Read on to get an insight into some key recommendations of the Task Force about amendments in Income Tax Act.

Direct Tax Reforms

The Kelkar Committee's Key Proposals


P.N. Shah

The Government had appointed a Task Force under the Chairmanship of Dr. Vijay Kelkar on 18.2.2004 basically to make recommendations for implementation of the Fiscal Responsibility and Budget Management Act (FRBM) passed by Parliament in 2003. The objective of this Act is to establish a broad framework for the conduct of fiscal policy by setting a medium term target to guide fiscal policy formation. The FRBM requires the Central Govt. to eliminate the revenue deficit of around 3.6% of GDP by March, 2008. For this purpose, the Govt. has to fix annual targets indicating the path of adjustments and required policy measures. The above Task Force was requested to draw up the medium term framework for fiscal policies to achieve the FRBM objective. It was also requested to formulate the annual targets indicating the path of adjustments and required policy measures. The Task Force submitted its report to the present Government on 16th July, 2004.

The report was divided into Seven Chapters. The recommendations made are basically aimed at taking our economy to a more commanding position to take full advantage from greater integration with the growing world economy and thus enable the country to achieve higher growth, greater employment opportunities, enhanced economic security and more equitable economy.

In this context, the Task Force has considered some of the provisions of the Income Tax Act, 1961, and made some significant recommendations for improvement of the existing tax structure with a view to reduce litigation, simplify procedure and at the same time increase the revenue from direct taxes. It is necessary to have a public debate on these issues as the Government is likely to take them into consideration before the next budget is presented in February, 2005.

The Task Force has observed that, at present, the Income Tax Act is riddled with tax concessions, which take the form of full or partial exemptions. These tax incentives are inefficient, iniquitous, impose greater tax payer compliance burden and administrative burden. This results in revenue loss and complexity of the tax laws and encourage tax avoidance. In fact, most of the tax litigation in our country centers around the allowance of tax incentives. To simplify the tax law

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and make it more equitable, the Task Force has suggested that all the tax incentives should be withdrawn and the rates of taxes should be reduced.

Rates of Taxes

The Task Force has observed that the global experience with lower tax rates and fewer opaque exemptions is that the administration of Income Tax became much simpler. It is now widely accepted that the design of tax policy is of paramount importance of tax administration.

If the objective is to have a transparent, efficient and feasible tax administration, the structure of all taxes should comprise common elements. These are low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges and few temporary measures.

In the rare instances where there are exemptions, there should be clear guidelines.

With this end in view, the task force headed by Dr Vijay Kelkar has recommended the following tax structure:

Personal income tax rates

(a)	**Income Slab**	**Tax Slab**
	Income below Rupees One Lac	Nil
	Income between Rs.1 Lac and 4 Lacs	20% of income in excess of Rs. one Lac
	Income above Rs.4 lacs	Rs. 60,000 plus 30% of income in excess of Rs. 4 Lacs
(b)	**Corporate tax rates**	
	For Indian Companies	30%
	For Foreign Companies	35%
(c)	**For Long Term Capital Gains**	Existing rate at 20% should continue
(d)	**Dividend distribution tax**	12.5%
(e)	**Surcharge**	Nil

"Reading the philosophy of the task force relating to rates of taxes the above recommendations appear to be reasonable. It may be noted that in the Finance (No.2) Act, 2004, it is provided that an individual having total income of Rs. 1 Lac or less will not be liable to pay any tax. There is also a provision for marginal relief. Therefore, if the total income is slightly more than Rs. 1 Lac, the tax liability will not exceed the amount by which the total income exceeds Rs.1 Lac."

Tax concessions for savings

The Task Force has considered the tax concessions given for financial savings. These concessions are provided in sections 10(10D), 10(11), 10(13), 10(15), 80 CCC, 80 L, 88 etc. The Task Force has also analysed the distortionary effect of these provisions and observed that these incentives are inefficient and iniquitous, calling for a comprehensive rationalization. It is also observed that apprehension about the adverse effect of the elimination of these incentives on national savings is also misplaced. The task force has recommended deletion of some of the tax incentives and suggested that EET method for others. In EET method, tax relief is given when investment is made in tax saving instrument, and income from such investment enjoys tax benefit. But when the amount is received on maturity of such instrument, it is subjected to tax. Some of the recommendations are as under:

(i) The tax rebate of 20% for specified investments in National Savings Certificates, NSS, EPF, PPF, LIP, etc. granted u/s 88 should be abolished.

