

A Historic Budget

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“Free Enterprise was born with man
and shall survive as long as man
survives.”

— **A. D. Shroff**

1899-1965

Founder-President

Forum of Free Enterprise

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By

H.P. RANINA*

Few countries in the world have the good fortune of having the right people at the helm of affairs at the most critical juncture. The economic crisis which India faced in June 1991 could have proved more disastrous for the teeming millions than all the natural and man-made adversities which our country has gone through in the last 40 years.

At its most dire moment, the Nation was saved from a catastrophe by the emergence of a new Government and, more importantly, a dynamic Finance Minister who made pragmatism and realism the ideology of the new Government.

Being on the threshold of a new millennium, the Finance Minister has responded with a sense of History. He knows that his proposals can lay the foundation for an economic miracle which has so far eluded India.

The fourth successive Budget of Dr. Manmohan Singh has been on predictable lines in view of the transparency in formulation of policies which have been

* *The author is a noted tax expert. The text is based on a talk delivered at a public meeting in Bombay on 1st March, 1994 under the joint auspices of several organisations including the Forum of Free Enterprise*

apparent during the last three years. The three most striking features of the 1994-95 Budget proposals are :

1. Structural changes in customs and excise laws which will simplify, streamline and generate a buoyancy in indirect taxation;
2. Accelerate the pace of liberalisation and enable Indian industry to come out of the recessionary situation of the past few months; and
3. Propel the economy towards full convertibility in the next three years and give a fresh impetus to the globalisation of the Indian economy.

The increase in fiscal deficit is a ground for worry as it gives the impression that the Government has temporarily loosened its grip and become fiscally undisciplined. However, since the Finance Minister's reputation depends upon sound fiscal management, his Ministry will go out of its way to ensure that the deficit is controlled.

The Finance Minister has introduced proposals which will also increase productive expenditure and provide a new thrust to welfare measures apart from large allocations for the backward classes. His stress on education, research and development, and upgradation of technology augur well for the future of the country and will certainly help in improving the standard of living for the masses.

Restructuring Corporate Tax Laws

One cannot but agree with the Finance Minister when he stated that our industrial sector both private and public has begun the difficult process of restructuring to face increasingly competitive market conditions. The climate for investment, both domestic and foreign, has vastly improved. The tax structure now proposed goes a long way towards the kind of modern tax system and moderate tax rates and an emphasis on compliance, which is the hallmark of all successful countries.

The corporate sector in India is going to be the biggest beneficiary of the Budget proposals for the following reasons:

1. Reduction in rates of corporate tax and long-term capital gains tax;
2. Reduction in rates of import duties which will make it possible for companies to source raw materials at the best available prices and upgrade the quality of the final products; and
3. The reduction in excise duty on a selective basis, the extension of Modvat and streamlining of procedures would remove the present anomalies in the excise structure and will create a level playing field which has been the demand of the captains of industry.

With a view to providing fiscal support for industrialisation of the industrially backward districts in

the country, it is proposed to provide in Section 80-IA that the five-year tax holiday will also be available to new industrial undertakings located in backward districts notified by the Central Government on the basis of the guidelines to be prescribed.

The five-year tax holiday will be available to undertakings which begin production after 1.10.1994 but before 31.3.1999. The deduction under Section 80 IA will be available at the rate of 100 per cent of profits in respect of the first five assessment years starting from the assessment year relevant to the previous year in which the industrial undertaking starts manufacture or production. For the subsequent assessment years, deduction from the profits of such undertakings will be allowed at the normal rate of 30 per cent in the case of companies and 25 per cent in the case of non-corporate assessees.

The deduction, at the enhanced rate and the normal rate together, will be limited to twelve assessment years in the case of co-operative societies and ten assessment years in the case of other assessees, as in the existing provisions. The incentive already available to industrial units set up in States or Union Territories specified in the Eighth Schedule will continue.

Some of the provisions of the Finance Bill, 1994 will adversely affect the corporate sector. They are as follows:

- (a) The first instalment of advance tax will now be payable by 15th June. This is going to be

difficult for many companies because very rarely is income earned in the first 2 1/2 months of an accounting year. The advance tax will have to be paid out of borrowings and the cash flow of companies will, therefore, be affected.

