Report

on

Income Tax Reforms

for building a new India

September, 2018

Task Force for drafting the new Income Tax Law

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DISCLAIMER

The views expressed in this report are the expert views of the members of the Task Force and do not necessarily reflect the views of the Government or organisation to which they belong.

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PREFACE

The Government constituted a Task Force on 22nd November, 2017, to review the existing Income-tax Act and to draft a new Direct Tax law in consonance with the economic need of the country. After extensive discussions, two separate Models of the income tax system have been constructed. The legislative framework of Model - I is presented in Volume - II of this Report and that of Model - II in Volume - III of this Report. Volume - IV contains the legislative framework for levy of wealth tax and equalisation levy.

The direct taxes system comprising income tax, wealth tax and the equalisation levy is designed to improve the efficiency, equity and effectiveness of the tax system. It is based on best international practices and seeks to remove the existing distortionary effects. The tax administration and procedures framework is designed to minimise the cost of compliance and administration based on end to end computerisation of the internal processes; and the way the tax administration interacts with the citizens. Overall, the entire set of recommendations particularly those in Model - I are expected to be transformational in their impact.

In crafting our recommendations, we have drawn on the scholarly work on the subject both within the country and internationally. We have also drawn heavily from the reports of several expert committees on tax reforms set up by the Government over the last half a century and the several earlier attempts to rewrite the income tax law.

The Task Force would like to place on record its gratitude to Dr. Arvind Subramanian, Chief Economic Advisor who as a permanent special invitee in the Task Force contributed significantly through his precise policy interventions, directions and thoughts in the design of the new Income-tax law. The Task Force also wishes to thank Prof. Alan J. Auerbach, Director at the Robert D. Burch Center for Tax Policy and Public Finance at the University of California, Dr. Michael Keen from International Monetary Fund and Dr Sebastian James from The World Bank for guiding the Task Force on several aspects of income taxation. The Task Force also extends its grateful thanks to Dr. Harsha Vardhana Singh, former Deputy Director General at the World Trade Organisation, Geneva for his useful contributions in framing the policy design of the new law.

The Task Force wishes to place on record the team work and collaboration of the officers of Tax Planning and Legislation (TPL) wing of the Central Board of Direct Taxes. We would also like to place on record our special thanks to the office of Tax Policy Research Unit (TPRU) which not only housed the Task Force for carrying out its work, but also contributed significantly in data and research work in preparation of the new Income-tax Act and the report of the Task Force.

The Task Force would also like to place on record its grateful thanks to the Directorate of Income Tax (Systems) particularly Sanjeev Singh, Ramesh Krishnamurthy and Manik Ghosh for providing data which formed key essential inputs into policy making. The Task Force wishes to recognise the secretarial assistance by Jaswant Singh of Department of Economic Affairs (Budget Press), G. Venkatesan, Nishant Gaurav, Kusum Lata Rajora and Balwan Singh and their tireless work in preparation of the Report. The Task Force also wishes to acknowledge all the officials and staff at TPRU for making excellent arrangements for the various meetings of the Task Force.

The Task Force is grateful to all other experts, individuals and anonymous persons who gave suggestions and made valuable contributions by their thoughts and ideas which formed significant inputs into the design of the new Income-tax Act and the Report.

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Date: 26th September, 2018

EXECUTIVE SUMMARY

Income-tax in India was introduced for the first time in 1860. It culminated into the first Act of 1886 wherein Income-tax legislation was drafted with the objective of augmenting revenues of the Government. The 1886 Act was replaced by an Act of 1918 which remained in effect until 1922. On the recommendations of the All India Income Tax Committee appointed in 1921, the Indian Income Tax Act XI of 1922 was introduced. This marked the shifting of administration of Income Tax from the hands of the Provincial Government to the Central Government. The Act of 1922 was amended 20 times between 1922 and 1939 to plug loopholes in the administration of the Act and to prevent tax avoidance and tax evasion. The rates of tax were steadily increased over the years to meet the growing needs of the Government for revenues. By 1939, Income tax had started contributing 20 percent to the government total tax revenue. Based on the recommendations of the Aiyer Committee Report (1936), the Income tax was amended in 1939 to introduce many anti-abuse provisions. However, the changes did not prove to be effective and the Act continued to be amended on a regular basis.

2. Based on the Report of the Law Commission in 1958 and soon thereafter the report of the Direct Tax Administration Enquiry Committee (set up to recommend measures to minimise inconvenience to assesses and to prevent evasion of income tax), the present Income-tax Act was enacted in 1961 replacing the Income-tax Act 1922. Since then, this Act has been amended on a yearly basis; the original framework of this legislation seems to have ´collapsed´. It has become the biggest cause of litigation. In the past, several attempts have been made to rewrite the 1961 Act. **The first** such exercise was undertaken during the period between 1986 to 1991 but could not be implemented since it was felt necessary to first undertake tax structure reforms recommended by the Chelliah Committee (1991-92). **The second** attempt was made in 1996 and the report of an in-house group was received by the Government in late 1997. This too could not be implemented due to change in Government. **The third** attempt was made in 2005 and the Direct Taxes Code, 2009 was released for public debate in August 2009. Subsequently, the Direct Taxes Code Bill 2010 was introduced in August 2010. It was referred to the Standing Committee on Finance which submitted its report in mid-2012. However, the Lok Sabha was dissolved and finally the exercise was abandoned in 2015. The present exercise is **the fourth** attempt at rewriting the Income Tax Act 1961.

3. Over the years, revenues from income tax have increased from 1.25 percent of GDP in 1950-51 to 5.84 percent in 2017-18; its share in central revenues has also increased from around 20 percent in 1939 to little over 50 percent in 2017-18. Similarly, the taxpayers base has increased from 0.22 percent of population in 1960-61 to 4.97 percent in 2015-16. At present, it remains the most

buoyant source of revenues. As the taxpayers' base expands, there is a clamour for overhauling the income tax regime so as to improve the efficiency and equity, simplify the law and procedures for optimal compliance and administration and relentlessly pursue tax evaders. The objective of our exercise is to deliver on these expectations.

4. In the past, the problem for most expert committees was to find ways to eliminate the business-related tax incentives, enhance neutrality in (i) the treatment of return on assets; and (ii) the method of capital financing, rationalise the tax treatment of savings, prevent base erosion and profit shifting to outside jurisdictions, reduce rates of corporate tax to international competitive levels, rationalise personal income tax rate structure and reduce cost of compliance and administration by leveraging new technology to modernize the tax administration functions. However, our task has been simplified on account of the Government's recent decisions to grandfather all business-related incentives and reintroduce long term capital gains on listed securities; computerisation of tax administration functions has gained momentum, thanks to bipartisan support. Similarly, progress has also been made on taxation of cross border transactions. Our objective is also to complete the unfinished agenda.

5. In our endeavour to meet citizens expectations and complete the unfinished agenda of tax reforms, we have developed two models of direct tax system; Model - I is based on cash accounting and source-based (territorial based) taxation; and Model - II is based on accrual accounting and global taxation for residents and source-based taxation for non-residents. The key features of the two models are enumerated below.

6. One of the key recommendations relating to both models is the tax treatment of cross border transactions. Hitherto, the source rule of taxation for non-residents was linked to physical presence (permanent establishment) with special rules for certain categories of intangibles and a separate equalisation levy to circumvent the rule of physical presence. In practice, these rules have led to protracted litigation, base erosion and profit shifting through truncated rights to taxation, transfer pricing and evasion in the absence of free flow of information. Recent efforts under the BEPS initiative of G-20 are only incremental. The problem has been further compounded by our network of international tax treaties which have been negotiated from a position of relative weakness. With growing disenchantment with the existing international tax order and some developed countries taking unilaterally aggressive positions, it is time for India to lead the world in establishing a "New International Tax Order" which is fair and equitable. India must assert its newly acquired economic prowess and recapture its lost taxing rights by redefining the source rules which are fair, equitable and simple to comply and administer. The present exercise to rewrite the law offers a great opportunity

to move in this direction. We have therefore, recommended that an income shall be deemed to be derived from a source in India, if the payment has been made from India. Further, in order to prevent potential abuse of this new rule, we have also recommended that a payment shall be deemed to be made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year.

7. We are conscious that the proposed new source rules complemented by our recommendation to move to a centrist position on tax treaty override from the existing extreme position of treaty supremacy, is likely to create an unwarranted cacophony and fear of diminished flow of foreign capital; we had heard of this even when India took the bold step of modifying its tax treaty with Mauritius. We have also recommended sharp reduction in corporate tax rates and beneficiary level taxation of dividends. The overall effect would be a pro-investment climate in India. We should leverage these recommendations along with our innate advantage of having a large market base. Regardless of misplaced apprehensions, India must develop its own international tax rules based on sound economic principles and "India First" policy to mobilise resources to meet the sustainable development goals.

8. Model - I is a simplified model requiring relatively low skills for compliance and administration. The key features are-

(a) in conformity with the principle of territorial taxation, the total income of a person will comprise of only income derived from a source in India; however, any income derived from a source outside India will not be included in the total income of the person;

(b) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(c) income shall be construed to have been derived from a source in India, if the payment has been made from India. However, in order to prevent potential abuse, adequate safeguards have been provided.

(d) there will be no distinction between resident and non-resident;

(e) tax shall be withheld (deducted at source) on every payment made by a person (including Government and all other exempt person) from India to any person outside India;

(f) the rate of withholding tax will be equal to the corporate tax rate.

(g) the total income shall be computed on the basis of cash system of accounting;

(h) there will be no distinction between capital and revenue, whether receipt or expenditure;

(i) there will be no distinction between debt and equity capital;

(j) full expensing of capital expenditure in the year in which it is incurred;

(k) full deduction for payment of interest and dividend;

(l) the total income shall include cash inflow, whether capital or revenue, from operational, financing and investment activities; and

(m) the total income shall exclude cash outflow, whether capital or revenue, in the course of operational, financing and investment activities.

(n) the personal income tax structure has been redesigned to eliminate all itemised personal-related deductions complemented by a liberal tax rate structure. The new rate structure shall be a two rate structure with a threshold exemption limit of Rs.6 lakhs; the total income between Rs.6 lakhs and Rs.20 lakhs will be taxed at 15 percent and income above Rs.20 lakhs will be taxed at 30 percent.

(o) A deduction upto 10 percent of gross total income or salary, as the case may be, shall be allowed in respect of contributions to the National Pension System (NPS). The savings in NPS will be subject to the EET- method of taxation.

(p) The corporate tax rates have been reduced to 5 percent in the case of financial companies and power producing companies and 15 percent in the case of all other companies. However, there will be no minimum alternate tax (MAT).

(q) Surcharge will continue at the existing rates in the case of personal income tax; in the case of corporates, it will be levied at a uniform rate of 10 percent on all companies.

(r) The foreign companies will be treated in the same manner as domestic companies.

Similarly, the key features of Model II are -

(a) a distinction will be made between a resident and a non-resident;

(b) in conformity with the principle of global taxation, the total income of a resident will comprise of his global income i.e., income derived from both a source in India and a source outside India;

(c) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(d) income shall be construed to have been derived from a source in India, if the payment has been made from India. However, in order to prevent potential abuse, adequate safeguards have been provided.

(e) tax shall be withheld (deducted at source) on every income which is construed as having been derived from a source in India under (d) above; and

(f) the total income shall be computed on the basis of accrual system of accounting;

(g) distinction between revenue and capital (both for receipt and expenditure) shall continue to be maintained;

(h) distinction between debt and equity capital will continue to be maintained;

(i) depreciation will be allowed in respect of capital expenditure; and

(j) full deduction for payment of interest will continue to be allowed; however, no deduction will be allowed for dividend pay-out.

(k) the personal income tax structure has been restructured; the new rate structure shall be a four rate structure with a threshold exemption limit at the existing level of Rs.2.5 lakhs. The total income between Rs.2.5 lakhs and Rs.5 lakhs will be taxed at the existing rate of 5 percent; income between Rs.5 lakh to Rs.10 lakhs will be taxed at 10 percent; income between Rs.10 lakh to Rs.30 lakhs will be taxed at 20 percent; and income above Rs.30 lakhs will be taxed at 30 percent. However, some itemised personal related deductions have been rationalised though not fully eliminated.

(l) A deduction upto 10 percent of gross total income or salary, as the case may be, shall be allowed in respect of contributions to the National Pension System (NPS). The savings in NPS will be subject to the EET- method of taxation.

(m) Several combinations of corporate tax rate and minimum alternate tax (MAT) have been proposed depending upon the choice of the MAT base and compliance effect. The best-case scenario is a sharp reduction in the corporate tax rate to 15 percent complemented by a MAT based on gross asset tax at 1.25 percent or a gross turnover base at 1.75 percent. However, the MAT rates will be 0.25 percent in the case of financial companies and power producing companies under both MAT bases.

(n) Surcharge will continue at the existing rates in the case of personal income tax; in the case of corporates, it will be levied at a uniform rate of 10 percent on all companies.

(o) The foreign companies will be treated in the same manner as domestic companies.

9. Economic growth is dependent, amongst others, on investment which in turn depends on cost of capital. In order to keep the cost of capital low, it is important to minimise the tax cost and eliminate the wedge between the tax cost on debt and equity. Further, the tax treatment of savings also feeds into the cost of borrowings by financial intermediaries. We have comprehensively analysed these aspects and made several recommendations relating to tax treatment of savings, financial

intermediaries and investments. On the tax treatment of savings, we have resisted the temptation to continue with the existing scheme of tax treatment of savings under section 80-C and similar other provisions of Income-tax Act, 1961. Under the existing rules, the tax treatment of savings is distortionary in as much as it distorts the return across class of savings and inequitable; they do not encourage net savings. Therefore, in Model - I we have proposed the complete elimination of such distortionary provisions in law; however, the consequent increased liability on the individual taxpayers has been suitably compensated by increasing the threshold limit. In the case of Model - II, we have continued to provide for deduction similar to those prevailing under section 80-C with the modification that the number of eligible savings products have been narrowed as a matter of rationalisation. However, in order to encourage net savings, we have recommended in both models the EET-method of treatment of savings in the National Pension System for contributions upto 10 percent of gross total income or salary, as the case may be.

10. The tax treatment of investment pooling vehicles (financial intermediaries) has also been rationalised to allow them a complete pass-thru status. Consequently, they will be bear no tax and any surplus distributed will be taxed at the level of the beneficiaries at their personal marginal rate of tax. This treatment will also facilitate the EET-method of tax savings.

11. The Task Force was extremely concerned about the high tax cost on return on equity which has potential of inhibiting investment. Similarly, the wedge in the tax cost between debt and equity has led to high leverage ratio in the corporate sector. Our recommendations on sharp reduction in corporate tax rate has the potential to substantially reduce the tax cost on equity and eliminate the bias in favour of debt. This will enable revival of private sector investment and reduce bankruptcy risk.

12. Our recommendations relating to corporate tax cuts could lead to windfall gains to investors in equity. Further, the moderate rates of personal income tax is not sufficiently progressive to contain growing inequality. Our recommendation to reintroduce wealth tax but on a comprehensive net wealth base (to include all financial and non-financial assets) is intended to attain this objective. However, in order to keep the compliance and administration cost low and prevent protracted litigation experienced under the Wealth Tax Act, 1957, the valuation of the assets will be, generally, at cost and for financial assets at cost or market price, whichever is lower. The threshold limit is proposed at Rs.10 crores to keep the middle class out of the purview of this tax. The new wealth tax will, to some extent, also fill the void created by the absence or inadequacy of property tax at the local level.

13. We have also made several recommendations to improve the effectiveness of the tax

administration. These are discussed at length in Chapter-XVIII. Briefly stated, it provides a complete legal framework for the introduction of E-assessment based on functional specialisation which will be paperless and faceless so as to enhance efficiency, effectiveness and accountability and eliminate all opportunities for rent seeking behaviour by the Department and intermediaries. This will qualitatively transform the way Department interacts with stakeholders and organises its internal processes. Similarly, the dispute resolution mechanism has been effectualised by creating a Directorate for Public Rulings mandated to issue pre-assessment clarifications to prevent litigation and provide certainty. Similarly, the existing dispute resolution panel has also been empowered to settle disputed issues. In the case of search cases, a fast track mechanism has been provided by establishing an in-house adjudicating authority which would settle such cases. Consequently, the Settlement Commission is proposed to be abolished.

14. Our recommendations to streamline the sanction system will enable the Department to take swift action against defaulters. Penalties for technical offences have generally being replaced by graded fees to be automatically levied. Similarly, any under reporting of income is proposed to be "penalised" by automatically charging additional income tax.

15. The Task Force took note of complaints against inaction by the Department on rectification applications and appeal effects. In order to ensure that these tasks are performed within the time permitted under the law or the citizen's charter, we have recommended the payment of cost to aggrieved taxpayers. This will be a direct action for improving accountability.

16. Following the enactment of the Insolvency and Bankruptcy Code, tax debts now take a back seat; they rank below unsecured creditors. It is therefore imperative to establish a mechanism within the tax law to ensure early payment of such debts. Accordingly, interest will be charged at graded rates linked to the period of default in payment of tax debts. It will achieve the twin objective of increasing the risk of protracted litigation and preventing delay in payment of tax.

17. Our recommendations relating to simplification of procedure for modification to correct for under reporting and misinterpretation will enable the Department to leverage effectively the large volume of information received by it without getting entangled in technical issues relating to reopening of assessments. This will also reduce a large number of writ petitions generally filed in various High Courts.

18. There are several other recommendations which have been dealt in the various Chapters of this report. Each of them is designed to improve the efficiency, equity and effectiveness of the tax system.

19. The draft legal frame-works for Model I and Model II are contained in Volume II and

Volume III of this Report, respectively.

20 While striving to achieve our objectives, we have tried to ensure that the overall effect of the reforms is revenue neutral; it is not an exercise for increasing revenue. The Task Force recognizes that the various changes, analysed on a standalone basis, will create losers (i.e those who are adversely impacted). However, we have endeavoured to secure that, over the medium term the impact of the entire package of changes is positive or neutral for most class of taxpayers. It is imperative to view the proposals as a package rather than individual actions on a set of people, asset classes or business transactions. Selectivity in the implementation of the proposals would jeopardise the cause of tax reforms.

CHAPTER - I

INCOME TAX IN INDIA: A HISTORICAL PERSPECTIVE

Taxation of Income from 1860 to 1886

1.1 The financial difficulties faced by the Government after 1857 led to the introduction of Income Tax in India for the very first time in 1860. The period between 1860 to 1886 was that of experimentation. Nearly 23 Direct tax Acts were passed. In 1860, a tax of 2 percent was levied on income between Rs.200 and Rs.500 and 4 percent on income above Rs.500. Persons earning income of less than Rs.200 from all sources (including agricultural income) were exempt from tax. All Government property was also exempt. The cultivators of land, the rent value of which was less than Rs.600 per annum and religious and charitable institutions were also exempt from tax.

1.2 In 1867, income tax was levied under a different nomenclature called 'licence tax', which was replaced by 'Certificate tax' in 1868 and 'General Income Tax' in 1869 and finally abolished in 1873. In 1878, a licence tax on trades and professions was introduced. Many permutations and combinations were used in the following years such as exemption of agricultural income, raising the exemption limit to Rs.500 per annum, maintaining the rate at 2 percent etc. These measures culminated into the first Act of 1886 wherein income tax legislation was drafted with the objective to augment revenues of the Government.

The 1886 Act

1.3 Act II of 1886 was the first legislation on income tax in the country. The Act contained certain features which are part of the Income Tax Act even till date. Some of the significant features of the 1886 Act included 'agricultural income' not being subject to tax, introduction of heads of income such as 'income from salaries and pensions', 'profits of companies', 'interest on securities' and 'other sources of income including income from house property'. A flat rate of 5 pies in the rupee of 192 pies (about 2.6%) was applied on income over Rs.2000 and a rate of 4 pies on 'salaries' between ₹500 and ₹2000. 'Interest on securities' was also taxed at the same rate.

1.4 In 1903, the minimum taxable income was raised to Rs.1000. The concept of enhanced rates of taxation by gradation which is akin to slab rates in the present-day Act was introduced in 1916 for different brackets of income. The first World War put pressure on Governments to garner more taxes. An additional income tax was introduced in 1917 which was called 'Super Tax'. A slab system was used for Super Tax.

1.5 In 1917, a penalty was introduced for failure to furnish returns for all assessees with an income of Rs.2000, or on assessees who were mandatorily required to file an income tax return. The Act of 1886 remained in force for 32 years until 1918.

The 1918 Act

1.6 Act VII of 1918 was a new Act and it was introduced to re-cast all of the existing tax law. The concept of 'all income if it accrues or arises or is received in British India' was introduced for the first time notwithstanding the source it was derived from. Section 2 of the Act contained definitions. The term 'company' and 'previous year' were defined. The definition of 'assessee' included Hindu Undivided Family. Section 3(2) of the Act contained a list of ten exemptions including agricultural income. Taxable income was divided into six heads viz., 'income from salaries', 'interest on securities', 'income derived from house property', 'income derived from business', 'income from professional earnings' and 'income derived from other sources'. The rates varied from 4 pies in the rupee to 12 pies in the rupee. This Act remained in effect until 1922. On the recommendations of the All India Income Tax Committee appointed in 1921, the Indian Income Tax Act XI of 1922 was introduced.

The 1922 Act

1.7 The 1922 Act marked the shifting of administration of income tax from the hands of the Provincial Government to the Central Government. The 1922 Act also saw the rates being specified in the Annual Finance Acts as opposed to being specified in the Basic Act. This Act applied to all incomes except capital gains, casual income and incomes in kind not convertible into money (except rent free accommodation). Charge in the year of assessment was established on the basis of the income of the 'previous year', instead of using the income of the previous year to make adjustments when the actual income of the assessment year was ascertained. Super Tax was incorporated into the Act and was defined as additional duty of income tax. The assessible entities were 'individual', 'HUF', 'company', 'firm' and 'other association of individual'.

1.8 The Act introduced the concept of set-off of loss from profits or gains under one head of income against profit under any other head, both relating to the same assessment year. The Act also provided relief for discontinuance of a business which was assessed under the Act of 1918. The Act of 1922 was amended 20 times between 1922 and 1939 to plug loopholes in the administration of the Act and to prevent tax avoidance and tax evasion. The rates of tax kept increasing to cater to the needs of the Government for increased revenues. By 1939, income tax occupied the second rank amongst Central taxes and contributed 20% to the Government's total

tax revenue. Increased taxes also saw introduction of deductions, allowances and reliefs. An Indian Taxation Enquiry Committee was constituted in 1924-25 to re-consider various aspects of taxation.

The 1939 Act

1.9 Act VII of 1939 was an amendment Act based on the recommendations of the Aiyer Committee Report (1936). This Committee was constituted to report on the efficiency in the administration of the Act. Based on the recommendations of the Aiyer Committee, foreign income of 'residents' in British India was brought to tax. The class of assessees between 'residents' and 'non-residents' called 'resident but not ordinarily resident' was created. An inclusive definition of 'income' was introduced which included receipts which were otherwise not taxable. 'Salary' which was taxable on 'receipt' basis was now taxable on 'due' basis. Carry forward of loss was allowed for six years. The slab system was replaced by a 'step' system of taxation. For example- income of Rs.10,000 was taxable at 5%. If the income exceeded Rs.10,000 by Rs.50, the whole income of Rs.10,050 would be taxed at the next rate of 10%. This increase of Rs.50 in the income would increase the tax payable from Rs.500 to Rs.1005. In contrast, tax under the 'slab' system rises gradually with income. The 1939 Act also introduced many provisions to check avoidance.

Income Tax in India from 1939 to 1961

1.10 The changes brought about in the 1939 Act did not prove to be very effective. The 1922 Act was amended 9 times between 1940 and 1947 and 29 times between 1939 and 1956. The system of advance tax was introduced in 1944. Differentiation between earned income and un-earned income was introduced in 1945. The scheme of provisional assessment was introduced in 1948.

1.11 Capital gains tax was imposed for the first time in 1946 which was amended many times later. In 1947, the Taxation of Income (Investigation Commission) Act, 1947, was passed giving effect to the recommendations made by the Investigation Commission. The India Income Tax (Amendment) Act, 1953 (XXV of 1953) giving effect to the recommendations made by the Investigation Commission was introduced. In April 1953, the Government appointed another Commission known as the Taxation Enquiry Commission under the chairmanship of Dr. John Mathai. The terms of reference for this Commission were wider than the 1935 Committee and 1947 Investigation Commission. This Commission looked into distribution of the burden of taxation and inequalities of income and wealth, suitability of the taxation system with reference to the development program of the country, effects of income taxation on capital formation, development

of productive enterprise and use of taxation to deal with price inflation. The Finance Act, 1955 incorporated many changes recommended by this Commission.

1.12 In January 1956, the Indian Statistical Institute invited Mr. Nicholas Kaldo to investigate the Indian Tax System to assess revenue requirement for the second five-year plan. His report concentrated on personal and business taxation. This report culminated into enactment of several taxation Acts, viz., the Wealth Tax Act, 1957, the Expenditure Tax Act, 1957 and the Gift Tax Act, 1958. Income tax on capital gains was also revived.

1.13 In 1956, the Government referred the Act to the Law Commission to re-cast the Income Tax Act in terms of logic and simplicity without affecting the basic structure. The report of the Law Commission was received by the Government on 26th September, 1958. Meanwhile, the Government appointed the Direct Tax Administration Enquiry Committee under the chairmanship of Shri Mahavir Tyagi to recommend measures to minimize inconvenience to assessees and to prevent evasion of income tax. This Committee submitted its report on 30th November, 1959. Recommendations made in these two reports led to the framing of the Income Tax Act, 1961.

The Income Tax Act, 1961

1.14 The Income Tax Bill, 1961 was submitted to the Lok Sabha on 24th April, 1961 based on the recommendations of the Direct Tax Administration Enquiry Committee and the Law Commission. On 1st May, 1961, it was referred to a Select Committee and the report was presented to the Lok Sabha on 10th August, 1961. After the bill was passed in both houses of the Parliament, it received the Presidential ascent on 13th September, 1961. The Income Tax Act of 1961 came into effect on 1st April, 1962 and replaced the Income Tax Act, 1922 that had been in effect for over 40 years. The present IT Act, 1961 has 298 sections and 4 schedules and is applicable to the whole of India including the state of Jammu & Kashmir.

1.15 Nearly every Finance Act has brought changes to the 1961 Act. Some of the changes are pursuant to the recommendations of various Committees and Commissions appointed by the Government from time to time. Committees appointed by the Government are:

i. Report on Rationalisation and Simplification of Tax Structure (Part I- April, 1967 and Part II - December, 1967), by Shri S. Bhoothalingam.
ii. The Report of the Working Group of Administrative Reforms Commission on Central Direct Taxes Administration under the chairmanship of Shri Mahavir Tyagi (1969),
iii. The Report of the Direct Taxes Enquiry Committee (1971), under the chairmanship

of Justice K. N. Wanchoo

iv. The Committee on Taxation of Agricultural Wealth and Income (1972), under the chairmanship of Dr. K.N. Raj

v. The Interim Report (1977) and final Report (1978) of the Direct Tax Laws Committee headed by Shri C. C. Chokshi,

vii. Economic Administration Reforms Commission under the chairmanship of Shri L.K. Jha (which submitted its report in 1983).

viii. Long-term Fiscal Policy, a white paper on the long term fiscal policy released by the Government on 19th December, 1985

viii. Direct Tax Laws (Amendment) Act, 1987 and 1989,

ix. A study on black money (March, 1985) by National Institute of Public Finance and Policy.

x. The Tax Reforms Committee (1991) under the chairmanship of Dr. Raja J. Chelliah (part-I in Aug., 1992 and part-II in Jan., 1993). The Raja Chelliah Committee recommended administrative reforms in both Direct and Indirect Taxes. It recommended changes to lower nominal rates and to broaden tax base.

xi. Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan (Planning Commission, May, 2001) under the chairmanship of Dr. Parthasarathi Shome.

xii Report of Task Force on Dierct Taxes (Dec, 2002) under the chairmanship of Dr. Vijay. L. Kelkar.

xiii. Report of the Task Force on Implementation of the Fiscal Responsbility and Budget Management Act, 2003 (July, 2004) under the chairmanship of Dr. Vijay. L. Kelkar.

xiv. Committee for Simplification of the Income Tax Act, (Oct, 2015) under the chairmanship of Justice (retd.) Shri R. V. Easwar.

1.16 The 1961 Act enlarged the number of categories of assessable entities to seven as compared to six under the 1922 Act to include 'every artificial juridical person' i.e. a residuary class. A scheme of self-assessment was introduced which replaced the scheme of provisional assessment. Provisions relating to payment of advance tax, interest and penalty were made more rigorous. The provisions stating the limit of 8 years for re-opening of assessment where an assessee fails to file return of income or fails to disclose all material facts was retained. The procedure for assessment from assessment year 1989-90 was completely re-cast.

1.17 The income-tax regime has witnessed several changes in both its structure and administration

since 1961. The rates of income tax as well as slabs have undergone frequent changes.

1.18 Attempts have always been made by the Government to keep the incidence of tax at a relatively low level for persons in the lower income groups. Accordingly, a minimum exemption limit has been prescribed for all individuals below which they are not subject to tax. Since 1947, exemption limits have continuously been revised upwards. At the time of introduction of IT Act, 1961, exemption limit for individuals was ₹3,000 and ₹6,000 for HUF. The concept of 'family allowance' was introduced in 1957-58 and concessions for married individuals with two or more children increased over time.

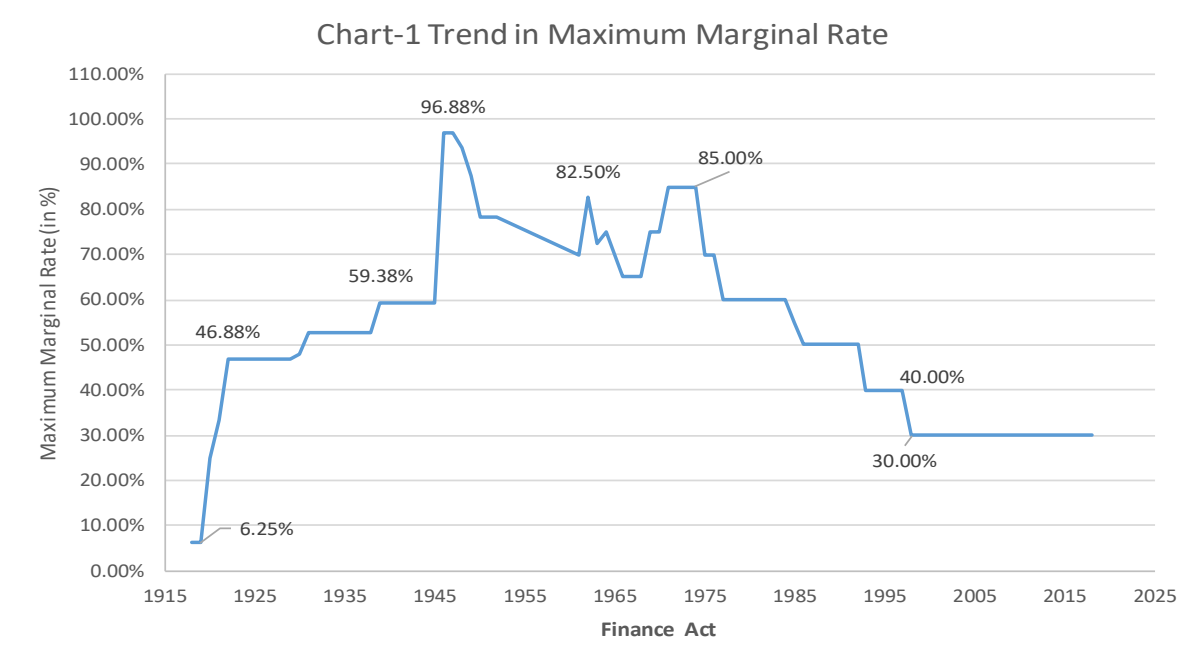
1.19 The scheme of 'personal allowance' was disallowed by Finance Act, 1970 and 'first tax free slab' which exempted income upto ₹5,000 for individuals was introduced in AY 1971-72 irrespective of the marital status of the individual. On the recommendations of the Wanchoo Committee (1971), the maximum marginal rate of income tax on individual was reduced from 97.7% in AY 1973-74 to 66% in AY 1980-81 on income exceeding ₹1 lakh.

1.20 The trend of changes in the personal income tax schedule is consistent with international trend though, of course, the maximum marginal rate is lower than the rate prevailing in comparable countries.

1.21 The trend of Maximum Marginal Rate (MMR) (exclusive of surcharge) over the last 96 years is depicted in Chart-1. The MMR was 6.25 percent in 1918-19 but rapidly increased to 46.88 percent (including Super Tax but excluding sur-charge) in 1922-23. Thereafter, it steadily increased to to 59.38 percent in 1945-46. In the year 1946-47, the rate was increased substantially to 96.88 percent and consequently declined to 65 percent in 1966-67. It again shot up to 85 percent in 1971-72 and remained at that level till 1974-75. It is widely held that this period was characterised by high tax evasion. Since then the MMR has been steadily declined to 30 percent in AY 1998-99(FY 1997-98) and has remained at that level till date. However, the surcharge has kept varying from time to time.

1.22 The trend of the minimum marginal rate has depends on the number of tax slabs; the larger the number of slabs, the lower the minimum marginal rate will be and vice versa. Overtime,the number of slabs have been reduced. In AY 1998-99, there were brought down to three to minimize the problem of "bracket creep" and have remained so since then.

1.23 The Income-tax Act, 1961 has undergone more than 2500 amendments to reflect international trends, evolution of the economy, taxpayers compliance behaviour and introduction of technology. The changes brough about by the innumerable amendments also reflect in the fluctuations in tax collection. As a result, direct tax collections (as shown in Chart-2) have increased



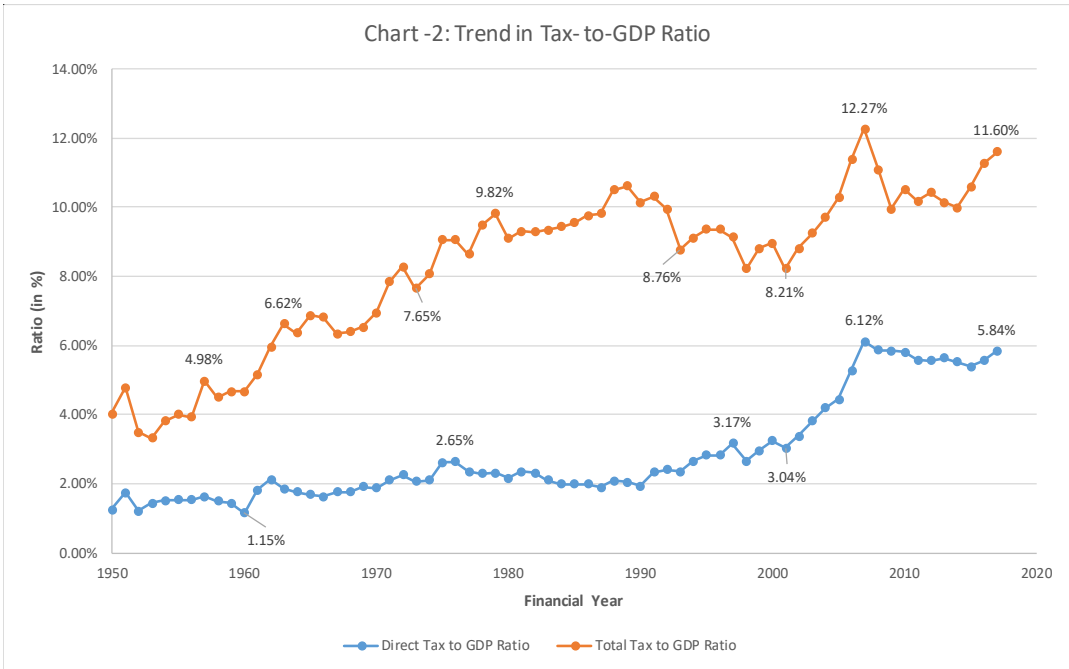
from 1.25 percent of GDP in 1950-51 to 3.04 percent in 2001-02. Soon thereafter it increased rapidly to 6.12 percent in 2007-08. Since the global financial crisis in 2008-09, it has steadily declined to 5.39 percent in 2015-16. This declining trend has been reversed and the direct tax- to- GDP ratio increased to 5.84 percent in 2017-18.

1.24 Chart-2A depicts the share of direct and indirect taxes in total tax revenues of the Central Government. The share of direct taxes declined from 43.5 percent in 1953-54 to 19.1 percent in 1990-91. With the liberlisation of Indian economy, the share of direct taxes increased to 58.9 percent in 2009-10. Since then it has declined to 50.4 percent in 2017-18. This recent decline in the share of direct taxes is primarily due to sharp increase in indirect tax on petroleum products. Overall, since the economic liberalisation, the progressivity of the Central tax system has substantially improved.

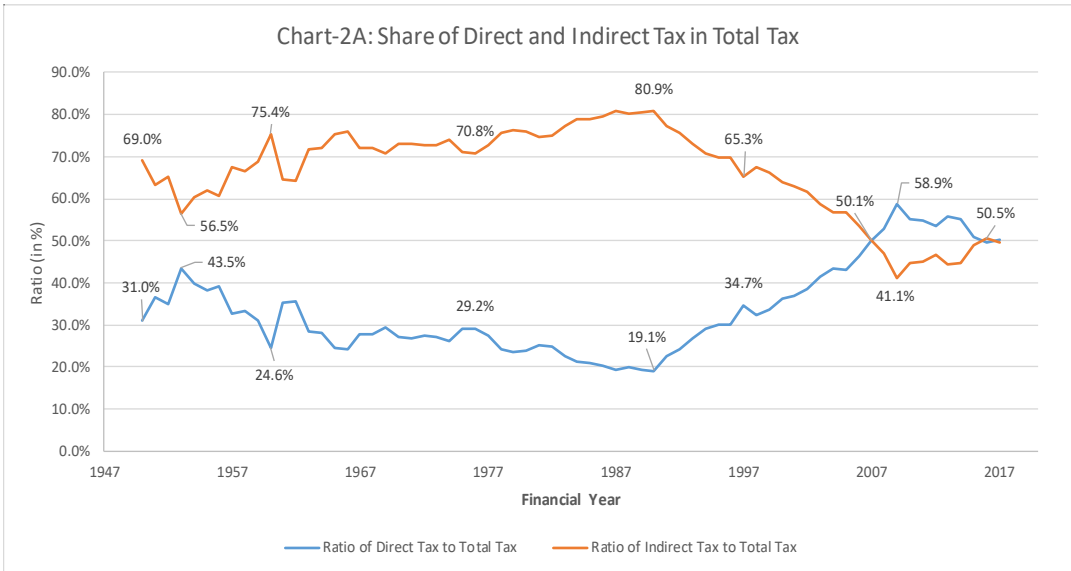
1.25 Similarly, the number of taxpayers have increased from 0.22 percent of population in 1960-61 to 1.14 percent in 1994-95. However, since then the rate of growth of the taxpayer base increased rapidly to 2.72 percent in 2002-03. Thereafter, the taxpayer base grew very slowly to 3.03 percent of the population in 2012-13. However, the growth in the taxpayer base increased rapidly to 4.97 percent in 2015-16. The recent increase in taxpayer base is attributable to data mining that helps to analyse and identify non-filers.

1.26 Over the last several decades, the philosophy underlying the tax base has also undergone changes. Starting with independence, the tax law became an instrument for promoting several socio-economic objectives of the Government in line with the prevailing international view point

and several tax incentives were introduced resulting in significant erosion of the tax base. A major fallout of this policy was prolonged large-scale litigation and increased cost of compliance and administration. With growing international disillusionment with the efficacy of tax incentives,

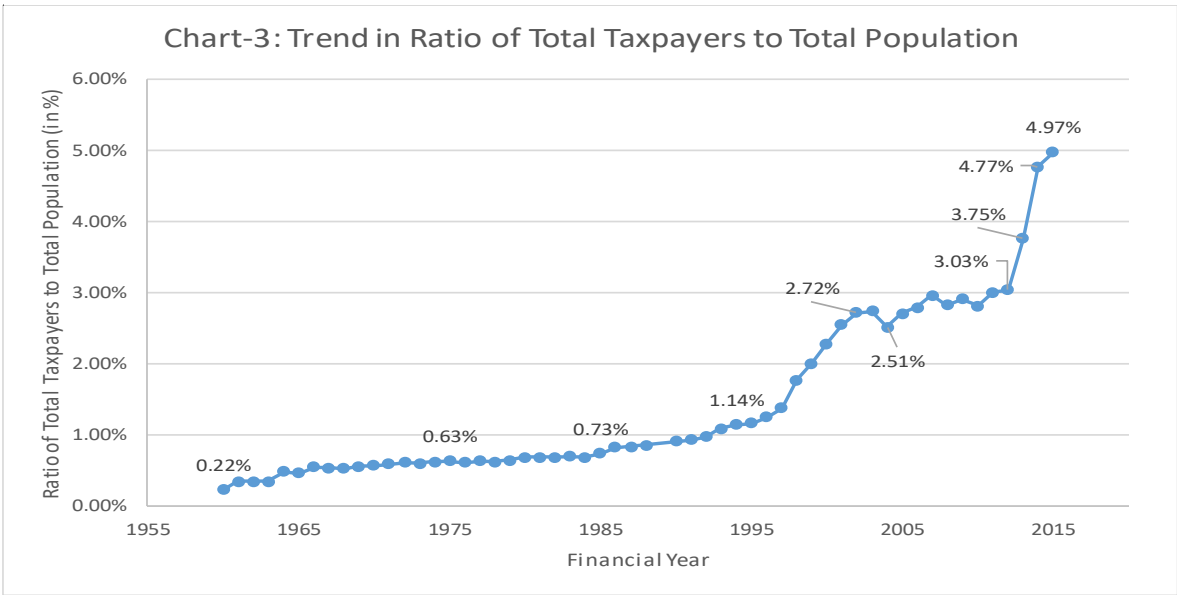


India also drew a program in 1985 for phasing out tax incentives. In 1990, most business-related tax incentives were withdrawn alongwith a cut in the corporate tax rate. However, soon thereafter, in the wake of liberalization, many of those incentives found their way back in the statute. After the enactment of the FRBM Act, 2003, there was growing support for phasing out the various tax incentives. Finally, in 2016, Government announced a program for grandfathering of all business related tax incentives alongwith a cut in the corporate tax rate. With this, the exercise to broaden the corporate tax base seems to have been completed. However, the full impact in terms of



revenue will be felt only after 2027.

1.27 One of the key changes over the last two decades has been the leveraging of technology in tax administration functions. The Department has moved from a manual administrative assessments to e-based self assessment and reporting. Today, except scrutiny assessment, all other functions are e-based. The Department has recently introduced, on a pilot basis, e-scrutiny to eliminate officer interface with taxpayers. Large-scale use of technology has helped to serve the taxpayers better



and faster and real time detection of tax evasion.

1.28 Given the profound changes in both law and administration of the income-tax over the last half a century, is it necessary to rewrite the present Income-tax Act, 1961 at the cost of stability and familiarity?

CHAPTER - II

REWRITING THE INCOME-TAX ACT

1.1 The current Income Tax Act dealing with the levy of income tax was passed in 1961 and has been amended every year through the Finance Acts often with the addition of new tax exemptions. Further, the amended legislation continues to retain many aspects of the original British drafted income tax Act of 1922.

1.2 Over the past two decades, countless amendments, deletions and additions have completely obscured the coherent structure of the *Income tax Act, 1961*. The numerous amendments have rendered the Act incomprehensible to the average tax payer. Besides, policy changes on account of the changing economic environment, increasing complexity and sophistication of commerce, development of information technology that have led to an increased need to focus on tax avoidance strategy. The problem has been further compounded by judgements (very often, conflicting) on ambiguities rendered by the courts at different levels. Tax administrators, chartered accountants and taxpayers have raised serious concern about the complex structure of the Income Tax Act. The amendments are long and have added to the complexity. Every attempt to clarify has spurned more litigation as reflected in the growing pendency at the various appellate levels and the growing volume of commentary on the subject. The clear position of law is no more discernible to trained tax administrators, ordinary citizens, practitioners or judges. The cumulative effect is that the tax jurisprudence today remains unsettled.

1.3 Any complex tax legislation increases the cost of compliance as well as administration. Given that the cost of compliance is essentially regressive in nature, this undermines the equity of the tax system. Similarly, high cost of administration is wasteful.

1.4 A well-conceived, structured, and drafted income tax statute should be based upon tax principles on all aspects of the legislation, structured so that those principles and the fundamental elements of the tax are evident and drafted in plain language so that it is simple to understand and interpret so that it can be applied predictably and with certainty. The *Income Tax Act, 1961* meets none of these criteria. Re-conceptualizing and redrafting the ordinance is not just a matter of aesthetics, it is essential if the income tax is to be a reliable, equitable and non-distortionary source of tax revenue in India.

1.5 An equally serious problem with the *Income Tax Act, 1961* is that it does not provide rules to deal with a good many of the commercial transactions that a modern economy generates. Some

of these details are perhaps the subject of internal guidelines and practices; however, in order to clarify and rationalize the law, to make it more transparent and accessible, and to ensure uniform application, more of these details should be found in the legislation and rules.

1.6 Finally, in addition to satisfying the traditional tax criteria of equity neutrality and simplicity, the increasing internationalization of domestic business, a modern income tax system should also be compatible with the prevailing international concepts and norms of taxation. Many tax concepts are in standard use across countries. As resources, such as financial capital, plant and equipment, and highly skilled labour, increasingly flow across national borders it is important to ensure that domestic tax laws are compatible with those in other countries and reflect international best practices.

1.7 In summary, the *Income Tax Act, 1961* is too complicated; the provisions are sometimes overlapping and even contradictory; it is replete with administrative discretion that undoubtedly leads to inconsistent application and opportunities for rent-seeking; its provisions are often inconsistent with basic tax principles; it has not adopted international best practices; and, it fails to deal with many common commercial transactions and thus undoubtedly allows for tax planning and avoidance opportunities that have serious revenue consequences.

1.8 Over the last three decades, the marginal tax rates for personal income tax have remained stable broadly reflecting the best international practices. However, the corporate tax rates are relatively higher than internationally comparable rates. Any further rationalization of the tax rates may not be feasible without corresponding increase in the tax base. Broadening (including deepening) of the base is important to enhance revenue productivity of the tax system and to improve horizontal equity.

1.9 The strategy for broadening the base essentially comprises of three elements. The first is to minimize exemptions. For many decades, the tax base has been eroded through a steadily escalating range of exemptions. The second element of the strategy relates to the problem of ambiguity in the law which facilitates tax avoidance. Therefore, it is necessary to amend the tax laws in the light of new trends in interpretation by the judiciary, aggressive tax planning by taxpayers, and new opportunities for reducing compliance cost through massive induction of technology and public private partnership. The third element of the strategy relates to checking of erosion of the tax base through tax evasion.

1.10 In devising an approach to tax reform, policy makers face a difficult choice between "bundling" and "sequencing" - that is, between attempting to adopt a comprehensive tax reform more or less at once, in what is sometimes referred to as a **"big bang"** approach **or** pursuing an incremental strategy or partial reform, what is often referred to as **"gradualism"**.

1.11 A comprehensive reform is defined as a change in the tax system that alters the entire structure of the system, or replaces it entirely. Tax structure includes the tax base, that is, the economic activity or benefit taxed (e.g, consumption, income, or property), as well as permitted exemptions, exclusions, deductions, and special provisions and treatment of savings and investment. Partial reform is a targeted change in details of the existing tax structure that leaves the basic structure intact. The re-introduction of tax on long term cap capital gains on sale of listed equity in the Union Budget, 2018 is an example of partial reforms

1.12 The case for a **"big bang"** approach is built on several considerations. **Firstly,** bundling reforms makes it easier to address distributional issues. There are examples of "bundled" tax reforms, involving the simultaneous adoption of multiple changes in taxes (and sometimes benefits) that will mitigate the costs of reform for that might otherwise be hard-hit by individual measures. VAT base-broadening measures, for example, increase tax to compensate poorer households through increased direct benefits. This approach was followed in Chile. Alternatively, the impact of VAT base-broadening could be offset by a reduction in PIT rates in the lowest personal income tax brackets or increases in the threshold at which PIT begins to bite. A statutory CIT rate reduction could be accompanied by an increase in taxes on capital income i.e. dividend at the personal shareholder level.

1.13 **Secondly,** bundling reforms also allows governments to allocate the benefits of reform to particular types of taxpayers, for example through indirect tax cuts. The potential to advance reform in combinations like these highlights the importance of viewing the tax system as a whole rather than considering individual taxes in isolation. In order to advance growth-oriented tax reforms, governments may also need to combine tax and benefit reforms in different areas in order to achieve a balance among the broader reform objectives of efficiency, growth, equity and revenue.

1.14 **Thirdly,** there are times when engineering a "big bang" reform may offer a far easier way forward than a more gradual approach in order to obtain sufficient support for growth-oriented tax reforms. This is particularly so in countries where many groups, agents or institutions have de facto veto power over tax policy, reforms might be delayed until the time when the distortions of the status quo hurt all groups, who then accept a "grand reform" that corrects all distortions at once. In such a situation, the strategy of bundling many reforms together becomes the only politically feasible strategy.

1.15 **Fourthly,** a "big bang" approach might prevent the formation of lobby groups powerful enough to stop the reform or to adjust the reform proposals in such a way that its main goals are no longer (or only partially) achieved. By acting quickly, governments might actually increase the

probability that efficiency enhancing tax reforms are implemented.

1.16 **Fifthly,** the **"big bang"** approach may also be preferred if the full tax reform pacakage is necessary in order to realize the long-term benefits of reform.

1.17 **Sixthly,** support for tax reform may be withdrawn if the realization of long run benefits becomes uncertain because of the apprehension that the tax reform will be stopped or reversed and therefore, one would get stuck at partial reform equilibrium. Tax reforms are not popular per se. This is particularly true in democratic socities and therefore, the planned reform sequence is often interrupted as Governments approach the end of their political cycle. There is no guarantee that it would resume in the new political cycle. In such a situation, taxpayers wait to adjust their behaviour instead of immediately anticipating the reform, in effect, taxpayers do not factor the benefits of a sequenced reform program in their business decisions until the completion of the program. In addition, it deprives countries of the stability and certainty needed to stimulate domestic enterpreneurship and to attract foreign investors.

1.18 **Seventhly**, an incremental approach runs the risk of losing focus and degenerating into ad hoc measures that do not lead to the "pro-growth"change that might be needed. A good comprehensive tax reform package is free from such risk.

1.19 **Eightly,** the comprehensive reforms of the income tax as reflected in the new tax law would require about two years before the tax reform gains become visible. Given the four- or five-year political cycle in most democratic societies, political executivies have a greater incentive to engage in tax reform if the gains will be visible by the time of the next election.

1.20 **Ninthly,** a comprehensive reform of consumption taxes is generally supplemented by a comprehensive reform of the income-tax (both personal and business taxation) to neutralize the regressivity of the consumption tax. India has recently introduced comprehensive reform of consumption taxes in the form of Goods and Servives Tax (GST) both at the Central and State level. Therefore, it is necessay to introduce similar reforms in direct taxes.

1.21 **Finally,** there is prima facie evidence to suggest that the overall performance of countries as measured by average annual inflation and growth in GDP also appear to be on average better among countries which undertook **"big-bang"** tax reforms. Similarly, foreign direct investment as per cent. of GDP is also significantly higher in such countries.

1.22 In the light of the above, a **"big- bang"** tax reform by re-writing the Income-tax Act, 1961 reform, is perferable. The case for a **"big bang"** approach is built on several considerations. Consequently, all anticipated amendments to the existing Income-tax Act could be subsumed in the new law.

1.23 In any case, a comprehensive tax reform does not necessarily rule out the necessity for incremental follow-up measres. A big-bang tax reform might create new loopholes, it might need to be corrected or amended subsequently, or it might exacerbate existing distortions that were not takled by the original reform plan. The further "fine-tuning"of the tax reform will then require incremental tax reform.

1.24 The **new tax law** will be a comprehensive exercise for reforming the direct tax system and will therefore have the benefit of taking a holistic view. To the extent the **new tax law** is designed on best international practice and sound principles of tax policy, it will provide stability and eliminate uncertainty; the need for making frequent amendments to the tax law will be eliminated.

CHAPTER - III

APPROACH TO TAX REFORM

3.1 Tax reforms is a complex economic and political process with conflicting objectives. It is, therefore, necessary identify the goals of reform and to remain on course. However, there is no single set of necessary and sufficient conditions commonly used to distinguish what is, from what is not, tax reform.

3.2 As early as Adam Smith's *The Wealth of Nations*, tax policy analysts enumerated criteria, or principles, of an economically sound tax system. Smith's list included equity and simplicity. He did not include economic efficiency as a separate principle: however, Smith's discussion makes clear that he regarded efficiency as a fundamental principle of sound taxation. Thus, some tax policy define tax reform as a change in the tax system designed to improve ***equity***, ***economic efficiency***, and ***simplicity***.

3.3 Two fundamental principles govern most tax analysts' discussions of **equity**. These are, first, the benefits principle, and second, the ability-to-pay principle. When the benefits principle is applied, citizens pay taxes according to identifiable benefits each receives from government services. This can work for a small set of specific services, such as transportation. The benefits principle cannot be implemented where individual benefits are hard to identify, such as in the cases of criminal courts and prisons. The ability-to-pay principle is applicable in the hard-to-identify cases. When the ability-to-pay principle is applied, citizens who have equal abilities are taxed equally, ('horizontal equity'), and citizens with higher abilities are taxed relatively heavily ('vertical equity').

3.4 **Economic Efficiency** is the least intuitive principle of taxation, and usually requires some explanation. It is best understood by considering its opposite, inefficiency. Inefficiency occurs when taxes alter taxpayer choices, reducing economic value. For example, colonial England imposed a tax on windows. Afterward, the English built houses with fewer windows. Houses with fewer windows have lower value. The decrease in economic value is a "deadweight loss;" that is, a cost to some taxpayers not offset by benefits to anyone. It has been likened to burning money. Tax inefficiency occurs because taxes provide incentives for taxpayers to spend time and other scarce resources to avoid taxes, rather than in production and consumption. For example, a sufficiently high payroll tax could discourage work effort or may encourage payment to professionals expert at shifting salary into tax shelters. A relatively efficient tax system would reduce deadweight tax losses to the minimum amount consistent with achievement of the other principles.

3.5 **Simplicity** means ease in compliance with, and administration of, the rules governing taxation. Since taxes are transfers and per se do not add economic value, the cost of compliance and administration should be minimised.

3.6 The Tax Reform Act of 1986 in the USA is often cited as an example of systematic tax reform. It was **designed** to improve equity, reduce inefficiency, and simplify the federal tax system. It was **not designed** to encourage economic growth, cut taxes, change the system for the sake of change, or increase or decrease the level of revenue (in fact, it was designed to be revenue neutral).

3.7 Overtime, several other principles of sound tax policy that guide tax reform have been added. Revenue sufficiency is an additional principle that is fundamental in a well designed tax system. A tax system which yields sufficient revenues grows with the economy in the long run. Sufficiency of revenues is fundamental because none of the other economic goals of reform is likely to be achieved if the tax system does not provide sufficient revenue to meet government funding requirements. If tax revenues are insufficient, the Government budget will experience periodic or persistent financial crises. During financial crises, the need to balance the budget drives implementation of distortionay taxes. Measures are introduced sweeping aside other goals of an efficient tax system. Further, in a federal structure, when revenues are shared with sub-national governments, it is extremely important to generate sufficient revenues at the federal level to sustain spending programs at the lower level.

3.8 Promoting the competitiveness of a country's industries and labour force are additional issues related to tax reform. A competitive revenue system promotes long-run economic development, job creation, and growth.

3.9 Therefore, tax reform is change that drives equity, economic efficiency, sufficiency and competitiveness of economies that consequently advance federalism.

3.10 Unfortunately, no single tax base can achieve all these goals simultaneously: A tax reform that moves the system closer to one goal often moves it away from others. For example, shifting from an income tax base to a consumption tax base would increase economic efficiency, because the former tends to discourage savings and investment and the latter does not. However, shifting from an income to a consumption tax base could reduce equity because consumption taxes tend to be regressive. There lies a dilemma.

3.11 There is at least one way out of this dilemma, broadening the tax base and reducing tax rates. Everything else constant, lower tax rates are relatively efficient. Financing rate reduction by broadening the tax base could improve fairness by reducing tax discrimination against some activities,

and by increasing progressivity. For example, eliminating some itemized income tax deductions would broaden the income tax base, allowing revenue to be raised at lower tax rates. At the same time, progressivity would be increased because relatively well off taxpayers tend to benefit most from itemized deductions.

3.12 The fact that some changes improve performance in one dimension while reducing it in others suggests that the principles should be applied to the tax *system* as a whole, not to each part separately. For example, if there is any single change in the tax system that would impair a favored principle, seemingly there should be no room for compromise. However, it is possible to move the overall *tax system* closer to both goals at once by trading off movements toward goals. For example, broadening the GST base would tend to improve efficiency, but might reduce progressivity. Similarly, increasing the income tax's threshold deduction would make the system more progressive, but would necessitate higher tax rates (to achieve a given level of revenue) reducing efficiency. Neither of these reforms by itself is capable of making the tax system more equitable and efficient. However, by carefully calibrating the two reforms simultaneously the *system* could be made more equitable and efficient.

3.13 Ability-to-pay is often held as the appropriate basis for equitable taxation. Taxation according to ability-to-pay sets two standards. Horizontal equity holds that citizens with equal resources should be taxed equally. Vertical equity holds that citizens with relatively greater economic resources should be taxed relatively more heavily. Almost all stakeholders and analysts agree about what horizontal equity requires. However, there appears to be a thorough lack of consensus on what vertical equity requires.

3.14 Tax administration is of paramount importance to those who are concerned with the key role that increased tax yields can play in restoring macro-economic balance and to those concerned with the tax policy and its impact on the economy. Tax administration has, indeed, a great impact in determining the effectiveness of a tax system. Not surprisingly, tax experts believe "tax administration is tax policy". Tax policy without good tax administration is futile. If the actual implementation is different from what the law intended to achieve, tax policy will lead to distortions in the economy and reduced revenue yields. Strengthening tax administration is thus critical to the successful implementation of the whole tax system. In practice, tax reform should address the issue of tax administration and tax structure simultaneously as they are dependent on each other.

3.15 There are certain prerequisities for successful tax administration reform. These are (a) simplification of the tax policy or system; and (b) committment at both the policymaking and managerial level. One of the main factors towards a weak administration is the complexity of tax

laws and the burden this places on the limited enforement capacity of most tax administrations in developing countries. The complexity of the tax laws leads to non-compliance by the taxpayers. A complex tax law makes compliance more difficult for taxpayers who want to comply and easier for those who want to evade; in either case, it leads to non-compliance and erosion of the tax base. In addition, complex laws increase the cost of compliance; there is empirical evidance to suggest that itemized deductions as opposed to standard deductions lead to higher compliance cost. Similarly, complex tax laws also increase the burden of tax administration by increasing the cost of auditing and litigation. Therefore, simplifying the tax law is crucial and a pre-requisite to make tax administration more effective and efficient.

3.16 A simple law is one that is easy to comply and also relatively difficult to evade or avoid. The most successful law will be one where these two properties coincide in a single law. In either case, it is the underlying substantive law of taxpayer obligations that must be designed so as to make compliance easy and non- compliance difficult. The first and most obvious technique of filling both criteria is to reduce the total number of people who must make tax calculations, file returns, or pay money to the government. For administration of an income tax, for example, it can mean exempting people below a certain income level from paying the tax and having as much tax as possible collected through a withholding system or pay-as-you-earn (PAYE) system. Withholding and PAYE form one of the central aspects of the administration of any income tax system. They can reduce significantly the actions that must be taken by taxpayers and reduce the number of persons who must ultimately file tax declarations. This is in effect a reduction in the cost of compliance for those taxpayers who have their obligations fulfilled, or intermediated, by others. Success is reflected in less work for the individual taxpayer and a reduction in the total number of individual taxpayer declarations that need to be filed.

3.17 A simple tax law may fulfil the twin requirements of being easy to obey and hard to disobey because it both allows the taxpayer, or taxpayer intermediary, to know more easily what is expected of him or her and also reduces its manipulability, thereby reducing the possibilities of tax avoidance. Complexity, and the chance to avoid tax obligations, can come from a number of sources. Inconsistency within the coverage of the law certainly can be one. Exceptions or special rules that provide for reduced obligations in certain circumstances not only add complexity, but they also create an incentive for taxpayers to try and fit into those circumstances. The converse is also true: the more special circumstances where taxpayers have increased obligations, the more those circumstances will be avoided.

3.18 Committment at both the policy making and managerial level is another prerequisite of tax administration reform; even the simplest tax law and the best reform strategy are doomed to failure

if there is lack of political will, to implement it. It is equally important that there are champions of tax reform within the tax administration take ownership of the reform program and ensure its successful implementation. Political will complemented by bureaucratic ownership is a necessary prerequisite for tax reform.

3.19 Strong revenue performance is a core ultimate objective, but a single-minded pursuit of revenue can be deeply counter-productive. The total amount of tax (and non-tax) revenue is the primary concern in meeting infrastructure, social and other spending needs. Strict pursuit of ill-conceived short-term revenue targets, however, is a common source of bad practice (in, for instance, the denial of refunds, or harassing taxpayers to enforce collections even though, in principle, they may not be due). This damages economic activity and feeds a vicious cycle of mistrust between taxpayer and tax authorities.

3.20 It is not just how much revenue is raised, but how it is raised that matters, for growth. Focus on revenue can help to promote structural reforms in some cases that can set the stage for well-designed and revenue-enhancing improvements in the medium term. There is fairly strong evidence, for example, that some forms of taxation (such as tariffs) are less supportive of growth than others (such as property taxes and VAT), though details are important within these broad categories (in the design, for instance of the corporate income tax). Conversely, revenue is often foregone in low-income countries by offering tax incentives that may have little impact in attracting investment or growth. In terms of implementation too, burdensome procedures (such as requiring unnecessary documentation or inordinate judicial delay) can act as significant obstacles to business and can undermine compliance.

3.21 Strengthening tax systems is also key to achieving equity objectives and enhancing state building-with strong links to the expenditure side. This is not only, or even mainly, a matter of taxation: most distributional objectives, especially in developing countries, are likely to be best achieved on the spending side. Moreover, the perception that the better off are not paying a reasonable amount or - often no less damaging - that some are escaping tax while others who are similarly positioned, perhaps competitors, are not, can undermine broader trust in and compliance with the tax system. Key to building that trust in the tax system, and hence the wider legitimacy of the state, is establishing a clear and credible link between the revenue that is raised and the services it finances, an area in which a number of countries are making greater effort. Too often, weak tax systems have undermined state building: governments do not trust taxpayers to behave honestly, and taxpayers have little incentive to do so-which prove self-fulfilling prophecies. Reversing this vicious cycle by strengthening tax capacity can be critical to improving governance and accountability, by fostering a shared interest of government and citizen in economic growth and encouraging the development

of respected revenue administrations that can spur improvements in other aspects of state capacity, and engaging taxpayer-citizens in politics.

3.22 International tax reforms are integral to domestic tax system development. The international tax landscape is changing rapidly, presenting developing countries with both challenges and opportunities in dealing with tax avoidance and evasion. The current drive to address Base Erosion and Profit Shifting (BEPS) and to exchange information for tax purposes between tax sovereignties are welcome efforts. They can help provide developing countries with the tools to address these international tax challenges, but only if they are integrated as part of the domestic tax system reform. Developing countries can benefit significantly from these advances. Importantly, however, ensuring that they do is not only a matter of capacity development, but of ensuring that the emerging international rules are appropriate for their circumstances and priorities.

3.23 A range of actors in the enabling environment determine the prospects for successful reform; their actions and interactions determine the design and performance of national tax systems. Non-governmental actors, including tax advisers, civil society, business and the media play key roles. Involvement of these stakeholders is critical, particularly if excluded groups can act as blockers. In addition, 'weakest link' dynamics among a wider set of stakeholders may hold back reforms. The justice system, for example, may be unable to process tax disputes in a timely and impartial manner. Ensuring adequate tax compliance is not solely the responsibility of the tax administration; all supporting institutions like legislature, judiciary, banks and financial institutions, civil society, professional bodies, other enforcement agencies and all other branches of the executive must necessarily collaborate in eleminating tax evasion and creating a large and stable fiscal space for economic development.

3.24 Tax administrations face significant human resource and skills challenges. In many low income countries, for instance, large numbers of staff are employed on very low-yielding activities, effectively taking part of their remuneration in corrupt payments-all of which can itself become an obstacle to constructive reforms (such as simplification of complex small business regimes). Developing and retaining necessary specialist skills is a major challenge, and not just within the revenue authority. Skills may also need to be developed outside government, not only among tax professionals, but also, for instance, in the judiciary. Further, the availablity, or the lack of it, of skill in the country should be an important input in the designing of the tax law and procedure.

3.25 Numerous studies have empirically substantiated that countries with high levels of corruption tend to have lower tax ratios. It is estimated that a one-point rise in a corruption index (on a scale of 1 to 10) results in a 1.5 percentage point fall in the revenue ratio (total public recurrent revenues

to GDP), a 2.7 point drop in the tax ratio, and a decline of 0.63% of GDP in personal income taxes collected. Further, in comparison to developed countries, corruption has a greater impact on direct taxes in developing countries. Taking into account the predominance of indirect to direct taxation in the latter, a four-point decrease in corruption would significantly increase the direct to indirect tax ratio. Similarly, in the case of sub-Saharan countries also, a negative statistical association was found between increased corruption and the tax ratio. These findings, and the notable divergences between statutory and effective tax rate, are indicative that tax ratios can be raised by strengthening the tax administration process.

3.26 A lower tax ratio leads to sub-optimal levels of public spending, distorted allocation of public resources, (due to corruption on the expenditure side of the budget), higher fiscal deficits, and lower growth rates. Fiscal corruption solely from the revenue/tax side of the public budget generates a tax gap and reduce tax system neutrality and progressivity. Therefore, reducing corruption in tax collection activities to enhance public revenues, should be one of the key objectives of the tax administration. Forging an anti-corruption tax strategy is imperative.

3.27 Based on the various issues relating to tax reform discussed in the foregoing paragraphs, our primary objective of re-writing the tax law is to reform the direct taxes so as to-

(i) improve efficiency of the income tax, both personal and corporate, by-
  (a) reducing or rationalizing the rates;
  (b) eliminating tax led distortion in treatment of savings, investment and financial intermediaries; and
  (c) treating non-natural persons as pass-thru entities;
(ii) enhance equity by eliminating the various exemptions, deductions and incentives;
(iii) enhance equity through increased effectiveness of the tax administration in preventing tax evasion;
(iv) ensure that laws and regulations are reasonably simple and coherent; the law need to be written in the "language" of the people - the citizens and tax administration personnel.
(v) facilitate compliance by introduction of end-to-end electronic-based interface with the tax administration; and
(vi) eliminate discretionary powers by restructuring the penalties and sanctions against non-compliance; and
(vii) remove ambiguity in law to minimize litigation and judicial abuse.
(viii) implement policies and procedures that limit opportunities for rent seeking and help identify and punish inappropriate behavior in the revenue administration.

3.28 Ad-hoc tax policies that have fragmented objectives and dispersed policy aims can create incentives and opportunities for noncompliance and constrain improvement in tax administration. An inadequate legal framework creates uncertainties for taxpayers and does not properly balance tax administration's powers and taxpayers' rights. Lack of harmonization among these tax system components leads to poor revenue performance (high evasion and avoidance), higher collection cost, opportunistic behavior (frivolous disputes, harassment…), lack of integrity, and other adverse effects. A holistic approach to reforming the tax system should be an overarching objective.

CHAPTER - IV
SCOPE OF TOTAL INCOME

Residence based taxation versus source based taxation

4.1 The principle of taxation requires that all people and firms should contribute towards the public services provided for them by the country where they live, on all their income whereever it comes from. This forms the underlying basis of the principle of residence-based taxation of income.

4.2 The principle of residence-based taxation asserts that natural persons or individuals are taxable in the country or tax jurisdiction in which they establish their residence or domicile, regardless of the source of income. In the case of non-natural persons such as companies or firms, the place of incorporation or the place where control or management is exercised is deemed to be the place of residence. In the context of income tax, the ability to pay of the residents of that country is fully measured by their global income. Therefore, the principle of residence-based taxation of income envisages the taxation of global income. Key reasons for taxing the foreign source income of residents are to achieve horizontal and vertical equity goals and to improve the tax neutrality of investment decisions (efficiency).

4.3 However, there are individuals/entities whose "residence" is in one country but their business is actually carried on in another country and their income is earned in the latter country. In such cases, the principle of residence-based taxation would be inappropriate. This would be especially so in developing countries which attract substantial foreign investments. Therefore, there is a view that the country which provides the opportunity and facilities to generate income or profits should also have the right to tax the same (standard benefits rationale). This forms the underlying basis of the principle of source-based taxation of income. This principle is invariably applied to non-residents in a country and envisages the taxation of only such income which is sourced in that country.

4.4 The justification for source-based rule is also articulated on the basis of "market access" theory in which taxation is viewed as a sort of price (tax) charged to non-resident taxpayers for entering the source jurisdiction's market (benefit). The chief merit of this sort of theory (over a more standard benefits rationale) is that it is supposed to give an answer to the criticism that the actual source base does not in any realistic way measure benefits conferred. Under market access,

one would apply the logic of revealed preference, common in economics regarding the determination of individual preference structure. That is, if taxapayers enter the market, then the "price" (in terms of tax) must have been set at a tolerable level. In other words, if the tax was not commensurate with the benefit (profit), the non-resident taxpayer would not enter the market.

4.5 Another justification for source based taxation is based on the 'ethical conception of sovereignity" view or the "force majeure" view. Under the former view, a country has the *legal right* to tax income that arises within their sovereign borders. Under the later view, a country has the right to tax any income simply because it has the *raw power* to do so, not because such right is legitimized under some legal determination. Placing the "source" label on income amounts to nothing more than an assertion of this power.

4.6 Conceptually, a country may adopt either pure residence based taxation or pure source based taxation. Theoretically one can imagine a world in which all countries adopted either pure residence jurisdiction or pure source jurisdiction. However, *pure residence based taxation is unrealistic* for three reasons. First, countries are unlikely to give up the right to collect tax from foreigners doing business within their economy and territory. Second, this system would reduce revenues in developing countries, who rely heavily on source-based taxation, in favour of developed countries where investors reside. Most importantly, residence taxation is much easier to evade or avoid by channeling international investment through tax havens.

4.7 Pure source based taxation is an option that has been favoured by some experts. However, the *major problem with this option* is that it enables foreign investors to play one country against another or others in order to obtain the lowest source based tax rate. This leads to aggressive tax competition (race to the bottom) resulting in erosion of revenue base. In addition, the problems of determining the source of income and of unraveling aggressive transfer pricing that leads to suppression of income would become much more acute in a world of pure source based taxation.

4.8 It would be helpful to compare the residence principle and the source principle. The basis for the residence principle (no matter how one defines residence) is that the existence of some requisite threshold political allegiance between a *taxpayer* and *a state* justifies the state's right to tax that individual. However, in the case of source principle, the political connection between taxpayer and the state does not exist; what exists is an economic allegiance. Further, it is argued that source-based tax is in conflict with the residence-based view (no matter how it is defined) that income taxation should be based on ability-to-pay principle (reflecting progressivity) rather than a benefits principle. Ability to pay should be based on a taxpayer's comprehensive income, not on portions of a taxpayer's income that have been subdivided based on source. The splitting of income into

different jurisdictional pots can be justified if the income tax is based on the benefits principle. Since the benefits principle undermines vertical equity, it violates the principle of ability to pay. Further, the benefits are difficult to measure. Therefore, the benefits-based justifications for income taxes have largely been rejected. However, these arguments against the source rule does not hold good closer scrutiny. In spite of the problems involved with the benefits principle, the source-based rule is widely accepted and practiced across countries thereby according legitimacy to the benefits rationale.

4.9 Among the legal provisions which govern international income, consistent treatment exists on at least one issue: no country which levies an income tax (and very few do not fail into this category today) forgeos taxing income sourced within its jurisdiction. Irrespective of who has derived it. Legislation differs extensively with regards to the definition of domestic source income. But there is no hesitation or dispute with regard to the principle that domestic source income, as far as it is taxable at all, shall be taxable whether derived by foreigners or by nationals.

4.10 In contrast, foreign source income is not taxed unanimously. Most countries, certainly, tax resident individuals and corporations with respect to their worldwide income and some, as has been mentioned, even tax the world wide income of citizens as well. This rule, however, is subject to a number of exceptions and qualifications. Among which the following are most important:

4.11 First, some countries confine themselves to levying income tax strictly on a territorial basis. i.e. they tax domestic source income only and do not tax foreign income at all. Countries falling into this category include Argentina, Hong Kong, Sambia, and Uruguay. In addition, Brazil and France tax only domestic source income of corporation; in both of these countries only individuals are subject to income taxation on a worldwide basis.

4.12 Second, according to the tax law of some countries certain classes of foreign income are exempt from domestic taxation. Thus, Switzerland does not tax foreign business income derived through foreign-based permanent establishments, or income from foreign real property.

4.13 Under Australian law, foreign income other than dividends, interests and royalties is tax-free, provided that it is taxable in the country where it arises. Subject to the same conditions, Dutch law exempts income from foreign permanent establishments, dividends received, and certain other items of foreign income. In Germany, parent companies with subsidiaries in developing countries can claim a credit for the amount of tax which would have been due on the dividends if the subsidiary were German; in practice this is equivalent to exempting the dividends from the parent corporation's tax. To the extent the income tax rates are progressive, however, these countries normally provide that the exempt income continues to apply in computing the tax rates (so-called

'exemption with progression'). This prevents taxpayers from avoiding the effect of the progressive rate structure by shifting investments – and consequently profits – to other countries.

4.14 Third many countries exempt foreign income under double taxation treaties. This was the primary method suggested by the treaty model of the League of Nations and it is the method which continental European countries traditionally have employed since that time. Today the OECD and UN model treaties provide for either exemption and/or foreign tax credit as two alternative methods for the avoidance of double taxation. Neither method, however, applies exclusively under the model treaties. If the exemption method applies in general, double taxation of dividends and interest is avoided under both models through a credit mechanism, and if the credit method applies in general, some distributive rules, as a consequence of a specific language used in the models, exempt certain types of foreign income. This is true even for double taxation treaties concluded by the United States.

4.15 These examples may suffice to show that different countries at different times have been inclined to confine taxation to income produced within their respective territories. The doctrine against worldwide taxation, finds evidence in some of there discussions and consequent actions adopted by the Government. Views on taxation of income, as far as they continue to be relevant today, can be traced back to two German authors of the late 19th century, Adolph Wanger and Georg Von Schanz. Wagner has been the most influential author on income taxation and covered the entire range of issues in his treatises. Schanz, on the other hand, is the original author of the concept of comprehensive income adopted across countries.

