UNION BUDGET 1995-96 : CEMENTING THE REFORM PROCESS

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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

Union Budget 1995-96 : Cementing the reform process

by
H. P. RANINA*

This year's Budget proposals were awaited with bated breath as the Finance Minister found himself in a peculiar situation where the economy was gaining strength while the political base of his Government was being eroded. Indeed, he has performed the balancing act between economic exigencies and political expediency with admirable ease.

The process which he started in 1991 has undoubtedly vindicated the soundness and strength of his basic economic philosophy. Unfortunately, as the Finance Minister himself has admitted, there is still an unfinished agenda. Perhaps, he may not have another opportunity, and that would indeed be a great tragedy.

The Finance Minister has tried to grapple with the monster of inflation by restricting the fiscal deficit to 5.5% of the Gross Domestic Product, reducing the

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* *The author is a noted tax expert. The text is based on a talk delivered at a public meeting in Bombay on 18th March, 1995 under the joint auspices of several organisations including the Forum of Free Enterprise.*

customs duties across the board, thereby making it possible for Indian industry to restrict their input costs and, finally, hoping that yet another good monsoon will help in bringing the inflation figure to a single digit.

The Finance Minister has rightly put emphasis on anti-poverty programmes. However, the Government has to fulfill the acid test that the expenditure which is of a developmental nature or which pertains to anti-poverty programmes, will ultimately benefit the most vulnerable sections of our society.

Unfortunately, the anti-poverty programmes will take time to bear fruit because several agencies to be manned by bureaucrats will have to be set up before the schemes can be implemented. This time-consuming process itself will ensure that the schemes would fall in place only by the middle of 1996, which would be too late for the present Government to secure any political mileage out of them.

While the Finance Minister has continued with the process of fiscal reforms on the indirect tax front, though conversion to a full value added tax system has not been announced, the corporate sector has been disappointed as a result of very few tax incentives being offered, thereby not fulfilling their expectations.

Indutry has responded magnificently to the measures which the Finance Minister introduced in the last three years and has fulfilled his expectations in abundant measure. In fact, there can be no greater proof of this than the substantial growth in revenue collection coupled with an upsurge of 8% in industrial production, a remarkable 24% being in the capital goods sector.

Whether industry has necessarily to be rewarded for its performance may be debatable, what essentially needs to be done is to give an additional push to industry to get into the higher growth plane of 12-14%, which, in fact, has been achieved for the past several years by our Asian neighbours, notably China, Taiwan and Malaysia.

A retrograde step has been taken to discontinue the tax rebate of 30% for new industrial undertakings under section 80-IA of the Income-tax Act where such new units commence production after 31st March, 1995. The Government has sought to justify this by stating that "in this liberalised atmosphere there is little justification for continuing across-the-board incentive to large scale industrial units in areas which are not backward".

This perception of the Government is unjustifiable and counter productive. However advanced a country may be, there is always a need for new

industrial units being set up in order to maintain the momentum of industrial growth.

Even advanced countries like West Germany and Japan still give incentives for new industrial units to be set up with certain levels of capital investment. In fact, there is a crying need for new industrial units to be set up in a country like India, because every new unit is the proverbial goose that lays the golden egg.

The reasons for this are not far to seek. Firstly, every new unit generates employment opportunities and India has a vast army of the unemployed which is growing every year. Secondly, every new unit would contribute to the national Exchequer in the form of excise duties and corporate taxes on an on-going and permanent basis.

A 30% sacrifice in income-tax revenue during the first ten years is an insignificant price to pay for the enormous benefits that the Nation would derive by the setting up of new industrial undertakings. If Indian industry is to achieve the growth rate of 12-14%, it is absolutely imperative that the number of new industrial units should increase so as to widen the tax base. Further, creation of more jobs would again mean putting income in the hands of the unemployed, which, in turn, could lead to collection of revenues.

It must also be pointed out that the new units which are in the process of being set up but would not be in a position to commence production by 31st March, 1995, will be deprived of the benefit even if the delay in the implementation of the project was unavoidable. In other words, when the projects were started, the relief was taken into account in calculating the financial viability and such estimates would, therefore, go awry for the simple technical reason that the deadline could not be met.

On the positive side, the Government has done well to continue the 100% exemption under section 80-HHE which is currently available to computer software exporters.

The granting of tax exemption in respect of dividends and long-term capital gains to venture capital funds and companies is indeed salutory. However, these funds have to be approved by the prescribed authority for being eligible for this exemption.

The extension of the five-year tax holiday under section 80-IA to infrastructural projects like roads, highways, expressways, bridges, airports, seaports and rapid rail transport systems, deserves special mention. In such cases, 100% of the profits derived from the aforesaid infrastructure facility would be exempt from tax during the initial five years and

30% of the taxable profits would be exempt for the next five years.

This provision has not come a day too soon. However, what needs to be pointed out is that the development of such infrastructural facilities involves colossal investment of funds running into hundreds of crores of rupees. Such capital intensive projects would necessarily have a long gestation period and, therefore, it is doubtful whether there would be a taxable profit in the first five years when the 100% exemption is sought to be given.

