

## Consequences of Replacing Section 88 with Section 80C by Finance Act, 2005

The new Section 80C has been inserted in place of old Section 88 by Finance Act, 2005. The Finance Ministry has implemented some of the recommendations of the Kelkar Committee on taxation of personal income despite its plea that all the recommendations should be considered as an indivisible unit. In particular, the Committee did not recommend that the rebate under section 88 should be replaced by a straight deduction under section 80C, nor that the present treatment of savings under the exempt-exempt-exempt (EEE) method should be replaced by the exempt-exempt-taxed (EET) method, preferring instead the taxed-exempt-exempt (TEE) method. This write-up evaluates the effect of the change from Section 88 to Section 80C, and finds it retrograde and regressive.

### Views of the Kelkar Committee on Tax Treatment of Income from Savings Instruments

The Kelkar Committee noted that as income tax is inherently biased against savings, the EET and TEE methods — at the stages of contribution, accumulation and withdrawal — are the two alternate ways of devising income tax which neutralises the bias. Under the EET method, contributions are deductible from the gross income, accumulation is exempt, and withdrawal is taxed. Fiscal neutrality demands that imposition of tax should not distort the choice between different forms of savings, and between consumption and savings, under a non-discriminatory tax treatment irrespective of the maturity period.

Under the existing tax provisions, savings are exempted at all the three stages i.e., the EEE method. This has impacted economic efficiency, equity and revenue efforts. Saving instruments with similar maturity but different tax concessions result in different effective yields, distorting investment decisions. Savings are rewarded, but dis-savings not taxed. There is a bias in favour

of short-term instruments creating serious distortions in the allocations of savings.

However, recognising the current imperatives of Revenue, the demographic profile of the taxpayers, and the transitional administrative problems in shifting from the existing EEE method to EET method, the preferred option is the TEE method.

The existing tax treatment of savings has also affected the equity of the tax system adversely. Deductions from income like, under section 10, section 80L and the provisions relating to roll over of capital gains favour upper tax bracket taxpayers disproportionately, the post-tax rates of return increasing with the upper marginal rate of the saver, and are, therefore, regressive.

To the extent relevant for this article, it recommended the “elimination” of deductions under sections 16(i), 88, 88B, 88C, 80L, and exemptions under section 10 relating to interest income from bonds, securities, debentures, etc. It felt that a comprehensive income tax with a sufficiently high exemption limit, and a two-tier broad-based rate schedule is preferable to an income tax riddled with exemptions on grounds of efficiency, equity and administrative simplicity and relatively low compliance burden.

### Departmental Volte-face

When Section 88 was inserted by the Finance



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Act, 1990, the reasons given for the same vide Circular No. 572, dated 3rd August, 1990, [(1990) 87 CTR (St) 1] were :

“22.1 Under the existing scheme of section 80C, a person gets relief at the highest marginal rate of tax applicable to him. Accordingly, it confers higher amount of tax benefits to a person with higher income vis-à-vis a person with a lower income. The scheme is, therefore, regressive and inequitable.

22.2 With a view to removing this imbalance, section 80C of the Income Tax Act has been replaced by a new provision in section 88. Under the new provision, an assessee will be entitled to a deduction of twenty per cent of the amount invested or deposited in life insurance policies.... The maximum tax rebate allowable will be Rs 10,000.”

The Memorandum Explaining the Provisions of the Finance Bill, 2005 says on the “new” (reintroduced) section 80C:

“The existing provisions of the Income Tax Act do not accord a homogeneous treatment to the taxation of financial savings. There is considerable variation in the taxation of the contributions made to savings schemes, the tax levied on the accumulations, and the tax treatment at the final stage of withdrawal. This lack of uniformity tends to induce artificial distortions and bias amongst the various financial instruments... The best international practice relating to taxation of financial savings is the EET method.

“The existing method of taxing financial savings is highly distortionary, resulting in economic inefficiency and inequity. With a view to removing such distortionary effects, it is proposed to adopt the EET method as the most preferred option. ...The design of some existing saving schemes in operation, particularly mandatory plans and insurance products, may not allow for sufficient flexibility in the short run to switch to an EET method of taxation...