To Wagner, worldwide income taxation is a consequence of the postulate that taxes should be general, i.e. that they should cover all types of income equally. Because he did not view foreign investment as particularly desirable, Wagner did not consider the problem of double taxation to be of much importance, Moreover, double taxation was not a problem of justice for Wagner, but only one of expedience. These views reflect a tendency towards isolationism and national egoism which was prevalent during the time Wagner was writing. The economic interest of a State was thought at that time to be best secured through self- sufficiency. However, in the era of globalization, they certainly do not provide a convincing basis for international tax policy decisions.

4.16 Schanz, on the other hand, is the original author of the concept of comprehensive income adopted across countries. Schanz set out his ideas in an article 'Zur Frage der Steuerpflicht' (Regarding Tax Liability) published in 1892. He discards residence, nationality or mere physical presence in a territory as the basic criterion for establishing income tax liability since all of these criteria lead to taxing people who get no benefit or at best derive only a partial benefit from a country's activities.

Thus, a burden would be imposed on them to the advantage of those who get the full benefit of the country's activities and this, Schanz argues, would be unfair. A combination of criteria, on the other hand, would not guarantee a clear limitation of taxing powers and could result in oppressive double taxation. According to Schanz, there is only one principle, which if consistently applied could avoid such negative results and would entail a fair and equitable distribution of tax burdens. Schanz refers to this principle as taxation according to 'economic allegiance'.

4.17 Economic allegiance to a state can be based on mere consumption or it can be based on business activities including investment activities. To the extent economic allegiance is founded on consumption, residence would constitute a suitable criterion; world-wide income would be taxed in the country of residence where all the consumption (present and future) would take place. However, if a person is economically bound not only to the country of his residence, but also to another country through business activities or by way of income arising in the other country, Schanz considers the allegiance to this other country, the source country, to be more important than that to the country of residence. He argues that the country of residence to which the taxpayer is connected through consumption should get its share, but it should get less than the source state where the income is produced. Consequently, Schanz recommends a division of the tax base. According to him, three-fourths of the income in question should be taxed in the country of source, and one-fourth in the country of residence. In other words, the source country should levy three-fourth of the tax that it would ordinarily levy on residents and the country of residence should levy one-fourth of the tax it would ordinarily levy on the domestic source income of non-residents.

4.18 Schanz observations on international taxation were as original and important as his discussion of the concept of income. They deserved to receive more consideration and should have had greater influence. All that has remained from his suggestions is the term 'economic allegiance', which is applied today as a blanket term by everyone to his or her convenience. The four economists appointed by the League of Nations in 1921 to prepare a report on questions of double taxation in their report delivered in 1923 gave primacy to "economic allegiance" rather than "physical location" and made it clear that physical presence was important only to the extent it represented the economic location. They observed that *"Physical situs is one thing; origin or economic location is quite another thing; they do not necessarily coincide. physical situs is of importance in economic allegiance only to the extent that it reinforces economic location"*. Even though the Economists adopted the term, their conclusions and recommendations were practically opposite of those Schanz had proposed. The Economists suggested that countries reciprocally exempt nonresidents from income taxation so that only taxation by the country of residence would prevail. However, the reasonings for their recommendations were not politically acceptable. Consequently, the task of further development of international tax

policy was transferred to technical experts.

4.19 The technical experts considered worldwide taxation as a matter of practical expedience and not a matter of principle. The technical experts, being administrative practitioners, were not particularly inclined to curtail country's revenues by rejecting a mode of taxation which at that time had been accepted by all countries applying a more sophisticated income tax. Their practical approach is made very clear by Herbert Dorn, who was head of Germany's technical experts. Dorn modified the term introduced by Schanz to 'State economic allegiance'. Through this modification Dorn sought to add the practical aspects of a state's ability to determine, control and enforce taxation, which in his view were as important as the aspect of economic connection. 4.20 Dorn's position considerably influenced subsequent German authors. But the two most prominent German scholars writing in the field of international taxation at that time, Armin Spitaler and Ottmar Buhler, returned to a more systematic argumentation. They emphasized that the character of income tax was that of a tax on global income, and consequently they considered exemption of any item, even of foreign source income, to contradict the basic premise of an income tax. In this regard, they reverted in part to Adolph Wagner's position. In the early 1950's, Professors Richard and Peggy Musgrave, basically, provided the same argument as extended in the equity reasoning of residence based taxation. This was combined with their new arguments relating to economic rationality to justify the case for residence based taxation.

4.21 Following the recommendation of the technical experts, the Leagues of Nations and its successors the United Nations and the OECD developed a series of model treaties that led to a set of over 2500 bilateral income tax treaties, which provides the framework of the international tax regime. Fundamentally, the treaties strike a compromise between source and residence taxation. Some rights to tax are given to the source, and the residence country is required to relieve double taxation either by giving a credit for such source taxes paid, or by exempting the relevant income from its taxes. Generally, source jurisdictions retain their right to tax active (business) income, except for short-term activities, but give up some of their right to tax passive (investment) income.

So, the source country has the right to tax the business profits attributable to a branch of a foreign company (defined as a permanenet establishment), as well as the profits of a foreign-owned company (subsidiary). In exchange, the source country agrees to apply no, or only a low, tax at source (described as a 'withholding' tax) on payments to residents of the other country, such as interest on loans, dividends on shares, or royalties on intellectual property. Thus, the main effect of the tax treaties is to reduce source-based taxation in favour of residence-based taxation of passive income (sometimes referred to as income from capital). The degree to which this is done depends on each treaty:

capital exporting richer countries prefer the OECD Model treaty, which is more favourable to residence based taxation, while capital-importing developing countries tend to favour the UN Model treaty, which is more favourable to source.

4.22 As per the allocation of taxing rule under Article 7 of OECD Model or UN model , business Profits of an enterprise is taxable in the country in which the taxpayer is a tax resident. The other country may also tax the business profits if the enterprise carries on its business in the other country through a 'Permanent Establishment' situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the 'Permanent Establishment' may be taxed in that other State. The 'Permanent Establishment' means a 'fixed place of business' through which the business of an enterprise is wholly or partly carried out provided that the business activities are not of preparatory or auxiliary nature and such business activities are not carried out by a dependent agent. For a long time, nexus based on physical presence was in use as a proxy to regular economic allegiance of a non-resident. The physical presence based PE rule continued meeting the needs of the economy to the extent the latter remained mostly physical.

4.23 Traditionally, international trade flows essentially comprised of trade in goods, and to a limited extent trade in intellectual property and technical services and foreign investment. The international trade in goods (or acquiring market access) could be conducted only by establishing a physical presence by way of a PE or through a dependent agent. Therefore, PE reflected the reality of the way in which business needed to be conducted in the end of the 19th century. The treatment of PE as a threshold for "economic allegience" was justifiable; it did not result in any significant erosion of the tax base of the country in which the consumption took place. The taxation of investment income, royalty and fees for technical services was also source-based. Consequently, in substance, most part of international trade in goods, services and investment was taxed on the basis of the source rule and residence based taxation was practised only to capture additional revenues from higher tax rate in the home country. However, the advancement in information and communication technology in the last few decades has changed the business models to operate remotely in a digital medium where the non-resident enterprises interact with the customers of another country without having physical presence in that country resulting in avoidance of taxation in the source country. Therefore, the rising count of businesses in a digital economy, the existing nexus rule based on physical presence is no longer adequate for taxation of business profits in a source country. As a result, the rights of the source country to tax business profits that are derived from its economy is unfairly and unreasonably restricted.

4.24 OECD under its BEPS Action plan 1 addresses tax challenges in a digital economy. The

approach of OECD was twofold i.e. BEPS related issues in a digital economy which allow for business arrangments that enable tax evasion and the "broader tax challenges of a digital economy" that relate to the non-applicability of physical presence based nexus rules ambiguities in characterization of income and the contribution in the value creation process of user data. On broader issues, OECD's interim report on Action 1 has not suggested a clear framework. However, it suggests several options to tackle the direct tax challenges arising in digital businesses such as introduction of a new nexus rule based on significant economic presence, a final withholding tax or an equalization levy.

4.25 The BEPS Action plan 1 report has dealt extensively with the option of a new nexus based on significance economic presence to tackle the taxation of business profits in a digital economy. As per the report a non-resident enterprise would create a taxable presence in a country if it has a significant economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools. It also mentions that revenue alongwith the aforementioned factors could provide threshhold to determine significance economic presence.

4.26 Over the years, there have been two significant changes in the field of taxation which has the effect of enhancing the efficiency and equity of the source rule: (i) sharp reduction in corporate and personal income tax rates across jurisdictions; and (ii) a trend towards convergence of tax rates across jurisdictions. The cumulative effect of these changes is a reduction in the opportunity for tax arbitrage in cross-border transactions resulting in minimizing the efficiency and equity gaps between the two systems. No useful purpose would be served by including the foreign income for domestic tax purposes and then allowing foreign tax credit without any additional revenue gain on account of convergence in tax rates; it would only result in higher deadweight loss through increased compliance and administrative cost. Further, the apprehension regarding more aggressive transfer pricing under the source-based taxation also appears to be exaggerated with reduction and convergence of tax rates. In any case, the source rule can be defined in a manner which can substantially reduce this unhealthy practice. Consequently, both the efficiency and equity gains in favour of source based taxation now makes it a relatively favoured option. It is therefore, not surprising that the world is now gradually moving to a source based taxation to prevent erosion of the tax base. The recognition of the concept of significant economic presence, the introduction of equalization levy to circumvent the threshold of PE, advancement in global digital economy and reduction and convergence in the tax rates across countries have collectively created a strong turf for source based taxation.

4.27 .If source is the basis of international taxation, it is imperative to define the source rule in an efficient and equitable manner. Interestingly, 'source' is not self-defining. Surprisingly enough, little has been published on this issue. Musgrave defined 'source' as the place of the income-generating activity and unfortunately thereafter, the concept of 'source' appears to have been taken for granted. Generally, all authors have take 'source' to be a natural, self-defining concept about which not much dissension or disagreement is possible. However, this is far from truth. The concept of 'source' is highly ambiguous and the only positive statement that can be made on the other hand is that 'source' refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good. In contrast, the type of connection that establishes the 'source' of income cannot be defined generally. Where exactly is value added, and how much, when an enterprise in state A sells goods manufactured in state B and now stored in state C to an enterprise in D-and, maybe, through an agent in E? Where is value added when the enterprise in A transfers know-how acquired in B and C to the enterprise in D? With regard to these and other questions both current and former legislation-and both domestic and foreign legislation-has defined the concept in many different ways.

4.28 The task of the source rules would then be to describe the factual predicate for when income arises in a jurisdiction. This would be like any other factual question about location that a legal rule might address - such as whether a person born in a foreign military installation counts as being born "in" a country for the purpose of determining citizenship.

4.29 The term 'source' is generally not defined in the tax legislation. Common law has developed a number of principles which operate in the absence of statutory provisions. Whether or not the income will be seen to be sourced in a country under the common law principles is a question of fact in the circumstances of a particular case. International practice varies as to the nature and extent of the source rules. Generally, countries use geographical boundaries, types of income or a mixture of both to determine the extent to which they will seek to tax income sourced in their jurisdiction.

4.30 In practice, countries have tended not to stay with the pure application of either principle. They have applied a mix of residence and source based direct taxation, the former for nationals (including non-natural persons) residing in the country and the latter for income earned within the country by non-residents. The precise nature of a mix depends on each taxing jurisdiction's perception of the relative importance of a number of factors, i.e. the volume of foreign investment, revenue implications, domestic administrative capabilities, and the degree of cooperation that can be expected from competing jurisdictions.

4.31 India advocated the use of nexus rules based on significant economic presence alongside that based on physical presence for taxation of cross border business profits, even before international organizations like OECD, UN, etc. began discussion. It may be mentioned here that, with regard to the provisions of paragraph 3, Article 5 of the OECD model conventions, 2017, India reserves the right to include significant economic presence in Article 5. The relevant paragraph is reproduced as under:

" 14.7 India reserves the right to include a provision in Article 5 to the effect that an enterprise having a significant economic presence in a contracting state , based on criteria identified in chapter VII of the Final report on Action 1of the OECD/G20 Base Erosion and profit shifting (BEPS) project, will be deemed to have a permanent establishment in that state."

4.32 The scope of "business connection" as per the provisions of section 9(1)(i)of the Income-tax Act,1961 is restrictive as it mostly addresses the physical presence based nexus rule for taxation of business profits of the non-resident in India. Secondly, Explanation 2 to the aforesaid section which defines 'business connection' is also narrow as it provides for taxability of certain activities or transactions of non-resident carried out through dependent agents only. The refore, the emerging business models such as digitized businesses which do not require its physical presence or that of any agent in India, were not covered under the scope of Section 9(1)(i) of the Income-tax Act,1961. Therefore, it was considered necessary to address the issue of taxation of businesses in digital economy by amending the Income-tax Act, 1961 so as to expand the scope of "business connection" to also include "significant economic presence" of non-resident. This wider definition of "business connection" in the domestic law will facilitate India's treaty negotiation for inclusion of a new nexus rule in the form of "significant economic presence".

4.33 The term "significant economic presence" has been defined to mean-

(i) any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed; or

(ii) systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed , in India through digital means.

This new change clearly demonstrates India's intent to move to a relatively more wider base for taxation of cross-border transactions. This reflects a gradual shift from a "physical presence" based rule of source towards a consumption-based rule of source.

4.34 An analysis of the historical evolution of the two methods of taxation of cross-border transactions reveals that objetion to the source rule is less principle-based and more in terms of administrative inconvenience. The World (including India) now recoginizes the urgent need to intervene more aggressively to prevent erosion of the tax base of the source country. This recognition is manifested in the form of various tax policy measures like widening the scope of permanent establishment, expansion in the anti-avoidance rules, introduction of equalisation levy to circumvent the threshold of permanent establishment, automatic exchange of information, and expanding the scope of the source based taxation of intangibles. The gradual shift has resulted in the crafting of different source rules with varying rates depending upon the type of income. Consequently, it has led to problem of characterization of income resulting in litigation and uncertainty. With this background, it is imperative to comprehensively describe the factual predicate for when income arises in a jurisdiction. In designing this description, due consideration should be given to simplicity, certainity and ease of compliance and administration. The Task Force is of the view that the determination of the source cannot be tied to a production base, a physical presence, or value addition in the country since such connection has led to multiple source rules, complexity, litigation, uncertainty, and increased compliance and administrative cost. It recognizes that a distinction must be made between "ability to earn" and "ability to pay". While mere production or value addition creates an "ability to earn", payment for supply of goods or services for consumption, or use, creates an "ability to pay". Since income tax is based on the "ability of pay", it would be appropriate to connect the source, in general, to a uniform payment-based rule and, as an anti-abuse, to supply of goods and services for consumption, or use, in India. Accordingly, the Task Force recommends the following -

(a) India should abandon the existing hybrid of residence-based taxation (global or world-wide taxation) and source based taxation (territorial based taxation) in favour of a comprehensive source based taxation;

(b) in confirmity with the principle of territorial taxation, any income derived from a source outside India will not be included in the total income of the person;

(c) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(d) the total income of a person will comprise of only income derived from a source in India;

(e) income shall be construed to have been derived from a source in India, if the payment has been made from India;

(f) In order to prevent potential abuse of this new rule, a payment shall be deemed to be

made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year.

(g) the following income shall be construed to have been derived from a source in India, namely: -

(i) income in respect of employment, outside India, if the employer is the Government;

(ii) income of a non-resident from alienation, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, to the extent attributable to assets located in India, if, -

(1) such company or entity directly, or indirectly, owns the assets situated in India; or

(2) the shares or interest derives, directly or indirectly, its value substantially from the assets located in India.

(h) there will be no distinction between resident and non resident;

(i) tax shall be withheld (deducted at source) on every payment made by a person (including Government and all other exempt person) from India to any person outside India;

(j) the rate of withholding tax will be equal to the corporate tax rate.

4.35 The comprehensive source rule defined in para 4.34 has the advantage of a unified rule and rate for all types of income. It has the added advantage of being simple, eliminating all uncertainty and reducing the cost of compliance and administration.

4.36 Alternatively, some Members were of the view that for the purposes of continuity, India should continue with the hybrid method of residence based taxation and source-based taxation and also continue to maintain a distinction between a resident and a non resident. Therefore, we have presented the hybrid method along the following lines.

(a) in conformity with the principle of global taxation, the total income of a resident will comprise of his global income i.e., income derived from both a source in India and a source outside India;

(b) the total income of a non resident shall be the income derived from a source in India;

(c) income shall be construed to have been derived from a source in India, if the payment has been made from India.

(d) in order to prevent potential abuse of this new rule, a payment shall be deemed to be

made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year;

(e) the following income shall be construed to have been derived from a source in India, namely: -

(i) income in respect of employment, outside India, if the employer is the Government;

(ii) income of a non-resident from alienation, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, to the extent attributable to assets located in India, if, -

(1) such company or entity directly, or indirectly, owns the assets situated in India; or

(2) the shares or interest derives, directly or indirectly, its value substantially from the assets located in India.

(f) tax shall be withheld (deducted at source) on every income which is construed as having been derived from a source in India under (c), (d) and (e) above.

4.37 As regards the hybrid method, some Members were of the view that the source rule proposed in Para 4.36 should be modified only to a limited extent to impart some clarity on existing issues of dispute. The drafts based on this view of the Members is presented as alternative drafts in Model - II.

4.38 The alternative proposal will be an improvement over the existing set of rules but will be a second-best option to the comprehensive source rule proposed in para 4.34 above.

4.39 The draft of the Income-tax Bill in Volume - II of this Report is based on the comprehensive source rule and the draft in Volume - III of this Report is based on the recommendation in Paras 4.36 and 4.37.

Test for residency

4.40 Residency rules have an important role to play in tax treaties as they clarify the right to tax and assist in the avoidance of double taxation. All countries have residence tests for both natural persons (individuals) and legal persons (companies). The residency test for individuals is usually based on either physical presence in the country (legal form, such as citizenship) or facts

and circumstances that prove residence in a country (economic substance, such as the country where the person has a fiscal presence) or a combination of the two. In many cases, this may be satisfied simply by being present in a country for a prescribed period of time. The tax residence of companies (that is, where companies are established or carry on business) is usually based on either place of incorporation (legal seat), location of management (real seat) or a combination of the two.

4.41 Under the Act, the residential status of an individual in a financial year will continue to be determined on the basis of his stay in India during the financial year and the earlier years. He would be a resident in India if,-

(a) he is in India for 182 days or more during the financial year; or

(b) he is in India for 365 days or more during the four years immediately preceding the financial year and for 60 days or more in the financial year.

4.42 The residency of an individual will be determined only on the basis of the test specified in sub para (a) of para 4.9 in the case of,-

(a) an Indian citizen who leaves India during the financial year for the purpose of employment outside India with an employer;

(b) an Indian citizen who leaves India as a member of a crew of an Indian ship; and

(c) an Indian citizen or a person of Indian origin, who comes to India on a visit during the financial year.

4.43 However, an individual will be treated as a resident, if he is a citizen of India and not liable to tax in any other country or territory by reason of his domicile or residence regardless of the fact that he is not a resident in terms of para 4.9 and para 4.10 above. Further, an individual shall be treated as a person of Indian origin if either he or either of his parents or any of his grand-parents was born in undivided India.

4.44 An Indian company will always be treated as resident in India. However, a foreign company can either be resident or non-resident in India. It will be treated as resident in India, if its place of effective management, in that year, is in India; (it need not be wholly situated in India, as at present).

4.45 A Hindu Undivided Family (HUF), partnership firm, an association of persons or any other person will be resident in India, if its place of effective management, in that year, is in India.

4.46 A person will be a non-resident in India, if he is not a resident in India.

4.47 Under the Act, the concept of "resident but not ordinarily resident" for an individual and a Hindu undivided family will be replaced by providing exemption to the income of an individual

sourced outside India and not derived from a business controlled or a profession set up in India. This exemption will be available to the individual in the financial year in which such individual becomes a resident and in the immediately succeeding financial year, if such individual was a non-resident for nine years immediately preceeding the financial year in which he becomes a resident.

Concept of financial year

4.48 Under the 1961 Act, the income earned in a year is taxed in the next year. The year in which income is earned is termed as 'previous year' and the following year in which it is charged to tax is termed as 'assessment year'. For example if a person earns any income during the year beginning on 1 April 2006 and ending on 31 March 2007, then 2006-2007 will be the previous year and the income shall be assessed to tax in assessment year 2007-2008. The use of the two expressions has caused confusion in both compliance and administration. In order to simplify the provisions, the separate concepts of 'previous year' and 'assessment year' will be replaced by a unified concept of 'financial year'. The existing concept of assessment year will be done away with. Under the Act, all rights and obligations of the taxpayer and the tax administration will be with reference to the 'financial year'. This change will not change the existing system of deduction of tax at source and payment of advance tax in the year of earning of income and payment of self-assessment tax in the following year before filing of tax return. This proposal will simplify the existing provisions.

Meaning of 'person', 'assessee', etc.

4.49 The 1961 Act provides for an inclusive definition of the word "person". It includes an individual, HUF, company, firm, association of persons, body of individuals, local authority and artificial juridical person. Taxable entities like co-operative society, any other society, non-profit organisation and private discretionary trust are assessed as association of persons. Similarly, the institution of Government, though otherwise exempt from tax in respect of its own income, is required to fulfill certain obligations in terms of withholding of tax and filing of information. In the Act, Government, trust, co-operative society, any other society and any non-profit organization will be included in the definition of 'person'. The persons specified in the Third Schedule will not be liable to income tax either wholly or partly, as specified therein.

4.50 Under the 1961 Act, assessee is a person by whom any tax or any other sum of money is payable or a person in respect of whom any proceeding under the 1961 Act has been taken (including representative assessee) or any person who is deemed to be an assessee or deemed to be an assessee in default. The definition is important since an assessee has certain rights and obligations under the 1961 Act. In the Act it is proposed to include the following "other persons" within the definition of 'assessee':-

(a) any person to whom any amount of refund is payable under the Act; and

(b) any person who voluntarily files a return of tax bases irrespective of the fact that he is otherwise not under an obligation to do so.

This change will enable taxpayers to obtain refund of tax deducted at source. It will also help tax payers currently below the threshold level to report their income and maintain a track record of filing returns in anticipation of earning higher - and hence taxable - incomes in the future.

CHAPTER-V

INTERACTION OF DOMESTIC LAW AND INTERNATIONAL LAW: ISSUE OF TREATY OVERRIDE

5.1 The rules relating to taxation of international transactions are provided in the Income-tax Act (the domestic law). Further, the domestic law also empowers the Central Government to enter into a treaty to mitigate the problem of double taxation across the home and the host country. However, it also provides that the domestic law shall apply to the extent it is beneficial to the taxpayer. Further, the Central Board of Direct Taxes (CBDT) has issued a circular to the effect that the treaty provisions will override the domestic law. Reading together, it implies that the treaty will override the domestic law except in cases where the domestic law is more beneficial.

5.2 Article 51 of The Constitution Of India 1949 relating to the promotion of international peace and security provides that " The State shall endeavour to -

(a) promote international peace and security;
(b) maintain just and honourable relations between nations;
(c) foster respect for international law and treaty obligations in the dealings of organised peoples with one another; and encourage settlement of international disputes by arbitration.".

5.3 The Supreme Court has in the case of Jolly George Verghese & Anr vs The Bank Of Cochin (1980 AIR 470) held that even though India is a signatory to the International Covenant on Civil and Political Rights and Article 51(c) of the Constitution obligates the State to "foster respect for international law and treaty obligation in the dealings of organised peoples with one another", until the Municipal Law is changed to accommodate the Covenant , what binds the courts is the former not the latter. Therefore, in terms of the Constitution, Domestic Law overrides an International Treaty unless the Domestic law is amended to accommodate the treaty provisions. There is nothing in the Constitution which provides supremacy to an international treaty over the domestic law.

5.4 With respect to Income-tax, the circular No 333 of 1981 issued by the CBDT, was in exercise of its powers under section 119 of the Income-tax Act to issue circulars for the purposes of the administration of the said Act. However, the powers to issue circulars cannot extend to powers to nulify the Constitution. Since the circular is violative of the Constitution, it cannot be regarded as 'good' law. Regardless of this, the circular will cease to exist with the repeal of the Income-tax Act, 1961 following the enactment of the new Income-tax Act. Therefore, the circular cannot form the basis for determining the relationship between the tax treaty and the tax law.

5.5 The provisions of section 90(2) of the Income-tax Act, 1961 which provides that the provisions of the Act shall apply to the extent they are beneficial to the taxpayer is a benefit extended by the Parliament against which there is no promissory estoppel. The provisions hold good until such time the Parliament decides to amend it. Parliament's competence to amend the law for withdrawing this benefit is absolute and unquestionable.

5.6 Interestingly, a DTAA is merely a subordinate legislation in the form of notification which is not even laid on the table of both Houses of Parliament. It is not written into the domestic law. It stands on its own footing as a notification, ranking as the weakest form of subordinate legislation. It is well-established that the basic law takes primacy over rules which in turn takes priimacy over notifications. However, according primacy to a tax treaty notification over the domestic law is a unwarranted deviation from the established rule of hierarchy of legislation. It is necessary to correct for this deviation under the new Act.

5.7 Another aspect of the interaction between tax treaty and the domestic tax law is whether the derogation to international obligation under the tax treaty because of changes in domestic law, is legal or not. The answer to this depends on the country's constitutional framework; as stated in para 5.3, the Constitution in India provides supremacy to domestic law over international treaty and therefore any derogation to international obligation by virtue of amendment to domestic law is perfectly legal.

5.8 The OECD report on Treaty override (1989) identified the following constitutional systems and the relationship between the domestic law and the treay under each of those systems:

(i) The constitution provides that the treaty is self-executing and becomes part of the domestic law without any further enactment, as "*lex specialis*" or special law. In a self-executing treaty, usually a tax treaty has a status superior to prior or subsequent to domestic law. The countries which follow such a system are Argentina, France, Italy, Netherlands, Japan, Switzerland.

(ii) The constitution requires a Parliament act to incorporate treaty provisions in Domestic law. But once this has been done, the treaty provisions acquire a superior status as compared to domestic provisions. The countries that follow such constitutional framework are Belgium, Finland, Germany, Iceland, Ireland, Luxembourg, Norway, Peru, Portugal, Singapore, Sweden.

(iii) The Constitution regards an International Agreement to be at par with Domestic legislation. For example: Austria, Brazil, Denmark, Indonesia, Israel, Korea, Sri Lanka, the United States. These countries give treaty obligations the same rank as the domestic law. In the case of conflict, the one last in date prevails under the maxim " *lex posterior*

derogat legi priori". Therefore, a subsequent change in law could lead to a treaty override, and violate the State's international obligations.

(iv) The Constitution is based on Parliamentary Sovereignty. It cannot bind itself or its successors like in the cases of Australia, Canada, India, New Zealand, United Kingdom. International agreements have no special status, and become part of domestic law by Parliamentary statute. A treaty, which can only have effect if legislative action is taken, can typically be overridden by subsequent legislative action. Therefore, Parliament can override a prior treaty by a subsequent amendment or repeal.

5.9 Therefore, as per OECD , those countries whose constitutional framework is based on Parliamentary sovereignty like India, **the treaty override can be carried out by the Parliament.** Secondly, if the domestic legislation is enacted as an anti-abuse measure , then irrespective of the constitutional framework of the countries, such legislation does not create treaty override even though they are in contravention to treaty provisions.Therefore, India's position visa viz treaty override is well known internationally and should not come as a surprise as and when it happens. From India's perspective, treaty override is, at worst, a matter of propriety and an ethical issue.

5.10 In the earler part of this chapter, we have advocated comprehensive 'source' based taxation in respect of cross border transactions. This is a *paradigm shift* from the existing regime for taxation of international transactions and the present exercise of tax reform is critical to the seamless implementation of the new 'source' rules. These rules cannot be given effect to unless the new Act overrides the existing network of DTAAs entered into by India. Our future economic development is dependent on our ability to mobilize domestic resources which in turn depends on comprehensive tax reforms of the kind proposed by us. Our reluctance to do so would seriously jeopardise our ability to achieve the millenium goals so necessary for the well-being of millions of Indians below the poverty line. It would be extremely myopic on our part to bind ourselves to treaties in which we have no future, treaties which our treaty partners override with impunity to create barriers of protection against free trade to our disadvantage, treaties which we have signed from a position of weakness, and treaties based on rules which have lost their utility in the face of a rapidly expanding global digital economy. Given our growing economic prowess, India should lead the establishment of a new international tax order. For this to happen, India must break away from the shackles of these tax treaties which no longer serve our national interest.

5.11 In the light of the foregoing discussions, we recommend a centrist approach to the relationship between domestic tax law and the tax treaty, whereby the tax law regards an international agreement to be on par with domestic legislation. These countries give treaty obligations the same rank as the domestic law; in the case of conflict, the one last in date prevails under the maxim " *lex posterior derogat legi priori"*. Therefore, a subsequent change in law could lead to a treaty override. Similarly, any change

in the treaty or a reiteration of the provisions of the treaty by a unilateral protocol subsequent to the change in the domestic law will override the domestic law. In effect, neither domestic law nor the treaty will have permanent supremacy. Further, it is also proposed that henceforth all treaties will be laid on the table of both Houses of Parliament.

5.12 Some members were of the view that the centrist approach will have a de-stabilising effect and create uncertainty in flow of investment. They have accordingly argued that the status quo should be maintained. In this regard, it is important to emphasize that there is no promissory estoppel against the statute and, more so, against a notification. The Parliament's competence to make a change in domestic law overriding the treaty is absolute and unfettered. Further, any change in the domestic law will be initiated by the Executive (which is also responsible for entering into a treaty) and approved by the Parliament. Obviously, they will take the needs of the economy into consideration before according their stamp of approval to the change. It would not be fair to ascribe lesser wisdom to the successor executive and the Parliament. We do not envisage a scenario that simply by taking a centrist approach, the Parliament will indulge in changing the laws frequently or abruptly creating uncertainty in the minds of foreign investors. All legislations are made after due deliberations and assessing the trade-off between socio-politico-economic national interest and relief granted to, or withdrawn from, a class of foreign participants. Furthermore, some of our major treaty partners like the USA has a similar centrist approach which is embedded in their tax legislation. While the USA can unilaterly override the treaty, it is unfair to expect India to not do so; reciprocity is one of the fundamental principles of International Relations. Moreover, India is not a signatory to the Vienna Convention and therefore, not bound by any overarching international convention to protect DTAAs; given our constitutional provisions, India is, at best, *ethically committed* to foster respect for international law and treaty obligations. Finally, a treaty cannot be allowed to hold hostage the process of tax reform or limit the scope of tax reform; in effect it would amount to curtailing the sovereignity of the Indian Parliament. We cannot hold an untenable view that even if the Parliament makes a law contrary to the treaty, it will not be given effect to. Ordinarily, we should avoid legislating changes in domestic law which has the effect of treaty override; however, if it is indeed necessary and the Parliament, in its wisdom, chooses to do so, it must be allowed to be given full effect. The will of the people embodied in the Parliament must prevail.Therefore, the case for maintaining the status quo is extremely weak.

5.13 Our recommendation for a centrist approach is an equitable rule of interpretation. It is dynamic in its effect, allowing for accommodation of the temporal requirements of treaty partners. It must be legislated accordingly.

CHAPTER - VI

TIMING THE RECOGNITION OF INCOME AND DEDUCTION

6.1 Income tax is imposed on a periodic basis of 12 months, often set to coincide with the government's budgetary year or with the calender year. The periodic imposition of the income tax requires a seperate calculation of the taxable income of a taxpayer for each tax period. For this purpose, it is necessary to provide rules (referred to as tax accounting rules) that allocate income and expenses to tax periods. These rules identify the tax period in which income and expenses are to be considered when calculating the taxable income of the taxpayer for a given tax period.

6.2 Generally, a single tax accounting rule does not apply to all taxpayers in respect of all items of income or deductible expense. Rules may change depending on the circumstances. In general terms, income or expenses may be accounted for on a cash or on accrual basis of accounting systems. Both systems measure income when it is derived and recognize expenses when they are incurred, but the time at which a taxpayer is considered to have derived an amount or incurred an expense can differ significantly under the two systems. Ordinarily, salary and wage earners account for income and deductions on a cash basis, and business tax payers above a certain size account for income and deductions on an accrual basis.

Cash Accounting

6.3 Under the cash-basis system, income is derived when it is actually received by, or made available to, or applied to the benefit of, the taxpayer, and expenses are incurred when they are paid. Under the cash method, income is derived in the tax period in which it is actually received by, made available to, or, in the case of benefit, provided to the taxpayer. Similarly, expenses are treated as incurred in the tax period in which the taxpayer actually pays them.

6.4 In this system of accounting transactions are recorded when there is actual flow of cash. Revenue is recognised only when it is actually received. Expenditure is recognised only on the outflow of cash. No consideration is given to the "due" part of a transaction. This system of accounting is simple to understand and as such needs less skill on the part of the accountant. Its focus is on cash management. The recognition trigger is simply the flow of cash. Budgetary and legislative compliance is easier under this system.

6.5 When an item of income is to be accounted for on a cash basis, it is important that the concept of "receipt" include a constructive receipt. This ensures that an amount that indirectly benefits the taxpayer or that is dealt with on behalf of the taxpayer behalf or as directed by the

taxpayer, is taken into account when in calculating the taxpayer's income, provided it has been actually received directly by the taxpayer. Situations covered by a constructive receipt rule include (i) an employer directly paying the school fees of an employee's child, (ii) the payment of part of an employee's salary or wages to the spouse of the employee, and (iii) payment of a part of an employee's salary or wages to a third party on account of a debt owed by the taxpayer to the third party. In each case, the application of a constructive receipt rule avoids the argument that, because the taxpayer does not actually receive the payment, there is no derivation of income by the taxpayer.

6.6 The cash accounting method can significantly reduce bookkeeping costs, since it is simpler and less time-consuming than accrual methods. Additionally, companies that utilize a cash accounting system can easily determine their current profitability. By keeping a current cash accounting balance sheet, corporate finance managers can assess the company's financial situation at a glance. For tax purposes, there are also definite advantages. Cash accounting ensures that taxes are not paid on monies that have not yet been received; this improves cash flow and ensures that funds are available for tax expenditures. Cash accounting is often considered superior to the accrual system, as it reflects taxpayer's current ability to pay.

6.7 Cash accounting does not allow for tracking the actual dates of sales and purchases. It usually does not provide a means of matching these transactions to specific items of inventory. There are no accounts receivable or accounts payable - records which are difficult for businesses to maintain, especially those that do not receive payment for goods immediately, or have unpaid bills. Since partial payments are not recorded in a cash accounting system, the cash accounting balance sheet may not reflect all monies due. Meticulous records of outstanding balances both on the payable and receiveable ends must be maintained so that companies receive/ make payments in a timely fashion, if at all.

Accrual Accounting

6.8 Under the accrual-basis system, income is derived when the right to receive the income arises, and expenses are incurred when the obligation to pay arises. However, special rules may apply in particular cases (e.g., for long-term contracts or prepayments).

6.9 It is a system of accounting in which transaction are entered into the books of accounts, when they become due. The transactions are recognised as soon as a right to receive revenue and/ or an obligation to pay a liability is created. The expenses are recognised when the resources are consumed and incomes are booked when they are earned. Therefore, the focus is on the recording flow of resources i.e. labour, goods, services and capital., the related cash flow may take place after some time (of event) or it may or may not take place in the same accounting period.

6.10 Accrual accounting can be complex and difficult to manage. Without the knowledge or resources available to manage accrual accounting, the accrual method can create confusion and lead to mistakes. Another disadvantage of accrual accounting is that confusion and complexity can lead to disceptive presentation of financial statements. Companies have misused the accrual accounting system to hide mistakes and weaknesses in their financial reporting. It can also be used in fraudulent activities.

6.11 The downside of this method is that you pay income taxes on revenue before you've actually received it. A significant failing of the accrual basis of accounting is that it can indicate the presence of profits, even though the associated cash inflows have not yet occurred. The result can be a supposedly profitable entity that is starved for cash, and which may therefore go bankrupt despite its reported level of profitability.

Advantages of the Accrual System of Accounting

6.12 The system of Accrual Accounting while retaining the advantages of the Cash Accounting System overcomes its limitations by inclusion of Cash Flow Statement in the Financial Statement of the entity. The major advantages are as under:

- It helps in the assessment of financial performance by correctly reflecting surplus/ deficit as all expenses whether paid or not and all incomes whether received or not are duly accounted for.
- It gives information on whether income streams are adequate to meet short and long term liabilities so that their early payment keeping in view their payment period (short term and long term) and nature (cheap or costly loan) can be better managed.
- It provides comprehensive information on expenses which helps in knowing the cost consequences of policies and enables comparison with alternative policies. Also, information about calculation of subsidy can be extracted from the accounts, which helps in its rationalisation. This ensures the adoption of good policy and also assures optimal use of scarce resources. It also helps in ascertaining the future sustainability of programmes.
- It gives comprehensive information on the financial position i.e. assets and liabilities of the government. In this system of accounting the financial decisions are not seen merely from the point of view of cash outgo or inflow but also from their impact on the asset- liability position of the government, funding requirements for assets including their timely maintenance and replacement.
- It provides disclosures on the account of contingent assets and contingent liabilities

so that risks associated with the guarantees issued and letters of comfort given, can be better assessed by the user of the financial statements.

- It bridges the gap prevelant in cash accounting including accrued expenses and revenues (receivables and payables), physical assets, capital work-in-progress and depreciation, pension liabilities and provisions etc. in the accounting system.
- It discloses the accounting policies used in the preparation of Financial Statements for better understanding and appreciation of the Financial Statements.

International Practice

6.13 Tax accounting practices vary by country. In some conutries, the law leaves the matter to be determined according to financial accounting principles or by the courts. In other countries, the tax law may, within limits, give taxpayers a choice in the method of accounting to be applied. Whatever practice is adopted, salary and wage earners would normally account for income and deductions on a cash basis, and legal persons conducting businesses account for income and deductions on an accrual basis. Individuals conducting business typically enjoy some flexibility. In particular, it may be appropriate and simpler for smaller businesses to use cash-basis accounting. However, if small business are allowed to use cash-basis accounting, the threshold between cash-basis and accrual-basis taxpayers must be first set clear.

Timing of recognition for calculation of taxable income

6.14 The timing of recognition of income and expenses is crucial to the calculation of taxable income under both the receipts-and-outgoings system and the balance-sheet system. Under both systems, the choice between cash-basis accounting and accrual-basis accounting will have a significant effect on the measurement of taxable income. So, too, will the rules that govern exactly when receipts and expenses are recognoized under cash- and accrual-basis accounting. As stated earlier the cash system reflects the current ability to pay, the accrual systems reflects the long term ability to pay of a person. Since the tax is levied on income of a twelve months period, a cash system may be more appropriate for measuring the ability to pay. Further, there are several provisions within the tax law which are based on cash accounting; similarly, serveral other provisions provide for deductions in respect of the business in deviation from the "matching" principle like allowability of interest, depreciation, prior period expenses and deferred revenue expenditure. The simplicity of the cash system in terms of compliance and enforcement is an added advantage.

6.15 A comprehensive cash system of accounting comprises of cash flow from operational , financial and investment activities. This comprehensive method has the added advantage of -

(a) eliminating the distinction between capital and revenue, whether receipt or expenditure, thereby eliminating a plethora of litigation arising on account of this distinction;

(b) eliminating the distinction between debt and equity capital;

(c) eliminating any ambiquity relating to timing of income and expenditure including deferred expenditure ;

(d) allowing for full expensing of capital expenditure in the year in which it is incurred;

(e) allowing for full deduction for payment of interest and dividend;

(f) overcoming the problem of valuation of inventories;

(g) eliminating the problem of inflation and bunching of gains;

(h) eliminating the problem of estimating bad debts and non performing assets; and

(i) providing tax neutral treatment of amalgamation and merger.

6.16 In effect, the cash system of accounting has the potential of virtually eliminating all litigation thereby providing certanity and stability. It does not require high skills for compliance and administration resulting in cost saving and consequently encouraging compliance and improving efficiency.

CHAPTER - VII

CHOICE OF TAX DESIGN

7.1 In Chapter III we discussed the dilemma between territorial (source based) taxation and global or world wide (residence based) taxation. Similarly in Chapter IV we also discussed the dilemma between cash method of accounting and the accrual method of accounting for the purposes of determining the taxable income. Given the pros and cons of the various methods, we have constructed two models which form the basis of our recommendations in this Report.

7.2 As stated earlier, based on the desire to promote equity - both horizontal and vertical, the home country seeks to extend its taxing jurisdiction over income which is sourced in another country through global taxation even though the income is sourced in another country. Most often, countries which operate world wide taxation for their residents, also operate territorial (source based) taxation for non residents. This results in double taxation in host and home countries requiring the need for designing a set of complex rules for mitigating its impact. The problem is further compounded by the absense of a source rule; generally, an income is treated as sourced in a country if it considers that the income has arisen within its jurisdiction. However, there is considerable ambiquity on what constitutes a source under the source rule; this varies across jurisdictions and character of income. The problem is further aggravated by the timing for recognition of income depending upon the choice of method of accounting. The outcome is unenviable volume of litigation, high uncertanity and increasing cost of compliance and doing business.

7.3 In the light of the foregoing, we have constructed two seperate models of income taxation with different combinations of taxing rights and method of accounting. **Model I** is based on territorial (source based) taxation complemented by mandatory cash system of accounting. Similarly, **Model II** is based on global (resident based) taxation complemented by accrual system of accounting.

7.4 The key features of **Model I** are -

(a) in confirmity with the principle of territorial taxation, the total income of a person will comparise of only income derived from a source in India; however, any income derived from a source outside India will not be included in the total income of the person;

(b) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(c) income shall be construed to have been derived from a source in India, if the payment has been made from India.

(d) In order to prevent potential abuse of this new rule, a payment shall be deemed to be made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year.

(e) the following income shall be construed to have been derived from a source in India, namely: -

(i) income in respect of employment, outside India, if the employer is the Government;

(ii) income of a non-resident from alienation, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, to the extent attributable to assets located in India, if, -

(1) such company or entity directly, or indirectly, owns the assets situated in India; or

(2) the shares or interest derives, directly or indirectly, its value substantially from the assets located in India.

(f) there will be no distinction between resident and non resident;

(g) tax shall be withheld (deducted at source) on every payment made by a person (including Government and all other exempt person) from India to any person outside India;

(h) the rate of withholding tax will be equal to the corporate tax rate.

(i) the total income shall be computed on the basis of cash system of accounting;

(j) there will be no distinction between capital and revenue, whether receipt or expenditure;

(k) there will be no distinction between debt and equity capital;

(l) full expensing of capital expenditure in the year in which it is incurred;

(m) full deduction for payment of interest and dividend;

(n) the total income shall include cash inflow, whether capital or revenue, from operational, financing and investment activities; and

(o) the total income shall exclude cash outflow, whether capital or revenue, in the course of operational, financing and investment activities.

7.5 Similarly, the key features of **Model II** are -

(a) a distinction will be made between a resident and a non resident;

(b) in confirmity with the principle of global taxation, the total income of a resident will comprise of his global income i.e., income derived from both a source in India and a source outside India;

(c) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(d) income shall be construed to have been derived from a source in India, if the payment has been made from India.

(e) In order to prevent potential abuse of this new rule, a payment shall be deemed to be made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year.

(f) the following income shall be construed to have been derived from a source in India, namely: -

(i) income in respect of employment, outside India, if the employer is the Government;

(ii) income of a non-resident from alienation, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, to the extent attributable to assets located in India, if, -

(1) such company or entity directly, or indirectly, owns the assets situated in India; or

(2) the shares or interest derives, directly or indirectly, its value substantially from the assets located in India.

(g) tax shall be withheld (deducted at source) on every income which is construed as having been derived from a source in India under **(e)** above; and

(h) the total income shall be computed on the basis of accrual system of accounting;

(i) distinctioin between revenue and capital (both for receipt and expenditure) shall continue to be maintained;

(j) distinction between debt and equity capital will continue to be maintained;

(k) depreciation will be allowed in respect of capital expenditure; and

(l) full deduction for payment of interest will continue to be allowed; however, no deduction will be allowed for dividend pay out.

7.6 The various issues relating to the tax base, tax rates and tax administration in respect of the two models have been seperately dealt in the subsequent chapters. The draft legal frameworks for **Model I and Model II** are contained in **Volume II** and **Volume III** of this Report, respectively.

CHAPTER - VIII
PERSONAL INCOME-TAX

8.1 The visible impact of personal income-tax makes its design extremely critical in achieving the objectives of equity and economic efficiency. There are essentially five components that comprise the determination and collection of personal income-tax liability. These are (i) the choice of the taxable unit; (ii) sources of income subject to tax; (iii) tax incentivies; (iv) tax rate schedule; and (v) the compliance management process.

8.2 Under a progressive rate structure the unit of taxation is important. In a system where the tax unit is a family, change in marital status could have serious tax implications. If the tax unit is the family, the total tax liability of two individuals would increase or decrease after marriage depending on their individual earnings, the extent to which income splitting is allowed under the PIT, and personal allowances granted to single individuals and families. The family as a unit of taxation is advocated on the consideration that joint filing with full income splitting - which effectively results in equalizing the marginal PIT rates between the two - is equitable across families. However, the individual as a unit of taxation is inequitable, since families with the same income could have different tax liabilities. The trend in country practices over the past few decades has shifted towards individuals as the taxable unit.

A. Tax Rates

i. Schedular vs Global income-tax

8.3 The structure of the personal income-tax rates can be schedular or global or a mix thereof. A schedular income-tax is one in which taxes are imposed on seperate catetagories of income. Under this system, gross income and deductible expenses are determined seperately or each type of income; in some cases, limited deductions or no deductions are allowed. The rates of tax applicable to each category of income is applied to the taxable amount of each type of income. The rates of tax may vary from category to category.

8.4 A global income tax is one in which a single tax is imposed on all income, whatever its nature. Under this system there is no matching of particular types of income to the expenses incurred to derive the income. All income and expenses are considered together to arrive at a single net income which is subjec to tax. Thus under a global system, the category of income is irrelevant.

8.5 Between pure schedular and pure global taxation, there are many possibilities. One of

these has been called "composite," under which a global-type system is superimposed on a set of schedular taxes. This approach involves combining some or most types of income for the purpose of imposing a progressive rate surcharge on top of the rates commonly imposed on the schedularized categories of income, as well as for the purpose of providing personal tax relief for family costs.

8.6 In general, the global income tax is considered to be superior to the schedular system because the schedular system suffers from the following disadvantages: -

(a) the seperation of an individual's income into more than one tax regime makes it difficult to impose progressive taxation and provide for personal tax relief in the form of exemptions, deductions, or rebates;

(b) the schedular system links to classification issues and therefore is potentially more difficult to administer; and

(c) the differences in the tax burden under a schedular system on income in different categories creates arbitrage opportunities leading to tax planning and restructuring.

8.7 In practice, all global income-taxes contain some schedular elements and most exisitng income-tax systems lie on the spectrum between global and schedular. The global systems of many countries have become partially schedularized by the use of final withholding taxes on certain types of income, particularly dividends and interest, and lower tax rates on capital income.

8.8 In principle, the global system is in practice in India. However, overtime this system has been diluted with the introduction of schedular rates for several types of income, in particular, dividend, capital gains, income of non-residents and certain casual and non-recurring income. This has added to the complexities of the PIT regime and led to increased litigation. Therefore, efforts should be directed towards minimizing the number of schedular rates.

ii. Number of rates

8.9 There is no scientific basis for determining the optimal number of PIT rates. Further, a multiplicity of rates is not necessary or rendering the PIT progressive; an adequate degree of progressivity could usually be achieved by only a few positive rates. Moreover, keeping the number of rates low would minimize the problem of "bracket creep" or "fiscal drag" and also ease administration. In general, since the mid-1990's, there has been a trend towards reducing the number of rates. In particular, countries, which have introduced income-tax since then or have undertaken comprehensive PIT reforms, have very few positive rates .

8.10 In general, the number of rates have reduced across countries over the last three decades. Table-8.1 summarizes the structure of PIT rate schedule in financial year 2017-18 across 53 countries. An analysis of the rate structure across these countries shows that the number of rates in most

Table 8.1 Global Comparison of Personal Income Tax Rates

Sl. No.	Name of Country	Number of Non-zero rates	Threshold Level (in $ PPP)	Minimum Tax Rate			Maximum Tax Rate	
				Rate (%)	Lower Slab (in $ PPP)	Upper Slab (in $ PPP)	Rate (%)	Lower Slab (in $ PPP)
1	Sweden	2	50,022	20.0%	50,022	72,769	25.0%	72,780
2	Cyprus	4	32,500	20.0%	32,500	46,667	35.0%	1,00,000
3	Netherlands	4	31,812	8.9%	31,812	56,989	52.0%	1,17,446
4	Colombia	3	27,172	19.0%	27,172	42,379	33.0%	1,02,208
5	Costa Rica	2	24,388	10.0%	24,388	36,582	15.0%	36,582
6	Finland	4	18,778	6.3%	18,778	28,111	31.5%	81,222
7	Peru	5	17,719	8.0%	17,719	30,375	30.0%	1,31,625
8	UK	3	16,429	20.0%	16,429	64,286	45.0%	2,30,714
9	Norway	4	16,088	24.9%	16,088	22,642	38.5%	91,574
10	Malta	3	15,167	15.0%	15,167	24,167	35.0%	1,00,000
11	Greece	4	14,393	24.2%	14,393	47,727	52.5%	81,060
12	India	3	14,045	5.0%	14,045	28,090	30.0%	56,180
13	Austria	6	13,750	25.0%	13,750	22,500	55.0%	12,50,000
14	Croatia	2	13,029	24.0%	13,029	73,029	36.0%	73,029
15	Indonesia	4	12,886	5.0%	12,886	24,818	30.0%	1,32,204
16	Czech Republic	1	12,641	15.0%	12,641	12,641	15.0%	12,641
17	Luxembourg	22	12,517	8.0%	12,517	14,637	42.0%	2,22,227
18	South Africa	7	12,418	18.0%	12,418	31,128	45.0%	2,45,902
19	Iceland	2	12,207	36.9%	12,207	83,346	46.2%	83,346
20	France	4	12,138	14.0%	12,138	33,523	45.0%	1,90,325
21	Australia	4	12,133	19.0%	12,133	24,667	45.0%	1,20,000
22	Switzerland	10	12,083	0.8%	12,083	26,333	11.5%	6,29,333
23	China	7	12,000	3.0%	12,000	17,143	45.0%	2,86,286
24	Italy	5	11,677	23.0%	11,677	33,106	43.0%	1,18,820
25	Brazil	4	11,424	7.5%	11,424	16,960	27.5%	27,988
26	Zambia	3	11,314	25.0%	11,314	14,057	37.5%	21,257
27	Germany	4	11,025	31.2%	11,025	67,560	42.0%	3,20,380
28	Chile	6	11,016	4.0%	11,016	24,480	35.0%	97,920
29	Ireland	2	10,313	20.0%	10,313	52,563	40.0%	52,563
30	Belgium	5	9,088	25.0%	9,088	22,925	50.0%	57,625
31	Canada	5	9,084	15.0%	9,084	44,404	33.0%	1,65,084
32	Spain	5	7,929	19.0%	7,929	25,714	45.0%	93,643
33	Slovak Republic	2	7,606	19.0%	7,606	70,044	25.0%	70,044
34	Lithuania	1	7,440	15.0%	7,440	7,440	15.0%	7,440
35	Turkey	4	7,108	15.0%	7,108	15,775	35.0%	80,441
36	Denmark	3	6,250	8.0%	6,250	13,043	56.0%	78,653
37	Slovenia	5	5,503	16.0%	5,503	18,872	50.0%	1,23,682
38	Macedonia	1	4,542	10.0%	4,542	4,542	10.0%	4,542
39	Argentina	9	4,519	5.0%	4,519	6,258	35.0%	32,345
40	USA	7	4,050	10.0%	4,050	13,375	39.6%	4,22,450
41	Japan	7	3,815	5.0%	3,815	23,394	45.0%	4,05,422
42	Poland	2	3,667	18.0%	3,667	6,111	32.0%	70,556
43	Estonia	1	3,600	20.0%	3,600	3,600	20.0%	3,600
44	Romania	1	2,118	16.0%	2,118	2,118	16.0%	2,118
45	South Korea	6	1,710	6.0%	1,710	15,392	40.0%	5,71,771
46	Israel	7	1,528	10.0%	1,528	21,170	50.0%	1,69,949
47	Latvia	1	1,440	23.0%	1,440	1,440	23.0%	1,440
48	Russia	1	697	13.0%	697	697	13.0%	697
49	Hungary	1	480	15.0%	480	480	15.0%	480
50	Mexico	11	-	1.9%	-	647	35.0%	3,26,087
51	New Zealand	4	-	10.5%	-	14,667	33.0%	46,667
52	Portugal	5	-	14.5%	-	11,818	53.7%	1,34,400
53	Bulgaria	1	-	10.0%	-	-	10.0%	-
	World Average	**4**	**11,740**	**14.7%**	**11,740**	**27,254**	**34.8%**	**1,52,976**

Note: Tax slabs of various countries have been adjusted to USD on Purchasing Power Parity (PPP) basis.
Source: OECD data on PPP and calculations by Tax Policy Research Unit, Department of Revenue, Ministry of Finance.

Chart - 1

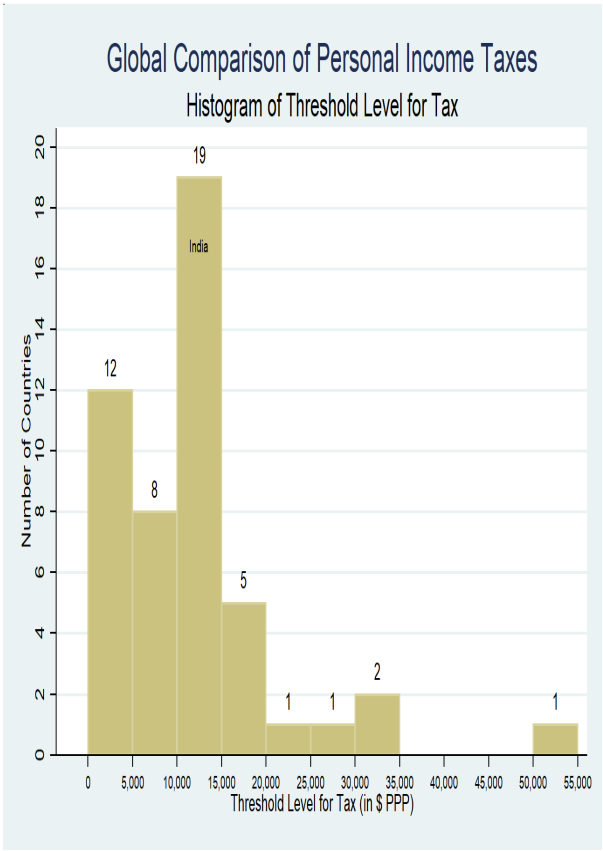


Chart - 2

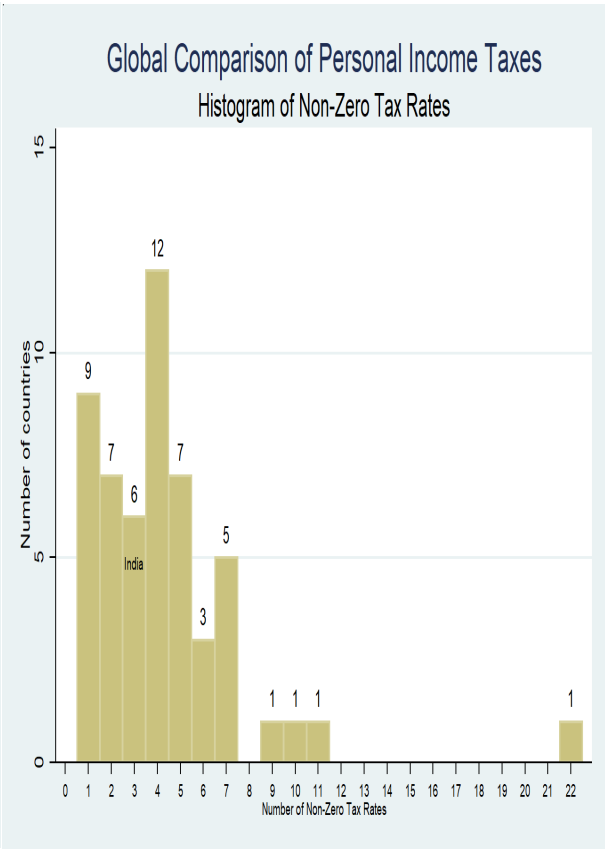


Chart - 3

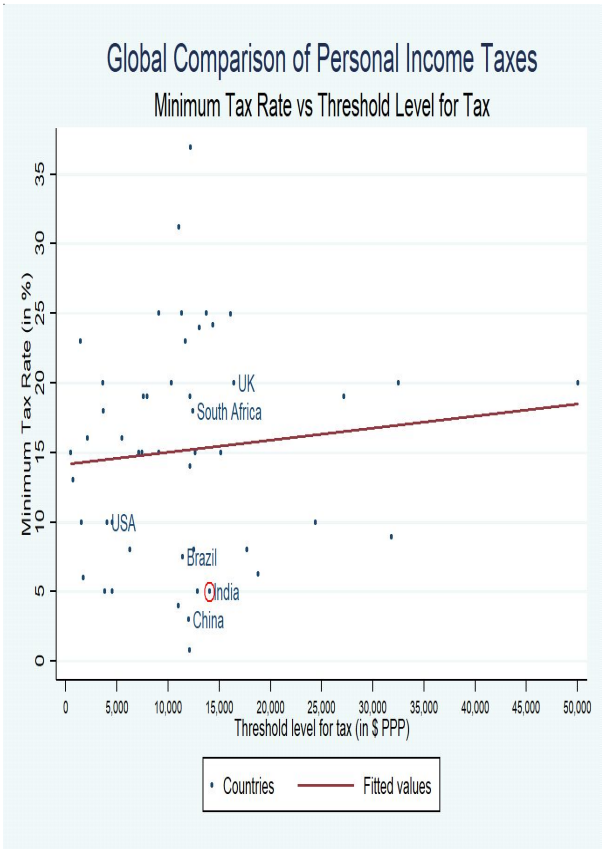
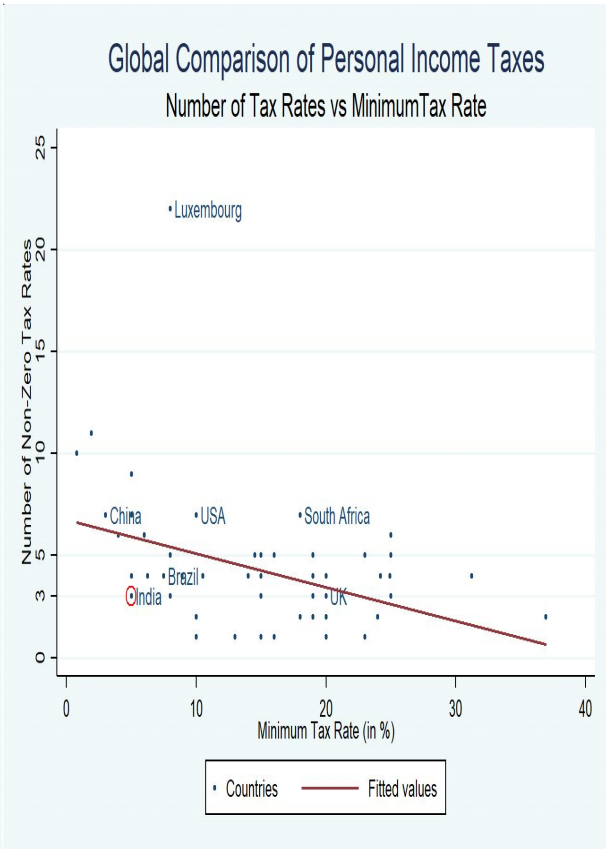


Chart - 4



Source: Calculations by Tax Policy Research Unit, Department of Revenue, Ministry of Finance.

Box-1: Bunching of Individuals around thresholds of Income Tax Slabs

Bunching analysis is a new empirical approach that has recently gained popularity in economics. This approach uses bunching around points that feature discontinuities in incentives to gain insights into behavioural responses by agents. An analysis was carried out in the Tax Policy Research Unit, Department of Revenue to study the existence of bunching behaviour around tax slabs in Personal Income Tax

Data

Personal Income Tax Data of Individuals was used for AY 17-18 i.e FY 16-17. The data consisted of slabs of Gross Total Income of Rs. 50,000 each, the number of taxpayers in each slab and the average Total Income of each slab. The data was classified into taxpayers having Business income and those having Non-Business income.

Methodology

The number of taxpayers was calculated and classified into slabs of Total Income from the data on Gross Total Income. Bunching was not examined for the threshold of Rs. 2,50,000 since individuals falling to the left of the threshold do not need to file a Return of Income. Two dummy variables were generated to denote the thresholds under consideration i.e Rs. 5,00,000 and Rs. 10,00,000. The dummy variables take the value 0 for Total Income < Threshold and 1 otherwise. In order to test the existence of bunching around the threshold, the following relationships were estimated-

$$No.of\ Taxpayers\ in\ the\ Slab = \beta_0 + \beta_1 * Slab + \beta_2 * dummy_{Rs.\ 5,00,000}$$

$$No.of\ Taxpayers\ in\ the\ Slab = \beta_0 + \beta_1 * Slab + \beta_2 * dummy_{Rs.\ 10,00,000}$$

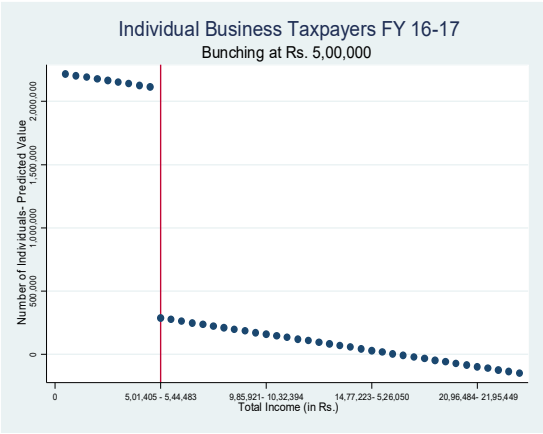
If the coefficient of the dummy variable is negative and significant, it would indicate a downward change in the intercept of the regression line at the threshold, showing a discontinuous break, and thereby indicating the presence of bunching. Bunching was examined for Business and Non-Business taxpayers around Total Income of Rs. 5,00,000 and Rs. 10,00,000.

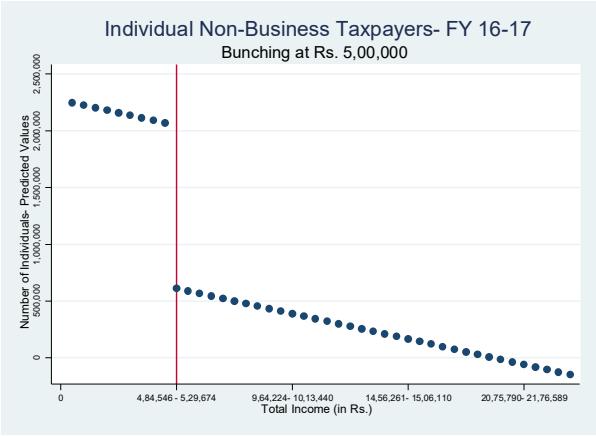
Regression Results

The results of the regression are given below-

	BUSINESS TAXPAYERS		NON-BUSINESS TAXPAYERS	
	At Rs. 5 lakh	At Rs. 10 lakh	At Rs. 5 lakh	At Rs. 10 lakh
VARIABLES	No. of Taxpayers	No. of Taxpayers	No. of Taxpayers	No. of Taxpayers
Slab	-12,850***	-65,509**	-22,355***	-52,049***
	(4,375)	(24,818)	(4,582)	(16,331)
dummy_5_lakhs	-1.813e+06***		-1.434e+06***	
	(559,701)		(239,797)	
dummy_10_lakhs		371,059		-63,691
		(408,294)		(328,021)
Constant	2.229e+06***	1.761e+06***	2.270e+06***	1.834e+06***
	(578,549)	(509,265)	(241,582)	(277,617)
Observations	44	44	44	44
R-squared	0.560	0.357	0.842	0.619
Robust standard errors in parentheses				
*** p<0.01, ** p<0.05, * p<0.1				

As can be seen from the above table, the coefficient of the dummy variable at Rs. 5,00,000 is significant for both Business and Non-Business taxpayers. The value of the coefficient is negative in both cases which indicates that there is a marked downward fall in the number of taxpayers at Rs. 5,00,000. The coefficient of the dummy variable at Rs. 10,00,000 is insignificant for both Business and Non-Business taxpayers. The presence of bunching at the threshold level of Rs. 5,00,000 strongly indicates manipulation of Total Income by individual taxpayers.





The graphs above plot the regression line of the number of taxpayers against different levels of Total Income for Business and Non-Business taxpayers. It can be seen that there is a marked discontinuity in the number of taxpayers at the threshold level of Rs. 5,00,000 for both business and non-business taxpayers. It can also be seen that the extent of the discontinuity is much larger for business taxpayers. This indicates that bunching is much sharper in the case of business taxpayers compared to non-business taxpayers. The result provides a rationale for reducing the number of tax slabs, especially at lower levels of income.

At the same time, bunching was not found at the threshold of Rs. 10,00,000. A possible reason for this is that taxpayers already reporting income at such high levels do not have much of an incentive to manipulate Total Income to gain marginal benefits through a lower tax slab. Furthermore, the number of taxpayers reporting such large income levels are also quite low which may result in statistical insignificance of bunching effects.

countries (34) are 4 or less, with some having more than 10 rates (Luxembourg, Mexico and Switzerland). Similarly, the threshhold level (adjusted for purchasing power parity) varies widely. Two broad conclusions can be drawn from the data (i) the lesser the numbe of rates, the higher the minimum tax rate i.e. the rate at the entry level; and (ii) the higher the threshhold level, the higher the minimum tax rate.

8.11 Historically, India started with a large number of tax rates consistent with the then prevailing international practice. However, the number of rates have gradually reduced to three in the Union Budget, 1997 (relevant for financial year 1997-1998) and have remained so since then. The present international practice is to have as few rates as possible.

iii. General (Basic) allowance

8.12 Under the personal income-tax, deduction is allowed for various kinds of personal allowances which narrow the tax base and complicate tax administration. The personal allowances fall broadly into two categories: general (basic) and targeted.

8.13 A general (basic) allowance (or threshold limit) - an exclusion of a certain amount of income from taxable income - is one that is granted to a taxpayer irrespective of his behavior or personal circumstances, economic or otherwise. The usual conceptual justification for this is that there is a threshold of income that in some sense goes to meet subsistence and should, therefore, be tax-free. Further, it is often argued that the general allowance should be sufficiently high on the consideration that (i) it imparts progressivity to even a flat-rate PIT; and (ii) it is used as a mechanism to exclude many low-income taxpayers - who are usually large in numbers but collectively pay little tax. The latter significantly eases tax administration and reduces wasteful compliance burden. However, the case for a high general allowance should be balanced against its revenue cost, which can often be very high, since it reduces the tax of everyone - not just those who have been left out of the tax net.

iv. Targeted allowances

8.14 Targeted allowances - allowances that are granted only if certain qualifying criteria are met - vary greatly in nature, but generally fall into two broad categories: those whose purpose is to address some equity concerns (e.g., handicap allowance), and those whose objective is to encourage certain activities (e.g., allowance for charitable giving). In reality, of course, a majority of targeted allowances have consequences that straddle both categories, irrespective of their original intentions. For example, a medical expenditure allowance may provide the necessary tax relief for the needy, but it may also encourage other taxpayers to incur unnecessary medical expenses whose burden

Table 8.2 Matrix of Deduction Claims in AY 2017-18: Number of Taxpayers (49,440,341)

Description	Housing Loan Int	80C	80CCC	80CCG	80D	80DD	80DDB	80E	80EE	80G	80GG	80GGA	80GGB	80GGC	80QQB	80RRB	80TTA	80U	87A
Housing Loan Int.	55,81,722	54,68,690	39,330	7,585	18,81,238	84,832	73,617	1,27,650	30,365	2,43,240	49,060	7,388	0	9,528	1,330	351	20,57,401	43,638	6,45,306
80C	54,68,690	3,49,63,006	1,89,918	42,843	82,19,244	3,60,448	3,54,323	4,74,879	1,04,552	9,59,572	10,63,008	36,285	0	34,000	7,089	2,892	1,40,00,889	2,19,896	49,57,145
80CCC	39,330	1,89,918	2,60,440	2,524	75,578	7,280	6,592	8,968	3,220	9,666	14,851	1,006	0	784	209	166	51,420	3,617	11,450
80CCG	7,585	42,843	2,524	44,416	19,606	3,883	4,167	4,740	3,211	1,945	5,750	1,290	0	1,632	211	271	7,223	871	1,595
80D	18,81,238	82,19,244	75,578	19,606	87,11,070	1,47,801	1,51,839	1,72,080	40,781	4,42,282	3,56,504	17,323	0	20,696	2,828	1,136	41,65,298	61,074	11,76,466
80DD	84,832	3,60,448	7,280	3,883	1,47,801	3,76,719	52,932	19,142	5,775	17,837	43,537	3,107	0	2,947	441	426	68,930	12,132	17,373
80DDB	73,617	3,54,323	6,592	4,167	1,51,839	52,932	3,79,125	18,655	7,322	17,079	66,538	3,540	0	4,402	444	432	78,657	9,411	29,360
80E	1,27,650	4,74,879	8,968	4,740	1,72,080	19,142	18,655	4,94,038	12,430	26,117	28,670	2,748	0	2,815	443	408	1,03,182	6,129	17,770
80EE	30,365	1,04,552	3,220	3,211	40,781	5,775	7,322	12,430	1,07,180	4,074	11,976	1,390	0	1,428	347	400	14,516	1,858	3,881
80G	2,43,240	9,59,572	9,666	1,945	4,42,282	17,837	17,079	26,117	4,074	10,10,686	19,066	8,718	0	3,420	689	111	4,80,914	11,293	65,126
80GG	49,060	10,63,008	14,851	5,750	3,56,504	43,537	66,538	28,670	11,976	19,066	12,41,279	4,302	0	5,757	545	613	3,10,100	7,455	1,99,284
80GGA	7,388	36,285	1,006	1,290	17,323	3,107	3,540	2,748	1,390	8,718	4,302	38,200	0	3,105	300	354	13,418	909	712
80GGC	9,528	34,000	784	1,632	20,696	2,947	4,402	2,815	1,428	3,420	5,757	3,105	0	35,038	336	397	9,394	705	2,573
80QQB	1,330	7,089	209	211	2,828	441	444	443	347	689	545	300	0	336	8,242	333	2,713	293	353
80RRB	351	2,892	166	271	1,136	426	432	408	400	111	613	354	0	397	333	3,529	258	238	245
80TTA	20,57,401	1,40,00,889	51,420	7,223	41,65,298	68,930	78,657	1,03,182	14,516	4,80,914	3,10,100	13,418	0	9,394	2,713	258	2,01,51,354	72,105	43,41,297
80U	43,638	2,19,896	3,617	871	61,074	12,132	9,411	6,129	1,858	11,293	7,455	909	0	705	293	238	72,105	2,51,694	17,190
87A	6,45,306	49,57,145	11,450	1,595	11,76,466	17,373	29,360	17,770	3,881	65,126	1,99,284	712	0	2,573	353	245	43,41,297	17,190	75,09,058

would be partially borne by the tax system. Allowances for child care, education, and many other activities all have similar characteristics. Hence, selectivity in granting targeted allowances is crucial if PIT revenue is to be safeguarded. Furthermore, moral hazard problems would argue for the imposition of ceilings to most such allowances. Targeted allowances, especially when numerous, increase administrative costs of the tax authorities and impose compliance costs on the taxpayers. To alleviate such costs, a blanket allowance could be granted to taxpayers in lieu of the various targeted allowances for which they qualify but choose not to claim. Such a blanket allowance could be merged with the general allowance which could be sufficiently high to compensate for the most prevelantly used targetted allowances.

8.15 In India, we have had a three rate structure for PIT since assessment year 1998-99. This is coupled with a large number of targeted allowances as indicated in **Table 8.2.** Of the several allowances and deductions, four of them are most commonly availed by taxpayers. These are deductions relating to (i) House Rent Allowance, (ii) deductions under section 80C, (iii) deductions under section 80D and (iv) deductions under section 80TTA. Several other deductions are availed by a very small proportion of taxpayers.

B. TAX BASE

i. Choice of the Tax Base

8.16 The choice of the tax-base for personal income-tax is essentially a choice between comprehensive income base and a consumption base. The comprehensive income base is akin to the Schanz-Haig-Simon income definition under which the income-tax base is the total amount that an individual can be expected to consume in a given period plus the increased economical wealth (acquistion to network) between that period and next. Taxing income comprehensively means taxing income from all sources - land, labour and capital. This includes cash flows to individuals such as wages, interest and dividends, as well as accruing capital gains and imputed rent from owner occupied dwellings. A tax on the comprehensive income base is equivalent to a consumption tax plus a tax on change in net worth (savings). Increases in net worth are generally derived from savings and become a source of a person's consumption in the future. Decreases in net worth are generally the result of drawing down of a person's past savings.

8.17 The other potentially broad taxation base is consumption which is a component of income and can be derived by excluding savings from the comprehensive income base. The ideal consumption base involves domestic rents and wage labour. If there are no domestic rents, then the consumption base is effectively labour income. Effectively all income from capital is exempt from taxation.

8.18 Many recent proposals for fundamendal tax reform have advocated replacing the current tax system with a broad-based consumption tax. It is argued that a switch to consumption taxation would lead to efficiency gains arising from four different sources. First, a broad-based consumption tax would be neutral between work and leisure. Second, the removal of the current tax on returns to new saving and investment would increase capital accumulation and, ultimately, family incomes. Third, the consumption tax would remove distortions in the allocation of capital across sectors and types of capital. Fourth, a broad-based consumption tax would avoid potentially costly distortions of firms' financial structures. Some estimates suggest that efficiency gains from consumption tax reform could be substantial.

8.19 The Schanz-Haig-Simon measure of income, though conceptually easy to define, is extremely difficult to implement due to data limitations. Nevertheless, leakages from the tax base under existing personal income tax systems are extensive, and substantial opportunities for base broadening exist, either by reducing the amount of exempt income or by eliminating deductions from income in calculating taxable income. Therefore, another group of proposals has suggested reforming the income-tax by reducing the tax rates and broadening the tax base as close to the Schanz-Haig-Simon measure as practically feasible. It is aruged that this proposal will generate efficiency gains which would not be significantly different from the gains arising from a switch to a consumption tax.

