THE UNION BUDGET 2000-2001

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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*

MISSED OPPORTUNITY FOR SECOND GENERATION REFORMS

When the Finance Minister last year spoke of the need for second generation reforms, which sentiment was reiterated by the President this year, it was expected that the Finance Minister would announce deep-cutting reforms to not only restrict the critical rise in fiscal deficit but also to propel the economy to a higher trajectory of growth. Mr. Sinha has performed a balancing act of keeping the economy firing on all cylinders and, at the same time, trying to keep the fiscal deficit in check.

While the Finance Minister has not come up with any adverse measure which would slow down industrial recovery, he has not announced any path-breaking measure which would catalyse economic growth.

PROPOSALS AFFECTING INDIVIDUALS : The Finance Minister has taken great pride in announcing that the compulsory tax return scheme which he has now extended to

★ The author is a noted tax expert. The text is based on a talk delivered at a public meeting arranged by the Forum of Free Enterprise jointly with several other organisations in Mumbai on 2nd March, 2000.

additional 79 cities has resulted in the number of assessees doubling from ten million to twenty million, thereby widening the tax net. He has made the mistake of thinking that an increase in persons filing the tax return would correspondingly lead to increase in tax revenue.

It is imperative that the tax administration should come up with exact figures of the amount of tax collected from those persons who have filed Form No.2-C under the One-by-Six scheme during the last two years. Unless this figure is made available to the public, or atleast to the Finance Minister, the efficacy of the new scheme initiated by the former Finance Minister P. Chidambaram cannot be gauged. It has to be emphasized that what the country sorely needs today is an increase in the number of tax payers and not an increase in the number of tax return filers who merely add to the administrative burden of the Tax Department.

The proposals of the Finance Minister offer a mixed package of tax and reliefs. These are discussed below.

While the increase in the surcharge from 10% to 15% for individuals who have a taxable income of more than Rs.1.5 lakhs will impose a tolerable burden, it will make India compare less favourably with other countries of the world where the rates of taxes are much lower. More importantly, the top slab of income in other countries is much higher than the threshold of Rs.1.5 lakhs at which India imposes the maximum marginal rate of 34.5%.

To illustrate, China imposes the maximum marginal rate of 45% (much higher than the proposed rate of 34.5% in India) but this high rate is applicable to a Chinese citizen only when his income exceeds around Rs.45 lakhs. Likewise, Germany and some European countries impose higher rates of tax but they become applicable only when the level of income of their citizens exceeds more than Rs.30 lakhs.

For women, the Finance Minister has been gracious in allowing a tax rebate of Rs.5,000 with effect from the financial year 2000-2001. Thus, a woman who is less than 65 years of age will have to pay no tax so long as her taxable income is Rs.80,000 or less. Once she reaches the age of 65, her limit of tax free income goes up to Rs.1,30,000.

As far as senior citizens are concerned, the Finance Minister has shown great sensitivity by relieving them of the need for filing tax returns by increasing the tax rebate under section 88-B. The rebate has been increased from Rs.10,000 to Rs.15,000. The implication of this is that a person who is more than 65 years of age will hereafter, beginning with the financial year 2000-2001, not be liable to pay tax on taxable income upto Rs.1,30,000. Thus, in his case, the initial exemption limit stands increased from Rs.50,000 to Rs.1.3 lakhs.

For students who have taken loans for higher education, the tax benefit under section 80-E has been increased from the present level of Rs.25,000 to Rs.40,000. This would cover loan amount of Rs.3 lakhs and over which would help students to prosecute higher studies for any graduate or post-graduate course in engineering, medicine, management or any post-graduate course in applied or pure science, including mathematics and statistics.

Another benefit given to individuals is for repayment of housing loans. The tax rebate of 20% under section 88 is increased from Rs.10,000 to Rs.20,000. This is in addition to the general limit of Rs.60,000 which covers investments in certain Government securities and recognised mutual funds as well as LIC premia, provident fund contribution, etc.

The capital gains tax exemption which is currently available under sections 54-EA and 54-EB in respect of long-term assets is sought to be discontinued. Under the first provision, a person who has made capital gains has the option to invest the sale consideration of the long-term assets in the bonds notified under section 54-EA for which there is a lock-in period of 3 years. Under the second provision, the investor may invest the capital gains only in the bonds notified under section 54-EB for which there is a lock-in period of 7 years.

