CHAPTER 5

CORPORATE TAX REFORM

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

Case for Levy of Corporate Tax

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

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

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

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

Case for Integration

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

Case for the "Classical" system

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

The case against the classical (Nonintegrated) system

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

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

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

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

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

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

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

The case for retaining a classical system

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

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

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

The meaning of "integration"

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

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

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

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

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

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

Economics of Tax Incentives

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

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

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

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

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

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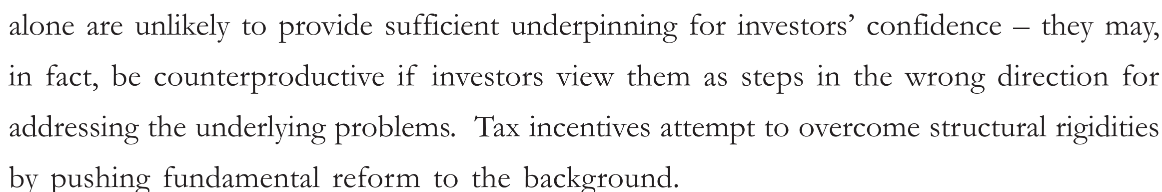
[58] In many developing countries such incentives are extended to promote FDI, reduce unemployment and promote specific economic sector or types of activities.



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

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

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

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

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

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

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

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

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

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

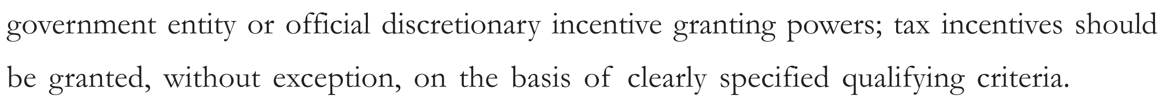
5.33 The revenue costs of tax incentives have two different dimensions. First, investment projects could have been undertaken even if there had been no tax incentives. For these projects, which typically comprise those of the highest profitability and, therefore, having the greatest economic merits,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

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

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

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

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



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

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

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

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

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

Widening the Corporate Tax Base

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

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

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

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

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

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

Exemption for Exports (Section 10A and 10B)

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

i) Articles or things ; or

ii) Computer Software.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

OR

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

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

Depreciation

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

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

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

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

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

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

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

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

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

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

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

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

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

Tax incentives for Shipping Industry

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

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

Tax incentives for Scientific Research and Development

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

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

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

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

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

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

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

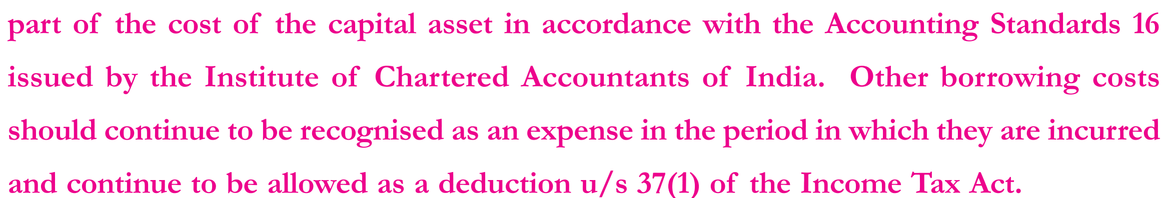
Deduction for payment of interest on borrowed capital.

