THE NEW PATTERN OF TAXATION

By

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FORUM OF FREE ENTERPRISE

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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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What strikes one most about the new Pattern of Taxation in India is that in one of its chief characteristics, viz., top heavy incidence of taxes, it is really one of the ages-old patterns of taxation. History records several instances of excessive taxation. It is only as civilization advanced and citizens became more conscious of their legitimate rights that taxes came to be confined within reasonable measure. In fact, excessive taxation has made history, as hunger has made history. Several revolutions and several wars had their genesis in crushing taxation. Thus to the extent to which the New Pattern of Taxation subjects the citizens to the maximum burden of taxes, it is really going back a few hundred years in history, not introducing any modern, enlightened system of taxation. But, in another sense, the pattern is really new because it comprises novel kinds of taxes introduced to form what is called an integrated pattern of taxation.

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. One can understand changes made with a view to ensuring a more just administration of the Law, or with a view to plugging loopholes which had been overlooked at the time of original enactment. But there are several changes made which are not based on any such rational ground. The law relating to the carry-forward of business losses is an instance in point. Prior to the amendment made by the Finance Act, 1955, no loss could be carried forward for more than six years. By the Finance Act, 1955, the time-limit was removed completely and a loss could be carried forward indefinitely. Then again by the Finance (No. 2) Act of 1957, a new time-limit of eight years was imposed. Six years to start with, then no period of limitation at all, and then a period of eight years. In between, nothing whatsoever had happened to justify the changes in this part of the law. There are other enlightened countries which permit losses not only to be carried forward but also to be carried backwards. If you have paid tax last year and this year you incur a loss, you get a refund of the tax paid last year. This is the law in several progressive countries; whereas, in our country we have even abolished the right to carry forward a loss after eight years. There seems to be no reason in fact and no justification in principle for having changed the law enacted in 1955 permitting losses to be carried forward indefinitely.

To take another instance of a change in the law

which is not based on any consideration of equitable distribution of the tax burden or of plugging a loophole, we may refer to the amendments proposed to be made by the Finance Act, 1958, to supersede a judgment of the Bombay High Court in respect of income derived from house property. Last September the Bombay High Court held that the owner of house property may be allowed a deduction from the bonafide annual value in respect of water rates and conservancy charges levied by the Municipality. The proposed amendment is intended to supersede that judgment. There are so many defects in the Income-tax law which work most harshly on citizens and which have been repeatedly pointed out in reported cases and yet nothing has been done to amend the law in those respects. This judgment of the High Court which upheld the decision of the Income-tax Appellate Tribunal that in the particular case the bonafide annual value could be calculated after deducting water rates and conservancy charges was fair and just, because, after all, if those taxes have actually been paid by the owner of the property there is no reason why they should not be permitted as deductions. And yet the law has been promptly amended so that the Revenue may not suffer any loss, irrespective of the question whether the proposed amendment is just and fair. Such precipitate and chronic tinkering with the law is fraught with insidious mischief. That all law is an experiment, as all life is an experiment, has passed into a byword. But experiments should not be so frequent, so short-sighted and so short-lived as to rob the law of that modicum of stability which is essen-

tial to its healthy growth. A nation cannot have taxation as an experimental measure without realizing its full implications at the time of introduction of the measure. The chronic changes work particular hardships in view of the fact that the income is earned in one year and the assessment is made for the next year; so, by the time the Finance Bill comes to be passed, certain accomplished facts confront the assessee. No assessee has a chance of arranging his affairs even legitimately, even fairly and honestly, in such a way as to attract upon himself the least burden of taxes.

The second thing noticeable about the New Pattern of Taxation is that it is in total disregard of any consideration for the convenience of the citizen. Look at the recent Current Profits Deposit Rules. Even when the system of Current Profits Deposit was abolished, the reason given in Parliament was that the burden on the administrative machinery far outweighed the collections made. But nobody seems to think of what it means to the citizens to be compelled to have any business expenditure "approved" by Government officials who may not know about the business one-tenth of what the citizen himself knows. Under the Current Profits Deposit Scheme Government officials were empowered to "approve" all expenditure in all kinds of businesses carried on by any Company, and even when its abolition came the abolition was not on account of the undue interference with individual freedom which the scheme involved but only on account of the burden on the administrative machinery. No one bothers to consider how many forms a law-abiding citizen has to fill

and how many legal formalities he has to comply with in order to carry on his business on the right side of the law. It is really a vicious circle: the more complicated taxes and the more numerous taxes there are, the more administrative machinery, more wastage of man power, more government employees and more public expenditure, and therefore greater need for more taxation.

