EXECUTIVE SUMMARY

Approach to Tax Reform

Following a period of modest fiscal consolidation, there has been a marked deterioration in our fiscal health since 1997-98. Concomitantly, the current trajectory of public-debt dynamics of the country is worrisome. Apart from the crowding-out effects on investment of this decline, our capacity for macro-economic stabilisation and counter-cyclical policy making, as well as our international standing, have the potential of being severely circumscribed. While strongly advocating rationalising the revenue side of this fiscal equation, the Task Force emphasises that fiscal reform needs to be undertaken as an integrated package; while initiating a revenue rationalisation exercise, the government needs to simultaneously control expenditure (and ensure that taxpayers' money is spent productively). Enacting and implementing the impending Fiscal Responsibility and Budget Management Bill will have a salutary impact on the regimen of such fiscal reform.

The Task Force undertook sustained interactions with various stakeholders – intending to elicit "customer" feedback – and found a striking consistency in their responses regarding complaints about the tax system – structural complexity, low transparency, delay in issue of refunds & PAN numbers, high compliance costs (and hence low compliance), lack of attention to taxpayer needs, taxpayer harassment, tax leakage, rent seeking, etc.

The Task Force also examined best international tax practices. It recognised that in the recent past, other economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration.

The approach of the Task Force has been influenced by these interactions and observations and consequently seeks to strike a balance between the need for enhancing "customer" satisfaction and stricter enforcement. This balance will be crucial to both attracting and retaining young taxpayers with their demand for customer-oriented systems, as well as to bring the "missing middle" – mainly service professionals who are currently outside the tax net – into compliance.

The Task Force discussed in-depth suitable policy frameworks for direct tax and deliberated on ways to reduce costs of tax administration and of taxpaying, as well as to empower the tax department in effectively fulfilling its core functions of assessment and enforcement. Over the course of these deliberations, the Task Force became convinced that the only way to thus empower the tax department is through an integrated and rapid programme of system-wide deployment of Information Technology, leveraging on the considerable skills in this area that are available in India.

The Task Force has endeavoured to ensure that the recommendations pertaining to the direct tax codes are congruent with generally accepted principles of taxation. The three principles relate to efficiency (minimising distortions in resource allocation), equity (progressiveness of effective tax rates) and effectiveness (of tax administration). To facilitate the systemic changes necessary for fulfilling these principles, the Committee has identified four operational objectives relating to the direct tax code that can most effectively achieve these principles. These are:

1) Institution of a simple and transparent system.

2) Reduction of transactions costs of tax revenue collection and compliance costs of taxpayers.

3) Alignment of incentives of taxpayers and the tax administration; and

4) Widening of the tax base.

The recommendations of the Committee, which are elaborated below, are aimed at efficaciously implementing these objectives. Before motivating these recommendations, the Committee would like to clarify its stance regarding rate cuts and exemptions: while the benefits of exemptions are limited to those who can gain access to them, rate cuts apply to tax-paying persons and entities across-the-board. The Committee would also like to place on record its concern that the efficacy of its recommendations is likely to be seriously vitiated if individual components are selectively accepted or rejected; <u>success of tax reform efforts depend on their implementation in an integrated manner</u>.

Tax policy and tax administration are inter-linked: complex tax policy leads to even more complex tax legislation, which then inevitably results in cumbersome administration through a cascading effect on filings, compliance procedures and enforcement measures. The series of *ad hoc* exemptions and other tinkering has only served to clutter the culture of compliance. Apart from its effects in distorting incentives, a weak and porous system has evolved, which by increasing transaction costs of participation dissuades potential taxpayers. One of the principal outcomes sought of this Report is the institution of a trust-based, rather than an overtly punitive, tax system which requires an alignment of the objectives of the tax authorities with obligations of taxpayers; in other words, enhance the incentive compatibility of the two groups. Over the years a number of perverse incentives have crept in: taxpaying is often punished (by harassment) and tax evasion is not sufficiently deterred. It is noteworthy that this undesirable outcome has occurred against the backdrop of considerable efforts in recent years by the tax authorities to fulfil its functions. There is a widespread perception that (frequent) changes in the tax code in the last decade or so have (unintentionally) been akin to substituting the erstwhile “license raj” with an “exemptions raj”.

Role of Tax Administration

If "tax administration is tax policy", as is widely recognised, then it is imperative to identify the role(s) of tax administration, so that responsibility and accountability is clearly established. The Task Force is of the opinion that the fundamental roles of tax administration, in order of priority, are:

1. To render quality taxpayer services to encourage voluntary compliance of tax laws; and
2. To detect and penalise non-compliance.

The extent of success of the tax administration in its role would be reflected in higher revenue growth.

