

Chapter 5

Reforms in Tax Policy and Tax Administration

PART I – DIRECT TAXES

Steps to remove leakages in government expenditure and control of wasteful expenditure are necessary to manage the ever-growing government spending in essential areas. At the same time steps to increase revenue i.e. the Tax-GDP ratio are also necessary. The main source of income for the government being tax revenues (direct & indirect taxes) sincere efforts are needed to meet the demands of high levels of growth through diligent tax administration. The Liberal Budget is based on the belief that tax revenues can be enhanced without making any changes in the current tax structure or rates of taxes. How this can be done is the subject matter of this chapter on tax policy and tax administration.

Principles and Objectives

Rationalising and simplifying direct and indirect tax laws and bringing them in line with the current needs of a liberalising and competitive global economy is an urgent though uphill task especially considering the mind set of the people involved in tax administration at different levels. Accordingly, in the areas of tax reforms, the liberal budget would be guided by the following broad principles:

- i. Any increase in tax revenue would not be by way of increase in tax rates, but by increasing the tax base to be achieved by humane, fair, efficient, transparent and accountable tax administration on the one hand and rationalisation and reasonable simplification of the tax laws on the other;
- ii. Tax reforms would be through the creation of an atmosphere in tax administration resulting in voluntary compliance with tax laws by tax payers;
- iii. Tax reforms would be through the creation of a simplified tax policy with rational and globally competitive tax rates;
- iv. Tax reforms should also be aimed at providing a fair, speedy and efficient mechanism to resolve genuine

disputes in the interpretation and administration of tax laws;

- v. Tax reforms should also be aimed at providing a speedy and efficient mechanism to severely punish habitual tax evaders and corrupt officials on the one hand, and give a fair deal to those tax payers who sometimes become victims of complex tax laws which are difficult to simplify beyond a point considering their basic nature. Likewise, such mechanism should also provide an opportunity for forthright officials to get a fair deal in the event of their becoming victims of the present system of tax administration;
- vi. Tax policy should aim at offering a lighter burden on earned income as compared to unearned income, by making proper and appropriate adjustments in the tax structure and tax rates; and

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- vii. Tax reforms should also be aimed at achieving a minimum number of tax rates even for individuals/HUFs by adopting a flat rate tax system (with an appropriate adjustment in the threshold limit) or by adopting not more than two rates of taxes, with appropriate adjustments in the level at which the second rate of tax should apply.

Tax Laws & Tax Administration and Broad Framework

To achieve the objectives of tax reforms, certain basic parameters for making/amending tax laws and their

administration should be fixed and should be adhered to strictly as has been the case with the Directive Principles of State Policy in the Constitution. The broad outline of such parameters is as follows:

- i. It has been the experience in the past that tax laws are amended with a view to punish a small percentage of defaulters. Unfortunately in the process, the tax laws turn out to be very harsh and complex for the large tax paying community. This is also the main cause for complexities in the present tax laws. Therefore, tax laws should be amended bearing in mind the convenience of the large number of taxpayers (and not with a view to punish a few defaulters). This will have the added advantage of creating an atmosphere of trust on the one hand, and substantial reduction in corrupt practices on the other.

“ The annual budget and amendments to the tax laws should be de-linked. Amendments to tax laws should be made only by a separate Tax Laws (Amendment) Act. ”

- ii. One of the basic tenets of a good tax policy is stability in tax rates for a period of at least five years. Therefore, frequent changes in tax rates should be avoided. Unfortunately, in the recent past, experience shows that while keeping the schedule of tax rates unchanged or while marginally reducing them, various 'clever' methods are adopted to indirectly increase tax rates. A classic example is the increase in surcharge for most of the assessees, introduction of Education Cess, introduction of Health Cess in a limited sector. Apart from this, the introduction of the Fringe Benefit Tax (FBT), has resulted in a substantial increase in the effective rates of tax in most cases.
- iii. Another basic tenet of a good tax policy is stability in tax laws. For this, there is need to formulate a long term tax policy for a period of at least five years. Once such a policy is formulated after public debate, it should not be tampered with except under extraordinary circumstances. This will avoid the need for frequent amendments in the tax laws, which have made present tax laws not only complex but also difficult to implement in a fair manner. Towards this end, the annual exercise of amendments in the tax laws through the Union Budget should be given up. The annual budget and amendments to the tax laws should be de-linked.

