An Analysis of Direct Tax Laws (Amendment) Bill, 1988.

Dinesh Vyas

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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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Taxation is a ground for continuous battle between the tax gatherers and the tax payers; for the conflict is between the financial claims of the State and the personal proprietary rights of private citizens. "For years a battle of manoeuvre has been waged between the Legislator and those who are minded to throw the burden of taxation off their own shoulders...". Of recent years, the battle has spread fairly wide from mere financial issues to various issues of procedure, reasonableness and complexity.

Without exaggeration, it can be said that in the history of Indian Tax Laws the bitterest battle between the governors and the governed was fought over the Direct Tax Laws (Amendment) Act, 1987 (hereafter "the 1987 Act"). The fallout of this battle is the present Direct Tax Laws (Amendment) Bill, 1988 (hereafter "the 1988 Bill"), which has been introduced in the Parliament a few days ago. The 1987 Act and the 1988 Bill have to be read together because they are substantially interlinked and interwoven; the former is the main cause of the latter.

The 1987 Act was a major exercise in tax reforms. It contained considerable directional changes with a view to achieve various objectives. It was based on the policy of reposing trust in the tax payers so as to encourage voluntary compliance. It attempted to make the tax laws effective by

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*The author is a practising Supreme Court Advocate. *This article is based on a speech delivered before the Western India Regional Council of Chartered Accountants of India on December 20, 1988 and the Forum of Free Enterprise on December 26, 1988 at Bombay.*

preventing leakage of revenue through instrumentalities of numerous taxable entities. It introduced a uniform accounting year and sought to ensure taxation of real income.

However, in achieving the above objectives, the 1987 Act introduced certain provisions which became a subject matter of intense criticism. A few of the provisions of the 1987 Act were subjected to an onslaught never witnessed in the past. It introduced a new scheme for taxation of firms and its partners. Fundamental changes were made in taxation of trusts and religious and charitable institutions. The scheme and procedure of assessment underwent a radical change with consequential changes in penal provisions. Against these provisions, there were countrywide protests. Cities of New Delhi, Bombay and Ahmedabad observed a Bandh. The President of India was approached to withhold his assent to the Bill of 1987 and return the same to the Houses with a message to reconsider the Bill. The Government noticed the intensity and the force of the public agitation and, therefore, although it allowed the Bill to become an Act, it immediately recognised the need to review some of the above controversial provisions. The then Finance Minister expressed the willingness to examine in detail the genuine difficulties arising out of the 1987 Act and to take corrective action wherever necessary. The 1988 Bill is a step in this direction.

The 1988 Bill deletes some of the controversial provisions of the 1987 Act on the one hand but retains some other fundamental changes. Some of the provisions in the statute book prior to the 1987 Act have been restored but with certain important modifications. Some provisions are partly abandoned but reintroduced in a different garb. The 1988 Bill also introduces major reliefs announced subsequent to the 1987 Act. It also deals with certain issues which were not raised or debated in the background of statutory amendments of the past. The amendments contained in the 1988 Bill operate from different dates; some prospectively, some immediately and some with retrospective effect extending to 1962, the year of coming into force of the Income-tax Act, 1961.

Obviously, these changes of diverse forms have created confusion and complexity of the highest magnitude. In respect of a particular issue what is the law applicable at a given point of time is now not a very easy question to answer. For, the 1988 Bill proposes to amend the Income-tax Act as it stood before and after the Act 1987 the very Direct Tax Laws (Amendment) Act, 1987 and not to leave out the Wealth Tax Act, the Gift Tax Act and the Rules enacted under the above three Direct Tax Statutes. Even one of the best brains cannot approach a normal problem of interpretation with total confidence and there can be no guarantee that the answer will necessarily be right.

It is in this background that one needs to examine some of the important amendments proposed by the Direct Tax Laws (Amendment) Bill, 1988. The first major restoration by the Government is in the field of taxation of charitable trusts and institutions. Stated broadly, Section 80F as introduced by the 1987 Act provided for a unified scheme of taxation of charitable and religious trusts. This section was also applicable to institutions of national importance including those involved in scientific research, rural development and conservation of natural resources. Accordingly, other provisions on the above subject which were scattered all over the Act were deleted. This is all undone by the 1988 Bill which reintroduces the old scheme almost in totality with certain modifications. One important modification is that the proposed amendment seeks to exempt income in the form of voluntary contributions to the corpus of a trust or institution from charge of tax. Restoration of exemption to the income of scientific research associations, associations or institutions established in India with the object of controlling, supervising, regulating or encouraging certain specified games in India and of notified funds or institutions established for charitable purposes has been achieved under the 1988 Bill. They now have more regulatory provisions. The above trusts and institutions are now required to apply their income or accumulate it for application wholly and exclusively for the objects for which they are established. These institutions are also required to invest or deposit their funds only in the prescribed mode and if this is not done there is an exposure to lose the exemption. Some of these institutions will now be required to apply for the grant of such exemption with a corresponding right of inquiry in the Government to examine such claim.

