage working employees to save for retirement, over and above their contributions to the Central Provident Fund (CPF). Contributions to the SRS by residents (up to an overall limit of S$15,000) are tax deductible the following year. The savings corpus, including interest, are to be taxed only upon withdrawal. Claims for deductions from taxable income are made automatically by the SRS operator to an individual's taxable income the following year. A penalty of 5 percent is imposed on premature withdrawal before retirement. The taxable base of the SRS corpus for an individual is 50 percent of his corpus, at a tax rate based on the individual's graduated tax rate of 0-26 percent.

[46] "Capital Markets in Chile", Investment Review, Foreign Investment Committee, Chile, February 2002.
[47] Internal Revenue Authority of Singapore, SRS Brochure, 2001.

4.73 The Indian tax system (emanating from the Income Tax Act, 1961) provides broadly the following types of tax incentives for financial savings:

(a) Deduction under section 80CCC for contribution to pension funds of Life Insurance Corporation of India or any other insurer, subject to a ceiling of Rs. 10,000/-. The pension/annuity under the scheme is, however, taxable.

(b) Deductions, provided in Section 80L allow for exemption of income up to Rs.12,000/- from income tax on specified financial instruments (including bank deposits, NSC, post office deposits, Government securities, etc. with an additional and exclusive sub-ceiling of Rs.3,000 for interest income arising from Government securities).

(c) Exemption under Section 10(10D) in respect any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy [other than any sum received under sub-section (3) of section 80DDA] [or under a Keyman insurance policy]

(d) Unlimited exemption under Section 10(11) and Section 10(12) in respect of any payment from a provident fund set up by the Central Government or set up under the Provident Fund Act 1925 or a recognised provident fund.

(e) Unlimited exemption under Section 10(13) in respect of any payment from a Superannuation Fund.

(f) Unlimited exemption under Section 10(15)(i) in respect of income by way of interest, premium on redemption or other payment on notified securities, bonds, annuity certificates, savings certificates, other certificates and deposits issued by the Central Government.

(g) Unlimited exemption under Section 10(15)(iib) in respect of interest on notified Capital Investment Bonds. However, no bonds can be notified after first day of June 2002.

(h) Unlimited exemption under Section 10(15)(iic) in respect of interest on Relief Bonds.

(i) Unlimited exemption under Section 10(15)(iid) in respect of interest on notified Bonds. However, no bonds can be notified after first day of June 2002.

(j) Unlimited exemption under Section 10(15)(iv)(h) in respect of interest on notified public sector bonds.

(k) Unlimited exemption under Section 10(15)(iv)(i) in respect of interest on deposits out of moneys received by an employee on retirement.

(l) Tax rebate, provided in Section 88, in respect of investment in specified assets (such as NSC, NSS, EPF and PPF, tax saving units of mutual funds, premium paid on life insurance, repayment of housing loans, and infrastructure bonds of IDBI and ICICI). In the financial year 2002-03, the rebates are provided at the following rates:

  (i) The rebate shall not be available in case of persons having gross total income (before deduction under Chapter –VIA) more than Rs.5 lakhs.

  (ii) For persons having gross total income (before deduction under Chapter – VIA) above Rs.1,50,000 but not more than Rs.5 lakhs, the rate of rebate shall be 15%

  (iii) The rebate 20% shall continue for taxpayers having gross total income, (before deduction under Chapter – VIA) not exceeding Rs.1,50,000.

  (iv) The rebate shall be higher @ 30% for salaried taxpayers having gross salary income not exceeding Rs.1 lakh (before allowing deduction under Section 16) and where gross salary income is not less than 90% of the gross total income from all other sources.

4.74 The limit of qualifying investment is Rs.1 lakh with exclusive limit of Rs.30,000 for subscription to equity shares or debentures of infrastructure companies, public financial institution and mutual funds.

4.75 The tax treatment of various financial instruments under the tax statue is summarised in **Table 4.8.**

Table 4.8 : Tax Treatment Of Financial Savings

Sl. No.	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
1	Gratuity	Exempt[a]	Exempt	Exempt[2]	EEE
2	Pension/Deferred Annuity Plans	Exempt[b]	Exempt	Exempt[3]	EEE
3	Life Insurance Policy	Exempt[b]	Taxable	Exempt[2]	ETE
4	Provident Fund	Exempt[b]	Exempt	Exempt[2]	EEE
5	Superannuation Fund	Exempt[c]	Exempt	Exempt[2]	EEE
6	Notified Securities, Bonds, Annuity Certificates, Saving Certificates, and Other Certificates	Exempt[b]	Exempt	Exempt[2]	EEE
7	9% Relief Bonds	Taxable	Exempt	Exempt[2]	TEE
8	Public Sector Bonds/Debentures	Taxable	Exempt	Exempt[2]	TEE
9	Deposit Schemes for Retiring Employees	Exempt[d]	Exempt	Exempt[2]	EEE
10	Certain Pension Funds of LIC (Section 80 CCC)	Exempt[e]	Exempt	Taxable	EET
11	Medical Insurance (Section 80 D)	Exempt[e]	Taxable	Exempt[2]	ETE
12	Any Security of the Central Govt. or State Govt.	Exempt[b]	Exempt	Exempt[4]	EEE
13	National Saving Certificates (6th , 7th & 8th Issue)	Exempt[b]	Exempt	Exempt[4]	EEE
14	Debentures of any Institution, Authority, Public Sector Company or Co-operative Society Notified by the Govt.	Taxable	Exempt	Exempt[4]	TEE
15	National Deposit Scheme	Taxable	Exempt	Exempt[4]	TEE
16	Any Other Deposit Scheme Framed by the Central Govt. and Notified	Taxable	Exempt	Exempt[4]	TEE

Sl. No.	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
17	Post Office (Monthly Income Account)	Taxable	Exempt	Exempt[4]	TEE
18	Units of Mutual Fund	Exempt[b]	Exempt	Exempt[4]	EEE
19	Units of UTI	Exempt[b]	Exempt	Exempt[4]	EEE
20	Deposits in Bank or Banking Co-operative Societies	Taxable	Exempt	Exempt[4]	TEE
21	Deposits in any other Bank	Taxable	Exempt	Exempt[4]	TEE
22	Deposits with Industrial Financial Corporations	Taxable	Exempt	Exempt[4]	TEE
23	Deposits with Local Development Authorities	Taxable	Exempt	Exempt[4]	TEE
24	Deposits by a member of a Co-operative Societies	Taxable	Exempt	Exempt[4]	TEE
25	Deposits with Housing Finance Companies	Exempt[b]	Exempt	Exempt[4]	EEE
26	Deposit Scheme of NHB	Exempt[b]	Exempt	Exempt[4]	EEE
27	ULIP	Exempt[b]	Exempt	Exempt[4]	EEE
28	10y Rs. or 15 yrs Account Post Office Savings Bank (Cumulative Time Deposits) Rules 1959	Exempt[b]	Exempt	Exempt[5]	EEE
29	Purchase of House Property	Exempt[b]	—	Exempt[6]	E-E

Note :

a : Employees are not required to contribute and the employers contribution to the Fund are deductible.
b : Eligible for tax rebate under Section 88.
c : Contribution by the employee is eligible for tax rebate under Section 88. Contribution by the employer to the superannuation Fund is deductible.
d : Contributions are from retirement benefits which are exempt from tax.
e : Contributions are deductible under Section 80D.
2 : Withdrawal of both the contribution and benefits are exempt.
3 : Commutation of pension is exempt but the monthly pension is taxable.
4 : Withdrawal of contribution is exempt. The withdrawals of benefit is partially exempt under Section 80L.
5 : Withdrawal of contribution is exempt but the withdrawal of benefit is taxable.
6 : Cost of the property is exempt. Capital gain is treated concessionally. Imputed Rent is exempt. Rent received is taxable.

4.76 Under the existing income tax provisions, therefore, financial savings of households is generally exempted from taxation at all the three stages of savings, *viz*., contribution, accumulation and withdrawals[48]. This liberalized treatment has impacted economic efficiency, equity and revenue efforts.

4.77 Saving instruments with similar maturity but different tax concessions result in different effective yields, which involve a distortion of signals for investment decisions. While investment (or saving) under Section 88 is rewarded, disinvestment (dis-saving) is not brought under charge. The incentives encourage not necessarily just savings but also diversion of funds, from one form of investment to another and that too for mere locking up these funds (i.e., surrendering the purchasing power to the government) only for a specified period of time. The netting principle is not applicable and dis-savings remain untaxed. Therefore, there is a bias in favour of investment in short-term instruments, thereby creating serious distortions in the allocation of savings. The tax rebate, for repayment of instalments of housing loans made by taxpayers to specified institutions encourages debt as against "equity" financing.

4.78 In any scheme of incentives for savings, it is desirable that the investments to be encouraged have broadly similar rates of return. Any variation in these rates should only be due to differences in the holding period, underlying risk or some other overriding consideration of priority for a particular sector.

4.79 Deduction of net investment and allowing deduction of income from such investment are broadly equivalent in that each is sufficient to achieve treatment of savings as under a proportional expenditure tax. Yet, assets such as National Savings Certificates and provident funds enjoy both deductibility in investment (under Section 88) and of interest earning (under Section 80L and 10(11) or 10(12) respectively). This leads to inordinately high effective rates of return on these assets (see **Table 4.9**). In turn, these serve as a benchmark for rates of return (discount rate) and therefore lead to high cost of borrowing across all sectors in the economy and to dampening of investment.

[48] except instruments listed at serials number 7, 8, 10, 14 to 17 & 20 to 24 of Table – 3.

4.80 The special limits of Section 80L deductions applicable to government securities create legally induced distortions in the allocation of savings as between these and other assets covered by Section 80L, irrespective of the intrinsic rates of return. While the major consideration behind the current incentive schemes seems to have been to encourage investment in financial assets so as to direct savings to the public sector, there are arbitrary variations in rates of return even among such assets. The rates of return bear no systematic relation to the length of the holding period of assets. In effect, by de-linking rates of return from holding periods, the public sector crowds out the private sector through offers of quick and perceptibly safer returns.

4.81 Exemptions from income tax for income from capital (as under Section 80L or Section 10) is equivalent to the expenditure tax principle but a progressive expenditure tax cannot be introduced through this route. Further, if exemption for capital income is given without limit under a progressive income tax, it amounts to having a progressive income tax only on work income. Hence, the introduction of public sector bonds and other instruments and exemption on these from income tax without any limit, as is the case under Section 10, leads to unjustified distortion.

4.82 A differential treatment of income from dividend/interest and capital gains introduces opportunities for distorted arbitrage arising between different maturities and different coupons and also leads to window dressing opportunities for tax purposes. Ideally, total return should form the basis for taxation. Moreover, certain savings instruments are more liquid than others. The resulting mis-alignment of the term structure of small saving instruments with market rates makes benchmarking more complex.

4.83 The existing tax treatment of saving schemes have also adversely effected the equity of the tax system. One consequence of the present scheme is that where the concessions take the form of deduction from income as in the case of Section 10, Section 80L and the provisions relating to rollover of capital gains tax, these favour upper bracket taxpayers disproportionately. The post-incentive rates of return vary substantially across taxpayers with different marginal tax rates. In general, the post incentive rate of return increases with the marginal tax rate of the saver. These provisions are therefore, regressive.

4.84 To the extent exemption is allowed for roll over of capital gains, the scheme is biased in favour of taxpayers with income on capital gains. Therefore, the scheme distorts horizontal equity. Further, since the large taxpayers generally have a larger proportion of their incomes from capital gains, the rollover provisions are biased in favour of the rich thereby distorting the vertical equity of the tax structure.

4.85 Inequity also arises from asymmetric information about the various tax concessions for savings. To the extent information is available with a taxpayer, he is able to avail of the tax concession. This problem is particularly aggravated in the absence of adequate taxpayer education and assistance program by the tax administration.

4.86 **Table 4.9** provides an illustration of the "excess returns" to selected small savings instruments that underlie these costs. It shows that a major portion of the excess returns arise due to Section 88. For instance, the excess return to NSC VIII, solely on account of the benefit under Sections 80L and 88, is 0.97 - 2.92 per cent and 6.06 per cent, respectively, over the tax adjusted nominal administered rate. In order to accommodate the total effective yield of NSC VIII adjusted for all three benefits (i.e., 10, 80L and 88) together, the issuer of a taxable bond had to incur a cost of 16.2 to 17.1 per cent, depending upon the income tax bracket of the investor. Similarly, the excess returns from PPF turn out to be very high due to its eligibility in Section 10. This will be in addition to return attributable to Section 88. Consequently, a taxable bond without any tax exemption would have had to incur a cost of 25.8 per cent to accommodate the return accruable from PPF (with all permissible withdrawals) to investors falling in the tax bracket of 30 per cent in 2000-01.

4.87 The existing tax system on financial instruments is quite complex, distorting the information efficiency of capital and debt markets and providing arbitrage opportunities resulting in misallocation of financial resources. The provision of various tax exemptions for savings instruments not only increases the costs of compliance but also serves to distort economic incentives and actually hinder economic growth in the long run.

4.88 An ideal income tax design entails full exemption for savings either on a TEE or EET method. However, this may not fully meet the ends of vertical equity and revenue loss would also be considerable. In order to overcome these problems, the incentives are generally capped. As a result, the income tax system is not fully neutral to savings. Hence,

Table 4.9 : Total effective returns adjusted for all tax concessions

	Excess Return Arising u/s 10/80L			Excess Return Arising u/s 88			Total Tax Benefit Adjusted Effective Return to Investor			Cost to Issuer of Taxable Bonds to Accommodate Total Effective Return		
Tax Brackets	10%	20%	30%	10%	20%	30%	10%	20%	30%	10%	20%	30%
NSC VIII												
Sep, 1993	1.18	2.37	3.55	6.55	6.55	6.55	18.38	18.38	18.38	18.84	19.36	19.97
Jan, 2000	1.13	2.26	3.39	6.43	6.43	6.43	17.73	17.73	17.73	18.17	18.66	19.24
Mar, 2001	0.97	3.39	2.92	6.06	6.06	6.06	15.78	15.78	15.78	16.16	16.59	17.09
PPF												
Sep, 1993	1.18	2.37	3.55	2.48	2.48	2.48	14.74	14.74	14.74	13.45	14.64	15.82
Jan, 2000	1.08	2.17	3.25	2.49	2.49	2.49	13.78	13.78	13.78	12.38	13.46	14.55
Mar, 2001	0.94	1.87	2.80	2.51	2.51	2.51	16.89	16.89	16.89	10.77	11.71	12.64
PPF with All Permissible Withdrawals												
Sep, 1993	2.17	4.24	6.22	6.45	6.45	6.45	19.02	19.02	19.02	21.80	24.88	28.35
Jan, 2000	2.16	4.22	6.22	6.49	6.49	6.49	18.16	18.16	18.16	20.90	23.93	27.32
Mar, 2001	2.15	4.21		6.54	6.54		16.89	16.89	16.89	19.57	22.51	25.78

Source: Annexure 1, Report of Expert Committee to Review the System of Administered Interest Rates and Other Related Issues, 2001.

so long as income remains the tax base, the bias against savings is inevitable. Further, the empirical evidence on the success of tax incentives for promoting savings is also extremely weak. Therefore, a comprehensive income tax packaged with a sufficiently high level of exemption limit and a two tier broad based rate schedule is preferred to income tax riddled with exemptions (including those relating to savings) with multiple rates on grounds of efficiency equity administrative simplicity and relatively low compliance burden. The bias against savings, if any is also minimised. The Task Force also recognizes the transitional administrative problems associated with the shift from the existing EEE method to EET method. Therefore, given the current imperatives of revenue and demographic profile of taxpayers, the preferred option is the TEE method.

4.89 A case for retention of the savings incentives is built around the argument that elimination of the saving incentives will adversely affect individual's savings behaviour and therefore national savings and social security. This is based on the consideration that the decision to save is affected, amongst other factors, by the return on savings (net of tax). Given the pre-tax return on savings, the post-tax return depends on the marginal rate of tax on personal income. In effect, the decision to save is also determined by the marginal rate of personal income tax. An exemption/deduction for savings has the effect of increasing the post tax return on savings. While, *a priori*, this may be true, the impact depends on the relative strengths of the income and the substitution effects, which in turn depends upon the individual's preferences for present consumption over future consumption. Empirical evidence indicates that given the pre-tax rate of return, taxation or exemptions from taxation have no significant effects on savings[49]. Considering the population as a whole, the income and substitution effects more or less cancel each other out. In fact, in recent years, the Kisan Vikas Patra mobilizes the maximum net savings in comparison to other instruments even though it does not enjoy any tax benefit. Therefore, the tax exemptions for savings do not in anyway enhance national savings. The impact on individual's savings behaviour and national savings is, at best, uncertain.

4.90 Further, consider the case of a person who is a "target saver". His only goal is to have a given amount of consumption in the future – no more and no less. For such "target saver", saving and the after-tax interest rate move in opposite directions. If the exemptions

[49] Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan.

for savings are eliminated, then the only way for him to reach his target is to increase savings, and vice versa.

4.91 It has been repeatedly pointed out that providing tax incentive to the "gross" savings in small saving instruments will encourage consumption and not savings. Because the exemptions are not designed to penalise dissavings, people can roll over their savings, avail tax credit and with higher disposable income (due to tax credit) increase consumption. Therefore, the elimination of the incentives could potentially have a positive impact on national savings.

4.92 The elimination of saving incentives will in turn lead to the elimination of forced savings and forced pre-emption of savings for certain sectors. It will now enable savings to flow into the most productive channel in a competitive manner. The current provisions relating to tax rebates for savings essentially act as SLR on individuals. There is no justification for pre-empting individual savings. A taxpayer can be freed to make his savings and investment decisions. The options for him are much wider with capital market reforms both in the debt and equity segments and the entry of many new intermediaries such as mutual funds and private sector banks.

4.93 Apart from the costs to the economy through the adverse impacts on efficiencies and equity outlined above, tax concessions involve various economic costs to the government — in terms of interest payment and forgone revenue. below. Given the relatively short recycling period of the savings instruments, the marginal contribution to national savings of the elaborate tax exemption system is negligible, and the transaction costs it entails are considerable. Such costs are estimated to be around 40 per cent. Details of costs

4.94 Tax incentives for savings, particularly for government guaranteed instruments, have the effect of increasing the floor interest rates across the economy. As a result, investment is adversely affected which in turn slows down the economic growth and employment creation[50]. Further, such incentives result in revenue loss thereby increasing the borrowings by government to meet its current expenditure. This further raises interest rates thereby crowding out private investment. Consequently, there is a slow down of

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[50] Infact a slowdown in the employment creation results in greater unemployment and therefore a tax at 100 per cent. Clearly the effect is regressive.

incurred by the Government in mobilizing small savings in FY 1999-2000 are tabulated in **Table 4.10.**

Table 4.10 : Cost of Small Saving Schemes incurred by Government (as at end-March 2000)

		Absolute cost (Rs.Crores)	% to gross collection of the year	% to outstanding balance at the beginning year
A.	Interest Payment	20,198	32.5%	11.5%
B.	Cost of Management	1,767	2.8%	1.0%
	i. Remuneration to Department of Post	1,055	1.7%	0.6%
	ii. Payment to Bank and Agent	691	1.1%	0.4%
	iii. Promotion (NSO) and other Cost	21	1.0%	0.0%
C.	Foregone Income Tax Revenue	5358	8.6%	3.0%
	TOTAL COST	**27,323**	**46.8%**	**16.5%**

Source : Ministry of Finance, Government of India (Taken from Annexure 1 of the Report of Expert Committee to Review the System of Administered Interest Rates and Other Related Issues).

Note Foregone income tax revenue is calculated in the table above by deducting 20 per cent of gross mobilisation during the year for the schemes eligible for tax deduction under Section 88, e.g., NSS 1992, NSS (VIII Issue) and PPF. Another 20 per cent of interest income is added to cost for schemes that enjoy tax free interest income under Section 10 or 80L. The 20 per cent tax rate on interest income is considered based on the assumption that all investors uniformly fall in this income tax bracket and they actually reap the tax benefit on interest income. The estimates of income tax revenue foregone are at best under-reported since the actual revenue loss on account of these incentives is estimated to be around Rs.12,000 crores based on typical tax payer profile.

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investment in the economy and therefore economic growth. What appears to be micro rational is, in fact, macro irrational.

4.95 The important variable for growth is social saving, defined as the sum of government and private saving. If the government were to save a proportion of tax receipt by eliminating the savings incentives, social saving could indeed increase even if private saving decreased.

4.96 Further, the tax exemptions are generally restricted to the small savings. A significant proportion of these small savings is indeed by individuals whose income is below the exemption limit and are therefore non-taxpayers. Such incentives do not benefit

this category of savers. The amount of small savings attributable to taxpayers is indeed a very small proportion of the total savings in the economy. Even if, one were to assume that their saving behaviour will be adversely affected by the elimination of the saving incentives, the impact would be far too negligible[51].

4.97 Another argument extended in support of tax incentives for savings relates to the apprehension about its adverse impact on social security. It is also argued that in the absence of a social security system in the country, the government must incentivise long-term savings by individuals. The Task Force recognises that smaller taxpayers may not save enough for old-age security because of individual myopia, thereby imposing a social burden. Such individuals must necessarily be encouraged to overcome their myopia by providing incentive for contribution to saving plans[52].

4.98 The wide range of tax incentives for savings is inefficient and inequitous. The apprehension about the adverse effect of the elimination of these incentives on national savings is also misplaced. Therefore, **the Task Force recommends the elimination of the tax incentives for savings under Section 88, Section 80L, Section 10(15)(i), Section 10(15)(iib), Section 10(15)(iic), Section 10(15)(iid), Section 10(15)(iv)(h) and Section 10(15)(iv)(i) of the Income Tax Act. These benefits must be withdrawn with immediate effect and not through a sunset clause.**

4.99 Further, with a view to overcoming the problem thrown up by individual myopia, **we also recommend the continuation of the deduction under section 80CCC for contribution to the pension fund of LIC or any other insurance company. The ceiling on the deduction should, however, be increased from the existing levels of Rs. 10,000/- to Rs. 20,000/-. This income-based deduction u/s 80CCC be converted to a tax rebate at the minimum marginal rate of 20 per cent53. Consequently, the ceiling**

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[51] It will be fiscally prudent for the government to swap the high cost borrowing from taxpayers by the relatively low cost government securities.

[52] Such individuals tend to apply whole of their current income for consumption and prefer to depend on the society for their future consumption.

[53] In the case of a taxpayer whose marginal rate of tax is 20 per cent, and income based deduction of Rs. 100, confers a tax relief of Rs. 20 (Rs. 100*0.2). Similarly, a taxpayer whose marginal rate of tax is 30 per cent enjoys a tax benefit of Rs. 30 (that is, Rs. 100 * 0.3). Therefore, a taxpayer in the higher income bracket enjoys a relatively higher tax benefit and hence iniquitous. However, under the proposed scheme of tax rebate, all taxpayers irrespective of their personal marginal rate of tax, will enjoy a tax relief of Rs. 20 (Rs. 100*0.2).

on tax rebate for contribution to the pension fund should be Rs. 4,000/-. The new ceiling has been proposed keeping in view the needs of the smaller taxpayers with income below Rs. 2 lakhs. The scope of section 80CCC may also be extended to a larger number of pension/annuity schemes within the overall ceiling of Rs. 20,000/-. Since savings in these pension funds will be taxable at the withdrawal stage, the tax benefit for such savings will be consistent with the EET method of tax treatment.

4.100 However, any sum received under a life insurance policy (including bonus) will continue to enjoy tax exemption under section 10(10D) of the Income Tax Act. Similarly, any withdrawal (including interest) from the provident fund will continue to enjoy tax exemption under sections 10(11) and 10(12) of the Income Tax Act. As a result, the tax treatment of savings in these schemes will confirm to the TEE method as against the existing EEE method. To this extent, the change will be economically efficient. Our recommendations for not modifying the tax treatment of other saving plans u/s 88 or u/s 80L or u/s 10(15) either along the EET method or TEE method is primarily based on the consideration that the rates of return are considerably higher, or the maturity period is not long enough to discourage "round tripping".

Treatment of Educational Expenses

4.101 The income tax law provides for deduction of Rs.40,000 in respect of repayment of loan taken by any taxpayer for higher education (Section 80E).

4.102 In view of the International practice **(Table 4.11)** and the fact that education is one of the basic amenities of life, generating positive externalities, **the Task Force considers it necessary to provide continued support under the tax law. However, on grounds of equity, we also recommend that the income based deduction under Section 80E should be converted to a tax rebate at the minimum marginal rate of personal income tax. The maximum amount of tax rebate should be restricted to Rs.4,000.**

Treatment of Medical Expenses

4.103 The income tax law provides for deduction of Rs.15,000 in respect of payment of medical insurance premium (Section 80D) and Rs.40,000 for medical treatment (Section

80DDB). **Since health is one of the basic amenities in life, the Task Force considers it necessary to provide continued support under the tax law.**

4.104 However, the provisions of Section 80DDB relating to deduction for actual expenses incurred on medical treatment are liable to be considerably misused, in the absence of a strong verification system. Even if, the tax administration were to successfully put in place a strong verification system, it would impose considerable administrative and compliance burden. A survey across countries on the tax treatment of medical expenses **(Table 4.11)** indicate that while most countries do not provide any form of deduction, some exempt subject to a ceiling while some others exempt the perquisite value of medical expenses. Therefore, **on balance of consideration, the Task Force recommends the immediate withdrawal of the tax benefit under Section 80DDB. However, consistent with international practice and in view of the special health circumstances of senior citizens54 , deduction for medical expenses may continue to be allowed in the form of a tax rebate at the rate of 20 per cent of the medical expenses, subject to a maximum of Rs.4,000. Further, on grounds of equity, we also recommend that the income based deduction under Section 80D should be converted to a tax rebate at the minimum marginal rate of personal income tax (i.e. 20 per cent). The maximum about of tax rebate should be restricted to Rs. 3,000.**

Treatment of Senior Citizens

4.105 Section 88B of the Income Tax Act provides for a tax rebate of Rs. 15,000/- to a senior citizen. A taxpayer is considered as a senior citizen if he is of the age of 65 years or more on the last day of the previous year. In view of the recommendation for increase in the exemption limit to Rs. 1 lakh and deduction of medical expenses for senior citizens, the Consultation Paper submitted by the Task Force had proposed the deletion of the provisions of Section 88B of the Income Tax Act.

4.106 The Task Force received a large number of representations through e-mails and post pointing out the sharp increase in tax liability of senior citizens because of the cumulative impact of the withdrawal of tax incentives on interest income, reduction in

[54] Senior citizens should be defined as taxpayers who are more than 65 years. in age on the 1st day of the financial year.

Table 4.11 : Tax Treatment of Medical and Educational Expenses Across Countries.

Country	Whether Medical Expenses are deductible?	Whether Educational Expenses are deductible?
Canada	No	No
France	No	Yes, only school fees of children is deductible from tax
Germany	No	Yes, if education is necessary for current profession
Italy	Yes, tax credit at the rate of 19 per cent.	Yes, tax credit at the rate of 19 per cent.
Japan	Yes, expenditure in excess of Yen 100,000 up to a maximum of Yen 2 million	Yes, expense exceeding Yen 10,000 up to a maximum of 25 per cent of adjusted total income
Netherlands	Yes, maximum of Euro 718 or 11.2 per cent of income, which ever is lower	Yes, only expenses above Euro 500/- but below EUR 15,000/-
United Kingdom	No	No
United States	Yes, if medical expenses exceed 7.5 per cent of adjusted gross income	No, except for higher education
Thailand	No	No
New Zealand	No	No
Malaysia	Yes, maximum tax credit of RM 7,000/-	Yes, maximum of RM 5,000/- of income
Indonesia	No	No
Philippines	No	No
Argentina	No	No
Peru	No	No
Australia	No	No
Singapore	No	Yes, maximum of $ 2,500 if the course is related to employment or profession.

interest rates and the elimination of the tax rebate of Rs. 15,000/-. Even though part of the impact would be neutralised by the exemption of dividend income and long-term capital gains on equity, this would hold good only for a limited number of senior citizens. Most senior citizens are risk averse and therefore have a choice for debt instruments. Such senior citizens face the prospect of a double jeopardy: reduction in interest rates and withdrawal of incentives. Their problem is further compounded by their inability to recoup the loss of income through employment in view of their advancing age and physical condition. With a view to providing a human face to the tax reform proposals, **we recommend that the basic exemption limit for senior citizens should be Rs. 50,000/- more then the exemption limit for the general class of individual taxpayers. In other words, the exemption limit for senior citizens should be Rs. 1,50,000/- as against Rs. 1,00,000/- for the general category of individual taxpayers recommended by us in Table-4.1. The exemption limit for senior citizens should be revised as and when the exemption limit for the general category of individual taxpayers is revised. We also recommend that this benefit of higher exemption limit should also be extended to widows.**

Other Personal Deductions

4.107 The Income Tax Act provides for the following other personal deductions:

1. An income based deduction of Rs.40,000/- in respect of maintenance[55] including medical treatment of handicapped dependent (Section 80DD). This deduction is conditional to expenditure on maintenance being actually incurred.

2. An income based deduction of Rs.40,000 in case the taxpayer suffers from permanent physical disability (including blindness). (Section 80U)

3. A tax rebate of Rs.5,000 to women taxpayers below 65 years of age. (Section 88C)

4.108 **Given the personal circumstances of handicapped, the Task Force recommends the continuation of the personal deductions under Sections 80DD and Section 80U.**

[55] Maintenance included payment to a scheme framed by the LIC and any other insurance agency for the maintenance of the handicapped.

However, on grounds of equity, we also recommend that the income-based deduction under these provisions should be converted to a tax rebate at the minimum marginal rate of personal income tax.

4.109 Further, in view of our recommendations for increase in the exemption limit to Rs.1,00,000/- and deduction of medical expenses for senior citizens, we recommend that the personal deductions in the form of tax rebate for senior citizens (Section 88B) and women (Section 88C) should be deleted.

Personal Tax Reforms : Implementation Strategy

4.110 The policy measures for the reform of personal income tax therefore comprises of the following elements:-

(a) Increase in the generalised exemption limit from Rs.50,000/- to Rs.1,00,000/- for all individual and HUF taxpayers. The exemption limit for senior citizens and widows would, however, be at an enhanced level of Rs. 1,50,000/-.

(b) The existing three slabs in the personal income tax rate schedule will be replaced by two slabs. Incomes between Rs.1,00,000/- and Rs.4,00,000 will be subjected to tax at the marginal rate of 20 per cent. All incomes above Rs.4,00,000/- will be subjected to tax at the marginal rate of 30 per cent.

(c) Dividends received from Indian companies will be fully exempt.

(d) Long term capital gains on listed equity will be fully exempt.

(e) The standard deduction for salaried taxpayers will be reduced to NIL. However, exemption for conveyance allowance subject to a ceiling of Rs. 9,600/- will continue.

(f) The income based deduction under Section 80D subject to a ceiling of Rs. 15,000/- in respect of payment of medical insurance premium will be converted to a tax rebate at the rate of 20 per cent subject to a maximum of Rs.3,000.

(g) The benefit of deduction under Section 80DDB will be withdrawn in so far as it relates to the general category of taxpayers. However, consistent with international practice and in view of the special circumstances of senior citizens,

deduction for medical expenses may continue to be allowed in the form of a tax rebate at the rate of 20 per cent of the medical expenses, subject to a maximum rebate of Rs.4,000.

(h) The income based deduction under Section 80E for repayment of educational expenses will continue to be allowed. However, on grounds of equity, the same should be allowed as a tax rebate at the rate of 20 per cent subject to maximum of Rs.4,000.

(i) The tax rebate schemes under Sections 88 for savings will be eliminated.

(j) The rebate under Section 88B for senior citizens will be eliminated in view of the enhanced exemption limit for them.

(k) The rebate under Section 88C for women taxpayers below the age of 65 years, will be eliminated.

(l) The income based deduction for handicapped under Section 80DD and 80U will however continue.

(m) The income based deduction under Section 80L for interest income and dividends will be eliminated.

(n) The exemption under Section 10 in respect of interest income from bonds, securities, debentures etc. will be eliminated.

(o) The deduction for mortgage interest in respect of loans for acquiring a owner occupied dwelling will be reduced to Rs. 50,000/-.