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

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

Table 5.3:: Comparative analysis of the tax treatment of expenditure on Scientific Research.				
Section	**Nature of Expenditure / Donations under the existing law (assessment year 2003-04)**	**Amount of deduction Force recommendations (assessment year 2004-05)**	**Amount of deduction as per Task**	**Remarks**
35(1)(i)	Revenue expenditure on Scientific Research related to the business	100 per cent of the expenditure	100 per cent of the expenditure to be allowed u/s 37(1)	
35(1)(ii)	Donation to – ➢ a Scientific Research Association set-up for scientific research; ➢ University, College or other institution to be used for scientific research	125 per cent of the donation	20 per cent tax rebate on 100 per cent of the donation (to be merged with the new provision for replacing section 80G)	Aligned to the tax benefit for non-business taxpayers. Hence equitable.
35(1)(iii)	Donation to a university, college or other institution to be used for research in social science or statistics	125 per cent of the donation	20 per cent tax rebate on 100 per cent of the donation (to be merged with the new provision for replacing section 80G)	Aligned to the tax benefit for non-business taxpayers. Hence equitable.
35(1)(iv)	Capital expenditure on scientific research related to the business	100 per cent of the expenditure	Depreciation to be allowed u/s 32	
35(2AA)	Donation to – ➢ A National Laboratory ➢ University or an Indian Institute of Technology or a specified person The donation must be with a specific direction to use for approved scientific research programme.	125 per cent of the donation	20 per cent tax rebate on 100 per cent of the donation (to be merged with the new provision for replacing section 80G)	Aligned to the tax benefit for non-business taxpayers. Hence equitable.

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



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

Tax Treatment of Non-performing Assets of the Financial Sector

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

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

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

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

Table 5.4

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

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

Tax Treatment Of Statutory Liabilities

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

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

The treatment of corporate tax losses

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

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

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

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

Tax Incentives under sections 80IA and 80IB

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[71] [1947] KB 130.

[72] Discipline in Law 1988 edition P 223

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

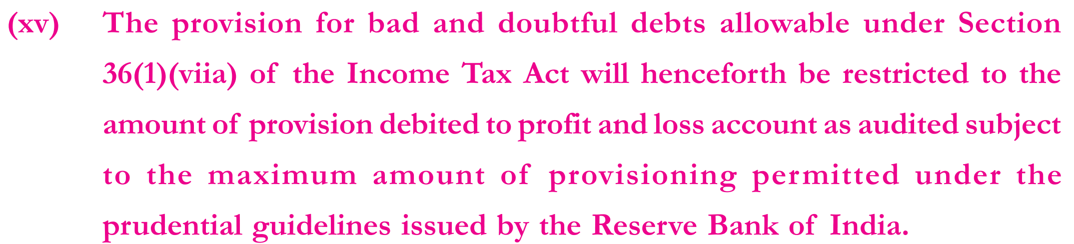
(x) Elimination of Section 33 B relating to Rehabilitation allowance.