8.20 In practice, the recent trend of personal income-tax reform is a hybrid of the two extreme set of proposals and is characterised by (i) reduction in the tax rates; (ii) broadening of the tax base; and (iii) allowing deduction for contributions for savings (including pension savings), exempting accumulations and taxing withdrawals (EET method of taxation of savings). The drafts of both the models are based on this trend.

8.21 In paragraph 8.39, we have recommended two Models for seperate reduced personal income tax rates. Reduction in rates and the broadening of the personal income tax base should be undertaken in the manner discussed in the following paragraphs.

8.22 The income-tax base, in law, is effectively defined as the taxable income (referred to as total income in both Models). The taxable income (total income) of a person for a tax period is commonly defined as the gross income of a person for the period less the total deductions allowed to the person for the period. The gross income of a person for a tax period is the total of the amounts derived by the person during the period which are subject to tax. The gross income of a person, therefore, does not include amounts that are exempt from tax. The total deductions of a personfor a tax period are the total of expenses incurred by the person during the period in deriving amounts

subject to tax plus any capital allowances and other amounts allowed as a deduction on a concessional basis (e.g., charitable donations). Consequently, there are three key elements in the definition of the tax base first, the inclusion of amonts in gross income; second, the indentification of amounts that are exempt income; and third, the allowance of amounts as deductions.

8.23 The inclusion of amounts in gross income is often specified by referrence to particular categories of income. For this purpose, income is commonly divided into employment, business, and property income. There are often supplementary definitions of each category of income and, in the case of property income, definition may include amounts included in property income (e.g., dividends, interest, rent and royalties etc.). However, not all amount derived from taxpayers fits neatly into one of these categories. This problem is overcome by including a seperate residual category of income.

8.24 The second element in the determination of the tax base relates to amounts which are not included in gross income. These amounts are usually identified as "exempt income". The law must clearly provide that amounts defined as "exempt income" are excluded from the definition of gross income and thus from the calculation of taxable income.

8.25 The third element in the determination of the tax base is the allowance of amounts as a deduction. The usual structure for allowing amounts as a deduction is to provide a general rule followed by supplementary definition and allowance provisions. The general rule commonly allows a deduction for expenses to the extent to which they are incurred in deriving amounts included in gross income. Consequently, the specification of amounts included in gross income also defines the basic parameters for the claiming of deductions. Supplemental provisions allow deductions for capital allowances (such as depreciation and amortization provisions) and incentives for participation in activities such as charitable donations and retirement fund contributions.

8.26 Further, the basic structural rules of the income tax law must provide for some general principles relating to apportionment of income and expense, recouped deductions (i.e., an expenditure or loss for which a deduction has been allowed that is subsequently recouped in whole or in part) and valuation.

8.27 Keeping in view the design principles discussed above, "gross income" is referred to as "income" and the same has been defined in both models. All accruals and receipts in the nature of income, other than those enumerated in the Second Schedule, will be classified into independent sources from which the income is derived. Each of these sources would be a "special source" or an "ordinary source".

8.28 The **"special sources"** are sources of income specified in the Fourth Schedule. The inocme from these sources will be liable to tax at a schedular rate on gross basis. No deduction is allowed for any expenditure and the gross amount is subject to tax, generally at a lower rate. This is the application of presumptive taxation. All other sources of income will be **"ordinary sources"**.

8.29 Under Model - I, the receipts are classified into two different heads: (i) Income from various sources; and (ii) Capital gains. However, under Model - II, the accruals or receipts relating to "ordinary sources" will be further classified under five different heads:

(i) Income from employment

(ii) Income from house property

(iii) Income from business

(iv) Capital gains

(v) Income from residuary sources

8.30 The income under all heads is aggregated to determine the "gross total income from ordinary sources". The amount of "gross total income from ordinary sources" so arrived, will be further reduced by incentivies in accordance with sub-chapter I of Chapter III of Model I and sub-chapter H of Chapter III of Model - II. The resultant amount will be "total income from ordinary sources".

ii. Treatment of perquisites

8.31 A perquisites (fringe benefits), is any monetary or nonmonetary benefit derived from employment that does not constitute cash salary or wages. Common examples of fringe benefits are employer-provided housing, the use of an employer-provided car for personal purposes, and the provision of discounted goods to employees.

8.32 The theoretical case for full inclusion of fringe benefits in the tax base is noncontroversial. Full taxation is prerequisite to horizontal equity between taxpayers who are wholly remunerated in cash and taxpayers remunerated partly through fringe benefits. It is also a prerequisite to vertical equity because the incidence of fringe benefits tends to rise with taxpayers' economic incomes and employment status. Full taxation of fringe benefits is also a precondition to achieving an economically efficient tax system. It ensures that the tax system will be netural between those employers able to provide fringe benefits and those not able to do so and removes the distortion in favor of providing goods and services that are not taxed. Finally taxation of fringe benefits is important to protect the revenue base.

8.33 The overwhelming theoretical case in favor of fringe benefits taxation is countered by a number of conceptual and political problems. A fundamental problem is that many taxpayers, and

some tax administrators, do not perceive benefits in kind to be income with the same economic capacity as cash wages or salaries. Subsidiary problems arise from the definition of fringe benefits, the difficulty in allocating general benefits among employees, and the difficulty in distinguishing genuine benefits from benefits that are consumed in the course of employment or that are a necessary condition of employment. The conceptual difficulties that arise with the income taxation of fringe benefits have often resulted in low levels of taxpayer compliance with, and administrative enforcement of, the tax law applying to these benefits. This in turn has led to a "tax culture" in some countries that regards fringe benefits as tax free remuneration so that attempts to expressly bring the value of fringe benefits within the tax base are subject to resistance.

8.34 In practice, three different methods of taxation of fringe benefits are prevelant. The first method provides for taxation of fringe benefits in the hands of the employee at the personal marginal rate applicable to him. Under the second method, fringe benefits are taxed by way of a seperate levy at the corporate level and at the corporate tax rate. This has been in force in New Zealand since 1984 and in Australia since 1986. India also experimented this between financial year 2005 and 2009 and later abandoned it in favour of the present system of taxing fringe benefits in the hands of the employee. The third method is to dis-allow the value of the fringe benefits in the computation of income of the employer. This method was also experimented between financial year 1983 to 1997 in India and given up since it led to large scale litigation.

Eliminating deductions

8.35 Much of the leakage from actual to taxable personal income arises from deductions based on specific tax-preferred used of income. Base-broadening income tax reform requires the elimination of many of them if rates are to be reduced significantly, and virtually all countries undertaking reforms have scrutinized existing tax deductions and credits.

8.36 Most income tax systems allow some deductions for the costs of earning income. Although the exclusion of such costs from the tax base is justifiable, it is often difficult to distinguish between necessary and discretionary outlays. Moverover in some countries, such as France, the ability of certain professions to make substantial employment expense deductions without substantiation has a significant revenue cost. Several recent income tax reforms have placed explicit limitations on what is allowable. For example, the United States reform allows miscellaneous work-related expenses only above a specified floor (2 per cent of adjusted gross income). Australia now requires proof of employment-related expenditures, particularly automobile and travel costs. Many countries are also seeking to limit entertainment expenditures, which are open to much abuse. However, the ability of the self-employed to inflate their expenses and reduce their taxes remains a problem in

most countries.

8.37 An important deduction in some countries is the exclusion of a portion of income set aside for retirement in the form of contributions to pension programmes or individual retirement programmes, combined with a favourable treatment of the income earned on these funds. Some countries, such as the United States and Japan, have sought to reduce the base-narrowing effect of such deductions. On the other hand, others have increased such deductions, as in France, where tax-preferred individual retirement accounts have been created and in Canada, where the retirement saving tax shelter has been significantly expanded.

8.38 Finally, it should be noted that lower marginal tax rates, almost universally the most important objective of tax reform, are also an important complement to any base broadening reform, since they greatly reduce the value of any remaining income leakage or tax deduction. In may countries reductions in marginal rates have concentrated on the highest rates, flattening the rate schedule.

Recommendations

8.39 Keeping in view the principles for designing the tax rate structure and the tax base and the best international practice, we have crafted two alternative packages relating to Personal Income Tax as described below:-

Package - I

(i) The threshold limit should be increased from ₹2.5 lacs to ₹6 lacs.

(ii) In the case of senior citizens, the threshold limit will be increased from ₹3 lacs to ₹6 lacs. However, in the case of very senior citizens, the threshold will be increased from ₹5 lacs to ₹8 lacs.

(iii) the rate structure under this alternative shall be as under-

Total Income	Rate
Below ₹6,00,000/-	Nil
6,00,000/- to ₹20,00,000/-	15 percent of the Income in excess of ₹6,00,000/-
Above ₹20,00,000/-	2,10,000/- plus 30 percent of the Income in excess of ₹20,00,000/-

(iv) consequent to the higher threshold of ₹6,00,000/-, the concessional tax treatment of the following targeted allowances should be withdrawn, namely :-

(a) House rent allowances
(b) Personal allowances granted at the place of duty
(c) Children education allowance
(d) Deduction for Mediclaim

(e) Deduction for royalty on books and patent
(f) Rebate under section 87A
(g) Deduction for rent paid
(h) Deduction for disabled persons
(i) Deduction for interest on education loan
(j) Deduction for interest earned in savings bank account
(k) Deduction for critical medical expenditure including those for senior citizens

(v) the tax treatment of savings, commutation of pension and other retirement benefits will be allowed as per **Bundle - I** in para 9.66 in Chapter IX;

(vi) tax perquisites received by an employee in his hand at the personal marginal income-tax rate applicable to him.

Package - II

(i) The threshold limit should continue at the existing level of ₹2.5 lacs.

(ii) Similarly, in the case of senior citizens, the threshold limit will continue at the existing level of ₹.3.00 lakhs

(iii) the rate structure under this alternative shall be as under-

Total Income	Rate
Below ₹2,50,000/-	Nil
₹2,50,000/- to ₹5,00,000/-	5 percent of the Income in excess of ₹2,50,000/-
₹5,00,000/- to ₹10,00,000/-	₹12,500/- plus 10 percent of the income in excess of ₹5,00,000/-
₹10,00,000/- to ₹30,00,000/-	₹62,500/- plus 20 percent of the Income in excess of ₹10,00,000/-
Above ₹30,00,000/-	₹4,62,500/- plus 30 percent of the Income in excess of ₹30,00,000/-

(iv) consequent to the lower threshold of ₹2,50,000/-, the targeted allowances shall be continued:

(v) the tax treatment of savings, commutation of pension and other retirement benefits will be allowed as per **Bundle - II** in para 9.66 in Chapter IX; and

(vi) tax perquisites received by an employee in his hand at the personal marginal income-tax rate applicable to him.

8.40 Further, in view of the discussions in paras 8.31 to 8.34 relating to treatment of perquisites, we recommend that the value of perquisites should continue to be taxed in both Model I and Model II in the hands of the employee. However, the prescribed value of the perquisites is extremely

low and do not fully reflect their fair market value. Similarly, with the proposed higher threshold limit in Model I and the broadening of the tax slabs, there is no room for allowing any exemption of house rent allowance or perquisite value of accommodation provided by employer to any class of taxpayers. Accordingly, we recommend that for the purposes of enhancing the equity of the personal income tax regime,-

(i) the exemption of house rent allowance and perquisite value of accommodation provided by employer should be withdrawn for all class of employee-taxpayers; and

(ii) the values of all other perquisites should be appropriately revised to reflect their fair market value.

8.41 We also recommend that with a view to protecting the taxpayers' base in the case of **Model I**, all persons who have availed business loans or housing loans may be mandated to file their tax return regardless of their total income. **This will ensure that the taxpayers base is fully protected.**

8.41 The design of the tax law in **Model I** is based on Package I and the design in **Model II** is based on Package II.

CHAPTER IX

TAX TREATMENT OF SAVINGS

1. Introduction

9.1 In India, the income-tax system designed substantially on the principle of comprehensive income base provides several tax incentives for financial savings. The case for concessional tax treatment of savings is built on the consideration that there is double taxation of savings under a comprehensive income tax: first at the point of contribution and again when the benefits are received. Therefore, a comprehensive income tax is inherently biased against savings. it leads to double taxation in as much as both the savings and the earnings are taxed. A tax at 30 percent on the pre-tax income of ₹100/- leaves an individual with a post-tax income of ₹70/-. If the entire amount is saved, it will yield an amount of ₹7/- as interest at 10 percent per annum and the post-tax interest earnings will be ₹4.90/-. Consequently, at the end of the first year, the total savings will be ₹74.90/- (₹70 + ₹4.90). However, if there is no double taxation i.e. the taxation is either at the point of contribution or withdrawal, the total savings will be ₹77/-.Tax incentives for savings are necessary to neutralize this bias and eliminate the distortions in the choice of consumption/ savings. Further, a tax concession for savings leads to higher post-tax return for the investor. The higher returns, in turn, create a positive substitution effect whereby, savings are preferred over current consumption leading to higher savings.

9.2 In contrast, experts have argued that tax incentives for savings are economically inefficient, inequitable, very costly and do not serve the intended purpose. Therefore, promoting voluntary savings through tax incentives may not be the appropriate instrument for promoting savings – GDP ratio in the economy. Their case is build on the argument that **firstly,** tax incentivies, while creating a positive substitution effect also creates a disincentive for savings (income effect) since the higher returns now require lower savings to meet the lifetime savings target. Empirical research on the impact of tax incentives on savings suggests that, at the most, only relatively small fractions of the funds going into tax-advantaged savings vehicles can be considered to be "new" saving. As such, the best interpretation of the evidence is that such policies are expensive ways of encouraging savings. Most studies that have analysed the interest rate effect on savings have not found convincing evidence of a systematic relation between rate of interest and savings. The emerging consensus is that even if the positive substitution effect and the negative income effect do not cancel out, the rate of return effects on saving are at best small. **Secondly,** to the extent that the reshuffling of assets leads to a reduction in the tax liabilities without any real change in economic behaviour, there is some deadweight loss associated with such policies. **Thirdly,** since those with the greatest

reshuffling possibilities are the wealthiest members of society, these policies will typically have some distributional impact. The tax benefits are regressive in as much as they provide relatively higher tax benefit to investors in the higher tax bracket; in fact, a large multitude of small savers who are outside the tax net do not enjoy any form of tax subsidy on their savings. **Fourthly,** the tax incentives for savings, particularly of the type which allows for exemption at all three stages of the savings process (EEE method of taxation), that is, exempt at all three stages of contribution, accumulation and withdrawal, do not encourage net savings (contribution plus accumulation minus withdrawals) since withdrawals are also exempt from tax. **Fifthly,** national savings comprise of household savings, government savings and corporate savings. To the extent, tax incentives for savings lead to fiscal loss, the government savings are adversely impacted thereby, partially neutralizing the increase in household savings. **Finally,** tax incentives for savings distort the interest structure, choice of instrument and merely help mobilize funds to specified savings instrument. It also leads to increase in the benchmark interest rate on borrowing from household thereby, adversely affecting investment.

9.3 The big question therefore is if there should be no tax incentive for savings, what should be the tax treatment of savings?

2. Criteria for designing an efficient saving incentive

9.4 For any tax proposal or provision accurately to be labeled a saving incentive, three criteria must be met. first, tax benefits should not go to taxpayers who simply switch assets from one form of saving (or one kind of account) to another. The shift of assets into a tax-preferred form permits taxpayers to achieve tax reductions with no' increase in their saving. When one asset is favored over others, there will indeed be additional investment in the advantaged activity. However, there will also be less investment in other activities and a less efficient allocation of investment across sectors and activities. Thus, although total saving and investment could conceivably increase if overall returns to capital rise, that increase would come at the cost of, a poorer allocation of the capital stock.

9.5 Second, no tax provision can be considered a true incentive if it does not apply at the margin. A deduction with a cap—that is, one with a limit on the amount of deduction or exclusion permitted—provides little marginal incentive for a person already receiving income in excess of the maximum.

9.6 Third, a tax incentive for saving must provide symmetrical treatment of. positive saving on the one hand and negative saving or borrowing on the other, If a taxpayer can borrow and deduct

the costs of interest while at the same time acquiring an asset yielding income that is partially or fully tax-exempt—a process that is known as "tax arbitrage"—the taxpayer may achieve a tax reduction with no increase in net saving whatsoever.

3. Tax treatment of savings: alternative methods

9.7 Generally, there are two distinct types of tax system: a comprehensive income tax and an expenditure tax. Under a comprehensive income tax all sources of income is explicitly taxed. An expenditure tax, on the other hand, only taxes consumption. Effectively it exempts from tax the returns from savings until they are consumed.

a. Expenditure tax method

9.8 There are two main forms of expenditure tax. The first involves giving tax relief on income that is saved, exempting from tax any interest and gains accumulating on those savings, but then taxing the total proceeds as and when the savings are withdrawn for consumption. This form is often described as EET, with E denoting an exemption or relief from tax and T denoting a point at which tax is payable.

9.9 Another form of expenditure tax regime followed is one where no relief is given for the investment, but the accumulating interest and gains and the proceeds of the investment are exempt from tax. This system is often described as TEE. The EET system is the classical example of an expenditure tax. The TEE system is often called the 'pre-paid expenditure tax'.

b. Comprehensive income tax method

9.10 Under a comprehensive income-tax system all income is taxed when it is received so saving is from taxed income; interest income from savings is taxed; but proceeds of saving do not suffer further tax. In practice, this system is described as TTE. Another variant of the comprehensive income tax is one where the tax exemption occurs at the point of contribution, while fund income and benefits are taxable (ETT). The effects of these two systems are the same. These two systems result in a disincentive to saving, because consumption now is worth more than consumption in the future. In as much as savings are taxed twice, this system is inherently biased against savings.

9.11 In order to neutralize this bias, most countries design their income tax structure, so as to provide for exemption/ concessional tax treatment of the various savings instruments by following one of the many variants of the two methods. Some experts are also of the view that the distortion arising out of the inherent bias against savings could be substantially moderated by adopting a

simple income tax structure with reasonable rates and a comprehensive base.A broader base would provide a more uniform treatment of capital income from disparate sources, thereby improving resource allocation. Saving would be directed toward the most efficient, rather than the most .tax-favored, uses. Even if some assets continue to receive tax preferences, lower tax -rates would reinforce the tendency toward efficient allocation by automatically decreasing the value of tax-preferred assets relative to other assets.

9.12 The remaining two criteria would also- be met easily by a, broader-base, lower-rate tax .structure. The very nature of rate reduction means that incentives would apply at the margin, -since-marginal-tax-rates-would-bereduced for most if not all, transactions. Finally, the tax arbitrage problem that is characteristic of existing saving incentives , would be avoided because the rate reductions would apply equally to both receipts and deductions. In fact, lower- rates. would actually reduce the potential gains from tax arbitrage by narrowing any remaining differential between the tax treatment of interest and the treatment of other types of capital income.

9.13 These two benchmark tax systems - the expenditure tax method and the comprehensive income tax method - are different ways of interpreting 'fiscal neutrality' with respect to savings. Equalising pre- and post-tax rates of return is neutral between present and future consumption. A comprehensive income tax is neutral between consumption and saving, treating savings in exactly the same way as any other form of consumption. However, savings are not a commodity like any other good or service. They are a means to future consumption, and this is particularly obvious where saving for retirement is concerned. Neutrality between consumption now and consumption in retirement is the relevant concept for taxing savings/ pensions, and that is the form of neutrality achieved by the expenditure tax..

9.14 An expenditure tax treats two individuals the same, regardless of when they choose to consume the income, which they earn, whereas a comprehensive income tax gives rise to double taxation of savings. Income is, first taxed when it is earned and thereafter the interest on savings is also taxed before the money is spent. An expenditure tax allows individuals to receive interest gross of tax. They can therefore determine their preferences for consumption now or in the future without distortions imposed by the tax system. By contrast, a comprehensive income-tax (TTE) (where returns to saving are taxed) would create such distortions, with associated inefficiencies.

9.15 A savings scheme is usually considered as being taxed favourably when its tax treatment deviates from a regime that treats all sources of income equally from a fiscal standpoint (the so-called comprehensive income tax regime). Using this as a benchmark, there are several ways in which tax incentives can be provided. In the case of an expenditure tax regime, it could either take

the form of EET or TEE. Under the TEE method, tax is paid in the year in which income is earned and the benefits are exempt when received. Therefore, there is no incentive to postpone consumption. However, under the EET method, exemption is provided to both the funds contributed and the accrued return on accumulated fund but the benefits are taxed when received. Under this method, the tax incentive for saving and accumulation entails tax deferral thereby providing an inherent incentive to postpone consumption.

9.16 The emerging wisdom is that savings should either be taxed at the point of contribution (TEE) or withdrawal (EET). The **case for** taxation at the point of contributions is built on the argument that it does not adversely affect immediate revenue collections. Therefore, in the context of a country running a large fiscal deficit, it enables the government to tide over the fiscal crisis without resorting to distortionary taxes. **Secondly**, a person has a psychological preference for payment of tax during his active life over payment of tax post retirement. However, there is no empirical evidence in support of such preference.

9.17 The **case against** contribution out of post tax income (i.e. case for tax exemption for contributions) is built on several arguments. **Firstly**, savings (contribution) lead to reduction in cash flow and therefore, the 'ability' to pay. Therefore, taxation at the point of contribution would create hardship and act as a disincentive to save. However, taxation at the point of withdrawal (principle or earnings) enhances the ability to pay and therefore, justified on principles of taxation. **Secondly,** under the TEE method, taxation at the point of contribution does not provide any immediate incentive to save nor does exemption of withdrawals discourage dissavings. However, under the EET method of taxation of savings, full deduction from income at the point of contribution and accumulation acts as an incentive for savings while taxation at the point of withdrawal penalizes dissavings. The combined effect is that it encourages the saver to build a self-financing old age social security system. **Thirdly,** under the TEE method, since withdrawals are exempt irrespective of the amount, there is no incentive to postpone consumption beyond the minimum lock-in-period, if any. However, if exemption is provided for contributions, there is an inherent incentive to postpone consumption so as to avail the benefit of tax deferral. It allows for consumption smoothening, particularly in old age. Further, under a progressive personal income tax rate structure, there is an in-built incentive to restrict withdrawals to meet necessary consumption only since lower withdrawals imply taxation at lower marginal tax rate and hence, lower tax liability. Consequently, the potential for old-age poverty is minimized. **Fourthly**, the EET method provides discretion to the saver for tax smoothening and minimize the tax liability arising from any bunching of gains. **Fifthly**, in the context of any long-term saving scheme, particularly the pension system, it is not sufficient to provide tax incentives. What is particularly important is to have an appropriate

and stable tax regime for such pension systems because of the long time scale that is generally involved in building up an adequate pension fund. Fifty years may elapse between the time when a pension scheme member pays his first contribution and the time when he draws his last benefit from the pension fund. If tax laws are changed during this period, it can be complicated and costly to protect the legitimate expectations of those who have been making provisions on the basis of the old law. There is always a problem of time inconsistency. In the absence of a promissory estoppel against the statute, any government in the future may not feel bound by promises of the previous government for tax exemption or concessional tax treatment of pensions in payment or investment returns and may view pension funds as soft revenue targets. This would be particularly so in the context of pressures to reduce fiscal deficit. Therefore, the taxation of contributions has the potential for inherent instability. Under the EET method, since taxation is at the last point in the savings process, there is no uncertainty about the potential tax liability unlike in the case of TEE method where the saver is uncertain whether the Government would impose a tax at the point of accumulation or withdrawal to raise revenue to overcome the fiscal crisis. **Sixthly**, the EET method is extremely simple in terms of compliance and administration since it can be operationalized by opening an account with a designated fund which, in turn, can invest in a mix of a broad range of debt and equity instruments depending upon the risk appetite of the saver. All earnings are required to flow into the same account and withdrawals, if any, can be subject to withholding tax. It does not require any complex tracking mechanism to prevent leakage of revenue. It is not necessary for the saver to maintain details of savings and earnings to claim tax benefit.

9.18 **Finally**, the EET method is also the best international practice. Most developed countries and many developing countries are implementing the EET method of taxation of savings. Ten countries (Austria, Canada, Finland, Greece, Iceland, Netherlands, Norway, Poland, Switzerland, and the United States) come close to the pure EET regime in which withdrawals are subject to tax at the progressive income tax rates. Another twelve countries (Belgium, France, Germany, Ireland, Japan, Korea, Mexico, Portugal, Slovak Republic, Spain, Turkey and the United Kingdom) also apply an EET regime, but one where withdrawals are generally taxed more leniently than in the first group of countries or where contributions are granted a tax credit rather than a full deduction. For instance, the United Kingdom, Ireland, Spain, France, Mexico and Turkey allow a partial tax-free withdrawal of benefits in the form of a lump sum, while France, Germany and Turkey allow a similar tax privilege to annuity pension income. In Mexico, Turkey and the Slovak Republic, pension income above a specified tax-free limit is taxed at a relatively low rate.

9.19 The practice in other OECD countries differs from the EET regime to the extent that contributions and/or accrued income are taxed. In Italy, Denmark, and Sweden, the tax treatment

Table 2: Tax Treatment of Financial Savings in India			
Sl. No.	**Section**	**Specified investments/ schemes eligible for deduction u/s 80C**	**Method**
1	80C(2)(i)	Insurance on the life of the individual, the spouse or any child of the individual.	ETpE
2	80C(2)(i)	Insurance on the life of any member of the HUF.	ETpE
3	80C(2)(ii)	Contract for a deferred annuity (other than an annuity plan of LIC/other insurer notified by Central Government) on the life of the individual, the spouse or any child of the individual	ETpE
4	80C(2)(iii)	Payable by the Government to any individual up to one-fifth of the salary of the individual for the purpose of securing a deferred annuity for himself or his spouse or children (CGEIS).	EEE
5	80C(2)(iv)	Any provident fund to which the Provident Funds Act, 1925 applies (GPF)	EEE
6	80C(2)(v)	Any provident fund set up and notified by the Central Government – **(Public Provident Fund)PPF Account can be opened by –** **(a) the individual in his name or in the name of the spouse or children.** **(b) HUF in the name of any member**	EEE
7	80C(2)(vi)	A recognised provident fund	EEE
8	80C(2)(vii)	An approved superannuation fund	EETp
9	80C(2)(viii)	Any notified security of the Central Government or any notified deposit scheme (i) A special small savings instrument for the welfare of the girl child was introduced under the Sukanya Samriddhi Account Rules, 2014. Further, the said Scheme has been notified under clause (viii) of sub-section (2) of section 80C of the Income-tax Act vide Notification number 9/2015 S.O.210 (E),F.No. 178/3/2015-ITA-I dated 21.01.2015. No other scheme/security notified for the purposes of section 80C. (ii) Further, National Savings Scheme (NSS) was notified for the purposes of section 88.	EEE EETp However, no rebate under section 88 since 2006
10	80C(2)(ix)	Savings as notified by the Central Government **(NSC VIII Issue)**	EETp However, no rebate under section since 2006
11	80C(2)(x)	Unit-linked Insurance Plan, 1971 of the Unit Trust of India in the name of (a) the individual or in the name of the spouse or children. (b) HUF in the name of any member	EEE
12	80C(2)(xi)	Notified unit-linked insurance plan of the LIC Mutual Fund in the name of- (a) the individual or in the name of the spouse or children. (b) HUF in the name of any member (Unit Linked Insurance Plan (formerly known as Dhanraksha-1989) of the Life Insurance Corporation Mutual Fund)	ETpE

Sl. No.	Section	Specified investments/ schemes eligible for deduction u/s 80C	Method
13	80C(2)(xii)	Notified annuity plan of the Life Insurance Corporation or any other insurer (New Jeevan Dhara, New Jeevan Dhara-I and New Jeevan Akshay, New Jeevan Akshay-I and New Jeevan Akshay-II, Jeevan Akshay-III)	ETpE
14	80C(2)(xiii)	Units of any Mutual Fund referred to in section 10(23D) or from the Administrator or the specified company under any plan formulated in accordance with such scheme as notified by the Central Government (Equity linked savings scheme, 2005)	ETpEp
15	80C(2)(xiv)	Any pension fund set up by any Mutual Fund referred to in section 10(23D) or by the Administrator or the specified company, as notified by the Central Government (UTI-Retirement Benefit Pension Fund)	ETpE
16	80C(2)(xv)	Deposit scheme or pension fund of the National Housing Bank established under section 3 of the National Housing Bank Act, 1987 (53 of 1987) and notified by the Central Government	EETp
17	80C(2)(xvi)	Deposit scheme of— (a) a long-term housing finance public sector company; or (b) any authority constituted in India by or under any law for providing housing accommodation or for city/town/ village planning or development or improvement and notified by the Central Government	EETp
18	80C(2)(xvii)	As tuition fees for full time education of two children in any college/university or school (excluding any development fees or donation or payment of similar nature)	--
19	80C(2)(xviii)	Repayment of loan for purchase or construction of a residential house property	--
20	80C(2)(xix)	Equity shares of a public company forming part of any eligible issue of capital approved by the Board or any eligible issue of capital by any public financial institution.	ETpE
21	80C(2)(xix)	Debentures (infrastructure bonds) of a public company forming part of any eligible issue of capital approved by the Board or any eligible issue of capital by any public financial institution.	EETp
22	80C(2)(xx)	Units of any mutual fund referred to in section 10(23D) and approved by the Board and subscribed only in the eligible issue of capital of any company:	ETpE
23	80C(2)(xxi)	Term deposit of a scheduled bank for a fixed period of not less than five years and which is in accordance with a scheme framed and notified, by the Central Government. Bank Term Deposit Scheme, 2006	EETp
24	80CCC	Contract for any annuity plan of LIC or any other insurer for receiving pension from a fund.	EETp
25	80CCD	Pension scheme notified by the Central Govt. for employees joining Central Govt. from 1.1.2004	EETp

SUMMARY ON INDIVIDUALS DECLARING HOUSE PROPERTY DETAILS - AY 2017-18

SR	SLAB (GTI)	No of PANs	Number of ITRs with Property					Number of ITRs with Self-Occupied Property					Number of ITRs with Let Out Property				
			HP=1	HP=2	HP=3	HP>3	Total	HP=1	HP=2	HP=3	HP>3	Total	HP=1	HP=2	HP=3	HP>3	Total
1	<2.5 Lakh	60,17,888	7,71,087	52,618	10,960	5,514	8,40,179	4,09,473	302	49	29	4,09,853	4,08,345	36,619	7,792	4,199	4,56,955
2	2.5 Lakh to 3 Lakh	73,67,208	6,77,117	34,834	7,848	4,192	7,23,991	3,69,688	216	28	17	3,69,949	3,32,250	26,068	6,290	3,525	3,68,133
3	3 Lakh to 3.5 Lakh	77,19,678	9,48,970	51,321	11,669	6,456	10,18,416	5,54,845	291	45	17	5,55,198	4,34,919	36,812	9,152	5,406	4,86,289
4	3.5 Lakh to 4 Lakh	46,17,478	8,46,358	50,448	11,967	6,986	9,15,759	5,42,960	310	38	17	5,43,325	3,49,636	34,093	9,255	5,666	3,98,650
5	4 Lakh to 4.5 Lakh	37,99,516	8,47,474	48,366	11,860	6,872	9,14,572	5,89,997	315	38	20	5,90,370	3,06,069	31,347	8,829	5,536	3,51,781
6	4.5 Lakh to 5 Lakh	32,73,849	8,14,734	47,191	12,015	7,168	8,81,108	5,85,947	318	44	25	5,86,334	2,77,835	30,383	8,903	5,708	3,22,829
7	5 Lakh to 6 Lakh	43,75,557	11,81,732	70,693	19,084	12,247	12,83,756	8,79,859	526	54	30	8,80,469	3,76,480	45,651	14,350	9,797	4,46,278
8	6 Lakh to 7.5 Lakh	42,28,033	12,43,748	75,827	21,582	14,403	13,55,560	9,60,176	573	70	29	9,60,848	3,67,271	48,503	16,092	11,486	4,43,352
9	7.5 Lakh to 10 Lakh	34,24,189	11,39,513	77,714	22,391	15,939	12,55,557	9,03,614	598	63	35	9,04,310	3,25,924	48,261	16,633	12,769	4,03,587
10	10 Lakh to 12 Lakh	13,90,042	5,19,208	44,318	13,033	9,339	5,85,898	4,10,061	344	40	29	4,10,474	1,63,264	26,821	9,433	7,444	2,06,962
11	12 Lakh to 15 Lakh	10,84,351	4,33,098	44,420	12,811	9,705	5,00,034	3,39,261	314	33	24	3,39,632	1,50,013	26,007	9,238	7,780	1,93,038
12	15 Lakh to 20 Lakh	8,61,004	3,70,543	45,654	12,883	9,830	4,38,910	2,93,137	358	48	16	2,93,559	1,38,191	25,627	8,978	7,816	1,80,612
13	20 Lakh to 25 Lakh	4,32,960	1,89,734	29,276	8,121	6,281	2,33,412	1,49,962	211	38	12	1,50,223	80,120	16,037	5,476	4,959	1,06,592
14	25 Lakh to 50 Lakh	5,85,733	2,50,164	55,044	17,028	14,075	3,36,311	1,95,252	407	55	39	1,95,753	1,32,032	31,357	11,508	11,246	1,86,143
15	50 Lakh to 1 Crore	1,73,395	61,973	23,916	8,765	8,291	1,02,945	53,177	225	37	21	53,460	44,168	14,552	5,871	6,603	71,194
16	Above 1 Crore	82,267	24,055	12,122	5,513	6,977	48,667	21,356	140	31	18	21,545	20,760	8,551	4,109	5,651	39,071
TOTAL		**4,94,33,148**	**1,03,19,508**	**7,63,762**	**2,07,530**	**1,44,275**	**1,14,35,075**	**72,58,765**	**5,448**	**711**	**378**	**72,65,302**	**39,07,277**	**4,86,689**	**1,51,909**	**1,15,591**	**46,61,466**

Deduction claims u/s 80CCE { 80C + 80CCC + 80CCD(1) } in ITRs of AY 2017-18

Amount in Rs Crore

SR	SLAB	Business			Non-Business			Total		
		No of ITRs	No of ITRs claiming Deduction	Amount	No of ITRs	No of ITRs claiming Deduction	Amount	No of ITRs	No of ITRs claiming Deduction	Amount
1	<2.5 Lakh	21,40,602	4,86,428	1,657	38,79,343	11,44,876	3,960	60,19,945	16,31,304	5,617
2	2.5 Lakh to 3 Lakh	48,31,843	11,23,174	2,698	25,41,802	10,91,221	3,925	73,73,645	22,14,395	6,623
3	3 Lakh to 3.5 Lakh	52,83,479	33,72,639	9,562	24,43,881	17,85,343	8,232	77,27,360	51,57,982	17,794
4	3.5 Lakh to 4 Lakh	25,39,562	20,47,592	11,525	20,83,044	17,93,336	13,269	46,22,606	38,40,928	24,794
5	4 Lakh to 4.5 Lakh	16,70,591	14,61,616	12,518	21,32,231	19,62,042	20,099	38,02,822	34,23,658	32,616
6	4.5 Lakh to 5 Lakh	12,24,356	10,62,603	11,269	20,51,723	19,18,631	22,427	32,76,079	29,81,234	33,696
7	5 Lakh to 6 Lakh	13,55,724	12,12,887	13,079	30,22,007	28,72,248	35,181	43,77,731	40,85,135	48,260
8	6 Lakh to 7.5 Lakh	10,01,250	9,10,153	11,028	32,28,095	31,23,906	41,575	42,29,345	40,34,059	52,602
9	7.5 Lakh to 10 Lakh	7,14,409	6,43,712	8,052	27,10,849	26,38,200	36,779	34,25,258	32,81,912	44,831
10	10 Lakh to 12 Lakh	3,15,760	2,89,330	3,773	10,74,774	10,48,474	14,980	13,90,534	13,37,804	18,753
11	12 Lakh to 15 Lakh	2,59,756	2,39,971	3,224	8,24,914	8,03,707	11,619	10,84,670	10,43,678	14,843
12	15 Lakh to 20 Lakh	2,09,016	1,94,088	2,657	6,52,136	6,34,858	9,266	8,61,152	8,28,946	11,923
13	20 Lakh to 25 Lakh	1,04,395	97,140	1,349	3,28,682	3,19,507	4,695	4,33,077	4,16,647	6,044
14	25 Lakh to 50 Lakh	1,62,127	1,50,990	2,120	4,23,682	4,07,666	5,998	5,85,809	5,58,656	8,118
15	50 Lakh to 1 Crore	60,712	56,612	806	1,12,699	1,04,767	1,536	1,73,411	1,61,379	2,342
16	Above 1 Crore	29,326	26,871	385	52,961	46,893	681	82,287	73,764	1,066
TOTAL		**2,19,02,908**	**1,33,75,806**	**95,700**	**2,75,62,823**	**2,16,95,675**	**2,34,223**	**4,94,65,731**	**3,50,71,481**	**3,29,924**

of private pension is closer to the comprehensive income tax system. While they allow for the deferral of taxation on contributions, they tax accrued income from fund investment – albeit at preferential rates – and pension benefits at withdrawal (ETT).

9.20 On the other hand, Australia, New Zealand, Czech Republic, Hungary and Luxembourg tax contributions to private pension schemes. In the latter three cases, either employee's or employer's contributions are exempt from taxation, but not both. Although the treatment in Australia is uniquely characterized as a TTT regime, contributions are partly exempted (especially for low-income participants) and investment earnings and pension benefits are both taxed at a preferential rate.

9.21 As discussed in the foregoing paragraphs, the expenditure tax method of treating savings ensures fiscal neutrality with respect to savings without compromising the equity of the tax system. Further, as discussed above, the contributions to and accumulation of, savings must be exempt but the withdrawals/benefits should be taxed. Therefore, the choice between the EET and the TEE method should settle in favour of the EET method.

9.22 If the existing system of taxing pensions and saving is economically inefficient and inequitable, it is reasonable to expect changes in tax rules as tax reform progresses. Therefore, it is not sufficient to design tax "incentives" to only maintain fiscal neutrality between consumption and savings. **It is equally necessary to ensure that the tax "incentives" do not distort household portfolio. Logically therefore all forms of savings must essentially follow the same pattern of EET method of tax treatment so that the yield curve based on post tax return is not biased against long-term pension savings. Deviations from the EET method, if any, would be justified only on grounds of equity, administrative convenience, institutional rigidity or transitional arrangement.**

9.23 In India, the tax system (emanating from the Income-tax Act, 1961) provides broadly the following types of tax incentives for financial savings:

(a) Deduction from income in respect of contributions to specified savings schemes such as GPF, NSC, NSS, EPF and PPF, tax saving units of mutual funds, premium paid on life insurance, repayment of housing loans, and infrastructure bonds. The deduction is capped at ₹1,50,000.

(b) Deduction from income for contribution to pension funds managed by any insurer, subject to a ceiling of ₹1,50,000/-. The pension/ annuity under the scheme is, however, taxable. [Section 80CCC]

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

(d) Exemption under section 10(11) and section 10(12) in respect of any payment from a provident fund set up by the Central Government or set up under the Provident Fund Act, 1925 or a recognized provident fund.

(e) Exemption under section (12A) of the Act for any payment from the National Pension System Trust to an employee on closure of his account or on his opting out of the pension scheme referred to in section 80CCD, to the extent it does not exceed forty per cent of the total amount payable to him at the time of such closure or his opting out of the scheme.

(f) Exemption under section (12B) of the Act for any payment from the National Pension System Trust to an employee under the pension scheme referred to in section 80CCD, on partial withdrawal made out of his account in accordance with the terms and conditions, specified under the Pension Fund Regulatory and Development Authority Act, 2013 (23 of 2013) and the regulations made thereunder, to the extent it does not exceed twenty-five per cent of the amount of contributions made by him.

(g) Exemption under section 10(13) in respect of any payment from a Superannuation Fund on the death of beneficiary or in commutation of annuity on retirement or by way of transfer to the account of the employee under a pension scheme referred to in section 80CCD and notified by the Central Government.

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

(i) Exemption under section 10(15)(iib) in respect of interest on Capital Investment Bonds notified before 1st day of June, 2002.

(j) Exemption under section 10(15)(iic) in respect of interest on Relief Bonds.

(k) Exemption under section 10(15)(iid) in respect of interest on Bonds notified before first day of June, 2002.

(l) Exemption under section 10(15)(iv)(h) in respect of interest on notified public sector bonds.

(m) Exemption under section 10(15)(iv)(i) in respect of interest on deposits out of moneys

Treatment of pension savings							
Sl.No.	Countries	Contributions	Fund		Pension payments		Method of tax treatment
			Income	Value	Annuities	Lump sums	
1	Canada	E	E	E	T	T	EET
2	Finland	E	E	E	T	T	EET
3	Greece	E	E	E	T	T	EET
4	Iceland	E	E	E	T	T	EET
5	Netherlands	E	E	E	T	T	EET
6	Norway	E	E	E	T	ot allowe	EET
7	Poland	E	E	E	T	T	EET
8	Switzerland	E	E	E	T	T	EET
9	United States	E	E	E	T	T	EET
10	Austria Individuals Employers	 T/Tp E	 E E		 T/Tp T	 T/Tp T	EET
11	Argentina	E	E		T	T	EET
12	Chile	E	E		T	T	EET
13	Costa Rica	E	E		T	T	EET
14	Uruguay	E	E		T	T	EET
15	Colombia	E	E		Tp	Tp	EET_P
16	France	E	E	E	T/ Tp	T/ Tp	EET_P
17	Germany	E	E	E	T/ Tp	T	EET_P
18	Ireland	E	E	E	T/ Tp	T/ Tp	EET_P
19	Japan	E	E	E	T/ Tp	T/ Tp	EET_P
20	Korea	E	E	E	T/ Tp	T/ Tp	EET_P
21	Mexico	E/S	E	E	T/ Tp	T/ Tp	EET_P
22	Slovak Republic	E	E	E	0.15	0.15	EET_P
23	Spain	E	E	E	T	T/ Tp	EET_P
24	Turkey	E	E	E	E	5%/ Tp	EET_P
25	United Kingdom	E	E	E	T	T/ Tp	EET_P
26	Belgium Individuals Employers	 T/ Tp E	 E E	 0.0017 0.0017	 T/ Tp T/ Tp	 0.1 0.165	EET_P
27	Portugal Individuals Employers	 T/ Tp E	 E E	 E E	 20%/ Tp 20%/ Tp	 T/ Tp T/ Tp	EET_P
28	Hungary Individuals Employers	 T E	 E E	 E E	 E E	 E E	TEE
29	Denmark	E	0.15	E	T	0.4	ETT
30	Italy	E	0.125	E	T/ Tp	T/ Tp	ETT
31	Sweden	E	0.15	E	T	T	ETT
32	Indonesia	E	Tp		T	T	ETT
33	Czech Republic Individuals Employers	 T/ Tp /S E/S	 E E	 E E	 15%/ Tp 15%/ Tp	 15%/ Tp 15%/ Tp	TET
34	Luxembourg Individuals Employers	 E 0.2	 E E	 E E	 T E	 T/ Tp E	TET
35	Peru	T	E	E	T	T	TET
36	New Zealand Individuals Employers	 T 0.21	 0.33 0.33	 E E	 E E	 E E	TTE
37	Australia Individuals Employers	 T 0.15	 0.071 0.071		 T/ Tp T/ Tp	 Tp /16.5% Tp /16.5%	TTT
38	Brunei	E	E	E	E	E	EEE
39	Malaysia	E	E	E	E	E	EEE
40	Singapore	E	E	E	E	E	EEE
41	Thailand	E	E	E	E	E	EEE
42	Philippines Individuals Employer	 T E	 T T		 E E	 E E	T_PTE

Note : E= exempt; T=taxed under personal income tax; Tp=partial taxation; S=state subsidy.

by an employee on retirement.

9.24 The effect of these provisions is that financial savings of households is generally exempted from taxation at all the three stages of savings, i.e., contribution, accumulation and withdrawals. The tax treatment of savings in India can therefore be characterized as exempt – exempt – exempt (EEE) for most taxpayers. The existing tax treatment of financial savings is presented in Table-2.

9.25 This liberalized treatment has impacted economic efficiency, equity and revenue efforts. Various committees have extensively documented the distortionary effects of the existing method of tax treatment of financial instruments in the past. To summarise, the following distortionary effects have been noted with concern:

(a) Saving instruments with similar maturity but different tax concessions result in different effective yields, which involve a distortion of signals for investment decisions. While investment (or saving) under section 80C is rewarded, disinvestment (dis-saving) is not brought under charge.

(b) The incentives encourage not necessarily just savings but also diversion of funds, from one form of investment to another and that too for mere locking up these funds (i.e., surrendering the purchasing power to the government) only for a specified period of time. The netting principle is not applicable and dis-savings remain untaxed. Consequently, this results in 'round-tripping' of the existing stock of savings to avail of tax benefit without any commensurate increase in the national stock savings. Therefore, there is a bias in favour of investment in short-term instruments, thereby creating serious distortions in the allocation of savings.

(c) The tax rebate, for repayment of installments of housing loans made by taxpayers to specified institutions encourages debt as against "equity" financing.

(d). The deductibility from income is restricted to investment in specified assets and does not cover the entire range of the savings products. This leads to inordinately high effective rates of return for much saving products. In turn, these serve as a benchmark for rates of return (discount rate) and therefore lead to high cost of borrowing across all sectors in the economy and to dampening of investment.

(e) While the major consideration behind the current incentive schemes seems to have been to encourage investment in financial assets so as to direct savings to the public sector, there are arbitrary variations in rate of return even amoungst such assets. The rates of return bear no systematic relation to the length of the holding period of

assets. In effect, by de-linking rates of return from holding periods, the public sector crowds out the private sector through offers of quick and perceptibly safer returns.

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

(g) A differential treatment of income from dividend, interest and capital gains introduces opportunities for distorted arbitrage arising between different maturities and different coupons and also lead to window dressing opportunities for tax purposes.

(h). Ideally, total return should form the basis for taxation. Moreover, certain savings instruments are more liquid than others. The resulting mis-alignment of the term structure of small saving instruments with market rates makes benchmarking more complex.

(i) The existing tax treatment of saving schemes have also adversely effected the equity of the tax system. Deductions from income favour upper bracket taxpayers disproportionately. The post-incentive rates of return vary substantially across taxpayers with different marginal tax rates. In general, the post incentive rate of return increased with the marginal tax rate of the saver. These provisions are therefore, regressive.

(j) Therefore, the provision of various tax exemptions for savings instruments not only increase the cost of compliance but also serves to distort economic incentives, undermine equity and actually hinder economic growth in the long run.

(k). In their present form, tax incentives for savings, particularly for government guaranteed instruments, have the effect of increasing the floor interest rates across the economy. As a result, investment is adversely affected which in turn slows down the economic growth and employment creation. Further, such incentives result in revenue loss thereby increasing the borrowings by government to meet its current expenditure. This further raises interest rates thereby crowding out private investment. Consequently, there is a slow down of investment in the economy and therefore economic growth. What appears to be micro rational is, in fact, macro irrational.

(l) Given the relatively short recycling period of the savings instruments, the marginal

contribution to national savings of the elaborate tax exemption system is negligible, and the transaction costs it entails are considerable.

9.26 In view of the various distortionary effects of the existing method of incentivising savings, the tax incentives for savings call for a comprehensive review. In any scheme of incentives for savings, it is desirable that the investments to be encouraged have broadly similar rates of return. Any variation in these rates should only be due to differences in the holding period, underlying risk or some other overriding consideration of priority for a particular sector.

c. Recommendations of Expert Committees in India:

9.27 The tax treatment of savings in India has been the subject matter of review by Expert Committees. The Committee on Expenditure Tax set up by the Govt. of India in 1985 under the Chairmanship of Dr. Raja J. Chelliah while rejecting the case for levy of an expenditure tax on all forms of expenses, recommended the expenditure tax method for taxation of income. Pursuant to this recommendation, the Govt. of India introduced the National Savings Scheme in 1987. The maximum annual contribution to the Scheme was ₹30000/- and the savings under this scheme were subject to the EET-method of tax treatment.

9.28 In 1991, the Tax Reforms Committee Chaired by Dr. Raja J. Chelliah recommended a sharp cut back in the amount eligible for tax rebate under the provisions of section 88 of the Income-tax Act and withdrawal of exemption to all forms of interest income. However, it recommended an increase in the annual contributions to the National Savings Scheme. The underlying consideration for these recommendations was to expand the scope of the EET-method of tax treatment subject to a ceiling on annual contributions and include all other forms of savings within the scope of the comprehensive income tax method. However, in the Union Budget, 1992, the EET-method of tax treatment of savings in the National Savings Scheme was given up.

9.29 In 2001, the Advisory Group on Tax Policy and Tax Administration chaired by Dr. P. Shome also reviewed the tax incentives for savings. Since, the EET-method of taxing savings had been abandoned, it recommended a sharp cut back in the level of incentive for savings qualifying for benefit under section 88 of the Income-tax Act. It also recommended the withdrawal of all concessions on interest income. Implicitly, therefore, the Group recommended the comprehensive income tax method for taxation of savings.

9.30 In 2002, the Task Force on Direct Taxes Chaired by Dr. Vijay Kelkar made similar recommendations as the Advisory Group on Tax Policy and Tax Administration. However, it recommended an increase in the annual contributions to the annuity scheme which was designed

on the pattern of the EET-method. Implicitly, therefore, the Task Force expressed its preference for the EET-method of treatment to savings in the annuity scheme (subject to a ceiling of ₹20000/-) and the comprehensive income-tax method for all other forms of savings.

9.31 In 2004, the Task Force on the Fiscal Responsibility and Budget Management Act, 2003, Chaired by Dr. Vijay Kelkar, recommended a comprehensive shift to the EET-method of treatment of savings subject to a ceiling of ₹1 lakh and the comprehensive income tax method for all other forms of savings.

9.32 The expert opinion, therefore, is overwhelmingly in favour of the EET-method of tax treatment of savings. This opinion is consistent with international trend.

7. Re-designing the method of tax treatment of savings:

9.35 In view of the foregoing, we recommend three options for taxation of savings. The key features of each of these option and their pros and cons are discussed below.

9.36 Option - A: The existing treatement of savings to continue. Broadly speaking, it will comprise of a hybrid of methods ranging from EEE method to EETp method, where Tp denotes partial taxation. Some members of the Task Force were of the view that the present regime for taxation of savings confers benefit to taxpayers and helps them to build a social security safety net, it should not be disturbed. As has been pointed out in para 9.25, the existing regime is economically inefficient, inequitable and adversely impacts revenue efforts. In terms of equity, these tax incentives provide larger benefit to those in the higher tax slab as against those in the lower tax slab. The problem is further aggravated by the fact that the taxpayers base in India is extremely narrow; consequently the bulk of the financial savers do not benefit in any way from the various tax incentives. This being so, these incentives provide benefit to those who need the least. They have also resulted in a significant revenue loss of ₹.46,417 crores in financial year 2016-17 (assessment year 2017-18). These distortionary effects have been extensively documented in the reports of various expert committees over the last three decades. Further, the provisions of section 80C of the Income-tax Act 1961 is extremely "crowded" in terms of the financial schemes eligible for the deductions. It also includes expenditure on education and repayment of loans for purchasing or constructing a house property. Given the age profile of the taxpayers, a large proportion of the deduction is availed for education, followed by repayment of loans, and the balance for financial savings.

Therefore, at best, the tax incentives under section 80C of the Income-tax Act 1961 have an insignificant impact on savings behaviour. Moreover, consequent to the rationalization of the personal income-tax rate structure proposed in Model - I and Model - II, the tax benefit from savings would be further reduced thereby undermining the effectiveness of the tax incentive to induce pro-savings behaviour. Accordingly, the case for continuing the existing regime of taxation of savings under section 80C, section 80CCC and section 80CCD of the Income-tax Act 1961, is extremely weak.

9.37 **Option - B:** This option provides for -

(a) an EET method of taxation of savings in the National Pension Scheme (NPS), under which -

(i) a deduction of an amount upto 10 per cent of the salary (gross total income in the case of non-salaried taxpayers) shall be allowed in respect of contribution to the National Pension Scheme (NPS) by the taxpayer;

(ii) in the case of salaried taxpayers, the employer would be allowed to contribute to the NPS a further amount upto 10 per cent of the salary;

(iii) the contribution by the employer will not be included in the income of the employee in the year in which the contribution by the employer is made.

(iv) the accumulation in the NPS will be exempt; and

(v) the withdrawals from the NPS (whether representing employee contribution, employer contribution or accumulation over the years) will be taxed in the year in whcih the withdrawal is made;

(vi) 60 per cent of the amount standing to the credit of the taxpayer at the time of the closure of the NPS shall be utilised for the purchase of an annuity plan and the annuity so received, shall be taxed in the similar manner as pension;

(vii) the balance 40 per cent of the amount will be allowed to be commuted and fully taxed (at present this amount is fully exempt). However, the taxpayer may roll over the amount in another EET based account without attracting any tax liability but the withdrawals from the later will be fully taxed.

(b) the amount of deduction hitherto allowed under section 80C, and section 80CC will be subsumed in the higher threshhold limit of ₹6.00 lakhs recommended in Package I in para 8.39; no deduction for savings in any of the schemes would be allowed under any other provision; and

(c) the benefits on accumulated balance in provident fund and superannuation fund as on

Analysis of Employer Contribution to various Employee Funds

(figures in Rs. Crore)

Employee Fund Name (PROFIT)	AY 2010-11		AY 2011-12		AY 2012-13		AY 2013-14		AY 2014-15		AY 2015-16		AY 2016-17		AY 2017-18		TOTAL
	No. of Cos	Amt	No. of Cos	Amt	No. of Cos	Amt	No. of Cos	Amt	No. of Cos	Amt	No. of Cos	Amt	No. of Cos	Amt	No. of Cos	Amt	Amt
Approved Superannuation Fund	2,646	₹ 5,137	2,749	₹ 11,693	2,547	₹ 8,925	2,760	₹ 10,082	2,672	₹ 10,579	2,745	₹ 13,786	2,836	₹ 6,460	2,922	₹ 8,989	₹ 75,651
Recognised Fund PF	55,445	₹ 20,319	58,287	₹ 24,746	63,297	₹ 27,028	67,285	₹ 32,921	69,802	₹ 35,133	68,157	₹ 41,759	71,846	₹ 45,070	75,121	₹ 51,281	₹ 2,78,258
Recognised Gratuity Fund	16,767	₹ 8,595	17,972	₹ 11,230	19,083	₹ 12,040	19,808	₹ 11,512	19,773	₹ 7,879	20,559	₹ 13,038	21,667	₹ 11,416	23,026	₹ 14,731	₹ 90,442
Any Other Fund	27,381	₹ 3,229	28,940	₹ 7,141	31,001	₹ 7,026	34,848	₹ 6,329	37,823	₹ 8,794	37,015	₹ 9,523	40,300	₹ 9,195	43,342	₹ 10,671	₹ 61,908
Total		₹ 37,280		₹ 54,810		₹ 55,019		₹ 60,843		₹ 62,335		₹ 78,106		₹ 72,142		₹ 85,673	₹ 5,06,259
Employee Fund Name (LOSS)	**AY 2010-11**		**AY 2011-12**		**AY 2012-13**		**AY 2013-14**		**AY 2014-15**		**AY 2015-16**		**AY 2016-17**		**AY 2017-18**		**TOTAL**
Approved Superannuation Fund	590	₹ 3,314	555	₹ 4,500	731	₹ 4,924	739	₹ 6,231	732	₹ 5,579	884	₹ 5,499	778	₹ 11,798	825	₹ 8,760	₹ 50,605
Recognised Fund PF	13,166	₹ 3,238	13,647	₹ 4,210	17,394	₹ 5,190	19,714	₹ 6,509	21,260	₹ 6,838	25,404	₹ 8,076	23,923	₹ 9,883	24,156	₹ 12,685	₹ 56,660
Recognised Gratuity Fund	3,983	₹ 1,912	4,185	₹ 2,944	5,527	₹ 3,647	6,211	₹ 2,536	6,618	₹ 2,434	7,742	₹ 5,014	7,426	₹ 5,211	7,549	₹ 3,880	₹ 27,578
Any Other Fund	5,697	₹ 765	5,713	₹ 2,366	7,270	₹ 1,938	8,961	₹ 2,553	10,146	₹ 1,936	12,816	₹ 2,433	11,895	₹ 2,987	12,353	₹ 5,627	₹ 20,655
Total		₹ 9,229		₹ 14,019		₹ 15,700		₹ 17,829		₹ 16,867		₹ 21,022		₹ 29,881		₹ 30,952	₹ 1,55,498
Employee Fund Name (ALL)	**AY 2010-11**		**AY 2011-12**		**AY 2012-13**		**AY 2013-14**		**AY 2014-15**		**AY 2015-16**		**AY 2016-17**		**AY 2017-18**		**TOTAL**
Approved Superannuation Fund	3,236	₹ 8,451	3,304	₹ 16,192	3,278	₹ 13,849	3,499	₹ 16,313	3,404	₹ 16,158	3,629	₹ 19,285	3,614	₹ 18,259	3,747	₹ 17,750	₹ 1,26,256
Recognised Fund PF	68,611	₹ 23,558	71,934	₹ 28,956	80,691	₹ 32,218	86,999	₹ 39,430	91,062	₹ 42,032	93,561	₹ 49,835	95,769	₹ 54,954	99,277	₹ 63,966	₹ 3,34,918
Recognised Gratuity Fund	20,750	₹ 10,507	22,157	₹ 14,174	24,610	₹ 15,688	26,019	₹ 14,047	26,391	₹ 10,313	28,301	₹ 18,052	29,093	₹ 16,627	30,575	₹ 18,611	₹ 1,18,020
Any Other Fund	33,078	₹ 3,993	34,653	₹ 9,507	38,271	₹ 8,964	43,809	₹ 8,882	47,969	₹ 10,730	49,831	₹ 11,956	52,195	₹ 12,183	55,695	₹ 16,298	₹ 82,563
Total		₹ 46,509		₹ 68,830		₹ 70,719		₹ 78,672		₹ 79,253		₹ 99,128		₹ 1,02,023		₹ 1,16,625	₹ 6,61,757

the appointed date (say, 31st day of March, 2019/2020/2021) will be grandfathered i.e., no new deposits will be allowed in these funds after the appointed date but the accumulation in the fund by way of interest, dividend, bonus etc. and withdrawal thereof will continue to enjoy the same tax benefit as is available immediately before the commencement of the new Act.

(d) employers would be free to maintain a Provident Fund or superannuation fund and employees free to contribute by opening a new account in the funds. While the employer will be entitled to claim the contributions by him to the fund as business expenditure, the employees will be required to include the employer contributions in their taxable income in the year in which the contributions are made. Similarly, the interest on the contributions would be taxable on cash / accrual basis depending upon the method of accounting followed by the employee.

9.38 This option will have the benefit of moving to the purest form of taxation of savings and a smooth transition by allowing a higher threshhold limit. Further, there is empirical evidence to suggest that itemised deductions lead to higher compliance cost. To the extent, the various benefits for savings would be replaced by a higher threshhold limit, substantial reduction in compliance cost can be expected.

9.39 **Option - C:** This Option provides for spliting up of the deduction hitherto allowed under section 80C and 80CCD and capped at ₹.1.50 lakhs, into four components. These components are -

(a) an EET method of taxation on savings upto 10 per cent of the salary (gross total income in the case of non-salary taxpayers) in the National Pension Scheme (NPS), along the same lines as indicated in serial no. (a) of **Option B** in **para 6.37**;

(b) a seperate deduction upto ₹.50 thousand for contribution to Government Provident Fund, Public Provident Fund, Recognized Provident Fund and any other fund notified by the Central Government. The ceiling of ₹.50 thousand will apply to the aggregate of the contributions by the employee and the employer. The interest on contributions and withdrawals (both principle and interest) will continue to remain exempt as under the existing law;

(c) a seperate deduction upto ₹.25 thousand towards payment of risk premium on the life of the taxpayers or his family members;

(d) a seperate deduction upto ₹.24 thousand towards tution fee for the eduction of a child of the taxpayer subject to a maximum of ₹.48 thousand; and

(e) no deduction will be allowed in respect of any contribution to the superannuation fund whether by the employee or the employer. Further the interest, dividend, bonus or any other sum credited to the account of the employee in the superannuation fund will also be taxed on cash or accrual basis, as the case may be.

9.40 Under this Option, the deductions for the various other schemes and repayment of housing loans allowed under section 80C will be withdrawn.

9.41 This Option will have the benefit of moving to the purest form of taxation of savings. However, in order to promote consumption of merit goods like education and insurance on life, seperate deductions have been allowed. Under the existing system, the expenditure on consumption of merit goods by way of payment of tution fee for education and premium for purchase of life insurance, are eligible for deduction under section 80C along with a host of other financial savings. As a result, the objective of promoting consumption of these merit goods is not fully achieved. Therefore, in order to promote the consumption of these merit goods, seperate deduction have been allowed. As regards deduction for contribution to Provident Fund, there is absolutely no economic rationale for a EEE method of taxation particularly, in the context of "reduction" in tax rates under Model - I and Model - II. Nevertheless, we consider it necessary to recommend the same so as to facilitate the transition to a more efficient and equitable tax regime. However, these itemised deductions will result in relatively higher compliance cost and to that extent, this Option is inferior to Option B.

f. Capping the tax incentives

9.42 Some Members were of the view that a 10 per cent deduction for contribution to NPS by taxpayers in the higher range of income may not fully meet the ends of vertical equity and revenue loss would also be considerable. It was therefore suggested that the contribution should be capped by both an ad valorem and a monetary amount. However, such capping would distort the tax treatment of savings; it would lead to deviation from the EET method and cease to be fully neutral to savings. The concern relating to erosion of vertical equity can be best addressed by resorting to direct methods like withdrawing other exemptions available to such taxpayers, and introducing a comprehensive wealth tax. Recognising the need for imporving the progressivity of the tax system, we have recommended several measures for withdrawing the exemptions and the introduction of a comprehensive wealth tax. We believe that these recommendations should be sufficient to address the problem.

g. Tax treatment of provident funds

9.43 The contributions by an employee to the Government Provident Fund (GPF), Public

Provident Fund (PPF), recognized provident fund (RPF) or any other provident fund (including the provident fund under the Employees Provident Fund and Miscellaneous Act) notified by the Central Government, are eligible for deduction from income within the overall ceiling of ₹1.50 lakh. The accumulation as well as the withdrawal is also exempt from tax. In addition, the employer (other than Government) also contributes upto 12 per cent of the salary to the RPF and other notified provident funds. The employer is entitled to claim these contributions as a deduction in the computation of its taxable income. However these contributions remained untaxed in the hands of the employee. Similarly, the interest on the accumulated amounts and the withdrawal (both principle and interest) also remain untaxed.

9.44 The tax treatment of these savings is designed along the EEE method and these are a major source of the various distortions discussed above. The existing treatement is also a source of significant revenue loss as indicated in **Table at page 76.** Further, this loss continues to increase at a rate higher than the growth of corporate tax revenues thereby regularly eroding the tax base.

9.45 Any meaningful reform of the tax treatment of savings for retirement must also take into account the existing tax treatment of savings in provident funds. Accordingly, consistent with the three Options discussed in **paras 9.36 to 9.40**, the tax treatment of savings in the provident funds may be reformed in the following manner:-

1. The existing tax benefits may be continued in line with **Option A** in para 9.36. Consequently, the various distortions and the revenue loss flowing from the present treatment will continue. Further, it would continue to discriminate between Government employees and Non Government employees;
2. Modify the tax treatment of contributions, interest and withdrawals in the manner discussed in serial number (c) and (d) of **Option B** in para 9.37; or
3. The tax treatement of contributions, interest and withdrawals will be as indicated in serial no. (b) of **Option C** in para 9.39.

9.46 **Option B** should be the most preferred policy since it is based on the EET method of taxation of savings and also broadens the base by eliminating the tax free perquisite in the form of tax exempt contribution by the employer to the provident fund. **Option C** can be ranked as second - best and **Option A** as the least preferred.

j. Tax treatment of commutation of pension

9.47 At present, a Government employee is entitled to commute 40 per cent of his pension received under the Civil Pension (Commutation) Rules of the Central Government or State

Government. Similarly a non-Governmental employer is allowed to build a pension plan for his employees by establishing an approved superannuation fund. Contributions to the approved superannuation fund can be made either by the employee or by the employer. The employee's contribution to the superannuation fund to the extent of ₹.1.5 lakh per annum is eligible for deduction from his income. Similarly, employer's contribution is also deductible in computing his income, up to a ceiling of 15 per cent of the employee's salary or ₹.1.5 lakh per annum, whichever is less. The accumulations within the fund are exempt from tax. 75 per cent of the amount standing credit to the account of the taxpayer at the time of retirement is used to buy an annuity plan and the balance 25 per cent is allowed to be commuted and paid to the taxpayer.

9.48 The benefits received by the employee in the form of annuity are taxable like any other pension. However, the commuted value of the pension received by an employee is exempt under section 10(10A) and section 10(13) of the Income-tax Act.

9.49 Conceptually, the commuted value of pension represents the present discounted value of the capitalized value of the commuted amount of pension. Since pension per se is taxable, there is no economic justification for exempting the commuted value. In principle, the full commuted value of pension should be subject to tax.

9.50 In view of above and the fact that the employer is allowed to contribute upto 10 per cent of the salary to the NPS, the tax treatment of the commutation of pension is recommended as under.-

(a) **Alternative - I**: the existing regime for taxation of commuted value of pension and the commuted value of the accumulated balance in the superannuation fund may be continued.

(b) **Alternative - II:**

(i) the commuted value of pension received under the Civil Pension (Commutation) Rules of the Central Government or State Government may be fully taxed;

(ii) the benefits on accumulated balance in superannuation fund as on the appointed date (say, 31st day of March, 2019/2020/2021) will be grandfathered i.e., no new deposits will be allowed in these funds after the appointed date but the accumulation in the fund by way of interest, dividend, bonus etc. and withdrawal thereof to be fully taxed like commuted value of pension from Government;

(iii) employers would be free to maintain a superannuation fund and employees free to contribute by opening a new account in the funds. While the employer will

be entitled to claim the contributions by him to the fund as business expenditure, the employees will be required to include the employer contributions in their taxable income in the year in which the contributions are made. Similarly, the interest on the contributions would be taxable on cash / accrual basis depending upon the method of accounting followed by the employee.

(c) Alternative - III:

(i) the commuted value of pension received under the Civil Pension (Commutation) Rules of the Central Government or State Government in excess of ₹.20 lakhs may be fully taxed; and

(ii) the commuted value of the accumuted balance in the superannuation fund as on the appointed date, in excess of ₹20 lakhs may be fully taxed.

9.51 Alternative - II being consistent with Option B, is the most efficient and accordingly the preferred policy. Alternative - III ranks second - best in as much as it reduces the inefficiencies and the inequity associated with Alternative - I. It will also partially eliminate the tax benefit hitherto provided and contain the revenue leakage. Further, the provision of de minimis of ₹.20 lakhs will ensure that a person drawing a salary of ₹.1 lakh per month at the time of retirement will not be liable to pay tax on the commuted value of the pension. Alternative - I being the most inefficient, inequitable and a drain on revenue, should be the least perferred policy.

k. Tax treatment of benefits received on retirement of an employee

9.52 An employee receives a number of other lump sum benefits on his retirement by way of superannuation or otherwise. These benefits are :

(i) Gratuity - The amount received as death-cum-retirement gratuity from the Central Government or State Government or under Payment of Gratuity Act on retirement or other wise is exempt from income-tax , subject to prescribed limits. [section 10(10)]

(ii) Leave encashment – The payment received towards encashment of earned leave at the time of retirement is exempt under section 10(10AA)(i), subject to a limit of ₹3 lakhs.

(iii) Payment on voluntary retirement – Any amount received by an employee on his voluntary retirement or termination of service is exempt to the extent it does not exceed ₹5 lakhs [section 10(10C)]

9.53 The benefits in the form of gratuity and leave encashment are deferred wages and the amount received on voluntary retirement represent the present discounted value of future wages.

Therefore, in principle, these benefits should be fully taxed. However, these are tax free, subject to prescribed limits thereby creating distortion and revenue leakage. Accordingly, the tax treatment of these benefits need to be rationalized in one of the following manners:

(a) Alternative - I: The existing tax treatment, though inefficient and inequitable, may be continued;

(b) Alternative - II: These benefits may be allowed to be deposited in an EET based designated account and the withdrawals should be fully taxed; and

(c) Alternative - III The benefits in excess of the de minimis limit may be allowed to be deposited in an EET based designated account and the withdrawals should be fully taxed. The de minimis limit for leave encashment and amount received on voluntary retirement shall be ₹.10 lakhs each. However the de minimis limit for gratuity shall be ₹.15 lakhs.

9.54 Given the impact on efficiency, equity and revenue collection, Alternative - II is the most preferred policy followed by Alternative - III and Alternative - I.

l. Method of collecting taxes on withdrawal

9.55 If the benefits are taxable, it is necessary to establish an effective mechanism for collecting taxes on such benefits. The system of withholding taxes is an effective system for collecting taxes on the benefits. Accordingly, all withdrawal/benefits may be subject to a withholding tax at the rate of 15 per cent without any threshold exemption. The present system of issuing non-withholding certificates may be continued to enable small taxpayers to receive the benefits without withholding. This must be complemented by establishing an effective refund mechanisim.

8. Impact of the proposals

a. Mutual fund

9.56 The existing framework of section 80C of the IT Act enables mobilization of household savings through a number of schemes operated by mutual funds. A concern has been expressed that the withdrawal of tax concessions for investment in mutual fund products would restrict the flow of funds to their schemes. The tax favoured savings comprise of a relatively small proportion of the total household savings. In the financial year 2016-17, the total deduction claimed under section 80C was ₹.3,27,103 crores. Given the fact that most part of the deduction is availed against investment in provident fund, NPS and childrens' education. Assuming 5 per cent of the deduction relate to investment in mutual fund, the investment in mutual fund is estimated at ₹.16000 crores of which the tax induced component may at best be 25 per cent thereof i.e., ₹.4000 crores. However, our recommendation in para ..... to tax dividends distributed by mutual funds in the hands of the

unit holder will result in substantial relief to small investors since their tax burden will reduce from 20 per cent DDT to Nil or 5 per cent. We believe this will more than neutralise the slowdown in investment on account of withdrawal of section 80C for investment in mutual funds. Overall, the impact on mutual funds as financial intermediaries will be extremely healthy.

b. On taxpayer

9.57 The EET method of taxing savings will impose no additional tax burden on a taxpayer at the point of contribution and on accumulation. However, there may be an additional tax burden on the taxpayer at the point of withdrawal depending upon whether the withdrawals are in small amounts to meet essential consumption or lump sum to meet conspicuous consumption or finance lumpy capital expenditure. To the extent withdrawals will be penalized, there will be an inbuilt mechanism to ensure consumption smoothening over the life time of the taxpayer and reduce dependency for social security on any external agency, including Government.

9.58 The proposed scheme is likely to impose an additional tax burden on the taxpayer in cases where the tax incentive is being withdrawn on existing saving schemes and the taxpayer has no mechanism for exiting from his commitment. This would essentially arise in the case of life insurance policies. However, this reversal of policy would be a step towards promoting greater equity since about 70 per cent of the insured are non-taxpayers and do not enjoy any tax benefit for seeking life protection. In any case, there is no promissory estoppel against the statute in this regard. Further, part of the additional burden on taxpayer policyholders would be neutralized by the benefit which an insurer can be expected to pass on.

9.59 A number of retirement benefits received by an employee are now proposed to be included in the tax base. However, a person may substantially reduce his tax burden by rolling over the retirement benefits to a designated account so as to smoothen consumption over his retired life. Therefore, the proposed withdrawal of exemption for retirement benefits may not impose any additional tax liability.

c. On national savings

9.60 In the financial year 2016-17, the gross total income of individual taxpayers was reported at ₹.29.32 lakh crores and the total deduction under section 80C at ₹.3.27 lakh crores. Therefore, savings under section 80C constituted 11.16 per cent of the gross total income. We have recommended a deduction upto 10 per cent of the gross total income for deposit in NPS which is not significantly different from the existing level of deduction under section 80C. Further, the

EET design of the NPS and other saving schemes will result in taxing dis-savings (withdrawals). The cumulative impact would be a significant increase in net savings thereby resulting in higher national savings.

d. On inflation

9.61 To the extent the proposals will result in higher national savings and reduce current consumption, these will also serve as a non-distortionary anti-inflationary measure without compromising on the growth potential of the economy.

e. On interest rates

9.62 The existing framework of tax treatment for savings has the effect of increasing the post-tax interest rate for public sector borrowing. Such interest rates serve as a bench mark for other sectors in the economy, thereby increasing the cost of borrowing for all sectors. The present proposals are merely in the nature of tax deferral, it does not have any adverse effect on the post-tax interest rate. Further, since dis-savings are proposed to be penalized, the supply of funds can be expected to increase significantly. Cateris paribus, this could potentially lead to a reduction in the interest rates.

9.63 Distortionary taxes are an important source of distortion and inefficiency in the financial sector. This has an adverse cascading effect on the real sector. To the extent the distortions in the tax treatment of savings across products are eliminated, this will significantly improve the efficiency of the financial sector and consequently, the real sector. This enhanced efficiency in the financial sector is also likely to be reflected in lower interest rates.

f. On equity

9.64 The inequity in the existing framework arises from the fact that there is considerable information asymmetry across taxpayers on tax benefits available in respect of the various savings product. Under the new regime the tax benefits will be restricted to ISSA and therefore, the inequity arising from information asymmetry will be eliminated. Further, since these proposals will lead to consumption smoothening over the life of a taxpayer, they will enhance both inter-temporal and inter-generational equity.

i. On compliance and administrative burden

9.65 No increase in compliance and administrative burden is expected on account of these proposals.

Conclusion

9.66 In view of the forgoing discussions, we have crafted two seperate bundles -

(a) **Bundle - I** comprises of Option B, along with Alternative - II in para 9.50 relating to tax treatment of commutation of pension and Alternative - II in para 9.53 relating to tax treatment of benefits received on retirement of an employee; and

(b) **Bundle - II** comprises of Option C, along with Alternative - III in para 9.50 relating to tax treatment of commutation of pension and Alternative - III in para 9.53 relating to tax treatment of benefits received on retirement of an employee.

9.67 In writing the draft tax law, we have included **Bundle - I** in **Model - I** and **Bundle - II** in **Model - II**. However, **Bundle - I** can also form part of **Model - II** and vice versa without effecting in any way the integrity of the two models. The decision to do so should be based on the outcome of stakeholders consultations.

CHAPTER - X

REFORM OF CORPORATE INCOME TAX

10.1 The corporate form of business organization, is the most dominant form for carrying out business in India. It is the single biggest driver of economic growth. Revenues from taxation of corporate profits are a major source of revenues in most countries. Therefore, it is necessary to design the tax regime for corporates so as to minimize economic distortions, enhance equity and yield increasing revenues.

