CONSULTATION PAPER
TASK FORCE ON DIRECT TAXES

CONTENTS

EXECUTIVE SUMMARY

Approach to Tax Reform

Following a period of modest fiscal consolidation, there has been a marked deterioration in our fiscal health since 1997-98. Concomitantly, the current trajectory of public-debt dynamics of the country is worrisome. Apart from the crowding-out effects on investment of this decline, our capacity for macro-economic stabilisation and counter-cyclical policy making, as well as our international standing, have the potential of being severely circumscribed. While strongly advocating rationalising the revenue side of this fiscal equation, the Task Force emphasises that fiscal reform needs to be undertaken as an integrated package; while initiating a revenue rationalisation exercise, the government needs to simultaneously control expenditure (and ensure that taxpayers' money is spent productively). Enacting and implementing the impending Fiscal Responsibility and Budget Management Bill will have a salutary impact on the regimen of such fiscal reform.

The Task Force undertook sustained interactions with various stakeholders – intending to elicit "customer" feedback – and found a striking consistency in their responses regarding complaints about the tax system – structural complexity, low transparency, delay in issue of refunds & PAN numbers, high compliance costs (and hence low compliance), lack of attention to taxpayer needs, taxpayer harassment, tax leakage, rent seeking, etc.

The Task Force also examined best international tax practices. It recognised that in the recent past, other economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration.

The approach of the Task Force has been influenced by these interactions and observations and consequently seeks to strike a balance between the need for enhancing "customer" satisfaction and stricter enforcement. This balance will be crucial to both attracting and retaining young taxpayers with their demand for customer-oriented systems, as well as to bring the "missing middle" – mainly service professionals who are currently outside the tax net – into compliance.

The Task Force discussed in-depth suitable policy frameworks for direct tax and deliberated on ways to reduce costs of tax administration and of taxpaying, as well as to empower the tax department in effectively fulfilling its core functions of assessment and enforcement. Over the course of these deliberations, the Task Force became convinced that the only way to thus empower the tax department is through an integrated and rapid programme of system-wide deployment of Information Technology, leveraging on the considerable skills in this area that are available in India.

The Task Force has endeavoured to ensure that the recommendations pertaining to the direct tax codes are congruent with generally accepted principles of taxation. The three principles relate to efficiency (minimising distortions in resource allocation), equity (progressiveness of effective tax rates) and effectiveness (of tax administration). To facilitate the systemic changes necessary for fulfilling these principles, the Committee has identified four operational objectives relating to the direct tax code that can most effectively achieve these principles. These are:

1) Institution of a simple and transparent system.

2) Reduction of transactions costs of tax revenue collection and compliance costs of taxpayers.

3) Alignment of incentives of taxpayers and the tax administration; and

4) Widening of the tax base.

The recommendations of the Committee, which are elaborated below, are aimed at efficaciously implementing these objectives. Before motivating these recommendations, the Committee would like to clarify its stance regarding rate cuts and exemptions: while the benefits of exemptions are limited to those who can gain access to them, rate cuts apply to tax-paying persons and entities across-the-board. The Committee would also like to place on record its concern that the efficacy of its recommendations is likely to be seriously vitiated if individual components are selectively accepted or rejected; <u>success of tax reform efforts depend on their implementation in an integrated manner</u>.

Tax policy and tax administration are inter-linked: complex tax policy leads to even more complex tax legislation, which then inevitably results in cumbersome administration through a cascading effect on filings, compliance procedures and enforcement measures. The series of *ad hoc* exemptions and other tinkering has only served to clutter the culture of compliance. Apart from its effects in distorting incentives, a weak and porous system has evolved, which by increasing transaction costs of participation dissuades potential taxpayers. One of the principal outcomes sought of this Report is the institution of a trust-based, rather than an overtly punitive, tax system which requires an alignment of the objectives of the tax authorities with obligations of taxpayers; in other words, enhance the incentive compatibility of the two groups. Over the years a number of perverse incentives have crept in: taxpaying is often punished (by harassment) and tax evasion is not sufficiently deterred. It is noteworthy that this undesirable outcome has occurred against the backdrop of considerable efforts in recent years by the tax authorities to fulfil its functions. There is a widespread perception that (frequent) changes in the tax code in the last decade or so have (unintentionally) been akin to substituting the erstwhile “license raj” with an “exemptions raj”.

Role of Tax Administration

If “tax administration is tax policy”, as is widely recognised, then it is imperative to identify the role(s) of tax administration, so that responsibility and accountability is clearly established. The Task Force is of the opinion that the fundamental roles of tax administration, in order of priority, are:

1. To render quality taxpayer services to encourage voluntary compliance of tax laws; and
2. To detect and penalise non-compliance.

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

Taxpayer Service

Provision of quality taxpayer service is an integral part of the enforcement strategy of any tax administration. The present scope of taxpayer service in India is too narrow to encourage voluntary compliance. It is, therefore, recommended that the income tax department must expand, qualitatively and quantitatively, the present scope of taxpayer service. These should, *inter alia*, include the introduction of a telephonic system (by voice message) to remind taxpayers of important dates and the provision of pre-formatted programmed floppy diskettes through retail outlets. The expenditure on taxpayer service must be increased from the present level of about one percent of the total expenditure

on tax administration to at least five percent. In this regard, an important start should be made by the establishment of taxpayers' clinic in different part of the country to enable taxpayers to walk in for assistance. The Task Force feels that better treatment of existing taxpayers has an important role in encouraging those outside the tax net to become taxpaying citizens. Further, the department should provide easy access to taxpayers through Internet and e-mail and extend facilities such as tele-filing and tele-refunds. It should design special programmes for retired people, low-income taxpayers, who cannot afford expensive services of tax consultants and other such groups with special needs.

Taxpayer Identification and Registration

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

1) **The PAN should be extended to cover all citizens and therefore serve as a Citizen identification number. This will obviate the need for the Home and Labour Ministries to issue new numbers.**
2) **Given the manifold increase in the coverage of PAN, the responsibility for issuing should be transferred to an independent agency outside the income tax department. However, the income tax department should have online access to the database for tax enforcement like any other agency.**
3) **The requirement of quoting PAN may be expanded to cover most financial transactions.**

Collection of Information

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

1. Income Tax Act should be amended to provide for submission of 'annual information return'. For this purpose, a proper format of the return also needs to be prescribed. As a result the flow of information will be continuous and the discretionary power with the CIB to collect information will be eliminated.

