

Interest from Fixed Deposits with Banks Deserves Exemption from Income-Tax on the Analogy of Dividend Exemption



A fond desire in the heart of persons in the lower and middle income groups, specially those who are in the evenings of their lives (popularly referred to as ‘senior citizens’), is to make savings in many cases at the cost of considerable hardship by sacrificing some of the needs of day-to-day life, to secure a way of living at standards to which they have been used to living, provide financial cover in the absence of an organised social security scheme for its citizens from the Government’s side, for meeting future needs and unforeseen contingencies. The hassle-free way of doing so is to put savings in fixed (term) deposits for varied periods in public and reputed private sector banks at pre-determined rates of interest to provide a source of income to meet current needs and deposits to provide security like an insurance cover for future needs/contingencies. It is mostly people with moderate incomes in these categories that put their money in term deposits. Those who can deploy their surplus funds in a way that can generate higher returns by putting such funds in business ventures or by investments in real estate or by way of share capital to companies or by putting the funds in bonds, high income earning securities or in other ways of generating higher returns do not put their funds in term deposits with the banks at rates of return which are quoted low and which though provide security but are not commensurate with the return that such sums can fetch by investment in other areas.



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Tax on interest from term/fixed deposits with banks

The interest earned from term/fixed deposits with banks is liable to tax under the Income-tax Act, 1961 (the Act) generally, as ‘income from other source’. Tax is deductible from such income at the time of credit

or payment whichever event occurs earlier if the aggregate of interest payable to an assessee from such source exceeds ₹10,000/- in a previous year. This can be avoided by filing forms Nos. 15G & 15H before the tax authorities by those taxpayers whose income is below taxable limit but the literacy level in the country being very low, many taxpayers being unaware of this or being not in a position to afford the service of tax consultants lose this tax even though their incomes are below the amount liable to tax under the provisions of the Act, being unable to comply with the requirement of filing the aforesaid forms. Thus the Government gets enriched by such unclaimed TDS from interest which rightfully belongs to the lower, middle and aged sections of the population which, *prima facie*, seems unfair.

Further, the income from this source becomes taxable at the rate of tax applicable to a taxpayer in the last income bracket in which he falls. If average of 3 bracket rates is taken at 20.60%, then interest income which is generally in the level of 8 to 10 percentage of the deposit gets further reduced by such a percentage reducing substantially the income from the source in the hands of those who need it most.

Whether interest income from banks term deposits needs to be exempted from income-tax?

In the above background, the issue needing serious consideration of the FM is whether interest income from such deposits needs to be exempted from tax more so when the income from dividends is exempt from tax to any extent? Apparently, there is gross discrimination in subjecting the interest income to tax and giving total exemption to dividends from tax *vide* Section 10(34) of the Act.

Historical background of exemption of dividend income from tax

There have been wide debates in India and abroad about the taxation of dividends from companies in shareholders' hands on the ground that this leads to double taxation. The argument advanced is that the company first pays tax on its taxable income and when such 'taxed' income is distributed to the company's shareholders as dividends, taxing the shareholders

again on such 'taxed' income amounts to double taxation which is claimed to be unfair and unjust. Such protagonists for exemption of dividends ignore the position that the 'companies' and 'shareholders' are separate categories of taxpayers paying tax on the basis of their own separate existence—the shareholders as a separate entity enjoying the benefit of limited liability and simultaneously claiming to be a part of it is anomalous! Hence the argument of double taxation is not valid!

However, such argument has worked in certain tax jurisdictions and in some countries dividend income is not being taxed, while a host of countries are still continuing with such taxation being not convinced by the argument of double taxation.

Taxation of dividends in the Indian context

The arguments claiming exemption of dividends from income-tax on the ground of double taxation have been raised in India also from time to time and debated. But no final decision could be reached in the matter one way or the other. The Finance Minister, Shri P. Chidambaram while presenting the budget for the year 1997-98 *vide* Finance Act, 1997 abolished tax on dividends by inserting sub-section(33) in section 10 of the Act (the same is numbered as sub-section (34) presently) with the following observations:

"Another area of vigorous debate over many years relates to the issue of tax on dividends. I wish to end this debate. Hence I propose to abolish tax on dividends in the hands of the shareholders."

Prima facie, the ground given by the Hon'ble FM for abolishing tax on dividends hardly indicates any thought-provoking exercises done for arriving at the decision. There are many other aspects in the Act of the country such as whether slab system of taxation should be introduced in taxing companies, whether surcharges should be imposed in normal times to raise revenue etc. which are being fiercely debated. Apparently, the FM has not ended the debate in these matters by abolishing income-tax on such debated aspects! Then why only dividends are picked up for giving exemption from tax to end the debate! The logic behind exempting dividend from tax remains unresolved to date!

Double taxation resorted to in a more blatant way!