Rationale for corporate taxation

10.2 The optimal design for taxation of corporate profits is based on several arguments. **First**, taxes should be paid by natural persons and non-natural persons are mere conduits. In the case of corporates, tax should only be paid on dividends. However, corporate earnings would escape taxation if dividend is not declared and the shareholder would realise benefit as capital gains. Since capital gains are generally taxed at a concessional rate or exempt from tax, most part of corporate earnings would escape taxation. Therefore, by levying corporate income tax, the authorities reduce the opportunities for shareholders to shelter their income from taxation. It acts as a "backstop" to personal income tax. **Second,** it also reduces the tax-induced incentives for businesses to incorporate and to transform high-taxed labour income into lower-taxed capital income. **Third,** A corporation income tax also enables a country to tax the profits earned within its borders by corporations whose shareholders reside elsewhere. Therefore, corporate income tax acts as a withholding tax on equity income earned by non-resident shareholders, which might otherwise escape taxation in the source country. **Fourth,** it could be designed to tax only economic rents – profit levels above the normal level of return required for a business to be successful. Economic rents mainly arise as the result of monopoly profits or market power and entrepreneurial skill or ideas. Because economic rents are profits in excess of the required normal return, such a corporate tax would not create any efficiency losses. **Fifth,** Governments may also want to levy corporate income tax because this revenue allows them to reduce other distortionary taxes; this might increase overall economic efficiency. **Sixth,** the separate taxation of the incomes of corporations and their shareholders follows the legal principle that corporations and shareholders are distinct entities. Some scholars argue that it also accords with economic reality, particularly for large corporations with many shareholders who do not participate actively in controlling the enterprise. They consider a corporation income tax justified as a charge for the privilege of doing business in the corporate form, as a means of covering the costs of public services that especially benefit business, and as a way of capturing part

of the profits of large enterprises.

10.3 Corporate income taxes are mainly flat-rate levies, rather than extensively graduated taxes (which means that rates rise according to income—as in the typical individual income tax). An acceptable schedule of progressive rates could hardly be devised for corporations, because they differ greatly in scale of operations and numbers of shareholders. (See progressive tax.) Moreover, the shareholders themselves may have either high incomes or (as is the case with corporate pension funds) low incomes.

10.4 A number of industrialized countries have corporate income tax rates upto 50 percent, sometimes with reduced rates for small corporations. Where the latter feature exists, safeguards may be instituted to prevent its abuse by enterprises that split into nominally independent corporations without giving up unified control. More significant are corporate mergers or acquisitions motivated by the possibility of saving taxes; offsetting the losses of some against the profits of others.

10.5 Corporate taxes may be graduated according to the rate of return on invested capital rather than the absolute size of profits. This is accomplished by an excess-profits tax on profits which are above a certain "normal" rate of return, sometimes further graduated upto the level of exemption. The excess-profits tax has been used widely during wars and other national emergencies. There are serious difficulties involved in determining accurately the value of invested capital and in selecting an appropriate normal rate of return.

Economic effects

10.6 Sharp differences of opinion exist concerning the economic effects of the corporate income tax, partly because it is difficult to determine who actually bears it. The traditional conclusion of economic theory is that the tax is not reflected in prices in the short run and hence must be paid out of profits. The theory does not predict what the long-run effects of the tax will be, although it indicates that they will mirror those of a tax on shareholders rather than on consumers.

10.7 This view of the incidence of the corporate income tax has been increasingly challenged. Its opponents argue that in many industries prices are decisively influenced by the actions of a few leading firms, which have as their objective not maximum profits in the short run but a target rate of return over a period of years. When the rate of corporate income tax is increased, they say, the leading firms will raise their selling prices in order to maintain the target return, and other firms will follow. Another traditional view is that labour unions may share the burden of the tax through lower wage settlements.

10.8 This debate among economists and businessmen has not been resolved by empirical research.

Some studies in the United States, Canada, and Germany indicate that the corporate income tax is largely shifted to consumers through short-run price rises, while other studies support the opposite conclusion.

10.9 If the tax is not shifted to consumers through price increases, it will tend to reduce the return on corporate-equity capital (because interest payments are deductible in determining taxable profits, the return on borrowed capital is not subject to the corporation tax.). The returns on capital in unincorporated enterprises and on bonds will tend to fall over time as investors try to avoid the corporate tax by shifting to untaxed areas. In this way the corporation income tax may actually burden all capital, rather than only that invested in the corporate sector. A general reduction in rates of return may curtail investment by cutting the reward for success and by reducing the quantity of resources available in the form of retained corporate profits and personal savings. This will tend to reduce the rate of growth of national product.

10.10 If the corporate income tax reduces either the return on corporate-equity capital or the returns on all capital, it will be broadly progressive in the aggregate; that is, it will reduce disposable income proportionately more for owners of capital who are generally high-income persons than for low-income persons. This is because the fraction of total income represented by returns from ownership of corporate stock and other capital assets rises with income. This effect holds, however, only in the aggregate, because some low-income people, including many retirees, depend heavily on investment income and on the capital that has accumulated in pension funds.

10.11 On the other hand, when the corporate income tax is passed along to consumers through higher prices, it will—like a sales tax—act as a regressive tax, reducing disposable income proportionately more for people with low incomes than for those with high incomes. A corporation tax that has been shifted to consumers will not be especially harmful to investment, but it may have an adverse effect on resource allocation and a company's competitive position in foreign markets.

Issues relating to corporate tax structure

10.12 In practice, the corporate income-tax structure is seriously flawed giving rise to corporate waste and inefficiency. The tax code distorts financial and investment decisions and encourages tax executives to hunt for loop holes and tax shelters. Some of the key fundamental flaws in the corporate income tax structure are discussed in the paragraphs below.

10.13 The **first flaw** relates to high corporate income tax rate (marginal tax rate) in many countries. High rate reduces investment, encourages firms to move profits abroad, and provides incentives to cross the legal boundaries of the tax code. Further, the law also imposes different marginal effective tax rates on different economic activities. These tax rate differences cause investment to be

misallocated across industries and across types of capital equipment. Empirical evidence suggests that inter-sectoral and inter-asset distortions create large deadweight losses, or inefficiency costs, under the current income tax structure. A key factor causing marginal tax rates to diverge across different economic activities is depreciation. It is very difficult to design depreciation schedules that accurately track the true depreciation rates of thousands of different assets in the economy. Expensing all capital investment would eliminate investment distortions as it would equalize marginal tax rates across industries and different types of assets.

10.14 The **second flaw** is intrinsic to the corporate income tax; the corporate tax base of net income or profits is inherently complex because it relies on concepts such as the definition of the time of "realization", cash versus accrual method of accounting, capital gains and capitalization of long-lived assets that are difficult to consistently account for in a tax system. These concepts raise serious difficulties in the definition of income and administration of an income tax.

i. Timing

10.15 Timing is everything under the income tax, which relies on capitalization and accrual accounting. The basic idea is to match expenses against corresponding income when earned. If cash is spent this year that creates benefits in future years, the expense should not be currently deducted. Instead, the cost must be capitalized and deducted later. Alternatively, rules are needed to deal with cash received this year that relates to economic activity in other years. Thus, in any given year under the income tax there are numerous income and deduction items on corporate tax returns that do not coincide with flows of cash but are based on tax law definitions determining the proper timing of recognition. It is extremely difficult, and perhaps impossible, to design a tax system that measures income perfectly. Even if rules for the accurate measurement of income can be devised, such rules can result in significant administrative and compliance burdens. Capital gains are a good example. In theory, broad based income taxation would tax capital gains on an accrual basis. But since that is not feasible, the income tax falls back on taxing most, but not all, gains when realized. Many corporates have exploited the fact that some gains are taxed on a realization basis and other gains, such as foreign currency contracts, are taxed on a mark-to-market, or accrual, basis.

ii. Capitalization

10.16 Under the income tax, business costs for assets that generate revenues in future years are typically not deducted at the time of purchase. Instead, items such as buildings, machines, and intangible assets are capitalized and deducted over future years. Under income tax theory, the purchase price of buildings and machines should be deducted, or depreciated, over time to match the loss in

economic value of the asset. When intangible assets are purchased, they are amortized over a specified period of time. There are two key problems with capitalization: (i) identifying which assets need to be capitalized and (ii) determining the period and method by which future deductions. are to be made. In income-tax theory any asset that produces benefits in the future should be capitalized. In practice, this principle becomes extremely ambiguous and therefore a source of considerable litigation. With respect to the method, income tax theory, depreciation deductions match an asset's obsolescence over time. But every asset is different, which means new types of assets are being invented all the time. Rough approximations are used to place assets in categories that determine the length of the period for deductions and therefore the formula required to calculate deductions. Most solutions offered to these problems are adhoc and contentious.

iii. Capital gains

10.17 Capital gains taxation has been known to cause distortion and complexities throughout the history of income tax. Capital gains taxation tends to get more complex as rules pertaining to new financial products are added. However, most of this complexity is intrinsic. One example of intrinsic capital gains complexity for businesses is the difficulty in drawing distinct lines between assets sold as a part of regular sales, which are taxed as ordinary income, and assets sold by investors for speculation, which are taxed as capital gains. For industries such as real estate, this classification of receipts as ordinary or capital gains is a continuing area of complexity and conflict. Another example relates to restrictions on set-off and carry forward of capital losses. While net capital gains by corporates are taxed at the regular corporate rate, capital losses are generally deducted only against capital gains, not ordinary income. Net capital losses may be carried forward for a limited period. These basic rules necessitate large amounts of tax planning. Companies have an incentive to avoid realizing gains unless they have losses available. Also, they generally prefer income to be characterized as capital gains not ordinary income, and losses to be characterized as ordinary losses not capital losses, because of the limitations on capital losses. Another example relates to differential treatment of capital gains across types of assets. Corporations pay capital gains taxes on sales of capital assets, such as shares of other corporations. But gains on the sale of depreciable assets involve other rules. Sales of personal property, such as machinery, are taxed partly as capital gains and partly as ordinary income. The overall taxable amount is the difference between the sales price and basis, which is generally the original cost less accumulated depreciation. That amount is taxed as ordinary income to the extent of previous depreciation allowances (depreciation is "recaptured"). Sales of real property, such as buildings, are also taxed partly as ordinary income and partly as capital gains, but different rules apply. In a nutshell, the corporate capital gains rules are complex and compel substantial tax minimization planning. In addition, they create distortions, such as

"lock in" of corporate investments in other companies, because built-in gains face corporate taxation when shares are sold. Thus, companies may avoid selling shares and be stuck holding old investments with low returns or be unable to reallocate their capital when business conditions change.

10.18 The tax rules for capitalized assets and capital gains are repeatedly exploited in corporate tax shelters. These rules also cause economic distortions as they interfere with capital investment, business reorganizations, and other decisions.

10.19 The **third flaw** is the unwarranted inconsistency in the tax code in the form of tax shelters. Tax shelters typically rely on some type of discontinuity in the tax law that treats certain types or amounts of economic activity more favorably than comparable types or amounts of activity. These discontinuities can arise in the basic structure of the income tax system or in specific provisions of the law. One such example relates to the disparate treatment of debt and equity.

10.20 Most countries apply a system of economic double taxation on corporate profits attributable to equity capital. In general, the return on equity investments is taxed both at the corporate level and at the shareholder level as dividends or capital gains. This double taxation is mitigated somewhat by the treatment of retained earnings, which are only subject to the corporate tax and not the individual income tax. To the extent that a shareholder indirectly realizes these profits through a sale of shares, they would be subject to an individual income tax on capital gains. This indirect second tax on retained corporate earnings is deferred until the shareholder disposes of his or her investment. The effect of such a deferral is substantial reduction of taxpayers' income from capital invested in shares.

10.21 The tax treatment of corporate debt is quite different from equity. Interest accrued on corporate debt is deductible from corporate profits. As a result, the marginal effective tax rate is lower in the case of debt-financed capital used in corporate activity, as against equity financed capital. This results in a bias in favour of debt.

10.22 The problem of debt versus equity has been further compounded by the development of sophisticated financial instruments, such as derivatives, which has facilitated the exploitation of these tax law discontinuities. The growth of new types of financial products has made it difficult for tax authorities to distinguish between debt and equity. Financial derivatives and other hybrid instruments have narrowed the distinction to such an extent that the distinction is meaningless in many cases.

10.23 Debt makes companies riskier. But, because payments on debt are tax deductible, and dividends are not, companies have a strong incentive to use debt rather than equity finance. The deductibility of debt payments also lowers the required rate of return for new projects, possibly

encouraging companies to invest in marginal ideas that aren't really worth it. If corporate income tax would not offer tax reductions on interest payments, they are likely to reconsider.

10.24 The disparate treatment of debt and equity and different marginal effective tax rates on different types of capital investment have not only resulted in investments being misallocated but also reduced the quantem of investment. Very little investment flows through corporate businesses, too much debt is used in financial structures, and corporate profits are retained rather than paid out. Such inconsistencies have created large costs to the economy by distorting capital markets and channeling investment into less productive uses.

10.24a The courts have followed various general principles or doctrines to challenge tax shelters, such as "substance over form," "business purpose," and "economic substance." The application of these doctrines to a particular set of facts is often uncertain." Indeed, courts often come to different conclusions in seemingly similar cases. Usually, the adverse court rulings are undone by the tax administration by imposing more detailed rules. A vicious cycle is created as legislative remedies themselves create the complexity that the next generation of tax shelters exploits, which leads to more complex responses, and so on. However, such rules do not eliminate the underlying economic incentives to avoid high taxes; they incentivise large companies to do more tax planning, either in house or through purchase of shelters. A large and sustained reduction in tax sheltering can be achieved by changing fundamental economic incentives, not by adding endless layers of new rules. Unless basic economic incentives are changed, narrow limitations on tax-driven activities may simply spawn new tax avoidance techniques.

International double taxation

10.25 Major corporations operate across national boundaries. Some countries exercise the right to tax the whole income of their nationals, even if it is earned abroad. Almost all countries consider it their right to tax income arising within their borders, whether or not the income is earned by individuals or corporations having their residence or exercising their management and control in the country. Increasing attention has therefore been given to the prevention of double taxation between countries, especially in response to the continuing rise in the number of corporations operating in more than one country and the number of stockholders of a corporation residing outside the country in which they operate. A network of tax treaties exists among the industrialized countries, but they apply perhaps only sketchily to the less-developed countries. There are doubts as to whether the standard provisions found in agreements between rich countries are suitable for agreements between industrialized countries and those at earlier stages of economic development.

10.26 The varying national tax policies can also be used to avoid paying taxes. Many developed countries do not actually tax the majority of investment income (especially interest) that originates

within their borders and flows to foreigners. They may thus attract capital from less-developed countries that either do not or cannot tax such income when it is received by their residents, but this worsens problems of capital shortages. Investment and the related income sometimes are channeled through "tax haven" countries in order to take advantage of tax treaties. To illustrate how this approach can be used to avoid taxes, consider the case of a resident of country R who wishes to invest in country I, with which country R has no tax treaty. If the funds flow through country T, which has a treaty with I, and if income is not reported to R, tax due to I, as well as tax due to R, can be avoided. (It might more properly be said that this involves illegal evasion rather than legal avoidance.)

10.27 Corporate taxation (or business taxation) is origin based whereby imports are deductible expenses in the determination of profits. This leads to problem of transfer pricing; countries have responded to this problem by establishing a complex set of rules to prevent base erosion and profit shifting. This has given rise to prolonged litigation and increased burden of compliance and administration. In effect, depending upon the rigours of the transfer pricing rules, it has prompted corporates to locate their business activities in jurisdiction with relatively weak transfer pricing regulations.

10.28 The rise of e-commerce (the electronic sale of goods and services over the Internet) has posed new questions of tax policy and administration. E-commerce makes it easier for business to be conducted in a country without creating a "permanent establishment," which would subject the platform to pay income tax. It blurs the distinctions between the sale of goods, the provision of services, and the licensing of intangible assets, each of which is subject to taxation. Equally problematic is a reliance on arms-length methods of income measurement. Tax codes continue to be revised as governments determine reasonable approaches to the taxation of electronic transactions.

10.29 The incidence of "corporate" taxes is not necessarily progressive. Many economists believe that the corporate tax burdern fall pretty much on the worker; corporations compensate for the extra cost by lowering the wages they offer. Taxes on corporate profits are exactly the same for middle class families who have some shares.

10.30 The corporate income tax encourages firms to waste resources on tax avoidance. In general, taxes are most efficient when they fall on those who have the most difficulty avoiding them. Big corporations can and do spend an enormous amount of money and human effort transforming their income into more tax-preferred forms—deferring it, moving it, swapping it with entities that have different tax rules, and so forth. They spend an enormous amount of energy trying to make rules to stop them, in vain. This exacerbates the problem of deadweight loss from taxation.

10.31 Briefly stated, the current corporate income tax bases in most countries are complex, increase the burden on tax administrations and lead to tax avoidance and evasion. Under these circumstances, a fundamental reform of the current corporate income tax is imperative. A corporate cash-flow tax - based on cash-flow accounting rules - is the most appropriate alternative to a corporate income tax. A well designed cash-flow tax would eliminate the distortions discussed above and put all businesses and investments on an equal footing. The design of the corporate cash-flow tax should comprise the following key elements:

10.32 Given the policy concerns related to corporate income tax, it is sometimes argued that it would be more efficient to abolish this tax altogether. There are, however, very good reasons to continue to levy corporate income tax. Firstly, corporate income tax rates have been declining for more than 30 years across countries, partly as a response to the greater mobility of investment and corporate tax bases and partly as an attempt to reduce the inefficiencies inherent in the corporate income tax system. The fall in statutory corporate tax rates has been substantial across the world. The fall in the corporate tax rate over time was fairly continuous; the **Table** below shows the trend of corporate tax rate reduction across regions. The global average has reduced from 29.42 percent in 2003 to 24 percent in 2018.

Table 10.1 : Average corporate tax rate across regions

Location	2003	2005	2008	2010	2014	2017	2018
Africa	32.36	30.79	28.75	28.49	27.85	28.21	28.26
America	31.29	30.52	28.84	28.28	27.77	28.29	27.89
Asia	30.19	29.79	26.24	23.72	22	21.04	21.21
EU	27.95	25.15	23.17	22.93	22.39	21.33	21.29
Europe	26.72	24.03	21.95	21.46	20.42	19.53	19.48
Global	29.42	28	25.66	24.65	23.85	24.04	24
Latin America	30.81	29.68	27.96	27.52	27.31	27.98	27.95
North America	35.3	38.05	36.75	35.5	33.25	33.25	26.75
Oceania	30.2	30.6	29.6	29	27	28.43	28.43
OECD	30.08	28.37	25.99	25.7	24.98	23.95	23.5
South America	30.81	29.68	27.96	27.52	27.31	27.98	27.95

10.33 In order to compensate for revenue lost through reduced corporate tax rates, most countries have broadened their corporate tax base by implementing less generous tax depreciation allowances and by eliminating special tax deductions and provisions. Over time, the average effective corporate tax rates have nonetheless declined across countries. This indicates that the reductions in statutory corporate tax rates have had a stronger impact on the average corporate tax burden than the measures to broaden the tax base.

10.34 Despite the strong reduction in statutory corporate tax rates, corporate tax revenues have kept pace with – or even exceeded – the growth in gross domestic product and in revenues from

other taxes in most countries till the begining of the financial crisis. However, since then there has been some decline in corporate tax revenues but continues to be higher than the level in late 1980's.

10.35 In addition to the impact of the base-broadening measures, a number of other factors might offer an explanation for the increase in corporate tax revenues. Evidence shows that the profitability of the corporate sector has increased as a result of globalisation and because of the increased importance of the financial sector. Lower corporate tax rates reduce the benefits of corporate tax-planning but also have increased the incentive to incorporate and to shift income from the non-corporate sector into existing corporations, thereby increasing the relative size of the corporate sector. The increase in corporate tax revenues in low-tax countries may also be caused by the inflow of investment and/or mobile corporate profits that are shifted out of high-tax countries to minimise corporate taxes.

Profile of corporate taxpayers in India

i. Breakup of corporate taxpayers

10.36 During AY 2017-18, 7.9 lakh returns were filed (Table 10.2), of which 7.8 lakh are resident and ~ 10,000 are non-resident. Returns include 9,427 PSUs, 414 banks, 625 insurance companies and 7,981 NBFCs.

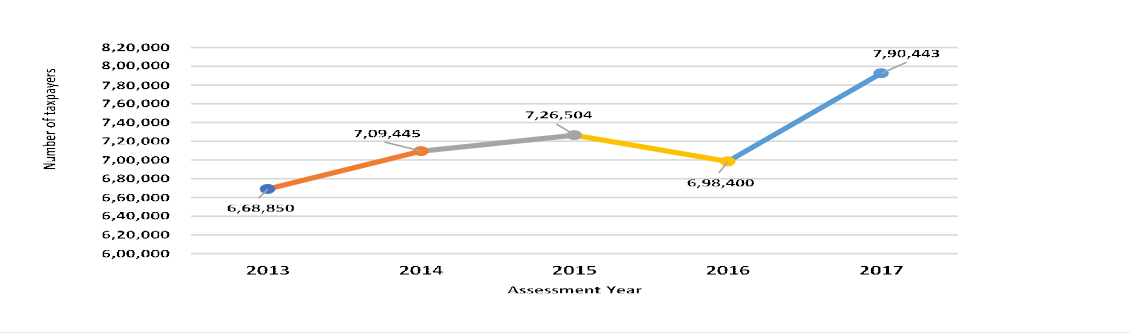
Table 10.2: Corporate taxpayers in AY 2017-18

Nature of company	Loss cases	Profit cases	All cases	Share in all returns
Resident companies	358426	421790	780216	98.7%
NRI companies	694	9533	10227	1.3%
Domestic companies	357893	421535	779428	98.6%
Companies liable to audit u/s 44AA	179778	239286	419064	53.0%
Companies liable to audit u/s 44AB	48617	198986	247603	31.3%
PSUs	4082	5345	9427	1.2%
Banking companies	163	251	414	0.1%
Scheduled Banks	140	243	383	0.0%
Company in which Govt or RBI holds more than 40% shares	296	518	814	0.1%
Insurance companies	227	398	625	0.1%
NBFCs	2167	5814	7981	1.0%

ii. Number of taxpayers

10.37 Number of returns have increased from 6.68 lakhs in AY 2013-14 to 7.9 lakhs in AY 2017-18. (Chart 10.1)

Chart 10.1 : Growth in number of corporate taxpayers AY 2013-2017



iii. Sector-wise growth in number of taxpayers

10.38 There has been a steady growth in number of taxpayers in the 'trading sector', 'service sector' and 'other sector'. However, the number of taxpayers in 'manufacturing sector' and 'financial service' have declined. (Table 10.3)

Table 10.3: Growth in number of corporate taxpayers

Sector Name	AY 2013-14			AY 2014-15			AY 2015-16			AY 2016-16			AY 2017-18		
	LOSS	PROFIT	TOTAL	LOSS	PROFIT	TOTAL	LOSS	PROFIT	TOTAL	LOSS	PROFIT	TOTAL	LOSS	PROFIT	TOTAL
Manufacturing	60617	100725	161342	60984	94120	155104	63706	85622	149328	54950	83277	138227	60334	89419	149753
Trading	58780	87768	146548	64788	93711	158499	69474	93059	162533	65533	92963	158496	74392	101290	175682
Commission Agents	1466	3575	5041	1504	3513	5017	1712	3410	5122	1663	3104	4767	1727	3210	4937
Builders	50492	38977	89469	55260	37934	93194	56265	35831	92096	50902	33322	84224	55554	35677	91231
Contractors	9512	18964	28476	10471	19635	30106	11799	19457	31256	10491	18614	29105	13003	21651	34654
Professionals	4879	8239	13118	5043	7962	13005	5415	7440	12855	5108	7528	12636	5888	8543	14431
Service	67069	92765	159834	74824	98595	173419	83306	99215	182521	80242	101491	181733	99693	117315	217008
Financial Service	17287	29754	47041	15697	28173	43870	14532	27017	41549	13360	25562	38922	13576	26795	40371
Entertainment	5037	4572	9609	4723	3679	8402	4503	3149	7652	4323	3190	7513	5109	3575	8684
Others	3258	3101	6359	14371	12444	26815	21293	18284	39577	21663	19098	40761	29844	23848	53692
Total	278397	388440	666837	307665	399766	707431	332005	392484	724489	308235	388149	696384	359120	431323	790443

iv. Distribution of profit and loss-making corporates

10.39 The share of loss-making companies has increased from 42% in AY 2013-14 to 45% in AY 2017-18 (Chart 10.2). The sharpest increase is seen in Entertainment (7%), Commission Agents (6%), Contractors (5%) and Builders (5%). Financial Services sector is the only sector where the number of loss making cases has decreased by 3%. (Table 10.4)

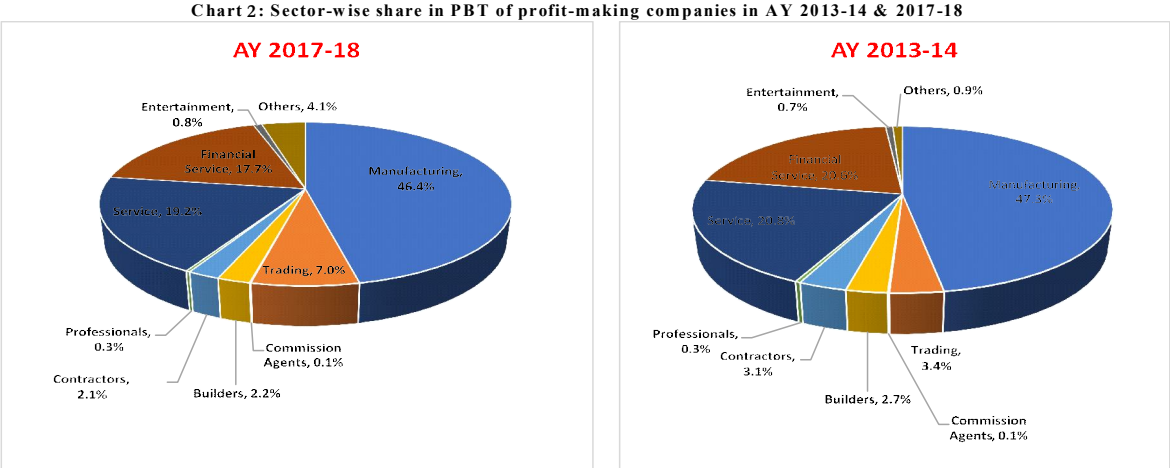
Table 10.4: Distribution of profit and loss-making corporates

	2013-14		2014-15		2015-16		2016-17		2017-18	
Sector	Loss	Profit	Loss	Profit	Loss	Profit	Loss	Profit	Loss	Profit
Manufacturing	38%	62%	39%	61%	43%	57%	40%	60%	40%	60%
Trading	40%	60%	41%	59%	43%	57%	41%	59%	42%	58%
Commission Agents	29%	71%	30%	70%	33%	67%	35%	65%	35%	65%
Builders	56%	44%	59%	41%	61%	39%	60%	40%	61%	39%
Contractors	33%	67%	35%	65%	38%	62%	36%	64%	38%	62%
Professionals	37%	63%	39%	61%	42%	58%	40%	60%	41%	59%
Service	42%	58%	43%	57%	46%	54%	44%	56%	46%	54%
Financial Service	37%	63%	36%	64%	35%	65%	34%	66%	34%	66%
Entertainment	52%	48%	56%	44%	59%	41%	58%	42%	59%	41%
Others	51%	49%	54%	46%	54%	46%	53%	47%	56%	44%
Total	42%	58%	43%	57%	46%	54%	44%	56%	45%	55%

v. Sector-wise share in profits

10.40 Time series of sector-wise share in 'Profits before taxes' of profit making companies in each sector shows that while share of manufacturing sector has remained almost the same at ~ 47%, share of service, shares of financial service and trading sectors have increased over last 5 years. (Chart-2)

Chart 2: Sector-wise share in PBT of profit-making companies in AY 2013-14 & 2017-18



vi. Tax Collection

10.41 The following table shows the trend of taxes paid by companies during last five assessment years. Taxes paid have increased from ₹.3.21 lakh crores in AY 2013-14 to ₹.4.68 lakh crores in AY 2017-18. 95% of taxes are paid by profit-making companies. About 10% of taxes are paid under MAT. About 70% of taxes are paid by advance tax and remaining 30% is paid by TDS and self-assessment tax. (Table 10.5).

Table 10.5: Corporate tax collection

fig in Cr. Rs.

Tax collection	2013-14		2014-15		2015-16		2016-17		2017-18	
	Loss	Profit	Loss	Profit	Loss	Profit	Loss	Profit	Loss	Profit
Mat Liability	46	30080	369	37632	110	36623	481	38672	382	48039
Aggregate Liability	1090	263777	1659	292773	1623	324699	4500	347490	2469	393014
Advance Tax	1335	226885	2317	244302	2883	272904	11871	282211	8481	325855
TDS	9142	64974	10546	71953	10403	78175	12017	81740	14337	89743
TCS	38	664	94	670	115	761	93	797	114	1041
Self Assessment Tax	150	19240	179	24518	291	23704	299	26786	340	29269
Tota Tax paid	10665	311763	13135	341442	13692	375543	24280	391534	23271	445908

vii. Loss-making companies

10.42 There has been an increase in loss declared by loss-making companies from ₹4.58 lakh crores (2.78 lakh cases) in AY 2013-14 to ₹.6.68 lakh crores (3.59 lakh cases) in AY 2017-18. This is an increase of 46%. During this period, average loss per company has also increased from ₹.1.65 crores to ₹.1.86 crores. The highest growth in loss is seen in the financial services (254%), Others (246%), Commission Agents (139%) and Professionals (70%). (Table 10.6).

Table 10.6: Losses declared by loss-making companies

fig in Cr. Rs.

Sector	AY 2013-14	AY 2014-15	AY 2015-16	AY 2016-17	AY 2017-18
Manufacturing	-200481	-158296	-232756	-274346	-287058
Trading	-47598	-49152	-59439	-76819	-65950
Commission Agents	-215	-831	-433	-587	-515
Builders	-23290	-22043	-22509	-21167	-28525
Contractors	-20754	-9235	-23544	-19442	-24042
Professionals	-2151	-1662	-2534	-2882	-3657
Service	-131418	-116887	-131034	-126099	-157668
Financial Service	-19900	-17515	-15020	-60640	-70362
Entertainment	-7385	-6527	-7269	-8245	-7015
Others	-7286	-1717	-10862	-11082	-25174
Total	-458465	-381851	-503386	-599293	-667949

viii. Profit-making companies

10.43 The profit before taxes (PBT) declared during AY 2013-14 to AY 2017-18 have increased from ₹.11.3 lakh crores (3.9 lakh cases) to ₹.15.1 lakh crores (4.3 lakh cases) by ~ 33%. The highest growth is seen in Others (510%), Trading (172%) and Entertainment (60%). However, there is a negative growth in Commission Agents (-2%) and Contractors (-10%) and a very low growth in Builders (8%) and Professionals (6%). (Table 10.7).

Table 10.7: Share in profits before taxes of profit-making companies

fig in Cr. Rs.

Sector	AY 2013-14	AY 2014-15	AY 2015-16	AY 2016-17	AY 2017-18
Manufacturing	536191	534254	538442	597435	700676
Trading	39082	35053	46237	46560	106198
Commission Agents	1120	987	1108	998	1103
Builders	30231	30932	31241	30715	32723
Contractors	35499	35075	25566	24874	32078
Professionals	3772	5835	3417	3892	4016
Service	235357	178409	269996	283850	289721
Financial Service	233081	265527	273687	246254	266828
Entertainment	7404	8205	6794	10993	11882
Others	10115	1761	29979	34409	61749
Total	1133864	1098052	1228481	1281996	1508990

ix. Key financial ratios

10.44 Some of the key financial ratios of loss and profit-making companies during AY 2015-16 to 2017-18 were studied. Results are as follows. It is seen that loss-making companies are highly leveraged and the debt to equity ratio has increased from 2.88 to 3.75 in this period. However, their interest coverage ratio is very low indicating their inability to service the debt and likelihood of getting into a debt trap. (Table 10.8).

Table 10.8: Financial ratios of loss and profit-making corporates

Ratio name	AY 2017-18		AY 2016-17		AY 2015-16		AY 2014-15		AY 2013-14	
	Loss	Profit	Loss	Profit	Loss	Profit	Loss	Profit	Loss	Profit
Inventory turnover ratio	1.8	4.2	1.9	4	2	3.7	2.2	3.7	2.1	3.8
Asset Turnover ratio (Sales / Total Assets)	21.1%	48.7%	19.5%	49.7%	32.3%	42.9%	33.5%	43.2%	37.5%	43.9%
Debt to Equity Ratio	3.75	1.73	4.72	1.57	2.88	2.05	2.94	2.03	2.63	2
Interest Coverage ratio (EBIDTA/Interest)	7.5%	294.5%	27.6%	291.8%	-28.4%	248.0%	-19.3%	253.0%	-29.5%	263.8%
Current ratio (CA / CL)	84.6%	126.5%	96.8%	124.1%	89.9%	118.1%	88.6%	127.9%	92.2%	124.3%
Cash ratio (Cash / CL)	11.3%	20.4%	12.4%	19.1%	7.9%	19.5%	8.1%	20.9%	8.1%	21.7%
Debt to Asset ratio (Debt / Total Assets)	60.4%	50.1%	65.4%	47.5%	51.2%	54.2%	52.9%	53.3%	50.8%	53.4%
Gross Profit Margin (Gross Profit / Revenue)	46.5%	41.6%	39.9%	41.0%	33.6%	42.8%	32.9%	41.5%	30.2%	41.5%
Net Profit Margin (Net Profit / Revenue)	-24.3%	9.8%	-23.4%	9.6%	-20.8%	9.5%	-18.8%	9.5%	-17.3%	10.0%
Return on Assets (PBT / Total Assets)	-5.1%	4.8%	-4.6%	4.8%	-6.7%	4.1%	-6.3%	4.1%	-6.5%	4.4%
Return on Equity (PBT / Total Equity)	-32.0%	16.5%	-33.0%	15.7%	-37.8%	15.5%	-35.0%	15.8%	-33.7%	16.4%
Return on Capital Employed	0.4%	11.4%	1.5%	11.9%	-1.5%	10.8%	-1.0%	10.8%	-1.4%	11.0%

x. Internal accruals

10.45 Earnings before interest and depreciation (EBIDTA), interest and depreciation expenses and average tax liability of profit making companies for the period AY 2013-14 to 2017-18 were analysed (Table 10.9). Since depreciation is only a notional expense, EBIDTA reduced by interest, referred to as gross internal accruals (GIA), is real earnings available for investment after payment of tax, dividend and DDT. It is seen that tax liability has increased from 19% to 21% of GIA.

Table 10.9: Internal Accruals of profit-making corporates

fig in lakh crore Rs.

PROFIT CASES	AY 2013-14	AY 2014-15	AY 2015-16	AY 2016-17	AY 2017-18
PBT	10.96	11.32	12.27	12.8	15.07
EBIDTA	21.96	23.51	26.08	24.87	28.53
Interest	8.32	9.29	10.52	8.52	9.69
Gross Internal Accruals (GIA)	13.63	14.22	15.56	16.35	18.84
Tax Liability	2.64	2.93	3.25	3.47	3.93
Tax Liability as a % of GIA	0.19	0.21	0.21	0.21	0.21
Dividend declared	1.21	1.55	2.06	2.16	2.36
Dividend as a % of GIA	0.09	0.11	0.13	0.13	0.13
DDT Liability	0.2	0.24	0.32	0.38	0.42
DDT Liability as a % of GIA	0.01	0.02	0.02	0.02	0.02
Retained earnings (RE)	9.59	9.5	9.93	10.33	12.13
RE as % of GIA	0.7	0.67	0.64	0.63	0.64
Depreciation	2.64	2.9	3.29	3.54	3.77
Depreciation as a % of GIA	0.19	0.2	0.21	0.22	0.2
Net Internal Accruals (RE - Depr)	6.95	6.6	6.65	6.79	8.36
Net Internal Accruals as % of GIA	0.51	0.46	0.43	0.42	0.44

Similarly, dividends declared have also increased from 9% to 13% of GIA. Retained earnings before depreciation have, therefore, decreased from 70% to 64% of GIA.

10.46 The investments of loss-making and profit-making corporates for the period AY 2011-12 to AY 2017-18 were analysed (Table 10.10). Investment was computed by taking the difference in opening and closing values of gross block of tangible assets and capital work in progress. The change in revaluation reserves was also adjusted. It is seen that the investment of loss-making corporates is higher in AY 2016-17 and AY 2017-18. This could be because of heavy investments by start-up companies that have mushroomed over the last few years.

Table 10.10: Investments by loss-making and profit-making corporates

fig in crore Rs.

AY	AY 2011-12	AY 2012-13	AY 2013-14	AY 2014-15	AY 2015-16	AY 2016-17	AY 2017-18
Investment - profit-making corporates	580769	415603	651569	471865	538405	121466	-40917
Investment - loss-making corporates	591781	509406	370808	632105	459651	912381	465968
Investment - all corporates	1172550	925010	1022376	1103969	998056	1033847	425051

xi. Distribution of income

10.47 Distribution of total income of all companies in AY 2017-18 is shown in Table 10.11. It is seen that only 0.2% of companies account for 67% of tax liability and 55% of companies account for merely 5.4% of the tax liability.

Table 10.11: Distribution of corporates in AY 2017-18

Total Income Range	No. of cases	Share in all cases	Total Income (Rs. Cr)	Agg Tax Liab (Rs. Cr.)	Share in Aggregate Liability
0	434784	55.0%	-	21166	5.4%
0 - 10 Lakhs	222000	28.1%	4971	2017	0.5%
10 - 50 Lakhs	72718	9.2%	17088	5754	1.5%
50 L - 1 Cr	22170	2.8%	15953	5204	1.3%
1 - 5 Cr	25476	3.2%	56640	20077	5.1%
5 - 10 Cr	5388	0.7%	38177	13008	3.3%
10 - 50 Cr	5737	0.7%	123057	39768	10.1%
50 - 100 Cr	1059	0.1%	74014	23734	6.0%
> 100 Cr	1213	0.2%	823113	264754	66.9%
Total	790545	100%	1153013	395482	100%

xii. Efficiency of corporate tax collection

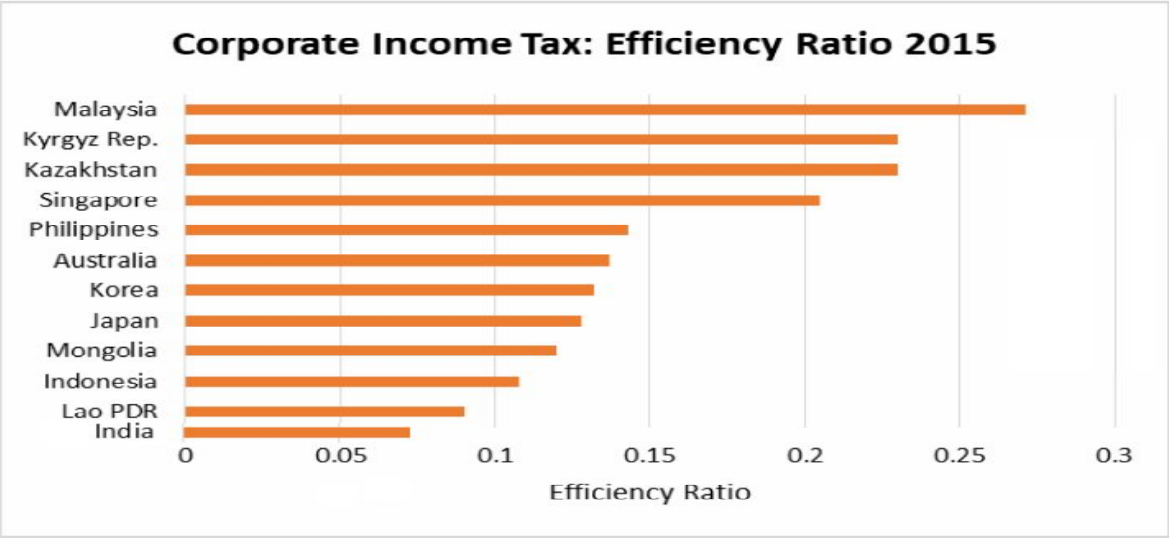
10.48 We estimated the collection efficiency of corporate tax based on the return data and GDP data. C-efficiency is defined as a ratio of actual tax liability to the potential tax liability (GDP x CIT rate). It indicates the extent to which the potential base (represented by GDP) is covered in the tax-net. The level of efficiency is indicative of low levels of corporatisation of the economy, low levels

of compliance and high level of revenue foregone due to exemptions / deductions under the direct tax law. Table 10.12 shows that the corporate tax efficiency ratio in India has been persistently low at approximately 7.5 percent. International comparision of corporate income tax efficiency in Chart 10.3 shows that India ranks very low thereby reflecting substantial erosion in the tax base.

Table 10.12: Efficiency of corporate direct tax collection

FY	GDP (Rs. Cr)	CIT Rate	Agg Liability (Rs. Cr)	Efficiency
2012-13	9944013	33.70%	264867	7.9%
2013-14	11233522	37.22%	294432	7.0%
2014-15	12467959	34.31%	326322	7.6%
2015-16	13764037	35.11%	351990	7.3%
2016-17	15253714	34.30%	395483	7.6%

Chart 3



Marginal Effective Tax Rates for Corporates in India

10.49 'Marginal Effective Tax Rate (METR)' has traditionally been used as a tool to determine the burden imposed by taxes on business investment. METR is defined as the amount of tax arising from the decision of a firm to undertake one more unit of an economic activity. In the case of capital, the activity is the employment of an incremental unit of capital, in the case of labour, it is an incremental worker; and in the case of production, it is an incremental unit of output. In contrast to the 'Average Effective Tax Rate (AETR)', which only indicates the average tax burden on lumpy investments, METR indicates the tax burden on the marginal investments. For example, if an additional investment provides a pre-tax return of 15% and post-tax return of 10%, METR is $\frac{(15-10)}{15}$% or 33%.

$$METR = \frac{r_g - r_n}{r_g}$$

where,

r_g = pre-tax rate of return on investment
r_n = post-tax rate of return on investment

10.50 Because we measure the taxes arising from an incremental unit of economic activity, a positive METR associated with that activity indicates that it is *discouraged* by the tax system, a negative METR indicates that the activity is *encouraged* by the tax system, while a *zero* METR indicates that the tax system is *neutral* with respect to the activity. Taxes imposed on capital (like the CIT) can affect both the level and composition of investment in an economy by distorting the return to an incremental unit of capital. The METR on capital is a summary measure of the size of this distortion.

i. METR for Indian Corporates

10.51 Data of all the corporate income tax returns for assessment year 2016-17 (financial year 2015-16) was used to compute the sub-sectoral and sectoral METRs. 74 sub-sectors and 10 sectors were identified on the basis of classification provided in the IT return. Similarly, 13 asset classes were identified on the basis of depreciation rates provided in the IT rules.

Table 10.13

***Sector* Name**	**Asset Class**	**Depreciation Rates**
Manufacturing	Plant & Machinery (PM)	15%, 30%, 40%, 50%, 60%, 80%, 100%
Trading	Buildings	5%, 10%, 100%
Commission Agent	Furniture & Fixtures	10%
Builders	Intangibles	25%
Contractors	Ships	20%
Professionals		
Service Sector		
Financial Service		
Entertainment		
Others		

10.52 Based on the above classification, 962 METRs were calculated for 13 asset classes in each of the 74 sub-sectors. Using the data of additional investment made during the financial year 2015-16 in various asset classes by companies in each sub-sector, weights were calculated to reduce 962 METRs to 50 METRs for the five asset classes in each of the 10 sectors. These weights were also used to compute a single METR for each sector as well as a single weighted average METR for all the Indian companies.

Methodology

10.53 To compute the post-tax return $'r_n'$ and $'r_g'$ values of various parameters viz. interest rate on debt, sales tax absorbed by companies, inflation rate and economic depreciation were estimated. 10-year Govt. securities yield as on 17.4.2015 was taken as interest rate on debt. Sales tax absorbed by companies was taken as 10%. Inflation rate and Economic Depreciation rates were taken from national accounts. Values of other parameters were taken from the Finance Act, 2016, IT Act and rules. CIT and PIT rates have been taken as those applicable to the taxpayers in the highest slab. Dividend pay-out ratio and Debt to Finance ratio was computed from e-filed return data for AY 2016-17.

Table 10.14

Name of parameter	*Symbol*	*Value of Parameter*
Interest rate on debt#	i	*7.84%*
Corporate Income Tax Rate	u	*34.60%*
Personal Income Tax Rate	m	*30.90%*
Dividend Distribution Tax Rate	t_d	*20.90%*
Capital Gains Tax Rate	t_c	*10%*
*Investment Allowance**	*IA*	*20.00%*
Sales tax absorbed	*ST*	*10.00%*
Inflation rate	π	*Sector wise variation*
Economic Depreciation	∂	*Sector wise variation*
Depreciation rate	α	*As per IT rules*
Dividend Pay-out Ratio	a	*Corporate returns AY 2016-17*
Debt to Finance Ratio	β	*Corporate returns AY 2016-17*

 # Source:https://rbidocs.rbi.org.in/Scripts/BS_NSDPDisplay.aspx?param=4
** additional depreciation available only on P&M for manufacturing sector if new investment in FY 2015-16 exceeds Rs.25 crores*

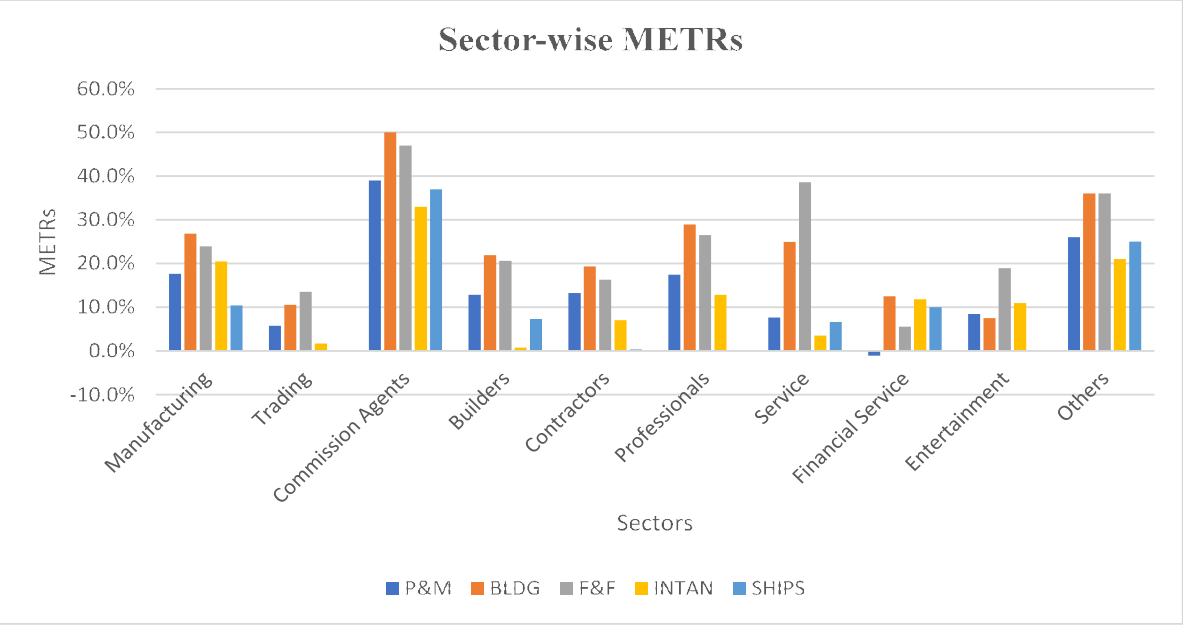
Results

10.54 Weighted average METRs for 5 asset classes in each of the 10 sectors are shown in table below.

Table 10.15

SECTOR NAME	P&M	BLDG	F&F	INTAN	SHIPS
Manufacturing	17.6%	26.8%	23.9%	20.5%	10.4%
Trading	5.7%	10.5%	13.5%	1.7%	0.0%
Commission Agents	39.0%	50.0%	47.0%	33.0%	37.0%
Builders	12.8%	21.9%	20.6%	0.7%	7.3%
Contractors	13.2%	19.3%	16.3%	7.0%	0.3%
Professionals	17.4%	28.9%	26.5%	12.8%	0.0%
Service	7.6%	24.9%	38.6%	3.5%	6.6%
Financial Service	-1.1%	12.5%	5.5%	11.8%	10.0%
Entertainment	8.4%	7.5%	18.9%	10.9%	0.0%
Others	26.0%	36.0%	36.0%	21.0%	25.0%

10.55 It may be seen that the METRs for P&M are very low in Trading, Service and Financial Service sectors. This is because both these sectors are highly leveraged with debt to asset of ratios of 45% and 52% respectively as compared to average debt to asset ratio of 37% for all sectors. In case of Manufacturing sector METR for P&M is also relatively lower because of the additional depreciation allowance of 20% available exclusively to this sector. METRs also show a high sensitivity to the value of ST. When ST is increased to 20%, METR of P&M for manufacturing sector increases from 17.6% to 29.3%.



10.56 METRs were further aggregated to compute single METR for each sector. These are shown for three different scenarios in table below.

Table 10.16

Sector Code	Base Scenario	Scenario 1	Scenario 2	Scenario 3
	IA=0.2 for Manf; ST=0.1; u=0.35	IA=0.2 for Manf; ST=0.2; u = 0.35	IA=1 for all sectors; ST=0.1; u=0.35	IA=0.2 for Manf; ST=0; u=0
Manufacturing	20.8%	31.5%	-1.9%	2.4%
Trading	8.5%	15.1%	-9.3%	-2.0%
Commission Agents	45.2%	55.3%	10.7%	9.9%
Builders	18.6%	29.6%	-13.8%	-2.1%
Contractors	11.3%	24.8%	-17.6%	-6.6%
Professionals	23.6%	35.7%	-12.0%	-2.0%
Service	11.0%	13.9%	2.7%	2.7%
Financial Service	1.8%	12.7%	-22.1%	-6.2%
Entertainment	9.7%	13.5%	1.8%	0.9%
Others	30.4%	42.6%	-1.6%	3.7%
All-sectors	17.7%	26.4%	-4.5%	0.0%

10.57 As compared to the base scenario, METR increases drastically from 17.7% to 26.4% when ST or the cascading effect of indirect taxes is increased to 20% in scenario 1. METR becomes negative in scenario 2 when full expensing is allowed by taking IA=1. In scenario 3, METR reduces to zero when all the taxes are removed.

Box – I: Tax Elasticity of Corporate Income

Do corporates change their behaviour in response to change in tax rate? Intuitively, corporates are likely to reduce their total income in response to increase in tax rates so that their tax liability remains the same. If it is so, we should expect the tax elasticity of total income declared under the direct tax law to be more than or less than one. To measure this elasticity, an eight-year period from FY 2009-10 to 2016-17 was selected. While there were no changes in the base corporate tax rate, moderate changes in rate of surcharge for domestic companies in the highest tax slab (which is a levy on tax payable at base rate) provided variability in gross tax rate that could be used for an econometric analysis. This data on changes in corporate tax rate, for the highest tax bracket is shown in the table below –

Table 10.17 Tax rates for domestic companies

A.Y.	Turnover in Previous Year	Tax on Taxable Income (I)	Surcharge		Education Cess/Secondary & Higher Edu Cess %	Gross Rate (1 Cr < I < 10 Cr)	Gross Rate (highest)
			(1 Cr < I < 10 Cr)	I > 10 Cr			
2010-11		30.00%	10.00%		3.00%	33.99%	33.99%
2011-12		30.00%	7.50%		3.00%	33.22%	33.22%
2012-13		30.00%	5.00%		3.00%	32.45%	32.45%
2013-14		30.00%	5.00%		3.00%	32.45%	32.45%
2014-15		30.00%	5.00%	10.00%	3.00%	32.45%	33.99%
2015-16		30.00%	5.00%	10.00%	3.00%	32.45%	33.99%
2016-17		30.00%	7.00%	12.00%	3.00%	33.06%	34.61%
2017-18	Turnover in PY 14-15. < 5 Cr	29.00%	7.00%	12.00%	3.00%	31.96%	33.45%
	Turnover in PY 14-15.> 5 Cr	30.00%			3.00%	33.06%	34.61%

We use a panel dataset of 1,991 domestic companies, which filed returns every year during this eight-year period from FY 2009-10 to FY 2016-17 and also fall in the highest tax slab. Similarly, we use a panel dataset of 3,578 companies who filed returns every year during FY 2009-10 to FY 2016-17 and have Total Income between Rs. 1 crore and Rs. 10 crore in every year. The variability in income for each firm and the change in gross corporate tax rates (inclusive of surcharge and cess) over the years allows for an econometric estimation using the Arellano Bond Generalised Method of Moments estimator. GDP is used as a control variable to account for all explained variation on account of macro-economic conditions. The addition of a lagged value of income to the regressors and instrumentation using differenced values of tax rates and GDP helps address the problem of endogeneity in the estimation. The equation is as follows.

$$\text{Log(TI)} = \alpha + \beta * \text{Log}(TI_{t-1}) + ? * \text{Log(Statutory Rate)} + \delta * \text{Log (GDP)} + \varepsilon$$

Results of the estimation are as follows.

	(1)	(2)
	Total Income > Rs. 10 crore	Total Income between Rs. 1 crore and Rs. 10 crore
VARIABLES	Log (Total Income)	Log (Total Income)
Log (Total Income) [t-1]	0.480***	0.446***
	(0.0248)	(0.0173)
Log (Statutory Rate)	**-0.779*** **	**-0.865*** **
	(0.287)	(0.246)
Log (GDP)	0.543***	0.125***
	(0.0516)	(0.0181)
Constant	-4.279***	4.591***
	(1.002)	(0.471)
Total Observations	11,869	21,351
Observations per year	1,991	3,578
Robust standard errors in parentheses		
*** p<0.01, ** p<0.05, * p<0.1		

The tax elasticity of total income is estimated to be (-)0.78 (significant at 99% level) for companies having Total Income of more than Rs. 10 crores. However, the tax elasticity of income is higher at (-)0.865 for companies having Total Income between Rs. 1 crore and Rs. 10 crores. The magnitude of the increase in Total Income is less for companies falling in the highest tax bracket (0.78%) and greater for those falling in a lower tax bracket (0.865%). This implies that a one percent reduction in corporate tax rate would lead to a 0.78 percent or 0.865 percent increase in taxable income, as the case may be.

10.58 To summarize, the key features of the corporate sector in India are the following: -

i. About 50 percent of the companies registered with the Registrar of Companies filed their income tax returns for the financial year 2016-17 (assessment year 2017-18);

ii. Of the 7,80,216 companies which filed their tax returns for AY 2017-18, 45.94 percent of corporate filers reported book losses and the balance 54.06 percent book profits;

iii. Of the 10,227 foreign companies which filed their returns, 694 foreign companies reported book losses;

iv. The share of loss making companies has increased from 42 percent in AY 2013-14 to 45 percent in AY 2017-18;

v. There has been a decline in the number of corporate filers from the manufacturing sector over the period AY 2013-14 to AY 2017-18;

vi. The share of manufacturing in the profits before taxes has marginally declined from 47.3 percent in AY 2013-14 to 46.4 percent in AY 2017-18;

vii. The debt to equity ratio for profit making companies has reduced from 2 in AY 2013-14 to 1.73 in AY 2017-18. However, there has been a reverse trend in the case of loss making companies with the debt to equity ratio increasing from 2.63 to 3.75 during the same period.

viii. The return on equity declined from 16.4 percent in AY 2013-14 to 15.5 percent in AY 2015-16 and thereafter has reversed the trend and increased to 16.5 percent in AY 2017-18.

ix. The return on capital employed increased from 11 percent in AY 2013-14 to 11.4 percent in AY 2017-18.

x. The gross internal accruals (EBIDTA minus interest paid) as a proportion of EBIDTA increased from 62.07 percent in AY 2013-14 to 66.04 percent in AY 2017-18.

xi. The corporate tax liability increased from 19 percent of gross internal accruals in AY 2013-14 to 21 percent in AY 2017-18.

xii. The DDT liability increased from 1 percent of gross internal accruals in AY 2013-14 to 2 percent in AY 2017-18.

xiii. The net internal accruals (gross internal accruals minus depreciation) declined from 51 percent of gross internal accruals in AY 2013-14 to 44 percent in AY 2017-18. However, in absolute terms, the corporate sector had sufficient net internal accruals to finance their investments without recourse to debt. In each of the years since AY 2013-14, the profit making companies had substantially more retained earnings (gross internal accruals minus tax liability) than the investments made during the year.

xiv. Depreciation allowed under the Income tax Act is substantially less than the investments during the year;

xv. The efficiency (productivity) of the corporate tax, which shows the policy choices regarding tax concessions and the overall levels of non-compliance, is extremely low at 7.5 percent over the period AY 2013-14 to 2017-18. Compared to other select economies, India's productivity of corporate income tax is the lowest.

xvi. The marginal effective tax rate (METR) is estimated to be 17.7 percent in assessment year 2016-17 as against the statutory corporate tax rate of 34.61 percent. METR for the manufacturing sector is estimated at 20.8 percent.

10.59 In the context of corporate tax, the key challenge is to re-design the corporate tax policy in a manner which would (i) eliminate bias against equity financing to reduce corporate leveraging and risk; (ii) reduce marginal effective tax rate on return on investment; (iii) provide an impetus to private investment; (iv) spread the burden of corporate tax liability more evenly across companies; (v) increase efficiency of corporate tax rate; and (vi) increase the buoyancy of corporate tax.

10.60 Given the limited fiscal space available to the Government, economic growth would necessarily have to be driven by private investment. A perusal of Table - 10.11 shows that corporate investment have remained virtually stagnant despite the availablity of sufficient retained earnings. The decision to invest is determined by the net present value of equity investment (NPV) which in turn is determined by the discount rate and the net benefit flowing from equity investments. The discount rate for determining the NPV of equity is dependent on the marginal effective tax rate (METR) on equity, post-tax return on debt and risk premium for equity investment. The METR on equity is the aggregate of tax on corporate profits and dividend distribution tax on marginal income from equity investment, expressed as a percentage of the marginal income. It increases with increase in the (METR) on equity and post-tax return on debt (i.e. interest net of tax). Similarly, METR increases with increase in the corporate tax rate. Any reduction in corporate tax rate will improve NPV/IRR of equity investments, thereby triggering private investment.

10.61 As presented in Table above, the marginal effective tax rate (METR) for return on investment in the corporate sector is estimated to be 17.7 percent. The METR for the manufacturing is 20.8 percent for AY 2017-18. Reduction in METR is best done by allowing full expensing (equivalent to 100 percent depreciation) of capital investment in the year of purchase. However, this policy initiative has serious revenue implications and therefore, not feasible. Interestingly, USA has allowed for full expensing in its tax reforms introduced in December, 2017. The next best option is to reduce the corporate tax rate.

10.62 Further, under the current income tax law, interest is deductible in determining profit while dividend pay-out is not. As a result, the marginal effective tax rate (METR) on equity financing is

relatively high at **52.24 percent** (this is based on the assumption that all of post-tax corporate profit is distributed as dividend and includes the 10 percent tax on dividends received in excess of ₹10,00,000/-) than the METR of **30.9 percent** on debt (the METR on debt is the tax on interest income paid by an individual on the marginal income from debt, expressed as a percentage of the marginal income). This implies that in the case of equity investment, in order to obtain a post-tax return of 12 percent per annum, the company must earn a profit of **22.97 percent**; there are very few projects which can give such high rates of return. Therefore, there is an inherent bias against equity and an incentive to resort to higher leveraging to reduce the weighted average cost of capital (WACC). This increases the risk of bankruptcy; it is not surprising that banks in India are plagued by increasing non-performing assests. It is imperative to reduce/eliminate this bias against equity by a sufficient reduction in the corporate tax rate, or like interest, by allowing a deduction in respect of dividend pay-out, thereby treating equity and debt alike.

10.63 The burden of a high corporate tax rate is unevenly distributed across companies; it is relatively more on the financial sector since they do not enjoy the benefits of any tax incentive. The problem is further compounded by the fact that they also bear the burden of implicit taxation due to mandated lending and reserve requirements. In general, financial institutions tend to shift the incidence of such excessive burden to the borrowers. This adversely impacts private investment. A reduction in corporate tax rate will either be passed on to the borrower in the form of lower cost of lending or improve the capital adequacy ratio.

10.64 Internationally, corporate tax rates are lower than the top marginal rate of personal income tax. In such cases the METR on equity investment approximates the METR on debt. In India, the position was the same till 1997 when PIT rates were sharply reduced but corporate tax rate could not be sufficiently reduced due to the persistent fear of revenue loss. Since the economy began to perform well and there was all round optimism, there was also no pressure on the Government to reduce corporate tax rates. With investment now stagnating, the case for rationalizing corporate tax rate is compelling.

10.65 In the last couple of years, corporate tax rates have globally registered a decline; the corporate tax rate in most countries have settled under 25 percent. A survey of the corporate tax rates in 2018 across 171 countries shows that that the corporat tax rate in India is amongst the highest and ranks 164. Incidentally, China reduced its corporate tax rate to 25 percent effective 1st January, 2008; similarly, USA has now reduced its corporate tax rate (including state corporate tax rate) to 27 percent. India has announced its intention to reduce the corporate tax rate to 25 percent and has made little progress over the last three years. There is no announcement regarding any move to abolish surcharge and cess. As a result the intention to reduce the basic rate to 25 percent would mean that the effective statutory corporate tax rate will continue to be as high as 29 percent. In the meanwhile, most countries have moved to yet lower rates of around 20 percent. As and when

India, indeed, moves to the basic rate of 25 percent (29 percent including surcharge and cess), the world would have, in general, moved to 20 percent. This will adversely impact India as a favourable investment destination if we do not find ways to affect a sharp cut in the corporate tax rate.

10.66 The case for reduction of corporate tax rate is clear, However, it could potentially lead to revenue loss and adversely impact the country's fiscal deficit. This would to a large extent, neutralize the benefit of lower tax rate. Accordingly, it is necessary to complement the reduction in corporate tax rate by a set of measures which will fully prevent any erosion in the corporate tax base. The complementary set of measures can take the form of discontinuation of tax incentives and/or a minimum alternate tax (MAT).

10.67 Tax incentives have been widely used in developing countries to promote economic growth, though their cost effectiveness has been challenged by fiscal experts for many years.1 In addition to foregone revenue, tax incentives can incur distortions in resource allocation, complicate tax administration and provide opportunity for corruption and rent-seeking. Fortunately, several business related tax incentives have been grandfathered in the Union Budget, 2016. This was a bold initiative, rarely witnessed across countries. There is empirical evidence to suggest that there is a fall in declared profits after the withdrawal of incentives. Therefore, it may be optimistic to expect higher revenues with the elimination of incentives. In any case, the revenue gains, if any, from grandfathering of the incentives will flow in gradually and there is little scope to improve upon this. Therefore, the minimum alternate tax (MAT) remains the only policy alternative which can facilitate a sharp reduction in the corporate tax rate to an internationally competitive level and simultaneously protect the revenue base.

10.68 The case for MAT is based on the twin consideration of combating tax avoidance and tax evasion. Over years, the Income-tax Act has been enshrined with several tax incentives which have been misused to erode the tax base. As stated above, corrective measures were adopted in the Union Budget 2016. Across the world, effective mechanisms have been put in place to deal with the problem of base erosion and profit shifting (BEPS). Regardless of this, several lacunae prevail; it is impossible for any administration to foretell all cases of misuse given the new and innovative business models. MAT is an effective instrument in dealing with tax evasion since it caps the benefits flowing from evasion by placing a floor on tax payable;

10.69 Some Members in the Task Force questioned the need to continue with MAT following the grandfathering of tax incentives and the spate of litigation arising from the implementation of the existing MAT provisions. The objective of introducing MAT was to prevent erosion of the tax base due to both tax avoidance and tax evasion. At best, grandfathering of tax incentives may have succeeded in addressing base erosion through tax avoidance. For large scale tax evasion, the need for MAT cannot be overemphasised. Further, given that almost 50 percent of companies continue

to report losses year after year, MAT will create an incentive to improve corporate performance and accurate reporting thereof. More importantly, it will facilitate the smooth transitioning to a new tax regime without jeopardising the flow of tax revenues. Further, if we were to accept the argument that MAT would be redundent with the elimination of tax incentives, the existance of MAT on the statute will be harmless to the taxpayer but provide a protection against the downside risk of revenues particularly till such time the new law stabilises. Therefore, the case against MAT is extremely weak. The concerns regarding increased litigation is valid and needs to be borne in mind when designing the new MAT provisions.

10.70 There are three designs variants of MAT: (i) profit based MAT; (ii) turnover based MAT; and (iii) asset based MAT. The **profit based MAT** can be designed on the basis of profits before taxes (PBT) or earnings before interest, taxes, depreciation and amortisation (EBIDTA). The existing MAT in the Income-tax Act is based on profits before taxes. As is well known, determining profit is an extremely complex exercise, vulnerable to accounting innovations. MAT is designed to precisely neutralise the base erosion resulting from accounting innovations and legal loopholes. Therefore, designing the MAT on a "defective" base, makes MAT inefficient. The result of persistent efforts to plug loopholes in the computation of MAT based on profit has led to extreme complexity and consequent litigation. Further, the profit based MAT creates a perverse incentive to report accounting losses. Therefore, it is not surprising that there is widespread disillusionment with the PBT based MAT. Moreover, this variant of MAT is not capable of yielding sufficient revenues to compensate for any revenue loss on account of a sharp reduction in corporate tax rate. The EBIDTA based MAT has the same complexity but has the advantage of a significantly larger base and therefore, capable of yielding sufficient revenue to support a sharp tax cut. Further, to the extent interest is not allowed as a deduction, it neutralises the bias in favour of debt. Similarly, by disallowing depreciation, it is neutral in its application between low capital intensive and high capital intensive companies. In effect, the deductions under EBIDTA based MAT is restricted to variable costs. Overall, the EBIDTA based MAT is superior to the PBT based MAT.

10.71 The asset based MAT can be linked to the book value of gross assets or net assets (net worth). The gross asset based MAT is economically efficient since it will ensure that capital flows in the absence of entry barriers will equate overtime the risk adjusted rate of return to assets across sectors. The efficiency effect of the gross asset based MAT is further enhanced since the liability also falls on loss making companies who will have the incentive to improve their performance. It is also neutral with respect to debt and equity. Further, gross assets are very stable unlike profits which are highly volatile. Therefore, the revenue yield from MAT linked to gross assets is more predictable. Given that the gross asset base is significantly large, it has the potential to support a sharp rate reduction. Unlike, the gross asset based MAT, the net asset based MAT does not allow for an intersectorally uniform

minimum expected rate of return. Further, it continues to retain a bias in favour of debt which could create opportunities for tax avoidance. It could also trigger tax induced higher dividend pay-outs. Therefore, a gross asset based MAT is preferable to a net asset MAT.

10.72 The gross asset MAT was an important element of the Direct Taxes Code, 2009 which was opposed by the corporates on account of five major concerns-

(i) it imposed a tax burden on loss-making companies who do not have the ability to pay;
(ii) it imposed a higher burden on manufacturing companies which have a relatively large base of fixed assets;
(iii) it imposed a greater burden on infrastructure companies than others in their initial years of operation;
(iv) the rate of MAT at 2 percent was considered extremely high; and
(v) it did not allow for MAT credit in subsequent years.

10.73 The gross asset MAT undoubtedly imposes a tax burden on loss-making companies which fall under two categories. The **first category** relates to companies making genuine losses. In such cases, the MAT liability will spur them to improve efficiency through corporate restructuring. To the extent profitability improves beyond the minimum expected return, they can claim credit for MAT paid in earlier years. Therefore, inter-temporal impact of MAT may not be significant. The **second category** relates to companies which under-report their income. In such cases the MAT liability will serve as a presumptive tax. Over time, they will be forced to disclose a certain minimum return on their assets. Accordingly, in both cases the overall impact will be to improve economic efficiency.

10.74 The relatively high tax burden on manufacturing companies due to a large base of fixed assets can be mitigated by reducing the book value of gross fixed assets through depreciation allowed under the Income Tax Act. In effect, the book value of gross fixed assets can be substituted by the written down value of assets under the Income Tax Act.

10.75 Similarly, the adverse impact on infrastructure companies and others who undertake expansion can be mitigated by allowing MAT credit in subsequent years. Consequently, the adverse effect will be limited to the time value of money. Further, such companies will be encouraged to expedite completion of projects to avoid any undue burden of MAT liability. Therefore, MAT could infact be efficiency enhancing.

10.76 The concern regarding denial of MAT credit in the Direct Taxes Code, 2009 is legitimate and the same should be provided to smoothen the inter-temporal effects of gross asset based MAT. Similarly, the rate of MAT may also be moderated.

10.77 The turnover based MAT is the simplest in its design. Its impact on infrastructure companies

and start-ups is also limited. Further, it has the potential to yield sufficient revenues to support a sharp tax cut. However, there may not be sufficient economic justification to presume a cross-sectorally uniform presumption of corporate taxability.

10.78 A survey of 40 countries summarised in the Table 10.18 below shows that the turnover based MAT is the most prevalent primarily on account of its simplicity and ease of compliance and administration. In general, African countries prefer a turnover based tax whereas the South American countries prefer asset based tax. Profit based MAT seems to be the least preferred.

Integration of corporate tax with personal income-tax

10.79 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). This leads to juridical double taxation. 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 overtaxation of income which is earned by a corporation but accrues in one form or another to individuals who are its ultimate owners.

Case for Integration

10.80 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. The level of integration is essentially determined by the manner in which dividend is taxed.

10.81 Most countries levy an individual income tax which includes dividends (distributions to shareholders paid out of corporate profits). As a general rule, these countries at the same time treat corporations for tax purposes as entities separate from their shareholders and levy a corporation income tax under which corporate profits are taxed at the corporation level as they are earned. The term integration relates to the reciprocal relationship between the corporation income tax and the individual income tax. As commonly used in the context of taxation, integration refers to a variety of tax techniques that, while different in form, have a common aim: the elimination or the reduction of the "extra" burden of the corporation income tax on distributed profits."

Table 10.18
Minimum Income Taxes applied around the World

Country	Tax Base	Tax Rate
Belgium	Adjusted Income	29.58%
Puerto Rico	Adjusted Income	30%
South Korea	Adjusted Income	7%-17%
USA (Corporations)	Adjusted Income	20%
USA (Individuals)	Adjusted Income	26%/28%
Pakistan	Book Profits	17%
Guatemala	Gross Assets	1%
Argentina	Gross Assets	1%
Dominican Republic	Gross Assets	0.5%
Nicaragua	Gross Income	1%
Panama	Gross Income	1.17%
Philippines	Gross Income	2%
Honduras	Net Assets	1%
Nicaragua	Net Assets	1%
Nigeria	Net Assets	0.50%
Peru	Net Assets	0.40%
Uruguay	Net Assets	1.5%
Luxembourg	Net Wealth	Flat amounts - progressive
Colombia	Net Worth	3.5%
Lichtenstein	None	Flat amount
Malta	None	Flat amount
Netherlands	Personal Capital Assets	1.2%
Bangladesh	Turnover	0.6%
Burkina Faso	Turnover	0.5%
Cambodia	Turnover	1%
Chad	Turnover	1.5%
Congo Brazaville	Turnover	1%
Congo DRC	Turnover	1%
Cote d'Ivoire	Turnover	1%
Djibouti	Turnover	1%
Equatorial Guinea	Turnover	3%
Gabon	Turnover	1%
Gambia	Turnover	1%
Laos	Turnover	0.1%
Madagascar	Turnover	0.1%-0.5%
Mauritania	Turnover	2.5%
Morocco	Turnover	0.5%
Senegal	Turnover	0.5%
Solomon Islands	Turnover	0.5%
Tanzania	Turnover	0.3%
Trinidad and Tobago	Turnover	0.6%
Tunisia	Turnover	0.1%

Case for the "Classical" system

10.82 Under a 'classical' corporate tax system, income tax is levied separately, both on a corporate income and on dividends received by shareholders. The case for the "classical" system is based on three considerations. **First**, it rests on the issue of legal form; it is argued 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.

The case against the classical (Non-integrated) system

10.83 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.

10.84 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 equity capital for expansion.

10.85 Another adverse 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.

10.86 **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.

10.87 **Fourth**, a classical corporate tax system reduces the incentive to invest, and may, therefore, inhibit growth. The additional tax that is levied on a company's income under a classical system, is additional discouragement.

10.88 Combined together, these four points represent a powerful case against the classical form of corporate income tax. Accordingly, there has been a general tendency over the last four 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

10.89 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 off against the benefits of integration.

10.90 **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.

10.91 **Finally**, some major benefits of 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"

10.92 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.

10.93 "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 retained or distributed, could result in shareholders often being liable to pay large amount of tax without having received cash with which those liabilities can be met. Therefore, no country applies a full integration to taxation of 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.

10.94 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.

10.95 **Third**, 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).

10.96 The **fourth** method of integrating the corporate tax with personal income-tax is to tax corporate income at a rate lower than the highest marginal rate of personal income-tax and dividends to shareholder taxed at the personal marginal rate applicable to them. Consequently, the total incidence would approximately equate the highest marginal rate of personal income-tax. If we assume that most (if not all) individual shareholders are subjected to tax at the highest marginal rate, of personal income-tax, the bias against equity will be eliminated. Further, in a progressive personal income-tax rate structure, the over taxation in the case of shareholders in the lower slab will be limited.

10.97 Over time several forms of integration have evolved. These are (i) classical system (USA and the Netherlands; (ii) full integration (USA); (iii) dividend exemption (South American Countries); (iv) dividend deduction (Australia); (v) dividend imputation system (France Germany, Singapore); (vi) tax on dividend distribution (India). Prior to 1997, India was following the classical system of integration whereby, corporate profits were liable to tax at the corporate level (with rates below the top marginal rate of personal income tax) and the distributed profits in the form of dividends were taxable in the hands of the shareholder after allowing for a low threshold exemption of ₹10,000 under section 80-L of the Income -tax Act. Further, in order to eliminate cascading effect of taxation of dividends in the hands of corporate shareholders, deduction for inter-corporate dividends was allowed under section 80-M of the Income-tax Act. The classical system of integration enabled the foreign investor in India to claim seamless foreign tax credit in their home country. Consistent with this regime, investment pooling vehicles were treated as complete pass-through and the dividend received by investors was taxed in their hands at the applicable marginal rate of personal income tax.