Taxpayer Service

Provision of quality taxpayer service is an integral part of the enforcement strategy of any tax administration. The present scope of taxpayer service in India is too narrow to encourage voluntary compliance. It is, therefore, recommended that the income tax department must expand, qualitatively and quantitatively, the present scope of taxpayer service. These should, *inter alia*, include the introduction of a telephonic system (by voice message) to remind taxpayers of important dates and the provision of pre-formatted programmed floppy diskettes through retail outlets. The expenditure on taxpayer service must be increased from the present level of about one percent of the total expenditure on tax administration to at least five percent. In this regard, an important start should be made by the establishment of taxpayers' clinic in different part of the country to enable taxpayers to walk in for assistance. The Task Force feels that better treatment of existing taxpayers has an important role in encouraging those outside the tax net to become taxpaying citizens. Further, the department should provide easy access to taxpayers through Internet and e-mail and extend facilities such as tele-filing and tele-refunds. It should design special programmes for retired people, low-income taxpayers, who cannot afford expensive services of tax consultants and other such groups with special needs.

Taxpayer Identification and Registration

The Task Force recognises the proximate role of PAN in building up an effective taxpayer information system. Given the ongoing and new initiatives by the Ministry of Home Affairs for issuing a Citizen Identification Number and by the Ministry of Labour for issuing a Social Security Number, the Task Force feels that the use of PAN can effectively integrate, on the lines of the US Social Security Number system, multiple tasks of tax and commercial enforcement, targeting government subvention, improving governance and enhance national security, both at the Central and State level. We recommend that:

1) The PAN should be extended to cover all citizens and therefore serve as a Citizen identification number. This will obviate the need for the Home and Labour Ministries to issue new numbers.
2) Given the manifold increase in the coverage of PAN, the responsibility for issuing should be transferred to an independent agency outside the income tax department. However, the income tax department should have online access to the database for tax enforcement like any other agency.
3) The requirement of quoting PAN may be expanded to cover most financial transactions.

Collection of Information

In view of the extant method of collection of information and constraints in digitizing the volume of information received by the tax administration, the Task Force recommends:

1. Income Tax Act should be amended to provide for submission of 'annual information return'. For this purpose, a proper format of the return also needs to be prescribed. As a result the flow of information will be continuous and the discretionary power with the CIB to collect information will be eliminated.

2. Such annual return of information should be mandatorily required to be submitted on electronic format.

3. Many of the Departments involved in transactions specified in Rule 114B do not have any mechanism for obtaining the PAN of the concerned person. It is, therefore, necessary that the proforma used by them for their departmental purposes e.g.. the application form for transfer of motor license, should carry necessary column requiring the applicant to disclose his Permanent Account Number (PAN).

4. The Department should set up a structure for Electronic Data Interchange (EDI) with some of the major departments and organisations involved in the transactions specified in Rule 114B, such as, Banks, Stock Exchanges, Telephone Companies, Regional Transport Authority etc.

Verification & Processing of Tax Returns

An IT-based system will facilitate considerable streamlining of procedures for receipt and processing of tax returns. Against this background the Task Force recommends that:-

1) All returns must be processed within four months of receipt. For this purpose, it would be necessary for the department to either hire additional personnel on a temporary basis during the peak period for

filing returns, or, outsource data entry work, as is done routinely by national tax administrations all over the world.

2) In line with our view that the tax department should concentrate on its core functions, the department should be allowed to outsource data entry work and clear the backlog of returns (which number 2.5 crores) by end-February 2003. A large number of these would be refund cases (contributing to the grievance against non-issue of refunds). Despite training in computer skills, the staff in the income tax department is at the lower end of the learning curve and in-house clearing of the backlog in a short period is not possible.

The cost of hiring additional personnel or outsourcing data entry work would be far less in comparison to the benefit from reduced interest burden on refunds and taxpayer satisfaction.

The process of selection of cases for audit (scrutiny) is the most important element of the enforcement strategy of any tax administration. It is this process of selective verification of the volume of information received by the tax administration which establishes deterrence. The Task Force was apprised about the negative aspects of the existing discretion-based system of selection of cases. The department should progressively develop a mechanism for risk assessment, which forms a scientific (and, therefore, objective) basis for identifying cases of potential tax evasion for in-depth scrutiny. In the interim, we recommend the identification of cases through a random non-discretionary centralised method deploying the PAN database. The current practice of issuing guidelines for selection of cases for scrutiny, which eventually finds its way to the public must be dispensed with. Further, the Task Force also recommends that the penalty orders must be passed simultaneously with the assessment order.