2. Such annual return of information should be mandatorily required to be submitted on electronic format.

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

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

Verification & Processing of Tax Returns

An IT-based system will facilitate considerable streamlining of procedures for receipt and processing of tax returns. Against this background the Task Force recommends that:-

1) **All returns must be processed within four months of receipt. For this purpose, it would be necessary for the department to either hire additional personnel on a temporary basis during the peak period for filing returns, or, outsource data entry work, as is done routinely by national tax administrations all over the world.**
2) **In line with our view that the tax department should concentrate on its core functions, the department should be allowed to outsource data entry work and clear the backlog of returns (which number 2.5 crores) by end-February 2003. A large number of these would be refund cases (contributing to the grievance against non-issue of refunds). Despite training in computer skills, the staff in the income tax department is at the lower end of the learning curve and in-house clearing of the backlog in a short period is not possible.**

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

The process of selection of cases for audit (scrutiny) is the most important element of the enforcement strategy of any tax administration. It is this process of selective verification of the volume of information received by the tax administration which establishes deterrence. The Task Force was apprised about the negative aspects of the existing discretion-based system of selection of cases. The department should progressively develop a mechanism for risk assessment, which forms a scientific (and, therefore, objective) basis for identifying cases of potential tax evasion for in-depth scrutiny. In the interim, we recommend the identification of cases through a random non-discretionary centralised method deploying the PAN database. The current practice of issuing guidelines for selection of cases for scrutiny, which eventually finds its way to the public must be dispensed with. Further, the Task Force also recommends that the penalty orders must be passed simultaneously with the assessment order.

Computerization of Tax Administration

The Task Force cannot over emphasise that effective tax reform must harness Information Technology (IT). The tax department is no different from most businesses. World-class customer service is critical when “all of India is its customer and Parliament its Board of Directors”. While the CBDT has to be commended for the effort it has expended and the action it has initiated for computerisation of taxpayer records, the business processes, systems and facilities have not kept pace with the growing demand on tax administration. The Task Force firmly believes that the tax department should be allowed to

concentrate on its core functions – an increasing emphasis on assessment and enforcement duties, rather than logistics and support services – which will surely lead to increased effectiveness of the tax administration. In this context, rapid and progressive outsourcing of many tasks of the tax department is not only feasible, given the significant pool of talent in the Indian software industry, but it is also desirable. In order to make IT infrastructure commensurate with the requisite processing tasks, the Task Force would like to explicitly put on record that implementation of this enhanced integration-software requires considerable investment in upgrading associated IT hardware and sufficient access to high-capacity bandwidth for implementing the network.

The process of systemic modernisation of tax administration cannot be further delayed. To empower the tax administration in executing its core function, the Task Force studied the existing depository system of the National Stock Depository Limited (NSDL) and concluded that it offered a scalable system to meet the requirements stated above. As this proven and tested infrastructure already exists, it can readily be adapted to offer a world-class, state-of-the-art IT architecture to rapidly empower the tax administration. Our study suggests that if action is initiated by the middle of November 2002, the system could be operational and available on-line by the beginning of the 2003-04 fiscal year.

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

1) **The Government should establish a national Tax Information Network (TIN) on a build, operate and transfer basis. This will comprise of a world class (common carrier) network system and have access to state-of-the-art IT infrastructure. A requisite in-built feature of the system is that it should be scalable to offer ease of access across tax administration and taxpayers. The network that is envisaged will facilitate transactions, akin to securities markets, and establish secure and seamless logistics of tax collection through integration of primary information, record keeping, dissemination and retrieval. It should be a repository of information, with a database of all tax payments and refunds. Data mining software associated with such relational databases will allow a quick and systematic identification of non-compliance and abuses, thereby helping to improve compliance. The existing facilities of the National Securities Depository Ltd. (NSDL) can be relatively quickly deployed to make a systemic improvement in processes and reduce transaction cost.**
2) **TIN will receive, on behalf of the tax administration, all TDS returns and other information returns for digitisation. The information would be received either online, or through magnetic media or in printed format. The digitised information will be downloaded by the National Computer Centre / Regional Computer Centres of the income tax department for further processing.**
3) **TIN will also receive online information about collection of taxes from the banks. The information could be downloaded by the income tax department as and when required.**
4) **The taxpayer will have the facility of accessing the TIN system through a secure and confidential Permanent Account Number (PAN) based identification to ascertain tax payments credited to his/her account and the status of returns and refunds.**

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

Collection and Accounting of Taxes

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

1) **A taxpayer will be required to fill up only one copy of the challan while making payment of taxes in the bank. The present requirement of filling up four copies of challan for payment of any tax will be given up.**
2) **The banks will be networked to the TIN and receive payments online. The banks will be required to issue a computerised receipt to the taxpayer instantaneously. The date of presentation of a cheque will be treated as the date of payment. If a cheque bounes, the bank will reverse the receipt, online, and the department would then be expected to prosecute the delinquent taxpayer.**
3) **With instant accounting of tax collection, the requirement of enclosing a copy of the challan as evidence of tax payment, along with the annual return of income could be done away.**
4) **Since the TIN will digitise all the TDS returns, the requirement to file TDS certificates along with the return of income will also be dispensed with.**
5) **At present, taxes are collected through approximately 10,500 bank branches. Since the proposed procedure requires banks to receive online payment, those banks that do not have adequate infrastructure for establishing online connectivity will be debarred from collecting taxes. Accordingly, the Government, in consultation with the Reserve Bank of India, should also consider paying higher charges for services rendered by banks.**

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

Refunds

The failure of the tax administration to issue refunds continues to be a major source of public grievance. This is partly due to its inability to promptly process the returns, whose numbers have increased substantially in the last three years, and partly due to the cumbersome process for issuing of refunds. Therefore, we recommend the following:

1) **The existing cumbersome and manually-operated procedures for issue of refunds must be replaced by a more efficient IT-based system. Under the new system the department will prepare a separate file of all refunds daily which will be downloaded by a payment intermediary, i.e., a designated bank.**
2) **The designated bank will be authorised to issue computerised refunds as is the current practice for issuing dividend and interest warrants by companies.**
3) **The designated bank will be required to transmit the information relating to the issue of refunds to the TIN, which will also allow a taxpayer to verify the status of his/her refund claim.**

Search and Seizure

The objective of conducting search and seizure operations is to collect evidence which would not otherwise be produced before the tax administration. However, keeping in view the problems arising in the course of searches and post search assessments, search and seizure have lost considerable deterrent effect therefore the Task Force recommends:-

a) Special procedure for assessment of search cases in chapter XIV B (Block Assessment) which provides for tax @60% and exonerates the concealed income detected as a result of search from penal consequences of interest penalty and prosecution, be omitted. When concealment is detected and established, it should suffer full penal consequence of interest, penalty and prosecution.

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

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

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

Income Tax Clearance Certificates

The present requirement of obtaining a tax clearance certificate before leaving the country must be abolished. Nevertheless, in order to protect against a consequent loss of revenues, the income tax department may be allowed to notify the immigration / customs authorities to prevent any particular person from leaving the country if such person is considered to be an offender. As a result, the process of tax clearance (prior to travelling abroad) will require to be fulfilled as an exception as against the current practice of obliging *everyone* to comply with the procedure.

The system of issuing Income Tax Clearance Certificates to contractors etc. should be eliminated forthwith. However, to help in enhancing effective tax enforcement, all government agencies should be required to obtain the PAN of entities participating in tenders, being designated as vendors to the government, etc. and periodically submit (pre-specified) relevant information to the tax administration.