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

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

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

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



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

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

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

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

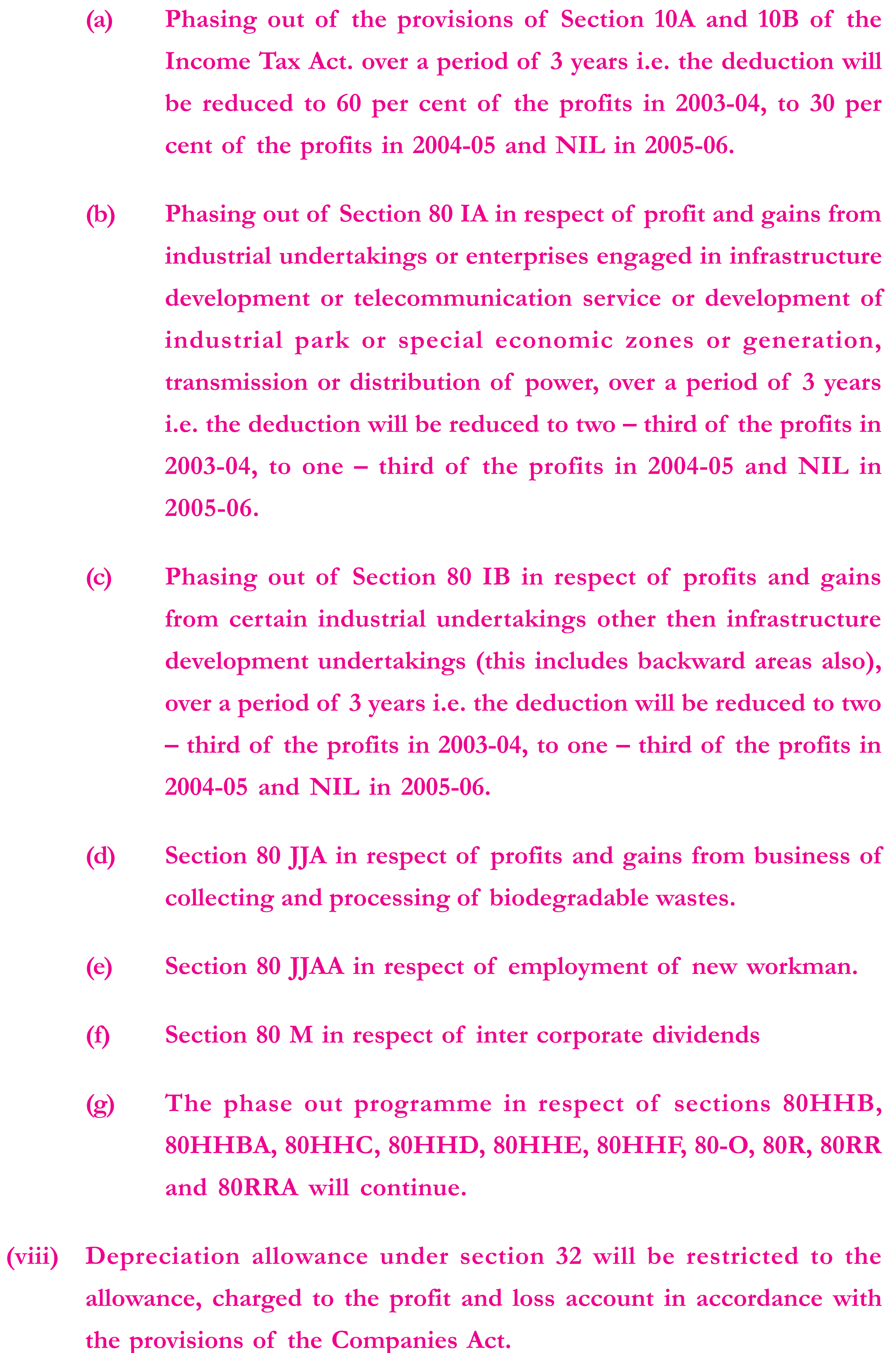
(iii) No tax on long terms capital gains on listed equity.