(p) The residential status of "Resident but Not Ordinarily Resident" will be eliminated.

4.111 The Task Force would like to place on record that the various recommendations relating to personal income tax in this report are interwoven and therefore indivisible. The recommendations must be seen as a package and piecemeal implementation must be avoided at all cost.

CHAPTER 5

CORPORATE TAX REFORM

5.1 In most countries with income taxation, corporate entities are subject to tax on their profits and, in addition, dividends are taxed in the hands of shareholders (subject to exemption up to a point). The base of the corporate income tax, however, is commonly the accounting profits derived with reference to historical costs. Certain modifications are also often made by law to accounting profits to provide incentives for activities considered important for social and economic policies or to provide relief from inflation as well as to curb misuse of the corporate form to reduce personal tax liability. From an economic point of view, the main issue of substance in this area, however, is not the legal form of the tax on the incomes of different entities but rather the extent to which provisions are made under the corporate income tax, the personal income tax, or both, to reduce or eliminate "double taxation" of income which is earned by a corporation but accrues in one form or another to the individuals who are its ultimate owners.

Case for Levy of Corporate Tax

5.2 Under a system of general income taxation, whether companies should be taxed independently as separate entitles has been the subject matter of prolonged debate among tax economists. One view is that since corporations are not persons, strictly speaking, there is no case in equity for taxing the profits of companies as such. The tax should be levied only on the owners, that is, the equity holders, by attributing the profits of the companies to the shareholders. Such a system, however, can operate smoothly only if all profits are distributed every year among the shareholders. Where part of the profits is retained, the gain to the shareholders accruing from appreciation in the value of equities escapes taxation unless there is an effective tax on realised capital gains or unless the undistributed profits are attributed notionally to the shareholders. This is not simple in the case of large corporations in which the shares undergo sale or transfer all the time.

5.3 Since capital gains are usually treated preferentially, even where the income tax is levied on capital gains, exclusion of retained profits of companies from taxation provides an easy way of avoiding taxation by accumulating profits under the corporate cover. Taxation on the basis of attribution also encounters problems in the determination of capital gains when the shares are transferred, as the cost basis has to be adjusted annually to take account of the notional distribution of accumulated profits underlying the capital gain. Besides, taxation on notional basis gives rise to liquidity problems and hence does not seem equitable or feasible. It is therefore generally accepted that some tax has to be levied on the profits of companies so long as individuals and unincorporated enterprises are subjected to tax on their profits.

5.4 Taxation of companies as separate entities is also justified as a withholding tax, which may be a useful means of ensuring that income flowing through the conduit is taxed in a comprehensive and timely manner and that the base of the individual income tax is protected. Many economists, including some who have not advocated full integration, have argued that this withholding function is indeed the main argument for the imposition of a tax on corporate income.

5.5 A separate tax on the profits of companies is considered reasonable also on the ground that incorporation confers substantial benefits such as limited liability of shareholders, right to sue and be sued and so on. What is more, corporate taxation is an administratively simple device for taxing an important type of income from capital.

Case for Integration

5.6 Tax should be levied, as a matter of fiscal equity, according to "ability to pay" – as measured by income. Further, corporate entities do not have an ability to pay taxes, in the relevant sense; they are simply a "conduit" through which income flows to individuals who are their ultimate owners. Combined, these propositions appear to suggest that corporate income should only be taxed in the hands of the individuals to whom it accrues. Hence, there is a case for integrating individual and corporate income taxes.

Case for the "Classical" system

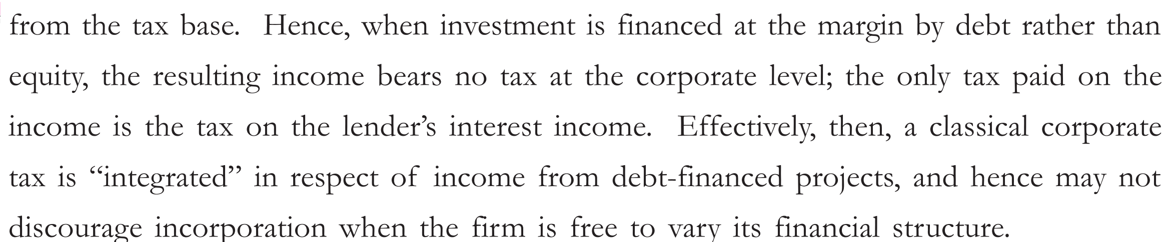
5.7 Under a "classical" corporate tax system, income tax is levied separately, both on company income and on dividends received by shareholders. The defense of this system is based on denying one of the propositions on which the integrationist case rests, or both. **First,** the case against integration or in favour of the "classical" system rests on the issue of legal form; it is asserted that companies are "separate entities", legally distinct from the individuals who own them. **Second,** it has been argued that the case for integration is based on a concept of "ability to pay", which now seems narrow and out-moded. The principle of taxation according to ability to pay can be interpreted more broadly, as requiring taxes to be levied on income – and indeed on other tax bases such as consumption and wealth in such a way as to minimize loss of social welfare. A **third** defense of the principle of a classical corporate tax system rests on the "benefit" principle that taxes should be levied according to the benefit provided by the taxing authorities. It has been argued that corporations enjoy benefits in the form of limited liability, and from government services that are provided more directly, and that some form of taxation of those benefits is appropriate[56] .

The case against the classical (Nonintegrated) system

5.8 Compared with a fully integrated system, a classical corporation tax which taxes the equity income of companies at a positive rate may distort incentives in four main ways.

5.9 **First** and most obviously, it acts to discourage businesses from incorporating, and hence from taking advantage of benefits which are associated with the corporate form of organization – such as the benefit of limited liability, which reduces the cost to companies of raising outside capital for expansion. It should be noted, however, that the discouragement to incorporation applies only insofar as the business is financed by equity. A corporate tax on equity income allows interest payments to the company's creditors to be deducted

[56] When the U.S. corporate income tax was introduced in 1909, it was seen, for example, as an "excise tax" on the privilege of limited liability. Defenders of a classical system now usually place little weight on this argument, however. The reason is that it is difficult to establish any direct connection between the benefit of limited liability and the income of a company.



from the tax base. Hence, when investment is financed at the margin by debt rather than equity, the resulting income bears no tax at the corporate level; the only tax paid on the income is the tax on the lender's interest income. Effectively, then, a classical corporate tax is "integrated" in respect of income from debt-financed projects, and hence may not discourage incorporation when the firm is free to vary its financial structure.

5.10 A **second** adverse incentive effect of a classical corporate tax is that it encourages companies to finance their projects by using debt rather than equity finance. This distortion increases the risk of bankruptcy. It will, therefore, bias companies toward relatively secure investments and discourage risks. Further, this bias in favor of debt financing gives companies an incentive to disguise the returns they provide to their shareholders, as far as possible, as "interest" payments rather than dividends. Most classical corporation taxes thus require extensive anti-avoidance provisions to limit what may be deducted from the tax base in the form of interest payments.

5.11 **Third,** given the imperfections of the capital market and lack of perfect foresight on the part of equity holders, a classical corporation tax encourages a company to retain its equity earnings rather than distributing them to its shareholders. When dividends are paid, the shareholder is subject to income tax at the appropriate rate. When earnings are retained, the shareholder should benefit, instead, from an increase in the market value of the company. In many countries, that capital gain is not subject to tax; and when there is a tax on capital gains, it is usually levied at a lower effective rate than the income tax on dividends. As a result of this bias in favor of retentions, equity funds may be "trapped" within particular companies rather than allocated between companies in the most efficient manner by financial markets, according to the investment opportunities that the companies face. **Fourth**, a classical corporate tax system reduces the incentive to invest, and may therefore inhibit growth. The additional tax that is levied on company income under a classical system, however, represents an additional discouragement.

5.12 Combined, these four points represent a powerful case against the classical form of corporate income tax. This case has in practice been influential one; there has been a general though not entirely universal tendency over the last two decades for existing classical systems to be replaced by some form of integration of corporate and individual income taxes.

The case for retaining a classical system

513. The **first,** and most powerful, argument for retaining a classical system or against integration is that it will generally entail a loss of revenue, compared with what was generated by the classical system that is replaced. This revenue loss must be made up in some way; the corporate tax rate might be increased, or some other taxes might be imposed. In either case, there are likely to be economic costs that must be set against the benefits of integration.

5.14 **Second,** doubts have often been expressed about empirical significance of particular benefits from integration, such as the reduction in bankruptcies, and in the costs of recognizing the activities of bankrupt firms. In addition, to the extent that equity is trapped within companies by an existing classical system, the burden of the additional tax that is payable on dividends when those earnings are eventually distributed may already be capitalized into share prices. In this case, much of the benefit of a shift to an integrated system could simply accrue as a windfall gain to existing shareholders.

5.15 **Finally,** some major benefits that may be claimed for a classical system, compared with most integrated systems that have been adopted in practice, are its simplicity and transparency. These features generally make a classical corporate tax system easier to administer than an integrated system. They also avoid most of the severe difficulties that arise in devising an appropriate tax treatment, in an integrated system, of dividends paid or received from abroad.

The meaning of "integration"

5.16 The term "integration" has been used in different ways. Traditionally, "full integration" has been used to denote an arrangement under which the incomes of all entities, both distributed and retained, would be attributed in an appropriate manner to the individual shareholders who are their ultimate owners. The income tax due would then be collected from those individual shareholders at the marginal tax rates, depending on their total incomes.

5.17 'Full integration' in this sense may be an ideal arrangement in principle but it is administratively impracticable. The **first** reason is that there would be an enormous amount of information reporting required: in many economies, a single company may have a very high number of ultimate owners, many of whom will have held shares for only a part of any tax year. **Second,** attributing retained earnings to different owners is problematic when there are different classes of corporate security holders, with heterogeneous claims such as ordinary shares, and convertible notes. **Third,** many company shares are held by other companies. Hence, tracing the ultimate owners can often be difficult. A **fourth** general difficulty is that if tax were to be levied on shareholders' earnings whether they are retained or distributed, it could result in shareholders often being liable to pay large amount of tax without having received cash with which those liabilities could be met. No country has tried to apply a full integration scheme of this kind to the taxation of all corporate income. Many countries, however, do effectively integrate company and individual income taxation, along these lines, in the case of small companies with a limited number of owners[57].

5.18 In particular circumstances, full integration could be achieved in principle by several systems besides the partnership method discussed above. One such system would be to abolish the corporate income tax completely and let shareholders pay taxes under the personal income tax on the dividends received plus net accrued capital gains on shares – that is, on a comprehensive income base. However, such a system is extremely burdensome in terms of both administrative and compliance cost. Further, it will also lead to considerable revenue loss, particularly in the transition, since the income in the hands of the shareholders will be very thinly distributed. Second, full integration could be achieved straightforwardly, in the special case where the personal income tax is levied at a single rate, by levying tax on corporate income at the same rate, while exempting dividends and capital gains on company shares from the personal tax. Such a corporate tax should serve as a scheduler final tax on income from equity capital.

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[57] For example, in the United States, certain companies with no more than 35 shareholders can qualify (as "Subchapter S" companies) to be taxed in a similar way to partnerships, with their income being allocated directly to their shareholder in the appropriate proportions. A similar effect may be achieved indirectly if the tax system allows small companies to pay out all of their taxable income to their owners in the form of tax-deductible directors' remuneration. This is sometimes referred to as "self-help integration".

5.19 The results of the full integration method can also be substantially achieved in a two rate personal income tax structure where the corporate tax is levied at the higher of the two rates and it is assumed that most (if not all) individual shareholders are subjected to tax at the highest marginal rate of personal income tax. Under this system, a company would not be able to defer tax simply by not paying dividends and therefore there would not be any loss of efficiency. Further, because the number of corporate entities are few than there are individual shareholders, and because they are more easily identifiable, having a corporate as a principal taxpayer makes administration much easier than having only the investors as legal taxpayers. It also makes it much easier for the tax administration to distribute refunds or collect adjustment resulting from scrutiny assessments (audit). **In view of the above, the Task Force recommends the adoption of this method of full integration of corporation or personal income tax, that is, levy a tax at the corporate level at the rate of 30 per cent being the maximum rate of personal income tax and exempt all dividends and long-term capital gains from tax in the hands of the shareholders. This method would not undermine any equity since most direct equity investors in the companies in India are likely to be taxed at the top marginal rate of personal income tax.**

5.20 The above system recommended by us would serve as a full integration model only if the accounting profits bear the full burden of corporate tax i.e., the effective corporate tax liability is equivalent to the statutory corporate tax rate. This is possible if there is no divergence between the taxable base for companies and accounting profits, which generally arises due to various tax incentives and artificial deductions. Therefore, where there is empirical evidence to establish that corporate profits (accounting profits) have indeed suffered full taxation, the case for taxation of dividend again in the hand of shareholders would be extremely weak. In such a case, dividend distribution should be seen as mere application of income (or transfer of capital).

Economics of Tax Incentives

5.21 The source of the problem of double taxation is, therefore, tax incentives, which are a prominent feature of many tax codes in both developed and developing countries. Tax incentives have been used by countries to achieve a variety of different objectives, not all of which are equally compelling on conceptual grounds. Such incentives have either

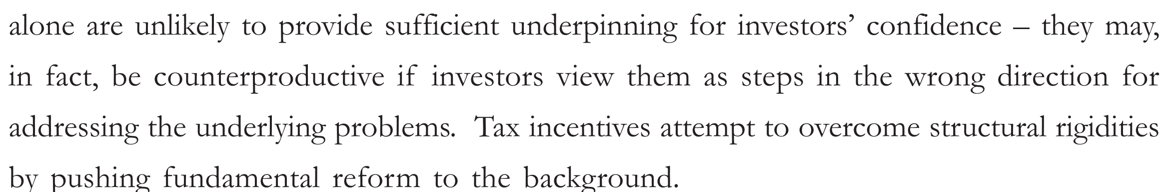
been for stimulating investment in general, or as a matter of economic or social policy and addressing regional development needs[58]. Quite often, countries pursue multiple objectives with overlapping tax incentives.

5.22 The various factors that could have a bearing on an (domestic or foreign) investor's decision to undertake an investment project in any country could be grouped under four broad categories : (1) tax-related considerations ; (2) nontax-related economic considerations; (3) non-economic considerations ; and (4) social policy considerations. An examination of these factors is necessary before we analyse the conceptual validity of the various objectives of tax incentives.

5.23 Tax-related considerations refer to features in the tax system as a whole that impact on the effective tax burdens on investment projects. If there are limitations in these features that impede investment, the first-best policy is to correct the limitations directly via appropriate tax reform, rather than to compensate for them through enacting tax incentives. If, for example, depreciation allowances are too restrictive or the corporate income tax rate is too high in relation to international norms, then restructuring depreciation allowances or lowering the CIT rate to competitive levels would be far more preferable than introducing tax incentives in restoring a favorable investment climate.

5.24 Non-tax related economic consideration refer to those that affect either the general macroeconomic or the microeconomic/structural environment, or both. If there are deficiencies in these environments that impede investment, the first-best policy is to implement sound macroeconomic policies and / or undertake relevant structural reforms, rather than to resort to tax incentives that do not address the root-cause of the deficiencies. For example, large budgetary imbalances can raise questions about the sustainability of present tax rates, and high inflation rates can generate considerable uncertainty about prospective macroeconomic developments. Likewise, rigidities in labour markets can raise labor costs above internationally competitive levels, and poor communication and transportation infrastructures can increase the costs of doing business significantly. When such macroeconomic imbalances occur and / or structural deficiencies exist, tax incentives

[58] In many developing countries such incentives are extended to promote FDI, reduce unemployment and promote specific economic sector or types of activities.



alone are unlikely to provide sufficient underpinning for investors' confidence – they may, in fact, be counterproductive if investors view them as steps in the wrong direction for addressing the underlying problems. Tax incentives attempt to overcome structural rigidities by pushing fundamental reform to the background.

5.25 Non-economic considerations refer to those related to the legal, regulatory and political economy environment. These considerations are often as important as tax and other economic considerations in fostering an environment that is conducive to investment. For example, investors are frequently concerned about the clarity of the law that governs the investment regime, and the transparency with which regulations (rules and procedures) associated with the investment law are enforced. Again, if there are deficiencies in this environment that impede investment, the first-best policy is to undertake corrective actions to remove the deficiencies. Investors' concerns about deficient legislation and onerous regulations, as well as perception of corruption on the part of those officials responsible for approving investment projects, can seldom be overcome by the availability of even generous tax incentives.

5.26 Social policy consideration refers to those that arise from equity concerns. Producers in certain sectors (e.g., agriculture) may be regarded as economically disadvantaged relative to other, more developed sectors (e.g., industry), and the provision of tax incentives to the former sectors may be considered as a way to advance equity objectives. However, such objectives can be more effectively addressed by an appropriately designed expenditure policy that targets individuals on the basis of their levels, rather than by tax incentives that target economic activities on a sectoral level.

5.27 The above discussions suggest that tax incentives are often not the first-best policy instrument to achieve the kind of objectives that they have commonly been used for. Indeed, since tax incentives, if effective, would by definition create an economic distortion between favored and regular investment projects, an economically compelling justification for their use is the rectification of market failures. Specifically, there are some types of investments that generate positive externalities (benefits that the market fails to internalize) for the economy as a whole. Since the amount of such investments would be socially sub-optimal if left entirely to market forces, tax incentives could play a legitimate role in encouraging them. Tax incentives justified on this basis would typically include those

given to project located in less-developed regions of a country (either to reduce congestion and/or pollution in the developed regions, or to reduce the disparity in income distribution that could be viewed as having some public good characteristics); projects entailing the use of advanced technologies that could raise the general technological absorption capacity of a country; projects that have a high propensity of leading to a build-up of key types of human capital whose benefits usually extend beyond the persons embodying them; and projects that involve R&D activities in targeted areas deemed important for whatever policy reasons. In all such cases, a compelling economic justification, could be made for the use of tax incentives as a corrective policy instrument.

5.28 Another plausible justification for the use of tax incentives could rest on the well known argument that, in small and open economies with mobile capital, the incidence of any tax on capital income would be shifted to less mobile factors such as labour, in which case it would be better to tax the latter factors directly rather than indirectly by taxing capital income. However, even in such economies, having some form of a corporate income tax could be essential as a backstop to labor taxes to prevent the artificial shifting of income from labor to corporations (e.g., owners of firms could incorporate, transform their wage income into corporate retained earnings, and receive returns in the form of capital gains from selling their shares). The optimal form of the corporate income tax under these circumstances would be a cash flow tax. The granting of certain forms of tax incentives could then be viewed as a means of achieving this end.

5.29 Once one departs from the position that no tax incentives should ever be granted, and accepts the proposition that the use of such incentives could be justified under certain circumstances, especially those that are associated with the presence of positive externalities, questions about targeting and measurement will inevitably arise. For example, how would one go about identifying investment projects that would generate the kinds of positive externalities that are deemed to be deserving of tax incentives? Once identified, how would the externalities be measured so as to determine that appropriate amount of tax incentives to be granted? These questions have no easy and clear cut answers, but they like most other policy matters involving difficult choices, nevertheless have to be resolved, by a rational and objective decision-making process informed of all relevant facts and constraints.

5.30 A crucial consideration that bears on the decision to grant tax incentives should be their cost-effectiveness. This implies that the mere identification of the existence of positive externalities associated with certain types of investment projects is not sufficient for justifying the use of such incentives in all instances. Rather, their use should be predicated on the belief that the benefits to the economy that can be expected from an increase (if any) in the incentive-favored activities would actually outweigh the total costs of the tax incentives granted.

5.31 Granting tax incentives entails four types of costs : (1) distortions between investments granted incentives and those without incentives; (2) forgone revenue (on the assumption that the government operates under a revenue constraint, so that the lost revenue would have to be compensated from alternative distortive taxes); (3) administrative resources required to administer them; and (4) the social costs of corruption and/or rent-seeking activities connected with abuse of tax incentive provisions. While these costs could be substantial, the benefits to the economy that could be attributed solely to tax incentives are less clear and not easily quantifiable. Hence, the cost-effectiveness of tax incentives is often questionable.

5.32 The distortion cost of the incentives could arise even if such incentives are used to correct for externalities, since the amount of incentives granted may not conform exactly to the extent of the externalities involved, due to the inherent difficulties in measuring the latter. By extension, such costs would also arise whenever tax incentives are erroneously granted to investment projects with no positive externalities, as could happen (for example) through abuse and leakage in the system.

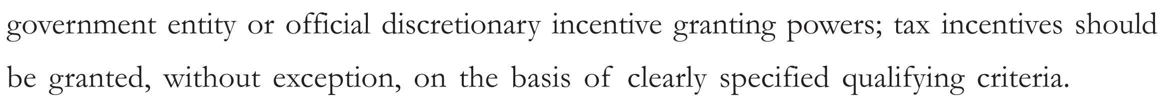
5.33 The revenue costs of tax incentives have two different dimensions. First, investment projects could have been undertaken even if there had been no tax incentives. For these projects, which typically comprise those of the highest profitability and, therefore, having the greatest economic merits, the availability of tax incentives would simply represent a free gift from the government to either the investors or, if they are of foreign origin, the treasury of their home countries. The latter outcome would come about if any income that is spared from taxation by the host country is taxed by the investor's home countries - as it would be the case when these countries have tax systems that are based on the residence principle.

5.34 The second dimension of the revenue costs of tax incentives is that, even when tax incentives are ineffective in attracting additional investments perhaps because of their failure to overcome other impediments to investment, they may still entail a revenue loss because their mere availability opens the door to potential abuse by investors not eligible to receive them.

5.35 Indeed, abuse and leakage are perennial problems with tax incentives, and their effective prevention can often absorb a substantial amount of quality administrative resources - a scarce commodity in most developing countries. The more scare resources are devoted to administering tax incentives, the other more important administrative tasks would be impaired - thus jeopardizing tax collection as a whole.

5.36 Administrative costs would clearly escalate with increased scope and complexity of the tax incentives provided. If the aim is to properly enforce them, a far more serious problem with incentive provisions has often to do with the unofficial condoning - or even encouragement - of abuse of such provisions by officials charged with the responsibility for their administration. Tax incentives also inevitably induce socially unproductive rent-seeking behavior. Once the incentive system gets going, those who are fortunate enough to have captured the rents will have an inherent interest to maintain the status quo. This explains, quite apart from economic reasons, why it is so difficult in reality to terminate or even phase out tax incentives once they are granted, even if such incentives are formally time-bound. The most effective way of overcoming these political economy problems of tax incentives is to ensure that the incentive-granting process is transparent and has accountability.

5.37 Transparency in granting tax incentives has three dimensions. First, there is the legal and regulatory dimension :all tax incentives should have a statutory basis in the relevant tax laws, and changes to such incentives should require amendments to these laws. This implies that incentive provisions should not be embedded in laws unrelated to taxation to avoid possible conflicts, inconsistencies, and overlaps across different laws; they should certainly not be embedded in instruments that have a lesser degree of legal standing than a law, such as regulations, decrease, or orders that could be issued by various government entities or officials on an ad hoc basis. Similar reasoning would then also indicate that statutory provisions in the relevant tax laws should not confer on any



government entity or official discretionary incentive granting powers; tax incentives should be granted, without exception, on the basis of clearly specified qualifying criteria.

5.38 The second dimension is economic, which involves making explicit the rationale for granting any tax incentives on the basis of well thought out economic arguments; estimating the economic impact and revenue cost of granting incentives based on clearly stated assumptions and methodologies; and subjecting the estimated revenue costs to public scrutiny in the budgetary process as tax expenditures. Explicit recognition of tax expenditures is a practice that can be found in many developed and an increasing number of developing countries, and can greatly facilitate the reviewing by policy makers on a continuing basis of the cost effectiveness of granting tax incentives to achieve specified policy objectives.

5.39 Finally, there is the administrative dimension of transparency, which involves formulating qualifying criteria for tax incentives that are simple, specific, and objective to minimize the need for subjective interpretation and application by the administering officials of the incentive system, as well as to ease monitoring and enforcement responsibilities on the part of tax administrators. These considerations clearly suggest that the triggering mechanism for granting tax incentives should be rendered as automatic as possible, i.e., one that allows an investment project to receive the incentives automatically once it satisfies the stipulated qualifying criteria, such as a minimum amount of investment in certain sectors of the economy. In granting the tax incentives, the relevant authorities would only undertake to ensure that the qualifying criteria are met. All other aspects of the investment are irrelevant.

5.40 In contrast, a discretionary triggering mechanism involves the approving or denying an application for tax incentives on the basis of a subjective value judgement of the relevant incentive-granting authorities after taking into account a variety of considerations, irrespective of any formally stated qualifying criteria. If such criteria exist, they are stated either as minimum conditions or in very general terms, thus requiring subjective interpretation. The discretionary application of tax incentives is one of the most important contributing factors to corruption in many countries.

5.41 Tax incentives are, therefore, inefficient, inequitous, impose greater taxpayer compliance burden and administrative burden, result in revenue loss and complexity of the tax laws, and encourage tax avoidance and rent seeking behaviour.

Widening the Corporate Tax Base

5.42 At present, the Income Tax Act is riddled with tax concessions, which take the form of full or partial exemptions, deductions, and tax. Inspite of economic distortions, which are caused by the various tax incentives, these have continued[59]. These concessions may have been justified in the era when the marginal tax rates were exorbitantly high. However, over the year the marginal corporate tax rates have been reduced substantially. Therefore, the exemptions and notional deductions should be discouraged and wherever necessary political environment created to purge the tax statute of such incentives. It is important to review the large number of these exemptions/deductions/holidays so as to expand the tax base and also increase the average tax liability. Given the government's bold initiative in eliminating the incentives relating to exports of goods and services, the die is now cast for eliminating other incentives[60].

5.43 The Task Force does not consider it necessary to reinvent the wheel by examining the efficacy of the various tax incentives. The adverse impact of various incentives have been well documented in the numerous reports of Committees, Task Force, and Study groups. A cursory look at the annual report of the Comptroller and Auditor General of India in respect of the Income Tax Department will bear out the fact that these incentives have become a source of abuse. The mounting appeals at all levels are an eloquent testimony to the complexity and the ambiguity in the tax law on account of the various incentives. The erosion in the tax base is evidenced by the divergence between the statutory corporate

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[59] Introduction of tax incentives creates a clientele for their continuation and spread. The fact that many industrial countries maintain some tax incentives after the tax reforms of the 1980s is less a statement that they are considered to be effective and more a testament to the political difficulty in removing them once they have been introduced. It is because of this tendency that many "temporary" measures, designed to respond to particular perceived disincentives, remain in force long after the conditions that originally led to their introduction have changed.

[60] Report of the Advisory Group on Tax Policy and Tax Administration.

tax rate and the effective tax rate. The effective tax rate of a sample of 3777 companies in 1999-00 was 21.7 per cent as against the statutory rate of 38.5 per cent. Similarly, the effective tax rate of a sample of 2585 companies in 2000-01 was 21.9 per cent as against the statutory rate of 39.55 per cent. This is inspite of the provisions of Minimum Alternate Tax (MAT) which, by itself, is a sore point with trade and industry. The Task Force was also of the strong view that the divergence between taxable income and book profit also undermines corporate governance.

5.44 Therefore, the Task Force considers it necessary to redesign the corporate profits tax so as to align taxable income and the book profit. This is possible only by eliminating the various tax incentives / preferences as well as rationalising the various other allowances which are inconsistent with accounting practice. Similarly, some of the artificial disallowances in the Income Tax Act which are neither anti-avoidance in nature nor consistent with accounting practice, also needs to be reviewed. As a result, the divergence between accounting profits and taxable income would be minimised (if not eliminated), and the corporate profits would bear the full burden of corporate tax. It would, therefore, be possible to further simplify the personal income tax by fully exempting the taxation of dividends in the hands of the shareholders. Further, since the retained earnings would have also borne full tax, it would not be necessary to levy separate tax on the capitalized value reflected in the long-term capital gains on equity. Yet another beneficial impact of aligning of book profits to taxable profits would be enhanced corporate governance, a key requirement for healthy capital markets.

Exemption for Exports (Section 10A and 10B)

5.45 Section 10A of the Income tax Act provides for deduction of profits and gains derived by an undertaking from the export of –

i) Articles or things ; or

ii) Computer Software.

Further, the undertaking must be located in one of the economic zones/parks and begins to manufacture after the date mentioned in the schedule below:

Location	Date of Commencement of Manufacturing
Free trade zone	01-04-1981
Electronic Hardware Technology park	01-04-1994
Software Technology park	01-04-1994
Special economic zone	01-04-2001

This deduction is available for ten consecutive assessment years beginning with the assessment year relevant to the year in which the undertaking begins to manufacture/ produce. The tax benefit u/s 10A for assessment year 2003-04 is restricted to 90 per cent of the profits and gains from exports. Further, no benefit u/s 10A will be available to any undertaking in assessment year 2010-11 and subsequent years.

5.44 The Finance Act, 2002 has amended the provisions of section 10A to provide that any undertaking established in SEZ in a previous year relevant to any assessment year commencing on or after 1-4-2003, shall be entitled to -

1. 100 per cent deduction for five consecutive assessment years (beginning from the assessment year relevant to the previous year in which it begins to manufacture or produce articles or things or computer software); and

2. a deduction of 50 per cent for further two assessment years.

Similarly, section 10B of the Income Tax Act provides for deduction of profits and gains derived by a hundred per cent export oriented undertaking from the export of any article or thing or computer software. This deduction is available for ten consecutive assessment years beginning with the assessment year relevant to the year in which the undertaking begins to manufacture/produce. The tax benefit u/s 10A for assessment year 2003-04 is restricted to 90 per cent of the profits and gains from exports. Further, no benefit u/s 10A will be available to any undertaking in assessment year 2010-11 and subsequent years.

5.45 The undertakings enjoying tax benefits u/s 10A and 10B of the Income Tax Act derive profits from the following revenue streams:-

1. Goods or services provided within the national boundaries of India (referred to as **"domestic sales"**)

2. Goods and services provided from India to clients in foreign countries (referred to as **"off-site exports"**).

3. Goods and services provided on-site in foreign countries, often involving the stationing of Indian employees in foreign countries(referred to as **"on-site exports"**).

5.46 The profits from "domestic sales" does not enjoy any tax exemption and is therefore subject to tax like profits from goods or services provided within the national boundaries of India from any other location. However, profits from "off-site exports" enjoy hundred percent exemption. Such exemption is neither justified on grounds of efficiency, equity or effectiveness.

5.47 The Finance Act 2000 amended the Income Tax Act to provide for a phased withdrawal of the export related incentives over a period of four years. The full deduction of the profits from exports allowed in assessment year 2000-01 has now been reduced to 50 per cent in assessment year 2003-04, 30 per cent in assessment year 2004-05 and full taxation in assessment year 2005-06. To the extent exports by undertakings covered u/s 10A and 10B continue to enjoy hundred per cent exemption in respect of profits from exports, undertakings located outside the economic zones or not declared as hundred per cent EOUs suffer a competitive disadvantage viz. a viz. the former. Such disadvantage arising solely from tax considerations will result in trade diversion and hence encourage inefficiency.

5.48 The FTZs/HTPs/STPs/SEZs are also endowed with better infrastructural facilities and input tax regime. Therefore, undertakings in such locations manufacture in an international environment. Inspite of the competitive advantage these undertakings enjoy higher tax benefits in comparison to undertakings located outside such zones/parks. Hence, the exemption u/s 10A and 10B for "off-site exports" also violate both horizontal and

vertical equity. Furthermore, the need for continuing monitoring of exemptions degrades the effectiveness of the tax administration as well.

5.49 The tax treatment of profits from "on-site exports" is complex. Such profits are first subjected to income tax in the foreign country; in many countries it could be at two different levels: state and federal level. Further, the Indian taxpayer would also be required to compensate its employees for the non-refundable / non-transferable social security contribution (tax)[61]. As a result the aggregate burden of foreign income tax (excluding social security contributions) on such profits is extremely high in comparison to their liability in India.