In the transition, it is proposed to take appropriate steps to facilitate the ultimate

switchover to the EET system. Under the EET system, the contributions to savings plan are deductible from income. Therefore, the existing system of providing rebate for investment in saving products is inconsistent with the EET method. The first step in the direction of the EET method is, therefore, to switch from the rebate method to income-based deduction method. Therefore, it is proposed to replace the existing method of providing tax rebates under section 88 for contributions/investments in specified savings schemes by an income-based deduction for contributions, by inserting a new section 80C under Chapter VI-A of the Income Tax Act.”

### **Change from Tax Rebate under Section 88 to Tax Deduction under Section 80C**

Section 80C reads as follows:

80C. (1) *In computing the total income of an assessee, being an individual or a Hindu Undivided Family, there shall be deducted, in accordance with and subject to the provisions of this section, the whole of the amount paid or deposited in the previous year, being the aggregate of the sums referred to in sub-section (2), as does not exceed one lakh rupees.*

80C(2) deals with the securities available for the investment.

In the change from section 88 to section 80C, saving instruments no longer currently available have been omitted, like in section 88(2)(viii) [10 or 15 year account in the post office savings bank], section 88(2)(xi) [subscriptions to NSC VI and VII issues], section 88(2)(xvi) [reference to sections 54EA and 54EB which refer to transfer of capital assets before 1st April, 2002], section 88(2)(xiiib) [removal of limit of Rs 10,000 on investments in mutual funds], section 88(2)(xiva) [removal of reference to section 80L as it is omitted from 1st April, 2006]. Notifications required under sections 80C(2)(v), 80C(2)(ix), 80C(2)(xi), 80C(2)(xii) and 80C(2)(xiii) have been issued on 3rd November, 2005.

The tax schedule is designed for a particular tax system or regime, and goes together with

the regime. The tax effect of the change in the system of taxation from tax rebate under section 88 to tax deduction under section 80C is considered in the cases of individuals/general salary earners, and senior citizens with the related tax schedules.

**a) Individual/General Taxpayers**

In Table A, the tax payable by individuals

covered by Part (a) varies from NIL at gross total income of Rs 1 lakh to Rs 2,70,400 at gross total income of Rs 10 lakhs, and the average rate varies from 0% to 27.4%, respectively; for individuals covered under Part (b) the tax payable varies from NIL at gross total income of Rs. 1 lakh to Rs. 2,20,000 and the average rate varies from 0% to 24.4%.

| <b>Table A</b>              |                    |                    |                         |              |                     |            |             |             |
|-----------------------------|--------------------|--------------------|-------------------------|--------------|---------------------|------------|-------------|-------------|
| <b>(a) Deduction U/S 88</b> |                    |                    |                         |              | <b>(Rs In '000)</b> |            |             |             |
| Sr. no.                     | Gross Total Income | Deduction U/S 80 L | Deposit/ Payment U/S 88 | Total Income | Gross Tax           | Tax Rebate | Tax Payable | Avg. Rate % |
| 1                           | 100                | 5                  | 30                      | 95           | 8                   | 8          | NIL         | 0           |
| 2                           | 200                | 10                 | 60                      | 190          | 31                  | 9          | 22          | 11.6        |
| 3                           | 300                | 15                 | 90                      | 288          | 60.4                | 13.5       | 46.9        | 16.3        |
| 4                           | 400                | 20                 | 120                     | 388          | 90.4                | 15         | 75.4        | 19.4        |
| 5                           | 500                | 25                 | 150                     | 488          | 120.4               | 15         | 105.4       | 21.6        |
| 6                           | 600                | 30                 | 180                     | 588          | 150.4               | --         | 150.4       | 25.6        |
| 7                           | 700                | 35                 | 210                     | 688          | 180.4               | --         | 180.4       | 26.2        |
| 8                           | 800                | 40                 | 240                     | 788          | 210.4               | --         | 210.4       | 26.7        |
| 9                           | 900                | 45                 | 270                     | 888          | 240.4               | --         | 240.4       | 27.1        |
| 10                          | 1000               | 50                 | 300                     | 988          | 270.4               | --         | 270.4       | 24.4        |

