A WARTS AND ALL GLIMPSE OF THE TAX SYSTEM IN INDIA

Prof. S.P. Srinivasan
Xavier Institute of Management & Entrepreneurship

The Indian Tax system can be classified as before 1991 and after 1991, with 1991 being the water-shed. Immediately after independence, India adopted the philosophy of using the tax system for transferring resources from the rich to the poor. In the Indian republic's constitution the powers of central and state Governments are delineated clearly, with the Union list consisting of taxes on income and wealth other than income from agriculture, on manufacture other than alcohol and narcotics as well as on imports and exports. Thus the central government levies income tax other than on income on agricultural activities, excise duty which is essentially duty on manufacture and customs duty which is duty on imports and exports. Power to tax sales is specified in the state list, so state governments levy sales tax. Many states also levy agricultural income tax on plantation activities. Stamp duty is specified in the concurrent list, so both central and state governments levy stamp duty.

Taxation theories postulate direct taxes as being progressive and indirect taxes as being regressive on the basis that direct taxes are levied based on ability to pay while indirect taxes affect the rich and the poor equally. Tax theories also talk about using taxes to transfer resources from the rich to the poor, penalizing certain activities which cause undesirable externalities and giving incentives to activities leading to desirable externalities.

When Jawaharlal Nehru, the first Prime Minister of India, invited Cambridge professor and economist Prof Nicholos Kaldor to suggest a suitable tax system, the aspect of transfer of resources was very much in focus. Nicholos Kaldor's response was to set out for good measure a comprehensive tax system wherein if one earns, income tax has to be paid; if one spends expenditure tax has to be paid; if one saves, wealth tax has to be paid; if one gifts, gift tax has to be paid and if one dies, estate duty has to be paid.

But many a time good theory makes for bad practice. Many of the founding fathers of independent India had good intentions, but good intentions are not good management. As the saying goes, the way to hell is paved with good intentions. In the case of the wealth-transferring Indian direct taxes, these were levied with multiple elements like income tax, expenditure tax, wealth tax, gift tax and estate duty, all with very high slab rates. The tax act was intertwined with too many exemptions for activities causing good externalities, thereby making the gap between slab and effective rate unduly high. Indirect taxes were levied at all too high rates on luxury goods, while essential goods were exempted or charged at low rates. Sometimes, whether something was an essential or a luxury good was determined based on end use. Innumerable rates therefore came to be prescribed, making the tax system hugely complicated and discretion-based. Indirect taxes were modelled on the basis of delegated legislation; while the highest rate which is the tariff rate was fixed by Parliament, the actual rates were prescribed by the executive through notifications. Thus in practice protection given by the constitution that no tax will be levied without authority of law stood violated. For another, as said before, the law also gave huge discretionary powers to officials enforcing it, leading to corruption.

As stated by an eminent jurist,"the Indian tax system started with the noble objective of transferring resources from the rich to the poor, but ended with the unintended consequence of transferring resources from the honest rich to the dishonest rich."

There is an old story, probably apocryphal, which says that when Queen Victoria took over the reins of administration from the East India Company, the then British government wrote to the Governor General of the East India Company requesting guidelines for governing India since they had had a hundred year experience. In reply, the Governor General wrote back only one line to the effect that the native should not be trusted. British rules were enacted based on this underling principle, which was subsequently followed also by independent India, unwittingly leading to huge unwieldy procedures with heavy compliance cost, ambiguity, need for frequent contacts for citizens with officials and consequent corruption.

Because of the division of powers provided in the constitution, multiple entities enacted multiple taxes like luxury tax, entertainment tax, and Octroi or entry tax. Even within income tax and excise and customs duties, various classifications like basic duty, special duty, surcharge and cess were levied, one cascading on other. In terms of diversity of tax authorities, India was balkanised with multiple check posts not only in between states but also in between municipalities. And states among themselves were engaged in competitive incentive policies, whereby several tax holidays and tax-free loans were granted to new industries. In sum, any investor leave alone foreign investor wanting to invest in India was unable to comprehend the gigantic complexities of the tax system created by central and state governments.

Now post 1991 which was a new era, India embraced the concept of VAT (value added tax), wherein the objective was to collect resources for the government in the least complicated manner, somewhat like a bee sucking honey from a flower without hurting it . It was thought that such an outcome could be achieved variously by keeping the rates reasonable, widening the tax base, avoiding both end user-based exemptions and incentives in the tax system, keeping the number of rates to one or three at the most, not exempting anything, taxing at every point and avoiding cascading. As for the extent of VAT, even though the central and state governments have been moving towards VAT, they have not completely embraced the concept due to political exigencies.

What with all that, India today has only income tax and a marginal wealth tax. The maximum rate of tax for an Indian company is 34%, while that for a foreign company it is 41%. A difference of 7% is rational since the Indian companies pay 15% tax on declared dividend, while foreign companies are not subjected to the same. Thus foreign companies are accorded complete non-discriminatory treatment under the Indian direct tax law. The tax levied on them at 41% is on income from permanent establishment. Income by way of royalties and interest is subject to withholding tax under double taxation avoidance agreements wherever these have been concluded with foreign countries.