Dispute Resolution

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

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

Accountability

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

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

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

1. The control of the Central Government over the tax administration must be formally reduced through a Memorandum of Understanding (MoU) between the Central Board of Direct Taxes and the Central Government (we understand that there is already a Cabinet decision to this effect). The Central Board of Revenue Act provides that the two boards (CBDT and CBEC) must function subject to the control of the Central Government, but the mechanism and the extent of control remains unspecified even after forty years.
2. The MoU must, *inter alia*, specify the financial commitment of the Central Government for tax administration.
3. The MoU must provide for full financial autonomy and control over deployment of human resources to the CBDT. The Central Government should only specify the general guidelines for financial expenditure and deployment of human resources.
4. The MoU should be for a period of five years specifying the observable performance indicators for the CBDT and the financial resources that would be made available to the CBDT on a year-to-year basis.
5. It must also specify, in financial terms, and in a manner to be decided later, the levels of penalty (reward) for under-performance (exceeding targets).
6. The CBDT should have exclusive power for designing the enforcement strategy, subject to the condition that it is non-discriminatory and transparent.

The Task Force was also concerned with the absence of any well-publicised rule for appointing as CBDT Members / Chairman and, therefore, recommends transparent procedures. Lack of transparency in appointments to senior positions in the tax administration can engender uncertainty and demoralise the tax bureaucracy. Therefore, it is recommended that the Central Government must formulate appropriate rules for appointments to the Board.

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

The Task Force also noted that the standards of accountability at the field formation level were considerably diluted since, *inter alia,* the performance targets, particularly those related to revenue collection, were unrealistic and thrust upon them. The field formations were either resigned to the failure of the targets or resorted to questionable practices to meet revenue targets divorced from underlying economic trends. The Task Force was informed that very often officers were (informally) directed to hold back refunds to boost revenue collection. Accordingly, it is strongly recommended that the revenue targets should be based on underlying economic trends.

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

Delegation of Financial Powers

Powers over the use of resources (both financial and human) must be commensurate with responsibility. Therefore, CBDT should be notified as a 'Department of Central Government' as defined in sub-rule (d) of rule 3 of Delegation of Financial Rules, 1978. Furthermore, CBDT should be authorised to remit the tax collections to the Central Government net of its expenditure budget and also be allowed to carry forward expenditure allocations. Consequently, it will have full control over its finances and therefore better placed to design and give effect to the medium term and long term enforcement strategy. For its part, CBDT must publish an annual financial report (statement), which will enable the government to assess the cost of tax collection.

Human Resource Management

The absence of control over human resources has further undermined accountability. Therefore, we recommend that the Central Government should delegate to CBDT full authority and responsibility regarding staff of the income tax department and its secretariat. This would include decisions on recruitment,

deployment, designing incentive schemes, discipline matters, performance management & appraisal, employee relations, training & development, and other matters related to human resource management. Reciprocally, the CBDT should design a system of performance targets. The CBDT should, however, exercise such delegated powers in a transparent manner within the framework of rules and guidelines framed for this purpose. Such rules and guidelines should be framed with the approval of the government.

Infrastructure

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

1) **A Task Force should be constituted to standardize the requirement of a modern occupant-friendly office (with modern methods of storage and retrieval of records). The Task Force should furnish its report, including financial estimates, by 31st December 2002.**
2) **Based on the report of the Task Force the CBDT should request Chief Commissioners to identify the shortcomings in their offices by 1st April 2003 and send forward a proposal to CBDT.**
3) **By 1st August 2003 a model Commissionerate including the offices at the range, circle and ward levels should be established in each zone.**

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

Tax Policy

The design of tax policy is of paramount importance for tax administration. If efficient and feasible administration is an objective, the tax structure should comprise of low rates, few nominal rates, a broad base, minimal exemptions and incentives, no surcharges and, in cases of exceptions, clear guidelines. This is because a simple tax structure induces better tax administration. Prior to listing the proposed changes in individual tax segments, the Task Force recommends that, as a general process check, the introduction henceforth of any exemptions and incentives to the tax structure be accompanied by a mandatory cost-benefit exercise (tax expenditure analysis), to be presented before Parliament.

Tax Treatment of Agricultural Income

Given the large scale shifting of non-agricultural income to agricultural income (with the attendant revenue loss) and the need to augment the resources of the States, our recommendations are:

(a) A tax rental arrangement should be designed whereby States could pass a resolution under Article 252 of the Constitution authorising the

Central Government to impose income tax on agricultural income. All taxes collected by the center (net of collection costs) would 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. It is noteworthy that given our recommendation on increasing the exemption limit to Rs. 1,00,000/- per individual, most (genuine) 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.

Reform of Personal Income Tax

The recommended *package* of policy measures for the reform of personal income tax, to be considered as a holistic / indivisible unit comprises of the following:

(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.

Reform of Corporate Income Tax

In most countries corporate entities are subject to tax on their profits and, in addition, dividends are taxed in the hands of shareholders. 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 objectives or to provide relief from inflation as well as to curb misuse of the corporate form to reduce personal tax liability. As a result, there is a divergence between the statutory corporate tax rate and the effective corporate tax rate. Depending upon the level of divergence, corporate profits are also subjected to tax when distributed – either in the hands of the shareholders or at the point of distribution by companies – leading to "double" taxation. The source of the problem of "double" taxation is, therefore, the panoply of tax exemptions which is a prominent feature of the Indian tax system.

The present scheme of corporate income tax is riddled with a large number of deductions and exemptions. As a result, the base is considerably lower than the book profit declared to shareholders. In effect, this has led to a non-transparent tax subsidy regime, complexity of the tax law, revenue loss, increased compliance cost and has encouraged rent seeking behavior.

The Committee recognised that there are two modes of implementing its recommended package of policy measures for reform of the existing scheme of corporate income tax:

Option I: **An immediate, one-time institution of rate cuts and elimination of exemptions.**

Option II: **A phase-in of rate cuts over a period of time, say 3 years, while simultaneously instituting a coordinated phase-out of tax exemptions and deductions.**

As with all choices, there are merits and disadvantages to both options. A phased and coordinated implementation of rate cuts and exemptions (Option II) is attractive in view of the "legacy drag" of India's past (and enduring) tax structures that had been marked by a complicated maze of exemptions and incentives. On the other hand, a one-shot implementation of the recommendations (Option I) does not suffer from the drawback that often (as observed in many parts of the world), particularly due to electoral cycles, it is difficult, if not impossible, to make a credible commitment to sustaining a particular reform process. If not implemented at one go, it has been recognised that reforms leave space for lobbying by interest groups. In addition, since the onset of reforms in the early nineties, the costs of doing business in India, especially the cost of capital, have been steadily falling. The justification for (artificial) relief in the form of exemptions has consequently been progressively waning.

After deliberating on the comparative merits of the two options, the Committee endorses the choice of Option I as the preferred method for implementing the package of policy measures for reform of the existing scheme of corporate income tax.

Option I

The recommendations of the Committee, under this option, comprises the following elements:

Option I :

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

Tax Treatment of Charitable Trusts

The exemptions under section 10 of the Income Tax Act need to be brought under the

single discipline of the provisions of section 11 to 13 of the Income tax Act, 1961 for the sake of uniformity.