Amendments to tax laws should be made only by a separate Tax Laws (Amendment) Act. This should be

enacted only after detailed public debate and after due consideration by a Select Committee of Parliament having members who are conversant with the complexities in tax laws and the realities of their administration. In the same manner, even tax rates should be de-linked from the Union Budget and incorporated in the tax laws. In an emergency, of course, the law can always be amended through ordinance. To begin with, this policy can be adopted for direct tax laws and then be subsequently extended to laws relating to indirect taxes.

- iv. For the purpose of raising tax revenues, it is necessary to widen the tax base rather than increase the tax burden of existing taxpayers. This is the only way to achieve real growth in tax revenue. The main hurdle in increasing the tax base is the perception of the people at large about tax administration. Unless this changes, it is unlikely that the tax base will increase in real terms. This can be achieved only by gaining the confidence of the citizens in the tax administration. For this, some permanent statutory provisions should be made whereby the small assessees can be asked to pay a fixed amount of tax in absolute terms upto a certain level of income with the assurance that their declaration of income will be accepted at face value without further enquiries except in cases where the Revenue Department has concrete evidence in its possession about the incorrectness of the declaration made by an assessee. For this, a simple scheme can be worked out in the Act itself to provide safeguards against the abuse of such a scheme.
- v. As stated earlier, it is the fear of harassment at the hands of the tax administration, which has kept a number of small potential tax-payers outside the tax net. Another way to persuade this large number of potential taxpayers is to assure them that by filing returns of income they will have some advantage.
- vi. It has been the experience that the present scheme of assessment of income by the Tax Department at various levels has also raised a number of practical issues with regard to harassment of the tax payers and an increasing resort to unethical practices. One way to combat this and also to create a proper atmosphere, is to encourage people to file their returns of income by eliminating many of the discretionary powers vested in Assessing Officers while assessing income. This can be done by providing a scheme of presumptive income for all medium level assessees on the lines of the present provisions of Sec.44AF, while simultaneously increasing the basic limits of Tax Audits to Rs.100 lakhs from the present Rs.40 Lakhs for Business and Rs.25 lakhs from the present Rs.10 lakhs for professionals. The earlier limits were fixed almost two decades ago and need revision.
- vii. In the recent past, it has been the experience of the tax paying community that tax laws are amended

with retrospective effect, in most cases to nullify the effects of judicial pronouncements. This has a dual effect, firstly, it creates an atmosphere of disrespect for the judiciary, which is not a good sign in the long term in any civilised, democratic country and secondly, it affects all financial projections of the assessees and in many cases, it has a severe impact on the business community. This, indirectly, contributes to the creation of disrespect for the tax laws and affects the basic spirit of the citizens to fight for their rights. In fact this is one of the main causes for large-scale corrupt practices so prevalent in the tax administration.

Therefore, bearing in mind the long-term interests of the country and its object of increasing tax revenue by voluntary compliance, as a policy, no retrospective amendment should be made in the tax laws, which will have an adverse effect on the taxpayers. All amendments to the tax laws should be made prospective and wherever possible, retroactive effect should not be given to such amendments on transactions entered into prior to the date of making such amendments.

viii. The Liberal Budget is guided by the basic principle that if a harsh tax law is administered in a fair and humane manner it does not have any impact on the large tax paying community but the reverse is not true. This does not mean that the tax laws should be made harsh but an acknowledgement of the fact that the manner of administration of tax laws is more important than the tax laws themselves from the point of view of achieving the objectives of tax revenue. Accordingly, genuine reforms in tax administration are paramount to provide humane, fair, efficient, transparent tax administration with accountability. Major reforms are required in this area. For this, a number of genuine steps need to be taken such as:

1. Some statutory monitoring mechanism with requisite powers independent of tax administration should be provided in the tax laws. Such mechanism should provide a forum to the tax paying community to approach them for redressal of unfair and discriminatory treatment. Such a forum should also have the power of taking *suo moto* action against tax officials at all levels of tax administration. Such forum should ultimately provide for speedy disposal of cases against erring officials and justice to honest officials who have, unfortunately, become victims of the present system. To begin with, such a forum can be created in each State (to be headed by the Chief Justice of the High Court in the State) and responsible to Parliament through the Finance Ministry (and not the CBDT). Such a forum should have representatives from tax profession and respectable citizens as its members in addition to retired judges of High Court and/or Supreme

Court. This forum should not become a place for extension of service, after the age of retirement, for tax officials as is the case with the Settlement Commission.