In other words, it would not make sense to grant exemption at a time when the project does not yield profits. It would, therefore, be eminently desirable to give the investor the option of claiming this benefit at any time within the first fifteen years, so that the incentive becomes a meaningful exercise and ensures the financial viability of the infrastructural project.

Development of infrastructure is an important area requiring fiscal support for encouraging private sector participation. The Finance Bill proposes to amend section 36(1)(viii) of the Income-tax Act to extend the benefit of deduction upto 40% of the income credited to a special reserve account to approved financial corporations providing long-term finance for development of infrastructure facilities in India.

The proposed amendments will take effect from 1st April, 1996 and will, accordingly, apply in relation to assessment year 1996-97 and subsequent years.

Under section 10-A of the Income-tax Act, a five-year tax holiday is allowed to any industrial undertaking in a free trade zone (FTZ) which manufactures or produces any article or thing. This tax holiday is in operation from assessment year 1981-82. Similarly, the provisions of section 10-B exempt the entire profits of 100% EOUs from assessment year 1989-90.

Units in FTZs/100% EOUs get special treatment by virtue of the fact that they export their entire produce. However, in order to provide economic flexibility to them and to allow them to dispose of the export rejects and by-products, they are allowed to sell 25% of their product in the domestic market. In effect, such units get exemption for 5 years even in respect of profits from the 25% domestic sales allowed to them.

As long as domestic sales are within reasonable limits (upto 25% of total sales), the exemption of profits in the case of units in FTZs/100% EOUs can be justified as a concession incidental to export. Recently, however, it has been noticed that several units approved as 100% EOUs/FTZs are allowed to sell 50% of their produce in the domestic market.

In view of this undue benefit, last year in the case of 100% EOUs, exemption under section 10-B was restricted only to units exporting atleast 75% of their turnover. It is now proposed with effect from assessment year 1996-97 that, in the case of units in FTZ also, exemption under section 10-A be restricted to units exporting atleast 75% of their turnover. Units which export less than 75% of their turnover can avail of the normal 100% deduction under section 80-HHC to the extent of the export profits. The restriction will apply to new units which begin to manufacture or produce an article or thing on or after 1.4.1995.

Section 33-AC of the Income-tax Act, 1961, was inserted by the Direct Tax Laws (Second Amendment) Act, 1989 with effect from 1st April, 1990 with a view to providing a tax incentive to public/Government companies engaged in the business of operation of ships. This deduction is available to the extent of the total income provided the amount is credited to a reserve account and is utilised for the purchase of a new ship within the specified period.

It has come to notice that shipping companies have diversified into trading, real estate business, etc., and are claiming deduction under this section even in respect of their income from activities other than shipping. There is no justification for allowing deduction with reference to income from activities

other than operation of ships. Further, it has been stated in the Finance Bill that the present 100 per cent deduction is excessive keeping in view the improved situation in the shipping industry.

The Bill, therefore, proposes to amend section 33-AC with effect from assessment year 1996-97 to restrict the deduction to 50 per cent of the income derived from the business of operation of ships only. This would take outside the purview of the deduction any income arising from businesses other than shipping business, or from sources other than business.

One unfortunate trend apparent from the budget proposals is the desire to supersede Court decisions. The most glaring example of this is in respect of capital gains pertaining to bonus shares. The Supreme Court of India has held more than thirty years ago that when bonus shares are sold, the cost is to be determined by the process of averaging, taking into account the cost of the original shares. In fact, the Supreme Court reiterated this formula on more than one occasion, but it is now sought to be superseded by a provision in the Finance Bill, 1995, treating the cost of the bonus shares as nil, so that the full capital gains become liable to tax.

If the bonus shares are sold within one year from the date of their issue, the rate of tax could be as

high as 40% if the other income of the investor together with the capital gains exceeds Rs.1.2 lakhs. Further, in respect of bonus shares, there can be no indexation hereafter because the cost of such shares would be deemed to be nil. Hence, shareholders would stand to lose as a result of this provision and, therefore, the mood on the stock exchange has been dampened in the post-budget session.

Another instance of the Finance Bill, 1995, superseding a Court decision is in respect of deduction of tax at source. Last year, a circular was issued by the Central Board of Direct Taxes to make payments to advertising agencies liable to deduction of tax at source. The Bombay, Delhi and other High Courts struck down this Circular as being illegal. Hence, a legislative amendment is now proposed to bring such payments within the withholding tax net.

A few measures have been proposed with the avowed objective of curbing tax evasion. However, this is not likely to have the desired effect.

One of the measures is to levy a withholding tax on the interest payable to bank depositors or in respect of dividends payable to mutual fund holders, if the amount exceeds Rs.10,000 per annum. Those who wish to get out of the proposed

amendment will obviously invest smaller amounts in term deposits with banks by placing multiple deposits with different banks so that the interest receivable from each is less than Rs.10,000 per annum.

Likewise, unit holders of mutual funds will spread their investments over various schemes to ensure that the total income does not exceed that figure. Hence, any collection of tax under the withholding tax scheme would be insignificant.