| <b>(b) Deduction U/S 80 C</b> |                    |                    |                           |              | <b>(Rs In '000)</b> |            |             |             |
|-------------------------------|--------------------|--------------------|---------------------------|--------------|---------------------|------------|-------------|-------------|
| Sr. no.                       | Gross Total Income | Deduction U/S 80 L | Deposit/ Payment U/S 80 C | Total Income | Gross Tax           | Tax Rebate | Tax Payable | Avg. Rate % |
| 1                             | 100                | 5                  | 30                        | 70           | --                  | --         | NIL         | 0           |
| 2                             | 200                | 10                 | 60                        | 140          | --                  | --         | 4           | 2.9         |
| 3                             | 300                | 15                 | 90                        | 210          | --                  | --         | 17          | 8.1         |
| 4                             | 400                | 20                 | 120                       | 300          | --                  | --         | 40          | 13.3        |
| 5                             | 500                | 25                 | 150                       | 400          | --                  | --         | 70          | 17.5        |
| 6                             | 600                | 30                 | 180                       | 500          | --                  | --         | 100         | 20          |
| 7                             | 700                | 35                 | 210                       | 600          | --                  | --         | 130         | 21.7        |
| 8                             | 800                | 40                 | 240                       | 700          | --                  | --         | 160         | 22.9        |
| 9                             | 900                | 45                 | 270                       | 800          | --                  | --         | 190         | 23.8        |
| 10                            | 1000               | 50                 | 300                       | 900          | --                  | --         | 220         | 24.4        |

## b) Salaried Class

In Table B, the tax payable by a person covered under Part (a) varies from NIL at income of Rs. 1 lakh to Rs. 2,70,400 at Rs. 10 lakhs, and average rate varies from 0% to 27.4% respectively. In Part (b) the tax payable varies from NIL to Rs. 2,20,000 at gross total income of Rs. 10 lakhs, and average rate varies from 0% to 24.4% respectively.

## c) Senior Citizens

In Table C, the tax payable by a person under Part (a) varies from NIL at a gross total income of Rs. 1 lakh to Rs. 2,50,400 at gross income of Rs. 10 lakhs, and the average rate varies from 0% to 25.3% respectively. In Part (b) the tax payable by the individual varies from NIL at gross total income of Rs. 1 lakhs to Rs. 2,08,000 at a gross total income of

| <b>(a) Deduction U/S 88</b> |                    |                    |                         |                    |              |           |            |             |             |
|-----------------------------|--------------------|--------------------|-------------------------|--------------------|--------------|-----------|------------|-------------|-------------|
| <b>(Rs In '000)</b>         |                    |                    |                         |                    |              |           |            |             |             |
| Sr. no.                     | Gross Total Income | Deduction U/S 80 L | Deposit/ Payment U/S 88 | Standard Deduction | Total Income | Gross Tax | Tax Rebate | Tax Payable | Avg. Rate % |
| 1                           | 100                | 5                  | 30                      | 30                 | 65           | 2         | 2          | NIL         | 0           |
| 2                           | 200                | 10                 | 60                      | 30                 | 160          | 22        | 9          | 13          | 8.5         |
| 3                           | 300                | 15                 | 90                      | 30                 | 258          | 51.4      | 13.5       | 37.9        | 14.7        |
| 4                           | 400                | 20                 | 120                     | 30                 | 358          | 81.4      | 15         | 66.4        | 18.5        |
| 5                           | 500                | 25                 | 150                     | 30                 | 458          | 111.4     | 15         | 96.4        | 21          |
| 6                           | 600                | 30                 | 180                     | --                 | 588          | 150.4     | --         | 150.4       | 25.6        |
| 7                           | 700                | 35                 | 210                     | --                 | 688          | 180.4     | --         | 180.4       | 26.2        |
| 8                           | 800                | 40                 | 240                     | --                 | 788          | 210.4     | --         | 210.4       | 26.7        |
| 9                           | 900                | 45                 | 270                     | --                 | 888          | 240.4     | --         | 240.4       | 27.1        |
| 10                          | 1000               | 50                 | 300                     | --                 | 988          | 270.4     | --         | 270.4       | 27.4        |

