INCOME-TAX BILL PENALISES HONEST TAX-PAYERS

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

—Eugene Black

President, World Bank

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The income-tax law, as we know it today, was enacted in 1922; and after 39 years it is going to have a rebirth. The re-enactment of the law presents a golden opportunity of bringing a modicum of justice and fairplay into the income-tax law; but the Bill is a fair indication that this golden opportunity will be completely missed. The Bill, no doubt, aims at introducing order and system into the income-tax law, whereas the present Act is exiled from order and system. But the Bill does not attempt to introduce an element of justice and fairness into the law. Unfairness is the main desideratum of the fiscal laws of this country; and the Bill, instead of removing the inequities, will inject fresh inequities into the income-tax law. Almost all the existing inequities will remain unredressed except on three or four points, while an abundant measure of new inequities will be imported into the law.

The Indian people fall into two sharp divisions — those who conceive and administer the laws, and those who timidly suffer the laws to be inflicted on them. It is because the first class is so powerful and the second so inanely unconscious of its rights and functions under a democratic Constitution, that the Government finds it possible to get through the legislature almost any legislative measure however irrational or unfair its provisions may be. Some of the strident inequities sought to be introduced or perpetuated by the Bill may be noted here.

Clause 2(47) of the Bill defines a "transfer" as including extinguishment of any right. This is a new provision which will have the effect of levying capital gains tax on the shareholders

of two companies which get amalgamated, whereas under the existing law capital gains tax is not attracted in such cases. This is one more instance of the growing desire of the State — to tax not wisely but too well. Amalgamations of companies are effected in order to achieve efficiency in administration or economy in working. Such amalgamations are approved by competent Courts of Law. Hereafter the shareholders would be reluctant to agree to amalgamation when they find that they will be saddled with liability to capital gains tax even in cases where they receive neither cash consideration nor shares of any higher market value than the shares which are extinguished on amalgamation. Thus the new provision will hit the middle classes who hold the bulk of the corporate share capital in this country.

Clause 9 proposes to perpetuate the doctrine of "business connection" on the basis of which foreigners are charged to Indian income-tax. The doctrine of business connection is so wide, and so vague and nebulous, that it is essential in the interests of India's export and import trade that the expression "business connection" should be given a precise and reasonably narrow connotation. We are anxious to have an export drive and are equally anxious to import capital goods and invite participation of foreign industrialists to promote the economic growth of the country. At such a juncture, it is essential that oppressive fiscal laws should be suitably modified. It is true that the Central Board of Revenue has adopted a certain policy for the moment of not taxing non-residents on the ground of business connection in certain circumstances. But there are two objections to this type of administration of the law. The first is that abridgement by "Circulars" of the Central Board of Revenue of statutory liability to tax is basically wrong and unauthorised by law, since the C.B.R. has no power to abridge any tax-payer's liability under the statute. There is no reason why the law should continue to be unreasonably vague and businessmen should be driven to ask for concessions at the hands of the Executive. Secondly, any policy of the C.B.R., apart from its having no legal sanction, might change any day and in law a citizen would have no remedy and no right to insist on the C.B.R.'s policy being implemented. This is not a mere theory. In fact it has been found that the C.B.R.

under the income-tax law, and the Collectors of Sales Tax under the State Sales Tax laws, have in a number of cases revised their earlier policies and reversed their former decisions, resulting in great confusion among the public and imposition of unexpected tax liabilities. The Bill provides an excellent opportunity of defining a non-resident's liability with some degree of precision, but that opportunity is going to be totally missed. In England the law fairly provides that trading *with* England does not attract tax while trading *in* England does. A similar provision could be easily incorporated into our law with tremendous advantage to the Indian economy which would far outweigh the small loss of revenue.

Clause 10(10) purports to exempt Government employees in respect of gratuities received on retirement, but this provision for exemption is not available in the case of private employees. With galloping inflation corroding the rupee every year and the high cost of even the bare necessities of life, it is difficult for the middle classes to save anything for their old age; and the least the Government can do for the people in this direction is to exempt gratuity from tax even in the case of employees in the private sector. In order to prevent misuse of such a provision, it would be better to enact that Gratuity Rules should be approved by the Commissioner of Income-tax rather than put a flat ceiling on the amount of gratuity exempted from tax.

