Chapter – III

ISSUES IN TAX POLICY

3.1 Ramifications of Tax Policy for Tax Administration[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.

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 relief 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 exemption.

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

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 — these all became a part of the fiscal landscape of India. Often, these exemptions led to inequitable taxation. For example, the

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

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.

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.

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 laws 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, Promotion 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.

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.

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.

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.

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.

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.

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.

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.

3.2 Personal Income Tax Rates

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 tax payers 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.

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 the rate 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.[2] 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.

[2] 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.

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.

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 out paced 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.

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[3]. 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[4]. With a moderate single rate, almost all the deductions and tax-preferences could be eliminated making the task of administration easy. All those with 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.

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.

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

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.

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.

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 multiply, and the tax administration ends up at square one — all the problems associated with a progressive rate schedule.

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.[5] But before outlining the slabs and their rates, it is necessary to explain the empirical reasons for arriving at such a conclusion.

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 the "Laffer Curve" 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 tax payers — 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.

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

In view of the above, **the Task Force recommends that the personal income tax rate schedule be revised along the lines indicated in Table 1.**

Table 1 : Proposed Personal Income Tax Structure.

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/-

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 Task Force recommends that the present surcharge of 5 per cent on taxpayers with incomes above Rs.60,000/- must be eliminated.**

3.3 Personal Income Tax Base

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[6] 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 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.

3.4 Exemption Based on Residential Status

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

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.

Residents are subject to tax on their worldwide income. Persons who are resident but not ordinarily resident are taxed only on Indian-sourced income[7], Non-residents are taxed only on Indian-sourced income and on income received, accruing or arising in India[8].

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.

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

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[7] This includes income deemed to accrue or arise in India, income received in India or income received out-side India arising from either a business controlled, or a profession established, in India.

[8] 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).

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

3.5. Standard Deduction for Employees

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 tax payer, 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. This deduction is allowed ostensibly to compensate on an estimated basis for the expenditure incidental to the employment of the taxpayer.

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[9].

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 discrimates against self-employment. The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan strongly recommended downward adjustment

[9]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.

of this benefit. Since then, the Task Force has also collected information across countries on the allowability of employment related expenses.

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

The Task Force, therefore, recommends that standard deduction under Section 16(1) of the Income Tax Act should be eliminated[10]. 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.

3.6. Treatment of Imputed Income from Owner Occupied House Property

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.

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. This is, therefore, in the nature of a tax subsidy. Such a tax subsidy is both iniquitous and inefficient.

These problems have 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. Moreover, the annual interest out-go of Rs.1,50,000 implies an EMI payment of approximately Rs.35,000 per month. A tax subsidy for such high levels of EMI payment only helps to undermine vertical equity. In fact in most countries, the mortgage interest in respect of loans for acquiring owner occupied dwelling is not deductible, as Table 2 shows.

Table 2: Tax Treatment of Mortgage Interest for Owner Occupied Dwelling

[10] The continuation of the present exemption of Rs. 9,600/- in respect of conveyance allowance received by an employee should serve as a reasonable deduction for employment related expenses.

Country	Is Mortgage Interest Deductible for Tax Purposes?
Canada	No
France	No
Germany	No
Italy	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. However, imputed income from owner occupied dwelling is also subjected to tax.
Japan	Yes, subject to limit of Yen 5,00,000/-.
Netherlands	Yes However, imputed income from owner occupied dwelling is also subjected to tax.
Sweden	Yes
United Kingdom	No
United States	Yes, subject to limits
Thailand	Yes, up-to maximum of 50,000/- Baht
New Zealand	No
Malaysia	No
Indonesia	No
Philippines	No
Argentina	Yes, up to a maximum of ARS 20,000/- annually.
Peru	No
Australia	No
India	Yes, up to a maximum of Rs.1,50,000/-

In view of the fact that interest rates for housing loans are sharply reducing, and that the average home loan is around Rs.5 lakh, **the Task Force recommends the phasing out of the deduction for mortgage interest in respect of loans for acquiring a owner occupied dwelling. The deduction should be reduced to Rs.1,00,000/- in assessment year 2004-05, to Rs.50,000/- in assessment year 2005-06 and NIL in assessment year 2006-07. This proposal will help rationalize the tax base.**

3.7 Tax Treatment of Agricultural Income

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 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 favorable treatment visa viz. those earning equivalent level of income from non-agricultural activities. To this extent horizontal equity was distorted. Similarly, the favorable 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.

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 center 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.