All Charitable Trusts and Institutions will be required to file tax returns. The returns identified for scrutiny / audit will only be through a computerised risk assessment system. 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 Comptroller & Auditor General (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; and a "B" rating for the trust will disqualify it from any tax exemption.

The income based deduction under sections 80-G and 80-GGA of the Income Tax Act should be converted to a tax rebate at the rate of 20 per cent of the amount of donation. In addition, it is recommended that deductions under sections 35(1)(ii) and (iii) should be transformed into tax rebates.

Tax Treatment of Non-Residents

A Number of issues were raised before the Task Force. These being too technical in nature to be dealt with in the limited time available the Task Force recommends setting up of a working group under the Director General of Income Tax (International Taxation). Further, we also recommend the strengthening of the foreign tax division in the Central Board of Direct Taxes.

Tax Treatment of Cooperative Societies

The deduction under Section 80P is recommended for elimination and the threshold exemption limit is recommended for an increase to Rs. 1,00,000/- with appropriate changes in the tax schedule.

Tax on Partnership Income

The tax rate on partnership income will continue to be aligned with the corporate income tax rate.

Tax Treatment of Statutory Liability

The Task Force recommends that delayed payment of statutory liabilities in respect of labour should also be allowed as a deduction in the year of payment.

Wealth Tax

The Task Force recommends abolition of the levy.

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.

Chapter – I
APPROACH TO TAX REFORM

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

The Task Force was intended as the forum to deliberate upon and correct many of the existing anomalies in the Indian direct tax system. Towards fulfilling this mandate, an attempt has been made to outline steps required for initiating and expediting a requisite *process transformation*; this Report contains its considered judgement, melded from views culled from a diverse section of stakeholders.

The approach of the Task Force has been influenced by the recognition that in the recent past economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration. The Task Force has examined best tax practices in the world, deliberated on ways to reduce costs of tax administration and extensively debated means of empowering Central Board of Direct Taxes (CBDT) to fulfill its function effectively.

The dynamic nature of economic activity in India is sure to impact upon the taxpayer profile, with changes in the relative share of industry, services and agriculture-value added being particularly important. Therefore, the recommendations of the Report are embedded in a forward-looking approach to taxation by imparting a sector-neutral flavour. The Task Force has endeavored to ensure that the recommendations pertaining to the direct tax codes are congruent with generally accepted principles of taxation. The three principles relate to efficiency (minimising distortions in resource allocation), equity (progressiveness of effective tax rates) and effectiveness (of tax administration). One of the principal outcomes sought of this Report is an alignment of the objectives of the tax authorities with obligations of taxpayers; in other words, enhance the incentive compatibility of the two groups.

There is a widespread perception that (frequent) changes in the tax code in the last decade or so have (unintentionally) been akin to substituting the erstwhile “license raj” with an “exemptions raj”. Tax policy and tax administration is inter-linked: complex tax policy leads to complex tax legislation, which inevitably leads to cumbersome administration through a cascading effect on filings, compliance procedures and enforcement measures. The series of *ad hoc* exemptions and other tinkering has only served to clutter the culture of compliance. Apart from its effects in distorting incentives, a weak and porous system has evolved, which by increasing transaction costs of participation dissuades potential taxpayers. Over the years a number of perverse incentives have crept in: taxpaying is often punished (by harassment) and tax evasion is not sufficiently deterred. It is noteworthy that this undesirable outcome has occurred against the backdrop of considerable efforts in recent years by the tax authorities to fulfill its functions.

Evaluation of tax policies has emerged as a concern of critical importance. The tax policy must be outcome oriented rather than input aligned; for instance, many tax incentives reward higher usage of particular factors of production (inputs) or provide tax breaks for specific savings instruments. These incentives need to be re-engineered so that outcomes, viz., higher productivity of income tax-payers and increased profitability of corporations is encouraged. This is the case with the most dynamic countries among the emerging markets.

Optimal tax policy should be pursued in the general interest of the economy rather than for catering to sectional interests. Every exemption has a constituency and democratic systems tend to respond to constituencies – a tax break to one constituency inevitably spawns similar demand by others. Hitherto, tax policy, including exemptions, has been used in instances where other instruments at the disposal of the government are *prima facie* more suited to achieve stated objectives. Confusion in allocating instruments to objectives result in an inefficient allocation of resources and often defeat stated aims. Clearly demarcated distinctions among objectives to be achieved and increasing transparency in the use of expenditure and tax instruments for these objectives can be expected to yield better results. An explicit separation of the two broad classes of instruments will have the secondary effect of reducing ambiguities in justification of expenditures and also impart greater effectiveness to parliamentary oversight of the government’s fiscal decisions.

Communication about taxes and tax policies is extremely important – taxpayer rights and obligations need to be clearly specified. The best tax systems in the world deal with taxpayers in a professional customer-relationship environment, which requires the system to be transparent, responsive and non-discriminatory. Furthermore, by increasing accountability of tax authorities, a durable welfare-improving social contract is established between taxpayers and tax administration.

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

Availability of IT expertise and the presence of world class (common carrier) network systems developed by, say, the National Stock Depository Limited (NSDL) can be relatively quickly deployed to make a *systemic* improvement in processes to reduce transaction costs (for both CBDT and the taxpayer). Establishment of a National Tax Registry can facilitate transactions, akin to securities markets, and establish *secure and seamless logistics of tax collection* through integration of primary information, record keeping, retrieval and enforcement. Centralised processing of TDS certificates, for example, has the potential to increase compliance and reduce fraud – false certificates result in increased costs of crosschecking and verification. Reciprocally, not only is there reduced potential for discretion and concomitant harassment, but it can also help to expedite refunds. Some of these activities, as well as systems for process automation, can be outsourced in conformity with procedures adopted by the best international tax administrations, thereby permitting the CBDT to pursue more effectively its core functions.

A change in attitudes has distinctly and perceptibly emerged in a previously largely adversarial relationship between the tax collector and taxpayer, when neither was inclined to believe the other’s integrity. Younger taxpayers are more willing to pay their dues to society. Simultaneously, this willingness is conditional; based on their experience as customers for commercial services, they have come to expect a professional interaction with service providers. The Task Force reiterates that all possible measures are instituted to prevent an alienation of this increasingly important demographic segment and an attendant reversion to the tax cynicism of earlier generations.

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

Chapter – II
REFORM OF TAX ADMINISTRATION

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

It is widely recognized that tax policy and tax administrations are intrinsically linked. In this interrelationship, however, tax policy formulation is generally seen to precede tax administration. This is because only when a tax structure is legislated does tax administration come to play its role in the implementation of the law. In developing countries, however, the direction of the link may not be quite so apparent. Indeed, it is said that in developing countries tax administration is tax policy[1]. This would imply that, however fine the design of the tax structure might be in a representative developing country, it is the interpretation and implementation of the law that counts. These elements reflect the need for adequate capacity of the tax administration in place to implement the law[2].