Computerization of Tax Administration

The Task Force cannot over emphasise that effective tax reform must harness Information Technology (IT). The tax department is no different from most businesses. World-class customer service is critical when “all of India is its customer and Parliament its Board of Directors”. While the CBDT has to be commended for the effort it has expended and the action it has initiated for computerisation of taxpayer records, the business processes, systems and facilities have not kept pace with the growing demand on tax administration. The Task Force firmly believes that the tax department should be allowed to concentrate on its core functions – an increasing emphasis on assessment and enforcement duties, rather than logistics and support services – which will surely lead to increased effectiveness of the tax administration. In this context, rapid and progressive outsourcing of many tasks of the tax department is not only feasible, given the significant pool of talent in the Indian software industry, but it is also desirable. In order to make IT infrastructure commensurate with the requisite processing tasks, the Task Force would like to explicitly put on record that implementation of this enhanced integration-software requires considerable

investment in upgrading associated IT hardware and sufficient access to high-capacity bandwidth for implementing the network.

The process of systemic modernisation of tax administration cannot be further delayed. To empower the tax administration in executing its core function, the Task Force studied the existing depository system of the National Stock Depository Limited (NSDL) and concluded that it offered a scalable system to meet the requirements stated above. As this proven and tested infrastructure already exists, it can readily be adapted to offer a world-class, state-of-the-art IT architecture to rapidly empower the tax administration. Our study suggests that if action is initiated by the middle of November 2002, the system could be operational and available on-line by the beginning of the 2003-04 fiscal year.

To speed up the process of modernisation, the Task Force therefore recommends the following:

1) The Government should establish a national Tax Information Network (TIN) on a build, operate and transfer basis. This will comprise of a world class (common carrier) network system and have access to state-of-the-art IT infrastructure. A requisite in-built feature of the system is that it should be scalable to offer ease of access across tax administration and taxpayers. The network that is envisaged will facilitate transactions, akin to securities markets, and establish secure and seamless logistics of tax collection through integration of primary information, record keeping, dissemination and retrieval. It should be a repository of information, with a database of all tax payments and refunds. Data mining software associated with such relational databases will allow a quick and systematic identification of non-compliance and abuses, thereby helping to improve compliance. The existing facilities of the National Securities Depository Ltd. (NSDL) can be relatively quickly deployed to make a systemic improvement in processes and reduce transaction cost.
2) TIN will receive, on behalf of the tax administration, all TDS returns and other information returns for digitisation. The information would be received either online, or through magnetic media or in printed format. The digitised information will be downloaded by the National Computer Centre / Regional Computer Centres of the income tax department for further processing.
3) TIN will also receive online information about collection of taxes from the banks. The information could be downloaded by the income tax department as and when required.
4) The taxpayer will have the facility of accessing the TIN system through a secure and confidential Permanent Account Number (PAN) based identification to ascertain tax payments credited to his/her account and the status of returns and refunds.

The TIN will therefore serve as a gateway to the National Computer Centre of the Income Tax Department. It will help overcome the paucity of technical manpower and inadequate technical infrastructure.

Collection and Accounting of Taxes

In view of our recommendation for the establishment of a TIN, we recommend a revised procedure for collection of taxes and their accounting. The new procedure will be as follows:-

1) A taxpayer will be required to fill up only one copy of the challan while making payment of taxes in the bank. The present requirement of filling up four copies of challan for payment of any tax will be given up.
2) The banks will be networked to the TIN and receive payments online. The banks will be required to issue a computerised receipt to the taxpayer instantaneously. The date of presentation of a cheque will be treated as the date of payment. If a cheque bounes, the bank will reverse the receipt, online, and the department would then be expected to prosecute the delinquent taxpayer.
3) With instant accounting of tax collection, the requirement of enclosing a copy of the challan as evidence of tax payment, along with the annual return of income could be done away.
4) Since the TIN will digitise all the TDS returns, the requirement to file TDS certificates along with the return of income will also be dispensed with.
5) At present, taxes are collected through approximately 10,500 bank branches. Since the proposed procedure requires banks to receive online payment, those banks that do not have adequate infrastructure for establishing online connectivity will be debarred from collecting taxes. Accordingly, the Government, in consultation with the Reserve Bank of India, should also consider paying higher charges for services rendered by banks.

The process outlined above will facilitate real-time accounting of TDS, Advance Tax and Self-Assessment Tax, and help the tax administration to swiftly identify non-compliance. Furthermore, the new procedure of tax accounting will facilitate electronic filing of tax returns.

Refunds

The failure of the tax administration to issue refunds continues to be a major source of public grievance. This is partly due to its inability to promptly process the returns, whose numbers have increased substantially in the last three years, and partly due to the cumbersome process for issuing of refunds. Therefore, we recommend the following:

1) The existing cumbersome and manually-operated procedures for issue of refunds must be replaced by a more efficient IT-based system. Under the new system the department will prepare a separate file of all refunds daily which will be downloaded by a payment intermediary, i.e., a designated bank.
2) The designated bank will be authorised to issue computerised refunds as is the current practice for issuing dividend and interest warrants by companies.
3) The designated bank will be required to transmit the information relating to the issue of refunds to the TIN, which will also allow a taxpayer to verify the status of his/her refund claim.