3.8 Rationalizing income tax exemptions on savings instruments

Tax exemptions for savings instruments have earlier been extensively analyzed 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[11] and Dr. Y.V. Reddy[12]. 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.

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 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.

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[13]. 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.

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

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

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

[13] 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*.

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[14]. There is, therefore, a strong justification for taking an integrated view of fiscal concessions for financial instruments of all maturities.

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

3.9 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[1]. 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[1], 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[15]. The four main schemes designed to encourage savings, keeping in mind an aging population, had been the Business Expansion Scheme (BES), Private Personal Pensions (PPP), Personal Equity Plans (PEP) and Tax Exempt Special Savings Accounts (TESSA)[16]. 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 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[17] allow new tax incentives to both salaried workers and the self-employed to encourage voluntary contributions to private pension funds. These will allow voluntary

[15] 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.

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

[17] "Capital Markets in Chile", Investment Review, Foreign Investment Committee, Chile, February 2002.

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)[18] 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.

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

(a) 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).

(b) 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]

(c) 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.

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

(e) 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.

(f) 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

[18] Internal Revenue Authority of Singapore, SRS Brochure, 2001.

June 2002.

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

(h) 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.

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

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

(k) 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 tax payers having gross total income, (before deduction under Chapter – VIA) not exceeding Rs.1,50,000.

(iv) The rebate shall be higher @ 30% for salaried tax payers 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.

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.

The tax treatment of various financial instruments under the tax statue is summarised in Table 3 below.

Table 3 : 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,	Exempt[b]	Exempt	Exempt[2]	EEE

	Annuity Certificates, Saving Certificates, and Other Certificates				
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 (6^{th} , 7^{th} & 8^{th} 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
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	10yRs.or 15yrs 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.

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[19]. This liberalized treatment has impacted economic efficiency, equity and revenue efforts.

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 installments of housing loans made by taxpayers to specified institutions encourages debt as against “equity” financing.

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.

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 A.3 in Annexure 2). In turn, these serve as a benchmark for rates of return (discount rate) and therefore lead to high cost of borrowing

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

across all sectors in the economy and to dampening of investment.

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 rate 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.

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.

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.

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.

To the extent exemption is allowed for roll over of capital gains, the scheme is biased in favor 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.

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.

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. Details of costs incurred by the Government in mobilizing small savings in FY 1999-2000 are tabulated in Table 4 below.

Table 4: 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, GoI (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.

Table A.3 in Annexure 2 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*.

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.

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, 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.

In view of the aforesaid considerations, 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.

3.10 Treatment of Educational Expenses

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).

In view of the International practice 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.

3.11 Treatment of Medical Expenses

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.**

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 5) 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 citizens[20], 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.**

Table 5: 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.

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

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 Eur 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.

3.12 Other Personal Deductions

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

1. An income based deduction of Rs.40,000 in respect of maintenance[21] 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.15,000 to individuals of 65 years or above of age. (Section 88B)
4. A tax rebate of Rs.5,000 to women taxpayers below 65 years of age. (Section 88C)

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, 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.

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

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 88D) and women (Section 88C) should be deleted.

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 tax payers.**
- **(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 equity will be fully exempt.**
- **(e) The standard deduction for salaried tax payers will be reduced to NIL.**
- **(f) The income based deduction under Section 80D 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. 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 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.**
- **(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 phased out. It will be**

reduced to Rs.1,00,000 in assessment year 2004-05, to Rs.50,000 in assessment year 2005-06 and NIL in assessment year 2006-07.

(p) 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.

3.13 Corporate Tax

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.

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.

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.

Taxation of companies as separate entities 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.

The system of taxation of companies independently of shareholders, however, causes misgivings, as it tends to be iniquitous in that no discrimination is made between shareholders with varying incomes. Theoretically, the corporate income should be attributed to the shareholder and subjected to tax at the corresponding personal income tax rate with credit for share of the corporate tax liability. This means that under the worst case assumption of all shareholders being liable to personal income tax at the maximum marginal rate, the corporate tax liability should, under no circumstances, exceed the maximum marginal rate of personal income tax. Taxation of profits in the hands of the company and again in the hands of the shareholders without any relief for the tax paid by the company – "double taxation" – has been assailed also on efficiency ground since, given the imperfections of the capital market and lack of perfect foresight on the part of equity holders, it creates a bias in favour of retention and thereby inhibits the flow of corporate surpluses into the capital market and thus, their efficient use. It also imparts a bias against equity capital by subjecting distributed profits to tax twice, apart from involving a discrimination against the corporate form of business organization. The double taxation of corporate profits is justified on the grounds that accounting profits do not bear the full burden of corporate tax on account of various incentives and deductions. Therefore, where there is empirical evidence to establish that corporate profits (accounting profits) have indeed suffer 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). Infact, in such a case, shareholders at the lower rates of personal income tax would have suffered more than the fair share of their liability. Depending upon the divergence between the statutory corporate tax rates and the effective corporate tax rate, attempts have been made to relieve the burden of double taxation through various devices, such as giving some credit to shareholders for the tax paid by companies or by taxing the distributed profits at a lower rate.