The ne plus ultra of absurdity has been reached by the proposed Gift Tax. As the Bill stands, if you make gifts aggregating to more than Rs. 10,000/- in a year, then you must, for that particular year, give a truthful account on oath to the Gift Tax Officer of every single rupee you have gifted during the 365 days. Any birthday gift, wedding gift or any other small gift which you may have given, say a rupee to somebody's servant who had brought a packet to your house, all these will have to be accounted for in your Gift Tax Return. This proposed law which requires every citizen to declare on oath at the end of the year every gift, however minute in value, which he has made during the year, gives one an idea of the care, circumspection and solicitude for the convenience of the citizen with which the new fiscal laws are being enacted.

One may then refer to the third short-coming of the New Pattern of Taxation—the absence of justice and fairplay. Many years ago, the House of Lords laid down in a classic judgment that tax and equity are strangers. But there is no reason why they should be enemies. There are many provisions in the New Pattern of Taxation which seem to be the sworn enemies of justice and fairplay.

Let us consider a few such provisions in the Indian Income-tax Act. The provision of Section 23-A of the Income-tax Act requires Companies in which the public are not substantially interested to declare a prescribed percentage of its profits by way of Dividend. As the House of Lords stated in Fattorini's case, it is really a penal provision imposed on Companies for not declaring substantially large dividends. In many foreign countries the corresponding provisions of the law are much more reasonable. They provide that if there is a reasonable justification for the non-distribution of a higher Dividend, the provision corresponding to Section 23-A would not apply. Under the Indian law even if there is the soundest justification for not declaring higher dividends, the Company is still hit by the penal provisions of Section 23-A, except in just two cases specifically mentioned in the Section. This provision of the law works enormous hardships in practice in many cases. The Income-tax Officer has to take the sanction of the Inspecting Assistant Commissioner before initiating action under Section 23-A but experience shows beyond doubt that this is hardly any safeguard at all for the citizen. There are no doubt some independent and impartial Inspecting Assistant Commissioners, but as a general rule the sanction to take action under this provision is given without any judicial approach to the problem.

Other instances of provisions which are not consonant with justice are two of the changes proposed to be made by the Finance Act, 1958, in the law relating to Development Rebate. One amendment proposed to be made by the Finance Act, 1958, is that you cannot sell your assets within ten years if you want to have the benefit of Development Rebate. This is one typical instance of how unfairly the rule of thumb works in the generality of cases. There may be a business where to sell an asset even in the eleventh year may be unjustified, and there may be another business where to keep an asset for more than five years would mean keeping a useless asset. When a particular asset should be sold or discarded depends upon the length of time over which the asset would be useful in business. Therefore, there cannot be a rule of thumb that you must not sell any asset within ten years if you want to have the benefit of Development Rebate. One can understand a rational basis founded on the normal life of a business asset. It is on the normal life of a business asset that the rates of depreciation are provided in the Indian Income-tax Rules, and taking such normal life of different assets a law may rightly provide that Development Rebate should not be given where the sale is effected even while the asset is useful to the business. But what justification can there be, in reason, for saying that the businessman who buys an asset which is useful only for eight years, that being the normal life of the asset, should be deprived of the benefit of Development Rebate if he sells the asset at the end of that period? Another provision in the Finance Act, 1958, in respect of Development Rebate is equally unjust. If the asset is sold within ten years, the Development Rebate is taken back in proceedings under Section 35 of the Indian Income-tax Act. Now there is no right of appeal against any order

passed under Section 35. An Income-tax Officer is as much fallible as any other mortal and it is very unfair to the citizen to be given no right of appeal against his decision in such an important matter as the denial of Development Rebate. In the last many years innumerable cases have arisen of great hardship caused to the assessee by reason of no right of appeal being provided against orders of rectification passed under Section 35, but no amendment has yet been made to remove this glaring hardship.

There is another aspect of the new changes sought to be made in the law relating to Development Rebate. The law says if you transfer your asset to any person within ten years, you forfeit the right to Development Rebate. Therefore, if a firm which has been carrying on business merely wants to reorganize its business and to convert itself into a private or public limited Company and with that object transfers the assets to the newly formed limited Company, the firm would lose the right to Development Rebate and whatever Development Rebate was given in the past would be taken back. Is it just and equitable that because a firm is converted into a limited Company, it should lose the right to Development Rebate?

Take another instance of how the New Pattern of Taxation is divorced from considerations of justice and fairplay. If a Company in which the public is substantially interested declares a low Dividend, it pays a penal tax under Section 23-A. If it declares a high Dividend, it pays a penal tax under the Finance Act, 1958. Imagine an Indian Penal Code which provided that if you commit dacoity you would go to prison for seven years and if you do not commit dacoity you would go to prison for five years. You would think that the man who made such a law had not the vaguest conception of what he was legislating about. But in this country for the last few years, there has been in force a law which tells you that if you declare a low Dividend a penalty would be imposed under one Section, and if you declare a high Dividend, a penalty would be imposed under another Section. This is some thing altogether unintelligible and irrational.