5.50 Under the scheme of the income tax act, the global profits (including profits from "on-site exports") of the undertaking would be subject to tax in the absence of tax exemption u/s 10A and 10B of the Income Tax Act. The Indian undertaking is allowed to claim credit for income tax paid in the foreign country. However, such credit is restricted to federal income tax and also to the amount payable on the profits from "on-site exports", at the Indian rates. If the amount of tax payable on such profits at Indian rates is less then the federal income tax paid in the foreign country, no adjustment is given for access federal income tax paid in the foreign country. Similarly, no tax credit is allowed for the state income tax paid in the foreign country. With the proposed corporate tax rate at 30 per cent, large amount of credit for federal income tax and state income tax paid in the foreign country would not be allowable.

5.51 In the course of its consultations with representatives from the Information Technology Sector, it was argued that the exemption u/s 10A and 10B was essentially restricted to exemption from income tax of profits from the exports of goods and services from India. It was pointed out that a significant proportion of the profits of the undertakings in the IT sector enjoying benefits u/s 10A and 10B of the Income Tax Act was from services provided on-site abroad. Since, the aggregate of the foreign county's federal and state income taxes was estimated as high as 45 per cent compared to 36.75 per cent liability in India, the exemption u/s 10A and 10B essentially served as compensation for the increased burden on off-site revenues, that is, the exemption from the point of view of the industry

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[61] The non-refundable/non-transferable social security tax serves as a labour input tax from which no unemployment and pension related benefits are derived.

was a "tax cross-subsidy" between on-site and off-site exports. Further, the representatives also argued that in the absence of a totalisation agreement between India and its major trading partners, they (and therefore India) had also to suffer the additional burden of both employer and employee contribution to social security in the foreign country and the same was non-refundable/non-transferable to India on return of the Indian employee[62].

5.52 The Task Force recognises that any company whose activities are spread across international borders could potentially incur a higher income tax burden on its global profits in comparison to a company whose activities are confined to the national boundaries. While companies exporting goods can potentially avoid the liability of the foreign country's federal and state income tax, the companies in the IT sector must necessarily bear the burden because of the very nature of their activities[63]. Potentially though the problem could be faced across sectors, in practice it is acute in the IT sector[64]. Infact, for companies whose revenues from on-site abroad are disproportionately large, the exemption u/s 10A and 10B may not offer any significant compensation. **The Task Force therefore recommends the elimination of the tax incentive u/s 10A and 10B of the Income Tax Act for all taxpayers other than those engaged in manufacturing computer software.**

5.53 **We also recommend that in the case of taxpayers engaged in manufacturing computer software, the Government of India must take immediate steps to negotiate with foreign governments to enter into a comprehensive totalisation agreement leading to a single point incidence of taxes. It may be noted that a number of countries across the globes already have totalisation agreements with each other related to payment of social security and other taxes[65]. However, in the interim, the Task Force recommends the following alternatives:-**

1. **Eliminate the tax exemption u/s 10A and 10B and amend Section 91 of the Income Tax Act to allow full credit for payment of foreign country's federal and state income tax. However, no refund of such foreign tax credit should be allowed;**

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62 It was pointed out that the annual loss to India in the absence of totalisation agreement was US $500 million and such loss was increasing rapidly.

63 Their activities are services in nature which, in most cases, has to be provided on-site abroad.

64 Overtime, this could threaten the international competitive advantage of the IT sector in India.

65 For instance, 17 countries have Totalisation Agreements with the US.

OR

2. **Since the arrangement is transitory in nature the benefit of tax exemption u/s 10A and 10B for manufacturing of computer software only may be continued till we enter into a totalisation agreement with trading partners. However, the distribution of dividend by computer software manufacturing companies availing of deductions u/s 10A or 10B should be subjected to a dividend distribution tax of 30 per cent. Similarly, the long-term capital gains arising from transfer of equities of such companies should also be subjected to tax like long-term capital gains from any other asset.**

The Task Force could not arrive at unanimity on the preferred alternative amongst the above two.

Depreciation

5.54 Under a corporate income tax designed to tax net income including returns from capital, corporations should be provided with deductions for the economic depreciation of capital inputs. In the absence of inflation, the amount of depreciation for tax purposes (i.e., capital cost allowances) over the lifetime of a capital asset used in production should equal to original investment expenditure. This tax treatment allows the taxpayer to recover tax-free the original investment, leaving tax applicable only to the return on the investment. The timing of depreciation claims is equally important for the proper measurement of the return to capital in each period. If the portion of the capital cost that a taxpayer is allowed to write-off in one year is greater (less) than the true cost, income will be understated (overstated).

5.55 In theory, depreciation claims should match economic depreciation, which, for a given asset, will follow a specific pattern over time. This pattern will depend on the length of time the asset is used in production and the pattern of income arising from the use of the asset in each of the years in which it is employed. The pattern of income arising from the use of the asset in each of the years in which it is employed. The pattern will also

depend on relative output and capital input price changes arising, for example as a result of technological change or obsolescence, and on the asset's residual value at the end of its useful life.

5.56 In principle, these considerations will be captured by movements in the inflation-adjusted value of the asset in each year, and depreciation could be measured by observing the value of second hand capital assets. In practice, the lack of an active market for used assets means that economic depreciation is generally unknown and must be inferred. For some assets, the contribution of an asset to output and thus income may remain roughly constant over time. In such cases, a reasonable (annual) depreciable amount may be a constant percentage of its original cost as under the straight line depreciation method. Other assets may contribute to income mainly in the early years of production, or may become obsolete relatively quickly, suggesting that relatively high depreciation charges should be taken in early year with successively lower charges in subsequent years as under the declining-balance method. In either case, a representative depreciation rate must be chosen. Typically these are based on rough estimates of the useful-life of assets, with additional precision being lost where a single depreciation rate is assigned to a basket of different assets, as is generally the case. In certain cases, taxpayers may be allowed to use for tax purposes depreciation rates that are in excess of what are estimated to be economic depreciation rates in order to encourage investment in the target capital asset.

5.57 The Income Tax Act read with the Income Tax Rules classifies capital assets into a basket of different assets and provides different percentage rates of depreciation for each such basket (known as a block of assets). The depreciable amount is determined on the declining-balance method. The general rate of depreciation for plant and machinery under the tax law is 25 per cent. This was first prescribed in 1991-92. Such high rate of depreciation was justified in 1991-92 because of the high corporate tax rate of 51.75 per cent which adversely affected internal accrual of resources for replacement and modernization. Consequent to our recommendation to reduce the corporate tax rate to 30 per cent from the existing levels of 36.75 per cent, it is now necessary to review the general rate of depreciation for plant and machinery.

5.58 The adequacy of the rate of depreciation depends on the (presumed) period of the useful life of the asset, the mode of granting depreciation, i.e., whether by the diminishing balance method or by the straight line method, and the past and expected rates of growth of prices of capital goods. For the general category of plant and machinery, it would seem reasonable to assume an average period of service life of ten years. Although in practice, machinery has come to be replaced in industry after a period much longer than ten years, nevertheless, in view of the rapidity of technological change, it would be prudent to keep in mind the notional period of ten years of useful life for machinery. Having made this assumption, we should aim at a shorter recovery period through higher or accelerated rate of depreciation. When this is done, the interest (net of tax) earned on the amounts recovered should also be taken into account in computing the accumulated balance at the end of the presumed life of the assets. It would seem reasonable to assume a 9 per cent rate of interest under the prevailing circumstances subject to tax at the rate of 36.75 per cent, for the purpose of an illustrative calculation. We find that depreciation allowances granted at 25 per cent on the basis of the diminishing balance method, if invested at 9 per cent rate of interest, would yield an accumulated balance at the end of ten years of Rs. 126.76 net of tax on interest, for an original cost of Rs. 100 including a Cenvat of Rs. 12.54 and a state VAT of Rs. 9.09[66] **(Table - 5.1).** In the context of our proposal to reduce corporate tax rate to 30 per cent, the depreciation rate corresponding to an equivalent yield at the end of 10 years, is 15 per cent **(Table – 5.2)**. Infact, accounting for the residual value of the machinery at the end of the 10 year the accumulated balance would be greater then the replacement value of the machine assuming that the historical rate of inflation of capital goods at 3.5 per cent will continue in the future. In any case, the improved internal generation of resources due to reduction in the corporate tax rates will help faster replacement. **In view of the above, the Task Force recommends that the general rate of depreciation for plant and machinery should be reduced to 15 per cent from the existing level of 25 per cent. We also recommend that the rates of depreciation for other blocks of assets must be reviewed along the above lines. Consequently, the depreciation amount charged for tax purposes will be similar to those charged under the Companies Act.**

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[66] We assume a Cenvat rate of 16 per cent and a state VAT of 10 per cent on capital goods. We also assume that the credit against Cenvat on capital goods will be spread over two years and in the case of state VAT over a period of three years.

Assumptions :	
Capital Cost	Rs. 100
Interest rate applied	9%
Depreciation	25%
Corporate Tax Rate	36.75%
Inflation (capital Goods)	3.5%

Table : 5.1
Computation of accumulated balance under Declining balance Method of Depreciation (with tax on Interest)

Year	Balance at the beginning of the year	Cenvat	State VAT	Depreciation (declining balance)				Interest	Tax on interest	Interest net of tax	Amount accumulated at the end of the year	Replacement value of machinery
				Cost	Cenvat Credit	State VAT Credit	Total					
1	78.37	12.54	9.09	19.59	6.27	3.03	28.89	0.00	0.00	0.00	28.89	100.00
2	58.78	6.27	6.06	8.82	6.27	3.03	18.12	2.60	0.96	1.64	48.65	103.50
3	49.96	0.00	3.03	7.49	0.00	3.03	10.52	4.38	1.61	2.77	61.95	107.12
4	42.47	0.00	0.00	6.37	0.00	0.00	6.37	5.58	2.05	3.53	71.84	110.87
5	36.10	0.00	0.00	5.41	0.00	0.00	5.41	6.47	2.38	4.09	81.35	114.75
6	30.68	0.00	0.00	4.60	0.00	0.00	4.60	7.32	2.69	4.63	90.58	118.77
7	26.08	0.00	0.00	3.91	0.00	0.00	3.91	8.15	3.00	5.16	99.65	122.93
8	22.17	0.00	0.00	3.33	0.00	0.00	3.33	8.97	3.30	5.67	108.65	127.23
9	18.84	0.00	0.00	2.83	0.00	0.00	2.83	9.78	3.59	6.18	117.66	131.68
10	16.02	0.00	0.00	2.40	0.00	0.00	2.40	10.59	3.89	6.70	126.76	136.29
11	13.61	0.00	0.00	2.04	0.00	0.00	2.04	11.41	4.19	7.22	136.02	141.06
12	11.57	0.00	0.00	1.74	0.00	0.00	1.74	12.24	4.50	7.74	145.49	146.00
13	9.84	0.00	0.00	1.48	0.00	0.00	1.48	13.09	4.81	8.28	155.25	151.11
14	8.36	0.00	0.00	1.25	0.00	0.00	1.25	13.97	5.13	8.84	165.34	156.40
15	7.11	0.00	0.00	1.07	0.00	0.00	1.07	14.88	5.47	9.41	175.82	161.87
16	6.04	0.00	0.00	0.91	0.00	0.00	0.91	15.82	5.82	10.01	186.74	167.53
17	5.13	0.00	0.00	0.77	0.00	0.00	0.77	16.81	6.18	10.63	198.14	173.40
18	4.36	0.00	0.00	0.65	0.00	0.00	0.65	17.83	6.55	11.28	210.07	179.47
19	3.71	0.00	0.00	0.56	0.00	0.00	0.56	18.91	6.95	11.96	222.59	185.75
20	3.15	0.00	0.00	0.47	0.00	0.00	0.47	20.03	7.36	12.67	235.73	192.25

Assumptions :	
Capital Cost	Rs. 100
Interest rate applied	9%
Depreciation	15%
Corporate Tax Rate	30%
Inflation (capital Goods)	3.5%

Table : 5.2
Computation of accumulated balance under Declining balance Method of Depreciation (with tax on Interest)

Year	Balance at the beginning of the year	Cenvat	State VAT	Depreciation (declining balance)				Interest	Tax on interest	Interest net of tax	Amount accumulated at the end of the year	Replacement value of machinery
				Cost	Cenvat Credit	State VAT Credit	Total					
1	78.37	12.54	9.09	11.76	6.27	3.03	21.06	0.00	0.00	0.00	21.06	100.00
2	66.61	6.27	6.06	9.99	6.27	3.03	19.29	1.89	0.57	1.33	41.67	103.50
3	56.62	0.00	3.03	8.49	0.00	3.03	11.52	3.75	1.13	2.63	55.82	107.12
4	48.13	0.00	0.00	7.22	0.00	0.00	7.22	5.02	1.51	3.52	66.56	110.87
5	40.91	0.00	0.00	6.14	0.00	0.00	6.14	5.99	1.80	4.19	76.89	114.75
6	34.77	0.00	0.00	5.22	0.00	0.00	5.22	6.92	2.08	4.84	86.95	118.77
7	29.56	0.00	0.00	4.43	0.00	0.00	4.43	7.83	2.35	5.48	96.86	122.93
8	25.12	0.00	0.00	3.77	0.00	0.00	3.77	8.72	2.62	6.10	106.73	127.23
9	21.36	0.00	0.00	3.20	0.00	0.00	3.20	9.61	2.88	6.72	116.66	131.68
10	18.15	0.00	0.00	2.72	0.00	0.00	2.72	10.50	3.15	7.35	126.73	136.29
11	15.43	0.00	0.00	2.31	0.00	0.00	2.31	11.41	3.42	7.98	137.03	141.06
12	13.11	0.00	0.00	1.97	0.00	0.00	1.97	12.33	3.70	8.63	147.63	146.00
13	11.15	0.00	0.00	1.67	0.00	0.00	1.67	13.29	3.99	9.30	158.60	151.11
14	9.48	0.00	0.00	1.42	0.00	0.00	1.42	14.27	4.28	9.99	170.01	156.40
15	8.05	0.00	0.00	1.21	0.00	0.00	1.21	15.30	4.59	10.71	181.93	161.87
16	6.85	0.00	0.00	1.03	0.00	0.00	1.03	16.37	4.91	11.46	194.42	167.53
17	5.82	0.00	0.00	0.87	0.00	0.00	0.87	17.50	5.25	12.25	207.54	173.40
18	4.95	0.00	0.00	0.74	0.00	0.00	0.74	18.68	5.60	13.08	221.36	179.47
19	4.20	0.00	0.00	0.63	0.00	0.00	0.63	19.92	5.98	13.95	235.94	185.75
20	3.57	0.00	0.00	0.54	0.00	0.00	0.54	21.23	6.37	14.86	251.34	192.25

Tax incentives for Shipping Industry

5.59 Section 33AC of the Income Tax Act provides for a deduction from the profits of a shipping company, of any amount transferred to a special reserve account. The total amount transferred to such reserve account is subject to a ceiling of twice the aggregate of the paid up share capital, the general reserves and share premium. The reserve must be used for the purpose of acquiring new ships. The use of these reserves for distribution of dividend is prohibited. The underlying objective of allowing this special deduction is to enable shipping companies to build up own capital for new acquisitions. The justification for this special dispensation is far too weak; this argument holds equally good for every other industry. This being so, it should be extended to all industries across the board which would be equivalent to an across the board rate reduction. Our proposal to affect a 18.38 per cent cut in the corporate tax rate[67] is a step towards a sector neutral tax regime. **Accordingly, we recommend that there is no further case for retaining the tax benefit u/s 33AC of the Income Tax Act and should, therefore be abolished.**

5.60 The shipping industry represented to the Task Force for the introduction of a tonnage tax for shipping companies as an option to the existing tax regime under the Income Tax Act. The Task Force was also informed that the Rakesh Mohan Committee had indeed recommended the introduction of such a tax and the recommendations were under the active consideration of the Ministry of Finance. We have also been informed that the Union Cabinet has, at the instance of the Cabinet Committee on Security, directed the Ministry of Finance/ Ministry of Shipping to separately examine the issue relating to the introduction of a tonnage tax. **The Task Force considers it only appropriate to refrain from making any recommendations on the introduction of the tonnage tax.**

Tax incentives for Scientific Research and Development

5.61 Companies undertaking research and development generally ignore the positive spillover benefits (externalities) that accrue to others (e.g. transfer of knowledge) when they decide upon the amount of R&D to undertake, which may result in an inefficiently

[67] A 6.75 percentage point reduction in the existing corporate tax rate of 36.75 per cent is equivalent to 18.68 per cent reduction.

low level of investment from society's perspective. Tax incentives targeted at research activities, or at the development and the implementation of production processes and products, are introduced to encourage companies to increase their investments in these areas

5.62 The income tax system in India also allows for concessional treatment of expenditure on Scientific Research and Development (Section 35). These take the form of deductions for both revenue and capital expenditure (other than land) on scientific research in the year in which these are incurred. While the treatment for the revenue expenditure is no different from any other expenditure, the treatment for capital expenditure tantamount to 100 per cent depreciation. Further, section 35(2AB)(1) also allows weighted deduction of 150 per cent of the expenditure (other than on land and building) on in-house research by companies engaged in the business of bio-technology, drugs and pharmaceuticals, electronic equipments, computers, tele-communication equipments, chemicals and any other article notified by the CBDT.

5.63 Given the fact that, the use of capital assets is fungible[68], it is rather difficult to identify whether the asset has been used only for scientific research. The full expensing of the capital expenditure on scientific research in the year in which it is incurred, creates a perverse incentive for fungibility. This leads to avoidable disputes between the revenue officials and the taxpayer. Further, the weighted expenditure linked deductions encourage shifting of expenditure from one head to another and making false expenditure claims. The recommendation to reduce the tax rates for corporate profits will now substantially enhance reward for research outcomes. Such outcome-based incentives are more efficient than input based incentives. **Accordingly, we recommend the abolition of section 35 of the Income Tax Act. As a result, the revenue expenditure on scientific research will qualify for deduction u/s 37 of the Income Tax Act and capital expenditure on scientific research will be eligible for depreciation under section 32 of the Income Tax Act. Since, expenditure link weighted deduction will also be abolished, there will be no perverse incentive to shift expenditure or make false claims.**

[68] It is rather impossible to identify whether a particular capital asset is used only for scientific research or also in the regular production process.

5.64 The provision of section 35 also allows weighted deduction in respect of donation to scientific research associations, university, college and other institutions engaged in scientific research, social science research and statistical research. It also allows weighted deduction for donation to approved scientific research programmes. In view of the fact that these confer higher benefit to donors engaged in business in comparison to non-business donors, **we recommend the rationalisation of the deduction for donation for scientific research, so as to be more equitable across taxpayers. Therefore, a tax rebate calculated at 20 per cent of the amount of donation for research (scientific, social sciences or statistical) should be allowed to all taxpayers irrespective of their source of income.** A comparative analysis of the tax treatment of expenditure on scientific research under the existing law and on the basis of our recommendations is contained in **Table 5.3.**

Deduction for payment of interest on borrowed capital.

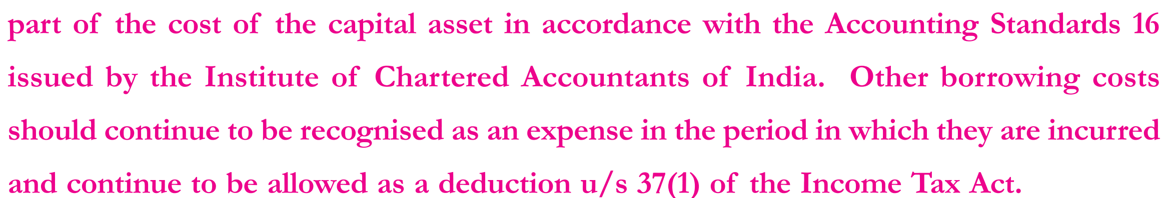
5.65 Section 36(1)(iii) of the Income Tax Act provides for a deduction in respect of interest paid on capital borrowed for the purposes of the business or profession. The Courts have interpreted that, unlike Section 37(1) of the Income Tax Act, there is no prohibition on the allowability of interest paid on capital borrowed for acquisition, construction or production of a capital asset. Therefore, such interest, even though capital in nature is allowable as revenue expenditure. As a result, the interest relating to the period prior to the completion of the project is being claimed as revenue expenditure in the computation of the taxable income. However, for the purposes of reporting to its shareholders, the same interest is capitalised as part of the cost of the capital asset in accordance with the Accounting Standards 16 issued by the Institute of Chartered Accountants of India. The Department continues to disallow the claim for deduction based on the Accounting Standards thereby giving rise to considerable dispute and uncertainty.

5.66 With a view to aligning the provisions relating to the allowability of deduction u/s 36(1)(iii) with those of the Accounting Standard 16 issued by the Institute of Chartered Accountants of India, **it is recommended that a suitable clarificatory amendment to Section 36(1)(iii) should be made to provide for the disallowance of the borrowing costs that are directly attributable to the acquisition, construction or production of a capital asset, as a revenue expenditure. Such borrowing costs will now have to be capitalized as**

Table 5.3:: Comparative analysis of the tax treatment of expenditure on Scientific Research.

Section	Nature of Expenditure / Donations under the existing law (assessment year 2003-04)	Amount of deduction Force recommendations (assessment year 2004-05)	Amount of deduction as per Task	Remarks
35(1)(i)	Revenue expenditure on Scientific Research related to the business	100 per cent of the expenditure	100 per cent of the expenditure to be allowed u/s 37(1)	
35(1)(ii)	Donation to – ➢ a Scientific Research Association set-up for scientific research; ➢ University, College or other institution to be used for scientific research	125 per cent of the donation	20 per cent tax rebate on 100 per cent of the donation (to be merged with the new provision for replacing section 80G)	Aligned to the tax benefit for non-business taxpayers. Hence equitable.
35(1)(iii)	Donation to a university, college or other institution to be used for research in social science or statistics	125 per cent of the donation	20 per cent tax rebate on 100 per cent of the donation (to be merged with the new provision for replacing section 80G)	Aligned to the tax benefit for non-business taxpayers. Hence equitable.
35(1)(iv)	Capital expenditure on scientific research related to the business	100 per cent of the expenditure	Depreciation to be allowed u/s 32	
35(2AA)	Donation to – ➢ A National Laboratory ➢ University or an Indian Institute of Technology or a specified person The donation must be with a specific direction to use for approved scientific research programme.	125 per cent of the donation	20 per cent tax rebate on 100 per cent of the donation (to be merged with the new provision for replacing section 80G)	Aligned to the tax benefit for non-business taxpayers. Hence equitable.

Section	Nature of Expenditure / Donations under the existing law (assessment year 2003-04)	Amount of deduction Force recommendations (assessment year 2004-05)	Amount of deduction as per Task	Remarks
35(2AB)(1)	Expenditure (other than on land and building) on in-house research by companies engaged in the business of – ➢ Biotechnology ➢ Drugs and pharmaceuticals ➢ Electronic equipments ➢ Computers ➢ Tele communication equipments ➢ Chemicals ➢ Any other article notified by the CBDT.	150 per cent of the expenditure	➢ 100 per cent deduction for revenue expenditure to be allowed u/s 37. ➢ Depreciation to be allowed u/s 32.	



part of the cost of the capital asset in accordance with the Accounting Standards 16 issued by the Institute of Chartered Accountants of India. Other borrowing costs should continue to be recognised as an expense in the period in which they are incurred and continue to be allowed as a deduction u/s 37(1) of the Income Tax Act.

Tax Treatment of Non-performing Assets of the Financial Sector

5.67 Under the general expense rule in the Income Tax Act, an expenditure is an allowable deduction if the liability is crystallized and quantified. Therefore, any provisioning for an expenditure is not an allowable deduction in the determination of the tax base if such provisioning is not a statutory obligation.

5.68 Section 36 (1)(viia) of the Income Tax Act, however, provides for a deviation from this general expense rule by allowing any provision for bad and doubtful debts made by commercial banks and public financial institutions subject to specified limits. The scope of the provision is summarized in **Table 5.4**.

5.69 The existing position is that in exercise of its statutory authority, the Reserve Bank of India mandates the banks and public financial institutions for provisioning of Non-Performing Assets (NPAs). Compliance to this is a statutory obligation[69]. However, for tax purposes, this statutory obligation is disregarded even though under the general expense rule, a statutory liability is a fully allowable deduction. As a result, the banks and public financial institutions face a double jeopardy: they have to statutorily provide for such non-performing assets thereby undermining actual profits as well as pay tax on such provisioning which further undermines the profits. **Accordingly, we recommend that the provisions of section 36(1)(viia) of the Income Tax Act should be amended to provide that the provision for bad and doubtful debts will be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.**

[69] It is neither a contractual obligation nor a case of diversion of profits.

Table 5.4

Tax Treatment of Provisions for Non-performing Assets of Banks and Financial Institutions

Section	Eligibility	Amount of deduction	Period
36(1)(viia)(a)	Scheduled Bank (other than foreign banks)	(I) Amount not exceeding the sum of 5 per cent of adjusted gross total income and 10 per cent of aggregate average advances made by rural branches; OR (II) 5 percent of the Non-performing Assets identified on the basis of RBI guidelines (10 per cent for assessment years 2003-04 and 2004-05).	Option I is available in every assessment year. Option II is available for assessment years 2000-01 to 2004-05.
36(1)(viia)(b)	Foreign Bank	An amount not exceeding 5 percent of adjusted gross total income	Every assessment year.
36(1)(viia)(c)	Public Financial Institution or State Finance Corporation or State Industrial Investment Corporation	I. Amount not exceeding 5 per cent of adjusted gross total income; OR II. 10 percent of the NPA identified on the basis of RBI guidelines.	Option I-Every assessment year. Option II-For assessment years 2003-04 and 2004-05.

Tax Treatment Of Statutory Liabilities

5.70 In terms of the provisions of Section 43B of the Income Tax Act, deduction for statutory payments relating to labour, taxes and state and public financial institutions are allowed as deductions if they are paid during the financial year. However, under the provisions payment of taxes and interest to state and public financial institutions are deemed to have been paid during the financial year even if they are paid by the due date of filing of return. Further, if the liability is discharged in the subsequent year after the due date of filing of return, the payment is allowed as a deduction in the subsequent year. In the case of statutory payment relating to labour, the deduction for the payment is disallowed if such payment is made any time after the last date for payment of the labour related liability. Trade and industry across the country represented that the delayed payment of statutory liability related to labour should be accorded the same treatment as delayed payment of taxes and interest i.e. they should be allowed in the year of payment.

5.71 Since, the objective of the provision is to ensure that a taxpayer does not avail of any statutory liability without actually making a payment for the same, we are of the view that these objectives would be served if the deduction for the statutory liability relating to labour are allowed in the year of payment. The complete disallowance of such payments is too harsh a punishment for delays in payment. **Therefore, we recommend that the deduction for delayed payment of statutory liability relating to labour should be allowed in the year of payment like delayed taxes and interest.**

The treatment of corporate tax losses

5.72 Most income tax systems permit businesses that earn a tax loss in one year (where taxable revenues are less than tax deductions in the same year) to carry the tax loss (i.e., the negative amount of taxable income) forward to future years, or (in a more limited number of cases) back to previous years, to be used to offset income in those years. The carry-back and carry-forward provisions are typically limited (e.g., a three year carryback and a seven year carryforward). These provisions are provided in recognition of the arbitrary choice of a fixed period (e.g., 12 months) for which to assess tax. The practice recognises that many companies/firms encounter negative cash flows during their initial phases, despite being profitable over the longer term or on a present value basis. Moreover, in certain high-risk industries, even very efficient and profitable firms may experience wide

fluctuations in their earnings over both negative and positive ranges. Disallowing loss transfers over time would be inconsistent with a proper matching of revenues and expenses, would impose a higher tax burden on firms with unstable profit profiles, and would discourage risk-taking.

5.73 Unless a tax loss in one year can be carried back to offset tax paid in a prior year, less than full loss- offsetting occurs, as when losses are carried forward, they typically may not be carried forward with an interest adjustment (to reflect the opportunity cost of funds). Therefore, the present value of losses deducted in the future will be less than the value of those losses if they could be currently used. Countries do not typically offer a cash refund for tax losses, for primarily two reasons. First there is a fear that refundability would encourage unprofitable or inefficient businesses. Second, providing for refundability would impose significant up-front revenue costs, and difficult transitional issues would be met in a move to such a system (i.e., how to treat accumulated pools of losses).

5.74 Finally, it is important to recognise that (conceptually) tax losses can be subdivided into three categories: i) operating business losses, ii) capital losses, and iii) tax incentive losses. Under the Indian income tax system, typically capital losses arising from depreciation are allowed to be carried forward indefinitely however the operating business losses are allowed to be carried forward only for the period of eight years. This discourages projects with long gestation period as well as those which incur losses in the initial years of their operations. With a view to eliminating this bias, **we recommend the removal of distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and lose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.**

Tax Incentives under sections 80IA and 80IB

5.75 The deductions u/s 80IA and 80IB are allowed in respect of profits from the eligible business at the rates and for the number of years as indicated in **Tables 5.5 and 5.6.** These deductions, in so far as they relate to backward areas and other specific locations, have not served their intended objective[70]. Similarly, like any other incentives, these also cause serious distortions in economic efficiency, equity and administrative effectiveness. If

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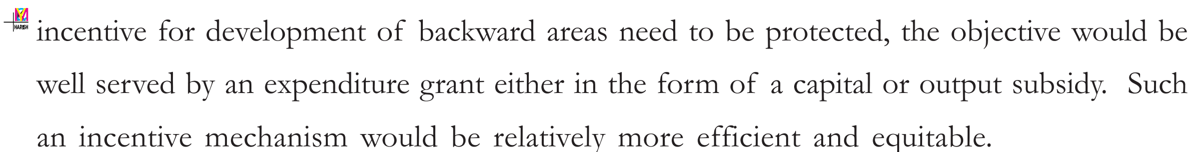
[70] Planning Commission (2001) Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan.



incentive for development of backward areas need to be protected, the objective would be well served by an expenditure grant either in the form of a capital or output subsidy. Such an incentive mechanism would be relatively more efficient and equitable.

5.76 Most often, the case for deduction in respect of profits of the eligible businesses referred in sections 80IA and 80IB is justified on the ground that these businesses have large gestation period and generate huge losses in the first five to seven years. The tax benefit from such losses is often lost out due to the arbitrary cut off period for carry forward and allowability of losses. Since, we have recommended in the earlier section, that business losses, like depreciation, should be allowed to be carried forward indefinitely, the inherent problem associated with such eligible business would stand resolved.

5.77 Further, most of the eligible businesses are regulated and therefore assured of a fixed rate of return. The fixation of tariffs in such cases renders tax payable to be a pass through. Thus the incidence of income tax does not by itself reduce the attractiveness of the project for the investors.

5.78 In a large number of cases covered under these provisions, the exemption is in respect of partial profits. Since, these provisions were introduced when the tax rate was 40.25 per cent (35 per cent plus 15 per cent surcharge), the substantial benefit flowing from our recommendation to reduce the tax rate to 30 per cent and exempt dividends and long-term capital gains on equity, is compensatory for the withdrawal of the benefit u/s 80IA and 80IB.

5.79 Another aspect of the tax benefit u/s 80IA and 80IB that needs to be placed on record is that such benefits only helped to camouflage the under performance of corporate managers. These benefits did not protect the shareholders; the dividends distributed from exempt profit were also taxable along with long-term capital gains. Further, these have also been a source of both abuse and large number of litigation increasing transaction costs all around.

5.80 **In view of the above, the Task Force recommends the elimination of the provisions of section 80IA and 80IB with immediate effect (and not by a sunset clause).**

Table 5.5 : Tax incentives Under Section 80IA – At a glance.

Section	Eligible business	Nature of deduction	Number of years for which deduction can be claimed	Remarks
80IA	Development or maintenance or operation of the following infrastructure facility :- 1. Roads including toll road, a bridge or a rail system. 2. A highway project including other activities which are integral part of the project. 3. Water supply project. 4. Water treatment system. 5. Irrigation project. 6. Sanitation and sewerage system. 7. Solid waste management system. 8. Port, air-port, inland waterway or inland port.	100 per cent of the profits derived from the eligible business.	➢ 10 consecutive assessment years out of 20 years. ➢ 10 out of 15 years for ports, air-ports, inland waterways or inland port	Regulated Industry (other than highway project)
80IA	Provision of Tele-communication services	➢ 100 per cent of the profits derived from the eligible business. For the first 5 years. ➢ 30 per cent of the profits derived from the eligible business. For the next 5 years	10 consecutive assessment years out of 15 years.	Regulated Industry
80IA	Development of industrial park	100 per cent of the profits	10 consecutive assessment years.	
80IA	Development of special economic zone	100 per cent of the profits	10 consecutive assessment years.	
80IA	Development and operation of special economic zone	100 per cent of the profits	10 consecutive assessment years.	
80IA	Maintenance and operation of special economic zone	100 per cent of the profits	10 consecutive assessment years.	
80IA 80IA 80IA	Generation of power Transmission of power Distribution of power	100 per cent of the profits 100 per cent of the profits 100 per cent of the profits	10 consecutive assessment years. 10 consecutive assessment years. 10 consecutive assessment years.	Regulated Industry Regulated Industry Regulated Industry

Table 5.6 : Tax incentives Under Section 80IB – At a glance.