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

In many developing countries, tax laws may be quite well designed and detailed. But unless the accompanying tax administration is able to handle those laws in terms of having the appropriate staff to interpret and implement them, the field-level reality of the actual incidence of the tax system may be quite different from the original objectives[3]. The taxes may be passed on to those on whom

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

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

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

they are not meant to fall, and the distribution of the burden may turn out to be indiscriminate. Lawyers find it easy to litigate tax matters because of the difficulties in interpreting complex tax laws and, accountants, ploughing through a myriad pages of the tax code, successfully advise clients in careful tax planning such that their tax burden is minimized. This implies that, in the long run, it has to be ensured that tax administration instruments facilitate, rather than ignore or hinder, the implementation of tax policy goals.

2.1 ROLE OF THE TAX ADMINISTRATION

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

Collection of taxes are merely transfer of resources from the large masses of taxpayers to the Government. The resources used in the collection of taxes are a dead-weight loss[4] unless the benefit flowing from the expenditure policy exceeds the dead – weight loss. Hence, it is necessary to use minimum resources in the collection of taxes. Therefore, the fundamental role of tax administration is, in order of priority:-

1. To render quality taxpayer services to encourage voluntary compliance of tax laws; and
2. To detect and penalise non-compliance.

The extent of success of the tax administration in its role would be reflected in higher revenue growth. These functions of the tax administration comprise the following seperable component activities :

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

2.2 TAXPAYER SERVICE

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

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

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

Taxpayer service, typically refers to the provision of information and material by the tax administration to the general mass of taxpayers so as to facilitate compliance with the tax law. A cross country survey of taxpayer service indicates that the relatively more successful tax administrations provide relatively high levels of taxpayer service. Inspite of the mindset in favour of enforcement, the Income Tax Department indeed provides a range of services to facilitate compliance. These services include pamphlets, brochures, booklets, web–based information and return forms. In some Metropoliton centres, an Interactive Voice Response System is operational. The recent introduced scheme of Suvidha and Sampark are all extensions of the taxpayer service programme. However, these are just beginnings and are clearly not enough. The present scope of taxpayer service in India is too narrow to encourage voluntary compliance. The evolution of the package of taxpayer services in India is accidental – the entire programme seems to have evolved in an ad hoc manner rather then as a strategy to promote voluntary compliance. The Task Force was informed that this was primarily due to inadequate financial resources for taxpayer service. The expenditure set apart for tax payer service is woefully small (less than 2 per cent of its annual budget). The existing taxpayer service programme is also handicapped by the absence of professionals trained for planning and executing focused media campaigns.

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

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

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

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

2.3 Taxpayer Identification and Registration

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

Income tax Act[5] provides for allotment of a Permanent Account Number (having ten alphanumeric characters). Every persons who fulfils any of the following conditions has to compulsory apply to the Assessing Officer for the allotment for permanent account number:-

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

The PAN is required to be quoted by a person

(a) In all his return to, or correspondence with any income tax authority.
(b) In all challans for the payment of any sum due under the income tax act
(c) in all documents pertaining to foreign transactions ;
(d) sale or purchase of any immovable property valued at five lakh rupees or more ;
(e) sale or purchase of motor vehicle or vehicle(does not include two-wheeled vehicles);
(f) a time deposit exceeding fifty thousand rupees with a banking company;
(g) a deposit exceeding fifty thousand rupees in any account with post office saving bank;
(h) a contract of a value exceeding one lakh rupees for sale or purchase of securities;
(i) opening an account with the bank;
(j) making an application for installation of telephone connection including a cellular telephone connection;
(k) payment of hotels and restaurants for an amount exceeding twenty five thousand at any one time;
(l) payment in cash for purchase of bank drafts or pay orders or bankers cheque from a bank for an amount aggregating fifty thousand rupees or more during any one day;

[5] Section 139A

(m) deposit in cash aggregating fifty thousand or more with a bank during any one day;
(n) payment in case in connection with travel to any foreign country for an amount exceeding twenty five thousand rupees at any one time.

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

(i) The PAN should be extended to cover all citizens and therefore serve as a Citizen identification number. This will obviate the need for the Home and Labour Ministries to issue new numbers.
(ii) Given the manifold increase in the coverage of PAN, the responsibility for issuing should be transferred to an independent agency outside the income tax department. However, the income tax department should have online access to the database for tax enforcement like any other agency.
(iii) The requirement of quoting PAN may be expanded to cover most financial transactions.

2.4 Collection of Information

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

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

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

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

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

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

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

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

5. **Income Tax Act should be amended to provide for submission of 'annual information return'. For this purpose, a proper format of the return also needs to be prescribed. As a result the flow of information will be continuous and the discretionary power with the CIB to collect information will be eliminated.**

6. **Such annual return of information should be mandatorily required to be submitted on electronic format.**

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

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

2.5 Verification & Processing of Tax Returns

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

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

1. **In line with our view that the tax department should concentrate on its core functions, the department should be allowed to outsource data entry work and clear the backlog of returns (which number 2.5 crores) by end-February 2003.**

2. **All returns must be processed within four months of receipt. For this purpose, it would be necessary for the department to either hire additional personnel on a temporary basis during the peak period for filing returns, or, outsource data entry work, as is done routinely by national tax administrations all over the world.**

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

The process of selection of cases for audit (scrutiny) is the most important element of the enforcement strategy of any tax administration. It is this process of selective verification of the volume of information received by the tax administration which establishes deterrence. The Task Force was appraised about the negative aspects of the existing discretion-based system of selection of case. The department should progressively develop a mechanism for risk assessment, which forms a scientific (and, therefore, objective) basis for identifying cases of potential tax evasion for in-depth scrutiny. In the interim, we recommend the identification of cases through a random non-discretionary centralised method deploying the PAN database. The current practice of issuing guidelines for selection of cases for scrutiny, which eventually finds its way to the public must be dispensed with.

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

Penalty proceedings for concealment of income are required to be initiated in the course of assessment proceedings (Section 271(1) of the I-T Act). The order imposing the penalty can be passed within six months from the end of the month in which the order of the Appellate Tribunal against the order of the assessment is received. The order of assessment and order of the first and second appellate authority against order of assessment take about seven years. So, the order of penalty for concealment of income is passed after seven years. Thereafter, the order of penalty goes through appeals which takes another five years. Thus, under the existing system, the imposition of penalty for concealment takes more than a decade. Firstly, penalty for concealment is successful in very few cases, secondly it materialises very late. The reason for this situation is that penalty proceedings are treated separate proceedings from assessment proceedings, though the same material is considered in both the proceedings. It would be advisable to pass order of penalty for concealment alongwith order of assessment. Section 275 may be suitably amended to make it obligatory for the assessing officer to pass the order of penalty for concealment along with the order of assessment. This would ensure deterrent impact of scrutiny assessment and penalty on tax evasion. This would reduce multiple proceedings and litigation.