It is now proposed to introduce section 54-EC with effect from 1st April, 2000 to provide a uniform lock-in period of 5 years in bonds which are to be notified under this new provision. Moreover, only capital gains are now required to be invested and not the sale proceeds of long-term assets. Further, only NABARD and National Highways Authority of

India will be eligible to issue the new bonds. If such bonds are converted into monies within the five-year period or any loan or advance is taken on the security of these bonds, the capital gains tax exemption would be withdrawn.

Under the existing provisions contained in the proviso to section 112(1) of the Income-tax Act, tax on long-term capital gains arising out of transfer of listed securities will not exceed 10% of the capital gains before allowing adjustment for Cost Inflation Index. The definition of securities follows the definition given in section 2(h) of the Securities Contract (Regulation) Act, 1956. The status of units of Unit Trust of India and units of Mutual Funds is not clear under the above definition.

It is, therefore, proposed to amend the proviso to sub-section (1) of section 112 to provide that tax on long-term capital gains arising from transfer of units of Unit Trust of India and units of Mutual Funds specified under section 10(23-D) of the Income-tax Act alongwith securities as defined in Securities Contract (Regulation) Act, 1956 shall not exceed 10% of the capital gains before allowing adjustment for Cost Inflation Index.

Section 54-F of the Income-tax Act exempts levy of tax on long-term capital gains arising from transfer of any long-term capital asset (not being a residential house), if invested in a residential house. There is, however, a stipulation that the above exemption cannot be availed of, if there is a house in existence on the date of transfer or if the person goes for a second house within the stipulated period. The above condition stands in the way of a large number of tax payers from availing of the deduction under section 54-F.

The existing house may be a small house or a tenanted house which is difficult to sell in view of the stringent tenancy laws or a house which cannot be sold because of non-availability of buyers or slump in market prices. Therefore, it is proposed to amend section 54-F of the Income-tax Act to provide that the deduction under this section may be available to an individual or Hindu undivided family as long as he has one and not more than one house existing on the date of transfer. Other conditions would remain the same.

BUSINESS RE-ORGANISATION : Extensive amendments were carried out in the Finance Act, 1999 relating to demerger, amalgamation and slump sale. Some of these provisions are proposed to be rationalised for clarity and to remove implementational difficulties.

Under the existing provisions contained in Explanations 2-A and 2-B to section 43(6), when the block of assets is transferred by the demerged company to the resulting company, the written down value of the block of assets of the demerged company for the immediately preceding year is reduced by the book value of the assets so transferred.

In Explanation 2-B, it is provided that in the corresponding situation, the written down value of block of assets in the case of the resulting company will be the value of assets as appearing in the books of the demerged company immediately before the demerger. However, if such book value of assets exceeds their written down value, the excess will be reduced. The above provision has been found to be discriminatory to the demerged company which is denied depreciation on a part of the actual cost.

It is, therefore, proposed to provide that the written down value of the assets, being transferred, shall be the uniform basis of adjustment in the hands of the demerged company as well as the resulting company.

Under the existing provisions contained in section 50-B(2) of the Income-tax Act, the cost of acquisition and the cost of improvement in relation to capital gains of the undertaking or division transferred by way of slump sale will be "net worth" of the undertaking or division for the purpose of calculating capital gains. "Net worth" has been defined as per the Sick Industrial Companies (Special Provisions) Act, 1985 in the Explanation to the section.

In Form No. 3-CEA notified subsequently, it has been provided that the "net worth" of an undertaking or division shall be derived from the net worth of the transferor company in a proportionate manner on the basis of the fixed assets. It has been pointed out that the above method of calculating the net worth will not be appropriate in all cases. Further, it has no application to non-corporate entities effecting slump sale.

It is, therefore, proposed to substitute the definition of "net worth". It will now be defined as the aggregate of the cost of depreciable assets as reduced from the block of assets of the transferror company in accordance with section 43(6)(c)(i)(C) and the value of other assets transferred as appearing in the books of account, ignoring any revaluation. From this, value of liabilities will be reduced.

MINIMUM ALTERNATE TAX : As the number of zero-tax companies and companies paying marginal tax had grown, minimum alternate tax (MAT) was levied from the assessment year 1997-98. The efficacy of the existing provision (section 115-JAA) has declined in view of the exclusion of various sectors from the operation of MAT and the credit system. It has also led to legal complications. It is, therefore, proposed to put a sunset clause in the existing provision, so that it is not applicable after the assessment year 2000-2001. In its place, it is proposed to insert a new provision which is simpler in application.

