TAX REFORMS COMMITTEE

FINAL REPORT
PART I

August, 1992

Government of India, Ministry of Finance (Department of Revenue)

CONTENTS

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INTRODUCTION

1.1 The Committee wishes to place on record its satisfaction with the action of the Government in initiating proposals of tax reform in the 1992-93 Budget broadly along the lines suggested by the Committee, especially in relation to direct taxes and customs tariff. It would appear that the framework of reforms recommended by the Committee would form the basis for the subsequent instalments of reform so that ultimately the entire tax system gets radically transformed into a simple, fair and economically rational one. In this hope, the Committee has now worked out the lines of reform of mostly those parts of the tax system and its administration which had not received attention in the Interim Report.

1.2 The Final Report of the Committee is divided into two parts. The present Report forms Part I of the Final Report. Part II of the Final Report will deal with the further restructuring and reform of the customs duties in the medium term framework; it will also work out the details of the removal of the excise and customs notifications and the incorporation of those that are to be retained in the statutory rates themselves. The present Report deals with, and makes recommendations on, issues in five broad areas:

a. Problems of direct taxes not considered in the Interim Report, namely, corporate profits tax including the taxation of foreign entities, problems relating to business taxation, the interest tax, taxation of agricultural income and the gift tax.

b. Further reform of the system of domestic indirect taxes, particularly at the Central level, more details regarding the extension of modified value added tax (Modvat) and conversion of Modvat into value added tax (VAT).

c. Improvements in procedures, including appellate procedures, removal of complicated provisions and provisions unduly weighted against the assessee: direct taxes - customs and excise.

d. Problems of administration : Making administration more efficient and at the same time more humane and more aware of the broader aspects of taxation. Changes in administrative structure, facilities, emoluments, selection procedures at the higher levels, punishments and rewards.

e. Revenue Audit - its role - the attitude of Audit and the problems created for the assessees - lines of reform.

1.3 Before we deal with the above-mentioned subjects, we would like to make some observations on the action taken by the Government on our recommendations in the Interim Report. We do this in Chapter 2. Chapter 3 deals with the lines of reform of direct taxes, while, in Chapter 4, the Committee considers in greater detail than in the Interim Report, the structural reform of the excise tax system and possible lines of harmonisation with the State sales taxes. Administrative procedures and removal of harsh or complicated provisions are dealt with in Chapters 5, 6 and 7. Chapter 5 deals with problems common to direct and indirect taxes. It discusses also operation of Revenue Audit by the Comptroller and Auditor General (C&AG). Following this discussion, the Committee recommends changes in the ambit of Audit and on the proper responses that the Departments should make. Chapter 6 deals with provisions and procedures under direct taxes and Chapter 7 with those under excises and customs. Chapter 8 discusses the ways in which the appellate procedures can be improved, with a view to speeding up settlement of disputes and avoidance of unnecessary litigation. Chapter 9 discusses the administrative set-up of the Tax

Departments, the facilities to be provided to them, emoluments, the system of staff appraisal, awards and punishments and the selection procedures at the top levels. The final Chapter gives a summary of conclusions and recommendations.

1.4 Dr Amaresh Bagchi, who was member of the Tax Reforms Committee as it was originally constituted, resigned his membership at the end of 1991 in order to take up an assignment with the World Bank. The present Report has been prepared by the following members:

1.	Dr Raja J. Chelliah	Chairman
2.	Shri S.V. Iyer	Member
3.	Shri V.U. Eradi	Member
4.	Shri V. Rajaraman	Member

1.5 Shri Gautam Ray, Deputy Collector, Customs and Central Excise and Shri Arbind Modi, Deputy Commissioner of Income Tax continued as the Secretary and the Additional Secretary to the Committee, respectively.

1.6 We wish to thank all those representative organisations of industry and trade, experts, eminent jurists and all other individuals who submitted to the Committee written comments and suggestions or gave oral evidence. Our tasks could not have been fulfilled without their willing co-operation and help. We would like to specially thank the Chairmen and Members of the Central Board of Direct Taxes (CBDT) and the Central Board of Excise and Customs (CBEC) for presenting their considered views before us and for helping us in numerous other ways including the supply of data on many aspects of the working of the Central tax system. The tax officers in the field with whom we had extensive discussions also gave us much valuable information and were frank in the expression of their views. We wish to thank them also. Finally, we must acknowledge our indebtedness to the staff of the National Institute of Public Finance and Policy on whose previous work and present research we have drawn. In particular, we would like to thank the Direct Taxes Cell of the Institute, funded by the Ministry of Finance, whose work on the Enforcement of Direct Taxes we found to be much value for our work.