Clause 11 provides for exemption to charities. Under the law today if the income of a charitable trust is accumulated for application to charitable purposes at a future date, it is nevertheless entitled to exemption; and the law provides that if in any subsequent year the accumulated income is applied to a non-charitable purpose, it would be taxed as the income of that year. This law has worked very well in practice and it is not at all necessary to change it. The Bill, however, seeks to provide that if more than 25% of the trust income is accumulated even for a bona fide charitable purpose authorised by the trust deed, the accumulated income would become liable to tax. For example, if a charitable educational trust in Poona has its building destroyed as a result of the floods and it accumulates its income to construct a new building, the Bill seeks to tax

the trust in respect of the income so accumulated. This provision of the Bill is so fantastic that it is most unlikely to be passed in its present form.

The Supreme Court has recently held that a trust which is bona fide created for public charitable purposes does not become disentitled to exemption merely because there is a provision inserted in the trust deed to the effect that as between two equally worthy applicants for benefit under the trust, preference should be given to a poor relative of the settlor. This law is sought to be changed by clause 13 of the Bill which seeks to enact that if any part of the trust income ensures directly or indirectly for the benefit of any relative of the settlor, the entire income of the trust would be disentitled to exemption. Even if the law is sought to be changed on this point, it is necessary that two amendments must be made to clause 13. First, the new provision should not apply to existing trusts which were bona fide created for public charitable purposes at a time when the law did not disentitle such trusts to exemption. Secondly, only the income applied for the benefit of a poor relative may be brought to charge but not the entire income of the trust. What sense does it make to tax the income of, say, Rs. 2 lakhs, arising from a large public charitable trust, merely because Rs. 300 out of that income is spent for a poor relative while the rest of the income is all spent for the public benefit. To tax such public charitable trusts would only mean that the poor and the needy of this country will be hit hard, because the income which would normally go to meet their needs would now be diverted to the Public Exchequer in the form of tax. Substantial charities are hardly created these days. It is only the old charities which are still catering to the elementary needs of hundreds of thousands of grief-stricken people throughout the country. It is not only unjust, but immoral, on the part of the Government to seek to deprive the poorest classes of society of the benefit of even existing public trusts merely because some amount, however small, is spent on the poor relatives of the settlor under the terms of the trust deed. The Government is hardly able to meet the needs of the homeless, to give adequate education to the poor classes, to heal the sick or feed the hungry. *Public charitable trusts are doing immeasurable good in*

alleviating such cases of distress. When a public charity is taxed, it is no burden on or detriment to the settlor, for the tax will come out of the income which would have gone otherwise to the public at large. Let the Government remember that every time they collect tax under clause 13 on the total income of a trust merely because some amount, however insignificant, goes to a poor relative of the settlor, they would be really depriving the poor citizens of this country of some desperately needed help which they might otherwise get under the trust. I cannot understand how any man in his conscience can ever commend to the Parliament such a legislative provision. The proposed provision would result literally and truly in taking bread out of the mouths of the hungry, depriving the destitute of a roof over their head, and robbing the sick and the infirm of medical or other assistance. It is difficult to conceive of a more blatant sin against humanity in the same of a Welfare State. Let two further facts be noted in this connection. First, trusts which are already created and which were perfectly valid public charitable trusts at the time of their creation, cannot be changed under existing law merely to avoid the application of clause 13. It is clear that if in a public charitable trust it is stated that, other conditions being equal, preference should be given to poor relatives of the settlor, such a provision cannot be changed by a Court of Law, even if the trustees apply for the change. Therefore, the Government of India will now become the main beneficiary under such public charitable trusts in substitution of the millions of paupers and destitutes in this country. Secondly, it must be remembered that the rate of tax on unearned income goes as high as 84% and, therefore, in the case of large public charities, however well administered, wherever a single relative of the settlor takes the slightest benefit under the terms of the trust (even though in his capacity as a destitute or needy person), the main part of the trust income will be drained away by way of taxation.

Clause 23 seeks to perpetuate the present injustice in assessing income from house property. Municipal taxes are obviously outgoings which go to reduce the income, and the true income from house property cannot be arrived at without deducting the Municipal taxes payable by the owner. Such taxes are fully allowable

as deductions in computing income from business (Section 10) or in computing income from other sources (Section 12); but only half of them are allowable as deductions in respect of income from post-1950 house property (Section 9). If the construction of the house has been completed before the 31st March 1950, full Municipal taxes are allowable as deductions. But if the construction of the house was completed on the 1st April 1950 or thereafter, only half the Municipal taxes are allowable as deductions. This provision is altogether irrational, and the dividing line, viz., the 31st March 1950, has no basis in history or in law. Even the most elementary sense of justice should convince the Government that owners of house property should be given full deduction in respect of Municipal taxes which go to reduce their true income.