10.98 In 1997, the Income-tax Act was amended to introduce tax on distributed profits (dividend distribution tax) at the corporate level and no tax was payable at the shareholder level. This new regime is *plagued with several problems*. **Firstly**, it is regressive since a flat rate is levied on the dividend irrespective of the applicable marginal rate of personal income tax; this problem was further aggravated with the increase in the dividend distribution tax rate from 10 percent to 15 percent and now to little over 20 percent. The **second** problem relates to cascading; while the problem is partially mitigated by exempting payment by subsidiary to the holding company, it has significant impact in the case of corporate cross-holdings. **Thirdly,** even though the tax on distributed profits is borne by the foreign investor in India, he is not entitled to claim foreign tax credit in his home

country thereby substantially reducing the return on his investment in India and effectively undermining India's international competitiveness as an investment destination. **Fourthly**, this regime also distorted the tax treatment of dividend pay-out by investment pooling vehicles in as much as small investors were being subject to over-taxation. However, this regime of dividend distribution tax, scores high on ease of administration and compliance. It is, therefore,
imperative to rationalize the regime for taxation of dividends

10.99 The underlying objective is to retain the ease of administration and compliance and also eliminate the distortionary effects of the existing regime; the investment pooling vehicles will be treated as tax pass-through and there will be no over-taxation of investors in such vehicles. Consequently, such vehicles which are designed to attract small and non taxpayers will once again become attractive and enable mobilization of small savings. The proposed regime for dividend distribution tax will eliminate cascading effect and also allow foreign investors to claim tax credit in their home country. Further, since individual shareholders who directly invest in equity are generally in the top marginal tax bracket, the flat rate of tax on distributed profits will not undermine the equity of the tax system.

Taxation of capital gains on equity

10.100 One of the most contentious issues in income tax is the treatment of capital gains. The argument for concessional treatment of capital gains is based on several considerations. **First,** taxing capital gains implies taxing the asset holder for any increase in the price of that asset. In an economy where inflation exists (i.e. every economy), this implies taxing both the inflationary and the real gains. Essentially, capital gains would be subject to tax even if there were no real gains. However, the inflation argument although legitimate, can be overcome by allowing asset holders to adjust the cost base of their assets by the inflation rate each year. Second, tax on capital gains serves as a disincentive for asset-switching thereby, creating a 'lock-in' effect and undermining economic efficiency. The problem is further compounded by the differential rates of tax on short-term and long-term capital gains. However, the problem is not intractable; the solution lies in providing for a comprehensive roll-over provision which would allow setting up a quarantined investment pool that investors can move the gains into. The gains moved into this pool would not be subject to tax and, once in the pool, the money could only be used for certain legitimate investment activities. Any withdrawals from the pool would be subject to tax at the applicable marginal rate. Third, like tax on dividends, tax on capital gains too, amounts to double taxation. It is often argued that since profits are subject to corporate tax, no tax should be imposed on dividends or on the increase in the capitalised value of dividends. In practice, this argument does not hold well in situations where the corporate tax incidence is substantially lower than the top marginal rate on account of base erosion

arising from several tax incentives; therefore, taxation of dividends is necessary to fill in this gap. However, a tax on dividends creates a perverse incentive for profit retention. The problem is further aggravated by the fact that higher profit retentions are reflected in higher capital gains which are subject to concessional tax. Therefore, if tax on dividends is justified, tax on capital gains is equally necessary to prevent avoidance of tax on dividends. **Fourth,** 'capital is mobile' and therefore, excessively taxing wealthy investors will lead to flight of capital to another country. While at the margin there may be some flows out of the country, a lower capital gains tax is not necessarily the best way to deal with the problem. Countries can stop chasing the money through tax policy and focus on other ways of competing for investment capital. Education, productivity, infrastructure, network effects, low administrative and compliance costs are all important factors in the assessment of how attractive a location is for investors. The 'lower taxes to attract investment' approach is essentially a lazy option. **Fifth,** capital gains tax would reduce the returns from investing (by raising tax rates) thereby incentivising substitution of saving and investment (future consumption) by current consumption. However, increase in capital gains tax liability would also create an income effect which would tend to neutralize the negative substitution effect. There is no empirical evidence to suggest tax benefit for savings have resulted in higher national savings. Further, tax concession for capital gains lead to revenue loss and in turn, higher fiscal deficit. Since national savings is the aggregate of household savings, corporate savings and government savings, any increase in household savings through tax concessions is neutralized by a decrease in government savings; consequently, there is no positive impact on national savings. In any case, the problem can be substantially addressed by allowing capital gains to be invested in an EET type savings scheme where contributions and accumulation would be exempt but withdrawal (consumption) would be taxed. **Sixth,** since capital gains arise over a long period of time, there is bunching of gains which leads to bracket creep and hence greater tax burden; this increase in tax burden needs to be alleviated.

10.101 Similarly, the case for taxing capital gains as normal income is also built around several arguments. **First**, capital gains are income and should be taxed like other forms of income. The preferential tax rates on capital gains undermine the progressivity of the income tax because capital gains are exceptionally concentrated among the highest-income taxpayers. Therefore, preferential treatment of capital gains is iniquitous. **Second**, lower rates on capital gains encourage people to re-characterize their ordinary income as capital gains leading to abuse and considerable dispute. **Third**, preferential treatment leads to financialization of corporates thereby creating a bias against investment in manufacturing. To the extent manufacturing is necessary to create large-scale jobs in the economy, this bias needs to be eliminated. **Fourth**, a reduction in corporate tax rates will lead to windfall gains to shareholders, a part of which needs to be shared with the Government.

10.102 Further, it is necessary to eliminate all embedded taxes on accumulation of savings so that the cumulative burden of tax is rationalized. Accordingly, the existing regime of taxation of listed equities and other instruments should be rationalized along the following manner:-

Recommendations

i. Corporate Tax Rate

10.103. In Chapter VII, we have recommended two separate tax regimes - Model I and Model II. Keeping in view the international tax rules and the accounting method specific to each of the Models, we recommend the following corporate tax rates, namely :-

(i) In the case of Model I, the corporate tax rate should be reduced from the existing level 30 percent (excluding surcharge and cess) to (a) **5 percent** for banks and financial institutions (including NBFCs) and power producing companies; and (b) **15 percent** for all other companies;

Table 10.19
Model - II: Corporate tax rates under alternative regimes and compliance levels

Level of Compliance	Corporate tax rate (in percent)	Type of MAT				Surcharge (in percent)	Revenues (Rs in crs)
		PBT (in percent)	EBIDTA (in percent)	Gross Asset (in percent)	Turnover (in percent)		
Baseline	30	18.5	-	-	-	10 (plus cess)	3,91,965
Existing level (assuming tax elasticity of income = 0)	18		12.5	-	-	10	3,88,375
	18		-	1.25	-	10	4,15,790
	18		-	-	1.75	10	4,15,762
Increase in Compliance by 14 percent (assuming tax elasticity of income = -0.30)	16.5		12.5	-	-	10	3,95,387
	16.5		-	1.25	-	10	4,17,290
	16.5		-	-	1.75	10	4,16,333
Increase in Compliance by 28 percent (assuming tax elasticity of income = -0.60)	15		12.5	-	-	10	4,04,791
	15		-	1.25	-	10	4,18,941
	15		-	-	1.75	10	4,17,180

Note: The MAT rate for banks and financial institutions and energy companies will be 5 percent under EBIDTA and 0.25 percent both in the case of Gross Asset based and Turnover based MAT

(ii) In the case of Model II, depending upon the level of compliance and the choice of the MAT base, the corporate tax rate should be reduced to levels as indicated in Table 10.19. The tax elasticity of income in the case of corporate for AY 2017-18 is estimated

to be -0.6 (refer Box I). This implies that 1 percent reduction in corporate tax rate will induce higher disclosure of income by 0.6 percent. Based on this result, the corporate tax rate should be reduced to 15 percent and, as indicated in Table 10.19, complemented by a EBIDTA-based MAT at the rate of 12.5 percent or a gross asset based MAT at the rate of 1.25 percent or a turnover based MAT at the rate of 1.75 percent. Similarly, if we conservatively assume the tax elasticity of income to be zero (i.e. compliance will remain unchanged), the corporate tax rate should be reduced to 18 percent and complemented by any one of the variants of MAT at the rate indicated in Table 10.19. Given the robustness of our estimation, we would recommend the corporate tax rate to be reduced from the existing level of 30 percent to 15 percent and appropriately complemented by any one of the variants of MAT at the rate indicated in Table 10.19.

ii. Choice of MAT

10.104 The retained earnings of corporates over the last five years has been adequate to meet their requirement for investment; there is no immediate necessity to provide relief to the corporates to enable them to augment their capital base. Therefore, if the corporate tax rate has to be reduced (which we believe should indeed be done to reduce the cost of equity capital), it is necessary to ensure that any revenue loss is fully recouped through complementary policy initiatives since there is no "fiscal space" available with the Government. Further, we do not view the present exercise as an exercise in revenue raising. However, given the present circumstances, we have to ensure that the package of measures are revenue neutral in the short-term and the tax buoyancy improves in the medium and long-term. Regardless of the robustness of our statistical estimates of tax elasticity of income, it is important to provide for a threshold tax liability to prevent any downside risk of revenues and which will also serve as an instrument to combat tax evasion; the MAT is one such instrument which can enable a seamless transition to the new tax regime.

10.105 In the light of the efficiency and equity effects and ease of compliance and administration, we believe that it is not necessary to complement the package of proposals in Model I with MAT. However, we are also of the view that the package of proposals in Model II should be complemented by the gross asset based MAT as the first best option followed by the turnover based MAT and then the EBIDTA based MAT (in this order). Depending upon our asumption regarding tax elasticity of income and the choice of the MAT base, the basic MAT rates would be as indicated in Table 10.19. However, the MAT rate for banks and financial institutions will be a lower rate 5 percent under EBIDTA based MAT and 0.25 percent both in the case of Gross Asset-based and turnover-based MAT.

10.106 We also recommend that the gross assets should be defined as the value of the gross assets of the company (excluding the amount of debit balance of profit and loss account, if any) as on the close of the financial year and reduced by the aggregate value of the capital work-in-progress and the accumulated depreciation as per the Income Tax Act. Further, it excludes all companies under liquidation and under corporate debt restructuring. Similarly, the gross turnover for the purposes of the turnover based MAT should be defined as all revenue accruals or receipts in the financial year, whether credited to the statement of profit and loss account or not, but shall not include the value of inventory as on the last day of the financial year, if credited to the said account.

10.107 We also recommend that the MAT liability during a year should be allowed to be carried forward for 15 subsequent years for set off against any liability in excess of the MAT liability. This will effectively reduce the MAT liability as an advance tax for the life time liability of an entity.

iii. Taxation of foreign companies

10.108 At present, foreign companies are taxed at a rate of 40 percent (excluding surcharge and cess), even though the rate for domestic companies is only 30 percent. The difference between the two accounts for the tax which would have been collected if the dividend by the foreign companes had been declared in India. This has given an impression of discrimination against foreign companies. Therefore, we recommend that the corporate tax rate for foreign companies should be reduced and aligned with the proposed tax rate for domestic companies. The treatment of dividend by foreign companies outside India should be dealt with in the manner provided in the subsquent paras.

iv. Dividend taxation

10.109 Presently, the taxation of dividends is extremely complex and distorts efficiency and equity. Further, the legislation is not flexible enough to accommodate new structures of investment pooling vehicles. Accordingly, we recommend the following:-

(i) Dividend distribution tax (tax on distributed profits) should be abolished;

(ii) Dividends should be taxed at the shareholders level at the personal marginal rate applicable to him;

(iii) Dividends received by companies shall be exempt to the extent it is distributed to its shareholders so as to eliminate cascading;

(iv) The definition of dividend should be expanded to include-

(a) any pay-out by way of buy-back of shares by any domestic company, whether listed or not;

(b) the value of any benefit provided by issue of bonus shares to the extent capitalised by the company in its books; and

(c) any pay-out to shareholders whether out of accumulated profits or otherwise;

(v) In the case of non-resident shareholder, the dividend distributed by the domestic company shall be subject to a final withholding tax at the rate of 20 percent. The non-resident shareholder shall be entitled to claim credit for the withholding tax against his income tax liability in his home country.

(vi) Further, the foreign company or the permanent establishement of non-resident shall be subject to a branch profit tax in lieu of the tax which would have been collected if the dividend by the foreign company had been declared in India. The branch profit tax should be levied at the rate of 20 percent or treaty rate for dividends.

(vi) All distribution of income (dividend, bonus or any other income by whatever name called) by investment pooling vehicles will be taxed at the unit holder/beneficiary level.

v. Capital gains tax on equity

10.110 We have made a compelling case for levying tax on long term capital gains arising from the transfer of listed equity in the earlier paragraphs. Fortunately, our task in this regard has been made easier by the decision of the Government to reintroduce tax on long term capital gains arising from the transfer of listed equity in the Union Budget, 2018. However, the reintroduction has only partly addressed the distortions in efficiency and equity arising from the exemption of such long term capital gains. This process of reform of taxation regime of capital gains, in particular for listed securities, needs to be taken forward and completed. For this purpose, we recommend the following:-

i. the distinction between short-term capital asset and long-term capital asset on the basis of the length of holding of the asset should be eliminated;

ii. the base for computation of capital gains should continue to be 1st February, 2011 for listed equities and 1st April, 2001 for all other assets; and

iii. cost of acquisition and cost of improvement should continue to be inflation indexed if the asset has been held for more than one completed year;

iv. the period of holding shall be computed from the first day of the financial year immediately following the year in which the asset was acquired;

v. inflation indexation should continue to be provided for 75 percent of the inflation during the year;

vi. a standard deduction of one-third of the long-term capital gains from equity shall be allowed to mitigate the burden of double taxation of return on equity; however, this

deduction should not be allowed for any other asset;

vii. the long-term capital gains should be aggregated with all other income and taxed at the personal marginal tax rate applicable to the transferor;

viii. the short-term capital gains from the transfer of equity should be aggregated with all other income and taxed at the personal marginal tax rate;

ix. transfer of personal effects and agricultural land should continue to be exempt from income-tax;

x. rollover benefits should be rationalized and the existing provisions relating to exemption of capital gains against purchase of bonds of notified public sector companies should be replaced by a new "Capital Gains Saving Scheme" which should be based on EET method of taxation of savings.

xi. Capital Gains Savings Scheme to be based on EET method;

vi. Securities transaction tax

10.111 The securities transaction tax was introduced in 2004 as a substitute of the tax on long-term capital gains on listed securities. Consequent to our recommendation for comprehensive taxation of long-term capital gains on listed equities in Para 10.109 above, the case for continuing the securities transaction tax is extremely weak. Accordingly, we recommend the abolition of the securities transaction tax (STT).

10.112 The package of reforms recommended by us will substantially eliminate the bias against equity investments, reduce METR for return on investment and also reduce METR on equity capital. Consequently, the NPV of investments will increase thereby improving the financial viability of investments in the margin. To the extent the bias against equity is reduced, the corporate risk of bankruptcy and the risk premium on borrowings will also decrease. Cumulatively, this has the potential of providing the necessary impetus to private investment. Further, this will substantially improve corporate valuation and create an opportunity for larger FII inflows and gains to domestic investors. Foreign companies would also be encouraged to set-up branches in India. Based on the corporate tax returns for assessment year 2017-18 (financial year 2016-17), the different combinations of corporate tax rates and MAT have been simulated to estimate the revenue potential which indicated in Table 10.19. The revenue estimates under the diferent corporate tax regimes are within a close range of baseline revenues of ₹.3,91,965/- crores. Overall, the package is revenue neutral and therefore, does not impose any additional burden on the exchequer; neither does it draw out more resources from the corporate sector. Upon implementation, the efficiency and equity of the overall tax system in India will be enhanced thereby creating a pro-business enviornment and new job opportunities.

CHAPTER - XI

TAXATION OF INVESTMENT POOLING VEHICLES

11.1 Investment pooling vehicles are entities owned by many persons and whose primary activity is investing in operating companies. The investment pooling vehicles act as an intermediary between the individual investor and the ultimate user of the capital. Several types of investment pooling vehicles exist like venture capital funds (these invest in greenfield ventures), private equity funds (these invest in firms, which have crossed the greenfield stage, but are not yet listed), hedge funds (these are structures where each customer brings in a minimum of say, ₹10 lakh of capital, so that the securities regulator ceases to work for investor protection, and only focuses on contract enforcement and fraud). Further, these vehicles could be "open-end" funds or "closed-end" funds. In the former, the vehicle (fund) issues and redeems its units from investors. In contrast, "closed-end" funds issue a fixed number of units, and investors trade units with other investors.

11.2 The design of a tax regime for investment pooling vehicles would depend upon the basic decisions made in designing the overall tax system for individuals and business enterprises. Within the framework of the overall tax system, the choice of the taxation regime for the investment pooling vehicles requires balancing three objectives: **first**, eliminate any barrier to the development of financial intermediaries, such as investment pooling vehicles; **second**, to design a tax regime which is comparable to those that apply to other investments; and, **third**, to adopt tax rules that can be administered and enforced. Further, the design of the tax regime for the investment pooling vehicles is also determined by the ability of investment fund managers to process substantial amounts of information and to allocate income to individual investors **and** 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. Generally, the investment pooling vehicles are likely to have the computer capability to process the information. However, in many countries, the ability of the tax administration to develop a system to ensure enforcement and compliance at the investor level is limited; in such a situation, taxation at the vehicle level is the preferred option.

11.3 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. Under this method, the charactor of the income at the vehicle level is maintained at the investor level. This method scores high on market neutrality and equity. However, it scores low on administrative and

compliance grounds, especially as a number of investors and the number of fund investments become quite large.

11.4 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; this scores low on equity considerations.

11.5 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.

11.6 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.

11.7 The taxation regime for investment pooling vehicles is a hybrid of pass-thru and entity level taxation. It is exremely rigid in so far as the law is not flexible enough to accommodate new structures. As is well known, investment pooling vehicles are essentially vehicles to mobilise small savings and, therefore, entity level taxation of income distributed at rate higher than the personal marginal rate of the investor imposes an unfair burden; the present tax regime is inequitable. Further, the existing system also scores low on efficiency consideration; interest, camouflauged as dividends, received from an equity-oriented fund is exempt in the hands of the beneficiary but taxable if received from a debt oriented fund. Similarly, in some cases like venture capital fund, the income distributed retains its character at the beneficiary level whereas in most other cases, it looses its character. Overall, the regime is highly complex and inhibits mobilisation of savings.

11.8 In the light of the foregoing and the package of reforms relating to taxation of dividends

and capital gains, we recommend the redesigning of the taxation of investment pooling vehicles in the following manner:-

(i) investment pooling vehicles shall mean a special purpose vehicle, which -

(a) is established or registered as a company, fund, trust, society or institution under any Central Act or regulations thereunder;

(b) combines capital from, or assets of, many investors to deploy it according to its particular investment strategy;

(c) distributes atleast ninty five percent of its surplus by -

(I) actual payout to the investors; or

(II) notionaly apportioning the surplus amongst the investors in the ratio of their respective investment and treating the share of the investor as reinvestment by him;

(d) is registered, or recognised, by SEBI, Reserve Bank of India or Pension Fund Regulatory and Development Authority; and

(e) belongs to a class of investment pooling vehicles, prescribed in this behalf.

(ii) all investment pooling vehicles should be treated as pass-thru and they should be exempt from income-tax at their level.

(iii) any surplus distributed by the investment pooling vehicles should be taxed in the hands of the unit holder/beneficiary at the personal marginal rate applicable to him after aggregating the surplus with all other income;

(iv) the capital gains arising on transfer of units of any investment pooling vehicle should be treated in the like manner as equity;

(v) the surplus distributed by the investment pooling vehicle shall be subject to withholding tax at the rate of 15 percent and will be allowed as a credit against the total tax liability of the unit holder/beneficiary; and

(vi) all investment pooling vehicle should be required to file their tax returns.

11.9 The proposed design will impart greater efficiency, equity and simplicity to the tax regime for investment pooling vehicles. As is well known, investment pooling vehicles are essentially vehicles to mobilise small savings and, therefore, entity level taxation of income distributed at rate higher than the personal marginal rate of the investor imposes an unfair burden. In effect it will impart greater transparency which will enable financial intermediation at minimum cost.

CHAPTER - XII

TAXATION OF INSURANCE BUSINESS

12.1 A review of the tax treatment of savings must include a review of the tax treatment of the insurance industry i.e. both the insured and the insurer since a significant proportion of domestic savings is channelized by this sector. Several countries' tax systems contain incentives to encourage life insurance contributions. Life insurance contracts are structured as a pure saving product or a pure insurance product or as a combination of the two. An insurance-cum-saving product embodies a significant element of saving with only a modest insurance component.

12.2 Ideally, tax provisions applicable to life insurances should be consistent with the general tax principles. If the promotion of savings is the objective, qualifying policies should be heavily savings oriented (e.g., annuities and endowments). If the promotion of death protection is the primary objective, qualifying policies should be predominately protection oriented (e.g., term life products). If they seek the promotion of both protection and savings, the policy will have to be much broader in its scope.

12.3 Tax deductibility tends to be operative on the saving component of the contract on consideration of tax neutrality, rather than on the pure insurance component. Typically, the tax advantage for the saving product is granted only if the investors commit to long-term contracts, which can be seen as a substitute for retirement savings (living benefits). Concessions are less commonly extended to policies whose purposes are exclusively or more predominantly, to provide insurance benefits (death benefits).

12.4. All OECD countries provide some tax concessions in the purchase, maintenance, or execution of life insurance policies. In several countries, tax relief is provided for premiums paid for qualifying life insurance policies. Table-12.1 below shows the cross country practice in this regard.

12.5. In most and perhaps all OECD countries, payments by life insurers for so-called living benefits exceed payouts because of the death of the insured. Living benefit payouts or accruals may be classified broadly into (i) dividends (bonuses) under participating (with profits) contracts; (ii) policy cash values and maturity (capital sum) amounts; and (iii) payouts under annuity contracts. Life insurance policy dividends, at least in the early years of a policy, represent largely a return to the policyholder of a deliberate premium overcharge. Consequently, the general rule in OECD countries is that dividends paid do not cause current taxable income.

Table 12.1: Tax treatment of premiums paid for life insurance policies

Sl. No.	Name of the Country	Whether tax relief is provided on premiums paid for individual life insurance policies
1.	Austria	Yes, Limited amount
2.	Belgium	Yes
3.	Denmark	Yes.
4.	France	Yes. Limited amount
5.	Germany	Yes.
6.	Greece	Yes. Limited amount
7.	Italy	Yes.
8.	Japan	Yes. Limited amount
9.	Korea	Yes. Limited amount
10.	Luxembourg	Yes. Limited amount
11.	Portugal	Yes. Limited amount
12.	Switzerland	Yes. Limited amount
13.	Turkey	Yes. Limited amount
14.	Australia15.	No
15.	Canada	No
16.	Finland	No
17.	Iceland	No
18.	The Netherlands	No
19.	Ireland	No
20.	Mexico	No
21.	Norway	No
22.	New Zealand	No
23.	Poland	No
24.	Spain	No
25.	Sweden	No
26.	United Kingdom	No
27.	United States	No

12.6. The cross-country practice on the treatment of the gain on the surrender or maturity of the policy representing the so-called inside interest build up varies widely. A few countries provide that certain policies with high cash values in relation to the policy's death benefit or with unacceptably short durations may trigger taxation of the inside interest build up. In addition, some countries deny the inside interest build up exemption to policies purchased from unlicensed insurers. Several other countries tax the inside build up indirectly by taxing that portion of insurers' investment income considered attributable to the taxpayer/policyholder's internal policy interest accruals. This tax is in addition to the regular corporate tax, although it may be taken as a deduction. As a policy, a relatively simple approach is to adopt a measure of gain on the policy that is administratively simple. It involves taxing a policyholder only on the gain i.e. maturity or surrender value of the policy plus the sum of all dividends/bonuses received minus the sum of the premium paid under the policy. This difference, if positive, may be subject to income tax. If the difference is negative,

no deduction is usually permitted against income on the theory that the procedure understates taxable income by allowing deduction for the risk premium.

12.7. Payments under annuity contracts are the third category of living benefits. Most OECD countries tax annuity payouts to some degree since they represent inside interest build-up and the premium paid (contributions). In a few countries - such as France, Italy, and Spain - a prescribed, fixed portion of each payment is subject to tax. In most countries, various mechanisms are prescribed in which the excess of payments received over premiums paid is taxed, usually on some type of prorate basis over the annuity payout period.

12.8. Most OECD countries exempt death proceeds paid under qualifying life insurance policies from income taxation, as Table 12.2 shows. Germany and the United States tax portion of death proceeds payable under certain high cash value policies. In Belgium, benefits are taxable on policies for which a tax deduction was taken for premiums paid. The Netherlands provides for income taxation of death proceeds in excess of specified maximums provided certain conditions are met. Such taxation is, however, the exception rather than the rule since Governments commonly levy inheritance taxes or other estate duties, measured on the value of property that a decedent owned, controlled, or transferred. Life insurance death proceeds are subject to estate duties in many OECD countries. In most of these instances, however, provision is made for special circumstances wherein the proceeds are excluded, in whole or in part, from assessment.

12.9. In India, the insurer enjoys tax benefit in respect of contribution towards life insurance premium under section 80-C of the Income tax Act. The inside interest build up is liable to tax indirectly by virtue of the actuarial surplus of the insurer being taxed at a uniform rate of 12.5 percent. However, there is no taxation of gain on surrender or maturity or of death proceeds.

Life Insurance company taxation:

12.10. The tax treatment at the corporate (supplier) level should not be ignored as it can affect product value. Typically, a life insurance contract is for a medium to long-term duration. During this period the Policyholder pays a uniform/level premium for covering a specified risk for a specified sum, and also aiming for a payout on surviving at the end of the term. However, the intensity of the risk is not level and increases with age. Therefore, the level premium results in 'pre-payment' in the early stages of the contract which accumulates to cover the 'deficits' in the premium payments at the later stage. For this reason, the income (premium and investment) of a life insurance company is not strictly comparable with the income of any other business. As each premium payment includes an amount for meeting future payouts, the insurer is required to maintain a permanent

Table 12.2: Income taxation of life insurance values (insurer)

Country	Taxation of inside interest buildup?	Taxation on gain on surrender?	Death proceeds subject to income taxation?
Australia	Yes	No	No
Austria	No	No, unless policy terminates in less than 10 years	No
Belgium	No	No, with exceptions	No, with exceptions
Canada	Yes, indirectly at 15%	Yes	No
Denmark	Yes, indirectly at 26%	Yes for tax deductible policies, otherwise no	Yes, same as surrender gain
Finland	No	Yes	No
France	No	Yes, for some policies	No, except for large policies
Germany	No	Yes, on deferred interest	No
Greece	Yes, indirectly at 15%	No	No
Ireland	No	Yes	No
Japan	No	Yes, on gain over - 500,000 at ½ ordinary rate	No
South Korea	No	No	No
Luxembourg	No	Yes, at low rate	No
Netherlands		Yes, on gain in excess of a deduction	Yes, same as surrender gain
New Zealand	Yes, indirectly	No	No
Poland	No	No	No
Spain	No	Yes	No
Switzerland	No	No, if certain conditions met	Yes, at special rates
Turkey	No	Yes, on gain in excess of a deduction	No
United Kingdom	Yes, indirectly	No, with exceptions	No
United States	No, if certain conditions are met	Yes	No, if certain conditions are met
India	Yes, indirectly at 12.5%	No	No

reserve which, along with future premiums and future investment income, would be adequate to meet future benefit payouts, future expenses and other future outgo. Therefore, life insurer taxation can take the form of premium taxation or net income taxation.

12.11 Under the typical premium tax structure, the tax base is the simple total of the insurer's premium revenue, with certain alterations. Premiums received from assumed reinsurance are usually

excluded from the tax base, as the original insurer that wrote the business would have already been subjected to tax on its direct premiums. Most jurisdictions permit a deduction from the tax base for dividends paid to policyholders. The premium tax base may include premiums received from personal accident and health insurance, but more commonly they are taxed separately, usually at a higher rate. Insurers' investment income is not included in the tax base. Most countries do not levy premium taxes on annuity considerations paid to insurers. Even those countries that tax annuity considerations typically exempt contributions to qualified retirement annuity plans or tax them at a lower rate.

12.12 Premium taxation is simple administratively for both tax collection authorities and the taxpayer. It produces a typically steady, predictable revenue stream. However, its application creates substantial inequity among life-products and is not competitor neutral given that it must be paid irrespective of profitability. The premium tax approach should be used only if the need for administrative simplicity dominates the goals of equity and neutrality.

12.13 Several OECD countries levy taxes on insurers' premium revenues. Table 12.3 shows the countries that do so along with their tax rates. Premium taxes are the most common, but some countries levy stamp duties and other assessments. The insurer is responsible for tax payment in the great majority of countries, although the insured may be responsible when business is placed with an unlicensed insurer. Even with the insurer responsible for payment, such taxation is closely related to policyholder taxation.

12.14 The corporate income tax is a logical, if potentially complex, means of taxing life insurers. Governments typically tax life insurers on some variation of net income in OECD countries, in much the same way as other companies are taxed. Table 12.3 shows the general approaches followed and the maximum marginal tax rates for selected OECD countries. In the past, several countries taxed life insurers on their investment income only; Australia, Sweden, and the United Kingdom follow the so-called I-E (investment income minus expenses) approach.

12.15 Determining life insurer profit is a challenge. The challenge arises from the difference in timing between premium payments and claim payments. The typical tax base for purposes of calculating taxable income is the sum of investment and premium income. The yearly increase in policy reserves, acquisition and administrative expenses, policy dividends paid, and premiums paid on ceded reinsurance usually are deducted from this sum. Other deductions may be permitted and special rules may exist for loss carryovers and (domestic and foreign) branch income.

12.15 There is a wide range of variation in calculating the deduction for policy reserves. Although

the reserves determined for regulatory purposes are calculated conservatively (and therefore intended to be higher than necessary), the simplest approach would be for the taxing authorities to adopt the

Table 12.3 : Taxation of life insurance companies

Country	Premium Taxation?	Basis for net income tax?	Maximum income tax rate?
Australia	Yes, at 10% of first year's premium depending on state and type of policy	Investment income less expenses	30% except pensions at 15%
Austria	Yes, at 4% except 10% for policies of less than 10 years duration	Total income	34%
Belgium	No, except group at 4%	Total income	39%
Canada	Yes, 2-4% depending on province	Total income	43-46% depending on province
Denmark	No	Total income	32%
Finland	No	Total income	29%
France	No	Total income	37.66%
Germany	No	Total income	40%
Greece	No, except 10% for policies less than 10 years duration	Total income	35%
Ireland	Yes, stamp duty of 0.01% of sum assured	Total income	22/24% policyholder/ shareholder fund; lower in future
Italy	Yes, 2.5%	Total income	
Japan	No, except limited prefectual taxation	Total income	36.21%
South Korea	Yes, 0.5%	Total income	17.6% on first ω100 million, 30.8 on excess
Luxembourg	No	Total income	30%
Mexico	Yes, 3% except no tax on group insurance	Total income	35%
Netherlands	No	Total income	35%
New Zealand	No	Total income	33%
Norway	No	Total income	28%
Poland	No	Total income	30%; lower in future
Portugal	Yes, 0.33%	Total income	32%
Spain	No	Total income	35/25% stock/ mutual insurer
Sweden	No	Investment income less expenses	20%
Switzerland	Yes, 5% except single premium at 2.5%	Total income	17-31% depending on canton
Turkey	No	Total income	33%
United Kingdom	No	Investment income minus expenses	23/30% policyholder/ shareholder funds
United States	Yes, 1-3% depending on state	Total income	35%

standards prescribed by the regulating authority's standards. If no published standards exist, the reserve position as reported in the company's financial statement could be used. As tax authorities develop expertise in this technical area, the tax reserve method could be changed. Use of the same standards simplifies the administrative burden on both tax authorities and life insurers. Life insurers would not have to prepare separate reserve calculations for both tax and regulatory authorities. The tax authorities in turn could place greater reliance on the accuracy of the calculation since the regulatory authority would be responsible for verifying it. The effect of using statutory reserves for tax purposes is to overstate the reserve deduction and, hence, to understate taxable income. This can be viewed as one aspect of a favorable tax policy.

12.16 Dividends paid on participating life insurance policies are usually deductible in whole or in part in determining taxable income under a total income tax system. In fact, a separate accounting of the income attributable to participating business is usually required in OECD countries. If the insurer is a stock company, the shareholders may be entitled to a small percentage only of the profits from the participating business. If the insurer is a mutual company, policyholders effectively own the company, in which case profits of any non-participating business plus those from the participating business may be distributed to the participating policyholders as policy dividends.

12.16 Policy dividends represent both a return of excess premiums and a distribution of income. Distinguishing between the two elements is difficult. To allow a full deduction for policy dividends may reduce the tax base of a life insurer below the comparable corporate tax base of other business. Within the industry itself, to do so may give mutual companies an unfair advantage over stock companies. In fact, most countries allow a full deduction for policy dividends. However, Canada limits the deduction to the amount of the participating income. This tends to place stock and mutual companies on a similar basis. The deduction for policy dividends in Japan is limited to a deemed minimum return of 7.0 percent on insurer surplus. Under the United States' system, deductions for policy dividends paid by a mutual company are limited to reflect a return on net worth, but full deductibility is allowed to stock companies.

12.17 In India, the profits and gains of a life insurance business are determined on the basis of the annual average of the surplus of the last 3 years. In arriving at this, adjustment to the surplus or deficit in the earlier years is allowed to be made so as to exclude from it any surplus or deficit included therein which was made in any earlier inter-valuation period. No further adjustment to the annual average of the surplus so arrived is made. Therefore, no further deduction is allowed in respect of any portion of the amount paid or reserved or expended on behalf of the Policyholders.

Similarly, the various statutory disallowances provided under sections 30 to 43A are also not required to be made. The profits and gains so arrived are charged to tax at the basic rate of 12.5 per cent as provided in section 115B of the Act.

12.18 The present system does not make any distinction between the surplus or deficit on the Policyholder's account and the profit or loss on the shareholder's account. In the Indian context, this is inequitable. The amount paid or reserved for policyholder represents excess premium and income from investment of policyholders' fund. To the extent it represents excess premium, the same is exempt on grounds of mutuality. However, the investment income is liable to tax in the hands of the policyholder and may be subject to a surrogate tax in the hands of the insurer at the rate applicable to the majority of the policyholders. In India, it is reported that there are about 38 crore life insurance policies of which approximately 70 percent (26.6 crores) are unique policy holders. Given the fact that there are about 6 crore tax return filers, most other policy holders are outside the tax net and yet bear the burden of the 12.5 percent tax on valuation surplus. This entity level taxation increases the cost of insurance for the economically poor and marginal people in the country thereby leading to under-consumption of this "merit" good. However, the taxpayers at the higher income slab are under taxed thereby aggravating the equity of the system. The problem is further compounded by the fact that consumption of this "merit" good by taxpayers is subsidised by way of deduction under section 80C of the Income-tax Act. Overall, the present system is highly inquitable. Therefore, in India, the case for surrogate tax on investment income is extremely weak. The burden of tax must shift from the insurer level to the level of the insured.

12.19 In view of the cross-country practices, the need to maintain tax neutrality across financial instruments and prevalent distortionary system in India, the tax treatment of the insured and the insurer, we recommend the following :-

(a) Since approximately 80 percent of life insurance policyholders are outside the tax net, it is highly inequitable to subsidise the richer 20 percent of the policyholders. Therefore, under Model I, no deduction is proposed to be allowed for premium paid for individual life insurance policies. However, under Model II, a deduction for the risk component in the premium paid for life insurance policies is recommended to be allowed; the risk component is estimated to be 5 percent of the premium and allowed accordingly subject to a maximum of ₹25,000/-.

(b) The exemption under section 10(10D) in respect of the maturity or surrender value of the policy should be discontinued and the net gain from such maturity or surrender should be liable to tax at the level of the policyholder.

(c) The insurer should be allowed a deduction in respect of dividends paid to or reserved for policy holders unlike the present practice of no such deduction.

(d) The taxable income of the insurer shall be charged to tax at the normal corporate tax rate unlike the present practice of a 12.5% on the net change in actuarial surplus and corporate tax rate on other investment income available for distribution to share holders.

Impact of the proposals:

a. On financial intermediaries

12.21 Insurers:- The insurers will stand to gain substantially in terms of savings in taxes on account of deduction for dividends paid to or reserved for policyholders. However, the gain to the insurers is likely to be partly neutralized by the need to pass on the benefit to the policyholders since tax benefit for premium paid by policyholders is proposed to be withdrawn. The relative elasticities of demand and supply for insurance policies will determine the proportion in which the savings in taxes will be shared between the insurer and the insured.

12.22. In view of the cross-country practices, the need to maintain tax neutrality across financial instruments and prevalent distortionary system in India, the tax treatment of the insured and the insurer is proposed to be reformed in the following manner:-

(i) The deduction allowed under section 80-C for premium paid for individual life insurance policies to be discontinued;

(ii) The exemption under section 10(10D) in respect of the maturity or surrender value of the policy to be discontinued and the net gain from such maturity or surrender to be liable to tax. The insurer will furnish a certificate of the net gain to the insured.

(iii) The insurer will be allowed deduction in respect of dividends paid to or reserved for policy holders unlike the present practice of no such deduction.

(iv) The taxable income of the insurer shall be charged to tax at the normal corporate tax rate unlike the present practice of a 12.5% on the net change in actuarial surplus and corporate tax rate on other investment income available for distribution to share holders.

12.23 These recommendations relating to taxation of insurance business will impart greater efficiency and equity; it has the potential to reduce the premium on life insurance and consequently increase consumption of this merit good.

CHAPTER - XIII
TAXATION OF UNINCORPORATED BODIES

Taxation of Partnership Firms

13.1 Forms of business partnership are recognized in both common law and civil law countries; however, the definitions and basic legal features vary significantly.

13.2 In common law systems, a partnership is defined as an essentially contractual relationship among persons to pursue a common business. Partnerships are generally not considered as persons for legal purposes. Civil law systems typically do not use the term partnership but they do have the concept of an association of persons for business purposes, in distinction to capital companies. Many civil law jurisdictions also make a distinction between a civil law partnership and a commercial law partnership.

13.3 The income of a partnership is either taxed at the level of the partnership, in a manner equivalent to or similar to the taxation of companies, or in the hands of the partners according to the rates applicable to them ("flow through" treatment).

13.4 In systems with flow through treatment there are two basic approaches to calculating and taxing the income of partners. The **"entity approach"** views the partnership as an entity separate from its partners. The income is calculated at the level of the partnership and then is allocated to the partners according to their share in the partnership. Under this method, the income is calculated at the level of the entity and the net amount is allocated to the partners as a single category of income, usually business income. The **"aggregate approach"** views the partnership as an aggregation of the partners, with each partner holding a fractional ownership interest in partnership assets. The partnership is not considered as an entity that exists separately from its partners. Each partner is simply allocated the partners' fractional share of partnership receipts and outgoings, and the tax consquences are determined in the hands of each individual partners, thereby maintaining their character. The taxable income therefore is not determined at the level of the partnership but is calculated for each partner separately. The two approaches can rarely be found in their pure form; it is more common to see hybrid solutions which combine the two approaches.

Country Practices

13.5 While the details of partnership taxation can be extremely complex and much variation can be found among countries, some general patterns can be identified.

13.6 Partnerships are generally treated as legal persons in most civil law jurisdictions with the

exception of certain type of partnerships such as civil law partnerships. Some countries treat partnerships with legal personality also as taxable persons (e.g. Belgium and Spain). In others, partnerships are treated as flow through entities even if they have a legal personality. In common law countries partnerships do not have a legal personality and are usually taxed on a flow-through basis. A few common law countries (especially transition countries) treat all partnerships as taxable persons.

13.7 The allocation of income under the partnership agreement is usually followed also for tax purposes. The allocation may be based on the proportion of capital contributed or may be based on the expertise or effort of the partner or the particular property contributed. Allocation of income under the partnership agreement may not be respected if it is not at arms length.

13.8 Countries tending to the aggregate view do not allow the deduction of salaries on the basis that a partner cannot be his or her own employee. In countries using the entity approach salaries may be deducted when calculating the partnership income.

13.9 With respect to losses the main question that arises is whether or not a partner may deduct a partnership loss from other income of the year. Some countries in effect treat the partnership like a taxable entity for this purpose and allow it only to carry over the loss and use it to offset against partnership income of other years. Other countries allow partnership losses to be deducted from other income of the partner. Some countries restrict the amount of loss that may be claimed to the tax cost of the partner's partnership interest or the amount the partner has at risk.

13.10 In many countries, partnerships are required to file tax returns even if no income tax is levied at the level of the partnership.

13.11 Treating partnerships as taxable persons is simpler from an administrative point of view than taxing the income in the hands of the partners. This is because tax has to be collected only from one person instead of various, and the tax returns of individual partners are kept simpler. Additionally, as all business entities are usually subject to the same rate of tax, entity level taxation ensures that the choice of taxpayers between different types of entities is based on commercial or other considerations and not motives related to taxation. The disadvantage of this approach is that income is taxed at the flat corporate tax rate instead of applying the tax rates applicable to individual partners. Further, given that some but not all countries decide to treat partnerships as taxable persons, discrepancies may result if foreign partnerships are also viewed as taxable entities for tax purposes.

13.12 In India, a partnership firm is not recognised as a legal entity but taxed as a separate entity. In computing the total income of the firm, any payment of salary, bonus, commission or remuneration, by whatever name called, to any working partner is allowed as deduction at the firm

level. For this purpose, a 'working partner'· means an individual partner who is actively engaged in conducting the business/ profession of the firm. Any remuneration paid to sleeping partners or financing partners is not allowed as a deduction in the computation of the total income of the firm. The firm can also claim deduction in respect of interest paid to a partner at a maximum rate of 12 percent per annum. However, the payments have to be authorized by, and is in accordance with, the terms of the partnership deed.

13.13 The share of the partner in the income of the firm is fully exempt from income-tax under section 10(2A). In case the share is a loss, the same can not be set off against partner's other business income. It is simply ignored. No tax is payable by the partners on their respective share of income from the firm. However, the amount of interest and/or remuneration etc. received by a partner is taxed in his hands as 'business or professional income'.

13.14 The partnership should be evidenced by an instrument in writing specifying individual shares of the partners. A certified copy of the instrument signed by all the partners (not being minors) is required to accompany the return of the firm for the first assessment as a 'firm'. In case of any change in the constitution of the firm or shares of the partners in any financial year, the firm is required to furnish a certified copy of the revised instrument of partnership signed by all the partners (not minors) along with the return of income for that assessment year If any default is made in compliance with the above provisions, the firm is assessed as a firm without allowing for deduction of interest and salary paid to partners from assessment year 2004-05 onwards and as an AOP up to assessment year 2003-04.

13.15 The present regime for taxation of firms at the entity level violates the principle of horizontal equity. Further, it inhibits the transformation of proprietorship firms into partnership firms, thereby restricting pooling of capital and the growth of business. Equally important from a tax policy perspective, the purpose of reduction is personal income tax rates is to induce voluntary compliance. Generally, the inducement effect in the case of salaried tax payers is minimal, if not negative. However, the inducement effect is strongly positive in the case of non-salaried tax payers. If this category of taxpayers, who are mostly organised as firms, end up being uniformly taxed at the entity level at the top personal income tax rate, the expected positive inducement effect is nullified. Therefore, it is important that their choice of the business organisation (proprietorship versus partnership) should be tax neutral. Therefore, the existing tax regime for partnership firms is inefficient and inequitable. The case for restructuring the existing regime of taxation of partnership firms is extremely strong.

13.16 In the light of the above, we recommend a new tax regime for partnership firms. The key features of the new regime are as under:-

i. The partnership firm will be treated as an entity separate from its partners.

ii. The partnership firm shall be treated as a 'flow through' whereby the total income (including losses, if any) will be calculated at the partnership level and then allocated to the partners according to their share in the partnership.

iii. In calculating the total income at the partnership level, no deduction shall be allowed in respect of any salary, remuneration, bonus, commission, interest or any other payment not being capital in nature.

iv. The amount so allocated to the partners shall be aggregated with any salary, remuneration, interest, commission or any other payment not being capital in nature (the aggregated amount shall be referred to as 'adjusted share')

v. The 'adjusted share' of the partner shall be a single category of income assessable under the head ' income from business' and taxed in his hands at the personal marginal rate applicable to him.

vi. Every partnership firm shall be required to file its return of income even if no income tax is payable at its level.

vii. The excess of the total income assessed in the case of the partnership firm over the total income declared by the partnership firm in its return of income, shall be taxed at the partnership firm at the maximum marginal rate so as to avoid making repitetive rectifications in the assesment of the partners.

viii. The excess referred to in item (vi.) above shall not be included in the total income of any partner regardless of whether such amount is apportioned between the partners or not.

ix. The Department may make a reallocation of the total income of the partnership firm between, or among, the partners -

   (a) to reflect economic reality if the instrument of aggreement does not have substantial economic effect; or

   (b) to reflect the respective contribution of the partcipants to the unincorporated body of capital, expertise and labour.

x. The partnership firm shall be taxed at its own level at the maximum marginal rate, if-

   (a) there is no instrument of agreement between the participans;

   (b) the share of any participant is unknown; or

   (c) any of the participants has not obtained the Permanent Account Number.

xi. The withholding tax credit allowable to the partnership firm will be allocated between the partners in accordance with the rules framed in this behalf.

13.17 The treatment of other unincorporated bodies and their participants will be in the same manner as partnership firms.

13.18 The proposed new regime will improve the productivity and equity of the tax system. It will provide relief to a large number of small partners from the burden of overtaxation.

CHAPTER - XIV

TAXATION OF NON PROFIT ORGANISATIONS AND POLITICAL PARTIES

14.1 The non profit sector represents a substantial and growing share of the national economy. Today, however, the non-profit sector represents a substantial and growing share of the national economy. Large concentrations of non-profits can be found in a number of vital and expanding service industries, including education, health care, research, the media, and the arts. Non-profit firms now commonly provide goods and services in direct competition with profit-seeking firms, and in many cases increasingly resemble their for-profit competitors in their manner of organization and operation.

14.2 Traditionally, the sector was small and, therefore, it was generally exempted from income tax. The case for exemption is based on several theories. **First,** it is justified on the basis of public good theory. It is argued that the Government is unable, or ill equipped, to fulfil all of the services that society might desire. When a non-profit step in and provides these services-be they, for example, education, research, or poverty relief-the government subsidizes such operations by providing a tax exemption. In the absence of the non-profit, the government itself would be forced to provide the service or society would have to go without. As an incentive for the private sector to fill in the gap, the government in essence agrees to split the cost with the non-profit. However, all exemption availing non-profit organisations (NPO) are not engaged in providing public goods and, therefore, this argument may not apply to all NPOs. The **second** argument is based on the income measurement theory. Under this theory, the surplus generated by the NPO is generally not equivalent to the concept of income under any tax law. Neither the "net income" concept nor the "ability to pay" rationale for income taxation can be satisfactorily applied to NPOs. The **third** argument is based on the capital formation theory. It is argued that non-profits are at a disadvantage when it comes to raising funds because they are unable to issue stock and raise capital. As a result, the only means by which a non-profit may raise capital are "debt, donations, and retained earnings." Donations are an "uncertain" source of funds, and many non-profits do not even rely on a model whereby they are supported by donations at all. The availability of debt, too, is likely to be inadequate as lenders are seldom willing to provide enough capital for all of a firm's needs. Thus, the sole remaining, semi reliable source of capital for a non-profit is retained earnings. By allowing non-profits to accumulate retained earnings tax-free, the tax law essentially gives these firms a lifeline for their need to raise capital. Not only can tax-exempt organizations use the money they are not paying in

taxes on capital expenditures, but also their increased cash flow as a result of not having to pay taxes will encourage lenders to extend them more debt financing, creating a double benefit. The exemption can be understood as a subsidy to capital formation. The **fourth** argument is based on the donative theory of exemption. Under this theory, the primary rational for the charitable exemption is to subsidze those organisations capable of attracting a substantial level of donative support from the public. When a public good is not provided at the optimally desired level by the government and such good is also not available in the private market largely due to free-rider problems, a confluence of both government failure and market failure emerges. For these types of public goods, the only mechanism by which those who desire the good can realize its production is to make a donation toward the creation of that good. Like other theories, this also works only for a sub-set of organisations.

14.3 Similarly, tax experts argue against tax exemption to NPOs due to over accumulation of surplus. It is argued that most of the wealthiest non-profits in the country not only generate significant surplus anually, but they also have a tendency to stock those surpluses away, building endowments seemingly simply for the sake of having a large endowment. It appears that a large endowment is built not for any grand design for the future of the field in which the NPO is engaged but because a large endowment is itself an indicator of prestige.

14.4 Further, this accumulation is considered wrong for two reasons: it is immoral and it is wasteful. First, implicit in the exemption for non-profits is the expectation that such firms will use their public subsidy to actually benefit the public. When a firm receives taxpayers' money, it has a moral duty to use the funds in the agreed-upon manner. The government directly subsidizes many other things; if the recipients of those direct subsidies took the money, put it in the bank, and never used it for anything, it would not be possible for the government to continue to provide such subsidies.

14.5 The second objection to the current practice of using taxpayers' money to build impenetrable endowments is that it is wasteful. Many NPOs do not need any income-tax exemption but because it is there on the statute and they are eligible for it, they take full advantage of it. Granting blanket tax exemptions to organizations that clearly do not need, is certainly a bad policy.

14.6 Whatever be the arguments against allowing exemptions, the complete removal of exemptions for non-profit organisations is neither desirable nor feasible. However, the tax regime needs to be redesigned in a manner which is capable of enabling the NPOs to persue their activities and preventing "abuse" of the tax exemptions.

14.7 Historically, philanthropy in our country has been playing a special and prominent role in

enriching our cultural heritage and also promoting education, medical, socio-economic and religious needs of our people. Government has throughout supported such philanthropic activities by providing exemption under the Income-tax Act. The exemption is governed under provisions of sec.11 to sec.13. Similarly, exemption is also provided u/s 10(23C) for any income received by any person on behalf of Prime Minister's Relief Fund, Prime Minister's Relief Fund for promotion of Folk Art, Prime Minister's Aid for students Fund, National Foundation for Communal Harmony, Institutions existing solely for the purposes of education or medical relief, Institutions or Funds or Trusts existing for charitable or religious purposes etc.

14.8 The exemption u/s 11 is granted subject to fulfilling of various conditions mentioned therein, whereas in the case of exemptions u/s 10(23C), certain cases receive unconditional exemption and in some other cases, subject to conditions provided therein. The primary condition for grant of exemption is that the income derived from property held under trust should be applied for the charitable purposes, and where such income cannot be applied during the previous year, it has to be accumulated and invested in the prescribed modes. If the accumulated income is not applied in the prescribed manner and within a specified time, the amount accumulated is deemed to be taxable income of the trust or the institution.

14.9 Section 13 of the Act, inter alia, provides for non-distribution of any income or funds or assets of the trust or institution to any interested person. This is designed to ensure that the trust or institution is not for private purposes.

Profile of Charitable Trust

14.10 Non-Governmental Organisations (NGOs), Trusts, associations, other not for profits entities perform a vital role in supplementing governmental efforts in promoting economic development and social welfare. Tax Administrations the world over recognises voluntary effort and provide incentives to genuine charitable organisations. The Indian Income Tax Act, 1961 incorporates several provisions to extend tax breaks and incentives to such organisations and donors.

14.11 This study is a measure of such activities, profiling of the charitable trusts, their incomes and its application for charitable purposes, investments, voluntary contributions and also areas where such entities may be used as vehicles for evasion of taxes.

TPRU for purposes of study of charitable trusts has used Income Tax returns in ITR-7 data for AYs 2014-15 to AY 2017-18. ITR-7 is the return form prescribed for Charitable/religious trusts [sec 139(4A)], political parties [(sec139(4B)], scientific research institutions [sec 139(4C)], university or colleges or institutions or khadi and village industries [Sec 139 (4D)].

14.12 Section 2(15) of the Income-tax Act defines charitable purpose as one or more of: relief to the poor, education, medical relief, yoga, preservation of environment, preservation of monuments or places or objects of artistic or historic interest or advancement of any other object of general public utility.

14.13 A brief profile of companies as per ITR-7 data is at **Table 14.1.**

14.14 The analysis of Table 14.1 shows that number of Trusts filing returns of income has decreased although the figures for FY 2016-17 are only uptil 30th Jan 2018. The largest increase is in charitable and religious trusts. The receipts of all these trusts across four years was also calculated (**Refer Table 14.2).:**

14.15 Gross Income shown by trusts including voluntary contributions have steadily increased in past four years. However, there is a significant decrease in 'income from Business and Profession' during FY 2016-17.

14.16 The analysis of application of income by trusts is at **Table 14.3.**

14.17 The application for religious and charitable purposes has also gone up. Sec 11(1)(a) permits exemption of income of a trust if it is actually applied for religious and charitable purposes during the year. Explanation 2 to Sec 11(1) permits application of income even if it is applied in the year it is actually received or in the immediately following year. It is at the option of the assessee to apply the income in a particular year provided he exercises that option before the due date for filing return.

14.18 Income accumulated or set apart for application: Sec 11(1)(a) also permits 'setting apart' or 'accumulation' of 15% of income besides income actually applied for charitable/religious purposes, for future application. If 85% of the income is not applied for religious/charitable purposes, sec 11(2) permits 'additional accumulation' or 'setting apart', if the following conditions are met:

i. The assesse has to state before AO, the specific purpose for which the amount has been set apart and the period should not exceed 5 years.
ii. Money so set apart / accumulated has to be invested in modes specified under sec 11(5).
iii Statement to the AO has to be given before the due date for filing of return of income.

14.19 Amount invested under sec 11(2) : The amount that is invested in specified securities for a specific purpose within a specific period, shall not be eligible for deduction, if, any infringement of condition of acumulation occurs as:

i. It is applied to purposes other than charitable or religious purposes
ii. It ceases to remain invested in the manner specified u/s 11(2)

iii. It is not applied for the purposes for which it was accumulated, or

iv. Payment is made to any other trust/institution mentioned in 11(3)(d).

14.20 An analysis of the amounts invested in the modes specified u/s 11(2) (Refer Table 14.4) shows that the amounts invested in Government saving Schemes has decreased. However, the amounts invested in 'scheduled bank' or 'cooperative society' and under the category 'any other investment' has substantially gone up.

Table 14.1 : Types and Numbers of Trusts

Nature of Trusts	2013-14	2014-15	2015-16	2016-17
Charitable	69721	87206	104242	110009
Electroral	127	129	156	127
News Agency	25	30	36	30
Political	115	182	180	163
Professional Body	231	299	334	327
Religious	7578	9507	11752	13723
Reserch	461	560	651	671
Trade Union	163	238	250	218
Others	95731	103230	69811	27309
Total	174152	201381	187412	152577

14.21 The maturity of the above investments as per ITR-7 data is at **Table 14.5.**

14.22 Analysing the investment figures for FY 2015-16 (Refer Table 14.4), it is seen that there is accumulated balance of ₹2,45,598 crore shown to be invested in specified sec 11(5) modes. However, total of accumulation and set apart amount (Refer Table-14.3) is only ₹42,563 crores (₹26,100+

Table 14.2 : Receipts of Charitable Trusts

(Rs. Crore)

Financial Year	No. of Returns Received	Voluntary Contributions	House Property	Business & Proffession	Capital Gain	Other Sources	Gross Income
2013-14	174152	61022	419	9798	167	238750	310186
2014-15	201381	77549	412	14757	414	303535	396624
2015-16	187412	97989	435	19984	1007	352209	471630
2016-17*	152577	117552	135	2212	627	39938	495556**

* Figures for FY 2016-17 are Returns filed uptil 31st Jan 2018

* Return Form for FY 2016-17 has been changed

**Total Voluntary Contributions (1,17,522) + Aggragate of Income as reportyed in column-3, Part-B, TI (3,78,004)

₹16,463). If the maturity amount (Refer Table14.5) is taken out from the accumulated balance of preceding year, the amount of fresh investment during FY 2015-16 is much more than what is shown as available for 'accumulation' and 'set apart'. If the same calculation is done for the next FY

2016-17, fresh investments during the year seems to be much more than what is shown as available

Table 14.3 : Amounts applied, deemed applied and accumulated by trusts

(Rs. Crore)

Financial Year	No. of Returns Received	Total Applications		Total Accumulation		
		Application for Religious & Charitable Purpose	Deemed Applied	Accumulated or set aside not exceeding 15%	Amount could not be applied but Accumulated Invested	Gross Total Applicaion and Accumulation
2013-14	174152	301146	6865	17655	13629	339294
2014-15	201381	304144	10286	23806	14222	352459
2015-16	187412	333955	6044	26100	16463	382563
2016-17	152577	346185	5347	29011	16270	396813

for 'accumulation' and 'set-apart' as per Table 3 above [₹45,281 crore (29,011+16,270 crore)].

Balance in Corpus/ Non-corpus Funds

14.23 The balance available in both corpus and non-corpus funds with the trusts has shown a steady increase. The figures for both corpus and non-corpus are at **Table 14.6**:

14.24 The non-corpus Fund consists of income from various heads being, house property, business and profession, capital gains, other sources and non-corpus contributions. Still the balance available in the non-corpus funds is lower than the balance in corpus funds. This implies that the trusts have chosen to apply non-corpus funds for charitable purposes in preference to corpus funds.

Voluntary contributions:

14.25 The **Table 14.7** shows that majority of voluntary contributions are non-corpus local contributions. Also, both local and foreign contributions have shown a steady increase over the years. Further, it was also found that only 1.5% (2330 trusts which have receipts in excess of 25 crores) of the total trusts (1,52,477 trusts) are receiving almost 61% of the total non-corpus donations.

Total Income and Taxes paid

14.26 The ITR-7 data shows that income returned by the trusts is very low. As is apparent from the **Table 14.8** , the cumulative tax liability of these trusts is extremely low.

14.27 The existing provisions relating to exemption relating to charitable trust or institutions have over the years developed into an extremely complex code by itself. The complexity extends to every aspect of the exemption regime. Even after almost six decades, the dispute relating to what constitutes "charitable purpose" continues; while the tax administration interpretes charity as alms

or concessions to the beneficiaries, the courts have consistently held the view that a trust or institution shall be treated as having being established for charitable purposes as long as the surplus is not distributed for private benefits. The procedure for registration is ambiguous and takes months for approval. Similarly, the determination of the income of the trust is equally complex; the determination of income includes notional income and expenditure whereas the application is more cash based.

Table 14.4 : Investments made in various specified modes by trusts

(Rs. Crore)

Financial Year	Investment in Government Saving Scheme	Investment in Post Office	Deposit in Scheduled Bank or Co-operative Society	Investment in UTI	Any other Investment	Total Investments
2013-14	27583	63	81792	204	33554	143195
2014-15	24980	32	246432	418	77604	349467
2015-16	23164	134	145253	1338	75709	245598
2016-17	15983	55	154017	769	210286	381110

The threshold for application is 85 percent of income which may or may not have been received.

Table 14.5 : Maturity of Investments made in various specified modes of trusts

(Rs. Crore)

Financial Year	Maturity from Investment in Government Saving Scheme	Maturity from Investment in Post Office	Maturity from Deposit in Scheduled Bank or Co-operative Society	Maturity from Investment in UTI	Maturity from Any other Investment	Total
2013-14	12480	65	61316	127	20762	94750
2014-15	19068	29	106515	203	42922	168737
2015-16	22124	62	120888	385	37834	181293
2016-17	11470	54	137067	412	44798	193800

Another problem relates to build-up of large endowments which are not effectively used for the charitable purpose for which it is set up. This has resulted in persistent litigation.

14.28 In view of the foregoing, we recommend a new taxation regime for non-profit orgainsations. The key features of this new regime are as under:-

(a) A non-profit organisation has been defined to mean an organisation, by whatever name called (including a trust), subject to fillfilment of several conditions including the condition that it should be established for carrying on philanthrophic activities.

(b) Under the new regime, the term 'philanthrophic activities' shall replace the term 'charitable purposes'. Charity tends to be a short term, emotional, immediate response, focused primarily on rescue and relief, whereas philanthrophy is much more long term, more stretegic, and focused on rebuilding. Charity is like giving a fish to a hungry man

but philanthrophy is like teaching a man to fish.

Table 14.6 : Composition of Funds		
		(Rs. Crore)
Financial Year	Corpus Fund	Non Corpus Fund
2013-14	330537	93282
2014-15	475312	249751
2015-16	516261	297662
2016-17	490453	270299

(c) The total income of non-profit organisation shall be computed as aggregate of following amounts:-

(i) surplus from philanthropic activities;

(ii) anonymous donation;

(iii) amounts remaining unutilised for specific purposes;

(iv) amount which ceases to remian invested or deposited in specfied modes;

(v) funds or assets deemed to have been applied for benefit of interested person.

(d) The manner of computation of surplus in the hands of a non-profit organisation has been expressely provided in the regime. The surplus is defined as gross receipts from philanthropic activities as reduced by outgoings in relation to such activities. Surplus

Table 14.7 : Voluntary Contributions					
					(Rs. Crore)
Financial Year	Domestic		Foreign		Total Contribution
	Corpus	Non Corpus	Corpus	Non Corpus	
2013-14	12189	40330	1122	7390	61032
2014-15	14496	52640	1449	8964	77549
2015-16	17601	68687	1569	10136	97993
2016-17	31513	73295	1628	11115	117551

is computed based on cash system of accounting.

(e) Gross receipts from philanthropic activities shall include voluntary conributions received, including contributitions towards corpus, other special grants or assistance, any other receipt (whether capital or revenue) such as consideration for sale of capital

Table 14.8 : Total Income and Tax Liability of Trusts

(Rs. Crore)

Financial Year	No. of Returns Received	Total Income	Gross Tax Liability	Total Taxes Paid	Refund Amount
2013-14	174152	2129	439	3380	2954
2014-15	201381	3011	642	4000	3383
2015-16	187412	2976	704	4530	3831
2016-17	152577	8039	883	4723	3843

asset, loans and advances, repayment of loans and advances, dividends, interest, royalty, fee, commission etc.

(f) Outgoings shall include voluntary contribution with specific direction that they shall form part of the corpus; any expenditure (whether capital or revenue) incurred or any loans and advances extended for the purpose of philanthropic activity or any incidental business; any contribution (other than corpus) paid to any other non-profit orgainsation.

(g) Any amount accumulated or set apart for the philanthropic activity shall also be included in the outgoings, subject to overall limit of 10 percent of the gross receipts, provided the same is deposited as per the prescribed scheme.

(h) However, outgoings shall not include any amount paid in cash or on which tax has not been withheld as per the provisions of this Act.

(i) The funds or assets of non-profit organisation shall be invested only in certain specified modes. Any investment made in violation thereof shall be included in income of the non-profit orgainsation.

(j) Specific provisions have been made to prevent use of funds or assets of the non-profit organisation for the benefit of an interest person. In this regard, certain circumstances/transactions have been specified in which it shall be deemed that the funds/assets have been applied for benefit of intrest person and the relevant amount shall be includued in income of the non-profit organisations.

(k) The amount of surplus from philanthrophic activities of a non-profit organisation to the extent of ₹.10 lakhs shall be exempt. Any amount in excess of ₹10 lakhs shall be charged to tax at the rate of 15 percent. However, in case of its conversion or merger with any form of organisation, which does not qualify as a non-profit organisation, tax shall be charged at the rate of 30 percent on its net worth.

(l) The aggregate of (i) the amount of anonymous donations; (ii) the amount remaining unutilised for specific purposes; (iii) the amount which ceases to reamin invested or

deposited in any of the specified modes; and (iv) the amount to the extent it relates to deemed use or application of funds or assets for the benefit of interested person, shall be taxed at the scheduler rate of 30 percent.

(m) There will be no requirment of registration or ex-ante approval [as under section 10 (23C) of the present law] of the NPOs for availing tax benefits.

(n) It will be sufficient for them to obtain a permanent account number (PAN) and file their return of income making a self claim of the exemption. The Department may

Table 14.9 :Tax treatment of political parties across countries

Country	Is there ban on anonymous donations to political parties?	Are political parties entitled to special taxation status?	Are donors to parties entitled to any tax relief?	Are political parties entitled to any other form of indirect public funding
Yes	46 Countries (41 percent)	30 Countries (27 percent)	20 Countries (18 percent)	27 Countries (24 percent)
No	64 Countries (58 percent)	80 Countries (72 percent)	91 Countries (82 percent)	84 Countries (76 percent)
No information available	1 Country	1 Country	-	-
Sample Size	111 Countries	111 countries	111 Countries	111 Countries

take appropriate action to deny the exemption, if on scrutiny it finds that the claim is incorrect.

14.29 Democracy is a public good and political parties are responsible for providing this public good. Based on the public goods theory, the case for tax exemption to political parties is no different than the case of other non-profit organisations. Any tax exemption amounts to an indirect public funding of political parties. To the extent political parties depend on corporates and other interest groups for donations, they are vulnerable and the democratic process is vitiated. Further, a tax exemption is inequitable in as much as the tax benefits increases with the increase in the amount of funds mobilised through public donations. Therefore, like all tax exemptions, such indirect public fundings are inequitable and non-transparent.

14.30 A cross country survey of a sample of 111 countries **(Table 14.9)** shows that most countries do not support indirect public funding through tax concessions. Similarly, majority of the counrties in the sample ban receipt of anonymous donations by political parties. It seems that most countries support direct public funding of political parties.

14.31 In India, there is no direct public funding of political parties. Consequently, political parties

are allowed indirect public funding which takes the form of anonymous donations upto ₹2000/-, tax exemption to donors, and tax exemptions to political parties. Further, there is a proliferation of political parties; while about 1400 political parties are registered with the Election Commission of India, only 400 political parties contest elections. It is obvious that the other 1000 parties are only engaged in building an endowment with no intention to use the same for promoting democracy in India. There is a wide spread public perception that some of these parties have been set up merely to launder black money. In the recent past, some steps have indeed been taken to prevent use of black money for political purposes.

14.32 We recognise that till such time a mechanism is not in place to provide public funding to political parties in India, we will have to continue to provide support to indirect public funding. We also take note of the inequitable and opaque tax regime relating to political parties, the wide spread perception regarding use of black money for political funding and cross country practices. Based on this, we recommend, like for other non-profit organisations, a partial withdrawal of tax exemptions for political parties so as to reduce the tax arbitrage in laundering of black money for political purposes. The proposed new tax regime for political parties is based along the same line as non-profit organisation with the following modifications:-

(a) political parties will be allowed a deduction to the extent of 50 percent of the gross receipts to be accumulated or set apart for carrying on their activity, if the said amount is deposited in accordance with a scheme prescribed by the Board in this behalf;

(b) Anonymous donations shall mean any voluntary contribution,-

(i) exceeding two thousand rupees which is received otherwise than by an account payee cheque drawn on a bank, or on an account payee bank draft, or urse of electronic clearing system through a bank account, or through electroal baond; and

(ii) in any other case, the person receiving such contribution does not maintain a record of the identity indicating the name and complete address and such other particulars as may be prescribed, of the person making such contribution as as to establish the correct identity of the said person.

14.33 The new tax regimes for both non-profit organisations and political parties have been crafted with the objective of ensuring that the benefit of tax exemptions actually translate into public goods rather than merely building endowments. Further, the partial withdrawal of the tax exemption will reduce tax arbitrage opportunities for laundering. The compliance procedure has also been simplified by eliminating ex-ante approval and registration to encourage more non-

profit organisations to venture into the 'community services' sector. Our recommendations are a fine balance between the legitimate needs of the sector and prevention of abuse of tax exemptions.

CHAPTER - XV

TAX TREATMENT OF HOUSING

Tax treatment of housing

15.1 The income tax systems of most countries provide for taxation of income from ownership of a house. However, it treats home-ownership favourably, compared to rental-occupied housing. This favourable treatment stems from different types of tax provisions, first and foremost of which is the income tax exemption of homeowners' implicit return on the asset value of their residence. Both homeowners and renters consume housing services; however, homeowners do not deplete cash resources for these services, as renters do.

15.2 In this respect, homeownership yields a return on investment (i.e. figurative or imputed rental income). Rather than being taxed as any other form of investment, imputed rental income is generally exempt from income taxation, thus causing a bias towards homeowners and creating distortions in investment decisions. Additional income tax provisions favouring homeownership include tax reliefs linked to the cost of home ownership, such as tax credits or deductions allowed on interest payments, and the exemption of capital gains.

15.3 Such 'homeownership bias' and its consequences for a wide range of economic outcomes, most notably in the housing and capital markets, have long been recognised. Arguments in favour of correcting this bias (e.g. through taxation of net imputed rent) are indeed quite old. In addition to neutrality and efficiency arguments, distributional reasons for removing the homeownership bias have been put forward, such as horizontal equity between homeowners and tenants. Under imputed rent exemption, horizontal equity between owner occupiers and tenants would be achieved if tenants were also allowed a deduction on the rent paid; however, this is in practice generally not the case. Further, the tax reliefs generally tend to favour higher income taxpayers, as the advantage depends on the homeowner's marginal tax rate.

15.4 The financial crisis in the late 2000s has revived interest in housing taxation. The homeownership bias embedded in the US tax system is deemed responsible for fostering the housing bubble that triggered the crisis. At the same time, housing taxation has been in the spotlight in Europe as one of the few practicable ways of raising tax revenues while entailing less harmful consequences for efficiency and growth when compared to other forms of taxation. The possibility of shifting the income tax burden away from labour to an immovable tax base has made housing taxation a focus of several recent policy recommendations to European Union (EU) countries. Although a removal of tax provisions favouring homeownership is generally advocated on efficiency

grounds, its distributional implications are often neglected. When considering the effects of potential tax reforms aimed at reducing the homeownership bias, one concern is that income inequality might be adversely affected, for example, in countries where older people, who are often overrepresented among homeowners, live on lower cash incomes than the rest of the population.

II. The homeownership bias in income taxation

15.5 The economic rationale for the taxation of net imputed rent together with other incomes relates to the 'comprehensive income taxation' view that an appropriate income tax base should reflect all those resources that contribute to enhancing an individual's consumption possibilities (Haig-Simons definition of income), taken as a measure of 'ability to pay'. Any non-monetary income that increases consumption possibilities, while leaving unaffected the original capital stock, should therefore be reflected in taxable income. An example is imputed rent (net of mortgage interest payments and other owner-occupier costs), which enhances homeowners' consumption possibilities because they benefit from housing services they would otherwise need to pay for, thus depleting cash resources. In this sense, net imputed rent is regarded as part of the net return on the housing investment and, as such, neutrality and efficiency principles recommend that it is taxed in an equivalent way to other forms of returns from investment to avoid creating distortions in the allocation of capital, imposing a deadweight loss to society. The inclusion of net imputed rent in taxable income, so that homeowners and renters endowed with the same (or higher) consumption possibilities bear the same (or higher) taxation burden, is one approach to making sure that horizontal and vertical equity principles are respected.

15.6 When considering the actual housing taxation policies found in western economies, a sharp disconnect between principles and practice is observed. Although the tax treatment of housing takes numerous forms and varies considerably across countries, in most cases the imputed rent of the principal residence enjoyed by owner is exempt from income taxation since it creates positive externalities because homeowners tend to take more interest in the community than tenants. In the few countries where it is subject to income tax, the corresponding notional rents are usually substantially lower than private market rents. Such provisions result in a favourable tax treatment for homeowners, who see a return on investment largely untaxed. The exemption of imputed rent for owner occupied property is limited to the principal residence.

15.7 The favourable treatment they enjoy is also reinforced by the fact that in many countries deduction is allowed for interest paid although more recently several countries are moving towards phasing out such measures. Clearly, the homeownership bias inherent in income taxation represents a common trait across different country-specific housing taxation practices. In several countries, property taxes are levied on owned-occupied housing, potentially compensating for the home

ownership bias inherent in income taxation. However, the revenues collected from recurrent property taxation represent a small portion of tax revenues, generally property taxes do not fully compensate the bias inherent in income taxation. Further, to the extent there is a bias in favour of debt for financing home ownership, the interest on the debt is capitalised to the value of the property. This helps to explain why homeownership rates have risen quite steadily in nearly all OECD countries since the mid-1980s.

15.9 The homeownership bias has non-trivial potential consequences. It results in (i) overinvestment in housing and displacement of other more productive forms of investment; (ii) restricted residential and, hence, labour market mobility; and (iii) increased house price volatility, leading to macroeconomic instability. Last but not least, undesirable distributional outcomes might arise under progressive tax systems, because provisions such as imputed rent exemption and mortgage interest relief tend to benefit disproportionally higher income taxpayers, who face higher marginal tax rates.

15.10 In India, the tax treatment of house property is similar to international practice; in the case of a rented property, the net rent (after allowing deduction for interest, local taxes and standard deduction for repairs and other incidentals) is subject to tax like in other countries. Similarly, consistent with international practice, the imputed rent on the principal residence is also exempt. However, unlike international best practice, the treatment of mortgage interest in respect of the principal residence is allowed as a deduction subject to a ceiling of ₹ 2,00,000/. This deduction is inconsistent with the matching principle of income and expenditure and has been adversely viewed by several expert committees in the past. Under the existing law, the rent in respect of owner occupied property other than principal residence is imputed as if it was rented and all other deductions are accordingly allowed. In principle, there is no economic case for allowing this deduction relating to mortgage interest in respect of the principal residence. However, given the overall circumstances, we do not recommend any change in this regard for the present.

15.11 In the context of the overall scheme of taxation of income from house property and capital gains arising from the transfer of the property, it is often argued that the concept of imputed rent must be abolished or, at the least, extended also to the second residence of the owner. This proposal has both efficiency and equity effects. Any exemption for imputed rent of any residence other than principal residence will, at the margin, encourage owners to keep their houses vacant thereby leading to sub-optimal utilisation of housing stock. If the effect is large, it could lead to increase in rents and inflation. It also creates a perverse incentive to report rented accommodation as owner occupied. Therefore, exempting imputed rent for the second property is grossly inefficient.