Section	Eligible business	Nature of deduction	Number of years for which deduction can be claimed	Remarks
80IB(3)(i)	Industrial Undertaking notified by the Central Government	25 per cent (30 per cent for company)	10 consecutive assessment years (12 year for cooperative societies)	Operations must begin before the date specified by notification with reference to any particular undertaking.
80IB(3)(ii)	Small scale industrial undertaking	25 per cent (30 per cent for company)	10 consecutive assessment years (12 year for cooperative societies)	Operations must begin between 1-04-1995 and 31-03-2002
80IB(4)	Industrial undertaking in an industrially backward state specified in the Eighth Schedule.	➢ 100 per cent of the profits derived from the eligible business in the first five years. ➢ 25 per cent (30 per cent for companies) of the profits derived from the eligible in the next 5 years.	10 consecutive assessment years	Begins to manufacture before 1-04-2004
80IB(5)(i)	Industrial undertaking located in backward district of category "A"	➢ 100 per cent of the profits derived from the eligible business in the first five years ➢ 25 per cent (30 per cent for companies) of the profits derived from the eligible in the next 5 years.	10 consecutive assessment years	Begins to manufacture before 1-04-2004

Section	Eligible business	Nature of deduction	Number of years for which deduction can be claimed	Remarks
80IB(5)(ii)	Industrial undertaking located in backward district of category "B"	➢ 100 per cent of the profits derived from the eligible business in the first three years ➢ 25 per cent (30 per cent for companies) of the profits derived from the eligible business in the next 5 years.	8 consecutive assessment years 9 12 assessment years for co-operative societies)	Begins to manufacture before 1-04-2004
80IB(6)	Business of ship	30 per cent of the profits	10 consecutive assessment years	Ship brought into use between 1-04-1991 and 31-03-1995
80IB(7)(a)	Business of Hotel in hilly areas or pilgrimage centres	50 percent of the profits	10 consecutive assessment years	Operations must begin before 1-04-2001
80IB(7)(b)	Business of Hotel in any other area	30 percent of the profits	10 consecutive assessment years	Operations must begin before 1-04-2001
80IB(7A)	Business of building, owning and operating a multiplex theatre	50 percent of the profits	5 consecutive assessment years	Operations must begin between 1-04-2002 and 31-03-2005
80IB(7B)	Business of building, owning and operating a convention centre	50 percent of the profits	5 consecutive assessment years	Operations must begin between 1-04-2002 and 31-03-2005
80IB(8)	Scientific Research and Development company	100 percent of the profits	5 consecutive assessment years	Operations must begin before 1-04-1999

Section	Eligible business	Nature of deduction	Number of years for which deduction can be claimed	Remarks
80IB(8A)	Scientific Research and Development company	100 percent of the profits	5 consecutive assessment years	Operations must begin between 31-03-2000 and 1-04-2003
80IB(9)	Commercial production or refining of mineral oil	100 percent of the profits	7 consecutive assessment years	
80IB(10)	Development and building of housing project approved by a local authority	100 percent of the profits		Operations must begin before 31-03-2001 and completed before 31-03-2003
80IB(11)	Business of setting up and operating a cold chain facility for agricultural produce	➢ 100 percent of the profits in the first 5 years ➢ 25 per cent (30 per cent for company) of the profits in the next 5 years.	10 consecutive assessment years	Operations must begin after 1-04-1999 but before 31-03-2003
80IB(11A)	Integrated business of handling, storage and transportation of food grains	➢ 100 percent of the profits in the first 5 years ➢ 25 per cent (30 per cent for company) of the profits in the next 5 years.	10 consecutive assessment years	Operations must begin on or after 1-04-2001

5.81 While considering the elimination of a various tax incentives particularly those under section 10A, 10B, 80IA and 80IB, with immediate effect and not by grandfathering them, the Task Force deliberated upon whether such a step would violate the principle of promissory estoppel.

5.82 The doctrine of promissory estoppel, though of ancient vintage, was rescued from obscurity by the decision of Justice Denning in the celebrated High Trees case[71]. This principle has been restarted by him in his book[72] in the following words: "it is a principle of justice and of equity. It comes to this: When a man by his words or conduct has led another to believe that he can safely act on the faith of them and the other does act on them – he will not be allowed to go back on what he has said or done when it would be unjust or unequitable for him to do so". Estoppel is thus a rule of equity.

5.83 In India the doctrine started in a significant way with the Indo-Afghan case in 1968 and after some vicissitude stabilised since mid-eighties with authoritative pronouncements in the cases of Godfrey Phillips, Pournami Oil Mills, Usha Martin, Filterco, Bakul cashew, Bakul oil etc. It is now well-recognised by the Courts and well-established in the administrative law of India.

5.84 The rule of interpretation that emerges from the plethora of judgments that if the government promises something about tax or benefit of import etc. To a citizen, the doctrine of promissory estoppel will apply provided the promise made itself is not against the statute (there is no estoppel against statue) and the person promising is competent to make a promise. The settled law is now that where the Government makes a promise knowing or intending that it would be acted upon by the promisee and in fact the promisee acting in reliance on it, alters its position, the Government would be held bound by the promise and the promise would be enforceable against the Government at the instance of the promisee, notwithstanding that there is no consideration for the promise and the promise is not recorded in the form of a formal contract as required by Article 299 of the Constitution.

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[71] [1947] KB 130.
[72] Discipline in Law 1988 edition P 223

5.85 The Supreme Court through its various judgements have decided that promissory estoppel applies against executive powers and not against legislative powers of the Government. The first limitation to the doctrine is that there can be no estoppel against the statute. There is also no estoppel against legislative function exercised by the legislature itself. There is also no estoppel against the taxpayer but only against the Government and public bodies. Promissory estoppel can operate even when the promise is not held out to one person but given in general as a scheme but no promise can be taken as estoppel if it is vague or derived in an indirect manner or given by an unauthorised person. If the concession promised is misused, then the government can withdraw the promised concession. Promise must be acted upon and the taxpayer must have altered his position in order that the promise upon and the assessee must have altered his position in order that the promise constitutes an estoppel. Against classification of goods there cannot be an estoppel. Since promissory estoppel is itself a creature of equity demands for the public good the discontinuance of a promise to an individual or to a class, then promissory estoppel will not apply. Public good will override private injury.

5.86 The Supreme Court in its judgement delivered as late as December, 2001 in the case of Sharma Transport Vs. Government of A.P. and Others[73] has reiterated the principles in the following observations:-

> "Next plea is the oft-repeated one of promissory estoppel. It has to be noted that even though a concession is extended for a fixed period, the same can be withdrawan in public interest. In STO vs. Shree Durga Mills ((1998) 1 SCC 572 : (1997) 7 Scale 726) it has been held by this court that a notification granting exemption of tax can be withdrawn at any point of time. There cannot be estoppel against any statute. Where it is in public interest, the Court will not interfere because public interest must override any consideration of private loss or gain (see Kasinka Trading Vs. Union of India ((1995) 1 SCC 274). In Shrijee Sales Corpn. V. Union of India ((1997) 3 SCC 398) it was observed that where there was supervening public interest, the Government is free to change its stand and withdraw the exemption already granted. One such reason for changing its policy decision can be resource crunch and the loss of public revenue. There is preponderance of judicial opinion that to invoke the doctrine of promissory estoppel, clear, sound and positive foundation must be laid in the petition itself by the

[73] 2002-(089)-AIR-0322-SC

party invoking the doctrine and that bald expressions, without any supporting material, to the effect that the doctrine is attracted because the party invoking the doctrine has altered its position relying on the assurance of the Government would not be sufficient to press into aid the doctrine…………………………………………………………………It has been pleaded as noted above that withdrawal is without any rational or relevant consideration. In this context, it has to be noted that the operators in the State of Andhra Pradesh are required to pay the same tax as those registered in other states. Therefore, there cannot be any question of irrationality. The tests of arbitrary action applicable to executive action do not necessarily apply to delegated legislation. In order to strike down a delegated legislation as arbitrary it has to be established that there is manifest arbitrariness. In order to be described as arbitrary, it must be shown that it was not reasonable and manifestly arbitrary. The expression "arbitrarily" means : in an unreasonable manner, as fixed or done capriciously or at pleasure, without adequate determining principle, not founded in the nature of things, non-rational, not done or acting according to reason or judgement, depending on the will alone. In the present cases all persons who are similarly situated are similarly affected by the change. That being so, there is no question of any discrimination. That plea also fails."

5.87 Since, the promise to confer the tax benefits under sections 10A, 10B, 80IA and 80IB for specified periods is by the legislature and there is no promissory estoppel either against the statute or against the legislature itself, the elimination of these provisions with immediate affect is perfectly legal in view of the various Supreme Court decisions.

5.88 As regards the ethics of such a course of action, the rule of promissory estoppel is essentially a rule of equity and not a fiction of law. If an action is equitable (and all actions of the legislature are deemed as equitable if the rule of promissory estoppel does not apply to legislative functions), then it must necessarily be ethical. Even otherwise, promises are made to human beings and therefore, in effect to shareholders; the company is only a conduit. The proposed package for corporate tax reforms do not in anyway alter the inter-temporal liability of shareholders. Under the existing law, the tax exemptions to companies are not protected in the hands of the shareholders. Therefore, while the company avoids payments of taxes, the shareholders suffer the full impact of the tax when they receive the profits as dividends. Consequent to our recommendations, the full burden of the tax will fall at the corporate level and the shareholders will be fully exempt. In other

words, there will be no change in the cumulative burden on corporate profits. Hence, in reality, there is no violation what so ever of the principle of promissory estoppel.

5.89 The existing system protects managers and undermines corporate governance. In theory a shareholder has a right to decide on the dividend pay out ratio. However, given the thin distribution of the voting powers of shareholders, the decision, in reality, is that of the managers. The emphasis therefore shifts to retention of profits resulting in deferment of taxes in perpetuity. Further, the tax incentives serve to camouflage poor corporate performance of managers. This undermines corporate governance.

5.90 It is also important to place on record the implication of the principle of promissory estoppel on the very process of economic reforms. It must be mentioned that the various "promises" made by the government were in the context of an economic regime characterized by high tax rates (both personal and corporate), high inflation, high tariffs and high interest rates. With considerable change in the economic regime (tax rates, import tariffs, interest rates and inflation have substantially reduced since then), it is imperative to realign the tax regime with these changes. If indeed promissory estoppel to the tax incentives has to be applied, the benefits flowing from reduced tax rates, import tariffs, interest rates and inflation would also have to be withdrawn. In other words, economic reforms must be reversed in its entirety. This will not be in the overall public interest.

5.91 Further, if incentives are retained on grounds of promissory estoppel, the effective tax burden shifts to the salaried and other vulnerable taxpayers who are not shareholders of equity. Therefore, the rule of promissory estoppel flowing from the rule of equity will, in effect, be inequitable.

5.92 In the light of the above, the Task Force is firmly of the view that there is no violation of the principle of promissory estoppel either legally or ethically. If the cause of economic reforms (in particular tax reforms) has to be advanced, it is necessary to simplify the tax system by eliminating the tax incentives across the board with immediate effect. The interest of the multitude of taxpayers should not be allowed to be sacrificed at the altar of some corporate managers.

5.93 The Task Force discussed the possible strategy for the successful implementation of the corporate tax reforms. Towards this, the Task Force recommends two alternate options for reform of corporate income tax:-

Option - I : The following measures to be introduced for the financial year 2003-04:-

(i) Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies.

(ii) Exemption of dividend from taxation in the hands of the shareholders. There will also be no tax on distribution of dividends by a company.

(iii) Exemption of long-terms capital gains on listed equity.

(iv) Elimination of Minimum Alternate Tax under Section 115JB.

(v) Removal of the distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(vi) Removal of the following deductions under Section 10 and Chapter VI A of the Income Tax Act with immediate effect and not by a sunset clause :-

(a) Elimination of Section 10A and 10B of the Income Tax Act for all tax payers other than those engaged in manufacturing computer software.

(b) In the case of taxpayers engaged in manufacturing computer software, the Government of India must take immediate steps to negotiate with foreign governments to enter into a comprehensive totalisation agreement leading to a single point

incidence of taxes. However, in the interim, the Task Force recommends the following alternatives:-

1. Eliminate the tax exemption u/s 10A and 10B and amend Section 91 of the Income Tax Act to allow full credit for payment of foreign country's federal and state income tax. However, no refund of such foreign tax credit should be allowed; OR

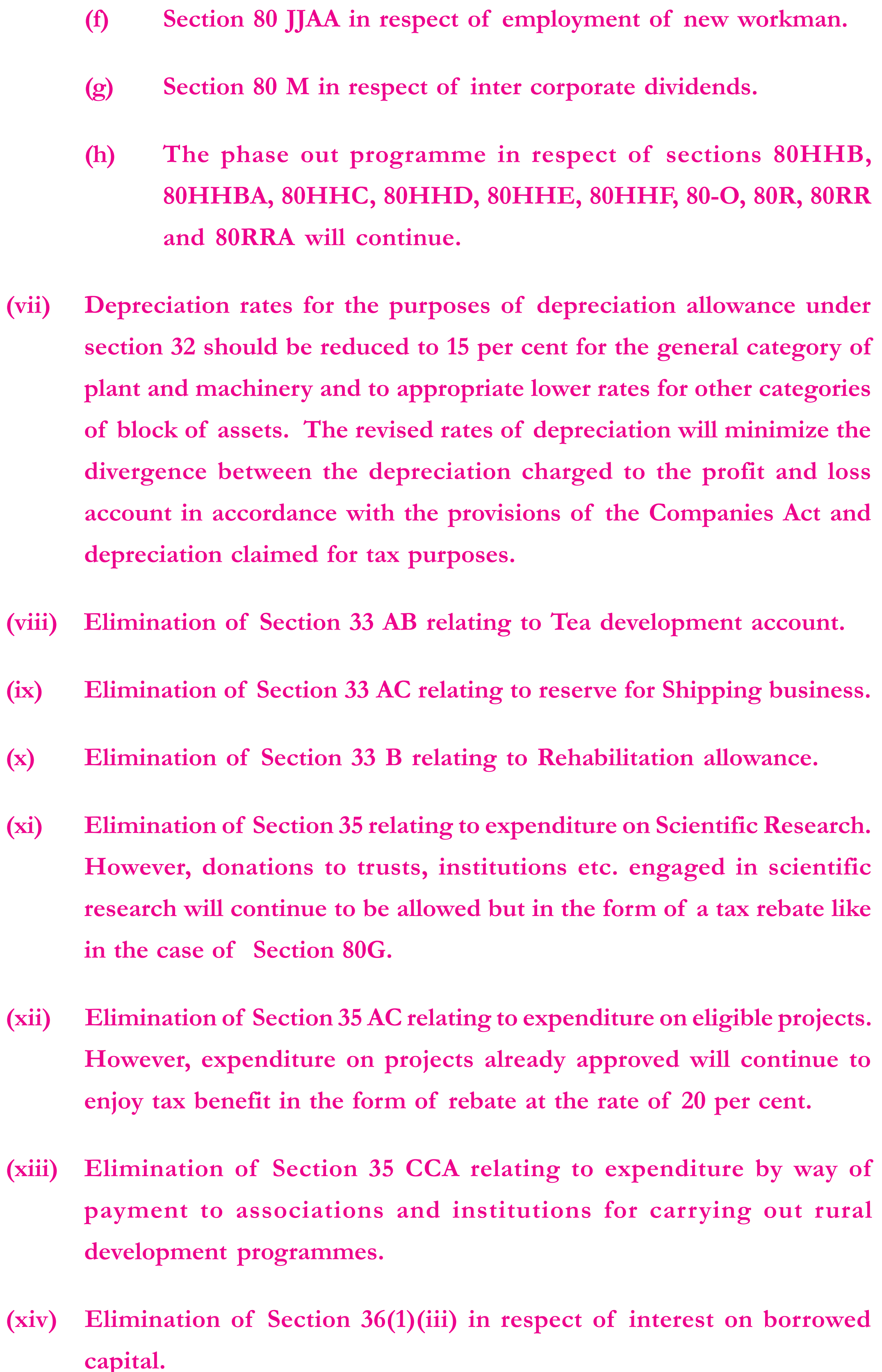
2. Since the arrangement is transitory in nature the benefit of tax exemption u/s 10A and 10B for manufacturing of computer software only may be continued till we enter into a totalisation agreement with trading partners. However, the distribution of dividend by computer software manufacturing companies availing of deductions u/s 10A or 10B should be subjected to a dividend distribution tax of 30 per cent. Similarly, the long-term capital gains arising from transfer of equities of such companies should also be subjected to tax like long-term capital gains from any other asset.

The Task Force could not arrive at unanimity on the preferred alternative amongst the above two.

(c) Section 80 IA in respect of profit and gains from industrial undertakings or enterprises engaged in infrastructure development or telecommunication service or development of industrial park or special economic zones or generation, transmission or distribution of power.

(d) Section 80 IB in respect of profits and gains from certain industrial undertakings other then infrastructure development undertakings (this includes backward areas also).

(e) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.



(f) Section 80 JJAA in respect of employment of new workman.

(g) Section 80 M in respect of inter corporate dividends.

(h) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(vii) Depreciation rates for the purposes of depreciation allowance under section 32 should be reduced to 15 per cent for the general category of plant and machinery and to appropriate lower rates for other categories of block of assets. The revised rates of depreciation will minimize the divergence between the depreciation charged to the profit and loss account in accordance with the provisions of the Companies Act and depreciation claimed for tax purposes.

(viii) Elimination of Section 33 AB relating to Tea development account.

(ix) Elimination of Section 33 AC relating to reserve for Shipping business.

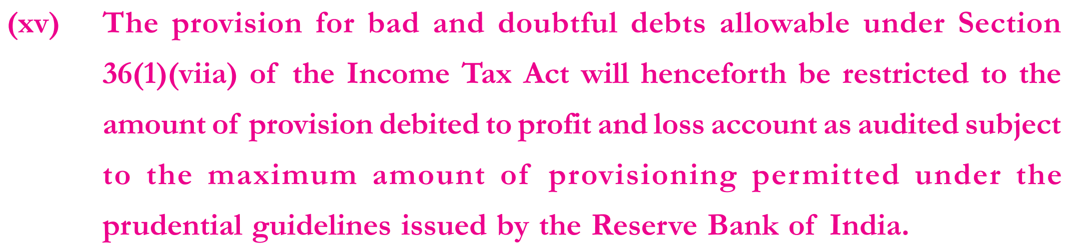
(x) Elimination of Section 33 B relating to Rehabilitation allowance.

(xi) Elimination of Section 35 relating to expenditure on Scientific Research. However, donations to trusts, institutions etc. engaged in scientific research will continue to be allowed but in the form of a tax rebate like in the case of Section 80G.

(xii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

(xiii) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

(xiv) Elimination of Section 36(1)(iii) in respect of interest on borrowed capital.


(xv) The provision for bad and doubtful debts allowable under Section 36(1)(viia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

Option - II : The package of measures along with their phased implementation, to be introduced through the Finance Bill 2003, in the following manner:-

(i) Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies over a period of three years. The rates for domestic companies will be 34 per cent in financial year 2003-04, 32 per cent in 2004-05 and 30 per cent in 2005-06. The rates for foreign companies will be 38.50 per cent in financial year 2003-04, 37 per cent in 2004-05 and 35 per cent in 2005-06.

(ii) No tax on dividend in the hands of the shareholders.

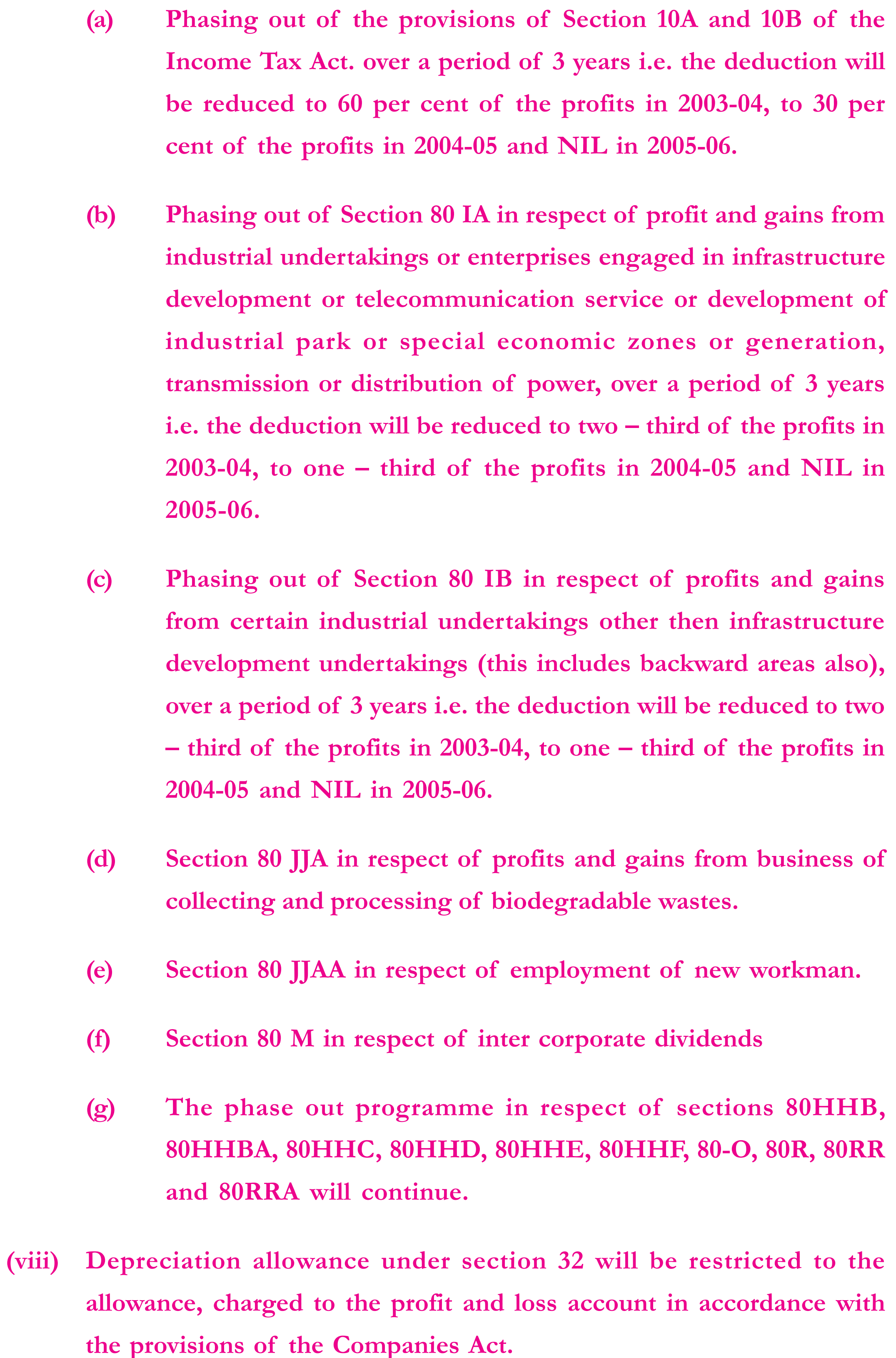
(iii) No tax on long terms capital gains on listed equity.

(iv) Elimination of Minimum Alternate Tax under Section 115JB.

(v) Removal of the distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(vi) Levy of a distribution tax on dividends at the rate of 15 per cent for dividends distributed in 2003-04, 7.5 per cent in 2004-05 and Nil in 2005-06.

(vii) Removal / Phasing out of the following deductions under Section 10 and Chapter VI A of the Income Tax Act with immediate effect and not by a sunset clause :-



(a) Phasing out of the provisions of Section 10A and 10B of the Income Tax Act. over a period of 3 years i.e. the deduction will be reduced to 60 per cent of the profits in 2003-04, to 30 per cent of the profits in 2004-05 and NIL in 2005-06.

(b) Phasing out of Section 80 IA in respect of profit and gains from industrial undertakings or enterprises engaged in infrastructure development or telecommunication service or development of industrial park or special economic zones or generation, transmission or distribution of power, over a period of 3 years i.e. the deduction will be reduced to two – third of the profits in 2003-04, to one – third of the profits in 2004-05 and NIL in 2005-06.

(c) Phasing out of Section 80 IB in respect of profits and gains from certain industrial undertakings other then infrastructure development undertakings (this includes backward areas also), over a period of 3 years i.e. the deduction will be reduced to two – third of the profits in 2003-04, to one – third of the profits in 2004-05 and NIL in 2005-06.

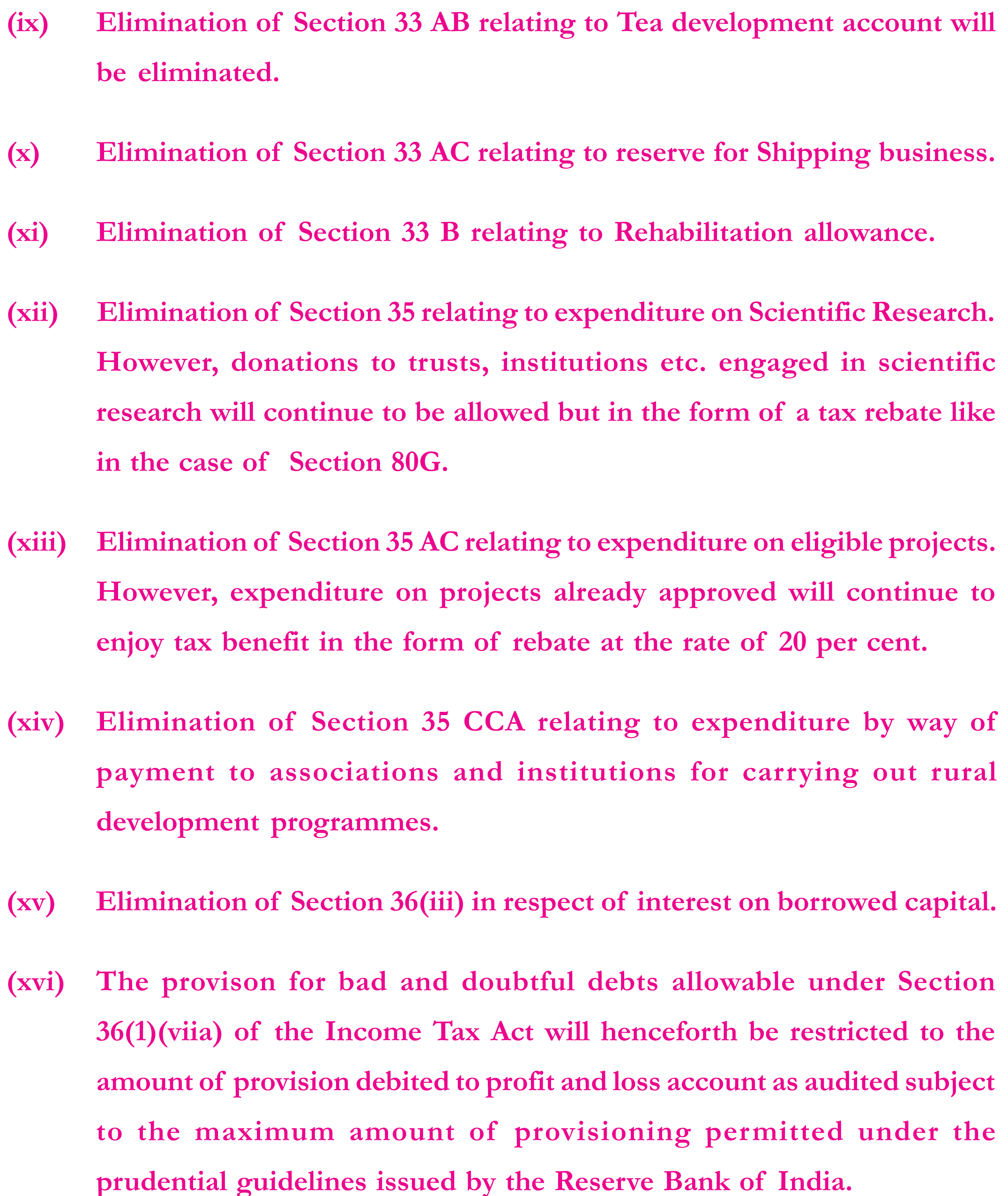
(d) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.

(e) Section 80 JJAA in respect of employment of new workman.

(f) Section 80 M in respect of inter corporate dividends

(g) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(viii) Depreciation allowance under section 32 will be restricted to the allowance, charged to the profit and loss account in accordance with the provisions of the Companies Act.



(ix) Elimination of Section 33 AB relating to Tea development account will be eliminated.

(x) Elimination of Section 33 AC relating to reserve for Shipping business.

(xi) Elimination of Section 33 B relating to Rehabilitation allowance.

(xii) Elimination of Section 35 relating to expenditure on Scientific Research. However, donations to trusts, institutions etc. engaged in scientific research will continue to be allowed but in the form of a tax rebate like in the case of Section 80G.

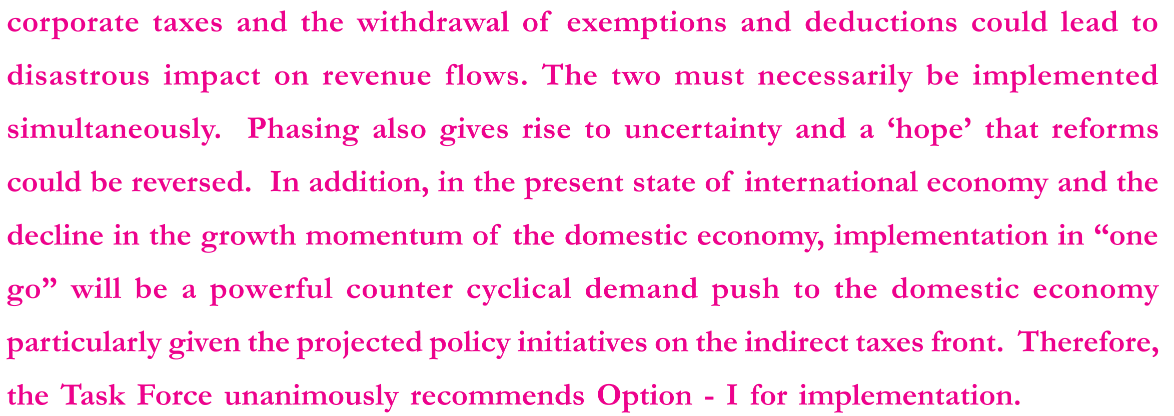
(xiii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

(xiv) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

(xv) Elimination of Section 36(iii) in respect of interest on borrowed capital.

(xvi) The provison for bad and doubtful debts allowable under Section 36(1)(viia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

5.93 The Task Force deliberated upon the two packages. It was unanimously agreed that it is rather difficult for any government to give a credible ex-ante time commitment. Such commitments are rarely sustainable. Past experience shows that while tax rates were reduced, successive governments failed to implement the phased withdrawal of incentives. As a result, we have reached a point where the corporate tax rates are close to their resting points and yet the statute continues to be riddled with exemptions and deductions. Any attempt to sequence the reduction in the



corporate taxes and the withdrawal of exemptions and deductions could lead to disastrous impact on revenue flows. The two must necessarily be implemented simultaneously. Phasing also gives rise to uncertainty and a 'hope' that reforms could be reversed. In addition, in the present state of international economy and the decline in the growth momentum of the domestic economy, implementation in "one go" will be a powerful counter cyclical demand push to the domestic economy particularly given the projected policy initiatives on the indirect taxes front. Therefore, the Task Force unanimously recommends Option - I for implementation.