| <b>(Rs In '000)</b> |                    |                    |                         |                    |              |           |            |             |             |
|---------------------|--------------------|--------------------|-------------------------|--------------------|--------------|-----------|------------|-------------|-------------|
| Sr. no.             | Gross Total Income | Deduction U/S 80 L | Deposit/ Payment U/S 88 | Standard Deduction | Total Income | Gross Tax | Tax Rebate | Tax Payable | Avg. Rate % |
| 1                   | 100                | 5                  | 30                      | --                 | 70           | --        | --         | Nil         | 0           |
| 2                   | 200                | 10                 | 60                      | --                 | 140          | --        | --         | 4           | 2.9         |
| 3                   | 300                | 15                 | 90                      | --                 | 210          | --        | --         | 17.9        | 8.1         |
| 4                   | 400                | 20                 | 120                     | --                 | 300          | --        | --         | 40          | 13.3        |
| 5                   | 500                | 25                 | 150                     | --                 | 400          | --        | --         | 70          | 17.5        |
| 6                   | 600                | 30                 | 180                     | --                 | 500          | --        | --         | 100         | 20          |
| 7                   | 700                | 35                 | 210                     | --                 | 600          | --        | --         | 130         | 21.7        |
| 8                   | 800                | 40                 | 240                     | --                 | 700          | --        | --         | 160         | 22.9        |
| 9                   | 900                | 45                 | 270                     | --                 | 800          | --        | --         | 190         | 23.8        |
| 10                  | 1000               | 50                 | 300                     | --                 | 900          | --        | --         | 220         | 24.4        |

Table C

| (a) Deduction U/S 88 (Rs In '000) |                    |                    |                         |              |           |                       |             |             |
|-----------------------------------|--------------------|--------------------|-------------------------|--------------|-----------|-----------------------|-------------|-------------|
| Sr. no.                           | Gross Total Income | Deduction U/S 80 L | Deposit/ Payment U/S 88 | Total Income | Gross Tax | Tax Rebate u/s 88/88B | Tax Payable | Avg. Rate % |
| 1                                 | 100                | 5                  | 30                      | 95           | 8         | 8                     | NIL         | 0           |
| 2                                 | 200                | 10                 | 60                      | 190          | 31        | 29                    | 2           | 1.1         |
| 3                                 | 300                | 15                 | 90                      | 288          | 60.4      | 33.5                  | 26.9        | 9.3         |
| 4                                 | 400                | 20                 | 120                     | 388          | 90.4      | 35                    | 55.4        | 14.3        |
| 5                                 | 500                | 25                 | 150                     | 488          | 120.4     | 35                    | 85.4        | 17.5        |
| 6                                 | 600                | 30                 | 180                     | 588          | 150.4     | 20                    | 130.4       | 22.2        |
| 7                                 | 700                | 35                 | 210                     | 688          | 180.4     | 20                    | 160.4       | 23.3        |
| 8                                 | 800                | 40                 | 240                     | 788          | 210.4     | 20                    | 190.4       | 24.2        |
| 9                                 | 900                | 45                 | 270                     | 888          | 240.4     | 20                    | 220.4       | 24.8        |
| 10                                | 1000               | 50                 | 300                     | 988          | 270.4     | 20                    | 250.4       | 25.3        |

| (b) Deduction U/S 80 C (Rs In '000) |                    |                    |                           |              |           |            |             |             |
|-------------------------------------|--------------------|--------------------|---------------------------|--------------|-----------|------------|-------------|-------------|
| Sr. no.                             | Gross Total Income | Deduction U/S 80 L | Deposit/ Payment U/S 80 C | Total Income | Gross Tax | Tax Rebate | Tax Payable | Avg. Rate % |
| 1                                   | 100                | 5                  | 30                        | 70           | --        | --         | NIL         | 0           |
| 2                                   | 200                | 10                 | 60                        | 140          | --        | --         | NIL         | 0           |
| 3                                   | 300                | 15                 | 90                        | 210          | --        | --         | 5           | 2.4         |
| 4                                   | 400                | 20                 | 120                       | 300          | --        | --         | 28          | 9.3         |
| 5                                   | 500                | 25                 | 150                       | 400          | --        | --         | 58          | 14.5        |
| 6                                   | 600                | 30                 | 180                       | 500          | --        | --         | 88          | 17.6        |
| 7                                   | 700                | 35                 | 210                       | 600          | --        | --         | 118         | 19.7        |
| 8                                   | 800                | 40                 | 240                       | 700          | --        | --         | 148         | 21.1        |
| 9                                   | 900                | 45                 | 270                       | 800          | --        | --         | 178         | 22.3        |
| 10                                  | 1000               | 50                 | 300                       | 900          | --        | --         | 208         | 23.1        |