Table 15.1

Income from House Property by Individuals

Aseessment Year 2017-18

SR	Gross Total Income	No of PANs	Number of ITRs with House Property				Number of ITRs with Self-Occupied House Property				Number of ITRs with Let Out House Property			
			1	2	3	>3	1	2	3	>3	1	2	3	>3
1	Less than 2.5 Lakh	60,17,888	7,71,087	52,618	10,960	5,514	4,09,473	302	49	29	4,08,345	36,619	7,792	4,199
2	2.5 Lakh to 3 Lakh	73,67,208	6,77,117	34,834	7,848	4,192	3,69,688	216	28	17	3,32,250	26,068	6,290	3,525
3	3 Lakh to 3.5 Lakh	77,19,678	9,48,970	51,321	11,669	6,456	5,54,845	291	45	17	4,34,919	36,812	9,152	5,406
4	3.5 Lakh to 4 Lakh	46,17,478	8,46,358	50,448	11,967	6,986	5,42,960	310	38	17	3,49,636	34,093	9,255	5,666
5	4 Lakh to 4.5 Lakh	37,99,516	8,47,474	48,366	11,860	6,872	5,89,997	315	38	20	3,06,069	31,347	8,829	5,536
6	4.5 Lakh to 5 Lakh	32,73,849	8,14,734	47,191	12,015	7,168	5,85,947	318	44	25	2,77,835	30,383	8,903	5,708
7	5 Lakh to 6 Lakh	43,75,557	11,81,732	70,693	19,084	12,247	8,79,859	526	54	30	3,76,480	45,651	14,350	9,797
8	6 Lakh to 7.5 Lakh	42,28,033	12,43,748	75,827	21,582	14,403	9,60,176	573	70	29	3,67,271	48,503	16,092	11,486
9	7.5 Lakh to 10 Lakh	34,24,189	11,39,513	77,714	22,391	15,939	9,03,614	598	63	35	3,25,924	48,261	16,633	12,769
10	10 Lakh to 12 Lakh	13,90,042	5,19,208	44,318	13,033	9,339	4,10,061	344	40	29	1,63,264	26,821	9,433	7,444
11	12 Lakh to 15 Lakh	10,84,351	4,33,098	44,420	12,811	9,705	3,39,261	314	33	24	1,50,013	26,007	9,238	7,780
12	15 Lakh to 20 Lakh	8,61,004	3,70,543	45,654	12,883	9,830	2,93,137	358	48	16	1,38,191	25,627	8,978	7,816
13	20 Lakh to 25 Lakh	4,32,960	1,89,734	29,276	8,121	6,281	1,49,962	211	38	12	80,120	16,037	5,476	4,959
14	25 Lakh to 50 Lakh	5,85,733	2,50,164	55,044	17,028	14,075	1,95,252	407	55	39	1,32,032	31,357	11,508	11,246
15	50 Lakh to 1 Crore	1,73,395	61,973	23,916	8,765	8,291	53,177	225	37	21	44,168	14,552	5,871	6,603
16	Above 1 Crore	82,267	24,055	12,122	5,513	6,977	21,356	140	31	18	20,760	8,551	4,109	5,651
	TOTAL	**4,94,33,148**	**1,03,19,508**	**7,63,762**	**2,07,530**	**1,44,275**	**72,58,765**	**5,448**	**711**	**378**	**39,07,277**	**4,86,689**	**1,51,909**	**1,15,591**

15.12 The equity effects are equally undesirable; the exemption benefits the rich relatively more than the poor. Table 15.1 shows the distribution of taxpayers across income range and the ownership and use of house property. Of the total number of 4,94,33,148 returns filed by individuals in AY 2017-18, income from house property was reported in 1,14,35,075 (23.13 percent of total return filers), of which **90 percent owned only one property.** Of the 1.14 crore returns declaring income from house property, 72,65,302 cases (63.54 percent of the returns declaring income from house property) reported income from self-occupied property and the balance 36.46 percent reported income from renting of property. **The number of individuals owning two or more self-occupied property was 6,537 only (less than 0.1 percent).** In any case, in India, individual being the unit of taxation, a household can effectively avail exemption in respect of computed rent for two residences. Therefore, the proposal to exempt imputed rent irrespective of the number of owner occupied properties is highly inequitable. Its benefits will be restricted to less than a handful of taxpayers.

15.13 From a compliance and administrative perspective, the determination of imputed rent poses considerable problems of estimation of market rents since no two properties are really same. This leads to protracted litigation and uncertainty; it also creates opportunities for rent-seeking. Some countries have resolved this problem by resorting to the system of presumptive income whereby a small percent of the cost (which may or may not be inflation indexed) of the property is presumed to be the imputed rent.

15.14 In view of the above, we recommend that the existing system of taxing imputed rent for all owner occupied property (other than the principal residence) be continued. However, in order to eliminate the possibility of disputes, we also recommend that the imputed rent may be estimated to be four percent of -

i. In the case of a property acquired before the 1st day of April, 2001, the fair market value of the property on the 1st day of April, 2001; and

ii. In any other case, the cost of acquisition of the property.

15.15 Another issue relates to allowability of interest on borrowings for acquiring the property. Based on the matching principle of income and expense, the allowability of interest against rental income is not questionable. We have in para 15.10 already commented upon the efficacy of allowing interest as a deduction. However, the issue for consideration is whether interest should be allowed at the nominal rate or any other rate. Under the present scheme of the Income tax Act, interest is calculated at the nominal rate and fully allowed as a deduction against rental income. and in the computation of capital gains, the cost of aquisition is indexed to inflation during the holding

period to compensate for the erosion in the cost (equity plus debt) of the property. This results in double deduction which needs to be corrected. This could be done either by restricting the deduction for interest from rental income or not allowing for any inflation indexing of the cost for the purposes of capital gains. Since the cost includes both equity and debt, the denial of inflation indexing will have a relatively larger adverse affect on the owner. We take note of the fact that the interest on home loans ranges between 9 percent to 10 percent and inflation rate ranges between 4 percent to 5 percent. Therefore, the non-inflation component of the interest is estimated to be 50 percent of the nominal interest. Accordinlgy, we recommend that the amount of interest deductible in the computation of income from house property shall be restricted to 50 percent of the amount actually paid.

15.16 The tax treatment of income from housing, as modified by our recommendations, will substantially improve the efficiency and equity of the tax system.

CHAPTER - XVI

TAXATION OF NET WEALTH

16.1 Taxation of wealth is a topic that excites strong passions. Some view it as the most direct means of effecting redistribution and key to achieving equality of opportunity. Others see it as the unjustified confiscation of private property by the state. Given these opposing viewpoints it is not surprising that this is an area of taxation where international practice differs dramatically. Some countries levy taxes directly upon wealth holdings while others only tax transfers of wealth. There are some countries which do not tax wealth at all.

16.2 Such diverging views have contributed to major differences between countries in the use of wealth taxes, their scope, their effectiveness and their political and opportunity costs. Wealth taxes have seen different levels of commitment and different levels of success across jurisdictions. Many developed countries have reduced the scope of wealth taxation by narrowing the tax base or have abandoned this tax source altogether, whilst increasing their reliance on other tax bases. Contrastingly, several developing countries continue to use wealth taxes in attempts to capture 'some' taxation revenue to address the significant inequality in the distributions of income and wealth among their citizens.

16.3 Wealth taxes can be grouped into three major categories: taxes on the holding or stock of wealth; on the transfer of wealth; and on wealth appreciation. The **first** category comprises the taxes levied periodically on a taxpayer's aggregate net wealth. These taxes can be ongoing annual wealth taxes ('AWT') or they may be sporadic capital levies, typically imposed at a time of national crisis or in the aftermath of a major disaster or upheaval, such as was the case in Japan after the Second World War. The **second** category of wealth taxes comprises those taxes levied on the recipient or the transferor of net wealth, whether inter vivos or at death. These wealth transfer taxes therefore include gift taxes, inheritance taxes (when imposed on the recipient of wealth on the death of the transferor) and estate taxes (when the tax is levied on the estate of the deceased). Typically these taxes are imposed at the time of the wealth transfer. Most OECD countries currently have such transfer taxes. The **third** category comprises taxes on net wealth appreciation. These are taxes such as the capital gains tax ('CGT'). These taxes are typically imposed when the asset sale or another realisation event takes place and there is a realised increase in the net wealth of the taxpayer. Most OECD (and, most non-OECD) countries have some form of CGT currently in operation. However, such taxes on the appreciation of capital are considered as part of the income base.

16.4 In addition to the obvious distinctions in the form of wealth taxes already identified, there

can also be significant variations in the nature of the tax base, in the tax units upon which the taxes are levied, and in the tax rates that are imposed upon the base and unit.

16.5 In general, Governments impose taxes to raise revenue, tackle inequality and inequity, discourage harmful consumption or address negative externalities. The **first** of these – revenue raising capacity – is not a trait of wealth taxes; they do not score high on this aspect. At best net worth taxes on the holding of wealth contribute a minute proportion of total tax revenue, and wealth transfer and wealth appreciation taxes hardly fare any better.

16.6 Perhaps the strongest rationale for the introduction or continuation of taxes on wealth lies in the second of the objectives for governments when they impose taxes: their ability to positively impact upon the horizontal and vertical equity of the tax system. In 1953, Nicholas Kaldor advocated wealth tax on the rational that "equity for the [wealth] tax is that income taken by itself is an inadequate yardstick of taxable capacity…Capital and income constitute two distinct … sources of spending power…a separate tax on each provides…a better yardstick of taxable capacity than either form of taxation itself".

16.7 When a wealth transfer tax is applied to intergenerational wealth transfers, it is also a fair tax. By placing relatively higher burdens on higher wealth transfers, this tax plays a role in tackling intergenerational inequality. This is because the quantum of physical disposable wealth of the heirs is proportionally reduced by the corresponding wealth transfer tax liability imposed at the time of the transfer. The imposition of this liability can also enhance social equality, especially when the tax is applied progressively. Therefore, like a net wealth tax, a wealth transfer tax has sound theoretical policy groundings as a result of its re-distributional properties.

16.8 Efficiency is also a frequently cited rationale for wealth taxes. When low yielding assets are subject to a wealth tax, taxpayers are incentivised to convert those low yielding assets into higher yielding assets. It is argued that taxpayers will have the desire to generate greater rates of return on their wealth in order to prevent its erosion. This contributes to increased efficiency of asset utilisation. Wealth taxes can also improve the incentives to work, since, unlike taxation of income, productive activities are not penalised by the taxation of wealth.

16.9 Although there are a number of administrative arguments against wealth taxes, policymakers advocating these taxes are still able to identify other, indirect, administrative benefits of wealth taxes. These benefits include the potential for reduction of tax avoidance and evasion, when wealth taxation complements income taxation. In this respect, governments can collect wealth tax data and cross check it against income tax data to ensure greater compliance and that any legislative loopholes in either wealth or income taxation are not exploited.

16.10 These arguments suggest that wealth taxation can be a useful policy tool, at least in theory. The arguments are also politically appealing as the wealth tax burden is placed on the more affluent sectors of the population. Nonetheless those who argue against wealth taxes are still able to enlist significant support, based upon major concerns relating to valuation, disclosure and appropriate attribution of legal and practical liability.

16.11 Notwithstanding these real problems with the implementation and operation of taxes on wealth, and the political controversy that often surrounds them, the powerful equity and efficiency arguments already identified mean that wealth taxes are still used in many developed and developing countries. The following section identifies how and where they are so used.

16.12 There are different combinations of wealth taxation forms used globally. The basic divergence stems from distinctions in historical, geographical, cultural and economic backgrounds. At the one extreme, tax havens such as the Cayman Islands, Monaco and Belize do not levy any form of wealth taxes. These small countries have traditionally differentiated themselves through their tax policy as attractive holding jurisdictions for the coffers of the wealthy. Middle Eastern countries, such as the United Arab Emirates, also do not levy wealth taxes. These countries have sought to attract foreign direct investment by implementing taxpayer friendly investment regimes in order to diversify their economies. At the other extreme, very few, mainly Western European, countries apply wealth taxes on both stocks and transfers of wealth – and even fewer on all three forms of wealth tax.

16.13 In terms of specific sub-categories, transfer taxes are currently more common than net wealth taxes. This is because uncovering wealth is typically easier when the wealth transfer takes place when the legal documents tied to the transfer stipulate entitlement and value. Transfer taxes are presently levied in more than half of the OECD nations and are most prevalent among the European Union members.

16.14 Wealth is spread far more unequally than income. Yet, in the OECD, wealth has not been targeted as a key source of tax revenue. OECD countries have historically raised relatively little revenue via net wealth and transfer taxes. Over the past 10 years, with the exception of Luxembourg and Switzerland, no OECD country has raised more than 2.5 per cent of their total tax revenue ('TTR') via these two tax categories in any one year. Indeed, Belgium, France, Hungary, Iceland, Korea, Luxembourg, Norway and Switzerland are the only OECD countries to currently collect more than 1 per cent of TTR via net wealth and transfer taxes.

16.15 Analysis of net wealth and transfer taxes from a GDP perspective paints a similar picture. The OECD average from both of these tax categories (combined) peaked at 0.51 per cent of GDP

(1969), to around 0.25 per cent of GDP.

16.16 The form of wealth tax most commonly eliminated by the OECD members has been the AWT. A total of only five OECD countries still had this tax operating in a comprehensive form in 2011, a decline from a peak of 16 countries in 1995. These taxes have reduced in popularity among the OECD members because, coupled with administrative difficulties, they have generated a low revenue yield and had an insignificant impact on progressivity. Germany and Sweden are examples of countries that have abandoned annual net wealth taxes in the past 15 years.

16.17 In comparison to net wealth taxes, wealth transfer taxes have been and continue to be used relatively more extensively by the OECD members. About 20 OECD countries have at least one wealth transfer tax in operation.

16.18 Among the OECD countries where net wealth and transfer taxes been retained, two key trends have emerged. The first trend is that the net wealth and wealth transfer tax bases have been narrowed to ease the administrative burden. The second trend, again designed to ease the operating costs of the taxes, is that the manner of operation of these taxes has been simplified.

16.19 One of the most interesting tax policy tools used in wealth taxation by developing countries is a corporate net wealth tax. A number of South American countries employ this tax mechanism as a minimum or a substitute tax to work in conjunction with income tax. It is often a minimum floor tax paid. This floor was introduced by these jurisdictions as they experienced prolific offshore income shifting by domestic entities that wanted to avoid income tax. Further, these countries have significant cash economies. An instrument was needed to act as a safeguard to compensate for the income tax lost due to these factors. Therefore, Ecuador, Argentina, Guatemala, Peru, Dominican Republic and Uruguay all use a corporate net wealth tax. The revenue raised from this tax in these countries presently ranges between 0.6 per cent and 0.7 per cent of each country's GDP.84 While these statistics reflect relatively small amounts, the absolute tax revenue is important for these developing countries. This is especially so for Guatemala and the Dominican Republic where the current TTR to GDP ratio is below 15 per cent. This is a significant divergence from the experience of developed countries which are more successful in administering income tax. Developed countries do not have the same need for corporate net wealth taxes to serve as a tax floor.

16.20 Recognition of divergence between developed and developing countries in the reasons for the wealth tax trends is important. In South America especially, 'on the ground' evasion looks more pronounced so the wealth tax mechanism is used to capture some revenue that is lost when income escapes income taxes of these countries. In contrast, developed countries appear to have experienced greater avoidance issues as taxpayers sought to minimise their tax burdens within the letter of the

law. The additional greater difficulty for developing countries, as seen in South America, is identifying alternative revenue sources. Evidence suggests that most developed countries have tax systems with greater flexibility to preserve progressivity in selection of an alternative revenue source when they eliminate a wealth tax.

16.21 Wealth tax in India has had a chequered history. It was introduced in 1957 following the recommendations of Nicholas Kaldor. The underlying objective of the tax was to deal with the problem of vertical inequality and more importantly collect wealth tax data and cross check it against income tax data to ensure greater compliance and that any legislative loop holes in either wealth or income taxation are not exploited. For the purposes of cross verification, it was necessary that the assets are valued at cost; market based valuation will be misleading since notional increase in value is not liable to income tax until realised. Regardless of this, India opted to use market value as the basis for wealth tax. Not surprisingly, this lead to large scale disputes and serious cash flow problem in the case of financial assets owned by promoters. Recognising this, the Tax Reform Committee under the chairmanship of Dr Chelliah recommended a truncated wealth tax levied on unproductive immovable assets; all financial assets were exempted. An immovable assets was considered as unproductive if it did not yield any rent. As a result, the base for wealth tax shrank and, not surprisingly, in 2016, the Government abolished it.

16.22 The case for wealth tax in India is extremely strong. **Firstly,** apart from the efficiency and equity aspects, wealth tax is justified in the absence of a weak property tax system. Local governments are averse to levying property tax; where it exists, the design is sub-optimal and incapable of yielding sufficient revenues. A robust wealth tax can be a good substitute for a weak property tax system (if necessary, the proceeds can be fully assigned to local bodies). **Secondly,** the package of reforms recommended by us on corporate tax regime is likely to provide windfall gains in terms of higher returns and valuation to the relatively richer section of the society. While it is true that, in general, such windfall gains would be taxed as capital gains when realised, however, in the case of promoters the shares are unlikely to be transfered in the short or medium term. Therefore, a wealth tax on such holdings would be reasonable. **Thirdly,** as stated in para 6.21, wealth tax serves an important function of enabling cross verification for income tax purposes. With computerisation of the Income Tax Department, the wealth tax based information would be exttremely helpful in risk management and tackling evasion. **Fourthly,** the wealth tax will complement the government's initiative to deal with benami property holdings.

16.23 Based on the discussions in the foregoing paragraphs, we recommend the re-introduction of a **comprehensive** wealth tax. The key features of the new levy would be the following : -

(a) Wealth-tax will be payable by an individual, HUF and private discretionary trusts.

(b) Wealth tax will be levied on net wealth on the valuation date i.e. the last day of the financial year.

(c) Net wealth will be defined as assets chargeable to wealth-tax as reduced by the debt owed in respect of such assets.

(d) Assets chargeable to wealth-tax will mean all assets, including financial assets and deemed assets, as reduced by exempted assets.

(e) The exempted assets will be restricted to the following:-

(i) Assets used as stock-in-trade.

(ii) The interest of the person in the coparcenary property of any Hindu undivided family of which he is a member;

(iii) The value of any one building used for the residence by a former ruler of a princely state.

(iv) Jewellery in possession of a former ruler of a princely state, not being his personal property, which has been recognised as a heirloom by the Central Government before 1st April, 1957 or by the Board after that date.

(vi) Any property held by the person under trust, or other legal obligation, for carrying out any permitted welfare activity in India;

(f) In general, the valuation of assets would be at cost; however, financial assets will be valued at cost or market price, whichever is lower.

(g) The net wealth of an individual or HUF in excess of Rupees ten crore will be chargeable to wealth-tax at the rate of 0.5 per cent.

(h) The threshold limit of Rupees ten crore will not apply to a private discretionary trust.

16.24 We recognise the administrative problems associated with the wealth tax in India in its earlier avataar. The fundamental problems related to valuation of assets and high compliance cost. We have addressed the problem of valuation by opting for valuation at cost. This will ensure that there are no disputes on this issue. Similarly, we have provided for a high threshold so that the burden of the levy is borne only by the richer section of the society. Since we have no data on net wealth, it would not be feasible for us to estimate the potential revenues. Given the limitations of having high personal income tax rates, our proposal to re-introduce a comprehensive wealth tax will add to the progressivity of the tax system.

CHAPTER - XVII

GENERAL ANTI-AVOIDANCE RULE

17.1 The Tax Laws of many Countries including India contain specific restrictive or anti-avoidance rules (SAARs) to neutralise aggressive transactions. Since liberalisation and opening up of the Indian economy, it was found that tax payers (with help from their advisors) have been devising innovative transaction structures beyond the ambit of SAARs, which may require consequential amendments in the domestic law for plugging the 'loopholes'. The use of sophisticated tax avoidance arrangements which circumvent specific rules has led to the framing of the General Anti Avoidance Rules (GAAR).

17.2 The measure as proposed in the Direct Tax Code of 2009, GAAR provisions were introduced in the Income Tax Act by the Finance Act, 2012. The substantive provisions relating to GAAR are contained in Chapter X-A (Sections 95 to 102) of the Income Tax Act. Procedural provisions are contained in Section 144BA of the Act. The Finance Act of 2012 codified the "substance over form" doctrine to prevent erosion of tax base through aggressive tax planning by notifying the General Anti Avoidance Rule. The main features of the GAAR are:

(i) An arrangement whose *main purpose or one of the main purposes* is to obtain a tax benefit and which also satisfies atleast one of the four tests, can be declared as an "impermissible avoidance arrangement". The four tests are:

(a) The arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length.

(b) It results in misuse or abuse of provisions of tax laws.

(c) It lacks commercial substance or is deemed to lack commercial substance.

(d) Is carried out in a manner, which is normally not employed for bona fide purpose.

(ii) It shall be presumed that obtaining of tax benefit is the main purpose of an arrangement unless otherwise proved by the taxpayer.

(iii) An arrangement will be deemed to lack commercial substance if:

(a) The substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) It involves or includes:

A. round trip financing;

B. an accommodating party;

C. elements that have effect of offsetting or cancelling each other; or

D. a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of fund which is subject matter of such transaction; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining tax benefit for a party.

(iv) It is also provided that certain circumstances like period of existence of arrangement, taxes arising from arrangement, exit route, shall not be taken into account while determining 'lack of commercial substance' test for an arrangement.

(v) Once the arrangement is held to be an impermissible avoidance arrangement then the consequences of the arrangement in relation to tax or benefit under a tax treaty can be determined by keeping in view the circumstances of the case, however, some of the illustrative steps are:

(a) disregarding or combining any step of the arrangement.

(b) ignoring the arrangement for the purpose of taxation law.

(c) disregarding or combining any party to the arrangement.

(d) reallocating expenses and income between the parties to the arrangement.

(e) relocating place of residence of a party, or location of a transaction or situs of an asset to a place other than that provided in the arrangement.

(f) considering or looking through the arrangement by disregarding any corporate structure.

(g) re-characterizing equity into debt, capital into revenue etc.

(vi) These provisions can be used in addition to or in conjunction with other anti-avoidance provisions or provisions for determination of tax liability, which are provided in the taxation law.

(vii) For effective application in cross border transaction and to prevent treaty abuse a limited treaty override is also provided.

17.3 The Finance Act, 2012 provided the procedure for GAAR as under:

i. The Assessing Officer shall make a reference to the Commissioner for invoking GAAR and on receipt of reference the Commissioner shall hear the taxpayer and if he is not satisfied by the reply of taxpayer and is of the opinion that GAAR provisions are to be invoked, he shall refer the matter to an Approving Panel. In case the assessee does not

object or reply, the Commissioner shall make determination as to whether the arrangement is an impermissible avoidance arrangement or not.

ii. The Approving Panel has to dispose of the reference within a period of six months from the end of the month in which the reference was received from the Commissioner.

iii. The Approving Panel shall either declare an arrangement to be impermissible or declare it not to be so after examining material and getting further inquiry to be made.

iv. The Assessing Officer (AO) will determine consequences of such a positive declaration of arrangement as impermissible avoidance arrangement.

v. The final order in case any consequence of GAAR is determined shall be passed by AO only after the approval by Commissioner and, thereafter, first appeal against such order shall lie to the Appellate Tribunal.

vi. The period taken by proceedings before Commissioner and Approving Panel shall be excluded from time limitation for completion of assessment.

vii. The Approving Panel shall be set up by the Board and would comprise of officers of rank of Commissioner and above. The Panel will have a minimum of three members. The procedure and working of Panel shall be administered through subordinate legislation.

17.4 In addition to the above, it was provided that the Board shall prescribe a scheme for regulating the condition and manner of application of these provisions. It was proposed that the said provisions would apply from AY 2013-14.

17.5 The Finance Bill, 2013 stated that the provisions of Chapter X-A and Section 144BA shall come into force from AY 2016-17. The major changes brought about by the Finance Act, 2013 are:

i. An arrangement, the *main purpose* of which is to obtain a tax benefit, would be considered as an impermissible avoidance arrangement. The current provision of Section 96 providing that it should be the "the main purpose or one of the main purposes" has been proposed to be amended accordingly.

ii. The factors like, period or time for which the arrangement had existed; the fact of payment of taxes by the assessee; and the fact that an exit route was provided by the arrangement, would be relevant but not sufficient to determine whether the arrangement is an impermissible avoidance arrangement. The current provisions of Section 97 which provided that these factors would not be relevant has been proposed to be amended accordingly.

iii. An arrangement shall also be deemed to be lacking commercial substance, if it does

not have a significant effect upon the business risks, or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained but for the application of Chapter X-A. The current provisions as contained in Section 97 are proposed to be amended to provide that an arrangement shall also be deemed to lack commercial substance if the condition provided above is satisfied.

iv. The Approving Panel shall consist of a Chairperson who is or has been a Judge of a High Court; one Member of the Indian Revenue Service not below the rank of Chief Commissioner of Income-Tax; and one Member who shall be an academic or scholar having special knowledge of matters such as direct taxes, business accounts and international trade practices. The current provision of Section 144BA, that the Approving Panel shall consist of not less than three members being income-tax authorities and an officer of the Indian Legal Service has been amended accordingly.

v. The directions issued by the Approving Panel shall be binding on the assessee as well as the income-tax authorities and no appeal against such directions can be made under the provisions of the Act. The current provisions of Section 144BA providing that the direction of the Approving Panel will be binding only on the Assessing Officer have been amended.

vi. The Central Government may constitute one or more Approving Panels as may be necessary and the term of the Approving Panel shall be ordinarily for one year and may be extended from time to time up to a period of three years. The provisions of Section 144BA have been amended accordingly.

vii. The two separate definitions in the current provisions of Section 102, namely, "associated person" and "connected person" will be combined and there will be only one inclusive provision defining a 'connected person'. The provisions of Section 102 have been amended accordingly.

17.6 Consequential amendments in other sections relating to procedural matters were also made.

17.7 The Finance Act, 2015 has made the implementation of GAAR provisions from AY 2018-19. The investments made upto 31.03.2017 have been protected from the applicability of GAAR by amendments in the relevant rules.

17.8 Recently in Paris, on 7th June 2017, 68 countries including India signed the "*Multilateral Convention to implement Tax Treaty related measures to prevent Base Erosion and Profit Shifting*", also referred to as Multilateral Instrument ("MLI") to modify large number of Bi-lateral Tax Treaties entered into between the 68 countries. Article 6 of the MLI requires express intent in tax treaties to exclude

opportunities for treaty abuse. Article 7 requires, as a minimum standard, countries to implement *at least one* of the following anti-abuse measures in their treaties-

i. a principal purpose test ("PPT") only, which is a general anti-abuse rule based on the principal purpose of transactions or arrangements,

ii. a PPT supplemented with either a simplified or a detailed limitation of benefits ("LOB") provision, or

iii. a detailed LOB provision, supplemented by a mutually negotiated mechanism to deal with conduit arrangements not already dealt with in tax treaties.

17.9 The principal purpose test has been introduced as a default test which provides that no benefit under the Covered Tax Agreement shall be granted if it is reasonable to conclude that obtaining that benefit was *one of the principal purposes* of any arrangement or transaction that resulted directly or indirectly in that benefit. This PPT supersedes existing general anti-abuse provisions in the existing treaties or shall be added to the treaty in absence of such provisions. Thus, in order to trigger a denial of treaty benefit under the principal purpose test, obtaining the benefit need not be the sole or dominant principal purpose of the transaction or arrangement, it would suffice even if *one of the principal purposes* was to obtain such benefit. India has chosen to apply the principal purpose test which simplified LOB across all notified treaties.

17.10 Aligned with the above position of India as a signatory to MLI, the proposed Income Tax Bill, 2018 (both the proposed laws) provides for presumption regarding an arrangement to have been entered into, or carried out, for *one of the principal purposes* of obtaining a tax benefit unless the person obtaining the tax benefit proves that the tax benefit was not one of the principal purposes of the arrangement. Similar presumption shall be raised if an arrangement is entered into, or carried out, for one of the principal purposes of a step in, or part of, the arrangement is to obtain a tax benefit, not withstanding the fact that one of the principal purposes of the whole arrangement is not to obtain a tax benefit.

CHAPTER - XVIII

TAX ADMINISTRATION AND PROCEDURE

18.1 Tax administration plays a crucial role in detemining the real (or effective) tax system, as opposed to the statutory tax system. Indeed, there is a growing conviction among tax policy specialists in developing countries that "policy change without adminstrative change is nothing" and that it is critical to ensure that "changes in tax policy are compatible with administrative capacity". In a very real sense, "tax administration is tax policy" in developing countires.

18.2 The "best" tax administration is not simply one that collects the most revenue. How that revenue is raised - that is, the effect of the revenue-generation effort on equity, on the political fortunes of governments, and on the level of economic welfare - is equally important. A poor-quality tax administration may collect large amounts from easy-to-tax sectors such as wage earners, while being unable to enforce taxes on bausiness enterprises and professionals. The level of collection is therefore a somewhat unsophisticated measure of the effectiveness of tax administration. A more accurate measure is the size of the "compliance gap" - that is, the gap between actual and potential tax revenues - and how that gap varies among the different sectors of the tax paying population. Over the last three decades Goverments of many countries have made considerable efforts to improve the effectiveness of their tax administrations. These efforts frequently took place under unfavourable macro-economic circumstances.

18.3 The goal of tax administration is to foster voluntary tax compliance. Penalizing tax evaders or going after delinquent taxpayers are not in themselves the object of tax administration. Voluntary compliance may be encouraged, however, if the administration is successful in establishing a strong prospect that noncompliance will be detected and effectively punished.

18.4 Tax compliance will thus be furthered if there is an effective tax administration. An effective tax administration should not be confused with an efficient tax administration. An administration may be efficient in that its tax collection costs are very low, yet at the same time it may be ineffective if it is unable to enforce compliance. The effectiveness of the administration is not the only determinant of the level of voluntary compliance, but it is likely to be the key factor, especially in countries in which there is a high level of non-compliance. Many reasons contribute to evasive behavior, including the degree to which the community supports the government and its economic policies. All the same, taxpayers will comply better if they believe that failure to do so will mean assuming a substantial risk of being penalized in a relatively severe manner.

18.5 In countries with a very high degree of non-compliance, the ability of the tax administration to impose effective penalties is perhaps the key to shaping the behavior of taxpayers. If this is so, then the problem is that of making tax administration effective. Tax administration will be effective if it is able to deal with the following key shortfalls:

(1) Unregistered taxpayers: The first shortfall orginates in the gap between potential taxpayers and registered taxpayers.

(2) Stopfiling taxpayers: The second shortfall reflects the difference between registered taxpayers and those who file returns.

(3) Tax evaders: The third is the difference between the tax reported by taxpayers and the potential tax according to the law.

(4) Delinquent taxpayers: The fourth and last gap is the one between the amount of taxes that taxpayers report owing, or that the tax administration may eventually assess, and the tax actually paid by taxpayers.

18.6 If tax compliance is to improve, the tax administration must take effective action to deal with each of these shortfalls. If the administration is able to effectively control only one of these gaps, non-compliance will shift to the gap where the administration exercises weaker control. It is not enough, for instance, to make strong efforts to eliminate the informal economy and register all potential taxpayers if registered taxpayers cannot then be made to file returns and to report and pay the proper amount of tax. This point is particularly important in designing tax policy as well as in allocating tax administration resources.

18.7 Tax administration reform can take place by improving the taxpayer identification and records, assessment procedures, payment and collection systems, legal instruments, enforcement action against defaulters, accounting and auditing systems, and the application of information technology and so on. These improvements can, however, take place only within a conducive organisational structure which enable greater than usual autonomy along several organizational design dimensions, including: legal foundation, governance framework, financing, personnel policy, procurement policy, internal organisation and accountability relationships. Keeping in view the international trend in the oganisational design of tax administrations, we recommend the codification of the several of the design dimensions, identically, in both models of the Income-tax Bill. Further, we have made recommendations on several other aspects of the tax administration whose broad contours are discussed in the following paragraphs of this Chapter.

A. Central Board of Direct Taxes

18.8 The tax administration shall be supervised and controlled by a central apex body being the

Central Board of Direct Taxes. The Board shall comprise of a Chairman and not less than six members to be appointed by the Central Government in accordance with rules made in this behalf. The general superintendence, direction and management of the affairs of the Board shall vest in the Board which shall exercise all powers and do all acts and things which the Board is authorized to do under this Act. The Board shall hold its meetings in accordance with such rules of procedure as may be prescribed. The Board shall have power to appoint officers of various ranks to its own secretariat, for the efficient discharge of statutory and administrative functions assigned to it. The Board shall also establish, with the approval of Central Government, the attached Directorates and subordinate offices at such places as considered necessary.

18.9 The primary responsibility of the Board is to collect revenues in a fair and transparent manner, and for this purpose it shall devise appropriate strategies to enforce compliance, educate taxpayers, provide services to taxpayers, redress grievances and optimize use of available resources. It shall also undertake periodic evaluation of strategies based on tax gap, cost of compliance and satisfaction of taxpayers.

18.10 The Board shall also advice the Central Government on matters relating to tax policy administration and legislation. It shall also provide public rulings on matters of public importance. The Board shall supervise and regulate functions of the Income-tax Department.

18.11 The Board shall also issue orders, instructions, directions or circulars for proper and efficient management of this Act. Whether the Board shall have powers to issue directions/instruction/orders/circulars to the income-tax authorities for the proper administration of the Act and whether such directions/instructions/orders/circulars are binding upon the income-tax authorities are vexed questions that have been agitated before the courts of law. The present position in law is that such directions/instructions/orders/circulars are binding upon the income tax authorities but not upon the taxpayers. Normally, each case arising under the Act should be dealt with under the provisions of the Act having regard to the facts and circumstances of that case and the applicable legal provisions. It is only in a situation where there are a number of cases that involve the same issue or where a provision of law, because of its ambiguity or any other reason, may give rise to a number of cases, it would be desirable to lay down a general principle that would guide the income tax authorities. Hence, it is felt that the power to issue directions/instructions/orders/circulars should be carefully circumscribed and should be invoked only in rare cases. Accordingly, the provision of law has been suitably drafted. Needless to say, once a direction/instruction/order/circular is issued, it would bind the income tax authorities.

18.12 The Board shall prepare its own Demand-in-Grant to meet the expenditure relating to salaries, allowances, remunerations and administrative expenses of the Board, its Secretariat, attached

Directorates and Subordinate offices. The Board shall maintain proper accounts and other relevant records in respect of the Demand-in-Grant and shall prepare an annual Statement of Accounts.

18.13 The Board shall furnish to the Central Government an annual report giving a complete account of its activities, policy and programmes during the financial year, within 90 days from the end of the financial year. The annual report shall be laid before each House of Parliament as soon as possible.

18.14 The Board shall also furnish returns, statements and other particulars, on periodic intervals, in respect of its functions and duties in prescribed manner.

18.15 The most important way in which good tax administration laws are organised mirrors the way in which tax authorities themselves are, or atleast should be, organised. In other words laws are primarily organised around the different functions necessary for the administration of a tax system. Functional organisation of tax administration law makes it easier for the taxation authority, as well as for other government officials involved in the taxation process, to follow and interpret the law. Each department in the taxation authority can concentrate primarily on a single part or parts of the law. A second strenght of the functional organization is that it enables a tax administration to tackle one of the main disadvantages of the tax organisation. That is it reudces administrative costs and increases staff productivity. A thrid advantage of functional organizationa is that it improves the integrity of the tax adminiwtation by reducing the possibility for collusion between taxpayers' and tax officials. Furthermore, a functional organizational structure can serve as a check and balance among staff and the various functioanal departments. Even though it is difficult to remove misconduct by merely organizing the tax administration functionally, there is a possiblity of decresasing such behaviour since any collusion between taxpayers' and tax officials in one department will be detected by tax officials in other departments during the course of their normal activities.

18.16 In practice, tax administration across the globe are organising themselves functionally. With the induction of information technology, the move towards functional organisation has been accelerated. Reflecting this global trend, we recommend that the Income-tax Department should be organised functionally along the lines indicated in the paragraphs below.

B. Income Tax Department

18.17 The Income-tax Department shall be an organization of subordinate offices comprising Income-tax authorities and executive and ministerial staff employed in execution of this Act. The hierarchy of Income-tax authorities under this Act shall be as under-

(a) Principal Chief Commissioners of Income-tax or Principal Directors-General of Income-tax,

(b) Chief Commissioners of Income-tax or Directors-General of Income-tax,

(c) Principal Commissioners of Income-tax or Principal Directors of Income-tax,

(d) Commissioners of Income-tax or Directors of Income-tax or Commissioners of Income-tax (Appeals).

(e) Additional Commissioners of Income-tax or Additional Directors of Income-tax,

(f) Joint Commissioners of Income-tax or Joint Directors of Income-tax,

(g) Deputy Commissioners of Income-tax or Deputy Directors of Income-tax,

(h) Assistant Commissioners of Income-tax or Assistant Directors of Income-tax,

(i) Income-tax Officer,

(j) Inspectors of Income-tax,

18.18 The Board shall also establish various function units within the Department to handle specialized tasks, including the following-

(a) Communication Unit;

(b) Filers Compliance Monitoring Unit;

(c) Examination Unit;

(d) Verification Unit;

(e) Technical Assistance Unit;

(f) Collection Unit;

(g) Judicial Management Unit;

(h) Transfer Pricing Unit;

(i) Advance Pricing Agreement Unit; and

(j) Such other functional units as may be prescribed having regard to the need or the expediency to do so.

18.19 The **Communication Unit** shall handle all communications between the Department and the taxpayer, including sending of notices, receiving responses thereto, facilitating personal hearing and providing copies of record of proceedings.

18.20 The **Filers Compliance Monitoring Unit** shall monitor filing compliance in respect of return of income, statement of financial transaction and any other statement required to be filed under this Act. It shall also pursue the non-filers and stop-filers so as to ensure compliance with filing requirements.

18.21 The **Examination Unit** shall examine any return of income or case and make assessment.

It shall identify the issues material for assessment, seek clarification on such issues, analyse the response/information furnished by the taxpayer/third party and perform other functions as may be required for tax examination. The Examination Unit shall make a reference to the Verification Unit for conducting verification on points or issues which are required to be verified.

18.22 The **Verification Unit** shall conduct field enquires, cross verification, examination of books of accounts, examination of witness, recording of statement and other functions necessary for verification. The Verification Unit shall make available the outcome of verification conducted in the prescribed manner.

18.23 The **Technical Assistance Unit** shall provide advice on legal, accounting, forensic, information technology, valuation, transfer pricing, data analytics, management or any other technical matter wherever required for the purposes of this Act. Its advice will be recommendatory nature and shall not be binding on any functional unit or Income-tax authority.

18.24 The **Collection Unit** shall monitor compliance with obligations for payment of any tax, interest, penalty, fee, fine or any other sum payable under this Act. It shall also deal with collection and recovery of any outstanding dues, and refund of any excess amount along with the applicable interest to the taxpayer.

18.25 The **Judicial Management Unit** shall manage litigation and represent the Department before the appellate forum such as Income Tax Appellate Tribunal, High Courts and Supreme Court.

18.26 The **Transfer Pricing Unit** shall determine the arm's length price of an international transaction and give effect to advance pricing agreements.

C. Concurrent powers

18.27 The Income-tax authorities in a functional unit shall exercise concurrently all the powers which are vested in such unit under this Act.

D. Jurisdiction

18.28 The Board shall assign jurisdiction to various functional units of the Department for the performance of their functions having regard to functional specialization, optimal utilization of resources by way of economy of scale and minimal interface with the taxpayer. The Board shall also assign jurisdiction to the Income-tax authorities for the exercise of powers and performance of functions under this Act. The assignment of jurisdiction shall be made having regard to anyone or all of the following criteria-

(a) territorial area;

(b) person or class of persons;

(c) income or class of income; and

(d) cases or class of cases.

18.29 Any dispute relating to jurisdiction of a function unit or Income-tax authority shall be decided by the Principal Chief Commissioner concerned. In case of any disagreement, the matter shall be referred to the Board. No person shall be entitled to question the jurisdiction after expiry of time limit as prescribed under this Act.

E. Allotment of Identification Number

18.30 A **Permanent Account Number** shall be allotted to every prescribe person having regard to the nature of transaction as may be prescribed. The Board shall provide by rules form for making applications for allotment of permanent account number, category of transactions and documents wherein it shall be quoted and other connected matters.

18.31 A **Withholding Account Number** shall be allotted to every with holding agent. This number shall be quoted in all withholding tax challans, certificates, statements and other prescribed documents.

18.32 A **Document Identification Number** (DIN) shall be allotted on every notice order letter or communication issued by the Department. Similarly, a DIN shall be allotted on every document, letter or correspondence received from any person.

F. Communications and Notices

18.33 The Documents, notices or any other communication issued by the Department shall not bear the name or signature of any Officer or Official. It shall be authenticated by quoting the document identification number and printing the common seal of the Department.

18.34 All Communications with the Taxpayer, and internal communications with in the Department, as also notices, shall be exchanged in electronic mode. The Board shall make rules to provide for circumstances under which the communications may be delivered or transmitted to the addressee.

18.35 Personal hearing shall be provided at the option of taxpayer, only through video conferencing. Any examination or recording of statement (except in search and Survey cases) shall also be conducted through only video conferencing.

G. Taxpayer Assistance

18.36 One of the key functions of the tax administration is to facilitate taxpayers to comply voluntarily by providing them with the requisite information and material. The purpose of taxpayer

services is to ensure that it is as easy as possible for citizens to comply with the legislation. Two goals follow from this purpose: (i) to inform people of their rights and obligations and (ii) to provide people with consistent, impartial, courteous, and prompt service.

18.37 Unfortunately, there is no evidence to assess the effort of the taxpayer service function on revenue raising capacity. Nevertheless, there are bits and peices of evidence showing that in the face of rising tax law complexity, taxpayer services increase compliance levels, improves taxpayer confidence, and ease the burden of compliance. This evidence is compelling enough, even without a bottom line on revenue-raising capacity, to dictate that tax administrators should actively pursue a program of assistance, information, and education. An examination of the evolution of the taxpayer sercice function in the United States illustrate some points that support the case for tax adminisration to provide assistance to citizens in meeting their obligations under the tax laws. These are as follows:-

i. A specifically designated taxpayer assistance cadre permits other employees to perform their regularly assigned tasks without interruption.

ii. Availability of information, such as through toll-free telephone system, provides service to citizens in a uniform manner without regard to location.

18.38 Based on global experience, the Income-tax Act 1961, was amended to empower the Board to frame a scheme to allow tax return preparers to assist taxpayers in furnishing their return of income. We recommend that the scheme may be continued. Accordingly, both the models of the Income-tax Bill empower the Board to frame a scheme for this purpose. The scheme may also provide for connected matters, including the following-

(a) The manner in which and the period for which the Tax Return Preparers shall be authorized to prepare and furnish the return of income;

(b) The eligibility criteria for a person to qualify as a Tax Return Preparer;

(c) The code of conduct for the Tax Return Preparer;

(d) The duties and obligations of the Tax Return Preparer;

(e) The circumstances under which the authorization given to a Tax Return Preparer may be withdrawn;

(f) Any other matter which is required to be, or may be, specified by the Scheme for the purposes of this section.

H. E-assessment procedure

18.39 Hon'ble Prime Minister, Shri Narendra Modi in his address to the tax administrators on 1st

September, 201, exhorted the Income Tax Department to chalk out a comprehensive plan to identify systemic weaknesses and take measures for reforms to eliminate corruption and nepotism in the system. The Prime Minister directed that following measures should be taken in this regard:-

(i) the entire system should be reviewed comprehensively and appropriate reforms should be carried out simultaneously at different stages of the business process. In order to change and improve the system, fragmented reforms should be avoided.

(ii) the existing work culture should be revisited to identify and remove the adversarial elements, so that the honest taxpayer can trust the system.

(iii) systemic deficiencies and shortcomings should be identified and technology and digital coding should be used for surveillance at each stage of functional chain.

(iv) new procedures should be brought in place where the person running the system at each stage of functional chain and the persons for whom the system has been built are not identifiable to each other.

(v) new online systems should be brought to reduce human interface.

(vi) if at all an interface is required, the facility for the same through video conferencing should be made available.

(vii) the functional areas should not be handled by the same set of persons.

18.40 In pursuance of the Hon'ble Prime Minister's directive, the Income-tax Act, 1961 has been amended by the Finance Act, 2018 to empower the Board to frame a scheme for this purpose. We do not believe that full effect to the directives can be given by formulating a scheme; since substantive rights of taxpayers are sought to be modified, it would be appropriate to codify the provisions in the law so as to prevent any legal challenge in the future. However, no such scheme has so far been notified. With the objective of giving effect to Hon'ble Prime Minister's directive, the Task Force recommends that the Department should move swiftly towards a paperless and faceless assessment system so as to impart transparency and fairness. For this purpose, we have designed a scheme of e-assessment and crafted the necessary legislative framework for creation of functionally specialized units within the Department and realignment of the assessment work flow. The salient features of the scheme of e-assessment are as under:-

(a) The concept of an Income-tax authority having jurisdiction in respect of a case or an assessee should be completely done away with.

(b) This should be replaced by an organisational approach, which means that various statutory functions required to be performed under the Income-tax Act shall be carried out under the name and common seal of the Income – tax Department.

(c) The work process relating to the core functional area of assessment should be realigned so as to split up the entire assessment procedure into separately identifiable specialized tasks.

(d) Each task should be assigned to a specialized Unit, comprising a team of income-tax authorities, which would be required to complete the task in a time-bound manner.

(e) No two consecutive tasks in a single case would be assigned to the same Unit.

(f) The task of finalizing the assessment in a case should be assigned only to such Unit which has not been assigned any other previous task in the same case.

(g) The assignment of tasks to the respective Units shall be made dynamically in a system driven environment based on the criteria of functional specialisation and equitable work load.

(h) The manpower in the Income-tax department should be restructured into specialized Units geared to handle the specialized functions, as per the new work process.

(i) All communications to the taxpayers should be sent, and all responses from the taxpayer should be received, by the Department, in electronic mode only through a centralized communication centre, so as to minimize interface with the taxpayer.

(j) Personal hearing, if requested by the tax payer, should be conducted through video conferencing only.

(k) Examination and cross-examination of witnesses and recording of statements should be allowed through video conferencing, in so far as possible.

(l) The Income-tax Department should create and maintain the infrastructure necessary to support the facility of video conference with the taxpayer.

(m) The complete record of proceedings should be maintained in electronic form only, so as to be accessible for future reference and retain its evidentiary value, in a reliable and secure manner.

(n) As a transparency measure, the taxpayer should be allowed a convenient access to the electronic record at any stage of the proceedings, with definite rights to view the record and take copies.

(o) As a trust building measure, person to person contact between the tax official and the taxpayer should be prohibited by law, subject to exceptions in certain cases.

(p) The selection of cases for tax examination should be done in accordance with a risk management strategy formulated by the Board.

(q) The taxpayer should be intimated about selection of his case for examination within a

prescribed time frame.

(r) The scope of tax examination would vary depending on the level of intensity to which the examination is required to be conducted, in order to arrive at a fairly reasonable assessment of taxable income and tax liability.

18.41 Upon implementation, the paperless and faceless e-assessment recommended by us has the potential to fundamentally transform the tax administration; it will close all opportunities for rent-seeking in the course of tax compliance and administration.

I. Self assessment

18.42 Modern tax administrations seek to optimize tax collections while minimizing administration costs and taxpayer compliance costs. The most cost effective systems of collecting taxes are those that induce the vast majority of taxpayers to meet their tax obligations voluntarily, leaving tax officials to concentrate their efforts on those taxpayers who do not comply. Taxpayers are more likely to comply voluntarily when the tax administration: (1) adopts a service-oriented attitude toward taxpayers, and educates and assists them in meeting their obligations; (2) creates strong deterrents to non-compliance through effective audit programs and consistent use of penalties; and (3) is transparent and seen by the public to be honest, fair, and even-handed in its administration of the tax laws. Experience shows that voluntary compliance is best achieved through a system of self-assessment.

18.43 Income tax has traditionally been assessed by the tax departments. Under an administrative assessment system, the onus is on the tax administration to (ex-ante) examine tax returns and financial statements, calculate the amount of tax payable, and notify the taxpayers of the tax liability. Administrative assessment systems are resource-intensive and tend to be ineffective. The following are the challenges of an administrative assessment system:

i. Costly to administer because of the high level of intervention of tax officials.

ii. Resource limitations mean that checks by the tax administration are often ineffective in detecting unreported income.

iii. Taxpayer education and assistance programs are often not well developed.

iv Penalties tend to be lower, and are often inconsistently applied or are open to negotiation.

v. Less tax is collected overall because of insufficient focus on the highest revenue risks.

vi. High level of disputes, often with each step in the dispute resolution process presenting an opportunity for taxpayers and tax officials to negotiate the tax liability.

18.44. Administrative assessment systems are however still common in many countries, including advanced countries such as Austria, Belgium, Denmark, France (for PIT only), Germany, Greece,

Netherlands, Norway, Portugal, etc. The system is also still common in many countries in the Middle East and some countries in South East Asia. It is not clear why advanced countries continue to operate a system that has many challenges but this is not the focus of this study. However, it should be noted that some of these countries have largely automated their return processing operations and risk assessment procedures so that only a small proportion of tax returns are identified for technical scrutiny before a formal notice of assessment is sent to the taxpayer.

18.45 The self-assessment system accepts the reality that no tax administration has, or ever will have, sufficient resources to determine the correct liability of every taxpayer. It also recognizes that taxpayers themselves—with appropriate assistance from the tax department—are in the best position to determine their tax liabilities, given that they have first-hand knowledge of their business affairs and financial transactions, and have ready access to underlying accounting records.

18.46 Self-assessment is based on the idea of voluntary compliance. In a self-assessment system, taxpayers calculate and pay their own taxes without the intervention of a tax official. If this is not done appropriately and within the prescribed timeframes, the tax administration detects this failure and takes appropriate enforcement action, including applying the penalties provided for in the law. Tax administrations generally accept tax returns at face value (i.e. not subjected to technical scrutiny) at the time of filing, at which time the tax due is paid. Some simple checks may be performed; however, the focus is to ensure arithmetical accuracy and that the taxpayer has completed the appropriate items on the tax return form.

18.47 Self-assessment systems require far less information and supporting documents from taxpayers when returns are filed. Business taxpayers must, however, keep records explaining all transactions relevant for tax purposes, including sales and expense invoices and receipts, wages records, cash register tapes, bank account statements, and details of debtors, creditors, trading stock and depreciable assets. Generally, it is permissible for a taxpayer to issue and store records in either paper or electronic form. The law typically provides for penalties for not maintaining the required records and for not keeping them for the required period, generally around five years for business taxpayers.

18.48 The role of the tax administration under self-assessment is first and foremost to assist the taxpayers to understand their rights and obligations under the law. Given that more responsibility is placed on taxpayers to correctly interpret the law, greater attention is given to educating and assisting taxpayers in understanding the law's requirements. The tax administration also makes it easy and as least costly as possible for taxpayers to meet their obligations. Self-assessment demands that tax administrations adopt a service-oriented attitude towards taxpayers.

18.49 The emphasis under a self-assessment system shifts the verification process from pre- to a

post-filing basis. The tax administration relies more on post-filing controls such as risk-based audits, collection enforcement measures, and prosecution of tax evaders. Tax administrations operating self-assessment systems adopt targeted verification approaches, (e.g., through information sharing, data matching, and risk-based desk and field audits) to verify the information contained in tax returns. In this way, the tax administration's limited resources are directed toward addressing the most significant threats to the tax system, while, in principle, leaving compliant taxpayers free to conduct their business without unnecessary intervention by tax officials.

18.50 Internationally, there has been a steady movement towards self-assessment and away from administrative assessment practices. Self-assessment for tax purposes is not a new phenomenon. Canada and the United States first implemented self-assessment in the 1910s, followed by Japan in 1947 and India in 1964. In the last 30 years, however, the spread of self-assessment for income tax has been a common phenomenon—Sri Lanka (1972), Pakistan (1979), Bangladesh (1981), Indonesia (1984), Australia (1986-87), Ireland (1988), New Zealand (1988) and the United Kingdom (UK) in 1996-97. Presently, around half (18) of revenue bodies in the OECD, for example, apply self-assessment principles for the PIT while 22 apply self-assessment for CIT.

i. Self reporting

18.51 The self-assessment system has been in vogue in India since 1964. Given the fact that this system is consistent with best international practice, we recommend that India should continue with the self-assessment system. As at present, under this system, taxpayers should be mandated to determine their own income and self-report their income by filing a return of income accompanied by payment of tax due, if any. The salient features of the provisions relating to filing of return of income are as follows-

(a) It shall be obligatory for the following persons to file their return of income-

- (i) An individual if his gross total income from ordinary sources exceeds the threshold limit;
- (ii) A Hindu undivided Family, if its gross total income from ordinary sources exceeds the threshold limit;
- (iii) An association of persons, body of individuals or artificial juridical person, if its gross total income from ordinary sources exceeds the threshold limit;
- (iv) A company;
- (v) A limited liability partnership
- (vi) A firm;
- (vii) A cooperative society;

(viii) A non-profit organisation;

(ix) A private Trust;

(x) A political party;

(xi) A local Authority;

(xii) A person, who is a resident and hold as a beneficial owner or otherwise, any asset (including any financial interest in any entity) located outside India;

(xiii) A person, who has a signing authority in any account located outside India;

(xiv) A person, who is a resident and is a beneficiary of any asset (including any financial interest in any entity) located outside India.

(xv) A person, who intends to claim refund of any amount paid to the Central Government by him or on his behalf.

(xvi) Any person who derives any income from special sources and is liable to pay income-tax thereon;

(xvii) Any person who intends to carry forward the loss or any part thereof in accordance with the provisions of the Act; and

(xviii) Any other person if his gross total income from ordinary sources exceeds the threshold limit.

(b) The due date for filing the return of income under the Act will be 30th June of the year following the financial year for all non-business non-corporate taxpayers and 31st August of the year following the financial year for all other taxpayers.

(c) The time limit for filing a voluntary belated return, prior to completion of assessment, shall be extended to Seven years from the end of the relevant financial year.

(d) A modification statement may be furnished so as to revise a return of income, if any omission or wrong statement is discovered therein, which has the effect of reducing or increasing the tax liability.

(e) The time limit for filing modification statement, shall be as under-

(i) Twelve months from the end of relevant financial year, prior to completion of assessment, if the discovery has the effect of reducing the liability; and

(ii) Seven years from the end of relevant financial year, if the discovery has the effect of increasing the liability.

18.52 In case a person is not required to file a return of income, he shall be required to furnish a certificate of income, if-

(a) he is otherwise not required to file his return of income;

(b) he does not intend to file a return of income; or

(c) he has –

(i) furnished a return or a certificate for the immediately preceding financial year;

(ii) been assessed for the immediately preceding financial year; or

(iii) not furnished a return, or a certificate, in response to a notice served

ii. Stop-filers and non-filers

18.53 In paragraph 18.5 we have identified the non-filers gap (unregistered taxpayers) and the stop-filers gap (stop-filing taxpayers) as two key shortfalls which the tax administration must deal effectively. The existing taxpayers base in India is low compared to international standards. There are no realistic estimates of potential taxpayers in India; however there is a widespread perception that there are a large number of non-filers. Similarly, there are also large number of stop-filers. Since larege shortfalls in non-filers and stop-filers reflect poorly on the effectiveness of any tax administration, we recommend a comprehensive mechanism to deal with these two problems. For this purpose, a **non-filer** is defined as a person who has not filed the return, and has not been served with a notice calling for return, for the relevant financial year and also for two financial years immediately preceding the relevant financial year. A **stop filer** is defined as a person who has not filed a return of income, belated return or certificate of income for the relevant financial year. The Act provides that a notice may be issued to the non-filers and stop filers calling for their return of income. However, such notice shall not be issued after seven years from the end of the relevant financial year.

iii. Processing of returns

18.54 As part of the self-assessment system, a two-step procedure will be followed for assessment of return filed with the tax administration. In the first stage, the return received will be processed to determine the tax payable or refund due to the taxpayer on the basis of the returned income subject to arithmetical corrections and adjustment of internal inconsistencies. In this stage, the returned income will be accepted by the Department but the tax payable (including additional income tax, fee and interest) on the returned income will be recomputed and claim of tax payment will be verified.

18.55 The exercise of processing of returns (excluding cases selected for scrutiny) will be done along the following lines-

(a) The Income-tax Department, or any other authority authorised by the Board, shall issue an electronic acknowledgement for receipt of the return. The electronic acknowledgement shall bear a unique return acknowledgement number.

(b) The Department shall process the return after making adjustment, if any, to the income in the return and determine the sum (tax and interest, if any) payable by or refundable to the taxpayer.

(c) The adjustment to the income shall relate to-

(i) Any arithmetical error in the return; and

(ii) Any incorrect claim, if such incorrect claim is apparent from the existence of other information on the return.

(d) The incorrect claim apparent from the existence of other information on the return shall mean to be a claim on the basis of an entry on the return-

(i) Of an item which is inconsistent with another entry of the same item or another item on such return; or

(ii) In respect of which information required to be supplied to substantiate such entry has not been furnished; or

(iii) In respect of a deduction which exceeds a statutory limit imposed, if such limit is expressed as a specified monetary amount, or as a percentage, ratio, or fraction.

(e) The Department shall, in all cases, re-compute the tax payable on the income determined after adjustment, if any, verify the claim for tax payment and determine the sum payable or refundable.

(f) The Department shall, in all cases, send an intimation in the prescribed from to the taxpayer specifying the tax bases so computed, the tax liability thereon, the amount of credit for prepaid taxes, if any, and the sum payable by the assessee or refundable to him. If no intimation is sent by the Department, the return shall be deemed to have been accepted in toto.

(g) The Department shall process the return within one year from the end of the month in which the return is furnished. However, if the return is processed beyond the time limit of one year, the taxpayer will not be liable to pay to the Central Government any sum payable on account of any adjustment to the income in the return. Therefore, in such cases the Department will not be entitled to issue any notice of demand in respect of such sum. This will not foreclose any claim for refund by the assessee or prejudice any demand, including interest thereon, arising on the basis of the tax base declared in the return.

J. Tax Exmination (Scrutiny Assessment)

i. Selection of cases

18.56 The Department may select certain cases for the purpose of tax examination (scrutiny assessment), where –

(a) the Department is in possession of information;

(b) a return of income has been filed; and

(c) a notice calling for return of income has been issued.

18.57 The selection of cases shall be made in an automated environment without any manual intervention, in accordance with the risk management strategy laid down by the Board from time to time. A case may be selected for any of the following types of examination –

(a) single issue examination;

(b) limited examination; and

(c) full examination.

18.58 After selection of the case, the Communication Unit shall communicate to the person that his case has been selected for tax examination, within a prescribed time limit. This communication shall specify the following particulars –

(a) the type of examination for which case has been selected i.e., single issue, limited or full examination;

(b) financial year for which the case has been selected for examination;

(c) the statutory time limit for completion of assessment in the case;

(d) rights and obligation of the person in the course of examination proceedings;

(e) manner of communication by which the person can interact with the Department;

(f) manner of conducting personal hearing upon request by the taxpayer;

(g) manner of obtaining copies of documents available on record; and

(h) consequences of non-compliance at various stages of the examination process; and taxpayers assistance services which can be availed.

18.59 The Examination Unit shall serve notice upon the taxpayer calling for the evidence, the requisite information, accounts, documents or statements in support of the return. The Examination Unit may direct the Verification Unit to conduct further enquiry on such issues as it considers necessary for tax examination. The Examination Unit may also seek advice from the Technical Assistance Unit on any legal, accounting, forensic or any other technical matter. The advice rendered by the Technical Assistance Unit shall be recommendatory in nature.

ii. Special Audit

18.60 The Department may, for the purpose of making assessment, direct Special Audit to be conducted in a case, if found necessary, having regard to the interest of revenue and –

(a) the nature and complexity of the accounts;

(b) volume of accounts;

(c) doubts about the correctness of the accounts;

(d) multiplicity of transactions in the accounts; or

(e) specialised nature of business activity of the person.

18.61 The remuneration and other expenses of such Special Audit shall be paid by the Department.

iii Reference for valuation

18.62 The Department may, for the purpose of making assessment, also make a reference to a Valuation Officer to estimate –

(a) the value of any asset, investment or expenditure; and

(b) the volume, weight and value of any mineral extracted from any mine.

18.63 The valuation made by the Valuation Officer shall be binding upon the Department.

iv. Determination of transfer pricing

18.64 The Department may select the case of any person for the purposes of determining the arm's length price of any international transaction undertaken during the financial year. The selection shall be made in accordance with the risk management strategy framed by the Board in this behalf.

18.65 The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, namely-

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method; and

(f) such other method as may be prescribed by the Board.

18.66 The determination of arm's length price shall be subject to safe harbour rule as may be prescribed by the Board in this behalf.

18.67 The Department shall determine the amount of any income, or expense, arising from an international transaction having regard to the arm's length price. Further, the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided by any associated enterprise shall be determine having regard to the arm's length price.

v. Assessment

18.68 The Examination Unit shall serve a show-cause notice on the taxpayer for the purpose of making assessment. The show-cause shall be prepared by the Examination Unit after taking into account-

(a) the information in possession of the Department;

(b) the information, statements, documents, accounts, explanation or objection furnished by the person in the course of examination;

(c) the outcome of enquiry made available by the Verification Unit;

(d) the advice made available by the Technical Assistance Unit;

(e) the report of the Valuation Officer;

(f) the report of special audit by the accountant;

(g) the order of the Transfer Pricing Officer;

(h) the order determining the consequences of an impermissible avoidance arrangement;

(i) the statement of the person, or any other person, recorded on oath;

(j) the oral submissions made by the person in the course of personal hearing; and

(k) any other information which is material for determination of total income and tax liability thereon.

18.69 The taxpayer shall be required to file reply to the show-cause notice within one month from the end of the month in which the notice was issued. The Examination Unit shall complete the assessment after taking into account reply of the taxpayer, if any, within two months from the end of the month in which the show-cause notice was issued.

vi Assessment in large cases

18.70 In a large case, the Examination Unit shall also serve a draft assessment order on the taxpayer for the purpose of making assessment. A large case shall be a case where the proposed addition to the total income exceed the limit of ₹.25 Lacs. The taxpayer shall be required to file his response in the form of acceptance of, or objections to, the draft order within one month from the end of the month in which the draft order is received. The objections may be furnished either before the Examination Unit for completion of assessment, or before the Dispute Resolution Panel (DRP) for resolution of dispute.

18.71 The Examination Unit shall complete the assessment after considering objections of the taxpayer, within one month from the end of the month in which the time allowed to file response expires. In a case where the taxpayer files the objections before the DRP, the Examination Unit shall complete the assessment in conformity with the directions of DRP, within one month from

the end of the month in which the directions are received.

vii. Best judgement assessment

18.72 The Department shall complete the assessment to the best of its judgement in a case where–

(a) the taxpayer does not comply with a notice for tax examination;

(b) the taxpayer does not co-operate with the Special Auditor appointed by the Department;

(c) the taxpayer fails to regularly follow the method of accounting, or the Income Computation and Disclosure Standards (ICDS) notified by the Central Government, as applicable to his case; or

(d) the Department is not satisfied about correctness or completeness of his accounts.

viii. Assessment in search cases

18.73 The procedure for assessment in search cases is divided in two stages –

I. In the first stage, a show-cause notice shall be served on the taxpayer requiring him to show-cause why –

a. he should not be liable in respect of the undisclosed income of the block period specified therein; and

b. prosecution should not be launched in respect of the offences is specified therein.

18.74 The show-cause notice shall be issued within twelve months from the end of the month in which search was initiated. At this stage, no demand notice specifying the sum payable by the taxpayer shall be issued.

II. The taxpayer, upon receipt of the show-cause notice, may furnish his acceptance of, or objections to, in full or in part, the determination of undisclosed income specified in the notice before the Adjudicating Authority. The Adjudicating Authority shall be a collegium of the Principal Commissioner to be appointed by the Board. Its directions shall be binding on the Department. In case of acceptance, the taxpayer shall be required to make payment of the amount of tax, interest and fee payable in relation to so much of the undisclosed income which he intends to accept.

III. In the second stage, the Adjudicating Authority shall make assessment of undisclosed income of the block period after considering the -

(a) show-cause notice;

(b) evidence found as a result of search;

(c) evidence available with the Department relating to the searched person;

(d) objections, or acceptance, furnished by the person;

(e) supporting evidence furnished by the person;

(f) records relating to the searched person;

(g) results of any enquiry made, or cause to be made; and

(h) report of the Valuation Officer, Transfer Pricing Unit, any other unit or income-tax authority, if any.

IV The Adjudicating Authority determine the sum payable by the person, on the basis of assessment of undisclosed income, after adjusting the amounts paid already.

V The Adjudicating Authority may grant immunity from prosecution in search cases, having regard to circumstances of the case, including whether–

(a) the taxpayer has extended co-operation in the course of search and seizure operation and thereafter till the completion of assessment proceedings;

(b) the taxpayer has accepted certain part of undisclosed income quantified in the show-cause notice and paid taxes thereon.

K. Modification to correct for underreporting and misinterpretation

18.75 An assessment order under this Act can be modified to give effect to-

(a) the outcome of any enquiry conducted in respect of the information received by the Department regardless of whether the information is received before, or after, the original assessment; and

(b) the outcome of any decision which is prejudicial to the taxpayer, rendered by the Appellate Tribunal under this Act, or by a Court under this Act or any other law, in his case or in case of any other person.

18.76 An assessment shall not be modified in pursuance to an information which was available on record while making the original assessment, or to give effect to findings of an enquiry which had been completed prior to making of original assessment. Further, no modification shall be made so as to increase the loss to be carried forward or decrease the income or any sum payable under this Act.

18.77 The Examination Unit shall serve a show cause notice on the person requiring him to show cause as to why the original assessment should not be modified. The Examination Unit shall modify the original assessment after considering the response furnished by the person, within a period of 6 months from the end of the month in which the show cause was issued.

L. Review to correct for underassessment

18.78 Any assessment order under this Act can be reviewed within a period of one year from the end of the financial year in which it was passed, if –

(a) the facts in the case have not been correctly determined;

(b) the instruction of the Board has not been followed; or

(c) the judicial decisions, prejudicial to the person have not been followed.

18.79 The power to review shall not extend to such matters which have been considered and decided in any appeal or on which an appeal is pending before the Commissioner (Appeals). Further, no review shall be made so as to increase the loss to be carried forward or decrease the income or any sum payable under this Act. Upon review, no direction shall be given to cancel the original assessment and make a fresh assessment.

18.80 The Examination Unit shall serve a show cause notice on the person requiring him to show cause as to why the original assessment should not be amended upon review, specifying therein the nature and quantum of the proposed amendment. The Examination Unit shall amend the original assessment after considering the material on record and the response furnished by the person.

M. Rectification of mistakes

18.81 An order under this Act can be rectified in respect of any mistake apparent from the record within a period of six month from end of the month in which the order was passed, or seven years from end of the financial year to which the order relates, whichever is later.

18.82 A mistake shall be deemed to be apparent from the record, if the order is not in accordance with-

(a) any subsequent judgement of Supreme Court or jurisdictional High Court;

(b) any finding or direction in an order passed by any authority or Court by way of appeal, reference or revision;

(c) any finding or direction in an order passed by a Court under any other law in so far as it has bearing on the liability under this Act.

18.83 Rectification of an order can be made by the Department on its own motion or on an application made by the person in whose case the order sought to be amended was passed. An application for rectification shall be disposed within six months from end of the month in which the same is received.

N. Resolution of disputes

18.84 A certain level of tax disputes is a normal part of a system of taxation based on the rule of law. Some countries, however, experience an excessive volume of tax litigation. This may involve a

high volume of litigation challenging tax assessments, delay in resolving these disputes, and often a lack of capacity in the judiciary. A lack of capacity might arise from an insufficient number of judicial personnel or a lack of the needed expertise, and can result in delay and poor quality of the decisions taken.

18.85 Excessive tax litigation can lead to a delay in collecting a large amount of tax. Protracted tax litigation can also be costly for the private sector, both by way of litigation costs and uncertainty created.

18.86 It is impossible to determine whether the volume of disputes is excessive based alone on statistics for the number or percentage of assessments disputed. Many factors might influence the volume of disputes. For example, if tax assessments tend to be aggressive, then the volume of disputes will, ceteris paribus, be higher. (In turn, a number of factors, including incentives in the functioning of the tax administration bureaucracy, and tax administration policy decisions, can influence the degree of aggressiveness.) If tax audits tend to focus on obvious cases of noncompliance (as opposed to issues where opinions on how the tax law should be applied might differ), the assessment may not leave much room for dispute. Complex or unclear tax laws might lead to a higher level of disputes. Cultural attitudes can influence the degree to which taxpayers tend to dispute administrative findings. While there is accordingly no benchmark level of tax disputes, it may be quite easy to identify situations where the level of disputes is too high for the system to handle. This might show up in the amount of time needed to process disputes, an increasing backlog of cases, and a substantial volume of outstanding arrears.

18.87 In assessing whether there is a problem with excessive disputes, attention should also be paid to whether there is a particular problem in a subset of disputes. A small volume of high-value cases which are stuck for a long time in the judicial system may pose as serious, or a more serious problem for the tax administrative system than a large volume of small tax cases. The latter might be annoying but not so dangerous for the revenue. Another possibility is that there is a large volume of cases, but they mostly involve a common type of issue. The solution for this might be different than for a generalized backlog of cases.

18.88 Ultimately, a judgment must be made whether the volume of disputes is causing problems for effective tax administration. If it is, then addressing this issue needs to be a priority. Even if it is not, of course, that does not rule out reforms, although they may take a lower priority in comparison with other challenges for the tax administration. Reforms might be warranted, for example, in order to save costs by improving the efficiency of tax administration.

18.89 Some countries experience the opposite problem, namely the existence of very few tax appeals.

This can be a symptom of a poorly functioning tax audit program, since if audits are not conducted energetically there may be little occasion to dispute audit results. It can also be a symptom of corruption in the audit process.

18.90 There are different types of tax litigation, including challenges to collection actions or requests for information, constitutional challenges, and miscellaneous challenges to the exercise of administrative power through judicial review; our focus is on appeals from tax assessments. Problems of excessive litigation affecting the tax administration can, of course, arise in areas other than appeals from tax assessments. Some countries might experience a bottleneck in enforced collection, arising from the need to go to court to enforce tax debts and the inability of courts to handle these cases expeditiously. Another example of litigation that does not involve appeals from assessments is civil litigation to enforce unpaid bills. Such litigation might be encouraged by rules in the tax laws allowing a deduction for bad debts only if measures have been taken to pursue the debtor in court. The main remedy might be to change the substantive tax laws to remove the requirement to go to court in order to get a tax deduction for bad debts.

18.91 A number of factors can contribute to an excessive volume of appeals. A long-term solution to the problem may involve making changes in several aspects of tax administration and procedure, depending on what is contributing to the level of disputes. Tax disputes can be reduced by adopting mechanisms like -

(i) public ruling, advance ruling and advance pricing agreement to change taxpayer behavior before the tax return is filed (pre-filing measures);

(ii) reference to dispute resolution panel and in-house settlement procedure during the course of assessment; and

(iii) creating appellate fora for disputes resolution after the making of an assessment.

i. Public Ruling

18.92 The Bill envisages that Board shall provide public rulings on all matters of public importance, including interpretation of treaty, arrangement, agreement or any statutory provisiosn of this Act. A separate directorate of public rulings shall be set up for the purpose of making proposals to the Board for providing public rulings. A ruling may be provided by the Board on an application made by a person or on its own motion. A draft of the ruling shall be placed in public domain inviting comments from the public. The ruling shall be binding both on the Department and on the applicant. Appeal against a public ruling shall be filed before the High Court of Delhi.

ii. Advance Ruling

18.93 The Bill envisages an Authority for Advance Ruling to be set up for the purposes of giving rulings on the question raised by the applicant seeking advance ruling in such form and manner as may be prescribed. The scope of ruling shall be-

(a) in case of non-resident applicant, determination in relation to a transaction undertaken or proposed to be undertaken, including any question of law or fact;

(b) in case of resident applicant, determination in relation to the tax liability of a non-resident or the applicant, arising out of a transaction undertaken or proposed to be undertaken, including any question of law or fact;

(c) in either case of applicant, determination or decision whether an arrangement which is proposed to be undertaken is an impermissible avoidance arrangement;

(d) in case of any class of resident notified by the Central Government, a determination of computation of income which is pending before any Income-tax Authority or the Appellate Tribunal, including any question of law or fact.

18.94 The Authority shall consist of a Chairperson and such number of Vice Chairpersons, law Members and revenue Members as the Central Government may appoint. The decision of the Authority shall be by the majority. The Authority shall have all the powers of a Civil Court under the Code of the Civil Procedure, 1908 and shall be deemed to be a Civil Court for the purposes of section 195 of the Code of Criminal Procedure, 1973. Every proceeding before the Authority shall be deemed to be a judicial proceeding under Indian Penal Code. The Authority shall have the power to regulate its own procedure.

18.95 On receipt of an application seeking advance ruling, the Authority shall, within a time limit not exceeding twenty days, either allow or reject the application, after hearing the applicant.

18.96 In case of applications allowed to be proceeded with, the Authority shall call for a report along with relevant records from the Principal Commissioner who shall furnish the same within a period of forty-five days from the receipt of the communication from the Authority. The Authority may, on the basis of the report of the Principal Commissioner, within a period of fifteen days of the receipt of the report, admit the application or declare the application as invalid.

18.97 The Authority shall, except in notified class of cases, not admit an application where the question raised is already is pending before any Income-tax Authority or Appellate Tribunal or any Court; or involves determination of fair market value.

18.98 The Authority may direct the Principal Commissioner to-

(a) make or cause to be made such further enquiry or investigation as it thinks fit in circumstances of the case; and

(b) furnish a report on outcome of such enquiry and any other matter relating thereto.

18.99 The Authority, after examining the records made available by the Principal Commissioner and all other material, shall pronounce its advance ruling within a period of twelve months from the end of the month in which the order admitting the application was passed.

18.100 The Authority may amend any order passed by it so as to rectify any mistake apparent on the face of record, either *suo moto* or at the behest of the applicant or the Principal Commissioner.

18.101 No person shall be entitled to inspect, or obtain copies of, any reports made by any Income-tax Authority to the Authority, but at the discretion of the Authority.

18.102 The Advance Ruling pronounce shall be binding only-

(a) on the applicant in whose case the Advance Ruling has been pronounced;

(b) in respect of the transaction in relation to which the Advance Ruling has been pronounced; and

(c) on the Principal Commissioner, and the income-tax authorities subordinate to him, in respect of the applicant and the said transaction.

18.103 However, the Advance Ruling shall not be binding, if there is a change in law, or fact, on the basis of which the Advance Ruling has been pronounced.

18.104 The Authority may declare an advance ruling to be void *ab initio* if it finds that the ruling has been obtained by fraud or misrepresentation of facts.

iii. Advance Pricing Agreement

18.104 The **Advance Pricing Agreement Unit** shall process applications for advance pricing agreements, analyze and prepare position papers on the points of agreement and disagreement with the applicant and prepare a draft advance pricing agreement for consideration and approval by the Board and the Central Government. The Advance Pricing Agreement entered into shall be binding-

(a) only on the person in whose case the agreement has been entered into;

(b) only in respect of the transaction in relation to which the agreement has been entered into; and

(c) on the Department only in respect of the said person and the said transaction.

18.105 The Advance Pricing Agreement shall be valid for such financial year as specified in the Agreement and upto five consecutive succeeding financial years and not exceeding four previous financial years preceding the financial year in which the arm's length price of the international transaction is determined.

iv. Dispute Resolution Panel

18.106 The Dispute Resolution Panel shall be a collegium of three Commissioners to be appointed by the Board, which shall seek to resolve disputes raised in the objections furnished against the draft order, and issue directions for completion of assessment. The directions of Dispute Resolution Panel shall be binding on the Department. The directions shall be issued within a period of nine months from the end of the month in which the objections against the draft order are furnished. These directions shall be appealable before the Appellate Tribunal.

18.107 The process of dispute resolution shall comprise of the following stages:-

I. In the first stage, the taxpayer, while filing objections to the draft order, shall make an offer of settlement on issues he intends to resolve, and identify issues he would like to contest.

II. In the second stage, the Dispute Resolution Panel shall, after making necessary enquiries and hearing the taxpayer, make a counter-offer of settlement on the relevant issues.