The Finance Bill seeks to insert a new section 194-J in the Income-tax Act providing for deduction of income-tax at source, at the rate of ten per cent, on payments to a resident of fees for professional services or fees for technical services exceeding twenty thousand rupees, in either case, in a financial year made by any person other than an individual or a Hindu undivided family. No deduction under the provisions of this section will be required to be made in respect of the aforesaid fees paid or credited before the 1st day of July, 1995.

Where the Assessing Officer is satisfied that the total income of any person in receipt of the said fees justifies deduction of income-tax at any lower rate or no deduction of income-tax, as the case may be, he shall, on an application made by such person in this behalf, give to him such certificate

as may be appropriate. Where any such certificaite is given, the person responsible for making the payment of the said fees to that person shall, until such certificate is cancelled, deduct income-tax at the rate specified in the certificate or deduct no tax at source as the case may be.

The expression "professional services" is being defined to mean services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or advertising or such other profession as is notified by the Board for the purposes of section 44-AA or of this section. The expression "fees for technical services" is proposed to be given the same meaning as in Explanation 2 below clause (vii) of section 9(1).

While payments to professionals in excess of Rs.20,000 in a financial year will be subject to deduction of tax at source, the dishonest professionals who receive their fees in cash would go unscathed as, in such a case, there would obviously be no deduction of tax by the payer.

The proposals to increase the limits which require the sanction of the Income-tax Department for transfer of immovable properties will, in fact, promote greater tax evasion. Currently, the limit of Rs.10 lakhs under Chapter XX-C of the Income-tax

Act, 1961, results in properties worth Rs.25-30 lakhs being transferred by declaring a consideration of Rs.10 lakhs in the document. By increasing the aforesaid limit, properties of higher value will hereafter be transferred by declaring a consideration which is less than what is to be notified.

In fact, one of the widest pool of black money is in the immovable property sector where huge profits are earned as a result of sky-rocketting prices without any gain to the Exchequer, by the simple process of undervaluation which goes unchallenged under the present provisions of Chapter XX-C.

Hence, tax evasion will increase rather than be curbed. The only way to effectively restrict the generation of black money is to change the law and provide that transfers would be subject to the permission of the tax authorities in respect of all properties which exceed a certain built-up area as per the original municipal sanctions. The area could vary from city to city.

Further, transfer of leasehold rights and monthly tenancies could also be brought within the purview of Chapter XX-C. In fact, unaccounted monies are fully used in transfer of leasehold and tenancy rights. Hence, the need for roping them in is absolutely imperative.

In order to make the procedure of assessment of search cases cost-effective, efficient and meaningful, it is proposed to introduce a new scheme of assessment of undisclosed income determined as a result of search under section 132 or requisition under section 132-A.

Under this scheme, the undisclosed income detected as a result of any search initiated, or requisition made, after 30.6.1995 shall be assessed separately as income of a block of ten years. Where the previous year has not ended or the due date for filing a return of income for any previous year has not expired, the income recorded on or before the date of the search or requisition in the books of accounts or other documents, maintained in the normal course, relating to such previous years shall not be included in the block.

This new procedure for search cases is proposed to be made effective in respect of searches initiated on or after the 1st day of July, 1995. This means that the block assessment procedure will apply to cases where the initial search was conducted on or after 1.7.1995. Where the initial search was conducted prior to this date and only the consequential searches continue beyond 30-6-1995, such cases will be taken up according to the old procedure.

At present, the provisions of section 133(6) empower income-tax authorities to call for information which will be useful for, or relevant to, any proceedings under the Act. In other words, the power under section 133(6) can be invoked only in the cases where proceedings are pending and not in other cases.

The existing provisions are being amended to enable certain income-tax authorities to call for information from any person which will be useful for or relevant to any inquiry or proceedings under the Income-tax Act. An income-tax authority below the rank of Director or Commissioner will be able to exercise the power in respect of an inquiry, in a case where no proceeding is pending, only with the prior approval of the Director or, as the case may be, the Commissioner. This would not, however, debar an Assessing Officer to call for information in specific cases in respect of which any proceeding is already pending as at present. The proposed amendment will take effect from 1st July, 1995.

The aforesaid proposed amendments will have a far-reaching impact. Possibly, some tax evaders may even have the comforting thought that a search has its silver lining, there being no penalty and interest which would be leviable under the new regime.

Dr. Manmohan Singh has proved that he is not only an erudite economist, but a suave politician. He has shown that a lot is being given to the poor and needy without, in fact, parting with a substantial amount from his own budgetary resources. This has been done by channelising the funds from the banking sector for the anti-poverty programmes.

In all fairness to Dr. Manmohan Singh, it has to be recorded that it would not be appropriate to judge his performance as Finance Minister by his acts of omission and commission while presenting the 1995-96 Union Budget. It is necessary to look at the entire package of reforms which he has brought about between 1991 and 1995.

While a lot remains to be done, like the revamping of the financial sector, the opening of the insurance sector, some credible exit policy and further steps towards convertibility of the Rupee, perhaps this may be left to another person to complete the unfinished agenda. Nevertheless, history will record that Finance Minister, Dr. Manmohan Singh was the primary architect who laid the foundation for an economic miracle which had eluded India during the last four decades.

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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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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