Search and Seizure

The objective of conducting search and seizure operations is to collect evidence which would not otherwise be produced before the tax administration. However, keeping in view the problems arising in the course of searches and post search assessments, search and seizure have lost considerable deterrent effect therefore the Task Force recommends:-

a) Special procedure for assessment of search cases in chapter XIV B (Block Assessment) which provides for tax @60% and exonerates the concealed income detected as a result of search from penal consequences of interest penalty and prosecution, be omitted. When concealment is detected and established, it should suffer full penal consequence of interest, penalty and prosecution.

b) Power of Settlement Commission to grant immunity from interest, penalty and prosecution may be restricted to cases other than those where the assessee admits of tax evasion consequent to search and seizure action taken by the department in his case.

c) The scheme of rewarding officers engaged in search and seizure activity be abolished.

d) Often in the course of search and seizure, stocks are either seized, deemed seized or put under order of attachment or prohibition. This hampers business, without any gain to revenue. Commerce Ministry has unveiled new export-Import Policy (2002-2007). At para 2.42.1 it states "No seizure of stock shall be made by any agency so as to disrupt the manufacturing activity and delivery schedule of export goods. In exception case, the concerned agency may seize the stock on the basis of prima facie evidence. However, such seizure should be lifted within 7 days." In line with this policy of the government, in the course of search and seizure under the Income tax Act, the stocks may only be inventorised but not seized. This can be done by issuing administrative instruction.

Income Tax Clearance Certificates

The present requirement of obtaining a tax clearance certificate before leaving the country must be abolished. Nevertheless, in order to protect against a consequent loss of revenues, the income tax department may be allowed to notify the immigration / customs authorities to prevent any particular person from leaving the country if such person is considered to be an offender. As a result, the process of tax clearance (prior to travelling abroad) will require to be fulfilled as an exception as against the current practice of obliging *everyone* to comply with the procedure.

The system of issuing Income Tax Clearance Certificates to contractors etc. should be eliminated forthwith. However, to help in enhancing effective tax enforcement, all government agencies should be required to obtain the PAN of entities participating in tenders, being designated as vendors to the government, etc. and periodically submit (pre-specified) relevant information to the tax administration.

Dispute Resolution

Under the current scheme of dispute resolution, the taxpayer has the option to either seek administrative redressal or judicial remedy. The Income tax Act specifies the categories of orders in respect of which a judicial remedy can be availed. There are several orders for which there is no judicial remedy and the administrative redressal mechanism is ineffective. This results in considerable dissatisfaction amongst taxpayers. The Task Force therefore recommends that the Income tax Act should be amended to provide that all orders/intimation imposing any additional burden should be made appealable.

A cross section of taxpayers lamented the absence of administrative response to their grievances particularly to those relating to issue of refunds (mostly women and senior citizens), rectification appeal effects etc. It was suggested that the office of Ombudsman along the lines in the banking sector may be setup which will help redress taxpayer grievances. Accordingly, the Task Force also recommends creating the institution of Ombudsman in the top ten-taxpaying cities and all state capitals on the lines of similar institutions existing in the banking sector. This institution will provide an independent system to assure that tax problems, which have not been resolved through normal channels, are promptly and fairly handled. It will also identify issues that increase burden or create problem for tax payers, and bring those issues to the attention of the Central Board of Direct Taxes (CBDT). The Ombudsman will also enquire into, should a complaint be filed, the practices and performance of all classes of tax professionals. Where necessary it will also make appropriate legislative proposals. This institution will be independent of the local tax office. Its goal will be to protect individual taxpayer rights and to reduce taxpayer burden. A consolidated annual report of the Ombudsman system will be tabled in Parliament.

Accountability

The ability of the tax administration to perform its role effectively and efficiently is in turn determined by its ability to coordinate and adapt over time the organisational structure and its resources. The organisational structure should follow from the organisations' objectives and conditions prevailing in the country. Until recently, the organisational structures of many tax administrations were not based on any overarching rationale, but instead had either emerged as a result of historical accident & bureaucratic inertia or had evolved in an ad-hoc manner. In the last few years, however, there has been a worldwide interest in reforming the organisational structure of tax departments.

One of the important general organisational issues relate to the placement of the tax administration in relation to the Ministry of Finance. While traditionally the tax administration has been placed within the Ministry of Finance, tax administrations are increasingly attracted to the Canadian model where the tax administration is placed outside the Ministry of Finance and therefore enjoys full autonomy. Since the Finance Ministry is responsible, as of now, for the preparation and execution of the government budget, the Task Force recommends that it must continue to have authority over both revenue collection and expenditure to fulfill that responsibility. Analogously, CBDT, which is responsible for administering the direct tax laws, must have the requisite autonomy if it has to be made more accountable.