III. In the last stage, the Dispute Resolution Panel shall issue directions affirming the counter-offer of settlement on settled issues, and confirming, reducing or enhancing the variation in total income relating to contested issues.

IV. The Dispute Resolution Panel may also give directions for reduction or waiver of penalty or grant of immunity from prosecution.

18.108 The Dispute Resolution Panel shall not issue any direction so as to (a) set aside any variation proposed in the draft order; (b) cause any further enquiry by the Department; or (c) waive any additional income-tax, interest or fee.

v. In-house settlement mechanism

18.109 The Act envisages a mechanism of in-house settlement available during assessment of search and seizure cases. In every search case, a Show Cause Notice shall be served on the searched person mentioning the particulars of undisclosed income, specified tax chargable and prosecution proceedings proposed to be launched. After receipt of Show Cause Notice, the searched person can make an offer of settlement to the Adjucating Authority, convening his part acceptance of the undisclosed income (and making payement of specified tax relating to such part), while objectiing to the determination of undisclosed income relating to other issues. The Adjucating Authority can also make a counter offer of settlement to the searched person before finalising the assessment of undisclosed income. The Adjucating Aauthority shall have the discretion to grant immunity from prosecution proceedings having regard to cooperation extended by the searched person, including his conduct in the process of settlement.

18.110 Since we are proposing the creation of an in-house settelment mechanism by establishiing

an adjucating Authority for search cases and a dispute resolutio panel in other large cases, we do not see any further relevance for continuing with an independent Settlmenmt Commission. Accordingly, we recommend its abolition.

vi Appeals

18.111 A taxpayer should have an easily accessible mechanism to prefer appeal against orders that are adverse to him. No taxpayer should be burdened with a liability which is not due under the Act. The Act provides for a hierarchy of authorities who shall exercise appellate jurisdiction.

18.112 The taxpayer may prefer an appeal before the Commissioner (Appeals) against any order passed or intimation issued by the Department under this Act, within thirty days from the date of service of the order.

18.113 An appeal shall lie to the Appellate Tribunal against an order passed under this Act-

(a) by the Commissioner (Appeals);

(b) by the Adjudicating Authority;

(c) with the approval of any authority above the rank of Principal Commissioner;

(d) in pursuance of direction of Dispute Resolution Panel or Approving Panel;

(e) in pursuance of an Advance Pricing Agreement or Mutual Agreement Procedure;

18.114 The taxpayer, or the Department may prefer an appeal before the appellate tribunal within sixty days from the date on which the order appealed against is communicated. The right to appeal by the Department against an order of the Commissioner (Appeals) or the Appellate Tribunal is retained.

18.115 An appeal shall lie to the High Court against an order of the Appellate Tribunal if the High Court is satisfied that the case involves a substantial question of law. The power of the High Court under Article 226 of the Constitution and of the Supreme Court under Article 32 of the Constitution is not affected. The power of the Supreme Court to entertain a Special Leave Petition under Article 136 of the Constitution is also not affected.

O. Collection and recovery

18.116 Amounts payable under this Act shall preferably be collected on '*pay-as-you-earn*' basis. The Act provides for the collection and recovery of amounts payable through the following mechanism-

(a) Withholding Tax on specified transactions undertaken during the financial year, which in general, constitute income in the hands of withholdee;

(b) Payment of advance tax during the financial year on the on the basis of estimated income;

(c) Payment of self-assessment tax before filing of return.

(d) Taxes paid by withholding or otherwise in any other country (Foreign Tax Credit)

18.117 There is no change in the provisions dealing with each of the above methods of collection and recovery of tax. The rates of withholding tax on specified transactions in the case of a resident withholdee are mentioned in the Table-5, and in the case of a non-resident withholdee are mentioned in the Table-5A, in the Chapter-X of this Act.

18.118 Every withholding agent, being a permitted financial institution or a cooperative society, shall be required to deliver a statement of payment of interest to residents without withholding of tax.

18.119 The collection Unit shall be responsible for enforcing the collection and recovery of any tax, additional income-tax, interest, penalty, fee, fine, or any other sum payable under this Act.

18.120 Any sum payable as per a notice of demand duly served upon the taxpayer shall be required to be paid to the credit of Central Government within thirty days of service of notice. However, the Collection Unit may extend the time for payment of demand, or grant instalment for payments thereof, subject to conditions as deemed fit.

18.121 The provisions relating to recovery of tax have been streamlined. The Collection Unit shall recover the amount specified in a certificate of tax arrears, in respect of which a person is in default, or deemed to be default, by any of the methods for recovery of tax, including by way of attachment and sale of movable and immovable property, in accordance with the provisions of the Third Schedule to the Act.

P. Interest

18.122 Late payments should automatically be assessed interest since interest reflects the time value of money. The application of interest should never be waived. The common practice is for interest to accrue at a market rate rather than some arbitrary rate that is either too low to fairly reflect the actual cost of the use of unpaid taxes by the taxpayer, or so much higher than market rates that it becomes a penalty. The rate of interest is typically set by regulation or some other mechanism where it can be periodically adjusted without requiring legislative approval for each change. The most common method of determining the rate is by reference to the Central Bank rate plus a certain percentage to approximate the rate of interest a business would be charged if it borrowed money from a commercial lender. In determining the surcharge on the Central Bank rate, it is presumed that a defaulting taxpayer would be charged a higher rate by a commercial lender than it would charge to one of its best customers. This higher rate further discourages defaulting taxpayers from cheaply "borrowing" from the government.

18.123 Bank rates can change frequently, so to avoid administrative costs that would result if the

rate were to change every few days, it is more convenient to establish specific dates on which the rate is set. Some countries may specify in the tax law that the Central Bank rate on the first day of each calendar quarter will serve as the base rate (plus pre-determined surcharge) to be charged on late tax payments for that calendar quarter. Other countries adjust their rate less frequently, but at a minimum the rate should be adjusted annually to account for changing global economic conditions.

18.124 Interest must be assessed on every late payment of tax or penalty, as well as on every payment due from the treasury to the taxpayer. It should be stressed that interest is not the same as a penalty due for non-compliance. Interest reflects the time value of money and should therefore never be waived or subject to compromise. An interest rate which reflects the full cost of money, including inflation, should be specified, typically by reference to the central bank discount rate, a rate on treasury obligations, or the like. To discourage "borrowing from the government," and to encourage the settling of disputes, the interest rate should exceed the basic rate given debtors in the economy. In part because the government is presumably a better credit risk than a defaulting taxpayer, it may be appropriate to provide a lower rate of interest on overpayments than on underpayments.

i. Payment of interest by taxpayer

18.125 A person shall be liable to pay interest to the Central Government on any shortfall in the amount payable under this Act. Interest shall be charged at cascading rates, as prescribed in Table-9 in the Chapter-X. During the first twelve months of default, simple interest shall be charged @ 12% per annum. Thereafter, the rate of interest shall increase by 6% per annum for every next period of twelve months of default. The maximum rate of interest shall be 36% per annum after forty eight months of default. However, in case the person furnishes the bank guarantee, interest shall be charged at reduced rates as prescribed in Table-9A in the Chapter-X.

ii. Payment of interest by Government

18.126 The Central Government shall pay simple interest on any amount refundable under this Act. Interest shall be paid at cascading rates, as prescribed in Table-10 in the Chapter-X. During the first twelve months of delay, simple interest shall be paid @ 6% per annum. Thereafter, the rate of interest shall increase by 3% per annum for every next period of twelve months. The maximum rate of interest shall be 18% per annum after forty eight months of delay.

Q. Payment of cost to taxpayer

18.127 The Department shall pay the cost to a taxpayer in case of delay in disposal of a rectification application, or delay in giving effect to an appellate order, beyond three months from end of the

month in which the rectification application/appeal order is received by the Department. The cost shall be payable at cascading rates, as prescribed in Table-11A in the Chapter-X. During the first 180 days of delay, cost shall be payable @ 100 rupees for each day of delay, which shall increase to 200 rupees per day for the next 180 days. After the first 360 days, cost shall be payable @ 300 rupees for each day of delay, till the date on which the rectification or appeal effect order is passed.

R. Sanctions

18.128 Effective penal provisions in the legal framework are necessary to encourage taxpayers to comply, and there is a considerable body of research into penalties for non-compliance. It should be noted, first, that not all taxpayers deliberately set out to be non-compliant. There are unintended errors and honest mistakes, and sometimes taxpayers simply do not understand how the law applies. As a result, non-compliance can be divided into two categories. The **first** category comprises taxpayers who are non-compliant because (i) they lack sufficient information on how to comply; (ii) the effort to be compliant is too expensive; or (iii) it is too difficult to comply. However, they would probably comply voluntarily if conditions were different.

18.129 The **second** category consists of taxpayers who willfully decide not to comply. These taxpayers may: (i) make an economic decision to evade paying tax, where the costs and risk of detection are less than the perceived benefit of non-compliance; (ii) fundamentally disagree with paying tax because they disagree with the government's policies; or (iii) avoid paying tax through overly aggressive tax planning.

18.130 In all countries, there are a very small number of taxpayers who for a variety of reasons make a conscious decision to be non-compliant. This small group requires the tax administration to expend considerable resources and apply the law to its fullest extent in order to obtain compliance. This is contrasted by the large majority of taxpayers who are generally compliant where it may only be necessary for the tax administration to send the taxpayer a low-cost reminder notice to assist them in complying.

18.131 The taxpayer's perception of the risk of being detected, combined with the taxpayer's perception whether the sanction will actually be imposed, is important. For example, the government willingness to impose sanctions and pursue cases in the courts, where necessary, is a factor in attaining compliance. Thus, when taxpayers know or perceive that their likelihood of being prosecuted in court is negligible, these sanctions become ineffective. The situation can worsen if taxpayers believe that non-compliance is relatively common and goes unpunished. An attitude of "crowd mentality" may emerge, resulting in the quasi- legitimization of non-compliance. This type of non-compliance is difficult to turn around.

In designing a penalty system, several fundamental issues need to be considered. There are-

(i) the rationale for sanctions is to correct or deter non-compliance. Financial penalties should not be viewed as an important source of revenue;

(ii) including imprisonment in the sanctions as an alternative to a monetary penalty can have fiscal implications for governments, and there may also be legal limitations on its use. Prison terms cost the government for facilities, incremental costs for each prisoner, trial costs, etc., and may result in increased expenditures that affect the budget. In addition, the ability to use imprisonment as a sanction should be reserved for the most severe economic crime of criminal fraud;

(iii) financial penalties may be inconsequential to some taxpayers, such as those with a high overall net worth or, conversely, those who lack the resources to pay the penalty. In other situations, where there is inflation, the effect of the sanction could be nullified if payment can legally be delayed long enough. Even well-crafted financial penalties, such as those that are proportionate to the amount due or that increase for subsequent offenses, may still be ineffective. In this circumstance, possibly imprisonment as an alternative penalty would be more effective or even the temporary closure of the business could be considered but their use would be under exceptional circumstances;

(iv) severe sanctions provide the possibility for abuse. This is also particularly important where there is corruption in the tax administration. Therefore, the general guidance for designing penalties to deal with non-compliance is to impose moderate penalties more frequently than by creating an elaborate scheme of penalties containing some provisions that are so severe that they are intended to be rarely applied;

(v) even well-intentioned administrative action to reserve the sanction for punishing presumably rare and severe cases of non-compliance can also be perceived as arbitrary. Thus, when designing sanctions as a deterrent, it is better to ensure that they are relatively light and have programs to detect non-compliance rapidly, as opposed to having severe sanctions that are applied infrequently.

(vi) the amount of penalty should be fair and should have a reasonable chance of being paid. Large penalties are likely to become uncollectible and, thus, will need to be written-off at a later date.

(vii) penalties should be structured to take into account varying degrees of culpability. For example, tax laws generally contain considerably more severe sanctions for cases of fraud, such as financial penalties that are twice as large as normal. Where the payment

is late, the usual approach is to calculate the penalty as a percentage of the amount of tax that is due. In this manner, the penalty is proportionate to the amount of tax that is not paid. Penalties of this type can, however, become excessive, and ultimately uncollectible, if the taxpayer does not pay quickly and the penalty amount continues to grow over time.

18.132 The above considerations are important when designing sanctions for non-compliance with the law. Usually, there are separate penalties for failure to file a tax return and failure to pay tax on time, as each of these acts is a separate form of non-compliance.

18.133 In cases of **delayed payment,** charging interest on penalties for non-compliance serves to protect the real value of the government's revenue, and is considered adequate to discourage non-compliance. Generally, the interest rates are structured to charge higher rates with increase in the period of default. However, **failure to file a tax return** is generally subject to a fixed penalty, rather than a proportion of the amount due. A proportional penalty for late filing leads to difficulties in situations where only a small amount of tax is due, as the small resultant penalty does not have a deterrent effect. Another difficulty with the proportional approach is that there would be no penalty in cases of "nil" returns and information returns. Furthermore, filing a tax return is a key document that is relied upon by tax administrations for determining other actions, such as risk analysis, audit selection, and statistical analysis of the tax base. For these reasons, the penalty is designed to impose a flat amount or a time-varying amount that applies in all cases regardless of the amount of tax that may be declared.

18.134 The more rapidly non-compliance can be detected the more effective the sanction will be as a deterrent. It is human nature for people to discuss, at least in broad terms, how the tax system has treated them or to sometimes boast about how they got away with something. Thus, if non-compliance is detected quickly and sanctions are applied, others in the community will become aware of the efficiency in detecting non-compliance through word of mouth. Identifying non-compliance quickly also affects the taxpayer's subsequent behavior. For example, if a taxpayer fails to file a monthly return and they are notified shortly after the due date that it was not received and an automatic penalty has been applied, this has a higher probability of correcting their behavior for the next monthly return. Secondly, if the failure to file the return was not an honest error and it was not dealt with quickly, there is a greater likelihood that the taxpayer's non-compliant behavior could be repeated. Similarly, it is also human nature to dislike paying a penalty, no matter how small. People may accept a penalty more easily if the rules are clear and known, but they will still take action to avoid being penalized. Therefore, processes and procedures should be designed to assist

in (i) the rapid detection of non-compliance when it occurs; (ii) the application of automatic sanctions; and (iii) the swift notification of the taxpayer.

18.135 Based on the discussions in the foregoing paras relating to the design of the penalty system, we recommend the following structure.

i. Fee

18.136 A person shall be liable to pay a fee in case of failure to furnish any return, statement, form, declaration, report or certificate by the relevant due date. The fee shall be payable at cascading rates, as prescribed in Table-11 in the Chapter-X. During the first 180 days of default, fee shall be payable @ 100 rupees for each day of default, which shall increase to 200 rupees per day for the next 180 days. After the first 360 days, fee shall be payable @ 300 rupees for each day of default till the date of filing.

ii. Additional Income Tax

18.137 In case a person has under reported his tax liability, an additional income-tax shall be charged at the rate of fifty per cent of under reported tax liability for the financial year. The additional income-tax shall be payable in addition to the tax payable, if any. No opportunity of being heard shall be allowed to a person for the purpose of charging additional income-tax under this Act.

iii. Penalty

18.138 The penal provisions under this Act have been designed with a view to ensure certainty of punishment upon non-compliance with the tax laws. Penalty has been broadly classified in two categories (a) penalty for misreporting of income; and (b) penalty for other defaults.

18.139 The quantum of penalty for misreporting shall not be less than, but shall not exceed two times, the tax payable in respect of the misreported income. The misreported income is defined as the total of additions or disallowances made on account of-

(a) misrepresentation of facts;
(b) failure to record investments in the books of account;
(c) claim of expenditure not substantiated by any evidence;
(d) recording of any false entry in the books of account;
(e) failure to record any receipt in books of account having a bearing on the total income; and
(f) failure to report any international transaction or any transaction deemed to be an international transaction or any specified domestic transaction.

18.140 The amount of tax payable in respect of the misreported income shall be calculated at the

maximum marginal rate in order to arrive at the quantum of penalty.

18.141 A person shall be liable to penalty for failure to keep and maintain the books of accounts or other documents or retain such books of account as prescribed in the Act. The quantum of penalty shall not be less than ₹50,000/-, but shall not exceed ₹3,00,000/-.

18.142 Further, penalty shall also be leviable in respect of the following defaults-

(a) failure to answer any question in the course of deposition;

(b) failure to sign any statement;

(c) failure to attend or produce books of accounts or documents;

(d) failure to comply with a notice for tax examination.

18.143 The quantum of penalty for the above defaults shall not be less than ₹10,000/-, but shall not exceed ₹1,00,000/-.

18.144 A Show Cause Notice shall be issued to the person before imposition of any penalty under this Act. The Show Cause Notice can be issued at any time within six months from end of the month in which the default is committed, or the relevant proceedings are completed, or the order of Commissioner (Appeals) or the Tribunal is received, whichever is later. The order imposing a penalty shall be passed within six months form end of the month in which the Show Cause Notice is served.

18.145 A penalty imposed for misreporting of income can be amended or revived, if the misreported income is amended in consequence to an Appellate order. The order amending the penalty can be passed within six months from end of the month in which the order amending the misreported income is passed.

18.146 The Department shall have the power to reduce the penalty, upto 50% of the minimum penalty imposable, having regard to-

(a) co-operation extended during the assessment and recovery proceedings; and

(b) payments made in respect of taxes or any other sum payable under this Act.

iv. Prosecution

18.147 The Act provides for prosecution for offences of a serious nature with a view to create effective deterrence against non-compliance. The salient features of the scheme for prosecution of offences are as under:-

a) Every offence under the Act shall be punishable with both imprisonment and fine.

b) There shall be no mandatory minimum term of imprisonment.

c) The maximum term of imprisonment for certain offences shall be two years or less and such offences shall be prosecuted adopting the procedure of summons trial. In the case of offences where the maximum term of imprisonment is more

than two years, the offence shall be prosecuted adopting the procedure of warrant trial.

d) The minimum and maximum amount of fine for various offences have been stipulated in the Act.

e) The prosecution of an offence under the Act shall be in addition to, and not in derogation of, the provisions of any other law providing for prosecution of offences thereunder.

f) It has been clarified that levy of penalty and prosecution are independent of each other. Any defence that an order of assessment or an order of penalty has not been made, shall not be admissible in a Court of law.

g) Prosecution for an offence shall not be launched except with previous sanction of the Competent Sanctioning Authority, which means the Principal Chief Commissioner, Principal Director General, Chief Commissioner or Director General.

h) The Competent Sanctioning Authority may compound an offence under this Act at the prescribed rates. The compounding of shall be permissible at any time before conviction by the trial court.

i) An offence under this Act shall be tried only by a Court which is not inferior to that of presidency magistrate or a magistrate ofthe first class.

18.148 The Bills provide for prosecution of following offences-

(a) Contravention of any prohibitory order;

(b) Failure to afford facility of inspection to the authorized officer;

(c) Removal, concealment, transfer or delivery of property to thwart tax recovery;

(d) Failure to comply with the provisions of section 313;

(e) Failure to pay the withholding tax;

(f) Willful attempt to evade tax;

(g) Failure to furnish return of income;

(h) Failure to furnish other returns, statements, reports;

(i) Failure to comply with any direction under this Act;

(j) False statement in verification, falsification of books of account or documents;

(k) Abetment of false return; and

(l) Disclosure of information by public servants.

18.149 The Central Government shall have the power to grant immunity from prosecution for any offence having regard to the fact that-

(a) the person has co-operated with the Department in any proceeding under this Act; and

(b) the person has made a full and true disclosure of the whole circumstances relating to the offence.

S. Power to rescind

18.150 The Act expressly provides that the Central Government, the Board, or any Income-tax Authority, shall have all the powers to rescind any notification, approval or order issued under this Act.

T. Disclosure of Information

18.151 The Act prohibits disclosure of information in respect of any taxpayer to any person by-

(a) the Board;

(b) any officer, authority or executive and ministerial staff, in the secretariat, attached office or sub-ordinate office of the Board; or

(c) any person, agency or authority engaged in any manner in the administration of this Act.

18.152 However, the Board, or any person specified by it by an order in this behalf, may furnish, or cause to be furnished, any information in respect of a taxpayer to any other person performing any functions under-

(a) any law relating to the imposition of any tax, duty or cess, or to dealings in foreign currency; or

(b) any other law as the Central Government may, if in its opinion it is necessary so to do in the public interest, specify by notification in the Official Gazette in this behalf.

U. Publication of names of defaulters

18.153 The Central Government may, if it is of the opinion that it is necessary, or expedient, in the public interest, cause to be published in any manner the name and any other particular relating to any proceeding, or prosecution, under this Act in respect of-

(a) any person;

(b) any participant of an unincorporated body; or

(c) any director, managing agent, secretary, treasurer, or manager of the company.

18.154 No publication under this Act shall be made in relation to any penalty imposed until the time for presenting an appeal to the Commissioner (Appeals) has expired without an appeal having been presented or the appeal, if presented, has been disposed of.

V. Power to make rules

18.155 The Board may make rules for the whole or any part of the India for carrying out the purposes of this Act and any order made, proceeding initiated or conducted, or liability or obligation discharged, in accordance with these rules shall be deemed to be made, initiated, conducted or discharged, in accordance of the provisions of this Act. Further, the power to make rules shall include the power to give retrospective effect to the rules so made.

W. Repeal and savings

18.156 The Income-tax Act, 1961 shall be repealed by this Act. However, the proceedings pending or initiated, returns filed or likely to be filed, or appeals pending or likely to be filed before any authority, tribunal or Court, in respect of any year prior to the commencement of this Act, shall be dealt with in accordance with the provisions of Income-tax Act, 1961, as if this Act has not been enacted.

CHAPTER XIX

Miscellaneous

a. Equalization Levy

19.1 If Permanent Establishment (PE) principles are to remain effective in the new economy operating in the digital domain, the fundamental PE rules developed for the old economy i.e. place of business, location, and permanency must be reconciled with the new digital reality. In this regard, the Organization for Economic Cooperation and Development (OECD) under Action plan 1 of Base Erosion and Profit Shifting (BEPS) project has suggested several options to tackle the direct tax challenges. The options *inter-alia* include an option to impose equalization levy on certain payments for digital goods or services provided by a foreign e-commerce provider. The committee on taxation of e-commerce formed by the CBDT, after deliberating on all the options provided by OECD, also recommended equalization levy in the form of final withholding tax option for taxation of digital transactions in India.

19.2 In view of the above, a Chapter titled "Equalization Levy" was inserted in the Act, so as to provide that an equalization levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment ('PE') in India, from a resident in India who carries out business or profession, or from a nonresident having permanent establishment in India.

19.3 Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed one lakh rupees in any financial year.

19.4 In order to avoid double taxation, it is also provided to exempt any such income arising from providing specified services on which equalization levy is chargeable from the ambit of the Income-tax.

19.5 In order to ensure compliance with the provisions of this Chapter, it is further provided that the expenses incurred by the person towards specified services chargeable under this Chapter shall not be allowed as deduction in case of failure of the person to deduct and deposit the equalization levy to the credit of Central government.

b. Old age security to taxpayers

19.6 One of the many concerns expressed in different foras is the fact that the government fails to adequately recognise the role of taxpayers in building the nation. More importantly, small and

medium taxpayers have often expressed anguished over the fact that inspite of payment of tax during their active economic life, the Govenment does not provide them with any kind of old age security.

19.7 In recognition of the above concern, the Task Force recommends that the Government should introduce a scheme to make a one-time annuity deposit in favour of a person so as to contribute, in a limited manner, to his old age security. The following are the key elements of the scheme: -

(i) The amount of annuity depost shall be five percent of the aggregate amount of standard tax liability paid by the person for a period of any fifteen financial years preceeding the eligible year.

(ii) The amount of annuity deposit shall not exceed ₹10 lakhs.

(iii) No annuity shall be provided unless the person has paid tax for a minimum period of fifteen years;

(iv) The annuity shall be provided within three months from the beginning of the eligible year.

(v) The eligible year shall be the later of -

(a) the financial year immediately following the financial year in which the person attains sixty years of age; and

(b) the financial year immediately following the fifteenth financial year in which the person has paid tax under the Income-tax Act.

19.8 The Central Government may formulate a comprehensive scheme within the aforesaid framework to provide for its administration and other checks and balances.

19.9 Since the amount of annuity deposit is linked to tax payment, it will encourage voluntary compliance. The cost of this scheme is estimated to be ₹ 3,000 crores in its first year of implemention.

CHAPTER XX

Impact of the Recommendations

20.1 The implementation of the various recommendations in this Report will have multi-dimensional impact on the country. It is therefore necessary to summarise the same in this Chapter. Table 19.1 shows the distribution of taxpayers across income. Most taxpayers are clustered around the threshold limit. The challenge is to induce them to move up in the income chain.

20.2 In **Model - I,** the various individual based deductions for savings in an assortment of schemes (including housing and children education) have been subsumed in the higher threshold of `6 lakhs. In addition, subject to the EET method of taxation, deductions for savings in the NPS is allowed upto 20 percent of salary for salaried employees and 10 percent of gross total income for the non-salaried. Table 19.2 to Table 19.6 summarizes the impact of the proposed changes; the calculations are based on an analysis of the profile of the entire population of 4.94 crore individual returns filed for assessment year 2017-18 (financial year 2016-17). It provides significant relief to the vast majority of small and marginal taxpayers who cannot avail of most of the tax benefits on account of insufficient cash-flow due to high marginal propensity to consume. Under this Model, taxpayers will have larger amount of free funds to excercise their choice between present consumption and future consumption. To a large extent, it mitigates the impact of higher incidence of GST which is generally the case when such a broad based tax is introduced.This will significantly reduce compliance cost for individual taxpayers.

20.3 In **Model - II**, we have proposed the continuation of personal based deduction and a four rate structure. Tables 19.7 to Table 19.11 summarizes the impact of the proposed changes in Model-II. The difference between the net impact estimated in both Table 19.6 under Model-I and the net impact estimated in Table 19.11 under Model-II is trivial. Both Models have the same impact in terms of revenues.

20.4 The measure of progressivity of the tax schedule i.e. the co-efficient of variation remained almost flat around 1.5 between 1995-96 to 2005-06, and has, thereafter steadily increased to 1.78 in 2018-19. The rate structure proposed in Model - I will lead to a sharp increase in the coefficient of variation to 2.05. Therefore, it will enhance progressivity to the highest level since 1995 (Table 19.13); taxpayers with incomes below ₹6 lakh will not have to bear the burden of complying with a progressive tax. Their contribution to the exchequer by way of consumption tax would be adequate. The taxpayers at the relatively higher level of income will now contribute a relatively higher proportion of the income tax revenues. Our estimate of the progressivity would further increase if the impact of our proposal to levy wealth tax is factored in our calculations.

20.5 At present, exemptions relating to savings are designed to promote gross savings rather than net savings thereby increasing distortions and economic inefficiency. The proposal to eliminate such savings incentives but provide a mechanism for promoting net savings will promote neutrality between present consumption and future consumption.Further, it will also enhance inter-temporal equity of the overall tax system. The existing incentives for savings provide larger benefits to the relatively richer class of taxpayers; however, the EET based taxation of savings will reduce / eliminate this inequity.

20.6 Further, we have recommended the revision in the values of the various perquisites to reflect their fair market value as well as the withdrawal of the exemption for house rent allownace and the perquisite value of accommodation provided by employers. In general, perquisites are provided to the middle and senior employees; any concessional tax treatment of perquisites dilutes the vertical equity of the tax system.Our recommendations on taxation of perquisites will further add to the progressivity of the direct tax system.

20.7 Our recommendations relating to rationalization of the tax treatment of retirement benefits received from employer will ensure that approximately 80 percent of the retirees will remain untaxed, and only the high-paid retirees will be liable to tax. While adding to the progressivity of the tax system, it will also contain future revenue loss since these benefits are likely to baloon in the future with increase in salaries.

20.8 Dividends are now proposed to be taxed at the individual taxpayer level; therefore, most taxpayers will benefit since their personal marginal tax rate will be substantially lower than the total DDT rate. However, this change will not alter the incidence for the promoters / large taxpayers since they will continue to pay tax on dividends at the same rate. In the assessment year 2017-18, an amount of ₹2,37,581 crores have been paid out by companies as dividends of which, ₹1,03,838 crores has been paid out to Central or State Governments. Pursuant to taxation of dividends at the beneficiary level, the dividend distribution tax received on payouts to the Government would be a tax revenue loss. However, the same can be recouped by the Governments by directing the public sector companies to pay higher dividends. Similarly, a large number of share holders are in the tax bracket which is lower than the DDT rate. Therefore, the change in the dividend tax regime would result in an estimated net revenue loss of ₹20,768 crores. However, there will be an estimated gain of ₹5,000 crores on account of branch profit tax (tax on deemed dividend in the case of branches/ permanent establishment of foreign companies). Therefore, the net impact would be an estimated revenue loss of ₹15,768 crores.

20.9 Similarly, the proposals to rationalize the taxation of long-term capital gains on listed equity will also improve the progressivity of the tax system since capital gains are mostly realised by the

relatively richer section of the society. The revenue impact of this proposal is estimated to be a gain of ₹15,000 crores. We have also proposed the abolition of the Securities Transaction Tax (STT) which would result in a revenue loss of ₹8,998 crores. Accordingly, the net revenue impact of rationalising the taxation of long term capital gains is estimated to be ₹6,002 crores.

20.10 Other recommendations which will enhance equity relate to the elimination of various sectoral/activity based incentives and the extensive use of information technology to identify tax evaders.

20.11 It is well recognised that taxpayers tend to bunch around the break in the tax slab; there is emperical evidence to support this phenomena. When the slab rate changes at ₹5 lakhs, we observe a large number of taxpayers reporting taxable income of little under ₹5 lakhs. The two rate personal income tax rate structure will reduce this behaviourial distortion and enable "seamless" reporting of income and enhance voluntary compliance.

20.12 Generally, increase in the threshold limit in personal income tax is discouraged on the consideration that it will lead to shrinking of the taxpayer base. These apprehensions are misplaced. For the wider goal of increasing the tax revenue-to-GDP ratio, the key question should be the total income that is being brought into the tax net, and not the number of taxpayers. Surely, a simple toll tax would bring more tax payers, but that would not give buoyancy to the tax-GDP ratio. In any case, the reported income of a large number of marginal taxpayers can be expected to increase on account of a shift from entity level taxation to taxation of beneficiaries; this can be expected to be further augmented by normal annual increase in income. Most taxpayers who are feared to "drop out" of the tax system will soon come back into it. Also, most taxpayers with incomes of up to ₹6 lakh will continue to file returns on account of our recommendation that all persons who have filed their tax returns over the last three years or have availed housing or car loans from banks should be mandated to continue to file their returns. Therefore the concern that the large number of marginal taxpayers would "drop out" of the tax net is misplaced.

20.13 Under Model - I, business taxation is proposed to be fully rationalized; it is designed as a tax on business surplus or profits determined on cash method of accounting of source based business receipts and expenditure. Under this Model, all receipts (whether capital or revenue) received from India are taxable and all payments within India are deductible. Receipts from outside India is exempt and, similarly payments remitted outside India are not deductible. Further, as against depreciation (partial expensing) for capital expenditure, full expensing is allowed in the year in which the payment is made. The surplus or profit so generated is subject to tax at the rate of (a) 10 percent for banks and financial institutions (including NBFCs) and power producing companies;

and (b) 15 percent for all other companies. Further, under this Model, there is no proposal to levy a minimum alternate tax (MAT). This Model is easy to comply and difficult to evade - simplification at its best.

20.14 Under this Model, there is no distinction between revenue and capital and between debt and equity; like interest, dividend is also deductible as long as it is paid within India. This existing regime for taxation of cross border transactions including transfer pricing is fundamentally transformed to eliminate any scope for base erosion and profit shifting on account of ambiguity in law, fragmented jurisdiction or transfer pricing. Since the tax base under this Model is fairly broad, the rates of taxes are considerably low thereby minimizing economic distortions. The proposed regime will enable India to become an export hub and encourage foreign companies to establish production base in India to exploit its large market.

20.15 More importantly, there is no scope for ambiguity in law arising out of accrual based accounting, characterisation of revenue and capital, timing issues, valuations and cross border transactions; in effect, the proposed tax regime would be litigation 'free'. Consequently, the cost of compliance would be significantly reduced and ease of business enhanced. It would need a relatively small team of people to administer and an equally small team in the private sector to facilitate compliance. Overall, Model-I will establish the most efficient, equitable, simple and feasible tax system.

20.16 The Task Force has made several recommendations relating to taxation of non-natural persons. In general, the non-natural persons (other than companies) are proposed to be treated as pass-thru entities where there will be no taxation at the entity level; however, the beneficiaries of the income distributed by these entities will be liable to pay tax on income so received at their personal marginal rate of tax. This will significantly improve the equity of the tax system. Individuals will be encouraged to pool their small savings with various categories of investment pooling vehicles without being subjected to overtaxation of their income at the entity level. Similarly, individuals will also be encouraged to pool their meagre resources in a partnership firm to carryout their businesses without fear of overtaxation. This will lead to greater formalisation of the Indian economy.

20.17 In **Model - II**, we propose a four rates (5 percent, 10 percent, 20 percent and 30 percent) structure with the threshold limit retained at the existing level of ₹2.5 lakhs. Along with this, we propose to retain individual based deductions for savings in life insurance, children education and provident fund. In addition, subject to the EET method of taxation, deductions for savings in the NPS is allowed upto 20 percent of salary for salaried employees and 10 percent of gross total income for the non-salaried. **Table 19.2** summarizes the impact of the proposed changes; the

calculations are based on an analysis of the profile of the entire population of 4.94 crore individual returns filed for assessment year 2017-18 (financial year 2016-17). Like in **Model - I**, this too provides significant relief to the vast majority of small and marginal taxpayers. However, taxpayers may not be left with sufficient cash flow to maintain their consumption level thereby, adversely impacting GST revenues. To a large extent, the package of recomendations under this Model too will mitigate the impact of higher incidence of GST which is generally the case when such a broad based tax is introduced. However, unlike **Model - I**, the compliance cost for individual taxpayers will be relatively higher.

20.18 In terms of progressivity, this Model will be an improvement over the existing rate structure but not as progressive as in the case of **Model - I**.

20.19 The tax treatment of dividends, capital gains and non-natural personals under the two Models being same, the impact will be as discussed in paras above.

20.20 Under **Model - II**, business taxation will essentially continue on the existing principle of determining profits on accrual method of accounting of global income of residents and source income of non-residents. The corporate income is proposed to be taxed at the rate of 15 percent and complemented by a MAT at a rate depending upon whether the base is gross asset, turnover or EBIDTA. Even though effort has been made to remove ambiguity in law relating to this Model, there are limits in view of the accrual method of accounting, partial expensing, valuation of inventory and the distinction between capital and revenue and between debt and equity. Accordingly, the impact of **Model - II** on efficiency and equity will be limited.

20.21 Taxation per se leads to economic distortions and deadweight loss. The Task Force has attempted to estimate the deadweight loss of corporate tax based on corporate tax elasticity of income. In **Box - 1** in Chapter X, the corporate tax elasticity of income is estimated to be (-) 0.8 that is, a one percent reduction in corporate tax rate will induce an increase of 0.8 percent in the reporting of corporate income. These estimates reinforce the common perception that a reduction in tax rate will induce voluntary compliance. Further, these estimates are relatively higher than estimates in other parts of the World. This is not surprising given that the compliance baseline is relatively low. Based on these elasticity estimates, we estimate the deadweight loss of corporate taxation at 14 percent of corporate revenue collection (35 * 0.8/2). Since our proposal is to reduce the corporate tax rate in **Model - II** to 15 percent, we estimate the deadweight loss to reduce to 6 percent of corporate revenue collection. **Given the fact that the corporate tax collection is around 3.75 percent of GDP, this reduction in the deadweight loss will translate into an increase in the GDP by 0.3 percent.**

20.22 The corporate tax rate proposed in **Model - I** is also 15 percent and the revenue yield is similar to that under **Model - II.** Therefore, the reduction in the deadweight loss under **Model - I** is estimated to be same.

20.23 There are several other proposals which would qualitatively have similar impact on deadweight loss particularly the pass thru treatment of partnership firms. Overall, the gain from reduction in deadweight loss is likely to be significant.

20.24 The sharp reduction in the corporate tax rate will result in an equally sharp reduction in the marginal effective tax rate on return on equity from the existing level of 52.24 percent to 45.3 percent (this based on the assumption that whole of post tax corporate profit is distributed as dividend). In actual practice, corporates tend to adjust their dividend payout policy so that the wedge between debt and equity is nominal. At present, the dividend payout is 20 percent of profit after tax. If we assume no change in the dividend payout policy, the proposed corporate tax rate of 15 percent will effectively result in the METR on return on equity to reduce from 39 percent to 20.1 percent - far below the METR of 30.9 percent on debt. Consequently, the bias against equity will be replaced by bias in favour of equity. This will reduce corporate leverage and bankruptcy risk.

20.25 Yet another important consquence of the reduction in the METR on equity will be a sharp reduction in the weighted average cost of capital and therefore, at the margin, many investment projects would become financially viable. This would also provide the necessary impetus to private sector investment.

20.26 Along with reduction in tax rate for domestic companies, a similar cut has also been propoed for foreign companies. Further, the taxation of dividends at the beneficiary level will enable foreign investors to avail tax credit in their home country (hitherto, no foreign tax credit was available against the dividend distribution tax, except in some countries). Overall, the tax cost of doing business in India will be significantly reduced. Further, the reduction in corporate tax rate to 15 percent will propel India's international ranking on statutory corporate tax rate from 164th position (out of 171 countries) to 26th position of which the top nine countries do not have any corporate income tax. Effectively, India's rank will be elevated to 15th position. Cumulatively, this will substantially improve the international ranking of India as an investment destination.

20.27 Table 19.12 summarises the revenue impact of all the recommendations. The estimates of revenue impact on account of corporate tax restructuring and personal income tax restructuring have been made after factoring the improvement in the level of compliance. In the case of corporate

tax restructuring, the estimate of improvement in the level of compliance is based our estimate of the tax elasticity of corporate profits at (-) 0.8. However, the estimate of improvement in the level of compliance in the case of personal income tax is based on anecdotal information on behavioural response of non-corporate business taxpayers to reduction in tax rates. Overall, the recommendations are projected to result in a revenue gain (both tax and non-tax) of ₹ 16,564 crores to the Centre and ₹9,510 crores to the States in the financial year 2019-20. Given the scale of this direct tax reform exercise, the revenue gains are marginal and therfore, can be broadly considered as revenue neutral. We believe that the various proposals relating to simplification of law and procedure will create a pro-compliance environment, induce voluntary compliance and enhance tax buoyancy; this effect has not been factored in our revenue estimates. To this extent, the estimates of revenue losses are higher and those of revenue gains lower.

20.28 As indicated in the earlier chapters, the existing tax incentives for investment in savings instruments are inefficient. The recommendations to eliminate/rationalize them and introduce the EET based taxation of savings, will improve efficiency of the economic system in as much as it will result in reduction in interest rates. It will encourage net savings and accordingly, help achieve the social objective of promoting genuine long term savings for increasing old age economic security.

20.29 In 2001-02, a NIPFP study commissioned by the Planning Commission had estimated the compliance cost of personal income tax to be as high as 48 per cent. We have been informed that a similar study commissioned by Income-tax Department through ICRIER in 2014-16 has estimated the compliance cost around the same levels. On the face of it, such high compliance cost may appear to be shocking particularly in the context of electronic payment and filing of tax returns. The genesis of such high estimates in percentage terms lies in the low tax rate at the entry point; usually, there is certain minimum cost of compliance which in percentage terms is high or low depending upon the tax rate at the entry point. Since the tax rate at the entry point has now been further reduced from 10 percent to 5 percent, the cost of compliance in percentage terms may have further increased. Mindful of the fact that (i) tax compliance entails a certain minimum compliance cost; and (ii) the burden of compliance cost is regressive, we have, in Model - I, recommended a higher threshold, elimination of personal deductions and allowances and a higher tax rate at the entry point. The cumulative effect of these proposals would be a reduction in the cost of compliance and improvement in progressivity. The proposal to introduce E-assessment so as to eliminate taxpayers interface with tax officials will also add to this effort.

20.30 Very often, any reduction in corporate tax rate is viewed as pro-rich and therefore, politically inconvenient. It is now well-recognised that the burden of corporate tax rate is shifted to labour as

reduced wages, to consumers as higher price of the product and to investors as reduced return on long term savings. In all eventualities, the burden of corporate tax is essentially borne by individuals. Further, corporation is the main vehicle for investment and creating jobs in the private sector; these cannot be created unless all tax barriers (tax cost) and non-tax barriers are eliminated to create a pro-investment climate. Any cut in the corporate tax rate should be viewed as conferring a benefit to individuals; it reduces the tax cost to help address the problem of unemployment, inflation and old-age economic insecurity which are all regressive in their impact.

20.31 One of the arguments advanced against corporate tax cut is the fact that it bestows larger benefits to promoter investors who are generally the richer section of the society. We have sought to address this concern by recommending a comprehensive tax on net wealth (including financial assets) valued at cost or market price whichever is lower with a threshold exemption of ₹10 crores. Consequently, the relief to the promoter investors by cut in corporate tax rates will be substantially neutralised by the incidence of wealth tax.

20.32 Regardless of the above, our proposals are designed to provide greater relief to individual taxpayers relative to corporate taxpayers. Table 19.12 summarises the benefits to these class of taxpayers from our recommendations; while the coporates will directly bear a higher liability of ₹65,102 crores, the individual taxpayers will receive an estimated benefit of ₹44,060 crores in the base financial year 2016-17. However, to the extent individual taxpayers will have higher disposable income, it will be used for consumption or savings. Therefore, the corporates will benefit from higher demand for their products or lower cost of capital due to higher savings. Since the overall impact of our recommendations is revenue neutral, in effect, the impact of the proposal is also revenue neutral across class of taxpayers - corporates and individuals.

20.33 The reduction in corporate tax alongwith restructuring of the base of MAT to have revenue neutrality would have distrubutional implications; it is often argued that the burden of corporate tax reform in the manner recommended by us, may be shifted to loss-making companies who may not have the "ability to pay". The Tax Policy Research Unit of the Department of Revenue had carried out an exercise of clustering companies based on common directors. It was found that most clusters comprised of both profit-making and loss-making companies; the later are, directly or indirectly, "subsidiaries" of the profit-making companies. In effect, the change in the tax burden on the "group" as a whole, may not, generally, be very significant.

20.34 The recommendations have been crafted to give India a truely modern tax system which will be ecnomically efficient and equitable and implemented in a fair and transparent manner. Its full implementation can be expected to result in higher tax buoyancy and help contain fiscal deficit.

TABLE 19.1

Distribution of Returns for Assessment Year 2017-18

SR	SLAB	No of ITRs			Distribution (%)		
		Business	Non-Business	Total	Business	Non-Business	Total
1	Less than 2.5 Lakh	21,40,602	38,79,343	60,19,945	9.77	14.07	12.17
2	2.5 Lakh to 3 Lakh	48,31,843	25,41,802	73,73,645	22.06	9.22	14.91
3	3 Lakh to 3.5 Lakh	52,83,479	24,43,881	77,27,360	24.12	8.87	15.62
4	3.5 Lakh to 4 Lakh	25,39,562	20,83,044	46,22,606	11.59	7.56	9.35
5	4 Lakh to 4.5 Lakh	16,70,591	21,32,231	38,02,822	7.63	7.74	7.69
6	4.5 Lakh to 5 Lakh	12,24,356	20,51,723	32,76,079	5.59	7.44	6.62
7	5 Lakh to 6 Lakh	13,55,724	30,22,007	43,77,731	6.19	10.96	8.85
8	6 Lakh to 7.5 Lakh	10,01,250	32,28,095	42,29,345	4.57	11.71	8.55
9	7.5 Lakh to 10 Lakh	7,14,409	27,10,849	34,25,258	3.26	9.84	6.92
10	10 Lakh to 12 Lakh	3,15,760	10,74,774	13,90,534	1.44	3.90	2.81
11	12 Lakh to 15 Lakh	2,59,756	8,24,914	10,84,670	1.19	2.99	2.19
12	15 Lakh to 20 Lakh	2,09,016	6,52,136	8,61,152	0.95	2.37	1.74
13	20 Lakh to 25 Lakh	1,04,395	3,28,682	4,33,077	0.48	1.19	0.88
14	25 Lakh to 50 Lakh	1,62,127	4,23,682	5,85,809	0.74	1.54	1.18
15	50 Lakh to 1 Crore	60,712	1,12,699	1,73,411	0.28	0.41	0.35
16	Above 1 Crore	29,326	52,961	82,287	0.13	0.19	0.17
TOTAL		**2,19,02,908**	**2,75,62,823**	**4,94,65,731**	**100.00**	**100.00**	**100.00**

TABLE 19.2

Model-I: IMPACT OF CHANGES IN PERSONAL INCOME TAX REGIME ON INDIVIDUAL BUSINESS TAXPAYERS

BASE YEAR AY 2017-18

SR	Slab	Total PANs	Existing Regime					New Regime (Without NPS)			New Regime (With NPS)			Change in liability per Taxpayer	
			GTI per Taxpayer	Chap VIA Deduction per Taxpayer	Total Income per Taxpayer	Tax per Taxpayer (incl. cap gains tax)	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Without NPS	With NPS
1	<2.5 Lakh	21,40,602	1,75,678	9,337	1,66,341	105	22	1,76,322	-	-	1,58,690	-	-	(105)	(105)
2	2.5 Lakh to 3 Lakh	48,31,843	2,83,169	6,814	2,76,356	1,379	666	2,83,538	-	-	2,55,185	-	-	(1,379)	(1,379)
3	3 Lakh to 3.5 Lakh	52,83,479	3,20,737	20,900	2,99,837	2,564	1,355	3,21,166	-	-	2,89,049	-	-	(2,564)	(2,564)
4	3.5 Lakh to 4 Lakh	25,39,562	3,70,886	51,879	3,19,007	3,597	913	3,71,750	-	-	3,34,575	-	-	(3,597)	(3,597)
5	4 Lakh to 4.5 Lakh	16,70,591	4,21,509	83,539	3,37,969	4,636	774	4,22,909	-	-	3,80,619	-	-	(4,636)	(4,636)
6	4.5 Lakh to 5 Lakh	12,24,356	4,71,383	1,02,231	3,69,152	6,294	771	4,73,369	-	-	4,26,032	-	-	(6,294)	(6,294)
7	5 Lakh to 6 Lakh	13,55,724	5,38,601	1,10,017	4,28,584	9,463	1,283	5,41,735	-	-	4,87,562	-	-	(9,463)	(9,463)
8	6 Lakh to 7.5 Lakh	10,01,250	6,58,123	1,25,143	5,32,979	20,038	2,006	6,63,621	9,543	956	5,97,259	-	-	(10,495)	(20,038)
9	7.5 Lakh to 10 Lakh	7,14,409	8,48,211	1,28,649	7,19,562	58,319	4,166	8,59,162	38,874	2,777	7,73,246	25,987	1,857	(19,444)	(32,332)
10	10 Lakh to 12 Lakh	3,15,760	10,73,507	1,36,266	9,37,240	1,03,279	3,261	10,92,419	73,863	2,332	9,83,177	57,476	1,815	(29,416)	(45,802)
11	12 Lakh to 15 Lakh	2,59,756	13,03,818	1,43,290	11,60,528	1,65,901	4,309	13,33,215	1,09,982	2,857	11,99,894	89,984	2,337	(55,919)	(75,917)
12	15 Lakh to 20 Lakh	2,09,016	16,66,967	1,48,689	15,18,278	2,76,930	5,788	17,16,478	1,67,472	3,500	15,44,830	1,41,724	2,962	(1,09,458)	(1,35,206)
13	20 Lakh to 25 Lakh	1,04,395	21,44,528	1,52,776	19,91,752	4,24,830	4,435	22,25,283	2,77,585	2,898	20,02,754	2,10,826	2,201	(1,47,245)	(2,14,003)
14	25 Lakh to 50 Lakh	1,62,127	32,24,391	1,58,129	30,66,262	7,65,377	12,409	34,01,869	6,30,561	10,223	30,61,682	5,28,505	8,568	(1,34,817)	(2,36,873)
15	50 Lakh to 1 Crore	60,712	64,45,739	1,72,179	62,73,560	17,87,505	10,852	69,42,036	16,92,611	10,276	62,47,832	14,84,350	9,012	(94,895)	(3,03,156)
16	Above 1 Crore	29,325	2,43,80,326	3,70,060	2,40,10,266	76,79,299	22,520	2,78,61,719	79,68,516	23,368	2,50,75,547	71,32,664	20,917	2,89,217	(5,46,634)
	TOTAL (BUSINESS)	2,19,02,907					75,532			59,187			49,669		

TABLE 19.3

Model-I: IMPACT OF CHANGES IN PERSONAL INCOME TAX REGIME ON INDIVIDUAL NON-BUSINESS TAXPAYERS

BASE YEAR AY 2017-18

SR	Slab	Total PANs	Existing Regime					New Regime (Without NPS)			New Regime (With NPS)			Change in liability per Taxpayer	
			GTI per Taxpayer	Chap VIA Deduction per Taxpayer	Total Income per Taxpayer	Tax per Taxpayer (incl. cap gains tax)	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Without NPS	With NPS
1	<2.5 Lakh	38,79,343	1,47,814	12,394	1,35,420	365	142	1,49,952	-	-	1,34,957	-	-	(365)	(365)
2	2.5 Lakh to 3 Lakh	25,41,802	2,77,265	17,924	2,59,341	729	185	2,78,781	-	-	2,50,903	-	-	(729)	(729)
3	3 Lakh to 3.5 Lakh	24,43,881	3,22,070	38,131	2,83,939	1,954	478	3,23,562	-	-	2,91,206	-	-	(1,954)	(1,954)
4	3.5 Lakh to 4 Lakh	20,83,044	3,73,215	70,339	3,02,876	2,910	606	3,74,764	-	-	3,37,287	-	-	(2,910)	(2,910)
5	4 Lakh to 4.5 Lakh	21,32,231	4,24,090	1,01,795	3,22,294	3,874	826	4,25,593	-	-	3,83,034	-	-	(3,874)	(3,874)
6	4.5 Lakh to 5 Lakh	20,51,723	4,72,684	1,19,964	3,52,720	5,391	1,106	4,74,167	-	-	4,26,750	-	-	(5,391)	(5,391)
7	5 Lakh to 6 Lakh	30,22,007	5,45,619	1,30,828	4,14,790	8,536	2,580	5,47,339	-	-	4,92,605	-	-	(8,536)	(8,536)
8	6 Lakh to 7.5 Lakh	32,28,095	6,66,518	1,43,759	5,22,759	17,423	5,624	6,68,652	10,298	3,324	6,01,786	268	87	(7,126)	(17,155)
9	7.5 Lakh to 10 Lakh	27,10,849	8,54,250	1,53,123	7,01,127	53,397	14,475	8,58,056	38,708	10,493	7,72,250	25,838	7,004	(14,688)	(27,559)
10	10 Lakh to 12 Lakh	10,74,774	10,83,715	1,59,347	9,24,368	98,630	10,601	10,90,755	73,613	7,912	9,81,679	57,252	6,153	(25,017)	(41,378)
11	12 Lakh to 15 Lakh	8,24,914	13,18,980	1,64,099	11,54,881	1,61,132	13,292	13,31,013	1,09,652	9,045	11,97,912	89,687	7,398	(51,480)	(71,445)
12	15 Lakh to 20 Lakh	6,52,136	16,96,470	1,68,749	15,27,721	2,74,848	17,924	17,18,487	1,67,773	10,941	15,46,638	1,41,996	9,260	(1,07,075)	(1,32,852)
13	20 Lakh to 25 Lakh	3,28,682	21,86,817	1,72,075	20,14,742	4,23,874	13,932	22,24,320	2,77,296	9,114	20,01,888	2,10,566	6,921	(1,46,578)	(2,13,308)
14	25 Lakh to 50 Lakh	4,23,682	32,15,577	1,75,358	30,40,218	7,45,307	31,577	33,25,977	6,07,793	25,751	29,93,380	5,08,014	21,524	(1,37,514)	(2,37,293)
15	50 Lakh to 1 Crore	1,12,699	63,58,480	1,81,523	61,76,957	17,51,822	19,743	68,13,605	16,54,081	18,641	61,32,244	14,49,673	16,338	(97,741)	(3,02,149)
16	Above 1 Crore	52,961	2,06,11,614	2,21,790	2,03,89,824	69,74,392	36,937	2,60,17,050	74,15,115	39,271	2,34,15,345	66,34,603	35,138	4,40,723	(3,39,788)
TOTAL (NON-BUSINESS)		2,75,62,823					1,70,027			1,34,493			1,09,822		

TABLE 19.4

Model-I: IMPACT OF CHANGES IN PERSONAL INCOME TAX REGIME ON ALL INDIVIDUAL TAXPAYERS

BASE YEAR AY 2017-18

SR	Slab	Total PANs	Existing Regime					New Regime (Without NPS)			New Regime (With NPS)			Change in liability per Taxpayer	
			GTI per Taxpayer	Chap VIA Deduction per Taxpayer	Total Income per Taxpayer	Tax per Taxpayer (incl. cap gains tax)	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Without NPS	With NPS
1	<2.5 Lakh	60,19,945	1,57,722	11,307	1,46,415	273	164	1,59,329	-	-	1,43,396	-	-	(273)	(273)
2	2.5 Lakh to 3 Lakh	73,73,645	2,81,134	10,644	2,70,490	1,155	852	2,81,898	-	-	2,53,709	-	-	(1,155)	(1,155)
3	3 Lakh to 3.5 Lakh	77,27,360	3,21,159	26,350	2,94,809	2,371	1,832	3,21,924	-	-	2,89,731	-	-	(2,371)	(2,371)
4	3.5 Lakh to 4 Lakh	46,22,606	3,71,936	60,198	3,11,738	3,287	1,519	3,73,108	-	-	3,35,797	-	-	(3,287)	(3,287)
5	4 Lakh to 4.5 Lakh	38,02,822	4,22,956	93,775	3,29,181	4,209	1,600	4,24,414	-	-	3,81,973	-	-	(4,209)	(4,209)
6	4.5 Lakh to 5 Lakh	32,76,079	4,72,198	1,13,337	3,58,861	5,729	1,877	4,73,869	-	-	4,26,482	-	-	(5,729)	(5,729)
7	5 Lakh to 6 Lakh	43,77,731	5,43,445	1,24,383	4,19,062	8,823	3,862	5,45,604	-	-	4,91,043	-	-	(8,823)	(8,823)
8	6 Lakh to 7.5 Lakh	42,29,345	6,64,530	1,39,352	5,25,179	18,042	7,631	6,67,461	10,119	4,280	6,00,715	107	45	(7,923)	(17,935)
9	7.5 Lakh to 10 Lakh	34,25,258	8,52,991	1,48,018	7,04,972	54,423	18,641	8,58,286	38,743	13,270	7,72,458	25,869	8,861	(15,680)	(28,555)
10	10 Lakh to 12 Lakh	13,90,534	10,81,397	1,54,106	9,27,291	99,686	13,862	10,91,132	73,670	10,244	9,82,019	57,303	7,968	(26,016)	(42,383)
11	12 Lakh to 15 Lakh	10,84,670	13,15,349	1,59,116	11,56,233	1,62,274	17,601	13,31,540	1,09,731	11,902	11,98,386	89,758	9,736	(52,543)	(72,516)
12	15 Lakh to 20 Lakh	8,61,152	16,89,309	1,63,880	15,25,429	2,75,353	23,712	17,17,999	1,67,700	14,442	15,46,199	1,41,930	12,222	(1,07,653)	(1,33,423)
13	20 Lakh to 25 Lakh	4,33,077	21,76,623	1,67,423	20,09,200	4,24,105	18,367	22,24,552	2,77,366	12,012	20,02,097	2,10,629	9,122	(1,46,739)	(2,13,475)
14	25 Lakh to 50 Lakh	5,85,809	32,18,016	1,70,590	30,47,426	7,50,862	43,986	33,46,981	6,14,094	35,974	30,12,283	5,13,685	30,092	(1,36,767)	(2,37,177)
15	50 Lakh to 1 Crore	1,73,411	63,89,030	1,78,252	62,10,778	17,64,315	30,595	68,58,569	16,67,571	28,918	61,72,712	14,61,814	25,349	(96,744)	(3,02,502)
16	Above 1 Crore	82,286	2,19,54,704	2,74,630	2,16,80,073	72,25,606	59,457	2,66,74,451	76,12,335	62,639	2,40,07,006	68,12,102	56,054	3,86,730	(4,13,504)
	TOTAL	4,94,65,730					2,45,559			1,93,681			1,59,450		

TABLE 19.5
Model-I: Impact of PIT Reforms

S No	Nature of Regime	Business	Non-Business	Total	Impact
I	Existing Regime	75,532	1,70,027	2,45,559	-
II	New Regime - Tax Rate Changes - Capital Gains Tax at Slab Rate - No Incentives	59,187	1,34,493	1,93,681	(51,878)
III	New Regime - Tax Rate Changes - Capital Gains Tax at Slab Rate - No Incentives - Deduction for NPS Contribution	49,663	1,09,822	1,59,450	(86,109)

Note: Tax Rates 0-6 L Nil, 6-20 L 15%, above 20 L 30%.

TABLE 19.6
Model-I: Summary of Impact of PIT Changes

S No		Description	Value
1		Revenue Loss	(86,109)
2		Less	
	i.	Improved Compliance by Business Assessees	25,869
	ii.	Partial Taxation of Retirement Benefits	-
	iii.	Limitation on Interest on Housing	4,000
	iv.	Rationalisation of Perquisite	8,000
	v.	House Rent Allowance	7,500
3		Net Revenue Impact	(40,740)

TABLE 19.7

Model-II: IMPACT OF CHANGES IN PERSONAL INCOME TAX REGIME ON INDIVIDUAL BUSINESS TAXPAYERS

BASE YEAR AY 2017-18

SR	Slab	Total PANs	Existing Regime					New Regime (Without NPS)			New Regime (With NPS)			Change in liability per Taxpayer	
			GTI per Taxpayer	Chap VIA Deduction per Taxpayer	Total Income per Taxpayer	Tax per Taxpayer (incl. cap gains tax)	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Without NPS	With NPS
1	<2.5 Lakh	21,40,602	1,75,678	9,337	1,66,341	105	22	1,66,985	-	-	1,50,286	-	-	(105)	(105)
2	2.5 Lakh to 3 Lakh	48,31,843	2,83,169	6,814	2,76,356	1,379	666	2,76,725	1,336	646	2,49,052	-	-	(43)	(1,379)
3	3 Lakh to 3.5 Lakh	52,83,479	3,20,737	20,900	2,99,837	2,564	1,355	3,00,266	2,513	1,328	2,70,239	1,012	535	(51)	(1,552)
4	3.5 Lakh to 4 Lakh	25,39,562	3,70,886	51,879	3,19,007	3,597	913	3,19,871	3,494	887	2,87,884	1,894	481	(103)	(1,702)
5	4 Lakh to 4.5 Lakh	16,70,591	4,21,509	83,539	3,37,969	4,636	774	3,39,370	4,469	747	3,05,433	2,772	463	(168)	(1,864)
6	4.5 Lakh to 5 Lakh	12,24,356	4,71,383	1,02,231	3,69,152	6,294	771	3,71,138	6,057	742	3,34,024	4,201	514	(237)	(2,093)
7	5 Lakh to 6 Lakh	13,55,724	5,38,601	1,10,017	4,28,584	9,463	1,283	4,31,718	9,086	1,232	3,88,546	6,927	939	(377)	(2,535)
8	6 Lakh to 7.5 Lakh	10,01,250	6,58,123	1,25,143	5,32,979	20,038	2,006	5,38,478	16,348	1,637	4,84,630	11,731	1,175	(3,691)	(8,307)
9	7.5 Lakh to 10 Lakh	7,14,409	8,48,211	1,28,649	7,19,562	58,319	4,166	7,30,513	35,551	2,540	6,57,462	28,246	2,018	(22,767)	(30,073)
10	10 Lakh to 12 Lakh	3,15,760	10,73,507	1,36,266	9,37,240	1,03,279	3,261	9,56,152	58,115	1,835	8,60,537	48,554	1,533	(45,163)	(54,725)
11	12 Lakh to 15 Lakh	2,59,756	13,03,818	1,43,290	11,60,528	1,65,901	4,309	11,89,925	1,00,485	2,610	10,70,933	76,687	1,992	(65,416)	(89,215)
12	15 Lakh to 20 Lakh	2,09,016	16,66,967	1,48,689	15,18,278	2,76,930	5,788	15,67,789	1,76,058	3,680	14,11,010	1,44,702	3,025	(1,00,872)	(1,32,228)
13	20 Lakh to 25 Lakh	1,04,395	21,44,528	1,52,776	19,91,752	4,24,830	4,435	20,72,506	2,77,001	2,892	18,65,256	2,35,551	2,459	(1,47,829)	(1,89,279)
14	25 Lakh to 50 Lakh	1,62,127	32,24,391	1,58,129	30,66,262	7,65,377	12,409	32,43,740	5,35,622	8,684	29,19,366	4,46,373	7,237	(2,29,755)	(3,19,004)
15	50 Lakh to 1 Crore	60,712	64,45,739	1,72,179	62,73,560	17,87,505	10,852	67,69,857	15,93,457	9,674	60,92,872	13,90,362	8,441	(1,94,048)	(3,97,144)
16	Above 1 Crore	29,325	2,43,80,326	3,70,060	2,40,10,266	76,79,299	22,520	2,74,91,659	78,09,998	22,903	2,47,42,493	69,85,248	20,484	1,30,699	(6,94,051)
TOTAL (BUSINESS)		2,19,02,907					75,532			62,035			51,296		

TABLE 19.8

Model-II:IMPACT OF CHANGES IN PERSONAL INCOME TAX REGIME ON INDIVIDUAL NON-BUSINESS TAXPAYERS

BASE YEAR AY 2017-18

SR	Slab	Total PANs	Existing Regime					New Regime (Without NPS)			New Regime (With NPS)			Change in liability per Taxpayer	
			GTI per Taxpayer	Chap VIA Deduction per Taxpayer	Total Income per Taxpayer	Tax per Taxpayer (incl. cap gains tax)	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Without NPS	With NPS
1	<2.5 Lakh	38,79,343	1,47,814	12,394	1,35,420	365	142	1,37,558	-	-	1,23,802	-	-	(365)	(365)
2	2.5 Lakh to 3 Lakh	25,41,802	2,77,265	17,924	2,59,341	729	185	2,60,857	543	138	2,34,771	-	-	(186)	(729)
3	3 Lakh to 3.5 Lakh	24,43,881	3,22,070	38,131	2,83,939	1,954	478	2,85,431	1,772	433	2,56,888	344	84	(183)	(1,610)
4	3.5 Lakh to 4 Lakh	20,83,044	3,73,215	70,339	3,02,876	2,910	606	3,04,425	2,721	567	2,73,982	1,199	250	(188)	(1,711)
5	4 Lakh to 4.5 Lakh	21,32,231	4,24,090	1,01,795	3,22,294	3,874	826	3,23,798	3,690	787	2,91,418	2,071	442	(184)	(1,803)
6	4.5 Lakh to 5 Lakh	20,51,723	4,72,684	1,19,964	3,52,720	5,391	1,106	3,54,203	5,210	1,069	3,18,783	3,439	706	(181)	(1,952)
7	5 Lakh to 6 Lakh	30,22,007	5,45,619	1,30,828	4,14,790	8,536	2,580	4,16,511	8,326	2,516	3,74,860	6,243	1,887	(210)	(2,293)
8	6 Lakh to 7.5 Lakh	32,28,095	6,66,518	1,43,759	5,22,759	17,423	5,624	5,24,893	14,989	4,839	4,72,403	11,120	3,590	(2,434)	(6,303)
9	7.5 Lakh to 10 Lakh	27,10,849	8,54,250	1,53,123	7,01,127	53,397	14,475	7,04,933	32,993	8,944	6,34,440	25,944	7,033	(20,403)	(27,453)
10	10 Lakh to 12 Lakh	10,74,774	10,83,715	1,59,347	9,24,368	98,630	10,601	9,31,407	55,641	5,980	8,38,267	46,327	4,979	(42,989)	(52,304)
11	12 Lakh to 15 Lakh	8,24,914	13,18,980	1,64,099	11,54,881	1,61,132	13,292	11,66,914	95,883	7,910	10,50,223	72,545	5,984	(65,249)	(88,588)
12	15 Lakh to 20 Lakh	6,52,136	16,96,470	1,68,749	15,27,721	2,74,848	17,924	15,49,738	1,72,448	11,246	13,94,764	1,41,453	9,225	(1,02,400)	(1,33,395)
13	20 Lakh to 25 Lakh	3,28,682	21,86,817	1,72,075	20,14,742	4,23,874	13,932	20,52,245	2,72,949	8,971	18,47,020	2,31,904	7,622	(1,50,925)	(1,91,970)
14	25 Lakh to 50 Lakh	4,23,682	32,15,577	1,75,358	30,40,218	7,45,307	31,577	31,50,619	5,07,686	21,510	28,35,557	4,29,611	18,202	(2,37,622)	(3,15,696)
15	50 Lakh to 1 Crore	1,12,699	63,58,480	1,81,523	61,76,957	17,51,822	19,743	66,32,082	15,52,124	17,492	59,68,873	13,53,162	15,250	(1,99,698)	(3,98,660)
16	Above 1 Crore	52,961	2,06,11,614	2,21,790	2,03,89,824	69,74,392	36,937	2,57,95,260	73,01,078	38,667	2,32,15,734	65,27,220	34,569	3,26,686	(4,47,171)
TOTAL (NON-BUSINESS)		2,75,62,823					1,70,027			1,31,068			1,09,821		

TABLE 19.9

Model-II: IMPACT OF CHANGES IN PERSONAL INCOME TAX REGIME ON ALL INDIVIDUAL TAXPAYERS

BASE YEAR AY 2017-18

SR	Slab	Total PANs	Existing Regime					New Regime (Without NPS)			New Regime (With NPS)			Change in liability per Taxpayer	
			GTI per Taxpayer	Chap VIA Deduction per Taxpayer	Total Income per Taxpayer	Tax per Taxpayer (incl. cap gains tax)	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Total Income per Taxpayer	Tax per Taxpayer	Total Tax	Without NPS	With NPS
1	<2.5 Lakh	60,19,945	1,57,722	11,307	1,46,415	273	164	1,48,022	-	-	1,33,219	-	-	(273)	(273)
2	2.5 Lakh to 3 Lakh	73,73,645	2,81,134	10,644	2,70,490	1,155	852	2,71,255	1,063	784	2,44,129	-	-	(92)	(1,155)
3	3 Lakh to 3.5 Lakh	77,27,360	3,21,159	26,350	2,94,809	2,371	1,832	2,95,574	2,279	1,761	2,66,017	801	619	(92)	(1,570)
4	3.5 Lakh to 4 Lakh	46,22,606	3,71,936	60,198	3,11,738	3,287	1,519	3,12,911	3,146	1,454	2,81,620	1,581	731	(141)	(1,706)
5	4 Lakh to 4.5 Lakh	38,02,822	4,22,956	93,775	3,29,181	4,209	1,600	3,30,639	4,032	1,533	2,97,575	2,379	905	(177)	(1,830)
6	4.5 Lakh to 5 Lakh	32,76,079	4,72,198	1,13,337	3,58,861	5,729	1,877	3,60,532	5,527	1,811	3,24,479	3,724	1,220	(202)	(2,005)
7	5 Lakh to 6 Lakh	43,77,731	5,43,445	1,24,383	4,19,062	8,823	3,862	4,21,220	8,561	3,748	3,79,098	6,455	2,826	(262)	(2,368)
8	6 Lakh to 7.5 Lakh	42,29,345	6,64,530	1,39,352	5,25,179	18,042	7,631	5,28,109	15,311	6,476	4,75,298	11,265	4,764	(2,732)	(6,778)
9	7.5 Lakh to 10 Lakh	34,25,258	8,52,991	1,48,018	7,04,972	54,423	18,641	7,10,268	33,527	11,484	6,39,241	26,424	9,051	(20,896)	(27,999)
10	10 Lakh to 12 Lakh	13,90,534	10,81,397	1,54,106	9,27,291	99,686	13,862	9,37,026	56,203	7,815	8,43,324	46,832	6,512	(43,483)	(52,853)
11	12 Lakh to 15 Lakh	10,84,670	13,15,349	1,59,116	11,56,233	1,62,274	17,601	11,72,425	96,985	10,520	10,55,182	73,536	7,976	(65,289)	(88,738)
12	15 Lakh to 20 Lakh	8,61,152	16,89,309	1,63,880	15,25,429	2,75,353	23,712	15,54,119	1,73,324	14,926	13,98,707	1,42,241	12,249	(1,02,029)	(1,33,112)
13	20 Lakh to 25 Lakh	4,33,077	21,76,623	1,67,423	20,09,200	4,24,105	18,367	20,57,129	2,73,926	11,863	18,51,416	2,32,783	10,081	(1,50,179)	(1,91,321)
14	25 Lakh to 50 Lakh	5,85,809	32,18,016	1,70,590	30,47,426	7,50,862	43,986	31,76,391	5,15,417	30,194	28,58,752	4,34,250	25,439	(2,35,444)	(3,16,611)
15	50 Lakh to 1 Crore	1,73,411	63,89,030	1,78,252	62,10,778	17,64,315	30,595	66,80,318	15,66,595	27,166	60,12,286	13,66,186	23,691	(1,97,720)	(3,98,129)
16	Above 1 Crore	82,286	2,19,54,704	2,74,630	2,16,80,073	72,25,606	59,457	2,63,99,821	74,82,446	61,570	2,37,59,839	66,90,452	55,053	2,56,841	(5,35,154)
	TOTAL	4,94,65,730					2,45,559			1,93,103			1,61,117		

TABLE 19.10
Model-II: Impact of PIT Reforms

S No	Nature of Regime	Business	Non-Business	Total	Impact
I	Existing Regime	75,532	1,70,027	2,45,559	-
II	New Regime - Tax Rate Changes - Capital Gains Tax at Slab Rate - No Incentives	62,035	1,31,068	1,93,103	(52,456)
III	New Regime - Tax Rate Changes - Capital Gains Tax at Slab Rate - No Incentives - Deduction for NPS Contribution	51,296	1,09,821	1,61,117	(84,442)

Note: Tax Rates 0-2.5 L Nil, 2.5-5 L 5%, 5-10 L 10 %, 10-30 L 20 %, above 30 L 30%.

TABLE 19.11
Model-II: PIT Revenue Impact Reconciliation

S No		Description	Value
1	Revenue Loss		(84,442)
2	Less		
	i.	Improved Compliance by Business Assessees	24,236
	ii.	Partial Taxation of Retirement Benefits	-
	iii.	Limitation on Interest on Housing	4,000
	iv.	Rationalisation of Perquisite	8,000
	v.	House Rent Allowance	7,500
3	Net Revenue Impact		(40,706)

Table 19.12
Summary of Revenue Impact

Sl. No	Description	Amount (in Crs)
1	Corporate Tax Restructuring	26,976
2	Restructuring Source Rule	38,126
3	Dividend Taxation	-20,768
4	Capital Gains Restructuring	15,000
5	Abolition of STT	-8,998
6	PIT Restructuring	-40,062
7	Change in partnership taxation	-10,000
8	Change in insurance taxation	-7,992
8	Deemed dividend on foreign companies	5,000
9	Total	-2,718
10	Centre's Share	-1,576
11	State's Share	-1,142
12	Additional Dividend to Centre	13,000
13	Additional Dividend to State	7,700
14	Centre's Gain (2016-17)	11,424
15	State's Gain (2016-17)	6,558
16	Centre's Gain (2019-20)	16,564
17	State's Gain (2019-20)	9,510

Note: Base year FY 2016-17

Table 19.13
Trend of Progressivity of personal Income Tax Schedule

Assessment Year	Coefficient of variation (Tax Liability)	
	Model I	Model II
1995-96	1.483	1.483
1996-97	1.484	1.484
1997-98	1.486	1.486
1998-99	1.495	1.495
1999-00	1.497	1.497
2000-01	1.497	1.497
2001-02	1.497	1.497
2002-03	1.497	1.497
2003-04	1.497	1.497
2004-05	1.506	1.506
2005-06	1.506	1.506
2006-07	1.547	1.547
2007-08	1.547	1.547
2008-09	1.549	1.549
2009-10	1.607	1.607
2010-11	1.605	1.605
2011-12	1.656	1.656
2012-13	1.661	1.661
2013-14	1.681	1.681
2014-15	1.719	1.719
2015-16	1.728	1.728
2016-17	1.736	1.736
2017-18	1.748	1.748
2018-19	1.783	1.783
Proposed	2.048	1.953

CHAPTER XXI

Summary of Tax Proposals

A. Place of Taxation (Chapter – IV)

I. Scope of Total Income: Residence based taxation versus Source based taxation

(a) India should abandon the existing hybrid of residence-based taxation (global or world-wide taxation) and source based taxation (territorial based taxation) in favour of a comprehensive source based taxation;

(b) in confirmity with the principle of territorial taxation, any income derived from a source outside India will not be included in the total income of the person;

(c) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(d) the total income of a person will comprise of only income derived from a source in India;

(e) income shall be construed to have been derived from a source in India, if the payment has been made from India;

(f) In order to prevent potential abuse of this new rule, a payment shall be deemed to be made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year.

(g) the following income shall be construed to have been derived from a source in India, namely: -

(i) income in respect of employment, outside India, if the employer is the Government;

(ii) income of a non-resident from alienation, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, to the extent attributable to assets located in India, if, -

(1) such company or entity directly, or indirectly, owns the assets situated in India; or

(2) the shares or interest derives, directly or indirectly, its value substantially from the assets located in India.

(h) there will be no distinction between resident and non resident;

(i) tax shall be withheld (deducted at source) on every payment made by a person (including Government and all other exempt person) from India to any person outside India;

(j) the rate of withholding tax will be equal to the corporate tax rate.

This comprehensive source rule has the advantage of a unified rule and rate for all types of income. It has the advantage of being simple, eliminating all uncertainty and reducing cost of compliance and administration.

Alternatively

India may continue with the hybrid method of residence-based taxation and source-based taxation and also continue to maintain a distinction between a resident and a non-resident. Therefore,

a) in conformity with the principle of global taxation, the total income of a resident will comprise of his global income i.e., income derived from both a source in India and a source outside India;

(b) the total income of a non resident shall be the income derived from a source in India;

(c) income shall be construed to have been derived from a source in India, if the payment has been made from India.

(d) in order to prevent potential abuse of this new rule, a payment shall be deemed to be made from India, if it is (i) for any goods or services which is consumed in India; (ii) towards interest, dividend, bonus, or any other form of return on capital (by whatever name called) which is utilised in India; and (iii) for any purpose and the amount is eligible for, or claimed as, a deduction in computing the total income of the person making the payment in the same, or any other, financial year;

(e) the following income shall be construed to have been derived from a source in India, namely: -

(i) income in respect of employment, outside India, if the employer is the Government;

(ii) income of a non-resident from alienation, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, to the extent attributable to assets located in India, if, -

(1) such company or entity directly, or indirectly, owns the assets situated in India; or

(2) the shares or interest derives, directly or indirectly, its value substantially from the assets located in India.