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 which are equally compelling on conceptual grounds. Stimulating investment in general, and – in most developing countries attracting FDI in particular, is include reducing unemployment, promoting specific economic sector or types of activities – as a matter of either economic or social policy and addressing regional development needs. Quite often, countries pursue multiple objectives with overlapping tax incentives.

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.

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.

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-caused 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 labour costs above internationally competitive levels, rigidities in labor markets can raise 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 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.

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.

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 inventives 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 individual on the basis of their levels, rather than by tax incentives that target economic activities on a sectoral level.

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 suboptimal 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.

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 CIT 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.

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.

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 in and of itself 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.

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.

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.

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 than these countries have tax systems that are based on the residence principle.

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.

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 more other important administrative tasks would be impaired - thus jeopardizing tax collection as a whole.

While 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 often has to do with both 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.

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.

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.

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.

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.

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 this, the tax incentives have continued[22]. As mentioned above, tax incentives are, therefore,

[22] 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.

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. 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[23].

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 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 is, in itself, a sore point with trade and industry.

The Task Force was of the strong view that the divergence between taxable income and book profit also undermines corporate governance. Therefore, the Task Force considers it necessary to redesign the corporate profits tax so as to align taxable income and the book profit. With such an alignment, 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.

In view of the aforesaid considerations, the Task Force recommends to alternate packages for reform of corporate income tax :-

Option I :

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

(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 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

(b) 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.

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

(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.

(vii) 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.

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

(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(iii) in respect of interest on borrowed capital.

(xv) Section 35 CCB relating to expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources.

(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.

Option II :

(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 38.5 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 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) Section 35 CCB relating to expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources.

(xvii) 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 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. **Therefore, the Task Force unanimously recommends Package "A" for implementation.**

3.14 Charitable Trust

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.

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.

The activities of this sector is 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, donation to trust are allowed as a deduction from the gross income to the donor. Empirically tax exemption for donation 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. 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.

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. All Charitable trust and Institutions will be required to file the tax returns.
2. Returns to be identified for scrutiny / audit only through a computerised risk assessment system.
3. Where 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.

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.

3.15 Tax Treatment Of Non-Residents

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.

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. Accordingly, we recommend the creation of 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. The working group must submit its report by the end of December so that the recommendations could be considered during the forthcoming budget exercise.

3.16 Tax Treatment of Cooperative Societies

Under the existing provision of Section 80P of the Income Tax Act, a cooperative society is entitle 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 godowns and warehouses is also fully exempt. Similarly, the income of a consumer cooperative society is exempt up-to a specified limit.

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 6 below.**

Table 6 : 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/-

3.17 Tax Treatment Of Partnership Firms

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 recommendation 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.

3.18 Tax Treatment Of Statutory Liabilities

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.

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.

3.19 Wealth Tax

Under the existing scheme a tax on selected assets is levied if the value of the net wealth exceeds a specified limit. 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. 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. **Accordingly, we recommend the abolition of wealth tax.**

3.20 Treatment of Capital Gains

Since 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 capital asset to determine the capital gain. In this regard, the capital gain is subjected to a concessional rate of tax to eliminate the bunching effect. Furthermore, the 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 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 subjected to taxation at the normal rates. Moreover, the exemption for roll over of capital gains must also be abolished for all schemes other than investment in house or the bonds of National Highway Authority of India until completion of the Golden Quadrilateral and the North-South & East-West corridors.

The long term capital gains on equity represent the capitalized value of retained earnings. Our recommendations relating to corporate tax structure will effectively eliminate the divergence between the effective corporate tax rate and the statutory tax rate. Since the profits of the company would bear the full burden of the tax, the retained earnings would have also suffered full taxation. Therefore, the case for taxation of long term capital gains on equity would be extremely weak. **Accordingly, we recommend the elimination of long-term capital gains on equity.**

3.21 Impact of the Recommendations

In conclusion, the Task Force is convinced that if its recommendations are adopted *in toto*, our tax system will become more transparent and it will align

the obligations of taxpayers with 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 the most dynamic countries among the emerging markets.