Deeply concerned about the lack of any meaningful accountability of the tax administration, the Task Force recommends the following:

1. The control of the Central Government over the tax administration must be formally reduced through a Memorandum of Understanding (MoU) between the Central Board of Direct Taxes and the Central Government (we understand that there is already a Cabinet decision to this effect). The Central Board of Revenue Act provides that the two boards (CBDT and CBEC) must function subject to the control of the Central Government, but the mechanism and the extent of control remains unspecified even after forty years.
2. The MoU must, *inter alia*, specify the financial commitment of the Central Government for tax administration.
3. The MoU must provide for full financial autonomy and control over deployment of human resources to the CBDT. The Central Government should only specify the general guidelines for financial expenditure and deployment of human resources.

4. The MoU should be for a period of five years specifying the observable performance indicators for the CBDT and the financial resources that would be made available to the CBDT on a year-to-year basis.
5. It must also specify, in financial terms, and in a manner to be decided later, the levels of penalty (reward) for under-performance (exceeding targets).
6. The CBDT should have exclusive power for designing the enforcement strategy, subject to the condition that it is non-discriminatory and transparent.

The Task Force was also concerned with the absence of any well-publicised rule for appointing as CBDT Members / Chairman and, therefore, recommends transparent procedures. Lack of transparency in appointments to senior positions in the tax administration can engender uncertainty and demoralise the tax bureaucracy. Therefore, it is recommended that the Central Government must formulate appropriate rules for appointments to the Board.

The Task Force also observed that the turnover of Members and Chairman of the Board was too high. Therefore, the rules for appointment of Members must provide for selection on criteria of merit cum seniority from amongst those who have a minimum period of two years of service before retirement as on the date on which the vacancy arises. Further, an officer once appointed as member of the Board should be debarred from any appointment either in the ITAT or Settlement Commission. Similarly, the Chairman, CBDT should be selected on criterion of merit cum seniority and once appointed should have a minimum tenure of two years.

The Task Force also noted that the standards of accountability at the field formation level were considerably diluted since, *inter alia,* the performance targets, particularly those related to revenue collection, were unrealistic and thrust upon them. The field formations were either resigned to the failure of the targets or resorted to questionable practices to meet revenue targets divorced from underlying economic trends. The Task Force was informed that very often officers were (informally) directed to hold back refunds to boost revenue collection. Accordingly, it is strongly recommended that the revenue targets should be based on underlying economic trends.

It must be appreciated that the ultimate accountability of the tax administration is to the Citizens. With a view to enhancing accountability of (and transparency in) tax administration, the CBDT must publish an annual report of its own, along the lines of the UPSC / CVC that is tabled in Parliament and put on its Website. The annual report must separately provide for performance achievements of each Chief Commissioner / Commissioner. In addition, the quarterly progress of achievement must be displayed on the Website, so that taxpayers have an opportunity to respond. While defining a stricter accountability structure, however, care must be taken to eschew an excessive and regimented accountability system which over-burdens Assessing Officers (AOs) with an

onerous and fragmented oversight that ultimately only serves to reduce its overall effectiveness.

Delegation of Financial Powers

Powers over the use of resources (both financial and human) must be commensurate with responsibility. Therefore, CBDT should be notified as a 'Department of Central Government' as defined in sub-rule (d) of rule 3 of Delegation of Financial Rules, 1978. Furthermore, CBDT should be authorised to remit the tax collections to the Central Government net of its expenditure budget and also be allowed to carry forward expenditure allocations. Consequently, it will have full control over its finances and therefore better placed to design and give effect to the medium term and long term enforcement strategy. For its part, CBDT must publish an annual financial report (statement), which will enable the government to assess the cost of tax collection.

Human Resource Management

The absence of control over human resources has further undermined accountability. Therefore, we recommend that the Central Government should delegate to CBDT full authority and responsibility regarding staff of the income tax department and its secretariat. This would include decisions on recruitment, deployment, designing incentive schemes, discipline matters, performance management & appraisal, employee relations, training & development, and other matters related to human resource management. Reciprocally, the CBDT should design a system of performance targets. The CBDT should, however, exercise such delegated powers in a transparent manner within the framework of rules and guidelines framed for this purpose. Such rules and guidelines should be framed with the approval of the government.

Infrastructure

The Task Force was aghast at the physical environment prevailing in most tax offices. We were also told by professionals that office space, work conditions and basic conveniences for staff, as well as storage facilities for tax records, are grossly inadequate. Facilities for taxpayers are even worse. The office layout is inimical to modernisation and induction of information technology. To institute these changes:

1) A Task Force should be constituted to standardize the requirement of a modern occupant-friendly office (with modern methods of storage and retrieval of records). The Task Force should furnish its report, including financial estimates, by 31st December 2002.