Clause 32 provides for depreciation in respect of buildings, machinery, plant and furniture. No depreciation is available in respect of mines, quarries, patents and copyrights, though they are all wasting assets. In most well regulated foreign countries, the cost of mines, quarries, patents and copyrights and similar assets which get exhausted in the process of working, is either allowed as a revenue expense or allowed to be depreciated year after year. The absence of such a provision was a crying injustice in the present income-tax law, and it remains unredressed by the Bill.

Clauses 33 and 34, which deal with development rebate, provide that the development rebate would be taken back if the new asset is sold within eight years. Now, it is but just and fair that the development rebate should not be taken back if the asset is not singly sold but the entire business is transferred as a going concern to a successor, e.g., where an individual is succeeded by a firm, or a firm by a limited company, or a Hindu undivided family is succeeded by a partnership or by a limited company. There is no rational justification for depriving the tax-payer of development rebate when there is a genuine, bona fide transfer of the business as a going concern; and yet the Bill proposes not to withdraw development rebate only in cases of amalgamation of two companies or succession to a firm by a private limited company. The picking out of only these two exceptions cannot be

justified on any principle of taxation or logical reasoning. It is impossible to conceive why a firm succeeded by a private limited company will not lose development rebate; but an individual or a joint family succeeded by a private or public company, or a limited company succeeded by another limited company, will lose development rebate in identical circumstances. The proposed legislative provision in this behalf, which has been copied from the Finance Act, 1961, is purely arbitrary and capricious. A little thinking would leave no doubt that the benefit of retaining development rebate should be extended to all cases of bona fide transfers of business as a running concern.

Clause 37 of the Bill proposes to make a violent departure from the existing provision for deduction of business expenses. Today the law enacts that if the revenue expenditure is wholly and exclusively incurred for the purpose of business, it should be allowed as a deduction. Now the Bill seeks to provide that the expenditure would not be allowable unless it is further proved to have been necessarily incurred. Needless to say, the omniscient Income-tax Officer would be the judge of the divergent "necessities" of the different industries whose cases he would deal with. Such a provision would become truly an engine of oppression in the hands of the Revenue. The injustice of the proposed provision is so palpable that it hardly needs any elaboration.

Two other clauses, clauses 62 and 64, would hit the middle classes very hard. Under the existing law, a trust created for a wife or minor child would result in the trust income being taxed in the hands of the settlor, irrespective of the question whether the trust is revocable or irrevocable. But if a trust is created for other beneficiaries and it is irrevocable for at least six years, the income is not taxed in the hands of the settlor during the period that the trust is irrevocable. The Bill proposes to make a complete departure in this respect and it seeks to provide that even if the trust is absolutely bona fide, so long as it is revocable after any period of time the income must still continue to be assessed in the hands of the settlor. I am not aware of any other country where genuine trusts are assessed in this highly unjust fashion. There may be perfectly legitimate human reasons

for making a trust revocable. The settlor may not be sure whether the beneficiary will turn out to be a worthy object of his bounty or not. Why should such settlor be assessed in respect of income which is the income of someone else under a perfectly bona fide trust? The present law has worked quite fairly and no justification whatever has even been attempted for a change. If a settlor is really dishonest and seeks to divert his income by creating a trust which is not bona fide, he can as well create a bogus irrevocable trust as a revocable one. Thus the mere fact that the trust is revocable after a period of time is no indication whatever that it is not a genuine trust. The only effect of the change in the law will be that a large number of absolutely honest, genuine trusts would hereafter result in the settlor being taxed in respect of income which is not his at all and which would not be taxable as his income in any other civilised country. The proposed provision is a typical instance of how the Revenue in this country is quite prepared to hit unfairly a thousand honest citizens merely to be able to collect revenue from a handful of dishonest ones. If a settlor reserves any right to re-assume power over the income or corpus, the income is taxed as his income even under the existing law. But it is palpably unfair and unjust to introduce a provision, as the Bill seeks to do, to tax the authors of perfectly honest trusts who have parted with all interest in the income and corpus, merely because the trust is made revocable at a distant point of time for reasons totally unconnected with tax evasion. The categories of fictional income can, no doubt, be enlarged by legislation; but when a new category is added which would hit honest tax-payers for no justifiable reason and contrary to the well settled principles of fiscal legislation, the provision can only breed disrespect for the law and a wonder in the mind of the honest citizen as to why he owes a duty to the State to pay his taxes fairly when the State treats him so unfairly in return.