CHAPTER 6

TAXATION OF CAPITAL GAINS

Treatment of Capital Gains

6.1 Under the existing law, profits and gains arising from the transfer of capital asset made in a previous year is taxable as capital gains. A capital asset is distinguished on the basis of the period of holding. A capital asset, which is held for more then three years, is categorised as a long-term capital asset. However, if the capital asset is in the nature of equity, it is categorised as a long-term capital asset if it is held for more then one year. All capital assets other then long-term capital asset is termed as a short-term capital asset.

6.2 The profits and gains arising from the transfer of a short-term capital asset are treated as short-term capital gains and included in the total income of the taxpayer for taxation at the rates applicable to him. Where a taxpayer incurs a loss from the transfer of a short-term capital asset (such loss is termed as "short-term capital loss") the same is allowed to be set off only against gain from the transfer of another short-term or long-term capital asset. In a case where the short-term capital loss remains unabsorbed, the same is allowed to be carried forward for set off only against gain from the transfer of another short-term and long-term capital asset in the subsequent year. However, such carry forward is restricted for a period of eight years. In other words, a short-term capital loss cannot be set off against income from salaries, house property, business or profession or income under the head "other sources".

6.3 Similarly, the profits and gains arising from the transfer of a long-term capital asset are treated as long-term capital gains. Since long-term capital gains represent accumulation of income over a period of time, these could turn out to be illusory in real terms. Accordingly, the cost of the asset is adjusted for inflation during the period of holding. The increased cost is set-off against the sale consideration of the long-term capital asset to determine the long-term capital gain. Such long-term capital gain is subjected to a

concessional rate of tax to eliminate the bunching effect[74]. Furthermore, the long-term capital gains are fully exempt if the proceeds are invested in specified savings plan / schemes. In view of the liberalized personal income tax rate schedule comprising of only two rates, the adverse impact in the form of increased tax burden arising from bracket creep due to bunching of capital gains would be considerably reduced and in most cases eliminated. **Therefore, we recommend that concessional treatment of long-term capital gains through a reduced scheduler rate of tax must be abolished. In other words, the long-term capital gains would be aggregated with other incomes and subjected to taxation at the normal rates. Further, since we have recommended the abolition of various saving incentives, we do not consider necessary to allow any exemption for roll over of long-term capital gains.** However, we do recognise that a large number of small taxpayers feel the necessity to finance their basic requirement of a house by selling other capital assets like equity etc. Similarly, the financing of the construction of the Golden Quadrilateral and the North-South & East-West corridors is dependent on the funds mobilize through investment of the long-term capital gains. **Given the public nature of the project, it is necessary to maintain the flow of funds. Therefore, we recommend that long-term capital gains should continue to be exempt if invested in a house or in the bonds of National Highway Authority of India until completion of the Golden Quadrilateral and the North-South & East-West corridors.**

6.4 In the section on corporate taxation, we have recommended the elimination of all tax preferences thereby increasing the effective tax burden on corporate profits to the statutory rate of 30 per cent. The divergence between the effective corporate tax rate and the statutory tax rate would be eliminated. Consequent to these recommendations, the retained earnings of a company would bear the full impact of the corporate tax. A substantial portion, if not all, of the long-term capital gains on equity represent the value of retained earnings. Since the profits of the company would bear the full burden of the tax, the retained earnings would have also suffered full taxation. Any tax on such long-term capital gains on equity would tantamount to "double taxation" of the retained earnings.

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[74] The rate of tax on long-term capital gains is 20 per cent. However, if the long-term capital asset is in the nature of listed securities (equity) or units, the rate of tax on long-term capital gains is 10 per cent of gains computed without inflation indexation or 20 per cent of gains computed after indexation, whichever is lower.

6.5 The case for taxation of capital gains on equity is often built around the argument that a part of the long-term capital gains on equity will represent the unrealized gains in the value of the assets, which would not have suffered taxation at the corporate level. Consequent to the exemption of long-term capital gains on equity, such unrealized gains would escape taxation. Such unrealized gains are assessed on realization at a future date, as part of the corporate tax base. The exemption of the long-term capital gain would essentially result in deferral of tax revenue. The revenue loss will be restricted to the extent of erosion in the time value of money. Given the simplification, which will follow from exemption of the long-term capital gains, there will be substantial reduction in dead weight loss. Therefore, the net loss from deferral of revenues may not be very significant. Similarly, the exemption will also not impair any equity. The buyer of the equity would have discounted the future value of unrealized gains to the extent of the potential tax liability resulting in lower long-term capital gains to the seller. Hence, the seller would have in any case suffered implicit taxation through lower prices.

6.6 Another argument offered against the proposal to exempt long term capital gains on equity is that part of such gains represent the "goodwill gains' – those arising from such factors as improved market position, technological developments and discoveries. Such goodwill gains will be reflected in the monopoly profits of the company, which in any case would suffer full taxation. Hence there is neither any loss of revenue or equity.

6.7 In view of the above, the case for taxation of long-term capital gains on equity is not sustainable. The Task Force recognizes that capital gains on equity could be related to a systemic shift in stock market prices, which may not in any way be related to the economic income of the company. Such gains would not have suffered any taxation at the corporate level. This is likely to be so only in the short term. **Accordingly, we recommend that while short-term capital gains on equity should continue to be taxed, the long-term capital gains on equity should be eliminated.** However, recognising the possibility of abuse by transferring real assets through the corporate vehicle, **we also recommend that the exemption on long-term capital gain on equity should be restricted to listed securities as defined in section 112 of the Income Tax Act.**

6.8 A large number of taxpayers pleaded before the Task Force that long-term capital gains on other assets should also be eliminated so as to give a boost to other asset markets.

We must clarify that the proposal to exempt long term capital gains on equity is founded on the argument of double taxation and not as an incentive to boost capital market. We do not find double taxation in any other asset market. For example in the case of a house, the investment in a house is essentially out of taxed income. The accumulation of the gain in the value of the house remains untaxed since unrealized gains are exempt. As and when the house is sold, the original investment in the house is allowed as a deduction in the computation of capital gains from the house since the original investment was out of taxed income. Hence, there is no double taxation of the investment in the house. Similarly, the taxation of capital gains on realization does not lead to any double taxation, since such gain was not subjected to any form of tax during the holding period.

Chapter 7

Treatment of Other Entities

Taxation of Investment Funds

7.1 Investment funds (mutual funds) are entities owned by many persons and whose primary activity is investing in operating companies. The investment fund acts as an intermediary between the individual investor and the ultimate user of the capital. Several types of investment funds exist. An "open-end" fund issues and redeems fund units from investors. In contrast, "closed-end" funds issue a fixed number of units, and investors trade units with other investors.

7.2 Basic decisions made in designing the overall tax system for individuals and enterprises frame the design of a tax regime for investment funds. Decisions are required on such questions as how to tax dividends and interest received by individuals and enterprises, how to tax capital gains and losses, how to tax foreign source income, and whether and how to adjust for inflation.

7.3 Within the framework defined by these decisions, the choice of tax rules for investment funds requires balancing three objectives: first, not to hamper the development of financial intermediaries, such as investment funds; second, to devise tax rules that are comparable to those that apply to other investments; and, third, to adopt tax rules that can be administered and enforced.

7.4 The tax regimes for investment funds in many countries rest, on the one hand, on the ability of investment fund managers to process substantial amounts of information and to allocate tax items to individual investors and, on the other hand, on the ability of tax administrators to receive information from investment fund managers and match this information with the individual tax returns of millions of taxpayers. The investment funds are likely to have the computer capability to process the information and allocate the tax items. The ability of the tax administration to develop a system to ensure enforcement and compliance with a tax regime that requires monitoring the tax

consequences to many investors is much more problematic and, in many countries, may not be worth the expenditure of substantial administrative resources, given the amount of tax revenue involved.

7.5 Another potential compliance problem that may be associated with a special tax regime for investment funds is the ease with which taxpayers can meet the tax and regulatory requirements for investment fund status. If qualification is easy, then adopting a favorable regime for investment funds will create strong incentives for taxpayers to arrange their affairs to obtain favorable tax treatment. If qualification is difficult, then the potential tax motivation for adopting this form of organization is reduced.

7.6 While designing a tax regime for investment funds and their investors, it is necessary to keep in mind: (1) the greater the variation in the treatment of different types of income in the hands of different types of investors, the greater the pressure to tax the income directly at the investor level; and (2) the lesser the variation in the tax regime by type of income in the hands of different types of investors, the stronger is the argument for simply taxing all income at the investment fund level and imposing no further taxes at the investor level.

7.7 There are broadly three different approaches to reducing or eliminating the double– or in some cases triple – taxation of dividends, interest and capital gains attributable to investment funds and their underlying investments. The **first method** would be to treat the investment fund as a pass through. In its purest form, this approach treats investors as if they earned the income directly and taxes them accordingly, even if the investment fund does not distribute the income to them. This method scores high on market neutrality. However, it scores low on administrative and compliance grounds, especially as a number of investors and the number of fund investments become quite large. Therefore, no country uses this system for investment funds.

7.8 The **second method** is to tax the fund and exempt the investors. The tax on the income of the Fund is treated as a final withholding tax. This method scores high on administrative and compliance grounds but it imposes a uniform tax burden irrespective of the size of the taxpayer.

7.9 The **third method** imposes tax on the investment fund on any income it receives at a rate that could be either the highest rate applicable to investors or, alternatively, the one that is most common to investors. This approach allocates to investors their share of the income of the fund and provides a credit for taxes paid by the fund allocable to that income. Investors may then file for a refund if the amount of tax paid exceeds their liability, or they could be assessed additional tax if the amount of tax paid exceeds their liability, or they could be assessed additional tax if the amount paid by the investment fund is less than their tax liability. This variation also requires rules for calculating an investor's basis in his or her investment in the fund to determine whether an investor would recognize gain when shares are redeemed.

7.10 Under the existing system in India, the investment fund is exempted from tax. The dividend received by the investor from such fund is subjected to tax at his level at his personal marginal rate of tax applicable to him. The retained earnings by the fund therefore remain untaxed. Therefore, the existing model is not a typically pass-through prototype. The system is biased against dividend distribution and also imposes higher administrative and compliance burden.

7.11 The dividend distributed by the investment funds comprises of the following categories of income:

1. Dividends earned from investments by the Fund in equity.
2. Long-term capital gains from sale of investment.
3. Short-term capital gains from sale of investment.
4. Interest received from investment in debt.

7.12 In our package for corporate tax reform we have recommended the abolition of any form of tax on dividend and long-term capital gains on equity. To the extent, the dividend distributed by the investment fund comprises of these exempt incomes, the full taxation of dividends from the investment fund would result in double (multiple) taxation. Therefore, the proportion of dividend income and long-term capital gain on equity comprised in the dividend distributed by the investment fund must necessarily be exempted.

If this be so, the dividend folio must indicate such proportion. This will further add to the complexity of administration and compliance.

7.13 Where there is a conflict between simplicity of equity, the Task Force has a preference for simplicity. Complexity is, inherently, regressive and non-transparent. Therefore, what may appear to be equitable could, in effect, be inequitable. **In the light of the problems associated with the existing system of taxation of investment fund and the package for corporate tax reform, we recommend the following:-**

1. **The income of the mutual fund derived from short-term capital gains and interest should be taxed at a flat rate in the hands of the mutual fund.**
2. **Since most investors in units are generally smaller taxpayers, we recommend that the rate of tax should be the minimum marginal rate of personal income tax i.e. 20 per cent.**
3. **With a view to overcoming double taxation, the dividends received by the unit holders should be fully exempted since the distributable surplus would have suffered the full burden of the tax.**
4. **The short-term capital gain arising to the investor from sale of units of investment funds should be taxed at his level at the personal marginal rate of tax.**
5. **The long-term capital gain arising to the investor from sale of units of mutual fund should be exempt from income tax.**
6. **The tax treatment of mutual funds and their investors should also be extended to venture capital funds[75], private equity funds[76] and hedge funds[77]. However, the tax rate for these funds should be 30 per cent since their investors are likely to be those in the highest tax slab.**

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[75] Venture capital funds invest in greenfield ventures.

[76] Private equity funds invest in firms, which have crossed the greenfield stage, but are not yet listed.

[77] Hedge funds are structures where each customer brings in a minimum of (say) Rs. 10 lakh of capital, so that the securities regulator ceases to work for investor protection, and only focuses on contract enforcement and fraud.

7. **All funds must necessarily obtain the PAN of the investor and the Databases about every payment made by the fund manager back to the investor, tagged with PAN, should be furnished to the tax authorities as a information return.**

Tax Treatment Of Partnership Firms

7.14 At present, the profits of a partnership firm are subjected to tax at the same rate of tax applicable to a domestic company. **In view of our recommendations, for corporate tax reform, we recommend that the rate of tax for partnership firms should be reduced to the same level as corporate rate of tax.**

Tax treatment of Charitable Trusts

7.15 The gross domestic product (GDP) from community services comprising educational services research and scientific services, medical and health services and religious and other community services has sharply increased from 247 crores in 1950-51 at current prices to Rs. 87529 crores in 1998-99 at current prices.

7.16 This unprecedented growth has outpaced with the growth of GDP at market prices at current prices. Accordingly, the share of GDP from community services to GDP at market prices has increased from 2.49 percent in 1950-51 to a high of 4.99 per cent in 1998-99. The share of this sector will continue to increase rapidly as per capita income increase since the demand for those services is generally income-elastic.

7.17 The activities of this sector are mostly through the vehicle of charitable trusts and institutions. These trusts have enjoyed tax support like in most countries across the globe. Under the present system, donations to trust are allowed as a deduction from the gross income to the donor. Empirically tax exemption for donations have been found to be efficient. However, the deductions from gross income are iniquitous in as much as they confer greater benefit to those the higher income levels. Therefore, we recommend that the tax benefit to donations must take the form of tax rebate at the minimum marginal

rate of tax at 20 per cent[78]. Further, we also recommend that there should be no quantitative ceiling either in absolute terms or as a fraction of the gross income as is presently provided under Section 80G.

7.18 The income of the Charitable Trust from property held under trust is exempt to the extent it is applied for charitable purposes. The surplus if any is allowed to be accumulated for future application, subject to certain specified conditions. The benefit of the exemptions is either enjoyed under various clauses of Section 10 or under Section 11 to 13. The compliance burden under the two schemes is different. Infact, the Task Force received large number of grievances particularly relating to delay in the issue of exemption notification under Section 10 by the Central Board of Direct Taxes. Such delays are inherent in the very procedure for issuing any statutory notification. **Therefore, the Task Force recommends that the exemptions under Section 10(21), 10(23B) and 10(23C)(iiiab) to (via), 10(29A) should be merged with Section 11 to 13A of the Income Tax Act. We also recommend that:-**

1. **The present practice of exempting a class of Charitable trust and Institutions through notifications should be abolished. However, the requirement to file a return of income by such trust and institutions as proof of fulfilling the various conditions stipulated u/s 10(23C), should continue.**

2. **Returns to be identified for scrutiny / audit only through a computerised risk assessment system.**

3. **Where a return is identified for scrutiny and the assessing officer is of the opinion that the activities of the trust are not charitable in nature,**

[78] Suppose a taxpayer makes a donation of Rs. 100/- to a trust for which 50 per cent deduction is allowed u/s 80G. Under the present arrangement, the tax benefit on the donation will vary depending upon the marginal rate of tax applicable to the taxpayer. If the marginal rate is 20 per cent, the 50 per cent deduction from income is effectively a tax relief of Rs. 10/-. If the marginal rate is 30 per cent, the tax relief is Rs. 15/-. The rebate under the proposed scheme will be Rs.100*0.5*0.2= Rs.10/-. This will be the same for all class of taxpayers irrespective of their marginal rate of tax.

such a case will be referred to a rating agency from amongst the panel drawn up by the C&AG[79]. An "A+" rating for the trust will mean that it is indeed a charitable trust. An "A" rating for the trust will mean that it will enjoy exemption during the current year and will be subjected to review again in the following year. A "B" rating for the trust will disqualify it from any tax exemption. The new procedure should be introduced from 01-04-2004 and the interregnum should be utilized to work out the details and also allowing the trust to adapt to the new procedures.

4. **Since a large number of provisions in the Income Tax Act are regulatory in nature, we also recommend the creation of a National Charities Board to assist the government in regulating and promoting charities on the lines of the National Charities Commission, U.K. Since, a number of States in India already have Charity Commissioners, the proposed Board may have to be advisory.**

5. **The Income Tax Department should reimburse to trusts, the fees payable to the rating agency.**

7.19 Consequent to the merger of all the provisions, there will be no requirement for any statutory notification to be issued by the CBDT. The Board will hereafter be able to devote more time on designing tax enforcement strategy rather than deal with individual cases of exemptions.

Tax Treatment of Cooperative Societies

7.20 Under the existing provision of Section 80P of the Income Tax Act, a cooperative society is entitled to 100 per cent exemption in respect of profits / income from a large number of activities like banking, credit facilities, cottage industries, market of agricultural produce, pisciculture, milk, fruits and vegetables. Further, the income from letting of

[79] A number of taxpayers were apprehensive whether such rating agencies indeed exist in India. We have been informed that Crisil is already engaged in rating NGOs for multilateral agencies.

godowns and warehouses is also fully exempt. Similarly, the income of a consumer cooperative society is exempt up-to a specified limit.

7.21 Consistent with our recommendations for personal income tax and corporate income tax, **we recommend the elimination of Section 80P of the Income Tax Act. However, the existing exemption limit of Rs. 10,000/- prescribed as part of the rate schedule, should be increased to Rs. 1,00,000/- and the revised income tax rate schedule for cooperatives should be as indicated in Table 7.1 below.**

Table 7.1 : Proposed Income Tax Structure for Cooperative Societies.

Income level	Tax rates
Below 1,00,000	NIL
1,00,000 – 4,00,000	20 per cent of the Income in excess of Rs. 1,00,000-
Above 4,00,000	Rs. 60,000/- plus 30 per cent of the Income in excess of Rs. 4,00,000/-

Tax Treatment Of Non-Residents

7.22 In the course of discussion with various Chamber of Commerce, Trade and Industry, a large number of issues relating to taxation of non-residential individuals and companies were raised. *Inter-alia*, some of the issues related to the following:-

1. The inability of the Foreign Tax Division (FTD) in the Central Board of Direct Taxes to respond swiftly to the various clarifications sought by trade and industry.
2. The delay in the outcome of the Mutual Agreement Procedure (MAP).
3. The absence of an institutional framework to deal with issues arising out of Foreign Tax Credit (FTC).
4. The absence of the mechanism of Advance Pricing Agreements (APA).

5. The existing procedure for issue of remittance certificate. A large number of representatives expressed concern on the new procedure of remittance without obtaining clearance from the income tax department.

6. The absence of any guideline regarding the database to be used for the purposes of transfer pricing.

7. The high level of penalty on transfer pricing contrary to international practice.

8. The restrictive scope of advance ruling. Representatives suggested that the Indian partner in a Joint Venture with a foreign entity should also be eligible for advance ruling.

7.23 The Task Force was informed that the issues at serial number 1 to 3 arose primarily because the composition of the FTD in the CBDT has remained unchanged for over three decades even though there has been a substantial increase in the work particularly in the last one decade. **The Task Force was therefore of the view that the manpower strength of FTD should be immediately augmented so as to assign one team each for America, Europe, South East Asia and Australia, and Rest of the World.** Each of the four teams should be headed by an officer in the rank of Joint Secretary to Government of India. However, these posts should be created by diverting them from the different field formations and not by creating new posts. Further, the Task Force was also of the view that the issues involved in the taxation of non-residents were far too technical and therefore needed an extended period of deliberation. **We understand that, as recommended by us in our Consultation Paper, the CBDT has already set up a working group headed by the Director General of Income Tax (International Taxation) and comprising of representatives also from trade and industry to examine the various issues relating to taxation of non-resident individual and foreign companies. We also understand that the working group is expected to submit its report by the end of December. We suggest that the recommendations should be processed during the forthcoming budget exercise.**

Chapter 8

Other Taxes

Wealth Tax

8.1 The levy of wealth tax is justified on the ground that it is a measure of taxable capacity and enables top marginal income tax rates to be reduced without sacrificing overall tax progressivity. A wealth tax also serves as a source of information to other tax administrations. Further, a separate wealth tax can help ensure that taxes evaded on income might be collected. However, if wealth tax has to serve the purpose of efficiency and equity, it is necessary to minimise the cost of administration and the compliance cost. Given the problems associated with the administration of the wealth tax and cross-country experience, "net wealth tax, although attractive in principle, must be judged impractical in most developing countries"[80].

8.2 Under the existing scheme a tax at the rate of one percent is levied if the aggregate value of the selected assets exceeds Rs. 15 lakhs. The selected assets are mostly unproductive assets in the nature of jewellery, vacant urban land and certain categories of house property. Since, the levy is based on current market value of the asset, these are often subject matter of immense dispute. Both the administrative and compliance cost is disproportionate to the revenues realised. **(Table: 8.1).** While at current prices, the revenues have almost stagnated at the measly level of approximately Rs 135 crores, in real terms there has been a sharp decline. While no official estimates of the cost of administering the wealth tax were available, it was widely accepted in the official circles that the cost would not be less than Rs 50 crores. Given the large-scale disputes on valuation an equal amount (if not more) could be reasonably estimated towards compliance cost.

[80] Richard Goode, Government Finance in Developing Countries (1984)

Table 8.1: Trend of Wealth Tax Revenues

Financial Year	Collections (in Rs. crores)	Financial Year	Collections (in Rs. crores)
1988-89	122	1995-96	74
1989-90	179	1996-97	78
1990-91	231	1997-98	113
1991-92	307	1998-99	162
1992-93	468	1999-00	133
1993-94	154	2000-01	132
1994-95	105	2001-02	135

Source: Government of India, Receipts Budget (of different years)

8.3 Further, one of the objectives of this levy was to help verify income earned between the two valuation dates. This objective could have been served if the valuation of the assets was based on historical costs and the scope of the levy was comprehensive. In fact, wealth tax assessments have thrown up large scale disputes at all levels particularly on the issue of valuation.

8.4 In view of the smallness of revenue from wealth tax and the large-scale problems of administration and compliance, the tax can hardly be said to have increased progressivity. The ends of progressivity would be better served if the income tax law is simplified to encourage voluntary compliance and income tax evasion is prevented. **Accordingly, we recommend the abolition of wealth tax.**

Expenditure Tax

8.5 Expenditure tax was introduced in 1987 on the plea that "those who can afford to patronize high class hotels should also be afforded the further pleasure of contributing to

the national exchequer." [81] To begin with, the tax was levied at 10 percent on expenditure in hotels where the room tariff was Rs.400 per individual. At present, it continues to be levied at 10 percent but on expenditure in hotels where the room tariff is Rs. 3000/- or more. In addition, most states also continue to levy a luxury tax on hotels.

8.6 **The present tax on expenditure in hotels is in the nature of a consumption tax. It was introduced as a separate tax in the absence of a tax on services. Since tax on services has since been introduced, it is only appropriate that this levy is merged with service tax. We recommend accordingly**.

[81] Paragragh 73 of the Union Budget Speech for the year 1987-88.

Chapter 9

Impact of the Recommendations

9.1 The impact of our recommendations on equity, revenue collections, savings, financial sector and transaction costs have already been indicated in various sections of this report. Nevertheless we consider it appropriate to summarise the multidimensional impact of our recommendations.

On Equity

9.2 The recommendations relating to personal income tax also enhance progressivity to the highest level in the last two decades **(Table 4.3 and Chart 1).** Taxpayers with incomes below Rs. 1 lakh will not have to bear the rigors of complying with a progressive tax. The consumption tax burden borne by such taxpayers would be adequate contribution to the treasury. The taxpayers at the relatively higher level of income will now contribute a relatively higher proportion of the income tax revenues.

9.3 The proposals to eliminate exemptions particularly those relating to savings will enhance the equity of the overall tax system. Individual with same gross income will now be treated equally. Since the corporate profits will now bear the full burden of the corporate tax, the effective burden on individual shareholders will be substantially higher inspite of the elimination of the tax on dividend and on long-terms capital gains. To the extent, the individual shareholders are likely to be higher income groups, the effective burden will be higher. As a result the recommendations should further improve the progressivity than what is reflected in the chart. Other recommendations which will enhance equity relate to the elimination of various sectoral/activity based incentives and the extensive use of information technology to identify tax evaders.

On Revenues

9.4 The Task Force conducted an elaborate exercise to analyse the revenue impact of the recommendations and identify the change in the incidence of the recommendations

on different categories of taxpayers. During the assessment year 2001-02, 2,04,70,771 tax returns were filed by individual taxpayers. Based on the actual distribution of these returns across income groups and the recent trend in the annual growth of tax returns, we have estimated the number of returns which are expected to be filed in assessment year 2003-04 and there distribution across income groups **(Table-9.1).**

9.5 In order to obtain a typical taxpayer profile for each income group, income tax return data of 9.25 lakh individual taxpayers was collected from the city of Mumbai which accounts for 35 per cent of the country's direct tax collections. The data related to four assessment years[82]: 1998-99, 1999-00, 2000-01 & 2001-02.

9.6 The sample data for the four years was segregated into two categories, i.e. salaried and non-salaried taxpayers[83]. For each income group and category, a typical taxpayer profile for each of the four assessment years was separately obtained. There after, we further determined the four years average of such profiles for each income group to obtain a typical taxpayer profile for all income groups for the purposes of revenue estimation.

9.7 **Table – 9.2** indicates the tax liability of a typical non-salaried men tax payer in each income group based on the tax law for assessment year 2003-04 and the total revenue collected from each income group. Similarly, **Table – 9.3** indicates the tax liability for a typical salaried men taxpayer. The total revenues collected from these two categoriesof tax payers is Rs.24,629 crores, excluding the tax on dividends in the hands of the shareholders. **Table – 9.4** and **Table – 9.5** indicate the tax liability for a typical non-salaried and salaried men taxpayer consequent to our recommendations. The revenue collections at the existing level of compliance is estimated to be Rs. 17,345 crores, thereby resulting in a tax relief of Rs. 7,284 crores to such individual tax payers.

9.8 The impact of our recommendations on senior citizens is also expected to be beneficial. Under the existing law, a senior citizen with income up-to Rs. 1,30,000/- does not have to pay any income tax. **Table 9.6** indicates the revenue collection from senior

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[82] Assessment year means the year following the financial year.

[83] A taxpayer deriving 90 per cent or more of his gross total income from salary has been categorised as a "salaried taxpayer".

citizens across income groups, under the existing law. Our recommendation to provide a higher exemption limit of Rs. 50,000/- for senior citizens means that senior citizens with income up-to Rs. 1,50,000/- will not have to pay any income tax. **Table 9.7** indicates the estimated revenue collection consequent to our recommendations. Those with income above Rs. 1,50,000/- will benefit significantly from a 10 percentage point reduction in the tax rate. Therefore, senior citizens at all income levels stand to gain by an estimated Rs.190 crores from our recommendations.

9.9 The demographic profile of taxpayers is in favour of relatively younger taxpayers. The income of such taxpayers can reasonably be expected to increase (in large number of cases rather rapidly) over the years. Under the existing law, the maximum marginal rate of personal income tax is leviable at a rather low income level i.e. Rs. 1,50,000/-. Most of the younger taxpayers therefore can be expected to pay at the highest rate rather early in life. The recommendation to levy the highest rate of 30 per cent only on incomes above Rs. 4 lakhs would benefit this generation of younger taxpayer substantially. Infact as their incomes approach Rs. 4 lakhs, this threshold for the highest rate would have increased due to inflation indexing overtime. Therefore, the lifetime income tax rate for most younger taxpayers would be the lower rate of 20 per cent.

9.10 **Table – 9.8** summarizes the tax benefit for senior citizens, salaried and non-salaried (other than senior citizens) taxpayers for each income group, arising from the recommendations made in this report. **It shows that taxpayers of all categories and in every income group benefit substantially from the recommendations.** Similarly, women as a class of tax payers will also benefit from the package of our recommendations. In the case of a married couple, the recommendations are likely to reduce tax liability on the family as a unit. The recommendation to abolish wealth tax will also benefit the female taxpayer. Women as a class of tax payers will benefit from a relief of Rs.404 crores. With reduced tax burden for each income group, disposable income will be higher for every class of taxpayer. This also means that the entire middle class will benefit from our proposals.

9.11 However, the calculations do not reflect the impact of taxation of dividend in the hands of the individual shareholders introduced by the Finance Act, 2002. Adjusting for

an estimated Rs. 1,500 crore in tax collection from dividends[84], the total revenue collection from individual taxpayers is estimated at Rs. 32340 crores representing about 75 per cent of the total income tax collection. The balance amount is collected from partnership firms, HUFs, etc., but does not include collection from companies.

9.12 Our recommendation to reduce the tax rate for partnership firms from the existing levels of 36.75 per cent to 30 per cent will result in a loss in the revenues 18.37 per cent. The current revenues from partnership firms is estimated to be Rs. 10,000 crore, thereby resulting in a revenue loss of Rs. 1,837 crore.

9.13 The package of recommendations relating to corporate tax will result in a estimated revenue gain of Rs. 10,762 crore **(Table-9.9)**. This estimate is based on the financial results of 1,334 profit making companies for the financial year 2001-02. This sample of 1.334 companies comprised of 59 banking companies reporting a corporate tax payment of Rs. 5,844 crores and 1,275 companies reporting a corporate tax payment of Rs. 13,420 crores. The effective corporate tax rate for assessment year 2002-03 for the sample non-banking companies and banking companies was 21.75 per cent and 35.01 respectively as against the statutory rate of 35.7 per cent. In the assessment year 2003-04, these effective rates are estimated to increase by 3 per cent on account of the increase in the surcharge. Adjusting for the measures recommended for the corporate tax reform, the revenue collection from the sample non-banking companies is estimated to increase by 34 per cent while in the case of banking companies it is expected to reduce by 35.5 per cent. In the aggregate the corporate tax revenues are estimated to increase by 22.42 per cent.

9.14 **Table-9.10** summarises the revenue impact of the recommendations. Overall, the recommendations are revenue neutral at the existing level of compliance. To the extent the new simplified and liberalized tax regime will induce compliance, the revenue gains are likely to be substantially higher and it will enhance buoyancy by widening the personal and corporate income tax bases.

[84] The collection from the 10 per cent dividend distribution tax was Rs. 1,480 crores in 2001-02. A significant proportion of the dividends is received by the government and a large number of other non-taxable entities such as charitable trusts. Therefore, the average tax on dividends in the hands of the shareholders is not likely to exceed 10 per cent.

On Savings

9.15 As indicated in the earlier chapters, the existing tax incentives for investment in savings instruments are inefficient. The recommendations to eliminate them will improve efficiency of the economic system in as much as it will result in reduction in interest rates. Further, the proposed doubling of ceiling on contributions to the pension plan under Section 80CCC to Rs.20,000/- will achieve the social objective of promoting genuine long term savings for increasing old age economic security.

On Financial Sector

9.16 Our recommendations for aligning the corporate tax base with real income means that banks will henceforth enjoy full tax credit for complying with the RBI prudential standards for NPA provisioning. This would encourage banks to "clean" their balance sheets, achieve improved capital adequacy ratio and help the country to move towards a sound and robust banking system. Since banks do not avail of any capital allowances, the benefits will lower tax rates will increase retained profits of the financial sector which will facilitate an increased supply of commercial credit. Banking companies will gain by as much as Rs.2,840 crores in tax reliefs from our recommendations.

On Transaction Costs

9.17 In the earlier chapters we had referred to a NIPFP study commissioned by the Planning Commission which had estimated the compliance cost of personal income tax to be as high as 48 per cent. Such high cost raise serious doubts about income tax as an efficient source of revenue. Therefore, the Task Force was singularly concerned with designing a new simplified system which will foster compliance, impart transparency and discourage rent seeking and crony capitalism. We must reiterate at the cost of being repetitive that our recommendations for eliminating the exemptions, the extensive use of information technology and privatization of non-core activities of the tax administration will result in sharp reduction in transaction cost. A 10 per cent reduction in the transaction cost for personal income tax would help taxpayers to save an estimated Rs. 4,000 crores. Since the burden of compliance cost is essentially regressive, such reduction in transaction cost is, by corollary, progressive.