While abolishing tax on dividends by the Finance Act, 1997, the FM introduced another tax by the same legislation, besides the normal corporation tax with

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surcharge, designated as 'Dividend Distribution Tax' (DDT) on the companies who make distribution of dividends with the following observations:

"Some companies distribute exorbitant dividends. Ideally they should retain the bulk of their profit and plough them into fresh investments. I intend to reward companies who invest in future growth. Hence I propose to levy a tax on distributed profits at the moderate rate of 10 per cent on the amount so distributed. This tax shall be an incidence on the company and shall not be passed on to the shareholder."

(Presently, this tax is imposed @ 15% on the distributed dividends)

Obviously, the DDT is a more exposed form of double taxation in the case of companies because a corporation first pays tax on its income in the normal course and when it distributes its taxed income as dividends it is subjected to pay tax again on the same income by way of DDT! This is quite different from the position when a shareholder pays tax as a separate legal taxable entity, on the dividends received by it which is paid by the company from out of its taxed income. The payment out of taxed income is in lieu of use of capital provided by the shareholders and is an income received for such use. It is of the same nature as rent that a person receives by letting out his property. Hence while there is no double taxation in cases of dividends being taxed in the hands of the shareholders, there is apparent/obvious double taxation when income paid as dividends by companies is taxed again in their hands by way of DDT!

Inequity in exempting dividend income accepted in a later year

The inequity of the system of taxation in the case of the companies and exempting shareholders from dividend income as introduced by the Finance Act, 1997 was accepted by the FM, Shri Yashwant Sinha, while presenting the Finance Bill for 2002-03. He said:

".... There is also an inherent inequity in the present system, which allows persons in high-

income groups to be taxed at much lower rates than the rates applicable to them. These issues have been troubling me over the past four years and I am now convinced that the system must go. Such income (meaning the dividend income) will henceforth be taxed in the hands of the recipients at the rates applicable to them...".

Thus, the old classical system of taxing company (on its income) and shareholders (for dividends) was restored. But the change remained operative for one year only. Shri Sinha's successor, Shri Jaswant Singh, next year reverted to the old system without assigning any reasons and it is continuing since then.

Shri Jaswant Singh, of the same NDA Government, restored the exemption of dividends from tax merely with the following observation:

"89, From April 1, 2003, it is proposed that dividends be tax free in the hands of the shareholders. Correspondingly, there will be a 12.5 percent dividend distribution tax on domestic companies."

The foregoing observations from the 3 Finance Ministers show that detailed consideration was not bestowed on the important decisions relating to exemption of dividends from tax, restoration of tax on such income and its withdrawal again.

Who is being benefited by exemption of dividends from tax?

The duality of policy of the Government of India *vis-à-vis* Indian people, making the rich richer and the poor poorer, was vividly disclosed sometime back when Planning Commission's data regarding people living below the poverty line was published, leading to a fierce debate about its trustworthiness. Immediately after just a few days of the disclosure of the position regarding the persons living below the poverty line as released by the Planning Commission (it has been slightly modified by declaration made a few weeks later) the Economic Times issue of 16th September,

The interest from bank deposits need to be exempted in the same way as dividends with a stipulation that if a person claims deduction u/s 80C(2)(xxi) of the Act for bank deposits, the interest attributable to such deposits will be taxed because double tax benefit cannot be claimed in respect of the same amount.

2011 published figures relating to huge amount of dividends being treated as exempt in the cases of only 6 super rich individuals in the country out of 42,800 persons having income exceeding ₹1 crore per year (as stated by the FM in the Budget Speech for 2013-14). The data (as stated later) has been compiled by the ET Intelligence Group of the paper and mentioned at page 1 under the caption “Higher Pay out make up for stock fall!. The study revealed, how a sum of ₹4,990 crore was received as tax free dividends only by 6 persons! The figures are:

Promoter	Industry	Fy 11 (₹ In Cr.)	YOU% CHG
Azim H Premji	Wipro	1,345.1	67.8
Mukesh Ambani	RIL	1,240.7	14.0
Rahul Bajaj	Bajaj	917.4	75.7
Anil Agarwal	Vedanta	790.2	29.3
Keshub Mahindra	M&M	312.2	26.2
Gautam S. Adani	Adani	304.0	112.7

The study has revealed the following further aspects:

- ₹48,191 crore aggregate dividend (obviously without income-tax payment) was earned in 2010-11 by business houses, up by 7.5%
- One of every three in the sample of top 54 promoters took home at least 50% more than a year earlier as payouts rose in a sliding market ended stock valuations.
- At least six of them had more than a two-fold jump in their dividends.

The FM has to put his hand on his heart and ponder whether income to the extent of ₹48,191 crore as dividend should remain untaxed and generally meagre amounts earned as interest from bank deposits by persons in lower and middle income groups pensioners, retirees war widows etc. much less in quantum in each

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Interest generating from deposits for a longer period has a better claim for deduction than interest arising from deposits in Savings Account and hence there seems to be no case for not extending the operation of this section to interest on term/fixed deposits.