2) Based on the report of the Task Force the CBDT should request Chief Commissioners to identify the shortcomings in their offices by 1st April 2003 and send forward a proposal to CBDT.
3) By 1st August 2003 a model Commissionerate including the offices at the range, circle and ward levels should be established in each zone.

CBDT should seek the requisite financial sanction to replicate the model offices by either upgrading existing offices or, where necessary, by purchasing new premises, etc. The entire exercise should be time bound so that by January 2005 modern offices are in place in all Commissionerates.

Tax Policy

The design of tax policy is of paramount importance for tax administration. If efficient and feasible administration is an objective, the tax structure should comprise of low rates, few nominal rates, a broad base, minimal exemptions and incentives, no surcharges and, in cases of exceptions, clear guidelines. This is because a simple tax structure induces better tax administration. Prior to listing the proposed changes in individual tax segments, the Task Force recommends that, as a general process check, the introduction henceforth of any exemptions and incentives to the tax structure be accompanied by a mandatory cost-benefit exercise (tax expenditure analysis), to be presented before Parliament.

Tax Treatment of Agricultural Income

Given the large scale shifting of non-agricultural income to agricultural income (with the attendant revenue loss) and the need to augment the resources of the States, our recommendations are:

(a) A tax rental arrangement should be designed whereby States could pass a resolution under Article 252 of the Constitution authorising the Central Government to impose income tax on agricultural income. All taxes collected by the center (net of collection costs) would be assigned to the States.
(b) Tax from agricultural income for the purposes of allocation between states will be the difference between the tax on total income (including agricultural income) and the tax on total income net of agricultural income.
(c) Where a taxpayer derives agricultural income from different states, the revenues attributable to a state will be in the ratio of the income derived from a particular state to the total agricultural income.
(d) A separate tax return form should be prescribed for taxpayers deriving income from agriculture.

These recommendations will help mobilise additional resources for the States without the attendant problem of administering the agricultural income tax. It is noteworthy that given our recommendation on increasing the exemption limit to Rs. 1,00,000/- per individual, most (genuine) agricultural farmers would

continue to remain out of the tax net. The proposed rental arrangement with the States could be packaged with the rental arrangement for taxation of services.

Reform of Personal Income Tax

The recommended *package* of policy measures for the reform of personal income tax, to be considered as a holistic / indivisible unit comprises of the following:

(a) Increase in the generalised exemption limit from Rs.50,000/- to Rs.1,00,000/- for all individual and HUF tax payers.
(b) The existing three slabs in the personal income tax rate schedule will be replaced by two slabs. Incomes between Rs.1,00,000 and Rs.4,00,000 will be subjected to tax at the marginal rate of 20 per cent. All incomes above Rs.4,00,000 will be subjected to tax at the marginal rate of 30 per cent.
(c) Dividends received from Indian companies will be fully exempt.
(d) Long term capital gains on equity will be fully exempt.
(e) The standard deduction for salaried tax payers will be reduced to NIL.
(f) The income based deduction under Section 80D will be converted to a tax rebate at the rate of 20 per cent subject to a maximum of Rs.3,000.
(g) The benefit of deduction under Section 80DDB will be withdrawn. However, consistent with international practice and in view of the special circumstances of senior citizens, deduction for medical expenses may continue to be allowed in the form of a tax rebate at the rate of 20 per cent of the medical expenses, subject to a maximum of Rs.4,000.
(h) The income based deduction under Section 80E for repayment of educational expenses will continue to be allowed. However, on grounds of equity, the same should be allowed as a tax rebate at the rate of 20 per cent subject to maximum of Rs.4,000.
(i) The tax rebate schemes under Sections 88 for savings will be eliminated.
(j) The rebate under Section 88B for senior citizens will be eliminated.
(k) The rebate under Section 88C for women taxpayers below the age of 65 years, will be eliminated.
(l) The income based deduction for handicapped under Section 80DD and 80U will however continue.
(m) The income based deduction under Section 80L for interest income and dividends will be eliminated.
(n) The exemption under Section 10 in respect of interest income from bonds, securities, debentures etc. will be eliminated.
(o) The deduction for mortgage interest in respect of loans for acquiring a owner occupied dwelling will be phased out. It will be reduced to

Rs.1,00,000 in assessment year 2004-05, to Rs.50,000 in assessment year 2005-06 and NIL in assessment year 2006-07.

(p) The residential status of "Resident but Not Ordinarily Resident" will be eliminated.

Reform of Corporate Income Tax

In most countries corporate entities are subject to tax on their profits and, in addition, dividends are taxed in the hands of shareholders. The base of the corporate income tax, however, is commonly the accounting profits derived with reference to historical costs. Certain modifications are also often made by law to accounting profits to provide incentives for activities considered important for social and economic objectives or to provide relief from inflation as well as to curb misuse of the corporate form to reduce personal tax liability. As a result, there is a divergence between the statutory corporate tax rate and the effective corporate tax rate. Depending upon the level of divergence, corporate profits are also subjected to tax when distributed – either in the hands of the shareholders or at the point of distribution by companies – leading to "double" taxation. The source of the problem of "double" taxation is, therefore, the panoply of tax exemptions which is a prominent feature of the Indian tax system.

