Chapter 7

Treatment of Other Entities

Taxation of Investment Funds

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

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

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

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

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

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

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

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

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

7.9 The **third method** imposes tax on the investment fund on any income it receives at a rate that could be either the highest rate applicable to investors or, alternatively, the one that is most common to investors. This approach allocates to investors their share of the income of the fund and provides a credit for taxes paid by the fund allocable to that income. Investors may then file for a refund if the amount of tax paid exceeds their liability, or they could be assessed additional tax if the amount of tax paid exceeds their liability, or they could be assessed additional tax if the amount paid by the investment fund is less than their tax liability. This variation also requires rules for calculating an investor's basis in his or her investment in the fund to determine whether an investor would recognize gain when shares are redeemed.

7.10 Under the existing system in India, the investment fund is exempted from tax. The dividend received by the investor from such fund is subjected to tax at his level at his personal marginal rate of tax applicable to him. The retained earnings by the fund therefore remain untaxed. Therefore, the existing model is not a typically pass-through prototype. The system is biased against dividend distribution and also imposes higher administrative and compliance burden.

7.11 The dividend distributed by the investment funds comprises of the following categories of income:

1. Dividends earned from investments by the Fund in equity.
2. Long-term capital gains from sale of investment.
3. Short-term capital gains from sale of investment.
4. Interest received from investment in debt.

7.12 In our package for corporate tax reform we have recommended the abolition of any form of tax on dividend and long-term capital gains on equity. To the extent, the dividend distributed by the investment fund comprises of these exempt incomes, the full taxation of dividends from the investment fund would result in double (multiple) taxation. Therefore, the proportion of dividend income and long-term capital gain on equity comprised in the dividend distributed by the investment fund must necessarily be exempted.

If this be so, the dividend folio must indicate such proportion. This will further add to the complexity of administration and compliance.

7.13 Where there is a conflict between simplicity of equity, the Task Force has a preference for simplicity. Complexity is, inherently, regressive and non-transparent. Therefore, what may appear to be equitable could, in effect, be inequitable. **In the light of the problems associated with the existing system of taxation of investment fund and the package for corporate tax reform, we recommend the following:-**

1. **The income of the mutual fund derived from short-term capital gains and interest should be taxed at a flat rate in the hands of the mutual fund.**

2. **Since most investors in units are generally smaller taxpayers, we recommend that the rate of tax should be the minimum marginal rate of personal income tax i.e. 20 per cent.**

3. **With a view to overcoming double taxation, the dividends received by the unit holders should be fully exempted since the distributable surplus would have suffered the full burden of the tax.**

4. **The short-term capital gain arising to the investor from sale of units of investment funds should be taxed at his level at the personal marginal rate of tax.**

5. **The long-term capital gain arising to the investor from sale of units of mutual fund should be exempt from income tax.**

6. **The tax treatment of mutual funds and their investors should also be extended to venture capital funds[75] , private equity funds[76] and hedge funds[77] . However, the tax rate for these funds should be 30 per cent since their investors are likely to be those in the highest tax slab.**

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[75] Venture capital funds invest in greenfield ventures.

[76] Private equity funds invest in firms, which have crossed the greenfield stage, but are not yet listed.

[77] Hedge funds are structures where each customer brings in a minimum of (say) Rs. 10 lakh of capital, so that the securities regulator ceases to work for investor protection, and only focuses on contract enforcement and fraud.

7. **All funds must necessarily obtain the PAN of the investor and the Databases about every payment made by the fund manager back to the investor, tagged with PAN, should be furnished to the tax authorities as a information return.**

Tax Treatment Of Partnership Firms

7.14 At present, the profits of a partnership firm are subjected to tax at the same rate of tax applicable to a domestic company. **In view of our recommendations, for corporate tax reform, we recommend that the rate of tax for partnership firms should be reduced to the same level as corporate rate of tax.**

Tax treatment of Charitable Trusts

7.15 The gross domestic product (GDP) from community services comprising educational services research and scientific services, medical and health services and religious and other community services has sharply increased from 247 crores in 1950-51 at current prices to Rs. 87529 crores in 1998-99 at current prices.

7.16 This unprecedented growth has outpaced with the growth of GDP at market prices at current prices. Accordingly, the share of GDP from community services to GDP at market prices has increased from 2.49 percent in 1950-51 to a high of 4.99 per cent in 1998-99. The share of this sector will continue to increase rapidly as per capita income increase since the demand for those services is generally income-elastic.

7.17 The activities of this sector are mostly through the vehicle of charitable trusts and institutions. These trusts have enjoyed tax support like in most countries across the globe. Under the present system, donations to trust are allowed as a deduction from the gross income to the donor. Empirically tax exemption for donations have been found to be efficient. However, the deductions from gross income are iniquitous in as much as they confer greater benefit to those the higher income levels. Therefore, we recommend that the tax benefit to donations must take the form of tax rebate at the minimum marginal

rate of tax at 20 per cent[78]. Further, we also recommend that there should be no quantitative ceiling either in absolute terms or as a fraction of the gross income as is presently provided under Section 80G.