The other clause dealing with private trusts is clause 64, which seeks to enact that if a trust is created for the immediate or deferred benefit of the spouse or a minor child, the income would be assessed in the hands of the settlor. The words "immediate or deferred" are sought to be introduced for the first time by the Bill. No doubt, the provision would be perfectly

reasonable and fair if what is intended is to cover cases where the spouse or minor child takes an immediate or deferred benefit in the income of the relevant accounting year. But the words, unfortunately chosen, are such as to lend themselves to the possible construction that even if the spouse or minor child is to take no benefit, immediate or deferred, at any time whatever in the income of the relevant accounting year, the provision would still apply if the spouse or minor child has any interest as a remainder-man after various life tenants. It is, therefore, imperative that the clause should be amended so as to make it clear that the immediate or deferred benefit of the spouse or minor child should be in the income of the relevant accounting year in order to attract the provisions of the clause.

Under the existing law a partner is allowed a deduction, under various judgements of the different High Courts, in respect of the revenue expenditure incurred by him in order to earn his share of the firm's profits. Thus, if under the terms of a partnership it is the duty of every partner to attend to the affairs of the firm and a partner who is ill engages an employee to look after the firm's affairs on that partner's behalf, the salary of the employee would be allowed to the partner as a deduction from his share of the firm's profits. Under clause 67(3) of the Bill, such a deduction would not be available to the partner. It is sought to be provided that no partner would ever get a deduction for whatever he spends even wholly and exclusively for earning his share as a partner, except the interest paid by him on capital borrowed for investment in the firm. This is again clearly unfair to honest tax-payers.

In other countries like England, the United States and Canada, where the Governments are imbued with a sense of justice and fairplay, the laws provide that business losses can be carried *backward*. In other words, the taxes that you have paid on your large income in the past would be refunded if losses are incurred in subsequent years. Here we have no such provision, the only provision being for carrying *forward* business losses, and even this right of carry forward is completely lost if the business in which the loss was incurred is discontinued. But the

Bill proposes to abridge still further the right to carry forward business losses. It is now proposed that in the case of companies in which the public are not substantially interested, the right to carry forward business losses would be completely lost unless at least 51% of the share capital continues to remain in the hands of the same shareholders. The proposed provision is both unreasonable and unfair. It would work harshly in cases where a change in shareholding may be totally unconnected with the question of liability to income-tax. So far from achieving any useful purpose, it would only enable unscrupulous shareholders to blackmail the others by threatening to sell off their shares with the resultant disadvantage to the company of being deprived of the right to carry forward its losses.

Clauses 86 and 182 seek to perpetuate the present unjust levy of double taxation on registered firms. In all other countries of the world, income-tax is levied only once on the same legal entity in respect of the same income. But India has chosen to assess the same legal entity twice over to income-tax in respect of the same income. Where a limited company is assessed on its profits and the shareholders are assessed on the dividend income, the position is understandable since the company and the shareholders are separate entities in law. But in the case of partnerships which are not legal entities at all, there is no justification whatever for taxing the same income twice over, once in the hands of the firm and again in the hands of the individual partners; and yet this is done in the case of registered firms. This gross injustice is sought to be continued by the Bill. Apparently, the only reason for this double levy is that the Government is able to collect an extra amount by these means. But if this were a justification for the provision, there would be justification for levying income-tax twice over on every tax-payer in respect of every item of income. The provision for double taxation on registered firms is basically unjust and fundamentally wrong.

A new provision is sought to be introduced in clause 87 which will hit more citizens than any other clause of the Bill. Under the existing law, rebate is allowed on life insurance premia, irrespective of the question as to the source or fund out of which

the life insurance premia are paid. Clause 87 of the Bill says that rebate would be allowable only if the premia are paid by the assessee out of his total income of the relevant accounting year. This provision is really absurd. A tax-payer's accounting year begins on the 1st April. If the premium falls due on the 2nd April and he pays the premium out of the last year's income or any other fund, he will not be entitled to rebate. Such an absurd provision can lead to only one conclusion — that the framers of the Bill have not at all applied their minds to the effect of the provision they seek to enact. How is the Income-tax Department concerned with the source from which the insurance premia are paid? Why should not a man pay the insurance premia out of moneys gifted to him by another and accumulate his taxable income, without losing rebate on the premia? It is provisions like these which make the lot of honest tax-payers so hard and make it so difficult for the citizens to have any respect for the laws by which they are governed. There is not one reason in logic or equity as to why a tax-payer should be denied rebate in respect of insurance permia unless he has paid them out of a prescribed fund.