2. All instructions issued by the CBDT that affect the rights and duties of the tax payers should be made public.
3. Now that the Right to Information Act has become operative, appropriate steps should be taken to see that the tax administration strictly complies with the provisions of the Act and gives appropriate publicity to the manner of its implementation.

“ Amendments to the tax laws should be made prospective and wherever possible, retroactive effect should not be given to such amendments on transactions entered into prior to the date of making such amendments. ”

4. We understand that recently the Prime Minister has taken the initiative to adopt the policy of performance-based promotion. For this, the method of evaluation of performance should be transparent and should be made known to citizens. At the same time, while adopting such a policy, merely higher collection of tax revenue should not be regarded as good performance unless such collection is proved to have been made in a fair and equitable manner and without being unduly harsh to the tax payer. For this, an appropriate scheme should be worked out to check if tax officials concerned have, in their over-enthusiasm, indulged in unjustifiable and harsh actions. This can be done by assessing their performance with reference to the ultimate result in terms of approval of their actions at the first two Appellate levels. Apart from this, to be fair to the tax officials, the targets fixed for collection should not be too high or unrealistic and should also be flexible by taking ground realities into consideration.
5. Appointment of Members of CBEC/CBDT should not be made merely on the basis of seniority. Members of such body should be of high integrity with proven track record with regard to fair and efficient tax administration. There should be some strict guidelines for such appointments to be monitored by an independent judicial form. This is of utmost importance because these bodies

are ultimately responsible for tax administration. The recent exposure involving the Chairman, CBEC involved in corrupt practices should be an eye opener.

Rates of Tax vs. Incentives

The Government has accepted the proposal that instead of the policy of having many tax incentives and high rates of tax, it is better to have fewer incentives which are absolutely essential and lower rates of tax. The Finance Act, 2005 has taken forward this policy. In this connection and to encourage compliance and reduce the cost of compliance which is quite high for tax-payers, it is suggested that:

- i. To bring simplicity, no surcharge and cess like education cess be levied and the basic rate must absorb such cess.
- ii. In any case, such surcharge/cess should not be made applicable on tax rates of TDS to avoid cumbersome rates like 1.0455, 5.2275.
- iii. Further, no rates be enhanced retrospectively e.g. in the month of September 2004, rates of TDS etc. enhanced by education cess w.e.f. 1st April, 2004.

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Real Income vs. Taxable Income

The Income-tax law contains many distortions in the computation of income which ideally should be one which is the real income, which any businessman would consider as income. While it may not be practical to eliminate completely all differences between taxable income and book income (real income), every effort needs to be made to match the two. Specific reforms in this direction to be carried out are:

- i. Depreciation allowance under the income-tax law be harmonised with the same under the Companies Act.
- ii. If any incentive-depreciation is to be granted, it should

be on the condition that it be provided for in the books of account.

- iii. The provisions of section 115JB, Minimum Alternate Tax (MAT) be deleted.
- iv. Carry forward of losses and depreciation be merged together and be treated on par and be allowed to be set-off indefinitely.
- v. Carry forward of losses under all heads of income be permitted. Currently it is not allowed for income from house-property, and income from other sources etc.
- vi. Both 'set-off in any year' and 'carry forward in subsequent year and set-off', be not compartmentalised on the basis of heads of income but be treated as a single block. However, items such as speculation loss or any similar item as exception to the general rule may be differently treated.
- vii. All expenses that are incurred for business purposes but are neither revenue in nature nor result in acquisition of a depreciable fixed asset should be allowed as deduction over a period of three to five years by way of amortisation.

Presumptive Computation of Income (optional)

1. In order to make the operation and management of the tax-system simple both for the tax-gatherer and taxpayer and to reduce compliance cost, it is suggested that the concept of presumptive tax be extended to many items of income at the option of the tax-payer.
2. To-day such provisions for income of the residents are for (a) Computing profits and gains of business of civil construction (b) Computing profits and gains of business of plying, hiring or leasing goods carriages (c) Computing profits and gains of retail business
3. We suggest that similar provision for computing income in cases of different professions be enacted at the earliest and then extended to (a) wholesale business (b) small scale undertakings (c) various service providers like caterers, commission agents, beauty parlours, interior decorators, fashion designers and the like.
4. Without prejudice to the above, we suggest the combination of actuals and presumptive basis be tried in some cases as an experiment. Under this system, only gross profit will have to be computed on actual basis and all overheads be allowed on presumptive basis. The advantage of this scheme would be that the tax officer will only have to verify items related to determination of gross profit such as sales, purchases, wages etc. and all the effort required to verify genuineness and allowability or otherwise of

overhead expenditure will get eliminated and become litigation free. Also, unethical practices of inflating overheads to reduce income and the official's temptation for indulging into corruption will get eliminated.