2.6 Computerisation of the Tax Administration

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

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

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

The process of systemic modernisation of tax administration cannot be further delayed. To empower the tax administration in executing its core function, the Task Force studied the existing depository system of the National Stock Depository Limited (NSDL) and concluded that it offered a scalable system to meet the requirements stated above. As this proven and tested infrastructure already exists, it can readily be adapted to offer a world-class, state-of-the-art IT architecture to rapidly empower the tax administration. Our study suggests that if action is initiated by the middle of November 2002, the system could be operational and available on-line by the beginning of the 2003-04 fiscal year.

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

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

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

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

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

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

2.7 Collection of Taxes and their Accounting

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

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

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

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

Since the Tax Accounting System in the Department has been fully computerised, it becomes necessary to transcribe the data on the challans after they are received in the Department. This involves a huge and an increasing data of work. Delays in this affects reporting of tax collection and the forecast of mechanism of budget collection to the Government.

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

(a) A taxpayer will be required to fill up only one copy of the challan while making payment of taxes in the bank. The present requirement of filling up four copies of challan for payment of any tax will be given up.
(b) The banks will be networked to the TIN and receive payments online. The banks will be required to issue a computerised receipt to the taxpayer instantaneously. The date of presentation of a cheque will be treated as the date of payment. If a cheque bounes, the bank will reverse the receipt, online, and the department would then be expected to prosecute the delinquent taxpayer.
(c) With instant accounting of tax collection, the requirement of enclosing a copy of the challan as evidence of tax payment, along with the annual return of income could be done away.
(d) Since the TIN will digitise all the TDS returns, the requirement to file TDS certificates along with the return of income will also be dispensed with.
(e) At present, taxes are collected through approximately 10,500 bank branches. Since the proposed procedure requires banks to receive online payment, those banks that do not have

adequate infrastructure for establishing online connectivity will be debarred from collecting taxes. Accordingly, the Government, in consultation with the Reserve Bank of India, should also consider paying higher charges for services rendered by banks.

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

2.8 Refund

The failure of the tax administration to issue refunds continues to be a major source of public grievance. This is partly due to its inability to promptly process the returns, whose numbers have increased substantially in the last three years, and partly due to the cumbersome process for issuing of refunds[6]. Therefore, we recommend the following:

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

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

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

2.9 SEARCH AND SEIZURE

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

The objective of the search is to ascertain facts and collect evidence of concealed income and to give a message that tax evasion will not go undetected or unpunished. But, in the course of the search as they are conducted, the main

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

objective of the search team is to obtain a declaration of undisclosed income from the person searched. It confirms success of the raid. Further investigations are slowed down or abandoned. Often such declarations are obtained under pressure. They are retracted in subsequent proceedings. After the raid, the officers of the investigation in charge of the raid, call to their office the persons searched to understand from them the seized accounts and documents. They record further statements. Mostly, the objective of this exercise is to obtain declaration of undisclosed income.

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

In a search case there is no “real” investigation. As a result, the assessment does not stand the test of judicial scrutiny in appeals. There is nominal revenue gain from the searched case. Overall, the contribution of searched cases to total revenue collection is less than 1% .

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

Today, in the income tax department the most sought after posting for most of the officers in any grade is to the search and seizure wing. The officers employ all stratagem to obtain posting to search and seizure wing . The reason is not that the search and seizure work provides high visibility with sense of being in power, without accountability for acts or omissions but the main reason is that it is profitable. The department gives handsome rewards to members of search team based on seizures and revenue realisations. Only officers posted to search and seizure wing have received good amounts of reward. This practice has contributed to obtaining forced confessions of undisclosed income and seizure of money, jewellery, stock or other assets though recorded in accounts or acquired from disclosed sources of income.

To sum up, Income tax raids in India are the most visible activity of the department. In public perception the identity of the Income tax department is ‘raids’ . Search and seizure has become substitute for all investigations and an end in itself. Search and seizure does not serve as deterrence against tax evasion. It has become a routine exercise. There is no meaningful investigation prior to, during or after the search. The concealed income declared as a result of search is widely publicized, but in judicial proceedings the additions made on that basis are not sustained. Search and seizure cases contribute less than 1% to the total revenue realizations. Search and seizure case does not suffer interest, penalty or prosecution. The social and economic cost of search and seizure activity is very high.

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

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

e) Special procedure for assessment of search cases in chapter XIV B (Block Assessment) which provides for tax @60% and exonerates the concealed income detected as a result of search from penal consequences of interest penalty and prosecution, be omitted. When concealment is detected and established, it should suffer full penal consequence of interest, penalty and prosecution.

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

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

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

2.10 Income tax Clearance Certificates

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

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

(ii) domiciled in India at the time of departure but-
  (a) intends to leave India as an Emigrant or
  (b) intends to leave India on a work permit for employment or occupation abroad or
  (c) in respect of whom income tax authority considers that a clearance is necessary.

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

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

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

It is therefore recommended that the present requirement of obtaining a tax clearance certificate before leaving the country must be abolished. However in order to protect the interest of revenue, we can continue to allow the income tax authorities to notify the immigration/custom authorities to prevent any particular person from leaving the country if such person is considered to be a proclaimed offender. As a result only a handful of notified persons will be subjected to the process of tax clearance as against the present practice of requiring all and sundry to comply with the requirement of obtaining tax clearance before leaving the country.

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

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

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

The existing system of issuing income tax clearance certificate has become a source of harassment and encourages rent-seeking behavior. A taxpayer is required to visit the income tax office a number of times. Thereby increasing the interface with the department, which must be avoided to the extent possible. It is not necessary that we should enforce compliance with the tax laws by denying "patronage". The tax laws provide for adequate penalties and prosecution for this purpose.

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

Dispute Resolution:

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

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

Accountability

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

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

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

(a) The control of the Central Government over the tax administration must be formally reduced through a Memorandum of Understanding (MoU) between the Central Board of Direct Taxes and the Central Government (we understand that there is already a Cabinet decision to this effect). The Central Board of Revenue Act provides that the two boards (CBDT and CBEC) must function subject to the control of the Central Government, but the mechanism and the extent of control remains unspecified even after forty years.

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

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

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

(e) It must also specify, in financial terms, and in a manner to be decided later, the levels of penalty (reward) for under-performance (exceeding targets).

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

The Task Force was also concerned with the absence of any well-publicised rule for appointing as CBDT Members / Chairman and, therefore, recommends transparent procedures. Lack of transparency in appointments to senior positions in the tax administration can engender uncertainty and demoralise the tax bureaucracy. Therefore, it is recommended that the Central Government must formulate appropriate rules for appointments to the Board.

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

The Task Force also noted that the standards of accountability at the field formation level were considerably diluted since, *inter alia,* the performance targets, particularly those related to revenue collection, were unrealistic and thrust upon them. The field formations were either resigned to the failure of the targets or resorted to questionable practices to meet revenue targets divorced from underlying economic trends. The Task Force was informed that very often officers were (informally) directed to hold back refunds to boost revenue collection. Accordingly, it is strongly recommended that the revenue targets should be based on underlying economic trends.