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persons' hand than huge amounts of exempt dividends in well-to-do persons' hands should be taxed?

Why dividends have been exempted from tax?

The ground advocated in support of exempting dividends from income-tax is claimed to be wider overall context relating to use of funds invested in shares and securities for the developmental and other needs in the country. But the same ground holds good in a more convincing way in case of funds provided to the banks for such use by means of deposits in banks by millions of people of India. The banks also use such funds in the same manner and for similar purposes as corporates do in respect of funds generated through the medium of issue of shares for the betterment and growth of the country. Rather in the case of corporations, the money raised is primarily for their private use and benefit to the country is incidental. In the case of funds routed through banks by depositors the prime objective is public interest and their use is in the overall interest of the country and the private use, if any, is merely incidental. Hence 'use wise' the interest on deposits made has better claim for exemption in comparison to dividends!

Interest on bank deposits has been exempted in the past

The Act had a provision by way of Section 80L giving exemption to interest income, *inter alia*, from banks along with deposits with certain other bodies to the extent mentioned in section 80L. Section 80L was inserted in the Act by the Finance (No. 2) Act 1967 and continued till the year 2005 when it was omitted by the Finance Act, 2005 w.e.f. 01-04-2006. At the time of its omission from the Act it exempted interest income, *inter alia*, from banks to the extent of ₹12,000 in a year irrespective of the period for which deposit was made.

Rationale for omitting Section 80L from the Act

This has been explained in paras 154 and 155 in the budget speech for FY 2005-06 which read as under:

“154 There is now a plethora of exemptions, ostensibly intended to promote savings. Some exemptions are based on the principle of deduction from taxable income and some exemptions are based on the principle of tax rebate. I believe the time is ripe to clean up these exemptions. At the same time, it is necessary to encourage savings, and tax relief is a method of induce people to save. Further, I think that the State must be neutral

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between one form of saving and another, and allow the taxpayer greater flexibility in making savings/investment decisions.

155. For all these reasons, in addition to the basic exemption limits, I propose to allow every taxpayer a consolidated limit of Rs. 1 lakh for savings which will be deducted from the income before tax is calculated. All prevailing sectoral cap will be removed. The rebate under Section 88 is being eliminated and Section 80L is being omitted to reflect the new regime.”

By the Finance Act 2005, a sub-clause (xxi) was inserted in Section 80C, which had earlier replaced Section 88 providing for rebate on life insurance premium, contribution to PFs etc. (but not bank deposits or interest thereon) by straight deduction instead of rebate. This provision reads as under:

”[xxi] as term deposit-

- (a) for a fixed period of not less than five years with a scheduled bank; and
- (b) which is in accordance with a scheme framed and notified, by the Central Government, in the Official Gazette for the purposes of this clause. “

The section provides for deduction of bank deposit up to ₹ 1 lakh on satisfying the laid down conditions. However, the interest earned on such deposits is subject to tax.

Discrimination regarding treatment in taxation of interest vis-à-vis dividends continues

The foregoing discussion shows that the handicap in regard to interest income continues vis-à-vis dividends. Firstly, the deduction for bank deposits has to compete with other pressing deductions relating to LIC premiums, provident funds, payment of tuition fees for children, payment towards securing annuities, post-office savings schemes, pension funds, interest for construction of residential house etc. while there is no such competition for investment in shares to earn such income. Hence room for getting deduction for bank deposits become quite limited and the tax benefit of deduction on this account becomes more illusory than real!



The funds need to be blocked in deposits for 5 years while there is no such requirement for investment to be made for dividends for claiming exemption from tax!

How to proceed

The interest from bank deposits needs to be exempted in the same way as dividends with a stipulation that if a person claims deduction u/s 80C(2)(xxi) of the Act for bank deposits, the interest attributable to such deposits will be taxed because double tax benefit cannot be claimed in respect of the same amount.

Concluding comments

Discrimination in taxation in regard to incomes from dividends and interest is seemingly unjustified. Hence, full exemption from income tax needs to be provided to interest income also in the same way, as it is accorded to dividends as funds for earning interest are used for the developmental needs including relating to capital market and for the welfare of people in the same way as funds generating dividends.

A beginning has already been made in this direction by the Finance Act, 2012 by insertion of the Part CA in Chapter VI-A of the Act where Section 80TTA has been inserted providing for deduction in cases of individuals/HUFs in regard to interest on Savings Accounts up to an amount of ₹ 10,000 in a year. Obviously, interest generating from deposits for a longer period has a better claim for deduction than interest arising from deposits in Savings Account and hence there seems to be no case for not extending the operation of this section to interest on term/fixed deposits.

It is hoped that the Hon'ble FM will see the logic of exempting interest income from deposits with banks in the same way as in the case of dividends and will provide for the same while finalising the Direct Taxes Code for the country. ■