Minimum tax payable by all filers of income-tax returns

It is our estimate that of the 4 crore persons filing income tax returns, nearly two thirds i.e. 2.6 crores pay no tax, yet have to file the return of income under various provisions of the Income-tax Act. In the light of this we suggest:

1. The Government considers it necessary that all persons covered under the "one-by-six" scheme having incomes below the threshold limit (currently Rs. 100,000) though may not have to pay any tax, they are required to file their return of income. Similarly every company and partnership firm even though it has no taxable income is required to file the return of income and so also many charitable trusts and similar institutions. Despite the existence of such provisions, we believe that crores of persons covered under these provisions do not file their return of income. We suggest that the department's efforts to bring such non-filers on record need to be strengthened. Such number is likely to increase rapidly with the growth of the economy, with the number of homes, cars and numbers of persons travelling abroad multiplying.
2. We realise that such a large number of return-filers add considerably to the volume of work of the tax administration and constitute a drain on the financial resources of the tax-department. Yet we do believe that it is in the interest of revenue to have mandatory requirement of filing of such returns.
3. However, to boost revenue, and to instil a spirit of pride in the tax return filers that they are contributing some tax to the national exchequer, we suggest that all individual and HUF return-filers other than senior citizens be required to pay tax of Rs. 1,000 per year assuming their income in the case of women is Rs. 1,45,000 and in other cases Rs. 1,10,000.

This proposal, assuming the number is around 3 crores, will bring in revenue of Rs. 3,000 crores and make all those who are covered proud citizens.

4. We are aware that the Finance Act, 1992 had introduced a scheme to enable certain small income earners to pay their tax without having to undergo the cumbersome task of computing their income and furnishing their returns. Under the scheme, a fixed annual tax of Rs. 1,400 per year was payable. The scheme was dropped with effect from 1.4.1998. We are of the opinion that this was because of improper administration of the scheme rather than any demerits in the scheme itself.

The scheme suggested here will not only serve the purposes envisaged in the "one-by-six provisions" and garner revenue of Rs. 3,000 crores and other benefits but also bring some part of unaccounted money, into the main stream as individuals who furnish returns of income under this scheme shall account for their income at Rs. 1,45,000/Rs. 1,10,000 as the case may be.

5. The revenue collected by the Government under this scheme will be additional revenue. We recommend that it be appropriated into a new fund to be called "old age security/pension fund" a long needed requirement of providing old age pension to citizens. Initially, only those individuals who have paid income-tax for 10 years, be covered, then progressively more and more individuals can get covered.

Tax on Non-agricultural Income When the Person also has Agricultural Income

At present agricultural income is exempt u/s. 10(1) of the Income-Tax Act, 1961. However, in the case of an assessee who has both agricultural and non-agricultural income, he should be taxed on non-agricultural income in a manner under which he pays tax slightly higher than what he would have paid on the same non-agricultural income if he had no agricultural income. Often it is believed that the agricultural income declared by such assesseees is fictitious and is usually black money camouflaged. We suggest

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1. that tax on non-agricultural income in cases of persons also having agricultural income be higher than in the method at present being prescribed in the Finance Act each year.
2. that in cases where agricultural income is higher than non-agricultural income, the rate of tax for non-agricultural income for all assesses should be at a flat rate of 40%. Where agricultural income is lower than non-agricultural income, tax should be at the rate of 30% multiplied by the ratio of total of agricultural income and non-agricultural income to non-agricultural income, or at 40% whichever is lower.

Illustration: Rate of tax on non-agricultural income

	1	2
Agricultural income	Rs.2 lakhs	Rs.1 lakh
Non-agricultural income	Rs.5 lakhs	Rs.7 lakhs

1. Rate of tax $30\% \times 7/5 = 42\%$ (Restricted to the instant case to 40%).
2. Rate of tax $30\% \times 8/7 = 34\%$ (rounded)

Section 80 CCA of the I.T. Act

Section 80 CCA of the I.T. Act was in operation from 1.4.1988 to 31.3.1992 providing for deduction in respect of deposits under National Savings Scheme or payment to a deferred annuity plan. We suggest

1. that the scheme similar to the above provisions be revived. It is very essential to encourage citizens to honestly pay their tax especially in cases when the earning-life is short or substantial additional income is earned in certain years. Citizens should be given the option to defer payment of tax on some portion of their income if they are prepared to block that income with such authority as may be prescribed.