(ii) Deduction allowed upto Rs. 12,000/15,000 u/s 80 L for interest on bank deposits, post office deposits, government securities, NSC, etc. should be discontinued.

(iii) Exemption in respect of interest on investment in specified bonds, Relief Bonds, etc. allowed u/s 10(15) should be restricted to investments so far made. Interest on any new investments made in such bonds hereafter should be withdrawn.

(iv) Provision of deduction u/s 80 CCC for contribution made to pension fund of insurance companies upto Rs. 10,000 should be deleted.

(v) Payment of premium of life insurance policy - While the premium paid on existing policies will no longer be eligible for tax rebate after the abolition of section 88, the amount received on maturity of such policies will continue to be exempt u/s 10(10D). However, the tax treatment of investments in new policies will be under the EET method of taxation.

(vi) Payment under a contract of deferred annuity- The contribution to any existing deferred annuity plan will no longer be eligible for tax rebate after the aboli-

Recommendation on Standard Deduction

A controversial proposal made by the Task Force relates to abolition of standard deduction, at present, allowed from income under the head "salaries". This proposal is most unjust and unfair. One of the reasons given for this abolition is that, with the suggested lower rates of taxes and increasing the exemption limit, there will be loss of revenue, which can be compensated by abolition of standard deduction which would yield about Rs. 4,000 crores. This is a queer logic. At present this deduction is allowed at 40% or Rs. 30,000 whichever is less where salary income is less than Rs. 5 Lacs. If the salary income is more than Rs. 5 lacs, deduction is allowed at Rs. 20,000. This deduction is allowed to salaried employees for meeting employment related expenses. It is true that conveyance allowance to a limited extent is not taxed. However, there are various other expenses such as expenditure on books, journals, training, traveling, computer, Internet etc. which are necessary to keep the employee updated for his work if he has to survive in his employment. The principle of allowing such standard deduction is being followed in computing income from property to avoid scrutiny of actual expenses claimed by assessees. Therefore, there will be no justification for abolishing the existing benefit available to salaried employees.

tion of section 88. However, the tax treatment of contributions to a new deferred annuity plan will be governed by the EET method of taxation of savings.

(vii) *Contributions to EPF Scheme, PPF account, recognized PF, GPF and approved superannuation funds* - Contributions to existing accounts of these funds will cease to enjoy rebates after the abolition of section 88. However, the interest earned on amounts outstanding in the existing accounts and withdrawals from these accounts will continue to enjoy exemption u/s 10(11), 10(12) and 10(13) of the Income Tax Act. Employees would be required to pen new accounts and contributions, accumulations and withdrawals would be subjected to the EET method of treatment of savings. The number of this new account could be the old account number suffixed by the alphabet "A".

(viii) *Subscription to any notified security or any notified deposit scheme of the central government or NSC* - In these cases every lump sum contribution is a one time investment. New investments will cease to enjoy tax rebate u/s 88. However, where income and withdrawal from these investments is exempt from income tax (other than under section 80 L), the existing investments will continue to enjoy such exemptions. All new investments made in any of these securities/schemes will be governed by EET method of taxation.

The Task Force has observed that, at present, Income Tax Act is riddled with tax concessions, which take the form of full or partial exemptions. These tax incentives are inefficient, iniquitous, impose greater tax payer compliance burden. This results in revenue loss and complexity of the tax laws and encourage tax avoidance.

(ix) Contribution to Unit Linked Insurance Plan (ULIP) - While the contributions to existing plans will no longer be eligible for tax rebate after abolition of section 88, the amount received on maturity of such policies will continue to be exempt u/s 10(10D). However, the tax treatment of investment in new plans will be under the EET method of taxation.

(x) Subscription to notified annuity plans of insurance companies - Savings in these plans are subject to EET method of tax-

Conversion of Stock-in-trade into investments

The task force has recognized that there is a provision in the Income Tax Act to recognize conversion of investment into stock-in-trade but there is no provision to recognize conversion of stock in trade into investment. It is, therefore, suggested that amendment should be made in section 49 of the Income tax Act to recognize such conversion. The cost of investment in such cases should be the value assigned to the asset as stock-in-trade in the books on the last day of the year preceding the year in which such conversion takes place.