The present scheme of corporate income tax is riddled with a large number of deductions and exemptions. As a result, the base is considerably lower than the book profit declared to shareholders. In effect, this has led to a non-transparent tax subsidy regime, complexity of the tax law, revenue loss, increased compliance cost and has encouraged rent seeking behavior.

The Committee recognised that there are two modes of implementing its recommended package of policy measures for reform of the existing scheme of corporate income tax:

Option I: An immediate, one-time institution of rate cuts and elimination of exemptions.

Option II: A phase-in of rate cuts over a period of time, say 3 years, while simultaneously instituting a coordinated phase-out of tax exemptions and deductions.

As with all choices, there are merits and disadvantages to both options. A phased and coordinated implementation of rate cuts and exemptions (Option II) is attractive in view of the "legacy drag" of India's past (and enduring) tax structures that had been marked by a complicated maze of exemptions and incentives. On the other hand, a one-shot implementation of the recommendations (Option I) does not suffer from the drawback that often (as observed in many parts of the world), particularly due to electoral cycles, it is difficult, if not impossible, to make a credible commitment to sustaining a particular reform process. If not implemented at one go, it has been recognised

that reforms leave space for lobbying by interest groups. In addition, since the onset of reforms in the early nineties, the costs of doing business in India, especially the cost of capital, have been steadily falling. The justification for (artificial) relief in the form of exemptions has consequently been progressively waning.

After deliberating on the comparative merits of the two options, the Committee endorses the choice of Option I as the preferred method for implementing the package of policy measures for reform of the existing scheme of corporate income tax.

Option I

The recommendations of the Committee, under this option, comprises the following elements:

Option I :

(i) Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies.

(ii) Exemption of dividend from taxation in the hands of the shareholders. There will also be no tax on distribution of dividends by a company.

(iii) Exemption of long terms capital gains on equity.

(iv) Elimination of Minimum Alternate Tax under Section 115JB.

(v) Removal of the distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(vi) Removal of the following deductions under Section 10 and Chapter VI A of the Income Tax Act with immediate effect and not by a sunset clause :-

(a) Elimination of Section 10A and 10B of the Income Tax Act

(b) Section 80 IA in respect of profit and gains from industrial undertakings or enterprises engaged in infrastructure development or telecommunication service or development of industrial park or special economic zones or generation, transmission or distribution of power.

(c) Section 80 IB in respect of profits and gains from certain industrial undertakings other then infrastructure development undertakings (this includes backward areas also).

(d) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.

(e) Section 80 JJAA in respect of employment of new workman.

(f) Section 80 M in respect of inter corporate dividends.

(g) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(vii) Depreciation allowance under section 32 will be restricted to the allowance, charged to the profit and loss account in accordance with the provisions of the Companies Act.

(viii) Elimination of Section 33 AB relating to Tea development account will be eliminated.

(ix) Elimination of Section 33 AC relating to reserve for Shipping business.

(x) Elimination of Section 33 B relating to Rehabilitation allowance.

(xi) Elimination of Section 35 relating to expenditure on Scientific Research. However, donations to trusts, institutions etc. engaged in scientific research will continue to be allowed but in the form of a tax rebate like in the case of Section 80G.

(xii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

(xiii) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

(xiv) Elimination of Section 36(iii) in respect of interest on borrowed capital.

(xv) Section 35 CCB relating to expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources.

(xvi) The provison for bad and doubtful debts allowable under Section 36(1)(viia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

Option II :

(i) Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies over a period of three years. The rates for domestic companies will be 34 per cent in financial year 2003-04, 32 per cent in 2004-05 and 30 per cent in 2005-06. The rates for foreign companies will be 38.5 per cent in financial year 2003-04, 37 per cent in 2004-05 and 35 per cent in 2005-06.

(ii) No tax on dividend in the hands of the shareholders.

(iii) No tax on long terms capital gains on equity.

(iv) Elimination of Minimum Alternate Tax under Section 115JB.

(v) Removal of the distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely.

(vi) Levy of a distribution tax on dividends at the rate of 15 per cent for dividends distributed in 2003-04, 7.5 per cent in 2004-05 and NIL in 2005-06.