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

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

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

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



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

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

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

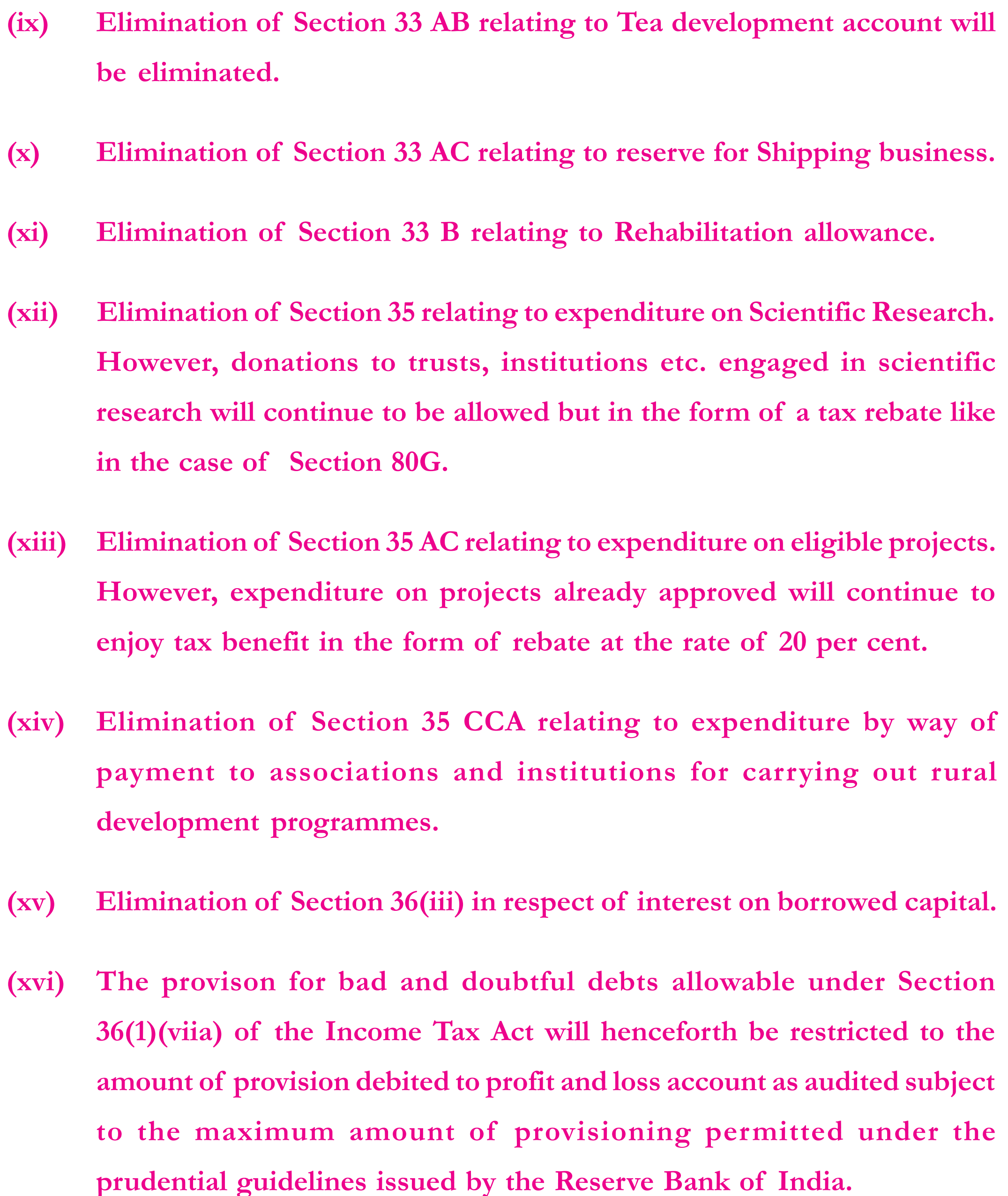
(d) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.

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

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

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

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



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

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

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

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

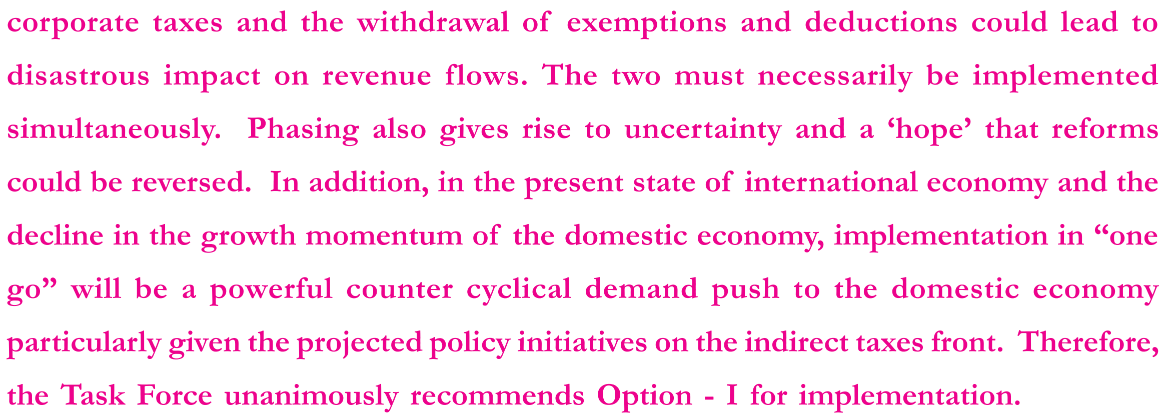
(xiii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

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

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

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

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



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