- (b) The return of income alongwith the tax audit report has to be filed by 31st October. There is no justification for this change and the present due date of 31st December should be continued.

On the indirect tax front, the key features of the customs tariff reform proposals are:-

- Further reduction in the peak rate of customs duty;
- Substantial reduction in duties on key raw materials, such as steel and chemicals;
- Reduction in customs duties on capital goods to boost investment combined with other incentives which will help the domestic capital goods industry.
- Reduction or removal of anomalies caused by import duties on raw materials and components being higher than on finished products.
- A systematic effort to unify rates on similar products to serve both economic rationality and to reduce the scope for classification disputes;
- A major pruning of notifications including end use exemptions to about half their present number, thus reducing discretionary power and possibilities for disputes.

This Budget proposes a major reform of the excise tax structure as part of the Government's programme of modernising the tax system. The principal features of this restructuring are :

- Extension of Modvat to capital goods and petroleum products;
- Shift in the bulk of excise taxation from specific to ad valorem rates which will assure much greater built-in buoyancy of revenues.
- Reduction in the total number of ad valorem tax rates to about half the existing number which will be a major step towards simplicity and transparency;
- Continuing the process of lowering rates when they are unduly high;
- Application of uniform rates for similar commodities to the extent possible. This will reduce classification problems, scope for misuse and widespread litigation;
- Removal of complicated price list procedure;
- Reduction of the number of special exemption notifications by about half.

These steps will promote growth of manufacturing output and employment, will make tax administration easier, less discretionary and also reduce the scope for misclassification, disputes and evasion. They will increase revenue elasticity and pave the way for an eventual adoption of a Value Added Tax.

These far-reaching proposals will certainly ensure the revival of the industrial sector and put it on the growth path of 6-7%. The Exchequer can also hope for buoyancy of revenues from this sector.

Revamping the Capital Gains Law

The Finance Bill, 1994 seeks to revamp the capital gains tax structure. Apart from reducing the rates of long-term capital gains tax on companies, amendments are sought to be made to supersede Supreme Court decisions on well-settled principles of computation of capital gains tax.

At present, the foreign companies are taxed on long-term capital gains at the rate of forty per cent and the non-resident partnerships, etc., are taxed at the rate of thirty per cent thereof. In the case of the non-resident individuals and Hindu undivided families, the income-tax rate on long-term capital gains is twenty per cent. As taxation at the uniform tax rate of twenty per cent is being provided on the income by way of interest, dividends, etc., in the case of the foreign companies and the non-resident non-corporate assessees, the Bill also seeks to amend Section 112 to provide that in their case, the income-tax rate on long-term capital gains will be twenty per cent.

By virtue of the provisions of Section 45 of the Income-tax Act, capital gains arising on transfer of a capital asset are subjected to income-tax. Section 48 lays down the method of computing capital gains. The cost of acquisition and expenditure relating to the

transfer are deducted from the full value of consideration to arrive at the capital gains. Section 2(14) defines "capital asset" to include all kinds of property except a few specified ones.

In a number of cases, the Courts have decided that, in case of self-generated assets like goodwill, or where the cost of the asset to an assessee (not covered by situations mentioned in Section 49) is nil, no tax on capital gains consequent to transfer of such assets could be charged. They have interpreted that, only if an asset did cost something to the assessee in terms of money, the provisions relating to the levy of tax on any capital gains under Section 45(1) read with Section 48(ii) would apply. A transaction to which these provisions cannot be applied has been held to be one never intended by Section 45(1) to be the subject of the charge.

The Courts have further interpreted that the intent of levying capital gains tax goes to the nature and character of the asset, that it is an asset which possesses the inherent quality of being available on expenditure of money to a person seeking to acquire it. The Courts have held that none of the provisions pertaining to the head "Capital gains" suggests that "capital assets" include an asset in the acquisition of which no cost at all can be conceived. The leading case propounding this interpretation is *C.I.T. vs. B.C. Srinivasa Setty* (128 I.T.R. 294 (SC)).

In order to overcome the judicial interpretation, the Finance Act, 1987, with effect from 1.4.88,

provided in Section 55(2)(a) that the cost of acquisition in case of self-generated goodwill will be taken to be nil. For the purpose of bringing to tax the capital gain arising from transfer of any of the following assets, in the acquisition of which the assessee has not incurred any expenditure, the Finance Bill proposes to amend the provisions and provide that the cost of acquisition is to be taken at nil:

- (1) Tenancy rights
- (2) Route permits
- (3) Loom hours

The proposed amendment will take effect from 1st April, 1995, and will, accordingly, apply in relation to the assessment year 1995-96 and subsequent years.