The 1987 Act had made changes of far reaching consequences in taxation of firms and its partners. Broadly stated, the new scheme permitted, subject to certain conditions, a deduction in the hands of the firm of payments of salary, bonus, commission or remuneration, by whatever name called, made to wholetime working partners for services rendered. Further, salary, bonus, commission or remuneration so received by a partner from the firm were taxable under the head "Profit and Gains of Business or Profession". But a partner of a firm was exempt from tax on his share in the firm's income. The firm was taxable on such income so computed under the provisions of the amended Act. Under the present 1988 Bill, the above scheme of taxation of firms and its partners is completely abolished and the old provisions as they stood prior to 1987 Act are restored.

A completely new scheme of assessment of income was an important feature of the 1987 Act. Under the new scheme, requirement of passing an assessment order in all cases where returns are filed was dispensed with. The assessing officer is now required to send to the assessee an intimation of any tax or interest payable by the assessee or issue refund, if any, to the assessee after making certain permissible adjustments regarding arithmetical errors and claims of deductions, allowances and reliefs. Under the new scheme, assessment order is to be passed only in a very few cases where the assessing officer considers it necessary or expedient to verify the correctness or completeness of the return of income filed. The new scheme would pave way for acceptance of a very substantial portion of the returns filed and limit the inquiry only to those cases where assessing officer finds it necessary to use his discretion. Under the new scheme, reopening of a completed assessment and reassessment of escaped income are governed by different provisions. Under the law prior to 1987 Act, the assessing officer had to establish a failure to disclose facts on the part of the assessee or had to have information in his possession to reopen a completed assessment or to reassess escaped income. Under the new scheme, these conditions were removed and the officer could reopen and reassess by recording reasons in writing. The present 1988 Bill retains, in principle, the new scheme. The changes in the present 1988 Bill, however, are as regards the connected issue of additional tax and levy of penalty.

The 1987 Act provided for an additional Income-tax at the rate of 30 per cent of the difference between the assessed income and the returned income and this was one of the provisions attacked the most in the public agitation. The 1987 Act further provided that levy of such additional tax at the rate of 30 per cent could be avoided only by disclosing and returning the disputed income or deduction and by simultaneously filing an application to the appellate authority on that disputed income or deduction. Since there was an automatic charge of additional tax, penalty for concealment of income was removed. It is in this area that the 1988 Bill proposes important changes. Now, levy of additional tax at the rate of 30 per cent under Section 158B is dropped but is reintroduced by insertion of sub-section(1A) in Section 143. The levy of additional tax in the proposed provisions is at the rate of 20 per cent of the tax payable on the difference between the assessed income and the returned income determined after certain adjustments. In addition, the 1988 Bill proposes to reintroduce the penalty provisions for concealment of income with greater force in as much as the maximum amount of penalty has been increased from twice the amount of evaded tax to thrice the amount of evaded tax. Simultaneously, the provision in the 1987 Act as regards application to the appellate authority on disputed income or deduction is deleted.

Subsequent to the enactment of the 1987 Act, the Finance Minister had made statements announcing Government's decision to give certain tax concessions and incentives. These, inter alia, related to incentives in respect of export profits, exclusion of electricity companies from the purview of Section 115J, reliefs for encouragement of tourism for augmenting foreign exchange resources. The 1988 Bill contains statutory provisions to implement the above announcements.

Hotels play a very major role in the tourism industry and consequently in the earnings of foreign exchange and, therefore, the proposed amendment in Section 80CC attempts to make investment in shares of an approved hotel company more attractive. Section 80CC grants deduction in respect of investment in certain new shares of companies carrying on the business of certain specified activities. This section is widened with inclusion of shares of a company owning a hotel approved by the prescribed authority.