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2. We suggest that an individual or HUF be allowed to deposit out of the annual income
 - 20% of his returned income equivalent to or less than as returned in the earlier year
 - 60% of his incremental income over and above as returned in the earlier year.
3. Such deposits shall be for the purpose of national infrastructure projects to be managed by any nationalised bank or as may be decided by the Government. Terms of the deposit will be:
 - a) Period of the deposit to be frozen / locked for a minimum 5 years with no limit for its continuity.

- b) Interest at the rate of 8% p.a. (taxable) to be credited to the deposit account for the period after the frozen / locked period or till the deposit is withdrawn
 - c) Any amount withdrawn, principal and interest shall be taxable in the year of withdrawal.
4. This scheme shall be an extension of the policy of EET (exempt-exempt-tax) which the Government is planning to introduce for investments referred to under section 80C of the Income-tax Act.
 5. This scheme has win-win benefits:
 - a) Creation of black money will be minimised
 - b) Infrastructure projects will have resources
 - c) Government gets the tax as and when the deposits are encashed
 - d) Scheme shall work as pension in old age or to meet additional expenditure on occasion of marriage, sickness etc.
 - e) It will act like insurance, with money available to the family after the death of the earning member.

PART 2 - INDIRECT TAXES

Rate structure

1. Significant stability has been achieved over the past few years as far as the CENVAT (Central Excise Duty) and Customs Duty rates are concerned. In line with the road map already drawn by the Government, median Customs duty rate for majority items can now be brought down to 10% from the existing level of 15% leaving aside sensitive items like agricultural and petroleum products. In Budget 2005-06, Additional Duty of Customs to countervail local taxes at the rate of 4% was levied on specified IT products under Section 3(5) of the Customs Tariff Act, 1975. Similar add-on duties should not be introduced in Budget 2006-07. This is to avoid the cascading effect of duties and to eliminate complexity in duty computations.
2. Inter-sectoral credit between CENVAT and service tax that has been allowed since 10 September 2004 is working well. It is also an accepted fact that as soon as possible, the CENVAT rates and service tax rates should be on par. As a step in that direction, median CENVAT rate of 16% should be reduced in Budget 2006-07 to 14%. Rates of CENVAT for other items may continue at their current levels.
3. State-level VAT introduced in a majority of states from 1 April 2005 has been a great success. As recommended by the Empowered Committee of State Finance Ministers, Central Sales Tax (CST) should

be phased out as soon as possible and as a step in that direction, the current rate of CST at 4% should be reduced to 2% from 1 April 2006.

Dispute Resolution Mechanism Under Service Tax

1. The benefit of seeking Advance Ruling is available only to joint ventures with non-residents or wholly owned subsidiaries of foreign companies. This facility should be extended to all non-residents (whether or not they have joint ventures or wholly owned subsidiaries in India) and also to residents. Further, in most cases, this facility is available only for proposed business activities. However, with expansion in the service tax net on a selective basis year after year, there is need to extend this facility to such newly introduced services as well, irrespective of the fact that the activities in such cases, are already being undertaken by the applicant.
2. To reduce litigation and help early recovery of dues, the Settlement Commission on the lines of that under the income tax law should be put in place even under the service tax law for persons who have not been issued show cause notices and who are ready to pay the tax *suo moto* on becoming aware of their liabilities.

Coverage of Service Tax

The time has come for extending the levy of service tax to all services except a specified negative list of services like medical services, social services, educational services, defence services etc. This would avoid classification disputes and also provide smooth mechanism for claiming input tax credits.

Administration of Service Tax Department

It is observed that lately, the power of issuing summons is being indiscriminately used by the Service tax Department. Summonses have been issued without first issuing routine enquiry letters and even in cases where the objective is merely gathering routine data from the assessees. This causes significant hardship to the management of the

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assessees and undue harassment by the Department. Detailed internal guidelines must be framed to avoid such misuse of power by prescribing existence of conditions precedent and steps to be followed, before issuing summons.

On the lines of CEBC's Central Excise Manual, a Manual of Service Tax should be prepared and made available to the public for a better understanding of the service tax law and its administration by the assessees. ❖