7.18 The income of the Charitable Trust from property held under trust is exempt to the extent it is applied for charitable purposes. The surplus if any is allowed to be accumulated for future application, subject to certain specified conditions. The benefit of the exemptions is either enjoyed under various clauses of Section 10 or under Section 11 to 13. The compliance burden under the two schemes is different. Infact, the Task Force received large number of grievances particularly relating to delay in the issue of exemption notification under Section 10 by the Central Board of Direct Taxes. Such delays are inherent in the very procedure for issuing any statutory notification. **Therefore, the Task Force recommends that the exemptions under Section 10(21), 10(23B) and 10(23C)(iiiab) to (via), 10(29A) should be merged with Section 11 to 13A of the Income Tax Act. We also recommend that:-**

1. **The present practice of exempting a class of Charitable trust and Institutions through notifications should be abolished. However, the requirement to file a return of income by such trust and institutions as proof of fulfilling the various conditions stipulated u/s 10(23C), should continue.**

2. **Returns to be identified for scrutiny / audit only through a computerised risk assessment system.**

3. **Where a return is identified for scrutiny and the assessing officer is of the opinion that the activities of the trust are not charitable in nature,**

[78] Suppose a taxpayer makes a donation of Rs. 100/- to a trust for which 50 per cent deduction is allowed u/s 80G. Under the present arrangement, the tax benefit on the donation will vary depending upon the marginal rate of tax applicable to the taxpayer. If the marginal rate is 20 per cent, the 50 per cent deduction from income is effectively a tax relief of Rs. 10/-. If the marginal rate is 30 per cent, the tax relief is Rs. 15/-. The rebate under the proposed scheme will be Rs.100*0.5*0.2= Rs.10/-. This will be the same for all class of taxpayers irrespective of their marginal rate of tax.

such a case will be referred to a rating agency from amongst the panel drawn up by the C&AG[79]. An "A+" rating for the trust will mean that it is indeed a charitable trust. An "A" rating for the trust will mean that it will enjoy exemption during the current year and will be subjected to review again in the following year. A "B" rating for the trust will disqualify it from any tax exemption. The new procedure should be introduced from 01-04-2004 and the interregnum should be utilized to work out the details and also allowing the trust to adapt to the new procedures.

4. **Since a large number of provisions in the Income Tax Act are regulatory in nature, we also recommend the creation of a National Charities Board to assist the government in regulating and promoting charities on the lines of the National Charities Commission, U.K. Since, a number of States in India already have Charity Commissioners, the proposed Board may have to be advisory.**

5. **The Income Tax Department should reimburse to trusts, the fees payable to the rating agency.**

7.19 Consequent to the merger of all the provisions, there will be no requirement for any statutory notification to be issued by the CBDT. The Board will hereafter be able to devote more time on designing tax enforcement strategy rather than deal with individual cases of exemptions.

Tax Treatment of Cooperative Societies

7.20 Under the existing provision of Section 80P of the Income Tax Act, a cooperative society is entitled to 100 per cent exemption in respect of profits / income from a large number of activities like banking, credit facilities, cottage industries, market of agricultural produce, pisciculture, milk, fruits and vegetables. Further, the income from letting of

[79] A number of taxpayers were apprehensive whether such rating agencies indeed exist in India. We have been informed that Crisil is already engaged in rating NGOs for multilateral agencies.

godowns and warehouses is also fully exempt. Similarly, the income of a consumer cooperative society is exempt up-to a specified limit.

7.21 Consistent with our recommendations for personal income tax and corporate income tax, **we recommend the elimination of Section 80P of the Income Tax Act. However, the existing exemption limit of Rs. 10,000/- prescribed as part of the rate schedule, should be increased to Rs. 1,00,000/- and the revised income tax rate schedule for cooperatives should be as indicated in Table 7.1 below.**

Table 7.1 : Proposed Income Tax Structure for Cooperative Societies.

Income level	Tax rates
Below 1,00,000	NIL
1,00,000 – 4,00,000	20 per cent of the Income in excess of Rs. 1,00,000-
Above 4,00,000	Rs. 60,000/- plus 30 per cent of the Income in excess of Rs. 4,00,000/-

Tax Treatment Of Non-Residents

7.22 In the course of discussion with various Chamber of Commerce, Trade and Industry, a large number of issues relating to taxation of non-residential individuals and companies were raised. *Inter-alia*, some of the issues related to the following:-

1. The inability of the Foreign Tax Division (FTD) in the Central Board of Direct Taxes to respond swiftly to the various clarifications sought by trade and industry.
2. The delay in the outcome of the Mutual Agreement Procedure (MAP).
3. The absence of an institutional framework to deal with issues arising out of Foreign Tax Credit (FTC).
4. The absence of the mechanism of Advance Pricing Agreements (APA).

5. The existing procedure for issue of remittance certificate. A large number of representatives expressed concern on the new procedure of remittance without obtaining clearance from the income tax department.

6. The absence of any guideline regarding the database to be used for the purposes of transfer pricing.

7. The high level of penalty on transfer pricing contrary to international practice.

8. The restrictive scope of advance ruling. Representatives suggested that the Indian partner in a Joint Venture with a foreign entity should also be eligible for advance ruling.

7.23 The Task Force was informed that the issues at serial number 1 to 3 arose primarily because the composition of the FTD in the CBDT has remained unchanged for over three decades even though there has been a substantial increase in the work particularly in the last one decade. **The Task Force was therefore of the view that the manpower strength of FTD should be immediately augmented so as to assign one team each for America, Europe, South East Asia and Australia, and Rest of the World.** Each of the four teams should be headed by an officer in the rank of Joint Secretary to Government of India. However, these posts should be created by diverting them from the different field formations and not by creating new posts. Further, the Task Force was also of the view that the issues involved in the taxation of non-residents were far too technical and therefore needed an extended period of deliberation. **We understand that, as recommended by us in our Consultation Paper, the CBDT has already set up a working group headed by the Director General of Income Tax (International Taxation) and comprising of representatives also from trade and industry to examine the various issues relating to taxation of non-resident individual and foreign companies. We also understand that the working group is expected to submit its report by the end of December. We suggest that the recommendations should be processed during the forthcoming budget exercise.**