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

Delegation of Financial Powers

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

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

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

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

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

In this backdrop, it will not be out of place to mention that it is a declared policy of the Government to encourage Ministries to delegate powers to subordinate offices. As a matter of fact, Government of India decision number 7 under Rule 13 of Delegation of Financial Rules, 1978 mentions not only of suitable delegation to match requirements of subordinate offices, it also stipulates a three-yearly review of the delegated powers. Unfortunately, CBDT has continued to function without any financial authority to guide and control affairs of Income Tax offices across the country. The task Force was of the view that the position must be immediately rectified.Therefore, CBDT should be notified as a ‘Department of Central Government’ as defined in sub-rule (d) of rule 3 of Delegation of Financial Rules, 1978. Furthermore, CBDT should be authorised to remit the tax collections to the Central Government net of its expenditure budget [and also be allowed to carry forward surpluses]. Consequently, it will have full control over its finances and therefore better placed to design and give effect to the medium term and long term enforcement strategy. For its part, CBDT must publish an annual financial report (statement), which will enable the government to assess the cost of tax collection.

Human Resource Management

The absence of control over human resources has further undermined accountability. Therefore, we recommend that the Central Government should delegate to CBDT full authority and responsibility regarding staff of the income tax department and its secretariat. This would include decisions on recruitment, deployment, designing incentive schemes, discipline matters, performance management & appraisal, employee relations, training & development, and other matters related to human resource management. Reciprocally, the CBDT should design a system of performance targets. The CBDT should, however, exercise such delegated powers in a transparent manner within the framework of rules and guidelines framed for this purpose. Such rules and guidelines should be framed with the approval of the government.

Infrastructures

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

(a) A Task Force should be constituted to standardize the requirement of a modern occupant-friendly office (with modern methods of storage and retrieval of records). The Task Force should furnish its report, including financial estimates, by 31st December 2002.
(b) Based on the report of the Task Force the CBDT should request Chief Commissioners to identify the shortcomings in their offices by 1st April 2003 and send forward a proposal to CBDT.
(c) By 1st August 2003 a model Commissionerate including the offices at the range, circle and ward levels should be established in each zone.
(d) CBDT should seek the requisite financial sanction to replicate the model offices by either upgrading existing offices or, where necessary, by purchasing new premises, etc. The entire exercise should be time bound so that by January 2005 modern offices are in place in all Commissionerate.

Chapter – III

ISSUES IN TAX POLICY

3.1 Ramifications of Tax Policy for Tax Administration[7]

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

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[7] 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.[8] The large number of tax slabs,also distorted the progressivity of the tax system due to bracket creep. The

[8] 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.

design of the tax rate schedule was neither economically efficient nor equitable, nor amenable to voluntary compliance.

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[9]. 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[10]. 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

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

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.

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.[11] 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

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

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.

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[12] 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

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

economic incentive sustained, it is necessary to review the various exemptions, deductions and rebates.

3.4 Exemption Based on Residential Status

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[13], Non-residents are taxed only on Indian-sourced income and on income received, accruing or arising in India[14].

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.

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[13] 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.

[14] 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).

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.

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[15].

[15] 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.

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 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[16]. 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

[16] 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.

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

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[17] and Dr. Y.V. Reddy[18]. 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[19]. 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

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

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

[19] 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*.

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

[20] 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[21]. 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)[22]. 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[23] allow new tax incentives to both salaried workers and the self-employed to

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[21] 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.

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

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

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

The Supplemental Retirement Scheme (SRS)[24] 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.

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

(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 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, Annuity Certificates, Saving Certificates, and Other Certificates	Exempt[b]	Exempt	Exempt[2]	EEE
7	9% Relief Bonds	Taxable	Exempt	Exempt[2]	TEE
8	Public Sector Bonds / Debentures	Taxable	Exempt	Exempt[2]	TEE
9	Deposit Schemes for Retiring Employees	Exempt[d]	Exempt	Exempt[2]	EEE
10	Certain Pension Funds of LIC (Section 80 CCC)	Exempt[e]	Exempt	Taxable	EET
11	Medical Insurance (Section 80 D)	Exempt[e]	Taxable	Exempt[2]	ETE
12	Any Security of the Central Govt. or State Govt.	Exempt[b]	Exempt	Exempt[4]	EEE
13	National Saving Certificates (6th , 7th & 8th Issue)	Exempt[b]	Exempt	Exempt[4]	EEE
14	Debentures of any Institution, Authority, Public Sector Company or Co-operative Society Notified by the Govt.	Taxable	Exempt	Exempt[4]	TEE
15	National Deposit Scheme	Taxable	Exempt	Exempt[4]	TEE
16	Any Other Deposit Scheme Framed by the Central Govt. and Notified	Taxable	Exempt	Exempt[4]	TEE
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[25]. 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

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

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 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[26], 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

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

Germany	No	Yes, if education is necessary for current profession
Italy	Yes, tax credit at the rate of 19 per cent.	Yes, tax credit at the rate of 19 per cent.
Japan	Yes, expenditure in excess of Yen 100,000 up to a maximum of Yen 2 million	Yes, expense exceeding Yen 10,000 up to a maximum of 25 per cent of adjusted total income
Netherlands	Yes, maximum of Euro 718 or 11.2 per cent of income, which ever is lower	Yes, only expenses above 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[27] 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

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

that the income based deduction under these provisions should be converted to a tax rebate at the minimum marginal rate of personal income tax.

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:-

- **(q)** **Increase in the generalised exemption limit from Rs.50,000/- to Rs.1,00,000/- for all individual and HUF tax payers.**
- **(r)** **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.**
- **(s)** **Dividends received from Indian companies will be fully exempt.**
- **(t)** **Long term capital gains on equity will be fully exempt.**
- **(u)** **The standard deduction for salaried tax payers will be reduced to NIL.**
- **(v)** **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.**
- **(w)** **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.**
- **(x)** **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.**
- **(y)** **The tax rebate schemes under Sections 88 for savings will be eliminated.**
- **(z)** **The rebate under Section 88B for senior citizens will be eliminated.**
- **(aa)** **The rebate under Section 88C for women taxpayers below the age of 65 years, will be eliminated.**
- **(bb)** **The income based deduction for handicapped under Section 80DD and 80U will however continue.**
- **(cc)** **The income based deduction under Section 80L for interest income and dividends will be eliminated.**

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

(ee) 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.

(ff) 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[28]. As mentioned above, tax incentives are, therefore,

[28] 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

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[29].

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.

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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.

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

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

Option I :

(xvii) 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.

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

(xix) Exemption of long terms capital gains on equity.

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

(xxi) 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.

(xxii) 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.

(xxiii) 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.

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

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

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

(xxvii) 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.

(xxviii) 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.

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

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

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

(xxxii) 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 :

(xviii) 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.

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

(xx) No tax on long terms capital gains on equity.

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

(xxii) 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.

(xxiii) 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.

(xxiv) 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 :-

(h) 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.
(i) 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.
(j) 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.
(k) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.
(l) Section 80 JJAA in respect of employment of new workman.
(m) Section 80 M in respect of inter corporate dividends
(n) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(xxv) 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.
(xxvi) Elimination of Section 33 AB relating to Tea development account will be eliminated.
(xxvii) Elimination of Section 33 AC relating to reserve for Shipping business.
(xxviii) Elimination of Section 33 B relating to Rehabilitation allowance.
(xxix) 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.
(xxx) 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.
(xxxi) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

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

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

(xxxiv) 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.