The Income-tax Act prescribes broad provisions on computation of income under the head "Capital gains". Specific methods of computing the cost of the asset have been provided only in respect of certain types of assets. There is no specific provision dealing with determination of the cost of financial instruments such as rights shares, rights entitlement, etc. In the absence of any such provisions, Courts have laid down certain methods for determining the cost which are not strictly in accordance with commercial principles [See *Ms. Dhun Dadabhoy Kapadia vs. C.I.T.* (63 I.T.R. 651)].

The Bill proposes to deem the cost of rights entitlement in the hands of the original shareholder as

nil. Of course, the cost of the rights share acquired by the original shareholder is the price actually paid by him to the company for acquiring the rights share. However, where the rights renounee acquires the rights share, the cost of the rights share is equal to the cost incurred by him for purchasing the rights entitlement plus the price paid by him to the company for acquiring the rights share.

The amount realised by the original shareholder by selling his rights entitlement will be short-term capital gains in his hands (as the cost is taken as nil). The period of holding of the rights entitlement will be reckoned from the date of offer made by the company to the date of renouneement.

The capital gains tax structure for foreign institutional investors has remained unchanged. This has disappointed many FIIs who thought that the capital gains tax structure would be brought in line with that prevailing in countries where there are other emerging capital markets.

The main grievance is that the short-term capital gains tax of 30% is extremely high. On the other hand, resident and non-resident Indians as well as overseas corporate bodies have levelled the charge of discrimination on the ground that FIIs are given special treatment.

While all have a certain point of view, it would be eminently desirable for the Government to abolish capital gains tax totally with the condition that exemption would be granted if Indian and foreign

investors were to reinvest the original investment made by them in shares of other companies. In other words, if the cost of acquisition of the original shares is rolled over and reinvested in the capital market within a specified period, say four months, no capital gains tax would be chargeable.

Such a Law would take care of the Government's apprehension that FIIs are fair-weather friends and that they would pull out their original investment in the near future. It has to be understood that FIIs have to service their unit holders in their home countries and, therefore, profits made necessarily have to be pulled out and repatriated. At the same time, if the original investment remains in India, by giving a suitable capital gains tax exemption, the view points of both the FIIs and the Government would be taken care of.

The same policy should apply to Indian investors as well as non-resident Indians and overseas corporate bodies, so that there is no discrimination amongst the investing public at large.

Presumptive Taxation

It is indeed distressing that a country which is reputed to have a middle-class of around 150 million people, has just 8 million tax-payers. Millions escape the tax net and the administration finds it impossible to lay their hands on tax dodgers who are spread over the length and breadth of India.

Presumptive taxation, collection and deduction of tax at source are, therefore, being increasingly resorted to with a view to widen the tax base.

A new Section 44-AD is proposed to be inserted in the Income-tax Act with a view to providing for a method of estimating income from the business of civil construction or supply of labour for civil construction work. The new section is applicable to all assesseees whose gross receipts from the above-mentioned business do not exceed Rs. 40 lakhs. The income from the above-mentioned business will be estimated at 8 per cent of the gross receipts paid or payable to an assessee. A tax-payer can voluntarily declare a higher income in his return.

The expression "civil construction" will include the construction or repair of buildings, dams, bridges, or other structures or of roads or canals. It will also include the execution of any other works contract.

All deductions, including depreciation, will be deemed to have been already allowed, and the written down value will be calculated accordingly.

The assessee will neither be required to maintain books of account under the provisions of Section 44-AA, nor be required to get his accounts audited under the provisions of Section 44-AB, in respect of his income from the business of civil construction. However, even such an assessee would be required to comply with the requirements of both Sections 44-AA and 44-AB in respect of his businesses which are not covered by this scheme.

The income from the business of civil construction, estimated in accordance with this provision, will be aggregated with other incomes of the

assessee, from any other business or under the other heads of income, in accordance with the normal provisions of the Income-tax Act. Accordingly, all deductions under Chapter VI-A and rebate under Chapter VIII will be available to the assessee, if the conditions therein are fulfilled.