Section 80HHC is an important section for the export industry since it grants deduction in respect of profits retained for export business. The 1988 Bill purports to widen this relief by amending this section but in reality the amendment is going to hit the export business adversely. Under the existing provision, a deduction is available to the taxpayer even if export activity results in a loss. In view of the rules of computation of deduction contained in sub-section (3), a taxpayer is eligible for this deduction on the basis of a formula which justifies a deduction even though exports result in a loss. In fact, in business, this formula had been applied to augment the exports even though it resulted in a loss since the loss was offset by the deduction under section 80HHC. In other words, the provisions of Section 80HHC gave a direct impetus to exports. The proposed amendment now requires the presence of profits for availing of the benefit under Section 80HHC. Consequently, it removes the attraction which the export community originally had. This appears to be an amendment whose adverse impact does not seem to have been appreciated well and, therefore, it will be very essential to reconsider the serious impact of this proposed amendment.

A very welcome provision of the 1988 Bill is the insertion of a new Section 80HHD providing deduction to approved hotels and licenced travel agents in respect of their convertible foreign exchange earnings arising out of services provided to foreign tourists. Under this new Section deduction will be allowed in respect of fifty per cent of such profits and a further deduction of the remaining profits to the extent to which the assessee creates a reserve in its accounts for the purposes of his business. The strict condition of the new Section is that it is confined only to incomes received in convertible foreign exchange by rendering services to foreign tourists. Strict conditions are provided even in respect of the reserve to be created. The reserve is necessarily to be used within a period of 5 years for augmenting the business of the assessee by construction of new hotels, conference or convention centres, purchase of new cars and coaches and sports equipments etc. If the reserve so created under Section 80HHD is used for any other purpose, the deduction originally enjoyed will be lost. Similarly, if the reserve is not used for the aforesaid business purpose within the period of 5 years, the deduction earlier availed of will be lost.

For the export industry, additional concession is granted by taking the industry out of the purview of Section 115J. This section provides that where the total income of an assessee for a particular year is less than 30 per cent of its book profits, the total income of such an assessee chargeable to tax for the year shall be deemed to be an amount equal to 30 per cent of such book profits. The proposed amendment in the 1988 Bill provides the exclusion of such export profits (as referred to in Sections 80HHC and 80HHD) in the computation of the aforesaid book profits. The effect of this amendment is that export businesses covered by Sections 80HHC and 80HHD are saved from this artificial levy of Income-tax under Section 115J.

Electricity undertakings have also to gain substantially from the amendment in Section 115J. The proposed amendment makes it clear that the said Section will not apply to a company engaged in the business of generation or distribution of electricity. This change may be regarded as a clarificatory change in as much as upon one view of the matter, the provisions of Section 115J do not apply to an electricity company.

Another important change proposed by the 1988 Bill is reintroduction of Investment Allowance for new plant and machinery. In respect of machinery or plant installed after March 31, 1988, a deduction by way of Investment Allowance shall be allowed at the rate of 20 per cent of the cost thereof. This change is in deference to the consistent and repeated demand made by business and industrial circles for the restoration of this relief. The relief, no doubt, is an encouraging news to business and industry but the manner in which this subject has been dealt with in the past years leaves behind an important lesson to be learnt. The lesson is that with regard to important tax measures directed towards the industrial development of the country a fairly high degree of stability is desirable.

Investment Allowance is a successor to development rebate. The provisions of development rebate were subject matter of frequent changes before they were replaced by similar provisions by way of Investment Allowance. Investment Allowance was introduced by insertion of Section 32A which itself was again a subject-matter of repeated changes almost year after year. In the long term fiscal policy presented by the Government, a decision was taken to withdraw the relief by way of Investment Allowance and in place thereof introduce a new relief by way of investment deposit account. The mode and the manner in which the funding scheme of IDBI was to function was totally different than the provisions of Investment Allowance. At that time, representations were made with all seriousness to oppose this change and one suggestion was made that the relief by way of Investment Allowance and the relief by way of funding an investment deposit account with IDBI should be made optional. Rejecting this suggestion, Section 32AB containing provisions for funding an investment deposit account was introduced by the Finance Act, 1986 and this relief in effect was in total replacement of Investment Allowance. The suggestion of option is now accepted after two years and that makes one happy but one is also left with sadness since the law remains in a fairly destabilised state in the immediate past.