Annexure 1

Summary of income tax benefits to savings and financial instruments provided till FY 2001-02

Table A.1 : Tax Benefits for financial instrument under various sections of the Income Tax Act 1961.

		Exemption of Income - Interest and dividend		Exemption from capital gains tax		Tax Rebate*
		Total exemption $$ (u/s 10)	Partial Exemption up to a limit @@ (u/s 80L)	Short-term	Long-term # (u/s 54EA, 54 and 54EC) 88	Section 88
1.	Bank Deposits	NA	Rs.9,000	NA	NA	NA
2.	Mutual Funds	$$	NA	NA	NA	@
3.	LIC Policies	$$	NA	NA	NA	NA
4.	Financial Institution Bonds	NA	NA	NA	#	$
5.	Shares	$$	NA	NA	NA	$
6.	Debentures of Companies	NA	NA	NA	NA	$
7.	Small Savings					
a)	Post Office Deposits	NA	Rs.9,000	NA	NA	NA
b)	Certificates VIII Issue ##	NA	Rs.9,000	NA	NA	NA
c)	Approved Provident Funds Including P.P.F.	$$	NA	NA	NA	NA
d)	National Savings Scheme, 1992	NA	Rs.9,000	NA	NA	NA
8.	Company deposits	NA	NA	NA	NA	NA
	NBFCs	NA	NA	NA	NA	NA
	NBNFCs	NA	NA	NA	NA	NA

Source: Advisory Group on Tax Policy and Tax Administration for the Tenth Plan**.**

Notes to legends:

NA Exemptions and tax rebates not available.

Income from long-term capital asset (if held for more than 12 months) is taxed at a flat rate 20 per cent after indexation (10 per cent without indexation). Exemption from long-term capital gains were available under section 54EA and 54EB where the investor was willing to block the funds generated from sale of long-term assets in specified securities. However, exemptions under Section 54EA and 54EB were withdrawn in the Union Budget 2000-2001 and a new Section 54EC was introduced, whereby tax exemption on long-term capital gains is now available only if the gain are invested in specified long-term assets, i.e., bonds issued by the NABARD or the NHAI that are redeemable after three years.

Available only for National Savings Certificate (NSCs). No tax rebate is available on Indira Vikas Patra and Kisan Vikas Patra. In respect of NSG VIII issue, though the investor gets a rebate on the original investment as well as subsequent interest earned u/s 88 of I.T. Act, the interest income received every year is not exempt under Section 80L of the I.T. Act and is taxable under the head “Income from other sources”.

@ Any unit linked insurance plan of UTI and LIC Mutual Fund and contribution to equity linked saving scheme of any mutual fund are provided tax exemption on capital income under Section 80-L subject to maximum of Rs.10,000/-.

@@ Though partial tax exemption up-to Rs.9,000/- is available individually with respect to item 1, 7(a), 7(b) and 7(d) an investor cannot claim an exemption of more than Rs.9,000/- on an aggregate even if he invested in more than one of these instruments.

$ Equity shares, debentures of a public company engaged in infrastructure (including power sector) only and bonds of FIs if proceeds thereof are intended to be deployed for infrastructure projects only).

$$ Maturity proceeds including income by way of interest in approved provident funds including P.P.F. and bonus in case of insurance policies are exempt from tax as capitalised income under section 10 of I.T. Act, 1961. Dividend income from shares of companies and units of mutual funds are also exempt u/s 10 of

the Income-tax Act.

* Tax rebate is available under Section 88 of the Income-tax Act, 1961. The maximum amount of rebate available is Rs.12,000/- (i.e. 20 per cent of Rs.60,000/-). By investing in shares or debentures of infrastructure sector, a higher qualifying amount of Rs.80,000 and a tax rebate of Rs.16,000/- (i.e. 20 per cent of Rs.80,000/-) can be claimed. By investing only in shares/debentures of an infrastructure company and bonds of FIs if proceeds thereof are intended to be deployed for infrastructure projects, maximum rebate of Rs.16,000/- (i.e. 20 per cent of Rs.80,000/-) may be claimed.

Table A.2: Details of Interest rate and tax incentive structures related to small savings instruments

	SCHEME	INTEREST RATES, PERIODICITY ETC.	TAX INCENTIVES
1.	Post Office Savings Account	3.5 per cent per annum on individual/joint and group accounts.	Interest is exempt from income tax u/s 10.
2.	5-Year Post Office Recurring Deposit Account	Compounded quarterly. Rs.10 recurring account fetches Rs.758.5 on maturity.	Interest earned is deductible under Section 80L.
3.	Post Office Time Deposit Account	Interest payable annually but compounded quarterly. PERIOD RATES 1-Year 7.5% 2-Year 8.0% 3-Year 9.0% 5-Year 9.0%	Interest deductible under Section 80L. Deposits are exempt from Wealth Tax.
4.	Post Office Monthly Scheme	9.5 per cent per annum payable monthly. In addition, 10 per cent bonus payable on maturity.	Interest and Bonus deductible under Section 80L.
5.	6-Year National Savings Certificate (VIII Issue)	Compounded half yearly. Amount inclusive of interest payable at maturity on a certificate of Rs.100 denomination is Rs.174.52.	Deposit qualify for tax rebate under Section 88 of I.T. Act. The interest accruing annually but deemed to be reinvested will also qualify for tax rebate under section 88 of I.T. Act. Such interest will be entitled to deduction under Section 80L of the Income Tax Act.
6.	4-Year National Savings Scheme Account 1992	9.0 per cent payable annually.	The amount deposited in a year qualifies for tax rebate under Section 88 of I.T. Act. The interest is deductible under Section 80L of I.T. Act.
7.	15-Year Public Provident Fund Account	9.5 per cent per annum, compounded yearly	Deposits qualify for Income Tax rebate under Section 88 of I.T. Act. Deposits completely exempt from Wealth Tax. Interest credited to the fund is totally exempt from income tax.
8.	6-Year Kisan Vikas Patra	Money doubles in 7 yRs.3 months, implying interest rate of 10.03 per cent per annum.	Amount of interest accrued every year can be shown for Income Tax purposes. No tax deduction at source.
9.	Deposit Scheme For Retiring Govt. Employees 1989 (3-Year)	8.5 per cent per annum payable half yearly on 30th June and 31st December.	Interest earned is fully exempt from income tax under Section 10(15) of I.T. Act.
10.	Deposit Scheme For Retiring Employees Of Public Sector Companies 1991(3-Year)	8.5 per cent per annum payable half yearly on 30th June and 31st December.	Interest earned is fully exempt from income tax under Section 10(15) of I.T. Act.

Source: Expert Committee to Review the System of Administered Interest Rates and Other Related Issues.

Annexure 2

Table A.3: Total effective returns adjusted for all tax concessions

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

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