There are also tax provisions designed to facilitate foreign investment. For example, to provide certainty for the international investor, the government has set up the Authority for Advance Ruling which determines the liability of foreigners both under direct and indirect taxes before commencement of business activities in the country--such determination is binding on the tax authorities- In another provision, listed shares held for more than 12 months are completely exempt from income tax, while listed shares held for less than 12 months will be charged at 15%. Now all these tax considerations are to be kept in view while deciding whether to set up a foreign company either as a subsidiary incorporated under the laws of India or as a branch. And when it comes to transactions with associate companies, these are regulated under transfer pricing regulations.

In excise duty under the post-1991 tax regime, for most of the items a single rate called Cenvat has been prescribed and the effect of cascading is avoided by offsetting input tax against output tax. The central government has introduced a service tax on specified services, the ultimate objective being to introduce uniform goods and service tax with full offset available for input tax paid against the output tax. The customs duties are charged broadly at an effective rate of 30%, even though credit is allowed up to 20% out of it for offsetting output duty. Addit6ionally, legal provision has been made for anti-dumping duties conforming to international norms.

As of now, 30 States and union territories have switched over to VAT. While there is a list of VAT-exempted goods, high value goods like gold and silver are taxed at 1% and goods of special importance are taxed at 4%; the general rate of tax itself is 12.5% with taxation on sin goods like liquor, tobacco is at 20%. Full tax offset is provided at each point of sale. Much as VAT has been adopted in the country since 2003, the Tax Act does provide incentives for preferred activities like exports, infrastructure, capital investments, development of backward regions and scientific research. Taking advantage of these benefits offers the possibility of reduction of effective tax rates. For example, if a unit exports 50% of its production it can become an Export Oriented Unit or a unit may locate itself in a Special Economic Zone and thus largely avoid paying taxes. On the other hand, agricultural income, interest on NRI deposits and long term capital gains on listed

shares are exempt from income tax while short term capital gains are taxed at 15% like dividends , providing scope for money laundering through routes like round tripping.

Anomalies

There are several anomalies in the post-1991 tax system which may also be mentioned. Central Sales Tax is an old impost; **it** still continues at 3% rate for which offsetting is not allowed, resulting in to cascading. Mention was made earlier of service tax; **it is** levied selectively on certain services and exempted on certain others, being left to taxman's discretion and thus complicating the tax system. Another complicating element is to be found in the fact that concepts like EET, ETE, and EEE are proposed to be introduced in direct taxes to provide vertical and horizontal equity. A similar observation may be made about the Minimum Alternate Tax (MAT); **it** still finds a place in the Income Tax Act and also in the proposed Direct Tax code, even though it is proposed as asset-based, despite the fact that the right solution is to remove incentives and not to complicate the tax regime through MAT. When it comes to excise duties, exemption powers under 5A (1) and 5A (2) and Customs under 25(1) and 25(2) still continue. If these cannot be removed they should be so designed as to be exercised very sparingly.

Harmonised System of Nomenclature which is a cumbersome system of classification is mandatory only for international taxation, thus excise and local VAT should adopt a far simpler system which is assessee friendly. Sometimes activities like right to use goods are taxed both as sales as well as service.

Real income should be taxed and all artificial restrictions in the Income Tax Act under setoff and carry forward of loss should be removed. To mention an example, in the absence of any state sponsored social security, restricting medical treatment only to specified diseases, that too subject to a low monetary ceiling, amounts to not taxing the real income. In other countries carry-forward of losses is allowed. It is high time that in India the government taxed real income and allowed carry

forward of losses against all sources without time limit permitting the same to be offset against any other source without exemptions.

Some simple reforms:

While significant progress has been made in reforming the Indian tax system, some simple measures could go a long way in addressing the long-felt tax payer grievances and more importantly, in accomplishing a fully transparent VAT-based regime through the proposed GST (for indirect taxes) and Direct Tax Code (for direct taxes) by 2011.

Specifically, the following reforms would need to be undertaken:

- Artificial disallowance of expenses that has now been introduced in tax laws to enforce other objectives should be removed.
- The prerogative given to bureaucrats who have become the law makers in valuing perquisites for levying tax is not keeping with the spirit of VAT and hence should be removed.
- Tax deduction at source is imposing enormous compliance cost on the tax payers. All TDS should be at a single rate, say 10%. Multiple returns should be replaced by a single return. Tax refunds and payments should be verified electronically and the mandatory tax deduction certificates should be abolished.
- Multiple taxes like surcharge, special duty, national calamity and contingency duty, cess, luxury tax, entertainment tax, octroi should all be subsumed into either a single rate of IT, state GST or central GST.
- CST should be abolished and Service Tax be levied on all services on a non- discriminatory basis.
- A separate National Tax Tribunal should be set up, with its decisions subject to appeal to the Supreme Court only on questions of law. This will go a long way in reducing the burden on the High courts and the delay and uncertainty imposed by conflicting decisions by courts.

- Special attention should be paid to delay in refunds made to tax payers. Different rates of interest for delay in refund and in payment of interest should be eliminated and they should be made uniform.
- The government should continue to streamline the tax administration by using information technology and minimise transaction cost for tax payers by going for trust-based self assessment.

* * *