Though the reintroduction of Investment Allowance by way of an option to the IDBI funding scheme is welcome, there are certain aspects which need serious consideration. The newly inserted provisions for Investment Allowance make sure that the relief is only in respect of machinery or plant installed after 31st day of March, 1988. Will it not be fair and just if this relief is introduced with a retrospective effect so as to cover even one year which has been left uncovered by this relief? Further, option granted by the newly inserted provision is illusory in the sense that if an option is exercised for one year, under no circumstances whatsoever the assessee can get out of that option for the next four years. In respect of the same plant and machinery, a double benefit may not be granted by the statute, but in respect of new and different plant and machinery a fairly wide option must be given to the taxpayer. The provisions, as proposed, tie down the assessee to one of the two reliefs for a long time in an unreasonable manner.

Two additional types of income have been granted statutory exemptions. Section 10(6C) has been introduced and this will benefit a foreign company which renders technical services to the Central Government in or outside India in projects connected with security in India. By this sub-section, power has been conferred upon the Central Government to declare by a notification in the official gazette, fees for technical services received by such foreign company as exempt. It may be noted that this sub-section is confined only to "fees for technical services" and does not relate to the payments by way of "royalty" which may include fees for technical know-how, designs, drawings etc. This proposal is a recognition of the fact that for a desirable import of high technology, Indian taxation is a great deterrent. In connection with the projects on its own hands, the Central Government must have itself realised the problems faced by foreign companies in this regard. What is true of a project to be executed by the Central Government in connection with security of India is also true of various other crucial projects which are being executed and implemented by private sector companies. The problems faced are exactly of the same nature. Keeping in mind the urgent need for import of high technology, this is the time when we need to consider seriously the tax burden on the foreign companies supplying technical know-how to India.

The other exemption proposed is in respect of interest received by a non-resident Indian from such bonds as are notified by the Central Government. This exemption will be available not only to the non-resident who purchased the bonds but also to his nominees and survivors and an individual to whom the bonds have been gifted by the non-resident Indian. The essential requirement is that the bonds should have been purchased by the non-resident Indian in foreign exchange and the interest and principal received in respect of such bonds should not be taken out of India. Those financial institutions who have been advertising such bonds in a big way need a note of caution. So far the public has been led to believe that the interest from such bonds is exempt even in the year of premature encashment. However, the position under the law is contrary since newly inserted section 10(15) provides that in a case where the bonds are encashed in a year prior to its maturity, the exemption for that year will not be available. The concerned financial institutions owe to the general public as a matter of legal duty the imparting of information of this legal aspect.

One of the most objectionable features of the present 1988 Bill is the widening of the term "income" by amending Section 2(24) and thus providing taxation of special allowances granted to employees to meet expenses in the performance of their duties to meet personal expenses at the place of residence or performance of duties and the allowances to compensate him for the increased cost of living. In this country while taxation is a pinch for the upper middle class, it is a downright squeeze for the lower middle class and in the lower middle class those who are hit the hardest are the salaried employees both in the public sector as also private sector. This amendment is a very severe blow to the salaried employees and it will be no surprise if the working class rises strongly against this measure.

This issue needs a serious consideration and in this context, it requires to note that the following two types of allowances will not be taxable in the hands of the employees:

(i) Any special allowance or benefit, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit, and

(ii) Any allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.

The genesis of this amendment is the fact that the Government has been over past two decades involved in disputes with its employees over tax exemptions claimed by them in respect of certain allowances it pays them. Most of the judicial pronouncements have gone in favour of the employees. The present amendment is to supersede all these decisions favouring employees. What makes the blow more bitter is the fact that this amendment is made restrospective from the first day of the operation of the present Income-tax Act, 1961, that is, with effect from 1st April, 1962.

The effect of the above amendment is far-reaching and covers an extremely wide period and an extremely wide number of tax payers. The amendment is not confined to only Government employees but it applies to private sector employees as well. The retrospective amendment will have an effect not only on the pending assessments but also those which are completed already. It will result in a crushing economic burden on a large number of employees who in fact deserve much greater relief than what they have today. This amendment will run counter to some of the recent amendments and whittle down the tax reliefs the employees in the organised sector have received in the recent past. The fact that under Section 10(14), an exemption is provided under certain circumstances to such allowances is not a redeeming feature. It must be noted that the exemption under Section 10(14) is wholly discretionary with the Central Government in as much as only those items which are specified in the Notification to be issued in the Official Gazette will hereafter be exempt. It will be completely within the uncontrolled and unguided discretion of the Central Government whether to issue such a notification or not and as to what items of allowances should be included within such a notification, if ever issued.