(vii) Removal / Phasing out of the following deductions under Section 10 and Chapter VI A of the Income Tax Act with immediate effect and not by a sunset clause :-

- (a) Phasing out of the provisions of Section 10A and 10B of the Income Tax Act. over a period of 3 years i.e. the deduction will be reduced to 60 per cent of the profits in 2003-04, to 30 per cent of the profits in 2004-05 and NIL in 2005-06.
- (b) Phasing out of Section 80 IA in respect of profit and gains from industrial undertakings or enterprises engaged in infrastructure development or telecommunication service or development of industrial park or special economic zones or generation, transmission or distribution of power, over a period of 3 years i.e. the deduction will be reduced to two – third of the profits in 2003-04, to one – third of the profits in 2004-05 and NIL in 2005-06.
- (c) Phasing out of Section 80 IB in respect of profits and gains from certain industrial undertakings other then infrastructure development undertakings (this includes backward areas also), over a period of 3 years i.e. the deduction will be reduced to two – third of the profits in 2003-04, to one – third of the profits in 2004-05 and NIL in 2005-06.
- (d) Section 80 JJA in respect of profits and gains from business of collecting and processing of biodegradable wastes.
- (e) Section 80 JJAA in respect of employment of new workman.
- (f) Section 80 M in respect of inter corporate dividends
- (g) The phase out programme in respect of sections 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA will continue.

(viii) Depreciation allowance under section 32 will be restricted to the allowance, charged to the profit and loss account in accordance with the provisions of the Companies Act.

(ix) Elimination of Section 33 AB relating to Tea development account will be eliminated.

(x) Elimination of Section 33 AC relating to reserve for Shipping business.

(xi) Elimination of Section 33 B relating to Rehabilitation allowance.

(xii) Elimination of Section 35 relating to expenditure on Scientific Research. However, donations to trusts, institutions etc. engaged in scientific research will continue to be allowed but in the form of a tax rebate like in the case of Section 80G.

(xiii) Elimination of Section 35 AC relating to expenditure on eligible projects. However, expenditure on projects already approved will continue to enjoy tax benefit in the form of rebate at the rate of 20 per cent.

(xiv) Elimination of Section 35 CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.

(xv) Elimination of Section 36(iii) in respect of interest on borrowed capital.

(xvi) Section 35 CCB relating to expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources.

(xvii) The provision for bad and doubtful debts allowable under Section 36(1)(viia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

Tax Treatment of Charitable Trusts

The exemptions under section 10 of the Income Tax Act need to be brought under the single discipline of the provisions of section 11 to 13 of the Income tax Act, 1961 for the sake of uniformity.

All Charitable Trusts and Institutions will be required to file tax returns. The returns identified for scrutiny / audit will only be through a computerised risk assessment system. Where the assessing officer is of the opinion that the activities of the trust are not charitable in nature, such a case will be referred to a rating agency from amongst the panel drawn up by the Comptroller & Auditor General (C&AG). An “A+” rating for the trust will mean that it is indeed a charitable trust; an “A” rating for the trust will mean that it will enjoy exemption during the current year and will be subjected to review again in the following year; and a “B” rating for the trust will disqualify it from any tax exemption.

The income based deduction under sections 80-G and 80-GGA of the Income Tax Act should be converted to a tax rebate at the rate of 20 per cent of the amount of donation. In addition, it is recommended that deductions under sections 35(1)(ii) and (iii) should be transformed into tax rebates.

Tax Treatment of Non-Residents

A Number of issues were raised before the Task Force. These being too technical in nature to be dealt with in the limited time available the Task Force recommends setting up of a working group under the Director General of Income Tax (International Taxation). Further, we also recommend the strengthening of the foreign tax division in the Central Board of Direct Taxes.

Tax Treatment of Cooperative Societies

The deduction under Section 80P is recommended for elimination and the threshold exemption limit is recommended for an increase to Rs. 1,00,000/- with appropriate changes in the tax schedule.

Tax on Partnership Income

The tax rate on partnership income will continue to be aligned with the corporate income tax rate.

Tax Treatment of Statutory Liability

The Task Force recommends that delayed payment of statutory liabilities in respect of labour should also be allowed as a deduction in the year of payment.

Wealth Tax

The Task Force recommends abolition of the levy.

Treatment of Capital Gains

Since capital gains represent accumulation of income over a period of time, these could turn out to be illusory in real terms. Accordingly, the cost of the asset is adjusted for inflation during the period of holding. The increased cost is set-off against the sale consideration of the capital asset to determine the capital gain. In this regard, the capital gain is subjected to a concessional rate of tax to eliminate the bunching effect. Furthermore, the capital gains are fully exempt if the proceeds are invested in specified savings plan / schemes. In view of the liberalized personal income tax rate schedule we recommend that concessional treatment of long term capital gains through a reduced scheduler rate of tax must be abolished. In other words, the long term capital gains would be subjected to taxation at the normal rates. Moreover, the exemption for roll over of capital gains must also be abolished for all schemes other than investment in house or the bonds of National Highway Authority of India until completion of the Golden Quadrilateral and the North-South & East-West corridors.