Conclusion

9.18 The Task Force is convinced that if its recommendations are fully adopted, our tax system will become more transparent and it will align the obligations of taxpayers with the objectives of the tax administration - this is crucial in engendering a trust-based system in place of the present one based on punitive enforcement (often bordering on harassment), This is crucial to both attracting and retaining young taxpayers with their demand for customer-oriented procedures, as well as to bring the "missing middle" - mainly service professionals who are currently outside the tax-net into compliance. The best tax systems in the world deal with taxpayers in a professional customer-relationship environment, which requires the system to be responsive and non-discriminatory. This reduces transaction costs for both taxpayers and the tax administration. We have sought to replace the present "exemption raj" with a tax system that is outcome oriented rather than input aligned, viz., higher productivity of income taxpayers and increased profitability of businesses is encouraged. This is the case with most dynamic countries among the emerging markets.

Table-9.1

DISTRIBUTION OF RETURNS FOR ASSESSMENT YEAR 2003-04

Income Range (in Rs.)	Distribution of returns filed for Assessment Year 2001-02 — Parcentage Distribution			Estimated Distribution of Returna for Assessment Year 2003-2004		
	Salaried	Non-salaried	Total	Salaried	Non-salaried	Total
0-40,000	5.52	26.00	17.73	602942	4194541	4797483
40,000-50,000	2.01	9.44	6.44	219549	1522838	1742387
50,000-60,000	11.26	17.31	14.87	1229913	2793270	4023184
60,000-80,000	17.09	14.74	15.69	1866716	2378324	4245040
80,000-1,00,000	10.18	8.79	9.35	1111947	1417762	2529709
1,00,000-1,50,000	27.77	13.30	19.14	3033277	2145185	5178462
1,50,000-2,00,000	17.32	7.04	11.19	1891839	1135695	3027534
2,00,000-3,00,000	5.05	1.33	2.83	551604	214072	765676
3,00,000-4,00,000	1.62	0.43	0.91	176950	69257	246207
4,00,000-5,00,000	0.73	0.21	0.42	79737	33897	113634
5,00,000-10,00,000	1.2	1.15	1.17	131074	185478	316552
>10,00,000	0.25	0.27	0.26	27307	43038	70345
Total	100	100.00	100	10922855	16132851	27055706

Note: The ditsribution of returns across income range is based on information given by the Chief Commissioners in April, 2002, on actual returns filed during F.Y. 2001-02. Total number of returns filed during F.Y. 2001-02 is 2.05 crores and a 15% annual increase in number of returns has been assumed to arrive at the population size for A.Y. 2003-2004.

Table-9.2

REVENUE COLLECTION FROM NON-SALARIED MEN AS PER THE LAW FOR ASSESSMENT YEAR 2003-04

INCOME RANGE (In Rs.)	NUMBER OF RETURNS	AVERAGE TOTAL INCOME	AVERAGE TAX AT CURRENT RATE WITHOUT SURCHARGE	AVERAGE HISTORICAL INVESTMENT IN SECURITIES SPECIFIES U/S 88	AVERAGE REBATE CLAIMED u/s 88	AVERAGE TAX AFTER REBATE	AVERAGE SURCHARGE	AVERAGE TAX INCLUDING SURCHARGE AT CURRENT RATE	REVENUE COLLECTION (WITHOUT SURCHARGE) (in Rs. crores)	REVENUE COLLECTION ON ACCOUNT OF SURCHARGE (in Rs. crores)	TOTAL REVENUE COLLECTION AT EXISTING RATES (in Rs. crores)
0-40,000	2096737	21884	0	105	21	0	0	0	0	0	0
40,000-50,000	912891	46098	0	131	26	0	0	0	0	0	0
50,000-60,000	1801169	54667	467	423	85	382	0	382	69	0	69
60,000-80,000	1650294	68482	2696	3024	605	2092	105	2196	345	17	362
80,000-1,00,000	987577	89130	6826	8168	1634	5192	260	5452	513	26	538
1,00,000-1,50,000	1504307	121877	13375	15938	3188	10188	509	10697	1533	77	1609
1,50,000-2,00,000	836005	171719	25516	20762	3114	22401	1120	23522	1873	94	1966
2,00,000-3,00,000	161935	241091	46327	24210	3632	42696	2135	44830	691	35	726
3,00,000-4,00,000	52841	343431	77029	25557	3834	73196	3660	76855	387	19	406
4,00,000-5,00,000	25791	445863	107759	26816	4022	103737	5187	108923	268	13	281
5,00,000-10,00,000	141981	685623	179687	25873	0	179687	8984	188671	2551	128	2679
>10,00,000	33170	3824798	1121439	26230	0	1121439	56072	1177511	3720	186	3906
Total	10973816								11949	594	12543

Table-9.3

REVENUE COLLECTION FROM SALARIED MEN AS PER THE LAW FOR ASSESSMENT YEAR 2003-04

INCOME RANGE (In Rs.)	NUMBER OF RETURNS	AVERAGE TOTAL INCOME	AVERAGE TAX AT CURRENT RATE WITHOUT SURCHARGE	AVERAGE HISTORICAL INVESTMENT IN SECURITIES SPECIFIED U/S 88	AVERAGE REBATE CLAIMED U/S 88 AS PER EXISTING LAW	AVERAGE TAX AFTER REBATE	AVERAGE SURCHARGE	AVERAGE TAX INCLUDING SURCHARGE AT CURRENT RATE	REVENUE COLLECTION (WITHOUT SURCHARGE) (in Rs. crores)	REVENUE COLLECTION ACCOUNT OF SURCHARGE (in Rs. crores)	TOTAL REVENUE COLLECTION AT EXISTING RATES (in Rs. crores)
0-40,000	301394	24746	0	292	88	0	0	0	0	0	0
40,000-50,000	131613	45312	0	1943	583	0	0	0	0	0	0
50,000-60,000	793078	54975	498	5183	1555	0	0	0	0	0	0
60,000-80,000	1295295	68898	2780	11499	3450	0	0	0	0	0	0
80,000-1,00,000	774554	89300	6860	17830	5349	1511	76	1587	117	6	123
1,00,000-1,50,000	2127080	120769	13154	23382	4676	8477	424	8901	1803	90	1893
1,50,000-2,00,000	1392615	171818	25545	24926	3739	21806	1090	22897	3037	152	3189
2,00,000-3,00,000	417261	237410	45223	26228	3934	41289	2064	43353	1723	86	1809
3,00,000-4,00,000	135008	342313	76694	31293	4694	72000	3600	75600	972	49	1021
4,00,000-5,00,000	60669	442347	106704	34263	5139	101565	5078	106643	616	31	647
5,00,000-10,00,000	100336	675284	176585	33028	0	176585	8829	185415	1772	89	1860
>10,00,000	21046	2415767	698730	23601	0	698730	34936	733666	1471	74	1544
Total	7429896								11510	576	12086

TABLE 9.4

REVENUE COLLECTION FROM NON-SALARIED MEN AS PER FINAL RECOMMENDATIONS OF THE TASK FORCE

INCOME RANGE (in Rs.)	NUMBER OF RETURNS	AVERAGE SALARY INCOME	AVERAGE TOTAL INCOME	AVERAGE STANDARD DEDUCTION	AVERAGE DEDUCTION UNDER SECTION	AVERAGE OTHER DEDUCTIONS UNDER CHAPTER VI-A	AVERAGE ADJUSTED TOTAL INCOME	TAX ON AVERAGE ADJUSTED TOTAL INCOME	SAVINGS UNDER 80-CCC	AVERAGE REBATE ON SAVINGS UNDER 80-CCC	AVERAGE OTHER DEDUCTIONS UNDER CHAPTER VI-A(OTHER THAN 80-CCC)	REBATE ON OTHER DEDUCTIONS UNDER CHAPTER VI-A	TOTAL AVERAGE TAX AFTER REBATE	TOTAL TAX PAYABLE AT NEW TAX RATES (in Rs. crores)
0-40,000	2096737	1899	21884	949	3441	906	27180	0	105	21	696	139	0	0
40,000-50,000	912891	4697	46098	2348	2339	496	51280	0	131	26	450	90	0	0
50,000-60,000	1801169	4083	54667	2042	1593	302	58603	0	423	85	292	58	0	0
60,000-80,000	1650294	6289	68482	3144	2694	625	74945	0	3024	605	595	119	0	0
80,000-1,00,000	987577	9546	89130	4773	4198	1289	99390	0	8168	1634	1073	215	0	0
1,00,000-1,50,000	1504307	16597	121877	8299	5844	2048	138068	7614	15938	3188	1842	368	4057	610
1,50,000-2,00,000	836005	25539	171719	12770	6952	2572	194013	18803	20000	4000	2167	433	14369	1201
2,00,000-3,00,000	161935	49917	241091	24959	7799	3515	277364	35473	20000	4000	3004	601	30872	500
3,00,000-4,00,000	52841	71038	343431	30000	8797	4663	386891	57378	20000	4000	4011	802	52576	278
4,00,000-5,00,000	25791	90469	445863	30000	9733	5951	491547	87464	20000	4000	4372	874	82590	213
5,00,000-10,00,000	141981	119173	685623	30000	9068	6354	731044	159313	20000	4000	5724	1145	154168	2189
>10,00,000	33170	363776	3824798	20000	10079	19308	3874186	1102256	20000	4000	18449	3690	1094566	3631
TOTAL	10973816													8622

Table-9.5

REVENUE COLLECTION FROM SALARIED MEN TAXPAYERS AS PER FINAL RECOMMENDATION BY THE FORCE

INCOME RANGE (In Rs.)	NUMBER OF RETURNS	AVERAGE SALARY INCOME	AVERAGE TOTAL INCOME	AVERAGE STANDARD DEDUCTION	AVERAGE DEDUCTION UNDER SECTION 80-L	AVERAGE OTHER DEDUCTION UNDER CHAPTER VI-A	AVERAGE ADJUSTED TOTAL INCOME	TAX ON AVERAGE ADJUSTED TOTAL INCOME	SAVING UNDER 80-CCC	AVERAGE REBATE ON SAVING UNDER 80-CCC	AVERAGE OTHER DEDUCTION UNDER CHAPTER VI-A (OTHER THAN 80-CCC)	REBATE ON OTHER DEDUCTION UNDER CHAPTER VI-A	AVERAGE TAX AFTER REBATE AT THE NEW TAX RATES	TOTAL TAX PAYABLE AT NEW TAX RATES
0-40,000	301394	27086	24746	13543	235	586	39111	0	292	58	572	114	0	0
40,000-50,000	131613	46375	45312	23187	130	310	68939	0	1943	389	294	59	0	0
50,000-60,000	793078	56047	54975	28024	132	241	83372	0	5183	1037	223	45	0	0
60,000-80,000	1295295	70246	68898	30000	166	267	99331	0	11499	2300	247	49	0	0
80,000-1,00,000	774554	90903	89300	30000	312	378	119990	3998	17830	3566	345	69	363	28
1,00,000-1,50,000	2127080	123287	120769	30000	768	684	152221	10444	20000	4000	549	110	6334	1347
1,50,000-2,00,000	1392615	175833	171818	25000	1530	1347	199695	19939	20000	4000	964	193	15746	2193
2,00,000-3,00,000	417261	241923	237410	25000	2302	1950	266662	33332	20000	4000	1372	274	29058	1212
3,00,000-4,00,000	135008	348288	342313	20000	3519	2801	368633	53727	20000	4000	1958	392	49335	666
4,00,000-5,00,000	60669	448346	442347	20000	4657	3429	470432	81130	20000	4000	2336	467	76662	465
5,00,000-10,00,000	100336	680533	675284	0	5564	4114	684963	145489	20000	4000	3014	603	140886	1414
>10,00,000	21046	2394841	2415767	0	7607	8258	2431631	669489	20000	4000	7099	1420	664070	1398
TOTAL	7429896													8723

Table-9.6

REVENUE COLLECTION FROM SENIOR CITIZENS AS PER THE LAW FOR ASSESSMENT YEAR 2003-04													
INCOME RANGE (In Rs.)	NUMBER OF RETURNS	AVERAGE TOTAL INCOME	AVERAGE TAX AT CURRENT RATE WITHOUT SURCHARGE	REBATE UNDER SECTION 88B	AVERAGE TAX AFTER REBATE UNDER SECTION 88B	AVERAGE HISTORICAL INVESTMENT IN SECURITIES SPECIFIED U/S 88	AVERAGE REBATE CLAIMED u/s 88	AVERAGE TAX AFTER REBATE	AVERAGE SURCHARGE	AVERAGE TAX INCLUDING SURCHARGE AT CURRENT RATE	REVENUE COLLECTION (WITHOUT SURCHARGE) (in Rs. crores)	REVENUE COLLECTION ON ACCOUNT OF SURCHARGE (in Rs. crores)	TOTAL REVENUE COLLECTION AT EXISTING RAGE (in Rs. crores)
0-40,000	239,874	21,883.85	0.00	0.00	0.00	105.02	21.00	0.00	0.00	0.00	0.00	0.00	0.00
40,000-50,000	87,119	46,097.57	0.00	0.00	0.00	131.36	26.27	0.00	0.00	0.00	0.00	0.00	0.00
50,000-60,000	201,159	54,667.13	466.71	466.71	0.00	422.73	84.55	0.00	0.00	0.00	0.00	0.00	0.00
60,000-80,000	212,252	68,481.54	2,696.31	2,696.31	0.00	3,024.02	604.80	0.00	0.00	0.00	0.00	0.00	0.00
80,000-1,00,000	126,485	89,129.74	6,825.95	6,825.95	0.00	8,168.47	1,633.69	0.00	0.00	0.00	0.00	0.00	0.00
1,00,000-1,50,000	258,923	121,877.04	13,375.41	13,375.41	0.00	15,938.41	3,187.68	0.00	0.00	0.00	0.00	0.00	0.00
1,50,000-2,00,000	151,377	171,719.07	25,515.72	15,000.00	10,515.72	20,761.62	3,114.24	7,401.48	370.07	7,771.55	112.04	5.60	117.64
2,00,000-3,00,000	38,284	241,090.82	46,327.25	15,000.00	31,327.25	24,210.23	3,631.53	27,695.71	1,384.79	29,080.50	106.03	5.30	111.33
3,00,000-4,00,000	12,310	343,430.57	77,029.17	15,000.00	62,029.17	25,557.20	3,833.58	58,195.59	2,909.78	61,105.37	71.64	3.58	75.22
4,00,000-5,00,000	5,682	445,863.24	107,758.97	15,000.00	92,758.97	26,816.38	4,022.46	88,736.52	4,436.83	93,173.34	50.42	2.52	52.94
5,00,000-10,00,000	15,828	685,623.00	179,686.90	15,000.00	164,686.90	25,872.71	0.00	164,686.90	8,234.34	172,921.24	260.66	13.03	273.69
>10,00,000	3,517	3,824,798.33	1,121,439.50	15,000.00	1,106,439.50	26,230.33	0.00	1,106,439.50	55,321.97	1,161,761.47	389.16	19.46	408.62
Total	1,352,785												1,039.45

Table-9.7

REVENUE COLLECTION FROM SENIOR CITIZENS AS PER FINAL RECOMMENDATIONS OF THE TASK FORCE

INCOME RANGE (In Rs.)	NUMBER OF RETURNS	AVERAGE SALARY INCOME	AVERAGE TOTAL INCOME	AVERAGE STANDARD DEDUCTION	AVERAGE DEDUCTION UNDER SECTION 80-L	AVERAGE OTHER DEDUCTION UNDER SECTION VI-A	AVERAGE ADJUSTED TOTAL INCOME	TAX ON AVERAGE ADJUSTED TOTAL INCOME	SAVING UNDER 80-CCC	AVERAGE REBATE ON SAVINGS UNDER 80-CCC	AVERAGE OTHER DEDUCTIONS UNDER CHAPTER VI A (OTHER THAN 80-CCC)	REBATE ON OTHER DEDUCTIONS UNDER CHAPTERVI-A	TOTAL AVERAGE TAX AFTER REBATE	TOTAL TAX PAYABLE AT NEW TAX RATES (in Rs. crores)
0-40,000	239874	1899	21884	949	3441	906	27180	0	105	21	696	139	0	0.00
40,000-50,000	87119	4697	46098	2348	2339	496	51280	0	131	26	450	90	0	0.00
50,000-60,000	201159	4083	54667	2042	1593	302	58603	0	423	85	292	58	0	0.00
60,000-80,000	212252	6289	68482	3144	2694	625	74945	0	3024	605	595	119	0	0.00
80,000-1,00,000	126485	9546	89130	4773	4198	1289	99390	0	8168	1634	1073	215	0	0.00
1,00,000-1,50,000	258923	16597	121877	8299	5844	2048	138068	0	15938	3188	1842	368	0	0.00
1,50,000-2,00,000	151377	25539	171719	12770	6952	2572	194013	8803	20000	4000	2167	433	4369	66.14
2,00,000-3,00,000	38284	49917	241091	24959	7799	3515	277364	25473	20000	4000	3004	601	20872	79.91
3,00,000-4,00,000	12310	71038	343431	30000	8797	4663	386891	47378	20000	4000	4011	802	42576	52.41
4,00,000-5,00,000	5682	90469	445863	30000	9733	5951	491547	77464	20000	4000	4372	874	72590	41.24
5,00,000-10,00,000	15828	119173	685623	30000	9068	6354	731044	149313	20000	4000	5724	1145	144168	228.18
>10,00,000	3517	363776	3824798	20000	10079	19308	3874186	1092256	20000	4000	18449	3690	1084566	381.47
TOTAL	1352785													849.35

Table-9.8

IMPACT OF THE RECOMMENDATIONS MADE BY THE TASK FORCE

Income Range	Salaries Taxpayers			Non-Salaried Taxpyers			Senior Citizens		
	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs.)	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)
0-40,000	0	0	0	0	0	0	0	0	0
40,000-50,000	0	0	0	0	0	0	0	0	0
50,000-60,000	0	0	0	382	0	382	0	0	0
60,000-80,000	0	0	0	2196	0	2196	0	0	0
80,000-1,00,000	1587	363	1224	5452	0	5452	0	0	0
1,00,000-1,50,000	8901	6334	2567	10697	4057	6640	0	0	0
1,50,000-2,00,000	22897	15746	7151	23522	14369	9152	7772	4369	3402
2,00,000-3,00,000	43353	29058	14295	44830	30872	13959	29080	20872	8209
3,00,000-4,00,000	75600	49335	26265	76855	52576	24279	61105	42576	18529
4,00,000-5,00,000	106643	76662	29980	108923	82590	26334	93173	72590	20584
5,00,000-10,00,000	185415	140886	44528	188671	154168	34503	172921	144168	28753
Above 10,00,000	733666	664070	69597	1177511	1094566	82946	1161761	1084566	77196

Table-9.9

REVENUE IMPACT OF CORPORATE TAX REFORMS			
Particulars	Non-Banking Companies	Banking Companies	All Companies
Sample Size	1275	59	1334
Statutory Corporate Tax Rate(Assessment Year 2002-03)	35.70	35.70	35.70
Profits before Tax (Assessment Year 2002-03)	61707	16695	78402
Corporate Tax Paid (Assessment Year 2002-03)	13420	5844	19264
Surcharge of 3 percent (Assessment Year 2003-04)	395	172	567
Corporate Tax Collection (adjusted for Asstt Year 2003-04)	13815	6016	19831
Effective Corporate tax Rate (Asst Year 2002-03)	21.75	35.01	24.57
Effective Corporate tax Rate (Asst Year 2003-04)	22.39	36.04	25.29
Pre-Reform Corporate Tax Base	37591	16371	53961
Post-Reform Corporate Tax Base	61707	16695	78402
Post Reform Tax Collection (@30 percent)	18512	5009	23521
Increase in Collection	4697	-1008	3690
Percentage increase in collection	34.00	-16.75	18.61
Tax Collection in 2002-03 (Asstt Year 2003-04)	40000	8000	48000
Revenue Impact of Recommendations	13601	-1340	12262
Impact of Full Allowance for NPAs	0	-1500	-1500
Net Revenue Impact of Recommendations	13601	-2840	10762

Table-9.10

SUMMARY OF REVENUE IMPACT

(Rs in crores)

Particulars	Proposed	Existing	Loss	Gain
Salaried taxpayers	8723	12086	3363	
Non-Salaried Taxpayers	8622	12543	3921	
Senior Citizens	849	1039	190	
Women	4767	5172	404	
Partnership Firms	8150	10000	1850	
Mutual Funds	1500	NIL	-	1500
Taxation of Dividends	-	1500	1500	
Long Term capital gains	-	1000	1000	
Corporate Tax	58762	48000	-	10762
Total	91373	91340	12228	12262

CHAPTER 10

SUMMARY AND RECOMMENDATIONS

Reform of Tax Administration

10.1 The fundamental role of tax administration is, in order of priority:

1. To render quality taxpayer services to encourage voluntary compliance of tax laws; and

2. To detect and penalise non-compliance.

The extent of success of the tax administration in its role would be reflected in higher revenue growth.

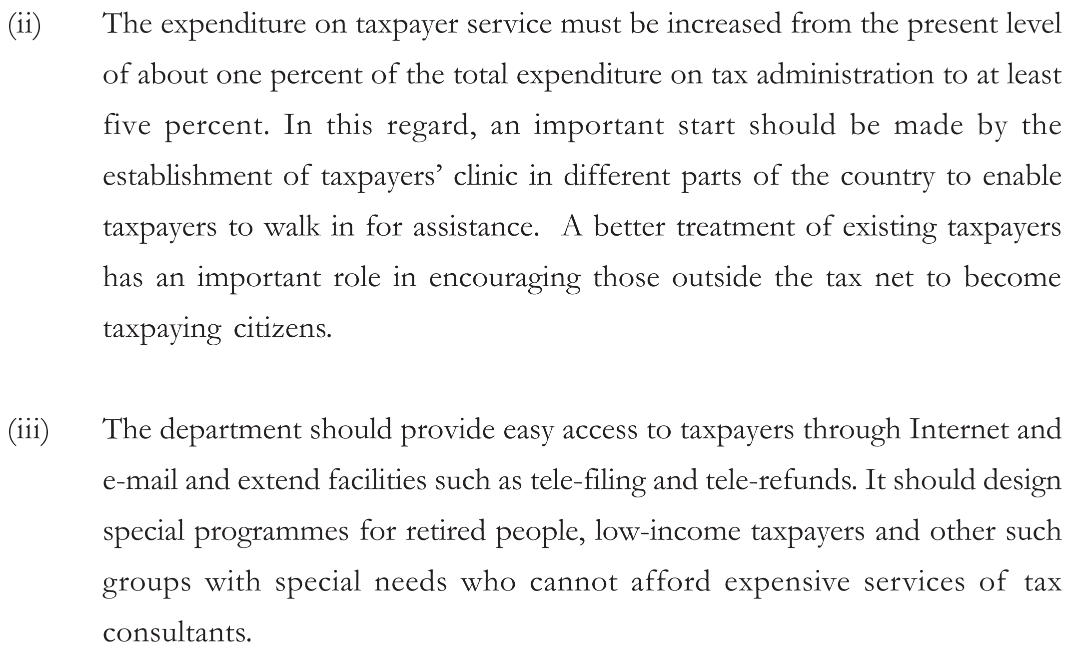
(Paragraph 3.6)

10.2 Traditionally, the role of the tax administration has been to enforce the tax laws and provide at least minimal taxpayer service. Most employees unable to reconcile to their new role continue to resist this shift in the role perception from an enforcement officer to a facilitator.

(Paragraph 3.8)

10.3 Given the best international practice in the area of taxpayer service and the future programme for widening the tax base through voluntary compliance, the following measures should be undertaken to expand the present scope of the taxpayer service programme:

(i) The income tax department must expand, qualitatively and quantitatively, the present scope of taxpayer service. These should cover the range of taxpayer services indicated in Table–3.1 and, inter alia, include the introduction of a telephonic system (by voice message) to remind taxpayers of important dates and the provision of pre-formatted programmed floppy diskettes through retail outlets.



(ii) The expenditure on taxpayer service must be increased from the present level of about one percent of the total expenditure on tax administration to at least five percent. In this regard, an important start should be made by the establishment of taxpayers' clinic in different parts of the country to enable taxpayers to walk in for assistance. A better treatment of existing taxpayers has an important role in encouraging those outside the tax net to become taxpaying citizens.

(iii) The department should provide easy access to taxpayers through Internet and e-mail and extend facilities such as tele-filing and tele-refunds. It should design special programmes for retired people, low-income taxpayers and other such groups with special needs who cannot afford expensive services of tax consultants.

(Paragraph 3.11)

10.4 Given the ongoing and new initiatives by the Ministry of Home Affairs for issuing a Citizen Identification Number and by the Ministry of Labour for issuing a Social Security Number, PAN can be used to effectively integrate, on the lines of the US Social Security Number system, multiple tasks of tax and commercial enforcement, targeting government subvention, improving governance and enhance national security, both at the Central and State level. The Task Force, therefore, recommends that:

(i) The PAN should be extended to cover all citizens and therefore serve as a Citizen identification number. This will obviate the need for the Home and Labour Ministries to issue new numbers.

(ii) Given the manifold increase in the coverage of PAN, the responsibility for issuing should be transferred to an independent agency outside the income tax department. However, the income tax department should have online access to the database for tax enforcement like any other agency.

(iii) The requirement of quoting PAN may be expanded to cover most financial transactions.

(Paragraph 3.15)

10.5 In view of the extant method of collection of information and constraints in digitising the volume of information received by the tax administration, the Task Force recommends :

(i) Income Tax Act should be amended to provide for submission of 'annual information return' by third parties in respect of various transactions as may be prescribed. For this purpose, a proper format of the return also needs to be prescribed. Consequently, the flow of information will be continuous and the discretionary power with the CIB to collect information will be eliminated.

(ii) Such annual return of information (including returns relating to tax deducted at source) should be mandatorily required to be submitted on electronic format.

(iii) Many of the Departments involved in transactions specified in Rule 114B do not have any mechanism for obtaining the PAN of the concerned person. It is, therefore, necessary that the pro forma used by them for their departmental purposes, e.g., the application form for transfer of motor license, should have the necessary column requiring the applicant to disclose his Permanent Account Number (PAN).

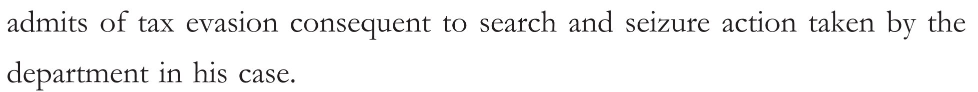
(iv) The Department should set up a structure for Electronic Data Interchange (EDI) with some of the major departments and organisations involved in the transactions specified in Rule 114B, such as, Banks, Stock Exchanges, Telephone Companies, Regional Transport Authority etc.

(Paragraph 3.17)

10.6 In view of the diminition in the deterrence effect of search and seizure operations, –

(i) Special procedure for assessment of search cases in chapter XIV B (Block Assessment) which provides for tax at the rate of 60 per cent, be omitted. As and when concealment is detected and established, it should suffer full penal consequences of interest, penalty and prosecution.

(ii) Power of Settlement Commission to grant immunity from interest, penalty and prosecution may be restricted to cases other than those where the assessee


admits of tax evasion consequent to search and seizure action taken by the department in his case.

(iii) The scheme of rewarding officers engaged in search and seizure activity be abolished.

(iv) The stocks found during the course of search and seizure operation under the Income Tax Act may only be inventorised but not seized. This can be done by issuing administrative instruction.

(Paragraph 3.26)

10.7 The Central Board of Direct Taxes must issue immediate instructions to the effect that no raiding party should obtain any surrender whatsoever. Where, a taxpayer desires to voluntarily make a disclosure, he should be advised to make so after the search. As a result, the taxpayer will not be able to allege coercion and successfully distract investigations. All cases where surrender is obtained during the course of the search in violation of the instructions of the CBDT, the leader of the raiding party should be subjected to vigilance enquiry. All statements recorded during the search should be video recorded. This will, indeed, add to the confidence of the taxpayer in the impartiality of the system.

(Paragraph 3.27)

10.8 The Task Force took note of the recent amendments conferring power to seize books of accounts during a survey operation. Accordingly, it recommends -

(i) A survey should be authorised after recording the reasons in writing and the power of authorization should not be vested in any officer below the rank of a Joint Commissioner of Income Tax.

(ii) The books of accounts impounded by the survey team should not be retained beyond a period of seven days since it has the potential of disrupting the business of a taxpayer. Where it is felt that the books need to be retained beyond the period of seven days, the department may obtain photocopies duly attested by the taxpayer for further investigation.

(Paragraph 3.28)

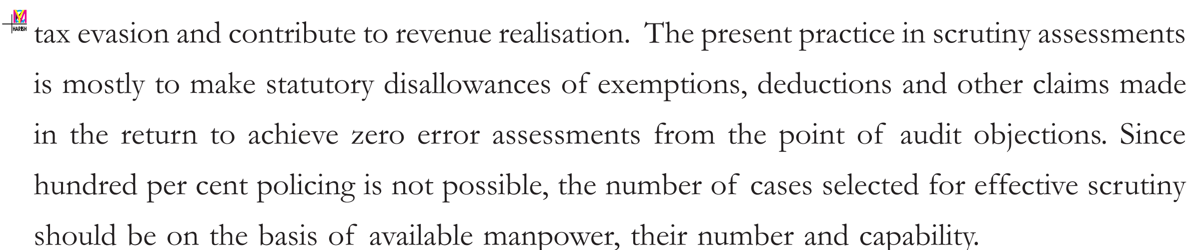
10.9 In line with our view that the tax department should concentrate on its core functions, the department should be allowed to outsource data entry work and clear the backlog of returns (which number 2.8 crores as on 30th September, 2002) by end February 2003. Similarly, all returns must be processed within four months of receipt. For this purpose, it would be necessary for the department to either hire additional personnel on a temporary basis during the peak period for filing returns, or, outsource data entry work, as is done routinely by national tax administrations all over the world. Further, we must emphasis that outsourcing of such data entry work relating to processing of returns should be done only to supplement the efforts of the departmental staff and officers and not as a substitute. The cost of hiring additional personnel or outsourcing data entry work would be far less in comparison to the benefit from reduced interest burden on refunds and taxpayer satisfaction.

(Paragraph 3.30)

10.10 The existing discretion based system of selection of returns should be immediately abolished. The department should progressively develop an audit selection system for risk analysis and assessment, which forms a scientific (and, therefore, objective) basis for identifying cases of potential tax evasion for in-depth scrutiny. However, before an audit selection system can be driven by risk analysis, good quality data has to be obtained over a number of years. Risk analysis will help to rank taxpayers and any local knowledge and intelligence must be factored to make a risk assessment. This will provide the most efficient and effective means of targeting tax officials to areas of greatest risk. It is important that cases for audit are selected on the basis of perceived risk and not simply by intelligence or speculation since intelligence would be available for only a few taxpayers. Further, selection of cases based on risk analysis and assessment must be combined with a certain small percentage of random audit, and carrying out issue- specific audits, such as refund audits. In the interim, we recommend the identification of cases through a random non-discretionary centralised method deploying the PAN database. The current practice of issuing guidelines for selection of cases for scrutiny, which eventually finds its way to the public, must be given up.

(Paragraph 3.32 to 3.34)

10.11 Once a case is selected for scrutiny, it should be fully investigated, covering investments, accretion to assets, expenses incurred, savings, transactions entered and profits made, turnover etc. The scrutiny assessment will then serve its purpose of deterrence against



tax evasion and contribute to revenue realisation. The present practice in scrutiny assessments is mostly to make statutory disallowances of exemptions, deductions and other claims made in the return to achieve zero error assessments from the point of audit objections. Since hundred per cent policing is not possible, the number of cases selected for effective scrutiny should be on the basis of available manpower, their number and capability.

(Paragraph 3.35)

10.12 Section 275 of the Income Tax Act should be suitably amended to provide that the penalty order should be passed within one year from the end of the financial year in which the first appellate order is received. Consequently, the delay in passing the order-levying penalty for concealment would be considerably reduced to about two years.