This suggestion is also welcome as it will resolve the practical difficulties at present felt by assessees who genuinely desire to convert whole or part of the stock-in-trade into investment portfolio and hold the same for a long period of time. Although the task force has not suggested how the period of holding of investment will be counted for long term capital gain, it is believed that when the amendments are made in the Income Tax Act this question will also be addressed.

ation. These savings will be subsumed in the proposed EET method of taxation of savings.

(xi) Contributions to any pension fund setup by mutual fund or UTI - Savings in these plans are subject to EET method of taxation. These savings will be subsumed in the proposed EET method of taxation of savings.

(xii) Tax free income from specified investments - Income from some form of investments (like tax free bonds of PSUs) is fully exempt under section 10 of the Income Tax Act. All existing investments will continue to enjoy the existing benefits. However, the new investment will be liable to the EET method of taxation of savings.

The task force has suggested a new scheme known as Individual Saving Account (ISA). In brief this scheme will be as under:

(i) The scheme will be in two parts. In the first part the mandatory pension contributions will be deposited and will be available to the depositor on attaining the age of 60 years. In the second part the deposits can be made without a lock in period and can be withdrawn at any time.

(ii) The deposits made in the ISA will be fully deductible from total income and interest credited in the account will also be exempt. However, when any amount is withdrawn from ISA it will be taxable. TDS on the amount withdrawn will be 20%. The maximum contribution in ISA in any year cannot exceed Rs. One Lac.

The suggestions of the task force relating to tax incentives for savings are radical and require consideration. Taking an overall view, there is merit in these proposals provided they are implemented as a package.

Taxation of Mutual and Investments Funds

Investment funds, such as Mutual Funds, Venture Capital Funds, etc. act as an intermediary between the individual investor and the ultimate user of the capital. At present investment fund is exempt from tax. However, the dividend distributed by the fund is subjected to Dividend Distribution Tax. In the hands of investor, the dividend is free of tax. The task force is of the view that the investment funds earn income from dividends on shares, interest on debentures/bonds, capital gains and income from trading in shares and debt instruments. As the entire income is exempt from tax there is a tendency among corporates and high net worth individuals to park their funds in mutual funds to reduce their incidence of tax. Balancing the conflict between neutrality, simplicity and equity; and in the context of the proposed corporate tax reforms, the following scheme of taxation of investment funds is suggested by the task force:

(i) The tax should be levied in the hands of the Mutual and other investment funds. There will be no tax on dividend received by the investors.

To simplify the tax law and make it more equitable, the Task Force has suggested that all tax incentives should be withdrawn and rates of taxes should be reduced.

(ii) The total income of the mutual fund should exclude dividend from companies and long-term capital gains.

(iii) The mutual fund will maintain separate income and expenditure statements in respect of investment made by companies and others.

(iv) The tax rate applicable in respect of income from investment made by companies will be the rate applicable to companies and in respect of other income it will be 20%.

(v) There will be no dividend distribution tax.

(vi) The investor will not be required to pay tax on both long term and short term capital gain on sale of units of mutual fund.

(vii) The above scheme should be applied to venture capital funds, private equity funds, and hedge funds. However, the rate of tax for hedge funds should be 30%.

The above suggestions will have far reaching implications so far as mutual funds are concerned and will require public debate. There will be some practical problems for investment funds in maintaining separate income and expenditure statements for two different categories of investors. Finance (No.2) Act, 2004, has levied dividend distribution tax @ 20% in respect of dividend payable by mutual funds to corporate sector and this will go a long way in discouraging companies from parking their funds in mutual funds. Therefore, the objective of above complicated scheme suggested by the task force can be achieved to some extent by the existing provisions.

The Task Force has agreed that the present system of taxing companies separately and exempting dividend income should continue. It has also suggested that the dividend distribution tax should continue.

Speculative Transactions

One very welcome suggestion of the task force is to abolish the concept of speculation income contained in sections 43(5) and Explanation to section 73 of the Income tax Act. The suggestion is that income from transactions relating to shares, securities, derivatives etc. put through recognized stock exchanges where no delivery is given or taken should be considered as a normal business income. Losses in such transactions should not be disallowed as speculation losses and treated separately. The task force is of the view that the concept of separate treatment of speculative transactions was introduced by the Finance Act, 1953 to avoid manipulation of transactions to generate artificial losses. This was possible when the trading in shares/securities was in physical form. Now that the transactions have to be put through electronic media there is no scope for such manipulation. The task force has suggested that in respect of other commodities the existing provisions of section 43(5) can continue but as and when the other commodity exchanges modernize and make the trading through electronic media compulsory, the applicability of section 43(5) to such commodities can be eliminated.