(f) tax shall be withheld (deducted at source) on every income which is construed as having been derived from a source in India under (c), (d) and (e) above.

II. Test for residency

1. Under the Act, the residential status of an individual in a financial year will continue to be determined on the basis of his stay in India during the financial year and the earlier years. He would be a resident in India if, -
   (a) he is in India for 182 days or more during the financial year; or
   (b) he is in India for 365 days or more during the four years immediately preceding the financial year and for 60 days or more in the financial year.
2. The residency of an individual will be determined only on the basis of the test specified in sub para (a) in the case of,-
   (a) an Indian citizen who leaves India during the financial year for the purpose of employment outside India with an employer;
   (b) an Indian citizen who leaves India as a member of a crew of an Indian ship; and
   (c) an Indian citizen or a person of Indian origin, who comes to India on a visit during the financial year.
3. However, an individual will be treated as a resident, if he is a citizen of India and not liable to tax in any other country or territory by reason of his domicile or residence regardless of the fact that he is not a resident in terms of conditions above. Further, an individual shall be treated as a person of Indian origin if either he or either of his parents or any of his grand-parents was born in undivided India.
4. An Indian company will always be treated as resident in India. However, a foreign company can either be resident or non-resident in India. It will be treated as resident in India, if its place of effective management, in that year, is in India; (it need not be wholly situated in India, as at present).
5. A Hindu Undivided Family (HUF), partnership firm, an association of persons or any other person will be resident in India, if its place of effective management, in that year, is in India.
6. A person will be a non-resident in India, if he is not a resident in India.
7. Under the Act, the concept of "resident but not ordinarily resident" for an individual and a Hindu undivided family will be replaced by providing exemption to the income of an individual sourced outside India and not derived from a business controlled or a profession set up in India. This exemption will be available to the individual in the financial year in which such individual becomes a resident and in the immediately succeeding financial year,

if such individual was a non-resident for nine years immediately preceding the financial year in which he becomes a resident.

III. Concept of Financial Year

In order to simplify the provisions, the separate concepts of 'previous year' and 'assessment year' will be replaced by a unified concept of 'financial year'. The existing concept of assessment year will be done away with. Under the Act, all rights and obligations of the taxpayer and the tax administration will be with reference to the 'financial year'. This change will not change the existing system of deduction of tax at source and payment of advance tax in the year of earning of income and payment of self-assessment tax in the following year before filing of tax return. This proposal will simplify the existing provisions.

IV. Meaning of 'Person', 'assessee', etc.

1. In the Act, Government, trust, cooperative society, any other society and any non-profit organisation will be included in the definition of 'person'. The Persons specified in the Third Schedule will not be liable to Income-tax either wholly or partly, as specified therein.
2. In the Act it is proposed to include the following "other persons" within the definition of 'assessee':-
   (a) any person to whom any amount of refund is payable under the Act; and
   (b) any person who voluntarily files a return of tax bases irrespective of the fact that he is otherwise not under an obligation to do so.

3. This change will enable taxpayers to obtain refund of tax deducted at source. It will also help tax payers currently below the threshold level to report their income and maintain a track record of filing returns in anticipation of earning higher - and hence taxable - incomes in the future.

B. Interaction of domestic law and international law: Issue of Treaty Override (Chapter – V)

1. A centrist approach to the relationship between domestic law and the tax treaty has been recommended, whereby the tax law regards and international agreements to be on par with domestic legislation. The treaty obligations will be the same rank as domestic law; in case of conflict, the one last in date shall prevail under the maxim *"lex posterior derogate legi priori"*. Therefore, a subsequent change in law could lead to treaty override. Similarly, any change in the treaty or a reiteration of the provision of the treaty by a unilateral protocol subsequent

to the change in the domestic law will override the domestic law. In effect, neither domestic law nor the treaty will have permanent supremacy.

2. It has also been proposed that henceforth all treaties will be laid on the table of both Houses of Parliament.
3. The recommendation follows a centrist approach which is an equitable rule of interpretation. It is dynamic in its effect, allowing for accommodation of the temporal requirements of treaty partners.

C. Timing the recognition of income and deduction (Chapter – VI)

Generally, a single tax accounting rule does not apply to all taxpayers in respect of all items of income or deductible expense. Different rules apply depending on the circumstances. In general terms, income or expenses may be accounted for on a *cash* or on *accrual* basis accounting systems. Both systems measure income when it is derived and recognize expenses when they are incurred, but the **time** at which a taxpayer is considered to have derived an amount or incurred an expense can differ significantly under the two systems. Ordinarily, salary and wage earners account for income and deductions on a cash basis, and business tax payers above a certain size account for income and deductions on an accrual basis.

I. Cash Accounting

1. Under the cash-basis system, income is derived when it is actually received by, or made available to, or applied to the benefit of, the taxpayer, and expenses are incurred when they are paid. Under the cash method, income is derived in the tax period in which it is actually received by, made available to, or, in the case of benefit, provided to the taxpayer. Similarly, expenses are treated as incurred in the tax period in which the taxpayer actually pays them.
2. In this system of accounting transactions are recorded when there is actual flow of cash. Revenue is recognised only when it is actually received. Expenditure is recognised only on the outflow of cash. No consideration is given to the "due" fact of the transaction. This system of accounting is simple to understand and as such needs less skill on the part of the accountant. Its whole focus is on cash management. The recognition trigger is simply the flow of cash. Budgetary and legislative compliance is easier under this system.
3. A comprehensive cash system of accounting comprises of cash flow from operational, financial and investment activities. This comprehensive method has the added advantage of -

(a) eliminating the distinction between capital and revenue, whether receipt or expenditure, thereby eliminating plethora of litigation arising on account of this distinction;

(b) eliminating the distinction between debt and equity capital;

(c) eliminating any ambiguity relating to timing of income and expenditure including deferred expenditure;

(d) allowing for full expensing of capital expenditure in the year in which it is incurred;

(e) allowing for full deduction for payment of interest and dividend;

(f) overcoming the problem of valuation of inventories;

(g) eliminating the problem of inflation and bunching of gains;

(h) eliminating the problem of estimating bad debts and non-performing assets; and

(i) providing tax neutral treatment of amalgamation and merger.

4. In effect, the cash system of accounting has the potential of virtually eliminating all litigation thereby providing certainty and stability. It does not require high skills for compliance and administration resulting in cost saving and consequently encouraging compliance and improving efficiency.

II. Accrual system of accounting

1. Under the accrual-basis system, income is derived when the right to receive the income arises, and expenses are incurred when the obligation to pay arises. Under the accrual method, income is derived in the tax period in which the right to receive the income arises, and expenses are accounted for in the tax period in which obligation to pay arises. Further, special rules may apply in particular cases (e.g., for long-term contracts or prepayments).

2. It is a system of accounting in which transaction are entered in the books of accounts, when they become due. The transactions are recognised as soon as a right to receive revenue and/ or an obligation to pay a liability is created. The expenses are recognised when the resources are consumed and incomes are booked when they are earned. Therefore, the focus is on the recording of flow of resources i.e. labour, goods, services and capital, the related cash flow may take place after some time (of event) or it may or may not take place in the same accounting period.

3. The system of Accrual Accounting while retaining the advantages of the Cash Accounting System overcomes its limitations by inclusion of Cash Flow Statement in the Financial Statement of the entity. The major advantages are as under:

(a) It helps in the assessment of financial performance by correctly reflecting surplus/ deficit as all expenses whether paid or not and all incomes whether received or not

are duly accounted for.

(b) It gives information on whether income streams are adequate to meet short and long-term liabilities so that their early payment keeping in view their payment period (short term and long term) and nature (cheap or costly loan) can be better managed.

(c) It provides comprehensive information on expenses which helps in knowing the cost consequences of policies and enables comparison with alternative policies. Also, information about calculation of subsidy can be extracted from the accounts, which helps in its rationalisation. This ensures the adoption of best policy, which in turn assures optimal use of scarce resources. It also helps in ascertaining the future sustainability of programmes.

(d) It gives comprehensive information on the Financial Position i.e. assets and liabilities of government. In this system of accounting the financial decisions are not seen merely from the point of view of cash outgo or inflow but also from their impact on the asset- liability position of the government, future funding requirements of assets enabling planning of their timely maintenance and replacement.

(e) It gives disclosures on account of contingent assets and contingent liabilities so that risk associated with the guarantees issued and letters of comfort given can be better assessed by the user of the financial statements.

(f) It bridges the gap leftover by cash accounting by inclusion of accrued expenses and revenues (receivables and payables), physical assets, capital work-in-progress and depreciation, pension liabilities and provisions etc. in the accounting system.

(g) It discloses the Accounting Policies used in the preparation of Financial Statements for better understanding and appreciation of the Financial Statements.

III. Timing of recognition for calculation of taxable income

The timing of recognition of income and expenses is crucial to the calculation of taxable income under both the receipts-and-outgoings system and the balance-sheet system. Under both systems, the choice between cash-basis accounting and accrual-basis accounting will have a significant effect on the measurement of taxable income. So, too, will the rules that govern exactly when receipts and expenses are recognized under cash- and accrual-basis accounting. As stated earlier the cash system reflects the current ability to pay, the accrual systems reflect the long-term ability to pay of a person. Since the tax is levied on income of a twelve months period, a cash system may be more appropriate for measuring the ability to pay. Further, there are several provisions within the tax law which are based on cash

accounting; similarly, several other provisions provide for deductions in respect of the business in deviation from the "matching" principle like allowability of interest, depreciation, prior period expenses and deferred revenue expenditure. The simplicity of the cash system in terms of compliance and enforcement is an added advantage.

D. Choice of Tax Design (Chapter – VII)

1. In Chapter – III the dilemma between territorial (source-based) taxation and global or worldwide (residence based) taxation has been discussed. Chapter – IV discusses the advantages and dis-advantages between cash method of accounting accrual method of accounting for the purposes of determining taxable income. Based on the pros and cons of the various methods, two models which form the basis of the recommendations in this report have been proposed.

2. **Model I** is based on territorial (source based) taxation complemented by mandatory cash system of accounting. Similarly, **Model II** is based on global (resident based) taxation complemented by accrual system of accounting.

3. The key features of **Model I** are -

(a) the total income of a person will comprise of only income derived from a source in India;

(b) in confirmity with the principle of territorial taxation, any income derived from a source outside India will not be included in the total income of the person;

(c) income shall be construed to have been derived from a source outside India if the payment has been received from outside India;

(d) income shall be construed to have been derived from a source in India if the payment has been made from India

(e) there will be no distinction between resident and non-resident;

(f) tax shall be withheld (deducted at source) on every payment made by a person (including Government and all other exempt person) from India to any person outside India;

(g) the total income shall be computed on the basis of cash system of accounting;

(h) there will be no distinction between capital and revenue, whether receipt or expenditure;

(i) there will be no distinction between debt and equity capital;

(j) full expensing of capital expenditure in the year in which it is incurred;

(k) full deduction for payment of interest and dividend;

(l) the total income shall include cash inflow, whether capital or revenue, from operational, financing and investment activities; and

(m) the total income shall exclude cash outflow, whether capital or revenue, in the course of operational, financing and investment activities.

4. Similarly, the key features of **Model II** are –

(a) a distinction will be made between a resident and a non-resident;

(b) in confirmity with the principle of global taxation, the total income of a resident will comprise of his global income i.e., income derived from both a source in India and a source outside India;

(c) the total income of a non-resident shall be the income derived from a source in India;

(d) income shall be construed to have been derived from a source in India, if -

(i) in a case where payment has been made by a taxable person, the payment has been made from India and a deduction is allowable under the extant law;

(ii) in a case where payment has been made by Government or any other exempt person, the payment has been made from India and a deduction would be allowable in the event they were liable to tax under the extant law;

(iii) in any other case, the payment has been made from India;

(e) tax shall be withheld (deducted at source) on every income which is construed as having been derived from a source in India under (d) above; and

(f) the total income shall be computed on the basis of accrual system of accounting.

5. The various issues relating to the tax base, tax rates and tax administration in respect of the two models have been separately dealt in the subsequent chapters. The draft legal frameworks for **Model I** and **Model II** are contained in **Volume II** and **Volume III** of the Report, respectively.

E. Personal Income-tax (Chapter – VIII)

Personal income-tax is visible in its impact and therefore its design is extremely critical in terms of equity and economic efficiency. There are essentially five components of the determination and collection of personal income-tax liability. These are (i) the choice of the taxable unit; (ii) sources of income subject to tax; (iii) tax incentives; (iv) tax rate schedule; and (v) the compliance management process.

I. Tax rates

i. Schedular versus Global Income-tax

1. The structure of the personal income-tax rates can be schedular or global or a mix thereof. A schedular income-tax is one in which taxes are imposed on separate categories of income. Under this system, gross income and deductible expenses are determined separately or each type of income; in some cases, limited deductions or no deductions are allowed. The rates of tax applicable to each category of income is applied to the taxable amount of each type of income. The rates of tax may vary from category to category.
2. A global income tax is one in which a single tax is imposed on all income, whatever its nature. Under this system there is no matching of particular types of income to the expenses incurred to derive the income. All income and expenses are considered together to arrive at a single net income which is subject to tax. Thus, under a global system, the category of income is irrelevant.
3. In principle, the global system is in practice in India. However, overtime this system has been diluted with the introduction of schedular rates for several types of income in particular, dividend, capital gains, income of non-residents and certain casual and non-recurring income. This has added to the complexities of the PIT regime and increased litigation. Therefore, efforts should be directed towards minimizing the number of schedular rates.

ii. Number of rates

In alignment with international practice, it has been recommended to have as few rates as possible.

iii. General basic allowance

The report recommends that the need for a high general (basic) allowance (or threshold limit) should balanced against its revenue cost, which can often be very high, since it reduces the tax of everyone – not just those who have been left out of the tax net.

iv. Targeted allowance

Certain targeted allowances may be essential to give tax relief to the needy, however, numerous allowances exact heavy administrative costs. The report recommends a blanket allowance which could merged with the general allowance and could be sufficiently high to compensate for the most prevalent targeted allowances.

II. Tax Base

i. Choice of the Tax Base

1. Keeping in view the design principles discussed in the report, *"gross income"* is referred to as

"income" and the same has been defined in both models. All accruals and receipts in the nature of income, other than those enumerated in the **Second Schedule**, will be classified into independent sources from which the income is derived. Each of these sources would be a *"special source"* or an *"ordinary source"*.

2. The **"special sources"** are sources of income specified in the **Fourth Schedule**. The income from these sources will be liable to tax at a schedular rate on gross basis. No deduction is allowed for any expenditure and the gross amount is subject to tax, generally at a lower rate. This is the application of presumptive taxation. All other sources of income will be **"ordinary sources".**
3. Under **Model - I**, the receipts are classified into two different heads: (i) Income from various sources; and (ii) Capital gains. However, under **Model - II**, the accruals or receipts relating to "ordinary sources" will be further classified under five different heads:
   (i) Income from employment
   (ii) Income from house property
   (iii) Income from business
   (iv) Capital gains
   (v) Income from residuary sources
4. The income under all heads is aggregated to determine the "gross total income from ordinary sources". The amount of "gross total income from ordinary sources" so arrived, will be further reduced by incentives in accordance with sub-chapter I of Chapter III of Model I and sub-chapter H of Chapter III of Model - II. The resultant amount will be "total income from ordinary sources".

ii. Treatment of Perquisites

Tax perquisites received by an employee may be chargeable in his hand at the personal marginal income-tax rate applicable to him.

Keeping in view the principles for designing the tax rate structure and the tax base and the best international practice, the report recommends two alternative packages relating to Personal Income Tax as described below: -

Package – I

(i) The threshold limit should be increased from Rs 2.5 lacs to Rs.6 lacs.

(ii) In the case of senior citizens, the threshold limit will be increased from Rs.3 lacs to Rs.6 lacs. However, in the case of very senior citizens, the threshold will be increased from Rs.5 lacs to Rs.8 lacs.

(iii) the rate structure under this alternative shall be as under-

Total Income	Rate
Below Rs. 6,00,000/-	Nil
Rs. 6,00,000/- to Rs. 20,00,000/-	15 percent of the Income in excess of Rs. 6,00,000/-
Above Rs. 20,00,000/-	Rs. 2,10,000/- plus 30 percent of the Income in excess of Rs. 20,00,000/-

(iv) consequent to the higher threshold of Rs. 6,00,000/-, the concessional tax treatment of the following targeted allowances should be withdrawn, namely :-

(a) House rent allowances

(b) Personal allowances granted at the place of duty

(c) Children education allowance

(d) Deduction for Mediclaim

(e) Deduction for royalty on books and patent

(f) Rebate under section 87A

(g) Deduction for rent paid

(h) Deduction for disabled persons

(i) Deduction for interest on education loan

(j) Deduction for interest earned in savings bank account

(k) Deduction for critical medical expenditure including those for senior citizens

(v) the tax treatment of savings, commutation of pension and other retirement benefits will be allowed as per Bundle - I as in Chapter IX;

(vi) tax perquisites received by an employee in his hand at the personal marginal income tax rate applicable to him.

Package - II

(i) The threshold limit should continue at the existing level of Rs. 2.5 lacs.

(ii) Similarly, in the case of senior citizens, the threshold limit will continue at the existing level of Rs.3.00 lakhs

(iii) the rate structure under this alternative shall be as under-

Total Income	Rate
Below Rs. 2,50,000/- Nil	Nil
Rs. 2,50,000/- to Rs. 5,00,000/-	5 percent of the Income in excess of Rs. 2,50,000/-

Rs. 5,00,000/- to Rs. 10,00,000/-	Rs. 12,500/- plus 10 percent of the income inexcess of Rs. 5,00,000/-
Rs. 10,00,000/- to Rs. 30,00,000/-	Rs. 62,500/- plus 20 percent of the Income inexcess of Rs. 10,00,000/-
Above Rs. 30,00,000/-	Rs. 4,62,500/- plus 30 percent of the Income in excess of Rs. 30,00,000/-

(iv) consequent to the lower threshold of Rs. 2,50,000/-, the targeted allowances shall be continued:

(v) the tax treatment of savings, commutation of pension and other retirement benefits will be allowed as per Bundle - II as in Chapter IX; and

(vi) tax perquisites received by an employee in his hand at the personal marginal income tax rate applicable to him.

Further, regarding treatment of perquisites, the report recommends that the value of perquisites should continue to be taxed in both **Model I** and **Model II** in the hands of the employee. However, the prescribed value of the perquisites is extremely low and do not fully reflect their fair market value. The report, therefore, recommends that the values of the various perquisites should be appropriately revised for enhancing the equity of the personal income tax regime.

F. Tax Treatment of Savings (Chapter – IX)

1. In India, the Income-tax system is designed substantially on the principle of comprehensive income base that provides several tax incentives for financial savings. A tax concession for savings may lead to higher post tax returns for the investor. The higher returns, in turn, create a positive substitution effect whereby, savings are preferred over current consumption leading to higher savings. In contrast, experts have argued that tax incentives for savings are economically inefficient, inequitable, very costly and do not serve the intended purpose.
2. **Criteria for designing an efficient saving incentive.** For any tax proposal to be labelled a saving incentive, three criteria must be met: First, tax benefits should not go to taxpayers who simply switch assets from one form of saving (or one kind of account) to another. Second, no tax provision can be considered a true incentive if it does not apply at the margin. Third, a tax incentive for saving must provide symmetrical treatment of positive saving on the one hand and negative saving or borrowing on the other.
3. **Tax treatment of savings: alternative methods.** Generally, there are two distinct types of tax system: a comprehensive income tax and an expenditure tax. Under a comprehensive income tax all sources of income are explicitly taxed. An expenditure tax, on the other

hand, only taxes consumption. Effectively it exempts from tax the returns from savings until they are consumed.

a. **Expenditure tax method**. There are two main forms of expenditure tax. The first involves giving tax relief on income that is saved, exempting from tax any interest and gains accumulating on those savings, but then taxing the total proceeds as and when the savings are withdrawn for consumption. This form is often described as **EET**, with E denoting an exemption or relief from tax and T denoting a point at which tax is payable. Another form of expenditure tax regime followed is one where no relief is given for the investment, but the accumulating interest and gains and the proceeds of the investment are exempt from tax. This system is often described as **TEE**. The EET system is the classical example of an expenditure tax. The TEE system is often called the 'pre-paid expenditure tax'.

b. **Comprehensive income tax method.** Under a comprehensive income-tax system all income is taxed when it is received, so saving is from taxed income; interest income from savings is taxed; but proceeds of saving do not suffer further tax. In practice, this system is described as **TTE**. Another variant of the comprehensive income tax is one where the tax exemption occurs at the point of contribution, while fund income and benefits are taxable (**ETT**). The effects of these two systems are the same. These two systems result in a disincentive to saving, because consumption now is worth more than consumption in the future. In as much as savings are taxed twice, this system is inherently biased against savings.

4. The report discusses in detail that expenditure tax method of treating savings ensures fiscal neutrality with respect to savings without compromising the equity of the tax system. Further, the contributions to and accumulation of, savings must be exempt but the withdrawals/ benefits should be taxed. Therefore, the report recommends that the choice between the EET and the TEE method should settle in favour of the EET method.

5. If the existing system of taxing pensions and saving is economically inefficient and inequitable, it is reasonable to expect changes in tax rules as tax reform progresses. Therefore, it is not sufficient to design tax "incentives" to only maintain fiscal neutrality between consumption and savings. The report finds that it is equally necessary to ensure that the tax "incentives" do not distort household portfolio. Logically therefore all forms of savings must essentially follow the same pattern of EET method of tax treatment so that the yield curve based on post tax return is not biased against long-term pension savings. Deviations from the EET method, if any, would be justified only on grounds of equity, administrative

convenience, institutional rigidity or transitional arrangement.

6. The report maps the tax incentives provided under the current Income Tax Act, 1961 for financial savings, such as, contribution to specified saving schemes, life insurance, repayment of housing loans [sec 80C], contribution to pension funds [sec 80CCC], sum received under a life insurance policy [sec 10(10D)], payment from a provident fund set up by Central Government [sec 10(11) and sec 10(12)], payment from the National Pension System Trust [sec 10(12A) and sec 10(12B)], payment from a Superannuation Fund [sec 10(13)], exemption under sec 10(15)(i), interest on Capital Investment Bonds [sec 10(15)(iib)], interest on Relief Bonds [sec 10(15)(iic)] etc. The report finds that the effect of these provisions is that financial savings of households is generally exempted from taxation at all three stages of savings, i.e., contribution, accumulation and withdrawals. The tax treatment of savings in India can therefore be characterized as exempt – exempt-exempt (EEE) for most taxpayers.
7. This liberalized treatment has impacted economic efficiency, equity and revenue efforts. Various committees have extensively documented the distortionary effects of the existing method of tax treatment of financial instruments in the past. The expert opinion is overwhelmingly in favour of the EET-method of tax treatment of savings. This opinion is consistent with international trends.
8. **Re-designing the method of tax treatment of savings**.

   As per detailed discussion in Chapter – IX of the report, the report recommends three options for taxation of savings:

   Option – A: The existing treatment of savings to continue. This will comprise of a hybrid of methods ranging from EEE method to EETp method, where Tp denotes partial taxation.

   However, the report as per analysis of data on savings finds that these tax incentives provide larger benefit to those in the higher tax slab – the tax base in India being low, the benefit is not available to bulk of financial savers. It has resulted in significant revenue loss. The report on the basis of its findings states that consequent to the rationalisation of the personal income-tax rate structure proposed in Model - I and Model - II, the tax benefit from savings would be further reduced thereby undermining the effectiveness of the tax incentive to induce pro-savings behaviour. Accordingly, the report finds that the case for continuing the existing regime of taxation of savings under section 80C, section 80CCC and section 80CCD of the Income-tax Act 1961, is extremely weak.

   Option – B: Option - B: This option provides for -

   (a) an EET method of taxation of savings in the National Pension Scheme (NPS),

under which -

(i) a deduction of an amount upto 10 per cent of the salary (gross total income in the case of non-salaried taxpayers) shall be allowed in respect of contribution to the National Pension Scheme (NPS) by the taxpayer;

(ii) in the case of salaried taxpayers, the employer would be allowed to contribute to the NPS a further amount upto 10 per cent of the salary;

(iii) the contribution by the employer will not be included in the income of the employee in the year in which the contribution by the employer is made.

(iv) the accumulation in the NPS will be exempt; and

(v) the withdrawals from the NPS (whether representing employee contribution, employer contribution or accumulation over the years) will be taxed in the year in which the withdrawal is made;

(vi) 60 per cent of the amount standing to the credit of the taxpayer at the time of the closure of the NPS shall be utilised for the purchase of an annuity plan and the annuity so received, shall be taxed in the similar manner as pension;

(vii) the balance 40 per cent of the amount will be allowed to be commuted and fully taxed (at present this amount is fully exempt). However, the taxpayer may roll over the amount in another EET based account without attracting any tax liability but the withdrawals from the later will be fully taxed.

(b) the amount of deduction hitherto allowed under section 80C, and section 80CC will be subsumed in the **higher threshold limit of Rs. 6.00 lakhs** recommended in Package I; no deduction for savings in any of the schemes would be allowed under any other provision; and

(c) the benefits on accumulated balance in provident fund and superannuation fund as on the appointed date (say, 31st day of March, 2019/2020/2021) will be grandfathered i.e., no new deposits will be allowed in these funds after the appointed date but the accumulation in the fund by way of interest, dividend, bonus etc. and withdrawal thereof will continue to enjoy the same tax benefit as is available immediately before the commencement of the new Act.

(d) employers would be free to maintain a Provident Fund or superannuation fund and employees free to contribute by opening a new account in the funds. While the employer will be entitled to claim the contributions by him to the fund as business expenditure, the employees will be required to include the employer contributions in their taxable income in the year in which the contributions are made. Similarly, the interest on the

contributions would be taxable on cash / accrual basis depending upon the method of accounting followed by the employee.

The report finds that this option will have the benefit of moving to the purest form of taxation of savings and **a smooth transition by allowing a higher threshold limit**. Further, there is empirical evidence to suggest that itemised deductions lead to higher compliance cost. To the extent, the various benefits for savings would be replaced by a higher threshold limit, substantial reduction in compliance cost can be expected.

Option - C: This Option provides for splitting up of the deduction hitherto allowed under section 80C and 80CCD and capped at Rs.1.50 lakhs, into four components. These components are -

(a) an EET method of taxation on savings upto 10 per cent of the salary (gross total income in the case of non-salary taxpayers) in the National Pension Scheme (NPS), along the same lines as indicated in serial no. (a) of Option B;

(b) a separate deduction upto Rs.50 thousand for contribution to Government Provident Fund, Public Provident Fund, Recognized Provident Fund and any other fund notified by the Central Government. The ceiling of Rs.50 thousand will apply to the aggregate of the contributions by the employee and the employer. The interest on contributions and withdrawals (both principle and interest) will continue to remain exempt as under the existing law;

(c) a separate deduction upto Rs.25 thousand towards payment of risk premium on the life of the taxpayers or his family members;

(d) a separate deduction upto Rs.24 thousand towards tuition fee for the education of a child of the taxpayer subject to a maximum of Rs.48 thousand; and

(e) no deduction will be allowed in respect of any contribution to the superannuation fund whether by the employee or the employer. Further the interest, dividend, bonus for any other sum credited to the account of the employee in the superannuation fund will also be taxed on cash or accrual basis, as the case may be.

Under this Option, the deductions for the various other schemes and repayment of housing loans allowed under section 80C will be withdrawn. This Option will have the benefit of moving to the purest form of taxation of savings. However, in order to promote consumption of merit goods like education and insurance on life, separate deductions have been allowed. Nevertheless, the report considers it necessary to recommend Option C so as to facilitate the transition to a more efficient and equitable tax regime. However, these itemised deductions

will result in relatively higher compliance cost and to that extent, this Option is inferior to Option B.

9. **Capping the tax incentives.**

Recognising the need for improving the progressivity of the tax system and to address the concerns relating to vertical equity, the report recommends several measures for **withdrawing the exemptions and introduction of a comprehensive Wealth Tax**.

10. **Tax treatment of Provident Fund.**

The contributions by an employee (upto Rs.1.50 lakhs), contribution by the employer (upto 12% of salary), accumulation and withdrawals to PPF, RPF, GPF etc. are exempt under EEE scheme. The tax treatment of the savings has led to distortions and is a source of significant revenue loss. As it continues to grow at a rate that is higher than corporate tax revenues, it is eroding the tax base. Accordingly, consistent with the three options, the report recommends reforms in the tax treatment of savings in the Provident Funds as:

(i) The existing tax benefits may be continued in line with **Option A**. Consequently, the various distortions and the revenue loss flowing from the present treatment will continue. Further, it would continue to discriminate between Government employees and Non-Government employees;

(ii) Modify the tax treatment of contributions, interest and withdrawals in the manner discussed in serial number (c) and (d) of **Option B**; or

(iii) The tax treatment of contributions, interest and withdrawals will be as indicated in serial no. (b) of **Option C**.

The report recommends **Option B** to be the most preferred policy since it is based on the EET method of taxation of savings and also broadens the base by eliminating the tax-free perquisite in the form of tax-exempt contribution by the employer to the provident fund. **Option C** can be ranked as second - best and **Option A** as the least preferred.

11. **Tax treatment of Commutation of Pension.**

At present Government employee is entitled to commute 40% of his pension. For non-government employee, contribution to approved Superannuation Fund established by his employer to the extent of Rs.1.5 lakh per annum, employer's contribution upto 15% of his salary or Rs.1.5 lakh per annum, whichever is less is exempt. Accumulations within the fund are also exempt. 75% of the amount standing to the credit of the taxpayer is used to buy an annuity plan which amounts are taxable like any other **pension**. Balanced 25% is allowed to be commuted.

Conceptually, the commuted value of pension represents the present discounted value of the capitalized value of the commuted amount of pension. Since pension per se is taxable, there is no economic justification for exempting the commuted value. In principle, the full commuted value of pension should be subject to tax.

In view of above and the fact that the employer is allowed to contribute upto 10 per cent of the salary to the NPS, the tax treatment of the commutation of pension is recommended as under-

(a) **Alternative - I**: the existing regime for taxation of commuted value of pension and the commuted value of the accumulated balance in the superannuation fund may be continued.

(b) **Alternative - II**:

(i) the commuted value of pension received under the Civil Pension (Commutation) Rules of the Central Government or State Government may be fully taxed;

(ii) the benefits on accumulated balance in superannuation fund as on the appointed date (say, 31st day of March, 2019/2020/2021) will be grandfathered i.e., no new deposits will be allowed in these funds after the appointed date but the accumulation in the fund by way of interest, dividend, bonus etc. and withdrawal thereof to be fully taxed like commuted value of pension from Government;

(iii) employers would be free to maintain a superannuation fund and employees free to contribute by opening a new account in the funds. While the employer will be entitled to claim the contributions by him to the fund as business expenditure, the employees will be required to include the employer contributions in their taxable income in the year in which the contributions are made. Similarly, the interest on the contributions would be taxable on cash/accrual basis depending upon the method of accounting followed by the employee.

(c) **Alternative - III**:

(i) the commuted value of pension received under the Civil Pension (Commutation) Rules of the Central Government or State Government in excess of Rs.20 lakhs may be fully taxed; and

(ii) the commuted value of the accumulated balance in the superannuation fund as on the appointed date, in excess of Rs. 20 lakhs may be fully taxed.

Alternative - II being consistent with Option B, is the most efficient and accordingly the preferred policy. Alternative - III ranks second - best in as much as it reduces the inefficiencies

and the inequity associated with Alternative - I. It will also partially eliminate the tax benefit hitherto provided and contain the revenue leakage. Further, the provision of de minimis of Rs.20 lakhs will ensure that a person drawing a salary of Rs.1 lakh per month at the time of retirement will not be liable to pay tax on the commuted value of the pension. Alternative - I being the most inefficient, inequitable and a drain on revenue, should be the least preferred policy.

12. **Tax treatment of benefits received on retirement of an employee.**

An employee receives a number of other lump sum benefits on his retirement by way of superannuation or otherwise. These benefits are:

(i) Gratuity - The amount received as death-cum-retirement gratuity from the Central Government or State Government or under Payment of Gratuity Act on retirement or otherwise is exempt from income-tax , subject to prescribed limits. [section 10(10)]

(ii) Leave encashment – The payment received towards encashment of earned leave at the time of retirement is exempt under section 10(10AA)(i), subject to a limit of Rs.3 lakhs.

(iii) Payment on voluntary retirement – Any amount received by an employee on his voluntary retirement or termination of service is exempt to the extent it does not exceed Rs. 5 lakhs [section 10(10C)]

The benefits in the form of gratuity and leave encashment are deferred wages and the amount received on voluntary retirement represent the present discounted value of future wages. Therefore, in principle, these benefits should be fully taxed. However, these are tax free, subject to prescribed limits thereby creating distortion and revenue leakage. Accordingly, the tax treatment of these benefits needs to be rationalized in one of the following manners:

(a) Alternative - I: The existing tax treatment, though inefficient and inequitable, may be continued;

(b) Alternative - II: These benefits may be allowed to be deposited in an EET based designated account and the withdrawals should be fully taxed; and

(c) Alternative - III The benefits in excess of the de minimis limit may be allowed to be deposited in an EET based designated account and the withdrawals should be fully taxed. The de minimis limit for leave encashment and amount received on voluntary retirement shall be Rs.10 lakhs each. However, the de minimis limit for gratuity shall be Rs.15 lakhs.

Given the impact on efficiency, equity and revenue collection, Alternative - II is the most preferred policy followed by Alternative - III and Alternative - I.

13. **Method of collecting taxes on withdrawal**

If the benefits are taxable, it is necessary to establish an effective mechanism for collecting taxes on such benefits. The system of withholding taxes is an effective system for collecting taxes on the benefits. Accordingly, all withdrawal/benefits may be subject to a withholding tax at the rate of 15 per cent without any threshold exemption. The present system of issuing non-withholding certificates may be continued to enable small taxpayers to receive the benefits without withholding. This must be complemented by establishing an effective refund mechanism.

14. **Impact of proposals**

i. **Mutual Fund:** In FY 16-17, total deduction claimed u/s 80C was Rs.3,27,103 crores. Most of the deduction is availed against investment in PF, NPS and children's education. Assuming 5% of deduction relates to investment in mutual fund (estimated as Rs.16,000 crores) of which tax induced component may be 25% (Rs.4,000 crores). The recommendation to tax dividends distributed by MFs in the hands of the unit holder will result in substantial relief to small investors since tax burden will reduce from 20% DDT to NIL or 5%. This will neutralize the slowdown on account of withdrawal of section 80C for investment in mutual funds.

ii. **On taxpayer:** The EET method of taxing savings will impose no additional tax burden on the taxpayer at the point of contribution and on accumulation. The additional tax burden at the point of withdrawal will depend upon whether withdrawal is in small amount or lump-sum. To the extent withdrawals will be penalized, there will be an inbuilt mechanism to ensure consumption smoothening over the life time of the taxpayer and reduce dependency for social security on any external agency, including Government.

Tax burden on exit from life insurance policies will ensure equity with 70% of the insured who are non-taxpayers and do not enjoy any tax benefit for seeking life protection.

The tax liability on retirement benefits that is now included can be substantially reduced by the taxpayers by rolling over the retirement benefits to a designated account to smoothen consumption over the retired life of the taxpayer.

iii. **On National Savings:** In FY 16-17, total deduction u/s 80C was 11.6% (3.27 lakh

crore) of the gross total income (Rs.29.32 lakh crore). The report has recommended a deduction upto 10% of the gross total income for deposit in NPS. This deduction is not significantly different from existing level of deduction u/s 80C. Further, the EET design of the NPS and other savings schemes will result in taxing dis-savings (withdrawals). The cumulative impact is a significant increase in net savings thereby resulting in higher national savings.

iv. **On inflation:** To the extent the proposals will result in higher national savings and reduce current consumption, these will also serve as a non-distortionary anti-inflationary measure without compromising on the growth potential of the economy.

v. **On interest rates:** To the extent the distortions in the tax treatment of savings across products are eliminated, this will significantly improve the efficiency of the financial sector and consequently, the real sector. This enhanced efficiency in the financial sector is also likely to be reflected in lower interest rates.

vi. **On equity:** Under the new regime the tax benefits will be restricted to ISSA and therefore, the inequity arising from information asymmetry will be eliminated. Further, since these proposals will lead to consumption smoothening over the life of a taxpayer, they will enhance both inter-temporal and inter-generational equity.

vii. **On compliance and administrative burden:** No increase in compliance and administrative burden is expected on account of these proposals.

Conclusion

The report therefore recommends crafting of two separate bundles –

(a) Bundle - I comprises of **Option B**, along with **Alternative - II** in proposal relating to tax treatment of commutation of pension and **Alternative - II** in proposal relating to tax treatment of benefits received on retirement of an employee; and

(b) Bundle - II comprises of **Option C**, along with **Alternative - III** in proposal relating to tax treatment of commutation of pension and **Alternative - III** in proposal relating to tax treatment of benefits received on retirement of an employee.

In writing the draft tax law, Bundle - I in Model - I and Bundle - II in Model – II has been included. However, Bundle - I can also form part of Model - II and vice versa without effecting in any way the integrity of the two models. The decision to do so should be based on the outcome of stakeholders' consultations.

G. Reform of Corporate Income Tax (Chapter – X)

Recommendations

i. Corporate Tax Rate

In Chapter VII, two separate tax regimes have been recommended- **Model I** and **Model II**. Keeping in view the international tax rules and the accounting method specific to each of the Models, the following corporate tax rates have been recommended, namely :-

Model - II: Corporate tax rates under alternative regimes and compliance levels

Level of Compliance	Corporate tax rate (in percent)	Type of MAT				Surcharge (in percent)	Revenues (Rs in crs)
		PBT (in percent)	EBIDTA (in percent)	Gross Asset (in percent)	Turnover (in percent)		
Baseline	30	18.5	-	-	-	10 (plus cess)	3,91,965
Existing level (assuming tax elasticity of income = 0)	18		12.5	-	-	10	3,88,375
	18		-	1.25	-	10	4,15,790
	18		-	-	1.75	10	4,15,762
Increase in Compliance by 14 percent (assuming tax elasticity of income = -0.30)	16.5		12.5	-	-	10	3,95,387
	16.5		-	1.25	-	10	4,17,290
	16.5		-	-	1.75	10	4,16,333
Increase in Compliance by 28 percent (assuming tax elasticity of income = -0.60)	15		12.5	-	-	10	4,04,791
	15		-	1.25	-	10	4,18,941
	15		-	-	1.75	10	4,17,180

Note: The MAT rate for banks and financial institutions and energy companies will be 5 percent under EBIDTA and 0.25 percent both in the case of Gross Asset based and Turnover based MAT

(i) In the case of **Model I**, the corporate tax rate should be reduced from the existing level of 30 percent (excluding surcharge and cess) to (a) **5 percent** for banks and financial institutions (including NBFCs) and power producing companies; and (b) **15 percent** for all other companies;

(ii) In the case of **Model II**, depending upon the level of compliance and the choice of the MAT base, the corporate tax rate should be reduced to levels as indicated in the Table below. The tax elasticity of income in the case of corporate for AY 2017-18 is estimated to be -0.6 (refer Box I). This implies that 1 percent reduction in corporate tax rate will induce higher disclosure of income by 0.6 percent. Based on this result, the corporate tax rate should be reduced to **15 percent** and, as indicated in Table below, **complemented by a EBIDTA-based MAT at the rate of 12.5 percent or a gross asset based MAT at the rate of 1.25 percent or a turnover based MAT at the rate of 1.75 percent**.

Similarly, if the tax elasticity of income is conservatively assumed to be zero (i.e. compliance will remain unchanged), the corporate tax rate should be reduced to 18 percent and complemented by any one of the variants of MAT at the rate indicated in Table below. Given the robustness of the estimation, the report recommends the corporate tax rate to be reduced from the existing level of 30 percent to 15 percent and appropriately complemented by any one of the variants of MAT at the rate indicated in the Table.

ii. Choice of MAT

1. The report finds that the retained earnings of corporates over the last five years has been adequate to meet their requirement for investment; there is no immediate necessity to provide relief to the corporates to enable them to augment their capital base. Therefore, if the corporate tax rate has to be reduced (which, the report finds should indeed be done to reduce the cost of equity capital), it has been recommended that it is necessary to ensure that any revenue loss is fully recouped through complementary policy initiatives since there is no "fiscal space" available with the Government.
2. Further, the present exercise is not viewed as an exercise in revenue raising. However, given the present circumstances, it is required to be ensured that the package of measures is revenue neutral in the short-term and the tax buoyancy improves in the medium and long-term. Regardless of the robustness of the statistical estimates of tax elasticity of income, it is important to provide for a threshold tax liability to prevent any downside risk of revenues and which will also serve as an instrument to combat tax evasion; the MAT is one such instrument which can enable a seamless transition to the new tax regime.
3. In the light of the efficiency and equity effects and ease of compliance and administration, it is felt that **it is not necessary to complement the package of proposals in Model I with a MAT.**
4. However, the report recommends that the **package of proposals in Model II should be complemented by the gross asset-based MAT as the first best option followed by the turnover based MAT and the EBIDTA based MAT (in the same order).** Depending upon the assumption regarding tax elasticity of income and the choice of the MAT base, the basic MAT rates would be as indicated in Table. **However, the MAT rate for banks and financial institutions will be a lower rate 5 percent under EBIDTA based MAT and 0.25 percent both in the case of Gross Asset-based and turnover-based MAT**.

5. It has also been recommended that the gross assets should be defined as the value of the gross assets of the company (excluding the amount of debit balance of profit and loss account, if any) as on the close of the financial year and reduced by the aggregate value of the capital work-in-progress and the accumulated depreciation as per the Income Tax Act. Further, it excludes all companies under liquidation and under corporate debt restructuring. Similarly, the gross turnover for the purposes of the turnover based MAT should be defined as all revenue accruals or receipts in the financial year, whether credited to the statement of profit and loss account or not, but shall not include the value of inventory as on the last day of the financial year, if credited to the said account.
6. It has been recommended that the MAT liability during a year should be allowed to be **carried forward for 15 subsequent years for set off** against any liability in excess of the MAT liability. This will effectively reduce the MAT liability as an advance tax for life time liability of an entity.

iii. Taxation of foreign companies

At present, foreign companies are taxed at a rate of 40 percent (excluding surcharge and cess), even though the rate for domestic companies is only 30 percent. The difference between the two accounts for the tax which would have been collected if the dividend by the foreign companies had been declared in India. This has given an impression of discrimination against foreign companies. Therefore, it has been recommended that the **corporate tax rate for foreign companies should be reduced and aligned with the proposed tax rate for domestic companies**. The treatment of dividend by foreign companies outside India should be dealt with in the manner provided subsequently.

iv. Dividend taxation

The taxation of dividends is presently extremely complex and distorts efficiency and equity. Further, the legislation is not flexible enough to accommodate new structures of investment pooling vehicles. Accordingly, the following is recommended: -

(i) Dividend distribution tax (tax on distributed profits) should be abolished;

(ii) Dividends should be taxed at the shareholders level at the personal marginal rate applicable to him;

(iii) Dividends received by companies shall be exempt to the extent it is distributed to its shareholders so as to eliminate cascading;

(iv) The definition of dividend should be expanded to include-

(a) any pay-out by way of buy-back of shares by any domestic company, whether listed or not;

(b) the value of any benefit provided by issue of bonus shares to the extent capitalised by the company in its books; and

(c) any pay-out to shareholders whether out of accumulated profits or otherwise;

(v) In the case of non-resident shareholder, the dividend distributed by the domestic company shall be subject to a final withholding tax at the rate of 20 percent. The non-resident shareholder shall be entitled to claim credit for the withholding tax against his income tax liability in his home country.

(vi) Further, the foreign company or the permanent establishment of non-resident shall be subject to a branch profit tax in lieu of the tax which would have been collected if the dividend by the foreign company had been declared in India. The branch profit tax should be levied at the rate of 20 percent or treaty rate for dividends.

(vii) All distribution of income (dividend, bonus or any other income by whatever name called) by investment pooling vehicles will be taxed at the unit holder/beneficiary level.

v. Capital gains tax on equity

A compelling case has been made out in the report for levying tax on long term capital gains arising from the transfer of listed equity. The Government has already reintroduced tax on long term capital gains arising from the transfer of listed equity in the Union Budget, 2018. However, the reintroduction has only partly addressed the distortions in efficiency and equity arising from the exemption of such long-term capital gains. This process of reform of taxation regime of capital gains, in particular listed security now needs to be taken forward and completed. For this purpose, the following has been recommended: -

(i) the distinction between short-term capital asset and long-term capital asset on the basis of the length of holding of the asset should be eliminated;

(ii) the base for computation of capital gains should continue to be 1st February, 2011 for listed equities and 1st April, 2001 for all other assets; and

(iii) cost of acquisition and cost of improvement should continue to be inflation indexed if the asset has been held for more than one completed year;

(iv) the period of holding shall be computed from the first day of the financial year immediately following the year in which the asset was acquired;

(v) inflation indexation should continue to be provided for 75 percent of the inflation during the year;

(vi) a standard deduction of one-third of the long-term capital gains from equity shall be allowed to mitigate the burden of double taxation of return on equity; however, this deduction should not be allowed for any other asset;

(vii) the long-term capital gains should be aggregated with all other income and taxed at the personal marginal tax rate applicable to the transferor;

(viii) the short-term capital gains from the transfer of equity should be aggregated with all other income and taxed at the personal marginal tax rate;

(ix) transfer of personal effects and agricultural land should continue to be exempt from income-tax;

(x) rollover benefits should be rationalized and the existing provisions relating to exemption of capital gains against purchase of bonds of notified public sector companies should be replaced by a new "Capital Gains Saving Scheme" which should be based on EET method of taxation of savings.

(xi) Capital Gains Savings Scheme to be based on EET method;

vi. Securities transaction tax

The securities transaction tax was introduced in 2004 as a substitute of the tax on long-term capital gains on listed securities. Consequent to the recommendation for comprehensive taxation of long-term capital gains on listed equities above, the case for continuing the securities transaction tax is extremely weak. **Accordingly, the report recommends the abolition of the securities transaction tax (STT).**

The package of reforms recommended in the report will substantially eliminate the bias against equity, reduce METR on return on investment and also reduce METR on equity capital. Consequently, the NPV of the investment will increase thereby improving the financial viability of investments in the margin. To the extent the bias against equity is reduced, the corporate risk of bankruptcy and the risk premium on borrowings will also decrease. Cumulatively, this has the potential of providing the necessary impetus to private investment. Further, this will substantially improve corporate valuation and create an opportunity for larger FII inflow and windfall gains to domestic investors. Foreign companies would also be encouraged to set-up branches in India. The overall package is revenue neutral and therefore, does not impose any additional burden on the exchequer; neither does it draw out more resources from the corporate sector. Upon implementation, the efficiency

and equity of the overall tax system in India will be enhanced thereby creating a pro-business environment and new job opportunities.

G. Taxation of Investment Pooling Vehicles (Chapter – XI)

Investment pooling vehicles are entities owned by many persons and whose primary activity is investing in operating companies. The investment pooling vehicles act as an intermediary between the individual investor and the ultimate user of the capital. Several types of investment pooling vehicles exist like venture capital funds (these invest in greenfield ventures), private equity funds (these invest in firms, which have crossed the greenfield stage, but are not yet listed), hedge funds (these 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). Further, these vehicles could be "open-end" funds or "closed-end" funds. In the former, the vehicle (fund) issues and redeems its units from investors. In contrast, "closed end" funds issue a fixed number of units, and investors trade units with other investors.

In the light of the package of reforms relating to taxation of dividends and capital gains, the report recommends the redesigning of the taxation of investment pooling vehicles in the following manner: -

(i) investment pooling vehicles shall mean a special purpose vehicle, which –

(a) is established or registered as a company, fund, trust, society or institution under any Central Act or regulations thereunder;

(b) combines capital from, or assets of, many investors to deploy it according to its particular investment strategy;

(c) distributes at least ninety five percent of its surplus by –

(I) actual pay-out to the investors; or

(II) notionally apportioning the surplus amongst the investors in the ratio of their respective investment and treating the share of the investor as reinvestment by him;

(d) is registered, or recognised, by SEBI, Reserve Bank of India or Pension Fund Regulatory and Development Authority; and

(e) belongs to a class of investment pooling vehicles, prescribed in this behalf.

(ii) all investment pooling vehicles should be treated as pass-thru and they should be exempt from income-tax at their level.

(iii) any surplus distributed by the investment pooling vehicles should be taxed in the hands of the unit holder/beneficiary at the personal marginal rate applicable to him after aggregating the surplus with all other income;

(iv) the capital gains arising on transfer of units of any investment pooling vehicle should be treated in the like manner as equity;

(v) the surplus distributed by the investment pooling vehicle shall be subject to withholding tax at the rate of 15 percent and will be allowed as a credit against the total tax liability of the unit holder/beneficiary; and

(vi) all investment pooling vehicle should be required to file their tax returns.

The proposed design will impart greater efficiency, equity and simplicity to the tax regime for investment pooling vehicles. As is well known, investment pooling vehicles are essentially vehicles to mobilise small savings and, therefore, entity level taxation of income distributed at rate higher than the personal marginal rate of the investor imposes an unfair burden. In effect it will impart greater transparency which will enable financial intermediation at minimum cost.

H. Taxation of Insurance Business (Chapter – XII)

In India, it is reported that there are about 38 crore life insurance policies of which approximately 70 percent (26.6 crores) are unique policy holders. Given the fact that there are about 6 crore tax return filers, most other policy holders are outside the tax net and yet bear the burden of the 12.5 percent tax on valuation surplus. This entity level taxation increases the cost of insurance for the economically poor and marginal people in the country thereby leading to under-consumption of this "merit" good. However, the taxpayers at the higher income slab are under taxed thereby aggravating the equity of the system. The problem is further compounded by the fact that consumption of this "merit" good by taxpayers is subsidised by way of deduction under section 80C of the Income Tax Act. Overall, the present system is highly inequitable. Therefore, in India, the case for surrogate tax on investment income is extremely weak. The burden of tax must shift from the insurer level to the level of the insured.

In view of the cross-country practices, the need to maintain tax neutrality across financial instruments and prevalent distortionary system in India, the tax treatment of the insured and the insurer, the report recommends the following: -

(a) Since approximately 80 percent of life insurance policyholders are outside the tax net, it is highly inequitable to subsidise the richer 20 percent of the policyholders. Therefore,

under **Model I**, no deduction should be allowed for premium paid for individual life insurance policies. However, under **Model II**, a deduction for the risk component in the premium paid for life insurance policies is recommended to be allowed but restricted to 5 percent of the premium subject to a maximum of Rs.25,000/-.

(b) The exemption under section 10(10D) in respect of the maturity or surrender value of the policy should be discontinued and the net gain from such maturity or surrender should be liable to tax at the level of the policyholder.

(c) The insurer should be allowed a deduction in respect of dividends paid to or reserved for policy holders unlike the present practice of no such deduction.

(d) The taxable income of the insurer shall be charged to tax at the normal corporate tax rate unlike the present practice of a 12.5% on the net change in actuarial surplus and corporate tax rate on other investment income available for distribution to shareholders.

Impact of the proposals:

i. On financial intermediaries

Insurers: - The insurers will stand to gain substantially in terms of savings in taxes on account of deduction for dividends paid to or reserved for policyholders. However, the gain to the insurers is likely to be partly neutralized by the need to pass on the benefit to the policyholders since tax benefit for premium paid by policyholders is proposed to be withdrawn. The relative elasticities of demand and supply for insurance policies will determine the proportion in which the savings in taxes will be shared between the insurer and the insured.

In view of the cross-country practices, the need to maintain tax neutrality across financial instruments and prevalent distortionary system in India, the tax treatment of the insured and the insurer is proposed to be reformed in the following manner: -

(i) The deduction allowed under section 80-C for premium paid for individual life insurance policies to be discontinued;

(ii) The exemption under section 10(10D) in respect of the maturity or surrender value of the policy to be discontinued and the net gain from such maturity or surrender to be liable to tax. The insurer will furnish a certificate of the net gain to the insured.

(iii) The insurer will be allowed deduction in respect of dividends paid to or reserved for policy holders unlike the present practice of no such deduction.

(iv) The taxable income of the insurer shall be charged to tax at the normal corporate tax rate unlike the present practice of a 12.5% on the net change in actuarial surplus and

corporate tax rate on other investment income available for distribution to shareholders. These recommendations relating to taxation of insurance business will impart greater efficiency and equity; it has the potential to reduce the premium on life insurance and consequently increase consumption of this merit good.

I. Taxation of Unincorporated Bodies (Chapter – XIII)

The report recommends a new tax regime for partnership firms. The key features of the new regime are as under: -

i. The partnership firm will be treated as an entity separate from its partners.

ii. The partnership firm shall be treated as a 'flow through' whereby the total income (including losses, if any) will be calculated at the partnership level and then allocated to the partners according to their share in the partnership.

iii. In calculating the total income at the partnership level, no deduction shall be allowed in respect of any salary, remuneration, bonus, commission, interest or any other payment not being capital in nature.

iv. The amount so allocated to the partners shall be aggregated with any salary, remuneration, interest, commission or any other payment not being capital in nature (the aggregated amount shall be referred to as 'adjusted share')

v. The 'adjusted share' of the partner shall be a single category of income assessable under the head 'income from business' and taxed in his hands at the personal marginal rate applicable to him.

vi. Every partnership firm shall be required to file its return of income even if no income tax is payable at its level.

vii. The excess of the total income assessed in the case of the partnership firm over the total income declared by the partnership firm in its return of income, shall be taxed at the partnership firm at the maximum marginal rate so as to avoid making repetitive rectifications in the assessment of the partners.

viii. The excess referred to in item (vi.) above shall not be included in the total income of any partner regardless of whether such amount is apportioned between the partners or not.

ix. The Department may make a reallocation of the total income of the partnership firm between, or among, the partners –

(a) to reflect economic reality if the instrument of agreement does not have substantial economic effect; or

(b) to reflect the respective contribution of the participants to the unincorporated body of capital, expertise and labour.

x. The partnership firm shall be taxed at its own level at the maximum marginal rate, if-

(a) there is no instrument of agreement between the participants;

(b) the share of any participant is unknown; or

(c) any of the participants has not obtained the Permanent Account Number.

xi. The withholding tax credit allowable to the partnership firm will be allocated between the partners in accordance with the rules framed in this behalf.

The treatment of other unincorporated bodies and their participants will be in the same manner as partnership firms. The proposed new regime will improve the productivity and equity of the tax system. It will provide relief to a large number of small partners from the burden of over taxation.

J. Taxation of Non-Profit Organisations and Political Parties (Chapter – XIV)

I. Taxation of NPOs

A new taxation regime for non-profit organisations has been recommended. The key features of this new regime are as under: -

(a) A non-profit organisation has been defined to mean an organisation, by whatever name called (including a trust), subject to fulfilment of several conditions including the condition that it should be established for carrying on philanthropic activities.

(b) Under the new regime, the term 'philanthropic activities' shall replace the term 'charitable purposes'. Charity tends to be a short term, emotional, immediate response, focused primarily on rescue and relief, whereas philanthropy is much more long term, more strategic, and focused on rebuilding. Charity is like giving a fish to a hungry man but philanthropy is like teaching a man to fish.

(c) The total income of non-profit organisation shall be computed as aggregate of following amounts: -

(i) surplus from philanthropic activities;

(ii) anonymous donation;

(iii) amounts remaining unutilised for specific purposes;

(iv) amount which ceases to remain invested or deposited in specified modes;

(v) funds or assets deemed to have been applied for benefit of interested person.

(d) The manner of computation of surplus in the hands of a non-profit organisation has been expressly provided in the regime. The surplus is defined as gross receipts from philanthropic activities as reduced by outgoings in relation to such activities. Surplus is computed based on cash system of accounting.

(e) Gross receipts from philanthropic activities shall include voluntary contributions received, including contributions towards corpus, other special grants or assistance, any other receipt (whether capital or revenue) such as consideration for sale of capital asset, loans and advances, repayment of loans and advances, dividends, interest, royalty, fee, commission etc.

(f) Outgoings shall include voluntary contribution with specific direction that they shall form part of the corpus; any expenditure (whether capital or revenue) incurred or any loans and advances extended for the purpose of philanthropic activity or any incidental business; any contribution (other than corpus) paid to any other non-profit organisation.

(g) Any amount accumulated or set apart for the philanthropic activity shall also be included in the outgoings, subject to overall limit of 10 percent of the gross receipts, provided the same is deposited as per the prescribed scheme.

(h) However, outgoings shall not include any amount paid in cash or on which tax has not been withheld as per the provisions of this Act.

(i) The funds or assets of non-profit organisation shall be invested only in certain specified modes. Any investment made in violation thereof shall be included in income of the non-profit organisation.

(j) Specific provisions have been made to prevent use of funds or assets of the non-profit organisation for the benefit of an interest person. In this regard, certain circumstances/transactions have been specified in which it shall be deemed that the funds/assets have been applied for benefit of interested person and the relevant amount shall be included in income of the non-profit organisation.

(k) The amount of surplus from philanthropic activities of a non-profit organisation to the extent of Rs.10 lakhs shall be exempt. Any amount in excess of Rs. 10 lakhs shall be charged to tax at the rate of 15 percent. However, in case of its conversion or merger with any form of organisation, which does not qualify as a non-profit organisation, tax shall be charged at the rate of 30 percent on its net worth.

(l) The aggregate of (i) the amount of anonymous donations; (ii) the amount remaining unutilised for specific purposes; (iii) the amount which ceases to remain invested or

deposited in any of the specified modes; and (iv) the amount to the extent it relates to deemed use or application of funds or assets for the benefit of interested person, shall be taxed at the scheduler rate of 30 percent.

(m) There will be no requirement of registration or ex-ante approval [as under section 10 (23C) of the present law] of the NPOs for availing tax benefits.

(n) It will be sufficient for them to obtain a permanent account number (PAN) and file their return of income making a self-claim of the exemption. The Department may take appropriate action to deny the exemption, if on scrutiny it finds that the claim is incorrect.

II. Taxation of political parties

The proposed new tax regime for political parties is based along the same line as non-profit organisation with the following modifications: -

(a) political parties will be allowed a deduction to the extent of 50 percent of the gross receipts to be accumulated or set apart for carrying on their activity, if the said amount is deposited in accordance with a scheme prescribed by the Board in this behalf;

(b) Anonymous donations shall mean any voluntary contribution, -

(i) exceeding two thousand rupees which is received otherwise than by an account payee cheque drawn on a bank, or on an account payee bank draft, or use of electronic clearing system through a bank account, or through electoral bond; and

(ii) in any other case, the person receiving such contribution does not maintain a record of the identity indicating the name and complete address and such other particulars as may be prescribed, of the person making such contribution as to establish the correct identity of the said person.

The new tax regimes for both non-profit organisations and political parties have been crafted with the objective of ensuring that the benefit of tax exemptions actually translate into public goods rather than merely building endowments. Further, the partial withdrawal of the tax exemption will reduce tax arbitrage opportunities for laundering. The compliance procedure has also been simplified by eliminating ex-ante approval and registration to encourage more non-profit organisations to venture into the 'community services' sector. The recommendations are a fine balance between the legitimate needs of the sector and prevention of abuse of tax exemptions.

K. Tax treatment of Housing (Chapter – XV)

The report recommends that the existing system of taxing imputed rent for all owner-

occupied property (other than the principal residence) be continued. However, in order to eliminate the possibility of disputes, it has been recommended that the imputed rent may be estimated to be four percent of –

(i) In the case of a property acquired before the 1st day of April, 2001, the fair market value of the property on the 1st day of April, 2001; and

(ii) In any other case, the cost of acquisition of the property.

Regarding allowability of interest on borrowings for acquiring the property, based on the matching principle of income and expense, the allowability of interest against rental income is not questionable. The report has already commented upon the efficacy of allowing interest as a deduction. However, the issue for consideration is whether interest should be allowed at the nominal rate or any other rate. Under the present scheme of the Income tax Act, interest is calculated at the nominal rate and fully allowed as a deduction against rental income. In the computation of capital gains, the cost of acquisition is indexed to inflation during the holding period to compensate for the erosion in the cost (equity plus debt) of the property. This results in double deduction which needs to be corrected. This could be done either by restricting the deduction for interest from rental income or not allowing for any inflation indexing of the cost for the purposes of capital gains. Since the cost includes both equity and debt, the denial of inflation indexing will have a relatively larger adverse effect on the owner. The interest on home loans ranges between 9 percent to 10 percent and inflation rate ranges between 4 percent to 5 percent. Therefore, the non-inflation component of the interest is estimated to be 50 percent of the nominal interest. Accordingly, the report recommends that the amount of interest deductible in the computation of income from house property shall be restricted to 50 percent of the amount actually paid.

The tax treatment of income from housing, as modified by the recommendations, will substantially improve the efficiency and equity of the tax system.

L. Taxation of Net Wealth (Chapter – XVI)

Two major types of taxes are levied on wealth: one applied to a person's wealth (net wealth taxes) and the other applied on the transfer of wealth (transfer taxes). Net wealth taxes are typically assessed on the net value of the taxpayer's taxable assets (i.e., value of assets minus any related liability).

The case for levy of wealth tax is based on several arguments. *Firstly*, the holders of substantial economic resources have the capacity to pay higher taxes than those with similar incomes but with less wealth. *Secondly*, it adds to the overall progressivity of an income tax without

having to increase marginal rates. *Thirdly*, a wealth tax base separate from an income tax base helps to partially capture the income tax avoided or evaded. *Finally*, wealth carries with it a degree of security, independence, influence and social power that is not adequately measured by the flow of income and, hence, wealth constitutes an independent tax base which can be legitimately taxed through an annual tax on net wealth.

The Act proposes to tax net wealth in the following manner –

(i) Wealth-tax will be payable by an individual, HUF and private discretionary trusts.

(ii) Wealth tax will be levied on net wealth on the valuation date i.e. the last day of the financial year.

(iii) Net wealth will be defined as assets chargeable to wealth-tax as reduced by the debt owed in respect of such assets.

(iv) Assets chargeable to wealth-tax will mean all assets, including financial assets and deemed assets, as reduced by exempted assets.

(v) The exempted assets will be restricted to the following: -

(i) Assets used as stock-in-trade.

(ii) The interest of the person in the coparcenary property of any Hindu undivided family of which he is a member;

(iii) The value of any one building used for the residence by a former ruler of a princely state.

(iv) Jewellery in possession of a former ruler of a princely state, not being his personal property, which has been recognised as an heirloom by the Central Government before 1st April, 1957 or by the Board after that date.

(v) Any property held by the person under trust, or other legal obligation, for carrying out any permitted welfare activity in India;

(vi) The valuation of financial assets will be at cost or market price, whichever is lower.

(vii) The net wealth of an **individual or HUF in excess of Rupees ten crore** will be **chargeable to wealth-tax at the rate of 0.5 per cent.**

(viii) The threshold limit of Rupees ten crore will not apply to a private discretionary trust.

M. General Anti-Avoidance Rule (Chapter – XVII)

1. The Tax Laws of many Countries including India contain specific restrictive or anti-avoidance rules (SAARs) to neutralise aggressive transactions. Since liberalisation and opening up of

the Indian economy, it was found that tax payers (with help from their advisors) have been devising innovative transaction structures beyond the ambit of SAARs, which may require consequential amendments in the domestic law for plugging the 'loopholes'. The use of sophisticated tax avoidance arrangements which circumvent specific rules has led to the framing of the General Anti Avoidance Rules (GAAR).

2. The measure as proposed in the Direct Tax Code of 2009, GAAR provisions were introduced in the Income Tax Act by the Finance Act, 2012. The substantive provisions relating to GAAR are contained in Chapter X-A (Sections 95 to 102) of the Income Tax Act. Procedural provisions are contained in Section 144BA of the Act. The Finance Act of 2012 codified the "substance over form" doctrine to prevent erosion of tax base through aggressive tax planning by notifying the General Anti Avoidance Rule.

3. Recently in Paris, on 7th June 2017, 68 countries including India signed the *"Multilateral Convention to implement Tax Treaty related measures to prevent Base Erosion and Profit Shifting",* also referred to as Multilateral Instrument ("MLI") to modify large number of Bi-lateral Tax Treaties entered into between the 68 countries. Article 7 requires, as a minimum standard, countries to implement *at least one* of the following anti-abuse measures in their treaties. The principal purpose test (PPT) has been introduced as a default test which provides that no benefit under the Covered Tax Agreement shall be granted if it is reasonable to conclude that obtaining that benefit was *one* of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit. This PPT supersedes existing general anti-abuse provisions in the existing treaties or shall be added to the treaty in absence of such provisions. Thus, in order to trigger a denial of treaty benefit under the principal purpose test, obtaining the benefit need not be the sole or dominant principal purpose of the transaction or arrangement, it would suffice even if *one of the principal purposes* was to obtain such benefit. India has chosen to apply the principal purpose test which simplified LOB across all notified treaties.

4. Aligned with the above position of India as a signatory to MLI, the proposed Income Tax Bill, 2018 (both the proposed laws) provides for presumption regarding an arrangement to have been entered into, or carried out, for one of the principal purposes of obtaining a tax benefit unless the person obtaining the tax benefit proves that the tax benefit was not one of the principal purposes of the arrangement. Similar presumption shall be raised if an arrangement is entered into, or carried out, for one of the principal purposes of a step in, or part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that one of the principal purposes of the whole arrangement is not to obtain a tax benefit.

N. Tax Administration and Procedure (Chapter – XVIII)

I. Assessment Procedure

Pursuant to the desire of the Prime Minister for designing a comprehensive administrative reform in the Income Tax Department, a concept paper for modernisation of the tax administration was presented to the CBDT containing broad principles for desired systemic reforms, the salient features of which are:

(a) The concept of an Income-tax authority having jurisdiction in respect of a case or an assessee should be completely done away with.

(b) This should be replaced by an organisational approach, which means that various statutory functions required to be performed under the Income-tax Act shall be carried out under the name and common seal of the Income – tax Department.

(c) The work process relating to the core functional area of assessment should be realigned so as to split up the entire assessment procedure into separately identifiable specialized tasks.

(d) Each task should be assigned to a specialized Unit, comprising a team of income-tax authorities, which would be required to complete the task in a time-bound manner.

(e) No two consecutive tasks in a single case would be assigned to the same Unit.

(f) The task of finalizing the assessment in a case should be assigned only to such Unit which has not been assigned any other previous task in the same case.

(g) The assignment of tasks to the respective Units shall be made dynamically in a system driven environment based on the criteria of functional specialisation and equitable work load.

(h) The manpower in the Income-tax department should be restructured into specialized Units geared to handle the specialized functions, as per the new work process.

(i) All communications to the taxpayers should be sent, and all responses from the taxpayer should be received, by the Department, in electronic mode only through a centralized communication centre, so as to minimize interface with the taxpayer.

(j) Personal hearing, if requested by the tax payer, should be conducted through video conferencing only.

(k) Examination and cross-examination of witnesses and recording of statements should be allowed through video conferencing, in so far as possible.

(l) The Income-tax Department should create and maintain the infrastructure necessary to support the facility of video conference with the taxpayer.

(m) The complete record of proceedings should be maintained in electronic form only, so as to be accessible for future reference and retain its evidentiary value, in a reliable and secure manner.

(n) As a transparency measure, the taxpayer should be allowed a convenient access to the electronic record at any stage of the proceedings, with definite rights to view the record and take copies.

(o) As a trust building measure, person to person contact between the tax official and the taxpayer should be prohibited by law, subject to exceptions in certain cases.

(p) The selection of cases for tax examination should be done in accordance with a risk management strategy formulated by the Board.

(q) The taxpayer should be intimated about selection of his case for examination within a prescribed time frame.

(r) The scope of tax examination would vary depending on the level of intensity to which the examination is required to be conducted, in order to arrive at a fairly reasonable assessment of taxable income and tax liability.

The new procedure for assessment that has been proposed in this Act is to provide the legislative framework necessary for creation of functionally specialized units within the Department and realignment of the work-process of assessment, based on the aforementioned principles for ushering in the systemic reforms.

F No 370149/230/2017
Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes
(TPL Division)
******

New Delhi, dated the 22nd November, 2017

OFFICE ORDER

In order to review the existing Income-tax Act, 1961 and to draft a new direct tax law in consonance with economic needs of the country, a Task Force is constituted with the following Members:

(i) Shri Arbind Modi, Member (Legislation), CBDT - **Convener**
(ii) Shri Girish Ahuja, practicing Chartered Accountant and non-official Director State Bank of India;
(iii) Shri Rajiv Memani, Chairman & Regional Managing Partner of E&Y;
(iv) Shri Mukesh Patel, Practicing Tax Advocate, Ahmedabad;
(v) Ms. Mansi Kedia, Consultant, ICRIER, New Delhi;
(vi) Shri G.C. Srivastava, Retd. IRS (1971 Batch) and Advocate.

2. Shri Arvind Subramanian, Chief Economic Adviser, will be a permanent special invitee in the Task Force.

3. The Joint Secretary (TPL-I), Joint Secretary (TPL-II), Commissioner of Income-tax (TPRU) and Director (Research) TPRU can be asked to remain present for the meetings of the Task Force. Further, the Task Force can decide to interact with other stakeholders, whenever it feels necessary.

4. The Terms of Reference (ToR) of the Task Force is to draft an appropriate direct tax legislation keeping in view:

(i) The direct tax system prevalent in various countries,
(ii) The international best practices.
(iii) The economic needs of the country and
(iv) Any other matter connected thereto.

5. The Task Force shall set its own procedures for regulating its work. The non-official members of the task force will be paid sitting fee of Rs. 6,000/- each per day of the meeting, subject to a ceiling of Rs. 60,000/- per month. The non-official

Members of the Task Force who stay outside Delhi/place of meeting of the Task Force shall be paid TA and DA (including accommodation) as admissible to a Secretary level officer in the Government of India during their stay in connection with the meeting of the Task Force. Transport cost to non-official Task Force Members for attending meetings shall be reimbursed as per actual. The expenditure of the task force shall be met from the budgetary grants of Department of Revenue. The TPL Division of CBDT shall provide the Secretarial Assistance to the Task Force.

6. The Task Force shall submit its report to the Government within six months from the date of its constitution.

7. This issues with the approval of the Finance Minister.

22.11.2017
(Niraj Kumar)
Under Secretary (TPL)-I
Tel: 011-23095468
E-mail: ustpl1@nic.in

Copy to:

(i) The Chairman and Members of the Task Force
(ii) PS to FM/ PS to MoS (Finance)
(iii) SrPPS to Revenue Secretary
(iv) PS to Chairman (CBDT)
(v) JS (Revenue), DoR
(vi) All officers in TPL & TPRU

22.11.2017
Under Secretary (TPL)-I

Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes
****

New Delhi, 22nd November, 2017

PRESS RELEASE

Constitution of Task Force for drafting a New Direct Tax Legislation

During Rajaswa Gyan Sangam held on 1st and 2nd September, 2017, Hon'ble Prime Minister had observed that the Income-tax Act, 1961 (the Act) was drafted more than 50 years ago and it needs to be redrafted. Accordingly, in order to review the Act and to draft a new direct tax law in consonance with economic needs of the country, the Government has constituted a Task Force with the following Members:

(i) Shri Arbind Modi, Member (Legislation), CBDT - **Convener**
(ii) Shri Girish Ahuja, practicing Chartered Accountant and non-official Director State Bank of India;
(iii) Shri Rajiv Memani, Chairman & Regional Managing Partner of E&Y;
(iv) Shri Mukesh Patel, Practicing Tax Advocate, Ahmedabad;
(v) Ms. Mansi Kedia, Consultant, ICRIER, New Delhi;
(vi) Shri G.C. Srivastava, Retd. IRS (1971 Batch) and Advocate.

Shri Arvind Subramanian, Chief Economic Adviser- will be a permanent special invitee in the Task Force.

The Terms of Reference of the Task Force is to draft an appropriate direct tax legislation keeping in view:

(i) The direct tax system prevalent in various countries,
(ii) The international best practices.
(iii) The economic needs of the country and
(iv) Any other matter connected thereto.

The Task Force shall set its own procedures for regulating its work and shall submit its report to the Government within six months.

(Y D Sharma)
Commissioner of Income-tax
(Media & Technical Policy)
Official Spokesperson, CBDT

181/c

F No 370149/230/2017
Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes
(TPL Division)
******

New Delhi, dated 22nd May, 2018

OFFICE ORDER

In order to review the existing Income-tax Act, 1961 and to draft a new direct tax law in consonance with economic needs of the country, a Task Force has been constituted by the Government of India vide Office Order of even number dated 22nd November, 2017, the Terms of Reference being drafting an appropriate direct tax legislation keeping in view:

(i) the direct tax system prevalent in various countries,
(ii) the international best practices.
(iii) the economic needs of the country and
(iv) any other matter connected there to.

2. As per the said Order, the Task Force is required to submit its report to the Government within six months from the date of its constitution, i.e., 22nd May, 2018.

3. The term of the Task Force is extended by three months beyond the initial term of six months, i.e., the Task Force shall now be required to submit its report to the Government by 22nd August, 2018.

4. This issues with the approval of the Finance Minister.

22-05-2018
(Niraj Kumar)
Under Secretary (TPL)-I
Tel: 011-23095468
E-mail: ustpl1@nic.in

Copy to:

(i) The Convener and Members of the Task Force
(ii) PS to FM/ PS to MoS (Finance)
(iii) Sr PPS to Finance Secretary
(iv) PS to Chairman (CBDT)
(v) The JS (Revenue), DoR
(vi) All officers in TPL & TPRU

22-05-2018
Under Secretary (TPL)-I

Task Force for drafting a new Direct Tax Law
List iof Meetings

S No	No	Date
1	First	Dec 14, 2017
2	Second	Dec 21, 2017
3	Third	Jan 4, 2018
4	Fourth	Feb 9, 2018
5	Fifth	Feb 20, 2018
6		Feb 21, 2018
7	Sixth	Mar 05, 2018
8		Mar 06, 2018
9	Seventh	Mar 22, 2018
10	Eighth	Mar 27, 2017
11		Mar 28, 2018
12		Mar 29, 2019
13	Ninth	Apr 11, 2018
14		Apr 12, 2018
15	Tenth	Apr 19, 2018
16		Apr 20, 2018
17	Eleventh	Apr 28, 2018
18	Twelfth	May 8, 2018
19		May 9, 2018
20	Thirteenth	May 17, 2018
21		May 18, 2018
22	Fourteenth	May 26, 2018
23	Fifteenth	June 11, 2018
24		June 12, 2018
25	Sixteenth	June 19, 2018
26		June 20, 2018
27	Seventeenth	July 02, 2018
28		July 03, 2018
29		July 04, 2018
30	Eighteenth	Aug 16, 2018
31		Aug 17, 2018
32	Nineteenth	Sept, 19, 2018