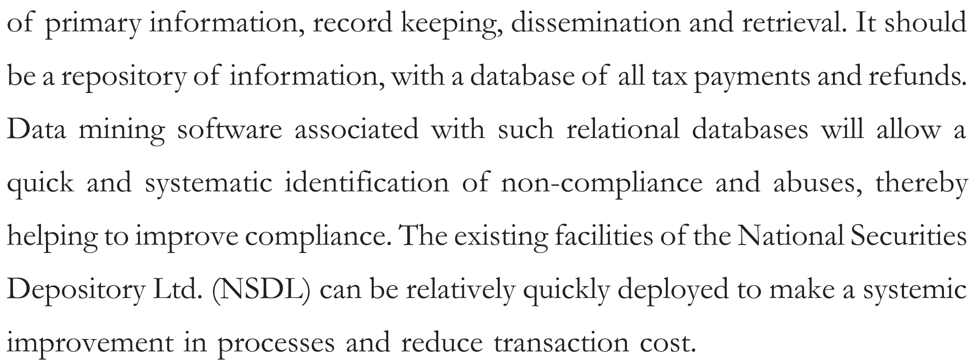
(Paragraph 3.37)

10.13 The tax department should be allowed to concentrate on its core functions – an increasing emphasis on assessment and enforcement duties, rather than logistics and support services – which will surely lead to increased effectiveness of the tax administration. In this context, rapid and progressive outsourcing of many tasks of the tax department is not only feasible, given the significant pool of talent in the Indian software industry, but it is also desirable. In order to make IT infrastructure commensurate with the requisite processing tasks, the Task Force would like to explicitly put on record that implementation of this enhanced integration-software requires considerable investment in upgrading associated IT hardware and sufficient access to high-capacity bandwidth for implementing the network.

(Paragraph 3.40)

10.14 To speed up the process of modernisation, -

(i) The Government should establish a national Tax Information Network (TIN) on a build, operate and transfer basis. This will comprise of a world class (common carrier) network system and have access to state-of-the-art IT infrastructure. A requisite in-built feature of the system is that it should be scalable to offer ease of access across tax administration and taxpayers. The network that is envisaged will facilitate transactions, akin to securities markets, and establish secure and seamless logistics of tax collection through integration



of primary information, record keeping, dissemination and retrieval. It should be a repository of information, with a database of all tax payments and refunds. Data mining software associated with such relational databases will allow a quick and systematic identification of non-compliance and abuses, thereby helping to improve compliance. The existing facilities of the National Securities Depository Ltd. (NSDL) can be relatively quickly deployed to make a systemic improvement in processes and reduce transaction cost.

(ii) TIN will receive, on behalf of the tax administration, all TDS returns and other information returns for digitisation. The information would be received either online, or through magnetic media or in printed format. The digitised information will be downloaded by the National Computer Centre / Regional Computer Centres of the income tax department for further processing.

(iii) TIN will also receive online information about collection of taxes from the banks. The information could be downloaded by the income tax department as and when required.

(iv) The taxpayer will have the facility of accessing the TIN system through a secure and confidential Permanent Account Number (PAN)-based identification to ascertain tax payments credited to his/her account and the status of returns and refunds.

The TIN will therefore serve as a gateway to the National Computer Centre of the Income Tax Department. It will help overcome the paucity of technical manpower and inadequate technical infrastructure.

(Paragraph 3.42)

10.15 Firms and individuals whose total sales, gross receipts or turnover from the business or profession carried on by it is less than the monetary limits specified under clause (a) or clause (b) of section 44AB should continue to be exempted from the liability of deducting tax at source. However, once the TIN, which has been recommended by this Task Force, is

fully operationalised, the requirement to issue TDS certificates to the payee can be dispensed and the scheme can be extended to the smaller taxpayers.

(Paragraph 3.45)

10.16 Where a payee receiving salary fails to furnish his PAN, tax should be deducted at a flat rate of 30 percent. In all other cases of such failure, tax should be deducted at twice the normal rate or 30 percent, which ever is lower. Further, -

(i) Tax should be required to be deducted at source irrespective of the amount of payment.

(ii) A payee should be allowed to claim exemption from TDS if she/he furnishes a self declaration to the payer that the tax on her/his estimated total income in which the income is to be included will be NIL and quotes her/his Permanent Account Number (PAN) on such.

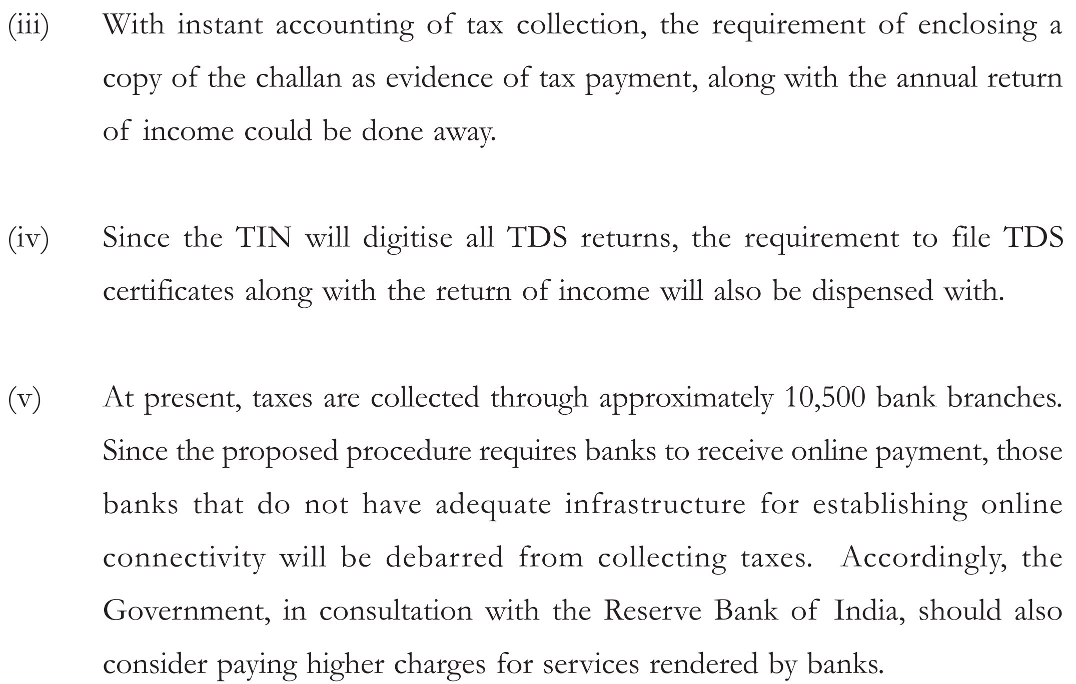
(iii) The present system of obtaining a certificate from the assessing officer for deduction at lower rate should be abolished so as to minimize the interface between the taxpayer and tax authorities.

(Paragraph 3.46 & 3.48)

10.17 In view of the recommendation for the establishment of TIN, a revised procedure for collection of taxes and their accounting may be designed along the following lines :-

(i) A taxpayer will be required to fill up only one copy of the challan while making payment of taxes in the bank. The present requirement of filling up four copies of challan for payment of any tax will be given up.

(ii) The banks will be networked to the TIN and receive payments online. The banks will be required to issue a computerised receipt to the taxpayer instantaneously. The date of presentation of a cheque will be treated as the date of payment. If a cheque bounces, the bank will reverse the receipt online, and the department would then be expected to prosecute the delinquent taxpayer.



(iii) With instant accounting of tax collection, the requirement of enclosing a copy of the challan as evidence of tax payment, along with the annual return of income could be done away.

(iv) Since the TIN will digitise all TDS returns, the requirement to file TDS certificates along with the return of income will also be dispensed with.

(v) At present, taxes are collected through approximately 10,500 bank branches. Since the proposed procedure requires banks to receive online payment, those banks that do not have adequate infrastructure for establishing online connectivity will be debarred from collecting taxes. Accordingly, the Government, in consultation with the Reserve Bank of India, should also consider paying higher charges for services rendered by banks.

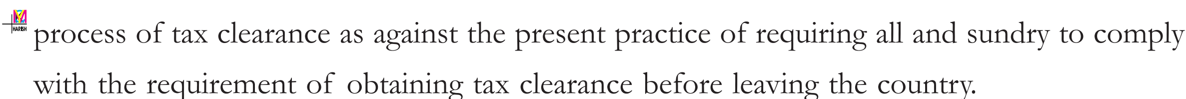
The process outlined above will facilitate real-time accounting of TDS, Advance Tax and Self-Assessment Tax, and help the tax administration to swiftly identify non-compliance. Furthermore, the new procedure of tax accounting will facilitate electronic filing of tax returns.

(Paragraph 3.54)

10.18 The existing cumbersome and manually-operated procedures for issue of refunds must be replaced by a more efficient IT-based system. Under the new system the department will prepare a separate file of all refunds daily which will be downloaded by a payment intermediary, i.e., a designated bank. The designated bank will be authorised to issue computerised refunds as is the current practice for issuing dividend and interest warrants by companies. The designated bank will be required to transmit the information relating to the issue of refunds to the TIN, which will also allow a taxpayer to verify the status of his/her refund claim.

(Paragraph 3.55)

10.19 The present requirement of obtaining a tax clearance certificate before leaving the country must be abolished. However in order to protect the interest of revenue, we can continue to allow the income tax authorities to notify the immigration/custom authorities to prevent any particular person from leaving the country if such person is considered to be a proclaimed offender. As a result only a handful of notified persons will be subjected to the


process of tax clearance as against the present practice of requiring all and sundry to comply with the requirement of obtaining tax clearance before leaving the country.

(Paragraph 3.60)

10.20 The system of issuing Income Tax Clearance Certificates to contractors and others should be eliminated forthwith. However, to help in enhancing effective tax enforcement, all government agencies should be required to obtain the PAN of entities participating in tenders, being designated as vendors to the government, etc., and periodically submit (pre– specified) relevant information to the tax administration.

(Paragraph 3.65)

10.21 On the issue of dispute resolution, the Task Force recommends the following:-

(i) the Income tax Act should be amended to provide that all orders/intimation imposing any additional burden should be made appealable.

(ii) The institution of Ombudsman should be established in the top ten-taxpaying cities and all state capitals along the lines of that in the banking sector. This institution will provide an independent system to assure that tax problems, which have not been resolved through normal channels, are promptly and fairly handled. It will also identify issues that increase burden or create problem for taxpayers, and bring those issues to the attention of the Central Board of Direct Taxes (CBDT). The Ombudsman will also enquire into, should a complaint be filed, the practices and performance of all classes of tax professionals. Where necessary, it will also make appropriate legislative proposals. This institution will be independent of the local tax office. Its goal will be to protect individual taxpayer rights and to reduce taxpayer burden. A consolidated annual report of the Ombudsman system will be tabled in Parliament.

(Paragraph 3.66 & 3.67)

10.22 Central Board of Direct Taxes (CBDT), which is responsible for administering the direct tax laws, should be given the requisite autonomy in the following manner so that it is made more accountable :-

(i) The control of the Central Government over the tax administration be exercised through a Memorandum of Understanding (MOU) between the Central Board of Direct Taxes and the Central Government (we understand that there is already a Cabinet decision to this effect). The Central Board of Revenue Act provides that the two boards (CBDT and CBEC) must function subject to the control of the Central Government, but the mechanism and the extent of control still remains unspecified.

(ii) The MOU should, inter alia, specify the financial commitment of the Central Government for tax administration. It should provide for full financial autonomy and control over deployment of human resources to the CBDT. The Central Government should only specify the general guidelines for financial expenditure and deployment of human resources. The CBDT should have exclusive power for designing the enforcement strategy, subject to the condition that it is non-discriminatory and transparent. The MoU should be for a period of five years specifying observable performance indicators for CBDT and the financial resources that would be made available to CBDT on a year-to-year basis.

(Paragraph 3.69 & 3.70)

10.23 The rules for appointment of Members should provide for selection on criteria of merit-cum-seniority from amongst those who have a minimum period of two years of service before retirement as on the date on which the vacancy arises. Further, an officer once appointed as member of the Board should be debarred from any appointment either in the ITAT or Settlement Commission. Similarly, the Chairman, CBDT should be selected on criterion of merit cum seniority and once appointed should have a minimum tenure of two years.

(Paragraph 3.71)

10.24 Expressing deep concern at the lack of accountability, the Task Force considers it necessary to reiterate the direction by the Honorable Supreme Court that disciplinary action must be taken in the following cases:

(i) Where the officer had acted in a manner as would reflect on his reputation for integrity or good faith or devotion to duty;

(ii) If there is prima facie material to show recklessness or misconduct in the discharge of his duty;

(iii) If the officer has acted in a manner which is unbecoming of a Government servant;

(iv) If the officer has acted negligently or that he omitted the prescribed conditions which are essential for the exercise of the statutory powers;

(v) If the officer has acted in order to unduly favour a party;

(vi) If the officer has been actuated by corrupt motive, however small the bribe may be because Lord Coke said long ago 'through the bribe may be small, yet the fault is great'.

(Paragraph 3.73)

10.25 As a confidence building measure, the Central Board of Direct Taxes should release annual information (giving Chief Commissioner-wise break-up) of number of complaints received from the public or acts of omission or commission identified through internal mechanism or by external agencies and the result of official enquiry into such complaints. The information must be provided separately for officers and staff. Such information may relate to tax payer profiles, returns received, headwise breakup of income, number of appeals filed and disposed of, penalty orders, rectification applications, reopening of assessment, refund orders, refunds issued, returns selected for scrutiny assessment and their results, break up of collection, etc.

(Paragraph 3.74)

10.26 With a view to further enhancing accountability of (and transparency in) tax administration, it is important that the CBDT publishes an annual report of its own, along the lines of the UPSC/CVC, that is tabled in Parliament and put on its web site. The annual report must separately provide for performance achievements of each Chief Commissioner/ Commissioner. In addition, the quarterly progress of achievement must be displayed on the web site, so that taxpayers have an opportunity to respond. While defining a stricter accountability structure, however, care must be taken to eschew an excessive and regimented accountability system which over-burdens AOs with onerous and fragmented oversight that ultimately only serves to reduce its overall effectiveness.

(Paragraph 3.75)

10.27 Lack of financial autonomy was identified as an important constraint in the functioning of the CBDT. Therefore, The Task Force is of the view that the position should be immediately rectified through adequate delegation of financial powers to bring in synergy and effectiveness in management functions.

(Paragraph 3.81)

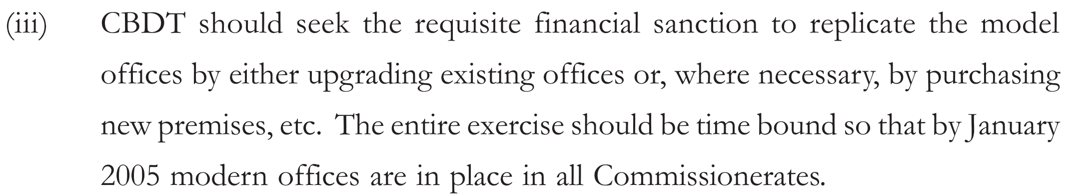
10.28 The absence of control over human resources has further undermined accountability. Therefore, it is recommended that the Central Government should delegate to CBDT full authority and responsibility regarding staff of the income tax department and its secretariat. The CBDT should, however, exercise such delegated powers in a transparent manner within the framework of rules and guidelines framed for this purpose. Such rules and guidelines should be framed with the approval of the government.

(Paragraph 3.82)

10.29 To institute changes for modernization of the tax administration –

(i) CBDT should request Chief Commissioners to identify the shortcomings in their offices by 1st April 2003 and send their proposals to CBDT for creating model tax offices.

(ii) By 1st August 2003 a model Commissionerate including the offices at the range, circle and ward levels should be established in each zone.



(iii) CBDT should seek the requisite financial sanction to replicate the model offices by either upgrading existing offices or, where necessary, by purchasing new premises, etc. The entire exercise should be time bound so that by January 2005 modern offices are in place in all Commissionerates.

(Paragraph 3.83)

Personal Income Tax Reform

10.30 At the beginning of the 21st century, some truths about taxation have become self-evident. Even so, they bear repetition.

(i) First, the design of tax policy is of paramount importance for tax administration.

(ii) Second, if the objective is to have a transparent, efficient and feasible tax administration, then the structure of all taxes should comprise common elements. These are low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges, few temporary measures. And in the rare instances where there are exceptions, there should be clear guidelines.

The Task Force is unanimously in favour of these overarching fiscal principles. The numerous recommendations derive from these objectives.

(Paragraph 4.12 & 4.13)

10.31 The Task Force endorses the following principles identified in the Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, for designing the rate schedule:

(i) The basic exemption limit must be at a moderate level — an appropriate balance between the tax liability at the lowest levels, administrative cost of collection and compliance burden of the smallest taxpayers. The ability of the tax administration to render quality services to taxpayers will also significantly affect the choice of the exemption limit.

(ii) The number of tax slabs should be few and their ranges fairly large to minimise distortions arising out of bracket creep.

(iii) The maximum marginal rate of tax should be moderate, so that the distortions in the economic behaviour of taxpayers and incentive to evade tax payment are minimised.

(Paragraph 4.14)

10.32 In view of the principles endorsed above, –

(i) the imposition of a single individual income tax rate is rejected in preference for a reformed system of personal income tax with more than one rate. The Task Force believes that the alternative lies in a multiple rate schedule, but with very little spread between such rates;

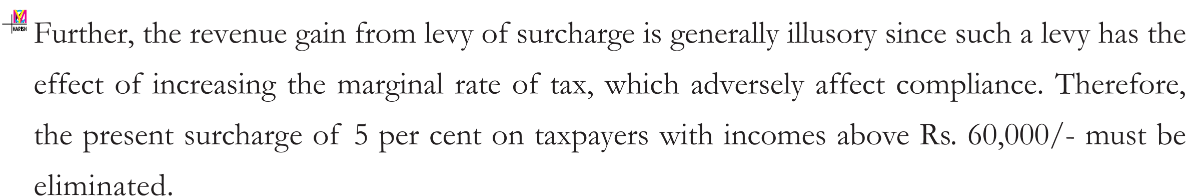
(ii) and in view of the distortionary impact of multiple slabs, the Task Force opts for a two rate personal income tax schedule;

(iii) and if the full effect of lower tax rates has to be realised, it is not only necessary to have an optimal enforcement strategy but also ensure that the benefits of a tax cut apply to all class of taxpayers — rather than be restricted to a handful of taxpayers at the top end. This is possibly achieved by broad basing the tax slabs.

Accordingly, the Task Force recommends the following personal income tax rate schedule :

Proposed Personal Income Tax Structure.

Income level	Tax rates
Below Rs. 1,00,000	Nil
Rs. 1,00,000-4,00,000	20 percent of the Income in excess of Rs. 1,00,000/-
Above Rs. 4,00,000	Rs. 60,000/- plus 30 percent of the Income in excess of Rs. 4,00,000\-



Further, the revenue gain from levy of surcharge is generally illusory since such a levy has the effect of increasing the marginal rate of tax, which adversely affect compliance. Therefore, the present surcharge of 5 per cent on taxpayers with incomes above Rs. 60,000/- must be eliminated.

(Paragraph 4.21, 4.23 to 4.26)

10.33 If compliance is to be fostered and nurtured and economic incentive sustained, it is necessary to move towards a comprehensive tax regime by reviewing the various exemptions, deductions and rebates.

(Paragraph 4.38)

10.34 Tax payers who are residents but not ordinarily residents must be subjected to tax on their global/world-wide income at par with residents. To do so, this unusual category of resident but not ordinarily resident taxpayers must be deleted. This will not only enhance the income tax base, but also remove an antiquated anomaly and simplify the law.

(Paragraph 4.42 & 4.43)

10.35 The standard deduction under Section 16(1) of the Income Tax Act should be eliminated. However, the exemption of conveyance allowance subject to a ceiling of Rs. 9,600/- should be continued. This should serve as a reasonable deduction for employment related expenses. The additional liability of a taxpayer on this account will be more than met by the reduction in rates of personal income tax proposed by the Task Force.

(Paragraph 4.53)

10.36 Individual myopia, particularly amongst the smaller taxpayer and the non-taxpayer may result in sub-optimal investment in the housing sector – a necessity for providing social security. This problem would not be resolved through the existing scheme of tax treatment of mortgage interest for owner occupied dwelling which is targeted to taxpayers alone. Therefore, the first best policy option would be to incentivise borrowings for housing by providing 2 per cent interest subsidy on all loans below Rs. 5 lakhs. This subsidy should be granted by the Government through the National Housing Bank. This will indeed target such loanees who suffer from individual myopia. The second best policy measure for this purpose would be to continue with the tax treatment of mortgage interest for owner occupied houses. However, given the average size of the home loan (around Rs. 3.5 lakhs), we recommend that the

ceiling on the amount of mortgage interest deductible for taxable income purposes should be reduced from the existing level of Rs. 1,50,000/- to Rs. 50,000/- only.

(Paragraph 4.66)

10.37 With a view to encourage the States to tap the full potential of their taxing powers and to prevent laundering of non-agricultural income as agricultural income, the Task Force recommends –

(i) A tax rental arrangement should be designed whereby States should pass a resolution under Article 252 of the Constitution authorising the Central Government to impose income tax on agricultural income. The taxes collected by the Centre would however be assigned to the States.

(ii) Tax from agricultural income for the purposes of allocation between States will be the difference between the tax on total income (including agricultural income) and the tax on total income net of agricultural income.

(iii) Where a taxpayer derives agricultural income from different States, the revenues attributable to a State will be in the ratio of the income derived from a particular State to the total agricultural income.

(iv) A separate tax return form should be prescribed for taxpayers deriving income from agriculture.

These recommendations will help mobilise additional resources for the States without the attendant problem of administering the agricultural income tax. Further, given our recommendations on increasing the exemption limit to Rs.1,00,000 per individual, most agricultural farmers would continue to remain out of the tax net. The proposed rental arrangement with the States could be packaged with the rental arrangement for taxation of services.

(Paragraph 4.68)

10.38 The tax incentives for savings under Section 88, Section 80L, Section 10(15)(i), Section 10(15)(iib), Section 10(15)(iic), Section 10(15)(iid), Section 10(15)(iv)(h) and Section 10(15)(iv)(i) of the Income Tax Act must all be eliminated. These benefits must be withdrawn with immediate effect and not through a sunset clause.

(Paragraph 4.98)

10.39 Further, with a view to overcoming the problem thrown up by individual myopia, we also recommend the continuation of the deduction under section 80CCC for contribution to the pension fund of LIC or any other insurance company. The ceiling on the deduction should, however, be increased from the existing levels of Rs. 10,000/- to Rs. 20,000/-. This income-based deduction u/s 80CCC be converted to a tax rebate at the minimum marginal rate of 20 per cent. Consequently, the ceiling on tax rebate for contribution to the pension fund should be Rs. 4,000/-. The new ceiling has been proposed keeping in view the needs of the smaller taxpayers with income below Rs. 2 lakhs. The scope of section 80CCC may also be extended to a larger number of pension/annuity schemes within the overall ceiling of Rs. 20,000/-. Since savings in these pension funds will be taxable at the withdrawal stage, the tax benefit for such savings will be consistent with the EET method of tax treatment.

(Paragraph 4.99)

10.40 In view of the International practice and the fact that education is one of the basic amenities of life, generating positive externalities, it is necessary to provide continued support to education under the tax law. However, on grounds of equity, we also recommend that the income based deduction under Section 80E should be converted to a tax rebate at the minimum marginal rate of personal income tax. The maximum amount of tax rebate should be restricted to Rs.4,000.

(Paragraph 4.102)

10.41 Since health is also one of the basic amenities in life, support under the tax law will continue to be provided under section 80D of the Income Tax Act for contribution to the mediclaim insurance schemes, subject to a ceiling of Rs. 15,000/-. However, the tax support would take the form of a tax rebate at the minimum marginal rate of 20 percent subject to a ceiling of Rs. 3,000/- in tax relief. Similarly, the income based deduction for medical expenses under section 80 DDB is proposed to be restricted to senior citizens subject to a reduced

ceiling of Rs. 20,000/-. The deduction would take the form of a tax rebate at 20 per cent subject to a maximum of Rs. 4,000/-.

(Paragraph 4.104)

10.42 With a view to providing a human face to the tax reform, we recommend that the basic exemption limit for senior citizens should be Rs. 50,000/- more then the exemption limit for the general class of individual taxpayers. In other words, the exemption limit for senior citizens should be Rs. 1,50,000/- as against Rs. 1,00,000/- for the general category of individual taxpayers recommended by us in Table-4.1. The exemption limit for senior citizens should be revised as and when the exemption limit for the general category of individual taxpayers is revised. We also recommend that this benefit of higher exemption limit should also be extended to widows.

(Paragraph 4.106)

10.43 Given the personal circumstances of handicapped, the Task Force recommends the continuation of the personal deductions under Sections 80DD and Section 80U. However, on grounds of equity between handicapped taxpayers, we also recommend that the income-based deduction under these provisions should be converted to a tax rebate at the minimum marginal rate of personal income tax.

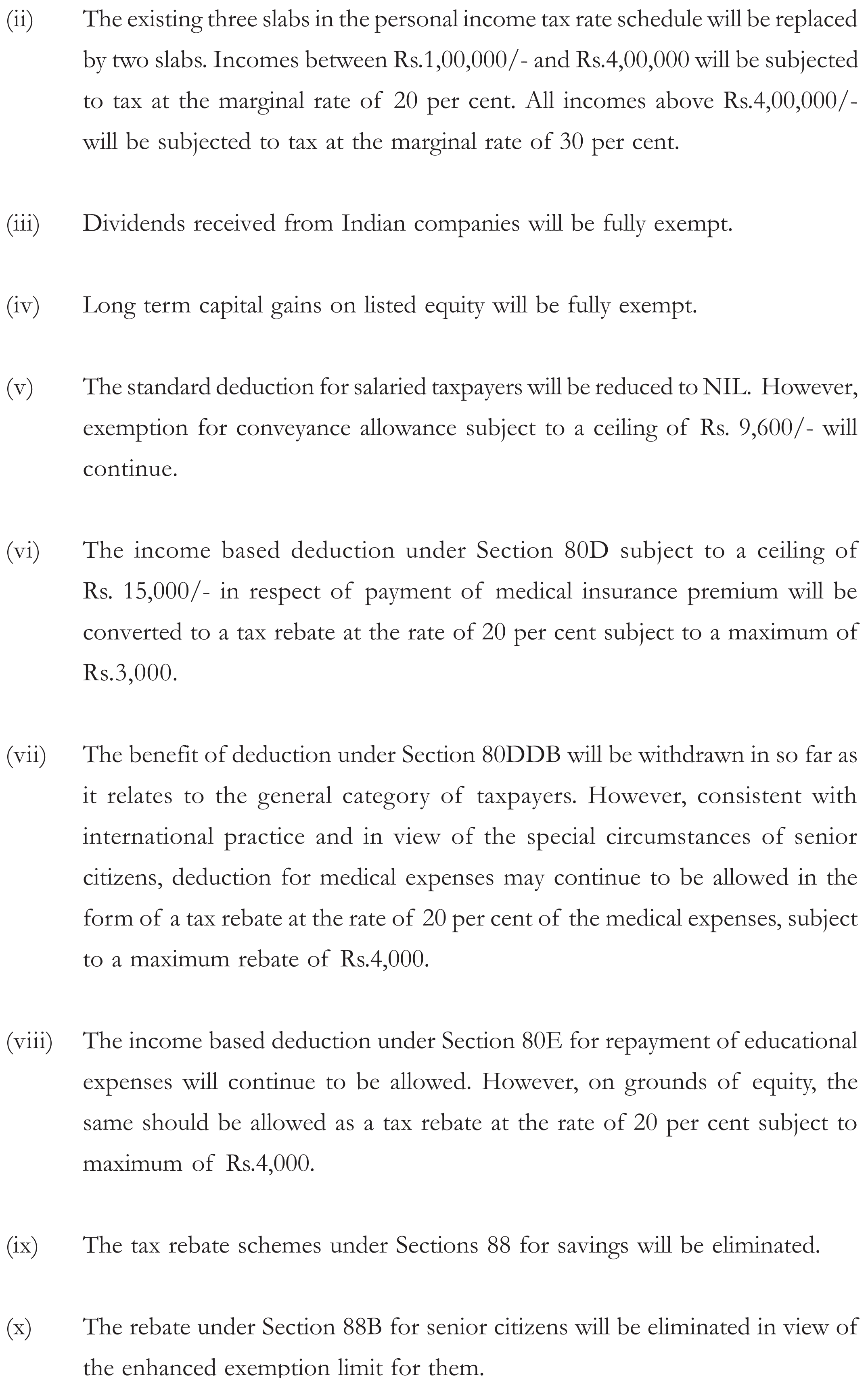
(Paragraph 4.108)

10.44 Further, in view of our recommendations for increase in the exemption limit to Rs. 1,00,000/- and deduction of medical expenses for senior citizens and widows, we recommend that the personal deductions in the form of tax rebate for senior citizens (Section 88B) and women (Section 88C) should be deleted.

(Paragraph 4.109)

10.45 The policy measures for the reform of personal income tax therefore comprises of the following elements:-

(i) Increase in the generalised exemption limit from Rs.50,000/- to Rs.1,00,000/- for all individual and HUF taxpayers. The exemption limit for senior citizens and widows would, however, be at an enhanced level of Rs. 1,50,000/-.



(ii) The existing three slabs in the personal income tax rate schedule will be replaced by two slabs. Incomes between Rs.1,00,000/- and Rs.4,00,000 will be subjected to tax at the marginal rate of 20 per cent. All incomes above Rs.4,00,000/- will be subjected to tax at the marginal rate of 30 per cent.

(iii) Dividends received from Indian companies will be fully exempt.

(iv) Long term capital gains on listed equity will be fully exempt.

(v) The standard deduction for salaried taxpayers will be reduced to NIL. However, exemption for conveyance allowance subject to a ceiling of Rs. 9,600/- will continue.

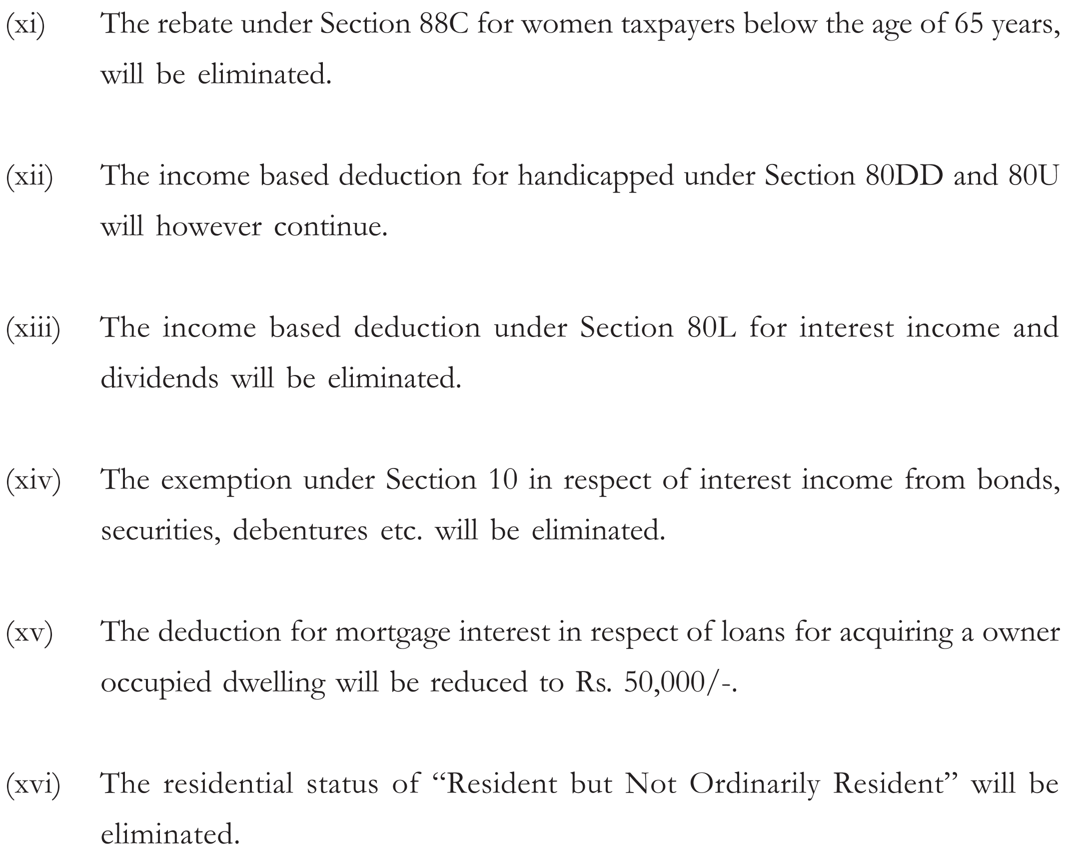
(vi) The income based deduction under Section 80D subject to a ceiling of Rs. 15,000/- in respect of payment of medical insurance premium will be converted to a tax rebate at the rate of 20 per cent subject to a maximum of Rs.3,000.