Further, the retrospective aspect of the amendment is likely to seriously affect the degree of resentment of the salaried class. To implement the retrospective amendment, even the completed assessments will be reopened and obviously to a large number of pending cases, the amended provisions will apply. To levy a tax retrospectively on the companies is one thing and to do similar thing to salaried employees is an altogether different thing. Moreover, to what extent the attempt to implement the retrospective aspect of the amendment will be successful is a difficult question to answer. Similarly, whether the utilisation of the energies of the Income-tax Department to dig the past is commensurate with the final revenue gains is also a questionable proposition. Therefore, looking at it from any angle, the amendment deserves a closer scrutiny.

The rules for valuation of assets under the Wealth Tax Act and the Gift Tax Act are now proposed as a part of the statutory enactment itself. The provisions of these rules are more or less on the same lines as those of the existing rules. Certain important but controversial changes have been proposed as regards valuation of immoveable properties and valuation of unquoted shares of companies other than investment companies. For the valuation of immoveable properties the principle of net maintainable rent has been retained but it has been further provided by a proviso that where such property is acquired or construction of which is completed after the 31st March, 1974, if the value so arrived at on the basis of net maintainable rent is lower than the cost of acquisition or the cost of construction, the latter cost shall be taken to be the value of the property. This change will affect very adversely a large number of owners of immoveable properties mainly the residential houses and flats. The Wealth tax burden of such assessees who have acquired or constructed their residential houses after 31st March 1974 will increase tremendously in comparison to the burden as it exists under the present rules. Further, as regards valuation of unquoted shares of a non-investment company, the position in law was quite well settled as a result of a series of High Court and Supreme Court decisions. The principle so well settled is that such shares must be valued by applying yield method and not the break-up method. Inspite of the above clear legal position, the new rules introduce a departure by making break-up method relevant to the valuation of such shares. The value to be adopted for tax purposes will be 80 per cent of the break-up value so determined. This departure from the existing rules is likely to throw a very heavy burden on the affected shareholders. Both the above changes appear to be very harsh and, therefore, their introduction requires a serious reconsideration.

The above changes proposed by the 1988 Bill are the ones which are important. The Bill also contains a large number of other changes of little lesser significance. What is the effect of all these amendments in the Direct Tax Laws is the question which remains uppermost in the minds of most tax professionals, taxpayers and tax officers.

The Income-tax Act came into force with effect from April 1, 1962 and has been a subject of Parliamentary onslaught from the very beginning. Very few pieces of legislation have undergone drastic amendments in the manner in which the Income-tax Act, 1961 has witnessed. The predecessor Indian Income-tax Act, 1922 was not luckier in this respect. In fact, what was said about the Income-tax Act of 1922 in the last years of its existence can truly be now said about the present Income-tax Act, 1961. In 1958, an eminent authority on taxation made the following observations on the 1922 Act:

"The first fault which many can find with the present tax system is its absolute instability and uncertainty. The instability is nowhere more clearly demonstrated than in the field of income-tax law. No year passes, some times not even half a year passes, without some material changes in the Indian Income-tax Act, 1922. No other Act in the history of this country has ever suffered more amendments or has been changed so much beyond recognition as this Act".

The state at which the 1961 Act has been brought makes it very difficult to understand and far more difficult to administer, implement and advise upon. Just as a theatre owner puts a board in the guest parking lot with the words "Owners park their vehicles at their own risk", tax professionals may do well to put up a similar board outside their offices with the words "Clients take advice at their own risk". The task for the assessing officer is more difficult because of the penal consequences he faces in the event of his making a mistake in the administration of law. Too frequent changes and different sets of provisions applying for different assessment years will need first a determination as to which is the relevant applicable law and secondly, as to what its exact interpretation is. And in this complex statutory jungle litigation will thrive.

The past quarter of the century shows that important cannons of taxation have been mercilessly violated. The first cannon of taxation is simplicity and clarity. Unfortunately, with every attempt of simplification, the Income-tax Act has become more complicated and ambiguous. The second important cannon of taxation is certainty. On this score, most of the widespread ill has resulted from an undue anxiety to reach the last paisa through a statutory net and the desire to create a system which is foolproof only on paper. Such misplaced anxiety however weakens the administration and provides a further boost to the attempts of tax evasion.

The developments in the last two decades have changed the face of direct tax laws beyond recognition. Creating a better tax system and presenting simpler direct tax laws tailored to the twenty-first century and to the national and personal needs of Indians is what the nation deserves by way of a right.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

— **Eugene Black**

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