The new provision (section 115-JB) provides that all companies having book profits under the Companies Act, prepared in accordance with Part-II and Part-III of Schedule-IV to the Companies Act, shall be liable to pay a minimum alternate tax at a rate of 7.5%, as against the existing effective rate of 11.55% of the book profits. This provision will be applicable to all corporate entities without any exception. However, export profits under sections 80-HHC, 80-HHE and 80-HHF are kept out of the purview of this provision during the phasing-out period of deductions available under those provisions. Under sections 10-A and 10-B, export oriented units and units in free trade zones, which are set up before 1.4.2000, are not covered by the new provisions of MAT.

A study done of the top 100 companies who fall within the MAT ambit reveals that the tax now payable will be Rs.255.74 crore as against Rs.59.95 crore. This shows that the various adjustments earlier available against the book profits (such as for developing infrastructure facility under section 80-IA and several others) did lead to a loss of revenue.

The entire method of identifying a MAT company has been revised. Under section 115-JAA, if the total taxable income was 30 percent of the book profits, then 30 percent of the book profits was treated as deemed income and was taxed at the applicable rate of 38.5 percent. This brought the effective rate to 11.55 percent.

However, under the new section 115-JB, a flat rate of tax of 7.5% on book profits is liable to be paid by a zero-tax company. The book profits are as computed under the Companies Act without allowing any deductions or adjustments. While companies involved in the export of goods, software, etc. have been excluded from the impact of section 115-JB, in view of the phasing out of benefits under section 80-HHC and other similar provisions, they will be liable to pay tax which will be higher than MAT. In other words, in the first year itself, such companies will be liable to tax at the rate of 7.70%, applying the rate of 38.5% to the taxable export profit of Rs.20 out of a total export profit of Rs.100.

HIGHER TAX ON DISTRIBUTED PROFITS : While the surcharge has not been increased on companies and they will continue to be liable for surcharge at the rate of 10%, companies will now be taxable on distributed profits under section 115-O at the rate of 20%, instead of the present rate of 10%, with effect from 1st June, 2000. The impact of this will be felt by all progressive companies which have promoted the interest of shareholders by rewarding them with handsome dividends. It is obvious that the distributable income of companies which will be declared as dividends would be restricted in view of the 100% increase in tax from 10% to 20%.

In fact, foreign companies which have set up subsidiaries in India will be affected much more than companies which have set up branches in India. A branch is liable to pay tax at the rate of 48%, there being no surcharge on foreign companies. On the other hand, subsidiary companies set up in India by their foreign parents will be taxable at the rate of 38.5%. Hence, 61.5% will be the after-tax profit.

Under the Companies Act, 10% has to be set aside to a reserve and only the balance 90% can be distributed as dividends. Therefore, the amount available for distribution after transferring 10% to reserves would leave 55.35% of the profits. If the whole of the amount available for appropriation is declared as dividend, 22% (20% plus 2% surcharge thereon) would be payable as tax on the distributed amount. This works out to 12.18% (22% of 55.35%). Thus, the total tax payable by the subsidiary company would be at the rate of 50.68% (38.5% plus 12.18%).

In other words, for every hundred rupees earned by the Indian subsidiary, Rs.50.68 would be paid by way of tax, Rs.10 would be set aside to a reserve and only the balance Rs.39.32 can be remitted as dividends to the foreign parent company. On the other hand, if a branch is set up by the foreign company, it would be able to take away the entire after-tax profit of Rs.52, the burden of tax being at the rate of 48%.

CONCLUSION

In conclusion, it must be pointed out that while the Finance Minister has stepped up investment on rural development, agriculture and socially desirable schemes for which he deserves accolades, the non-Plan expenditure has increased to such an extent that his ability to allocate higher resources for infrastructure has been considerably inhibited. Of course, both NABARD and National Highways Authority of India will be able to raise resources through the issue of bonds under section 54-EC but such mobilisation of resources may not be adequate.

Economic growth can ride on the back of higher investment spending. Fortunately, current indications are that investment spending may witness a gradual pick-up. A key factor that will drive it, however, is a rise in infrastructure spending, which is typically initiated by an increase in public spending. Once that happens, it is usually followed by private sector spending. The Government, therefore, has to kick-start spending in this crucial sector.

The budget does not deliver the kind of growth and demand impetus the economy needs. The need of the hour is to curb Government expenditure, control the fiscal deficit and give a boost to knowledge-led services, capital goods and the manufacturing sectors. Mr. Sinha has done well on the social development front, but on the macro-economic front his budget leaves much to be desired. The budget does not reflect any great vision for ensuring that the Indian economy is able to sustain a growth rate of 8% for the next 15 years so as to put it in the forefront of the league of Nations.

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

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

– Eugene Black

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