Similar other instances are the tax on Bonus Shares and the tax on 'Excess Dividend'. The yield to the Government is very low from the tax on Bonus Shares but in its operation the tax works as a grave disincentive to the growth of a healthy corporate economy. . Such a tax should not be levied because, after all, Bonus Shares are issued out of profits which have already borne tax in the hands of the Company and after the issue of Bonus Shares the real value of a Shareholder's holding in the Company is precisely the same as before. It would be a good rule of democracy if any Minister who wants to continue a particular fiscal measure should be able to give an answer in reason to an objection raised in reason. If you say, "It is in my power to tax you and therefore I shall do it", then there is an end of all argument. If "prestige measures" were not continued in perpetuity, India could make much bigger progress.

As regards the tax on "Excess Dividend", a penal tax is imposed if Dividend in excess of 6% is declared. What is taken into account for the

purpose of computing the percentage of Dividend is only the Paid-up Capital and not the Reserves of the Company, which is clearly unfair. Again, as has been repeatedly pointed out, a Company which has declared no Dividend for the last ten years and declares in the eleventh year 11% Dividend, which works out to only 1% average Dividend a year, must pay penal tax. Another Company paying 6% Dividend consistently for 11 years, pays no penal tax at all. This is another instance of the injustice inherent in the insensate rules of thumb which permeate our New Pattern of Taxation.

As regards the new amendments proposed to be made to the Estate Duty Act, the raising of the limit from two years to five years for Gifts which are not to attract Estate Duty, is not unjust or unfair. The limit of five years applies in other countries **also.** After the enactment of the Estate Duty Act, 1953, people are more inclined to make gifts than they were before. There has indeed been a very noticeable increase in the degree of generosity characterising monied people. But the other proposed amendments to the Estate Duty Act are open to grave objections. It was at no time during the past fifty years more difficult to sell large immovable properties than it is to sell such properties today. The provision in the Estate Duty Act, 1953, which permitted Estate Duty to be paid within eight years in respect of immovable property, is proposed to be amended so as to make the Duty payable within a period of three years. If the State has passed other fiscal measures which have made it impossible to effect the sale of large

immovable properties, there is no justification for reducing the period from eight years to three years for the payment of Estate Duty. If the property being unsaleable, the Estate Duty Officer still insists that the property is saleable at a certain value and that a certain slice of the estimated sale price should be paid to the Government within the short period of three years, the heirs should be entitled to tell the Government, "If you think the property can be sold, we are prepared to **sell** it to you and you can set off the Estate Duty against the price". The other part of the Estate Duty Act which is sought to be amended is the maximum limit of non-taxable Estate which is proposed to be reduced from one lac to Rs. 50,000/-. It is worth considering whether the net return to the Government will not be outweighed by the larger work involved and the great strain on administrative machinery and the harassment caused to small people in respect of small Estates. To levy an Estate Duty on an Estate worth Rs. 50,000/- (which would be equal to Rs. 12,000/- prior to the last war) is to levy the duty on those strata of society who should not be troubled with this kind of levy.

The fourth flaw in the New Pattern of Taxation is that the pattern owes more to an ideology, a doctrine, than to practical considerations of the Nation's development. There are two approaches to every problem. One may try to work out on paper as a matter of abstract principle, what should be the new taxes, while shutting one's eyes to the realities of the situation. Alternatively, you may take stock of the realities and visualise the actual results of the application of a proposed law.

Nations are known to come to grief as a result of the first course being pursued, but it would be difficult to find a single instance in history where a Government pursuing the second course has come to grief. As a matter of doctrine or pure theory, the integrated tax-structure makes a beautiful pattern. There is income-tax which is levied on what you earn. Then the Expenditure Tax levied on what you spend, the Wealth Tax on what you save, the Gift Tax on what you give in your life time, and the Estate Duty on what you are unwise enough to die without spending or giving away. That certainly makes a very coherent pattern. The only question is whether its coherence is about its only virtue or whether it would be conducive to the healthy development of India's economy. If as a matter of blunt fact, India has too little to earn, too little to spend, too little to save, too little to invest, too little to gift, then all these plethora of taxes seem to be a little misplaced. Where the aggregate of the Wealth Tax and Income Tax can alone go upto much more than 100%, and with the Gift Tax and the Expenditure Tax the tax can go as high as, say, 250% of the total income, one realises that in substance it is not really the levy of a tax but expropriation of property without compensation. It is noteworthy that Kaldor had specifically suggested that the aggregate of the various taxes should not exceed 100% of the income. A doctrinaire approach seemed to suggest that the recent heavy excise duty on cloth would benefit the Nation by reducing the profits of those who were making excessive profits, but the doctrinaire approach was proved

to be hopelessly wrong and the effect of the heavy excise duty was so deleterious on the Nation's economy that the duty had to be recently reduced very substantially. The same tale might have to be told about some of the new taxes in other fields.