When the above suggestion is implemented it will go a long way in reducing litigation relating to interpretation of Sections 43(5) and 73(Explanation). The present uncertainty about taxation of income or loss from transactions in derivatives, futures and options will also be resolved.

Deep Discount Bonds

Financial Institutions and others issue Deep Discount Bonds or Zero Coupon Bonds (ZCB) for financing infrastructure development. These bonds have a long period of maturity and are issued at a discount. The Investor is paid much higher amount on maturity. The issue relating to the treatment of the difference between the amount payable on maturity and the amount invested for tax purposes has been a matter of debate. Assessees claimed that this difference is taxable as capital gains. But, CBDT has taken the view that this difference in interest is taxable in the hands of

the investors as interest. CBDT issued clarifications from time to time. There are circulars issued in 1996 and 2002, which have complicated the matters further. The task force has noted that the 1996 Circular violated the principle of fiscal neutrality fundamental to the design of any tax provision. It has also noted that 2002 circular has given rise to new problems without resolving the old ones. Therefore, to correct distortions in the tax treatment of ZCB the task force has made the following suggestions:

(i) All gains from ZCBs listed in the market be treated as capital gains and subjected to tax as short term gains or long term gains depending upon the period of holding.

(ii) All ZCB issues should be dematerialized.

(iii)The amount paid on maturity be exempted from tax deduction at source (TDS).

(iv) In view of the broad basing of the personal income tax rate structure, there is no case for providing any separate relief for bunching of income.

In other words benefit of indexation will not be available.

CORPORATE TAXATION

The Task Force has agreed that the present system of taxing companies separately and exempting dividend income should continue. It has also suggested that the dividend distribution tax should continue. However, the rate of income tax should be reduced in the case of Indian Companies to 30% and Foreign Companies to 35%. Further, no surcharge should be levied. In the scheme of taxation suggested by the task force, there will be no need to levy book profit tax i.e. MAT.

As discussed earlier, the task force has suggested abolition of all tax incentives provisions. In brief, the following suggestions are made:

(i) General rate of depreciation on Plant and Machinery should be reduced from 25% to 15%. Rates of depreciation on other assets be reviewed. The main reason for this suggestion is to see that the gap between taxable income and book profit be reduced.

(ii) The incentives u/s 80 IA and 80 IB of the Income Tax Act have not served the purpose for which they were introduced. Therefore, they should be phased out over a period of 2 years. Alternatively, these incentives may continue for existing units and units started after a specified date will not be allowed this deduction.

(iii) Distinction between unabsorbed depreciation and unabsorbed business loss be removed. The unabsorbed business loss and depreciation be carried forward for indefinite period.

(iv) Tax incentives u/s 10 A, 10 B, 80 JJA, 80 JJAA, 33 A, 33 AC, 33 B, 35 AC and 35 CCA should be allowed only to existing units/businesses. However, units/business setup on or after 1.9.2004 will not be entitled to this deduction.

(v) No fresh tax incentives should be granted. Similarly no tax incentives should be revived or any sunset clause for incentives be extended.

It will be noticed that the above suggestions for reforms in corporate taxation will have far reaching consequences so far as the working and planning of corporate entities are concerned. These suggestions will need public debate before they are implemented.

To sum up

The recommendations of the Task Force relating to direct taxes, barring one or two, such as withdrawal of standard deduction and taxation of mutual funds, are commendable. Broadly stated, the suggestion is to reduce tax rates, increase basic exemption limit and eliminate all tax incentives that are given to achieve some social or political objectives. These suggestions will go a long way in simplification and rationalization of our direct tax laws and will reduce litigation if they are implemented as a package. If these are distorted for political or other reasons, the desired objective will not be achieved. ■

For Information of the Members

Embassy of India, Kingston (Jamaica) has informed us about the interest of the Government of Bahamas in securing the services of 20 Certified Chartered Accountants from India on an urgent basis. The Accountants are likely to be placed with the Ministries and Department of Government of Bahamas, initially on contract basis for a period of two years.

Interested Members of the Institute may apply for the above at the following address:

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