Rs. 10 lakhs, and the average rate varies from 0% to 23.1% respectively.

of Rs. 1 lakh to Rs. 50,400 at a gross total income of Rs. 10 lakhs. Likewise, the tax loss varies from NIL to Rs. 50,400 in Table B, and from NIL to Rs. 42,400 under Table C.

#### d) Difference In Tax Liability

Table D shows the difference in the taxes payable under Part (a) and (b) for incomes from Rs. 1 lakh to Rs. 10 lakhs. The tax loss by allowing deduction under Section 80C instead of rebate under Section 88 in Table A varies from NIL at a gross total income

#### Exemption from Tax

Under Section 23 of the Indian Evidence Act, to exempt is to give immunity from a liability, obligation, penalty, law or authority. The Supreme Court observed in Union of India vs.

| Table D            |                       |     |            |                       |      |            |                       |     |            |
|--------------------|-----------------------|-----|------------|-----------------------|------|------------|-----------------------|-----|------------|
| (Rs In '000)       |                       |     |            |                       |      |            |                       |     |            |
| Gross Total Income | Table A Tax liability |     |            | Table B Tax liability |      |            | Table C Tax liability |     |            |
|                    | (a)                   | (b) | Difference | (a)                   | (b)  | Difference | (a)                   | (b) | Difference |
| 100                | NIL                   | NIL | NIL        | NIL                   | NIL  | NIL        | NIL                   | NIL | NIL        |
| 200                | 22                    | 4   | 18         | 13                    | 4    | 9          | 2                     | NIL | 2          |
| 300                | 46.9                  | 17  | 29.9       | 37.9                  | 17.9 | 20.9       | 26.9                  | 5   | 21.9       |
| 400                | 75.4                  | 40  | 35.4       | 66.4                  | 40   | 26.4       | 55.4                  | 28  | 27.4       |
| 500                | 105.4                 | 70  | 35.4       | 96.4                  | 70   | 26.4       | 85.4                  | 58  | 27.4       |
| 600                | 150.4                 | 100 | 50.4       | 150.4                 | 100  | 50.4       | 130.4                 | 88  | 42.4       |
| 700                | 180.4                 | 130 | 50.4       | 180.4                 | 130  | 50.4       | 160.4                 | 118 | 42.4       |
| 800                | 210.4                 | 160 | 50.4       | 210.4                 | 160  | 50.4       | 190.4                 | 148 | 42.4       |
| 900                | 240.4                 | 190 | 50.4       | 240.4                 | 190  | 50.4       | 220.4                 | 178 | 42.4       |
| 1000               | 270.4                 | 220 | 50.4       | 270.4                 | 220  | 50.4       | 250.4                 | 208 | 42.4       |

Wood Papers Ltd. (1990) 4 SCC 256. 260: AIR 1991 SC 2049. 2051-52. "Literally exemption is freedom from liability, tax or duty. Fiscally, it may assume varying shapes, specially in a growing economy. For instance, tax liability to new units, concessional rate of tax to goods or persons for limited period or with the specific objective, etc. That is why its construction, unlike charging provision, has to be tested on different touchstone. In fact an exemption provision is like an exception and on normal principle of construction or interpretation of statutes, it is to be construed strictly either because of legislative intention or on economic justification of inequitable burden or progressive approach of fiscal provisions intended to augment State revenue". In *Indian Express Newspapers (P) Ltd. vs. Union of India* (1986) 159 ITR 856 (SC) the Supreme Court held that a power which has to be exercised in the public interest has to be exercised in a reasonable way.