Another instance of the unfairness of the tax structure is the levy of Wealth Tax on Companies and at the same time on shareholders in respect of their holdings in Companies. It is a commonplace that Kaldor who evolved the New Pattern of Taxation said that income-tax should not exceed 45% and there should be no Wealth Tax on Companies. We borrowed the pattern from Kaldor but retained the rates of income-tax at a little over 84% for unearned income and 77% for earned income, and at the same time levied double wealth tax on Companies and on shareholders. These are grave disincentives to effort and they have to be removed before the nation can satisfactorily progress. When the government's main grievance is that there is colossal tax evasion, how could the government in the same breath evolve a pattern of taxation which is based on the assumption that every citizen is prepared to work? Yet the New Pattern of Taxation is based entirely on the hypotheses that the citizen exists for the State and not the State for the citizen, and that man is made for the law and not the law for man.

The fifth flaw in the New Pattern of Taxation—the gravest flaw of all—is the approach of the authorities who administer the laws. Innumerable assessees have come to grief, and rightly come to grief, as the result of tax evasion; but I have never seen a single Income-tax Officer coming to grief

as the result of making a fantastic assessment, although fantastic assessments are made regularly throughout the different States,—more frequently in some States than in others. There are many cases in which Income-tax Officers have purported to reach certain conclusions where no rational mind, applying itself to the facts of the case, could have possibly come to those conclusions. With the advent of more taxes and a greater tax burden, it is eminently desirable that those administering the laws should be independent and judicial in their approach and not try to extract more revenue out of the citizen than is legitimately due to the State. Tax evasion is most reprehensible, but no less reprehensible is unjust assessment to tax. We do not lack talent and integrity in our administrative service. The Indian intelligence compares favourably with the intelligence of any other nation in the world, but it is really the fault of the people right at the top who exercise their powers of granting promotion in such a way as to give cause to the Income-tax Officers to believe that their promotion and their prospects depend on how much revenue they get for the Government every year. The result is that in many cases where the taxing Officers are themselves genuinely convinced that a certain order should not be passed, they still pass. the order purely out of selfish motives of trying to better their own prospects. Again, there have been a large number of cases where the Income-tax Officers being genuinely satisfied that a certain type of assessment should not be made, are yet compelled by the Inspecting Assistant Commissioners to make such assessments. In such cases,

the Inspecting Assistant Commissioners, instead of acting as a check on the Income-tax Officers making unfair or erroneous assessments, actually compel the Income-tax Officers to make certain types of assessment which the Income-tax Officers themselves are intelligent an independent enough to understand as being unsustainable in law or in fact. If one has to choose between a change in the pattern of taxation and a change in the attitude of the persons who administer the new taxation laws, one would rather have the second type of change. The greater evil is not really the law but the spirit in which it is being administered. Under the New Pattern of Taxation where formerly there was only one tax, Income-tax, there are now five taxes and the same Income-tax Officer administers all the five taxes. Ultimately, the citizen has to go to the Appellate Tribunal which would be the final fact-finding authority in respect of all the five taxes. Now it is a matter of the utmost importance that men of the highest integrity and high calibre should be given adequate salaries and appointed to the Appellate Tribunal. The men at the top should so deal with the question of promotions of Income-tax Officers as to make it clear that if the Officer makes a bad assessment his promotion and prospects might be impaired, but not if he makes a just and independent assessment. Unless such a change is brought about in the administrative machinery and in the approach of the officers entrusted with the task of administering the law, a mere change in the legislation would avail us very little.

There was a great Lord Chancellor of England

called Lord Eldon. It is said that Lord Eldon and his brother between themselves consumed more Portwine than any other two brothers known to history. Once when they were sitting together at dinner, the brother of Lord Eldon turned to him and said, "This wine is very good". Lord Eldon replied, "All wine is good, only some wine is better than other". The policy of the Government seems to be to regard all taxes as good, but only some taxes as better than other. This is in conflict with what has been thought by great thinkers in the past. In 1836 when Lord Macaulay was in this country drafting our Indian Penal Code, he wrote a very strong Minute dissenting from the view that court-fee should be levied in respect of litigation. In that Minute appeared the famous sentence that all taxes in themselves are evil and the burden is always on those who support a tax to prove that it is in the public interest. The approach makes all the difference.

In conclusion, one may say that it is better to have good and just laws which can be scrupulously obeyed in a spirit of co-operation by citizens, rather than unjust laws based on ideological considerations which even law-abiding citizens would find difficult and trying to obey fully.

Views expressed in *this* booklet do not *necessarily represent 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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