The scheme is optional. A system of rebuttal has been provided. A person can claim that his income in respect of the above-mentioned business is lower than the specified estimate of income. In such a case, he must produce necessary evidence to prove his case. Such a case will be scrutinised for regular assessment under Section 143(3).

The proposed amendment will take effect from 1st April, 1994 and will, accordingly, apply to the assessment year 1994-95 and subsequent years.

A new Section 44-AE is proposed to be inserted in the Income-tax Act with a view to providing for a method of estimating income from the business of plying, hiring or leasing trucks owned by a tax-payer. The scheme applies to persons owning not more than ten trucks. The income from each truck, being a heavy goods vehicle, will be estimated at Rs. 2,500 for every month or part of a month during which the truck is owned by the assessee. The income from each truck, other than a heavy goods vehicle, will be estimated at Rs. 2,000 for every month or part of a month during which the truck is owned by the assessee. In either case, the tax-payer can declare his income from trucks at a higher amount than that specified above.

The following two illustrations give a better idea of the mode of calculation.

An assessee owns a light commercial vehicle for 9 months 15 days, a medium goods vehicle for 9 months and a medium goods vehicle for 12 months during the previous year. His profits and gains from the three trucks shall be deemed to be $(Rs. 2,000 \times 10) + (Rs. 2,000 \times 9) + (Rs. 2,000 \times 12)$, i.e. Rs. 62,000.

An assessee owns a heavy goods vehicle for 9 months 7 days, a medium goods vehicle for 9 months and a light commercial vehicle for 12 months during the previous year. His profits and gains from the three trucks shall be deemed to be $(Rs. 2,500 \times 10) + (Rs. 2,000 \times 9) + (Rs. 2,000 \times 12)$, i.e. Rs. 67,000.

All deductions, including depreciation, will be deemed to have been already allowed, and the written down value will be calculated accordingly.

The assessee will neither be required to maintain books of account under the provisions of Section 44-AA, nor be required to get his accounts audited under the provisions of Section 44-AB, in respect of his income from the truck business. However, even such an assessee would have to comply with the requirements of both Sections 44-AA and 44-AB in respect of his businesses which are not covered by this scheme.

The income from the truck business, estimated in accordance with this provision, will be aggregated

with other incomes of the assessee, from any other business or under other heads of income, in accordance with the normal provisions of the Income-tax Act. Accordingly, all deductions under Chapter VI-A and rebate under Chapter VIII will be available to the assessee, if the conditions therein are fulfilled.

The scheme is optional. A system of rebuttal has been provided. A person can claim that his income in respect of the above-mentioned business is lower than the specified estimate of income. In such a case, he must produce necessary evidence to prove his case. Such a case will be scrutinised for regular assessment under Section 143(3).

Further Liberalisation Measures

Exporters will continue to get the requisite boost as they will now be able to retain 25% of their export earnings in foreign currency which can be used for promotion of exports, travelling, market research and advertising products in foreign countries. The reduction in interest rates on bank lending will help the corporate sector in general and exporters in particular.

The move towards greater convertibility will give a boost to tourism as Indians are now permitted to draw every year upto U.S. Dollars 2,000 for foreign travel. There is also total liberalisation pertaining to release of foreign exchange for medical and educational purposes. The reduction of expenditure tax on hotel bills from 20% to 10% will also make India more attractive as a destination for foreign tourists.

While the interest burden on the Nation has increased, the good news is that the Government is going to repay its obligations to the International Monetary Fund earlier than scheduled and will also be encouraging private companies to retire their debts as soon as they are able to do so. In fact, the Rupee will continue to rule strong and the Reserve Bank of India will have to try hard to keep it at its present level in order not to hurt exporters.

To conclude, the process of liberalisation is going to bear fruit during the fiscal year 1994-95 and the full impact will be felt, reflecting in a higher rate of industrial growth, increase in the gross domestic product, burgeoning of foreign exchange reserves, greater inflow of foreign direct investment and, above all, enhancing employment opportunities for the faceless millions, alleviating to some extent the pangs of poverty.

FORUM OF FREE ENTERPRISE

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions and other means as befit a democratic society.

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Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235, Dr. Dadabhai Naoroji Road, Post Box No.209, Bombay 400 001.

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