(vii) The benefit of deduction under Section 80DDB will be withdrawn in so far as it relates to the general category of taxpayers. However, consistent with international practice and in view of the special circumstances of senior citizens, deduction for medical expenses may continue to be allowed in the form of a tax rebate at the rate of 20 per cent of the medical expenses, subject to a maximum rebate of Rs.4,000.

(viii) The income based deduction under Section 80E for repayment of educational expenses will continue to be allowed. However, on grounds of equity, the same should be allowed as a tax rebate at the rate of 20 per cent subject to maximum of Rs.4,000.

(ix) The tax rebate schemes under Sections 88 for savings will be eliminated.

(x) The rebate under Section 88B for senior citizens will be eliminated in view of the enhanced exemption limit for them.



(xi) The rebate under Section 88C for women taxpayers below the age of 65 years, will be eliminated.

(xii) The income based deduction for handicapped under Section 80DD and 80U will however continue.

(xiii) The income based deduction under Section 80L for interest income and dividends will be eliminated.

(xiv) The exemption under Section 10 in respect of interest income from bonds, securities, debentures etc. will be eliminated.

(xv) The deduction for mortgage interest in respect of loans for acquiring a owner occupied dwelling will be reduced to Rs. 50,000/-.

(xvi) The residential status of "Resident but Not Ordinarily Resident" will be eliminated.

The Task Force would like to place on record that the various recommendations relating to personal income tax in this report are interwoven and therefore indivisible. The recommendations must be seen as a package and piecemeal implementation must be avoided at all cost.

(Paragraph 4.110 & 4.111)

Corporate Tax Reforms

10.46 A corporate entity should be viewed as a 'conduit' and therefore the need for integration of corporate tax and personal income tax. Given the pros and cons of the various full/partial integration methods, the Task Force recommends the adoption of this method of full integration of corporation and personal income tax whereby a tax at the corporate level is levied at the same rate as the maximum rate of personal income tax and all dividends and capital gains is exempted from tax in the hands of the shareholders. Accordingly, the Task Force recommends that a corporate tax rate of 30 per cent for domestic companies, being the top marginal rate for personal income tax, and exempt from tax all dividends and long term

capital gains from listed equity. This method would not undermine any equity since most direct equity investors in the companies in India are likely to be taxed at the top marginal rate of personal income tax.

(Paragraph 5.19)

10.47 This system recommended by us would serve as a full integration model only if the accounting profits bear the full burden of corporate tax i.e., the effective corporate tax liability is equivalent to the statutory corporate tax rate. This is possible if there is no divergence between the taxable base for companies and accounting profits, which generally arises due to various tax incentives and artificial deductions.

(Paragraph 5.20)

10.48 The tax incentive u/s 10A and 10B of the Income Tax Act must be eliminated for all taxpayers other than those engaged in manufacturing computer software.

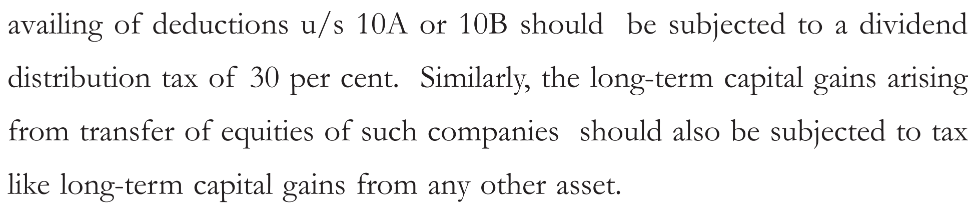
(Paragraph 5.52)

10.49 The Task Force recommends that in the case of taxpayers engaged in manufacturing computer software, the Government of India must take immediate steps to negotiate with foreign governments to enter into a comprehensive totalisation agreement leading to a single point incidence of taxes. It may be noted that a number of countries across the globes already have totalisation agreements with each other related to payment of social security and other taxes . However, *in the interim*, the Task Force recommends the following alternatives:-

1. Eliminate the tax exemption u/s 10A and 10B and amend Section 91 of the Income Tax Act to allow full credit for payment of foreign country's federal and state income tax. However, no refund of such foreign tax credit should be allowed;

OR

2. Since the arrangement is transitory in nature the benefit of tax exemption u/s 10A and 10B for manufacturing of computer software only may be continued till we enter into a totalisation agreement with trading partners. However, the distribution of dividend by computer software manufacturing companies



availing of deductions u/s 10A or 10B should be subjected to a dividend distribution tax of 30 per cent. Similarly, the long-term capital gains arising from transfer of equities of such companies should also be subjected to tax like long-term capital gains from any other asset.

The Task Force could not arrive at unanimity on the preferred alternative amongst the above two.

(Paragraph 5.53)

10.50 The general rate of depreciation for plant and machinery should be reduced to 15 per cent from the existing level of 25 per cent. The rates of depreciation for other blocks of assets must be reviewed along the same lines as in the case of plant and machinery. Consequently, the depreciation amount charged for tax purposes will be similar to those charged under the Companies Act.

(Paragraph 5.58)

10.51 The tax benefit u/s 33AC of the Income Tax Act should be abolished.

(Paragraph 5.59)

10.52 The Task Force recommends the abolition of section 35 of the Income Tax Act. As a result, the revenue expenditure on scientific research will qualify for deduction u/s 37 of the Income Tax Act and capital expenditure on scientific research will be eligible for depreciation under section 32 of the Income Tax Act. Since, expenditure link weighted deduction will also be abolished, there will be no perverse incentive to shift expenditure or make false claims.

(Paragraph 5.63)

10.53 In view of the fact that deduction for donations to scientific research institutions confer higher benefit to donors engaged in business in comparison to non-business donors, we recommend the rationalisation of the deduction for donation for scientific research, so as to be more equitable across taxpayers. Therefore, a tax rebate calculated at 20 per cent of the amount of donation for research (scientific, social sciences or statistical) should be allowed to all taxpayers irrespective of their source of income.

(Paragraph 5.64)

10.54 With a view to aligning the provisions relating to the allowability of deduction u/s 36(1)(iii) with those of the Accounting Standard 16 issued by the Institute of Chartered Accountants of India, it is recommended that a suitable clarificatory amendment to Section 36(1)(iii) should be made to provide for the disallowance of the borrowing costs that are directly attributable to the acquisition, construction or production of a capital asset, as a revenue expenditure. Such borrowing costs will now have to be capitalized as part of the cost of the capital asset in accordance with the Accounting Standards 16 issued by the Institute of Chartered Accountants of India. Other borrowing costs should continue to be recognised as an expense in the period in which they are incurred and continue to be allowed as a deduction u/s 37(1) of the Income Tax Act. Accordingly, it is recommended that the provisions of section 36(1)(viia) of the Income Tax Act should be amended to provide that the provision for bad and doubtful debts will be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

(Paragraph 5.66 & 5.69)

10.55 Since, the objective of the provisions of section 43B is to ensure that a taxpayer does not avail of any statutory liability without actually making a payment for the same, we are of the view that these objectives would be served if the deduction for the statutory liability relating to labour are allowed in the year of payment. The complete disallowance of such payments is too harsh a punishment for delays in payment. Therefore, it is recommended that the deduction for delayed payment of statutory liability relating to labour should be allowed in the year of payment like delayed taxes and interest.

(Paragraph 5.71)

10.56 The distinction between unabsorbed depreciation and unabsorbed business loss should be eliminated. In other words unabsorbed depreciation would be merged with business loss and lose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(Paragraph 5.74)

10.57 The Task Force recommends the elimination of the provisions of section 80IA and 80IB with immediate effect (and not by a sunset clause).

(Paragraph 5.80)

10.58 The Task Force discussed the possible strategy for the successful implementation of the corporate tax reforms. Towards this, the Task Force recommends two alternate options for reform of corporate income tax :-

Option - I : The following measures to be introduced for the financial year 2003-04:-

(i) Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies.

(ii) Exemption of dividend from taxation in the hands of the shareholders. There will also be no tax on distribution of dividends by a company.

(iii) Exemption of long-terms capital gains on listed equity.

(iv) Elimination of Minimum Alternate Tax under Section 115JB.

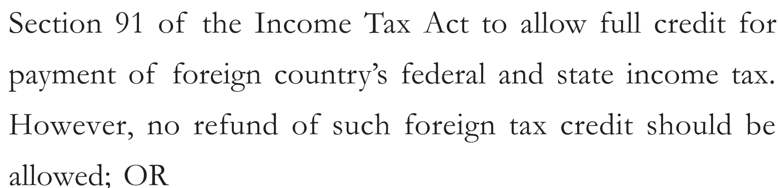
(v) Removal of the distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(vi) Removal of the following deductions under Section 10 and Chapter VI A of the Income Tax Act with immediate effect and not by a sunset clause :-

(a) Elimination of Section 10A and 10B of the Income Tax Act for all tax payers other than those engaged in manufacturing computer software.

(b) In the case of taxpayers engaged in manufacturing computer software, the Government of India must take immediate steps to negotiate with foreign governments to enter into a comprehensive totalisation agreement leading to a single point incidence of taxes. However, in the interim, the Task Force recommends the following alternatives:-

1. Eliminate the tax exemption u/s 10A and 10B and amend



Section 91 of the Income Tax Act to allow full credit for payment of foreign country's federal and state income tax. However, no refund of such foreign tax credit should be allowed; OR

2. Since the arrangement is transitory in nature the benefit of tax exemption u/s 10A and 10B for manufacturing of computer software only may be continued till we enter into a totalisation agreement with trading partners. However, the distribution of dividend by computer software manufacturing companies availing of deductions u/s 10A or 10B should be subjected to a dividend distribution tax of 30 per cent. Similarly, the long-term capital gains arising from transfer of equities of such companies should also be subjected to tax like long-term capital gains from any other asset.

The Task Force could not arrive at unanimity on the preferred alternative amongst the above two.

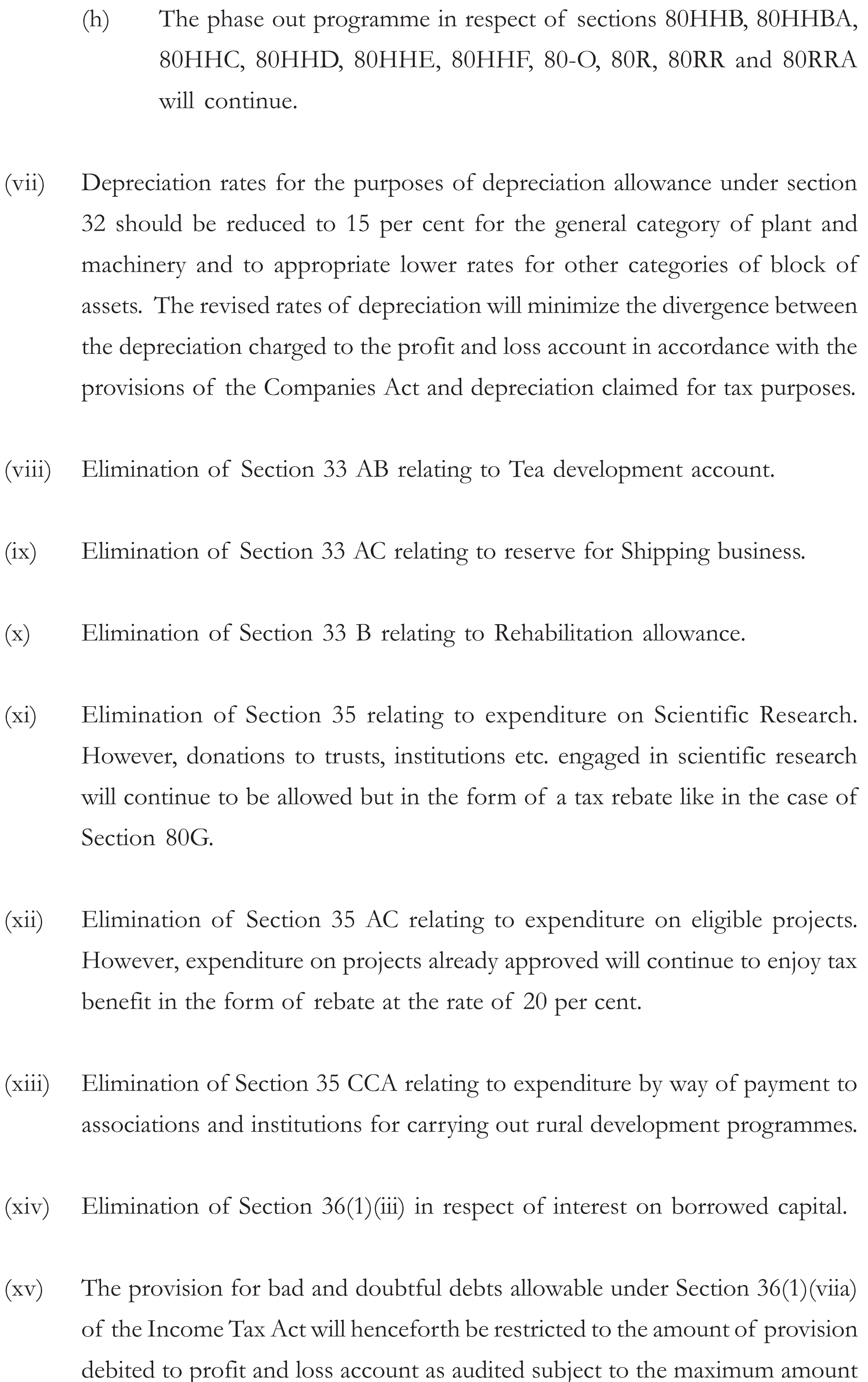
(c) Section 80 IA in respect of profit and gains from industrial undertakings or enterprises engaged in infrastructure development or telecommunication service or development of industrial park or special economic zones or generation, transmission or distribution of power.

(d) Section 80 IB in respect of profits and gains from certain industrial undertakings other then infrastructure development undertakings (this includes backward areas also).

(e) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.

(f) Section 80 JJAA in respect of employment of new workman.

(g) Section 80 M in respect of inter corporate dividends.



(h) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(vii) Depreciation rates for the purposes of depreciation allowance under section 32 should be reduced to 15 per cent for the general category of plant and machinery and to appropriate lower rates for other categories of block of assets. The revised rates of depreciation will minimize the divergence between the depreciation charged to the profit and loss account in accordance with the provisions of the Companies Act and depreciation claimed for tax purposes.

(viii) Elimination of Section 33 AB relating to Tea development account.

(ix) Elimination of Section 33 AC relating to reserve for Shipping business.

(x) Elimination of Section 33 B relating to Rehabilitation allowance.

(xi) Elimination of Section 35 relating to expenditure on Scientific Research. However, donations to trusts, institutions etc. engaged in scientific research will continue to be allowed but in the form of a tax rebate like in the case of Section 80G.

(xii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

(xiii) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

(xiv) Elimination of Section 36(1)(iii) in respect of interest on borrowed capital.

(xv) The provision for bad and doubtful debts allowable under Section 36(1)(viia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount

of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

Option - II : The package of measures along with their phased implementation, to be introduced through the Finance Bill 2003, in the following manner:-

(i) Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies over a period of three years. The rates for domestic companies will be 34 per cent in financial year 2003-04, 32 per cent in 2004-05 and 30 per cent in 2005-06. The rates for foreign companies will be 38.50 per cent in financial year 2003-04, 37 per cent in 2004-05 and 35 per cent in 2005-06.

(ii) No tax on dividend in the hands of the shareholders.

(iii) No tax on long terms capital gains on listed equity.

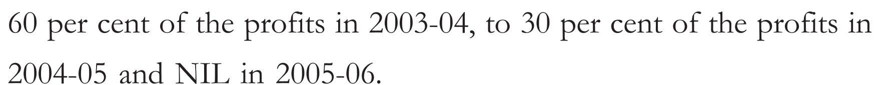
(iv) Elimination of Minimum Alternate Tax under Section 115JB.

(v) Removal of the distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(vi) Levy of a distribution tax on dividends at the rate of 15 per cent for dividends distributed in 2003-04, 7.5 per cent in 2004-05 and Nil in 2005-06.

(vii) Removal / Phasing out of the following deductions under Section 10 and Chapter VI A of the Income Tax Act with immediate effect and not by a sunset clause :-

    (a) Phasing out of the provisions of Section 10A and 10B of the Income Tax Act. over a period of 3 years i.e. the deduction will be reduced to



60 per cent of the profits in 2003-04, to 30 per cent of the profits in 2004-05 and NIL in 2005-06.

(b) Phasing out of Section 80 IA in respect of profit and gains from industrial undertakings or enterprises engaged in infrastructure development or telecommunication service or development of industrial park or special economic zones or generation, transmission or distribution of power, over a period of 3 years i.e. the deduction will be reduced to two – third of the profits in 2003-04, to one – third of the profits in 2004-05 and NIL in 2005-06.

(c) Phasing out of Section 80 IB in respect of profits and gains from certain industrial undertakings other then infrastructure development undertakings (this includes backward areas also), over a period of 3 years i.e. the deduction will be reduced to two – third of the profits in 2003-04, to one – third of the profits in 2004-05 and NIL in 2005-06.

(d) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.

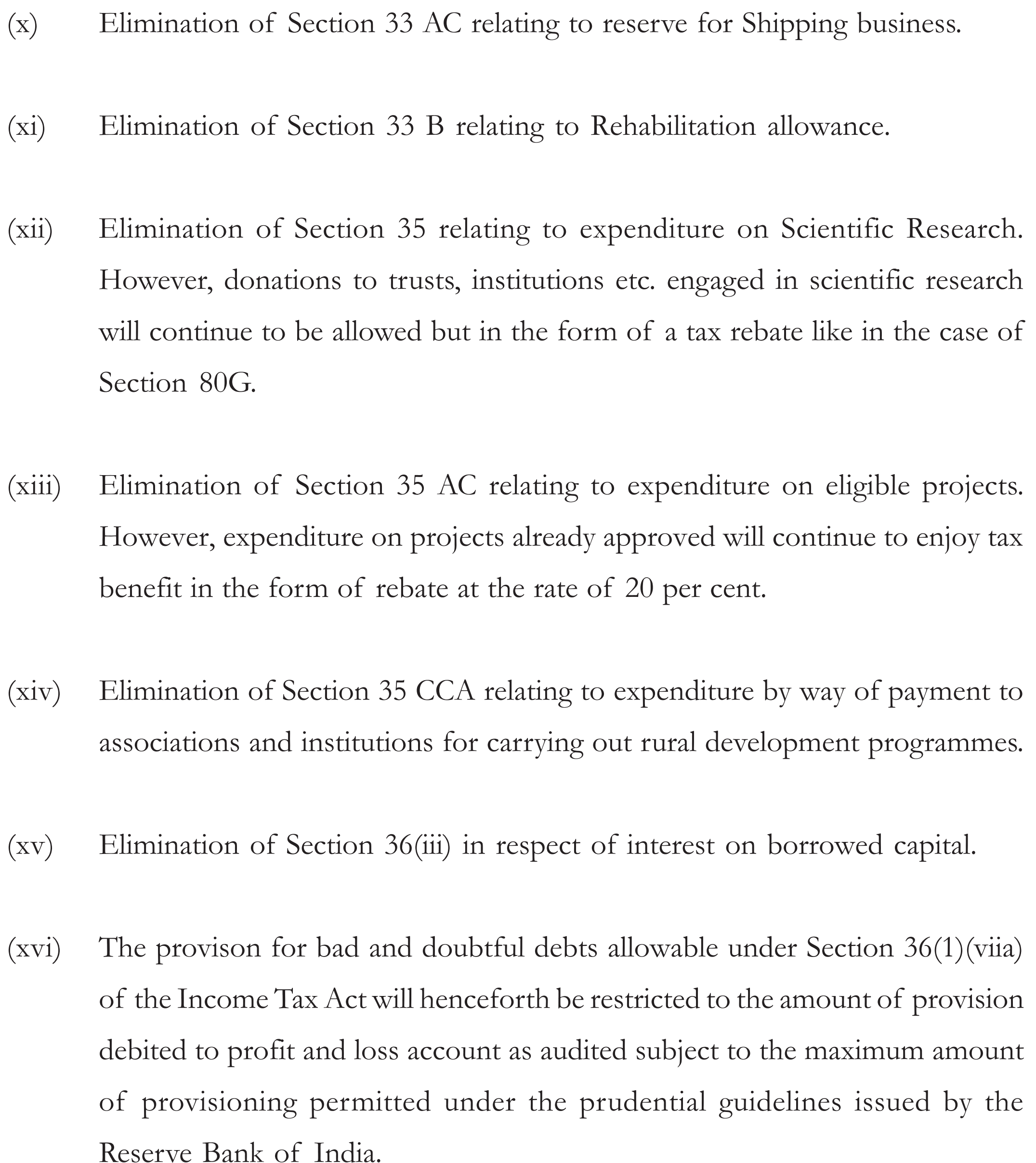
(e) Section 80 JJAA in respect of employment of new workman.

(f) Section 80 M in respect of inter corporate dividends

(g) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(viii) Depreciation allowance under section 32 will be restricted to the allowance, charged to the profit and loss account in accordance with the provisions of the Companies Act.

(ix) Elimination of Section 33 AB relating to Tea development account will be eliminated.



(x) Elimination of Section 33 AC relating to reserve for Shipping business.

(xi) Elimination of Section 33 B relating to Rehabilitation allowance.

(xii) Elimination of Section 35 relating to expenditure on Scientific Research. However, donations to trusts, institutions etc. engaged in scientific research will continue to be allowed but in the form of a tax rebate like in the case of Section 80G.

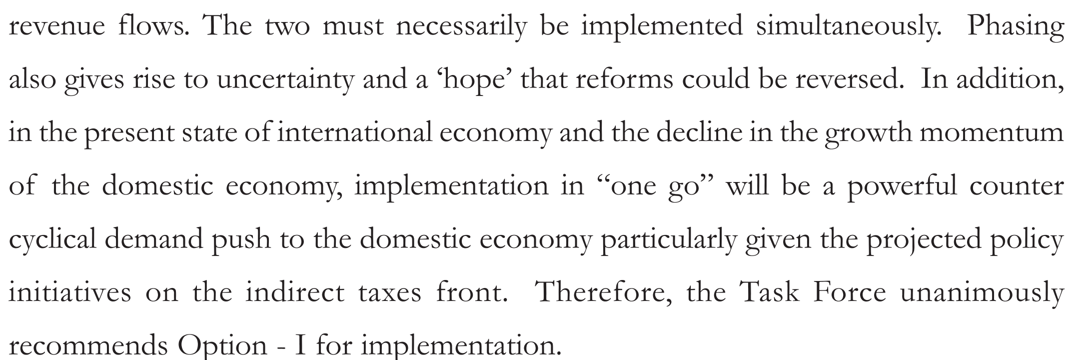
(xiii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

(xiv) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

(xv) Elimination of Section 36(iii) in respect of interest on borrowed capital.

(xvi) The provison for bad and doubtful debts allowable under Section 36(1)(viia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

The Task Force deliberated upon the two packages. It was unanimously agreed that it is rather difficult for any government to give a credible ex-ante time commitment. Such commitments are rarely sustainable. Past experience shows that while tax rates were reduced, successive governments failed to implement the phased withdrawal of incentives. As a result, we have reached a point where the corporate tax rates are close to their resting points and yet the statute continues to be riddled with exemptions and deductions. Any attempt to sequence the reduction in the corporate taxes and the withdrawal of exemptions and deductions could lead to disastrous impact on


revenue flows. The two must necessarily be implemented simultaneously. Phasing also gives rise to uncertainty and a 'hope' that reforms could be reversed. In addition, in the present state of international economy and the decline in the growth momentum of the domestic economy, implementation in "one go" will be a powerful counter cyclical demand push to the domestic economy particularly given the projected policy initiatives on the indirect taxes front. Therefore, the Task Force unanimously recommends Option - I for implementation.

(Paragraph 5.93)

Taxation of Capital Gains

10.59 The concessional treatment of long-term capital gains through a reduced scheduler rate of tax must be abolished. In other words, the long-term capital gains would be aggregated with other incomes and subjected to taxation at the normal rates. Further, since we have recommended the abolition of various saving incentives, we do not consider necessary to allow any exemption for roll over of long-term capital gains.

(Paragraph 6.3)

10.60 Given the public nature of the project, it is necessary to maintain the flow of funds. Therefore, we recommend that long-term capital gains should continue to be exempt if invested in a house or in the bonds of National Highway Authority of India until completion of the Golden Quadrilateral and the North-South & East-West corridors.

(Paragraph 6.3)

10.61 We have also recommended that while short-term capital gains on equity should continue to be taxed, the long-term capital gains on equity should be eliminated. However, recognising the possibility of abuse by transferring real assets through the corporate vehicle, we also recommend that the exemption on long-term capital gain on equity should be restricted to listed securities as defined in section 112 of the Income Tax Act.

(Paragraph 6.7)

10.62 Where there is a conflict between simplicity of equity, the Task Force has a preference for simplicity. Complexity is, inherently, regressive and non-transparent. Therefore, what may appear to be equitable could, in effect, be inequitable. In the light of the problems associated with the existing system of taxation of investment fund and the package for corporate tax reform, we recommend the following:-

(i) The income of the mutual fund derived from short-term capital gains and interest should be taxed at a flat rate in the hands of the mutual fund.

(ii) Since most investors in units are generally smaller taxpayers, we recommend that the rate of tax should be the minimum marginal rate of personal income tax i.e. 20 per cent.

(iii) With a view to overcoming double taxation, the dividends received by the unit holders should be fully exempted since the distributable surplus would have suffered the full burden of the tax.

(iv) The short-term capital gain arising to the investor from sale of units of investment funds should be taxed at his level at the personal marginal rate of tax.

(v) The long-term capital gain arising to the investor from sale of units of mutual fund should be exempt from income tax.

(vi) The tax treatment of mutual funds and their investors should also be extended to venture capital funds, private equity funds and hedge funds. However, the tax rate for these funds should be 30 per cent since their investors are likely to be those in the highest tax slab.

(vii) All funds must necessarily obtain the PAN of the investor and the Databases about every payment made by the fund manager back to the investor, tagged with PAN, should be furnished to the tax authorities as a information return.

(Paragraph 7.13)

10.63 At present, the profits of a partnership firm are subjected to tax at the same rate of tax applicable to a domestic company. In view of our recommendations, for corporate tax reform, we recommend that the rate of tax for partnership firms should be reduced to the same level as corporate rate of tax.

(Paragraph 7.14)

10.64 The tax benefit for donations to charitable trusts must take the form of tax rebate at the minimum marginal rate of tax of 20 per cent. Further, we also recommend that there should be no quantitative ceiling either in absolute terms or as a fraction of the gross income as is presently provided under Section 80G.

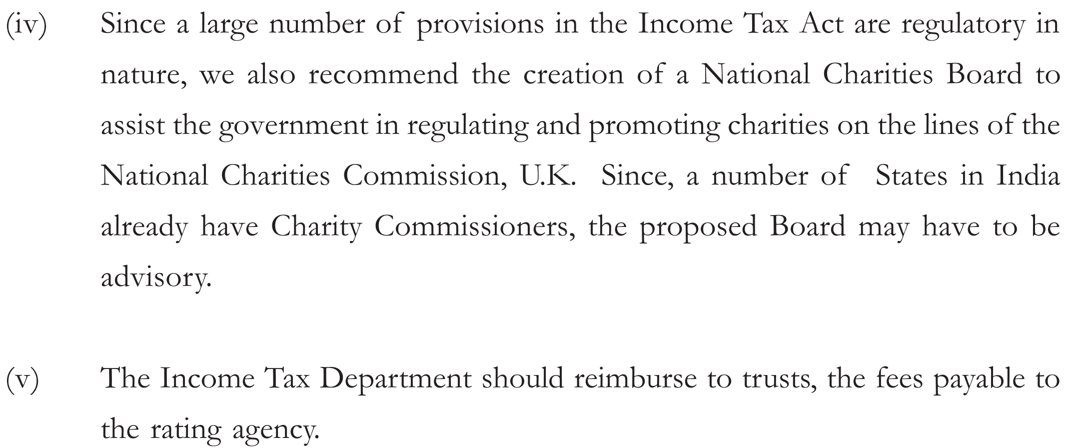
(Paragraph 7.17)

10.65 Therefore, the Task Force recommends that the exemptions under Section 10(21), 10(23B) and 10(23C)(iiiab) to (via), 10(29A) should be merged with Section 11 to 13A of the Income Tax Act. We also recommend that:-

(i) The present practice of exempting a class of Charitable trust and Institutions through notifications should be abolished. However, the requirement to file a return of income by such trust and institutions as proof of fulfilling the various conditions stipulated u/s 10(23C), should continue.

(ii) Returns to be identified for scrutiny/audit only through a computerised risk assessment system.

(iii) Where a return is identified for scrutiny and the assessing officer is of the opinion that the activities of the trust are not charitable in nature, such a case will be referred to a rating agency from amongst the panel drawn up by the C&AG. An "A+" rating for the trust will mean that it is indeed a charitable trust. An "A" rating for the trust will mean that it will enjoy exemption during the current year and will be subjected to review again in the following year. A "B" rating for the trust will disqualify it from any tax exemption. The new procedure should be introduced from 01-04-2004 and the interregnum should be utilized to work out the details and also allowing the trust to adapt to the new procedures.



(iv) Since a large number of provisions in the Income Tax Act are regulatory in nature, we also recommend the creation of a National Charities Board to assist the government in regulating and promoting charities on the lines of the National Charities Commission, U.K. Since, a number of States in India already have Charity Commissioners, the proposed Board may have to be advisory.

(v) The Income Tax Department should reimburse to trusts, the fees payable to the rating agency.

(Paragraph 7.18)

10.66 We recommend the elimination of Section 80P of the Income Tax Act. However, the existing exemption limit of Rs. 10,000/- prescribed as part of the rate schedule, should be increased to Rs. 1,00,000/- and the revised income tax rate schedule for cooperatives should be the same as recommended for personal income tax.

(Paragraph 7.21)

10.67 The manpower strength of FTD should be immediately augmented so as to assign one team each for America, Europe, South East Asia and Australia, and Rest of the World.

(Paragraph 7.23)

10.68 We understand that, as recommended by us in our Consultation Paper, the CBDT has already set up a working group headed by the Director General of Income Tax (International Taxation) and comprising of representatives also from trade and industry to examine the various issues relating to taxation of non-resident individual and foreign companies. We also understand that the working group is expected to submit its report by the end of December. We suggest that the recommendations should be processed during the forthcoming budget exercise.

(Paragraph 7.23)

Other Taxes

10.69 The Task Force recommends the abolition of wealth tax.

(Paragraph 8.4)

10.70 The present tax on expenditure in hotels is in the nature of a consumption tax. It was introduced as a separate tax in the absence of a tax on services. Since tax on services has since been introduced, it is only appropriate that this levy is merged with service tax. We recommend accordingly.

(Paragraph 8.6)

Impact of Recommendation

10.71 Individual Taxpayers of all categories and in every income group benefit substantially from the package of recommendation.

(Paragraph 9.8)

10.72 Overall, the recommendations are revenue neutral at the existing level of compliance. To the extent the new simplified and liberalised tax regime will induce compliance, the revenue gains are likely to be substantially higher and it will enhance bouyancy by widening the personal and corporate income tax bases.

(Paragraph 9.14)

10.73 The recommendations for eliminating the exemptions, the extensive use of technology and privatization of non-core activities of the tax administration will result is sharp reduction in transaction cost. A 10 per cent reduction in transaction cost for personal income tax would help taxpayers to save an estimated Rs. 4,000 crores. Such reduction in transaction cost is progressive.

(Paragraph 9.17)