The companies in which the public are not substantially interested, which are today governed by Section 23A of the existing Income-tax Act, would now fall under clause 104 of the Bill. In England, from the laws of which we have borrowed the provision in question, it is expressly provided that if a company does not declare dividends because of current business requirements, the company should not be punished by the levy of a penal super-tax. However crying the needs of a company, however urgent and pressing its financial commitments, in India it is still subjected to a penal super-tax unless it declares the statutory percentage of profits by way of dividend. A number of cases have arisen in practice where companies which sought to apply the income of a certain year to paying off arrears of past tax liabilities which had arisen as a result of unforeseen disallowances by the Department, or which sought to discharge bona fide trade liabilities as a result of losses incurred immediately after the close of the relevant accounting year, have been mulcted in penal super-tax by the Government for using the profits in paying arrears of tax or in discharging trade liabilities instead of frittering them away by declaring

dividends. Thus companies which act prudently and honestly are yet ordered to pay a penalty. Such a legal provision makes no sense at all. It is saturated with injustice, and yet the Bill seeks to perpetuate the injustice.

Clause 179 marks a violent departure from the well settled principles of Indian jurisprudence. A limited company is an entity with limited liability. This is a principle universally recognised throughout Indian jurisprudence and has no exception to it. The directors and shareholders of a limited company are not personally liable for the liabilities of the company. For the first time in the history of Indian law, clause 179 seeks to unsettle the law on the point and provide for personal liability of directors and shareholders for the tax dues of a private limited company in liquidation. After the death of the director or shareholder, his heirs would be again liable for the company's tax dues, to the extent of the estate inherited by them from the deceased. This is a most dangerous innovation. If today such a provision is enacted in income-tax law, it may be enacted tomorrow in the excise law, the customs law, the sales tax law, and the wide variety of other laws which constitute the terrific burden of direct and indirect taxation on the people of this country It is basically wrong to cut at the very root of the juristic concept of a limited company merely to get at some dishonest directors and shareholders. If a shareholder or director is really dishonest, he would have secreted his assets away so that the Department may never trace them and, therefore, even with clause 179 the object of the legislature can still be frustrated. The only effect of such a provision would be to scare away honest people from the directorship of private companies, for fear of unlimited liability. The most irrational and unfair feature of this clause is that the shareholders and directors are sought to be made personally liable even if they have acted with absolute honesty and were totally unaware of any tax evasion.

Clause 254 seeks to confer power on the Income-tax Tribunal to enhance an assessment. Under the existing law the Tribunal has no power to enhance an assessment and the result is that an appellant cannot be in a worse position by going to the Tribunal, whereas under the proposed provision he can be in a worse position.

The Tribunal would be converted into an Assessing Officer and would be empowered to assess income which was not charged by the Income-tax Officer. There are ample provisions in the existing law to take care of income which escapes assessment. The Income-tax Officer can reopen assessments under Section 34 or rectify them under Section 35; the Commissioner can revise assessments under Section 33-B, and the Appellate Assistant Commissioner can enhance assessments under Section 31. Having four avenues open to it to tax unassessed income, it is not at all necessary or desirable to give to the Tribunal the power to enhance assessments.

Coming to the credit side of the Bill, you find two new provisions in favour of the tax-payer. First, if a bad debt is disallowed in a certain year on the ground that it had become bad in an earlier year, the Income-tax Officer would have to rectify the assessment for the earlier year and allow the bad debt as a deduction for that year. Secondly, if an application for registration of a firm is defective, the Income-tax Officer cannot refuse registration merely on account of the defect but must point out the defect to the assessee and give him time to rectify the defect. Under the existing law, this elementary consideration is not shown to the tax-payer.

It will be clear from the above that whereas the changes made by the Bill in favour of the tax-payer are few and insignificant, the changes in favour of the Government and against the tax-payer are numerous and of far-reaching effect. The Bill is heavily loaded against the tax-payer. The lot of honest tax-payers is sought to be made more difficult merely in order that the dishonest may be caught within the net.

Mr. Justice Frankfurter observed some years ago that democracy involves hardship — the hardship of the unceasing responsibility of every citizen. Where the entire people do not take a continuous and considered part in public life, there can be no democracy in any meaningful sense of the term. Democracy is always a beckoning goal, it is not a safe harbour. Freedom is an unremitting endeavour, never a final achievement. The most important office in the land is not that of the President or the Prime Minister of India — it is that of being a citizen. All of

us are born to that important office, few of us discharge the functions attached to that office. When a piece of legislation which is not based on notions of justice and fairplay, is sought to be passed into law, it is not only our right but our duty as citizens to protest against it and to seek amendment of the undesirable provisions.

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.

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

—A. D. Shroff

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