### Some Views on the Change from Rebate System to Deduction System

The relevant Kelkar Committee's recommendations have been mentioned in the initial paras of this article. In particular, they did not recommend the replacement of rebate

under Section 88 by deduction under section 80C. On the other hand, the Committee said that deductions such as those under sections 10 and 80L are regressive and disproportionately favour upper-bracket taxpayers. No doubt, the Committee while speaking of the EET method said that contributions to a savings plan/scheme are deductible from the gross total income, but its preferred option was the TEE method and not the EET method. Further, exemption does not mean that it can be given only by way of a straight deduction from income, as discussed below.

According to economists, it is necessary in principle to exclude savings from the base of income tax to neutralise the bias against savings inherent in the taxation of income, and also because of the critical need for raising savings in developing countries. Tax relief for savings results in a wide variation in the rates of return of financial assets, entailing an unduly high cost to the exchequer that goes unnoticed. The operation of a large number of schemes is a source of distortion in the channelisation of savings. The conflict between equity and efficiency comes out sharply in determining the degree of 'progressivity' in the Income Tax rate

structure. One way of resolving the conflict is to widen the base and lower the marginal rates, and apply them uniformly across all income categories—though there's sharp disagreement over an acceptable trade-off between equity and efficiency.

The changeover from the present EEE to EET has been adopted in principle, and involves formidable transitional problems. The Kannan Expert Committee looking into this matter was considering 90 savings schemes in operation. These schemes have periods of maturity ranging from 3 to 30 years, with varying rates of pre-tax returns. At present there are exemptions under Section 10 for 12 schemes and rebate/deduction under section 88/80C for 18 schemes.

The current approach appears to be to categorise instruments with maturity over five years as long-term to be taxed at 10%. In a current instrument with a maturity of 30 years, at the time of entry, the marginal rates could have probably varied from 0% at minimum to 70% at maximum. In the intervening years, the contributions would have been rebated or exempted at the respective marginal rates: yearly interest on the accumulations of the savers in these long-term instruments are exempt in the hands of the funds. As far as the saver is concerned, since he has no dominion or control over the annual interest, it could be a matter of debate whether he can be said to have been exempted on the said accretion. Finally, on maturity, the receipts are exempt. At this stage, it is difficult to say that the receipt constitutes the saver's income, merely because the contributions had been tax rebated/tax deducted at the time of entry and the yearly interest on the accumulations in the hands of a fund to which the contributions were made was exempt (the saver can claim with justification that he had no control over the accretion in any way).

Income may be defined as the gain received from land, capital or labour, or any two or more

of them. [*Bhagwan Dass Jam vs. Union of India (1981) 21 CTR (SC) 339 : (1981)128 ITR 315 (SC)*] Under the income Tax Act, income chargeable to tax is the income that is received or deemed to be received in the previous year, or the income that accrues or arises or is deemed to accrue or arise during such year. Every receipt cannot be deemed to be income, and whether any particular receipt is income or not depends on the nature of the receipt and the scope and effect of the relevant taxing provisions. Taxation of these receipts will require yet another addition to deemed incomes under section 2(24) deeming accumulations of 3–30 years as the income of the previous year, a minor revolution in the Income Tax Law.

## Conclusion

In the EET method, now in the transitional stage, the taxability of the maturity receipt can be a matter of extended debate. Further, just as T does not signify that the maturity receipt can only be taxed at the appropriate marginal rate, E cannot mean that there should be total exemption by way of deduction at the time of entry for contribution/payment. We have 30 instruments eligible for exemption/deduction under the Act itself, apart from 60 others waiting in the wings. As the Supreme Court noted "Fiscally, exemption can take varying shapes, specially in a growing economy". There can be little doubt that tax rebate is vastly preferable to a straight deduction.

As the Supreme Court observed and economists concede, the Income Tax Act should be so structured as to simultaneously raise savings, augment revenue, be progressive and not regressive as to favour the upper brackets, and be simple to administer. Easier said than done. The present section 80C depletes revenue and is also regressive (Para 3). It cannot be said that it is simple to administer, and it is not known, at least now, whether it has any direct effect on increasing savings. □