1.7 We would like to acknowledge also the considerable help that we have received from the administrative and other staff of NIPFP including Mrs. Rita Wadhwa, for editing the Report. Competent secretarial support was provided by Miss Sushila Panjwani, Shri S.B. Mann, Shri Digvijay Mishra, Shri B.K. Shrivastva, Shri M.C. Aggarwal, Shri A.K. Baronia, Shri S.C. Tandon, Shri Navin Kumar Singh and Shri Satish Kamath. Shri N. Natarajan and his unit helped in the production of the Report.

1.8 A list of organisations and individuals who submitted memoranda or gave formal evidence before the Committee is given in Appendix I.

2

RECOMMENDATIONS IN THE INTERIM REPORT

2.1 The Committee is gratified that the Government has accepted the approach and the broad lines of reform advocated in its Interim Report and has amply drawn upon its recommendations, particularly in regard to direct taxes and import tariff. Since the broad approach of the Committee, that the tax system should be simple and broad based with moderate rates and minimum of exemptions/concessions has been endorsed and substantial reforms consistent with that approach have been initiated, we are encouraged to suggest further reforms in the structure with corresponding and necessary changes in its legal provisions and administrative procedures. It need hardly be pointed out that without the latter changes, the benefits of the structural reform would not reach the assessees or stimulate the economy in full measure.

2.2 We have already indicated in our Interim Report, and we would like to reiterate, that the complexity of the tax structure which is also economically irrational in several respects (particularly on the indirect taxes side) and the unsatisfactory manner of its administration, with the attendant delays, disputes and prolonged litigation, together constitute as much an impediment to the efficient utilisation of resources, smooth flow of economic transactions and fast growth with equity, as the major ingredients of the control regime such as exchange control, import control and pervasive industrial licensing, which are being dismantled. For example, the foreign investor is much worried about the tax regime and the state of its administration. However, neither the characteristics of a sound tax system nor the critical evaluation of the existing structure and its administration have received much or detailed attention of economists or political thinkers. So, while the need for reform in other areas is widely recognised, taxation has remained an area of darkness. It is one of the major purposes of our Report to bring this under light and scrutiny. Another important point to be made is that the package of recommendations that we have made already and are now making in this Report have been worked out as an integrated body of consistent measures keeping in view revenue buoyancy, simplicity, moderate rates for inducing better tax compliance and for reducing corruption, economic rationality, and minimisation of harassment and of litigation. Therefore, as far as possible the whole package of measures would have to be put through without major modifications. If the Government for some reason cannot accept the various key recommendations, an alternative consistent package will have to be considered.

Direct Taxes

2.3 In our Interim Report, we had argued at length to show that if the basic objective of an income tax, namely, taxation according to ability, was to be fulfilled, income must be defined as comprehensively as possible, for tax purposes. This means, among other things, that as many tax shelters as possible should be removed, and that perquisites should be brought under tax to a reasonable extent. The reduction in tax shelters and bringing within the tax net at least the most important perquisites would not only improve horizontal equity, but also enable the reduction in the marginal rates of taxation. The Income-tax Act does contain provisions for the taxation of certain fringe benefits such as residential accommodation, conveyance for personal use and gas, water and electricity charges paid for personal use. However, some of the rules are found to be too liberal and to discriminate amongst employees in the Government, the public sector and the private sector and also as between the salaried and the self-employed persons. At the same time, some of the

perquisites have been left free of taxation.

2.4 The Committee, therefore, recommended that the perquisite value of rent free or concessional rent residential accommodation provided should be taken to be equal to 20 per cent of salary (or the actual expenditure by the employer, if lower) for those employees whose annual income under the head 'Salary' exceeds Rs.36,000. This would be applicable to all employees without discrimination. The taxable perquisite value would be the perquisite value as reduced by the sum of rent paid and House Rent Allowance (HRA) foregone (para 6.71 of the Interim Report). The Committee also recommended the partial taxation of leave travel allowance, the inclusion of sitting allowances received by members of Parliament and State Legislatures in taxable income (para 6.74), the limitation of allowances exempted from tax under sub-clause (ii) of clause (14) of Section 10 of the Income-tax Act to 10 per cent of salary (para 6.75) and the taxation of fringe benefits implicit in the concessional interest rate charged on loans granted to employees for the acquisition of durable goods and houses (para 6.77).

2.5 We firmly believe that the implementation of the above-mentioned recommendations would improve the fairness of the income tax system and help broaden the base, especially with the expected rapid growth of the organised sector. The visible improvement in the fairness of the system would also induce greater voluntary compliance. We, therefore, wish to reiterate our recommendations referred to in the previous para. Until favourable tax treatment of employees in the Government and in the public sector is mitigated, it does not seem fair to proceed further in the matter of taxation of fringe benefits provided to employees in the private sector. Hence we make no recommendations in this regard.

2.6 The Committee had recommended in the Interim Report that as a first step towards the rationalisation of the rate structure of personal income tax, a three-slab rate schedule should be introduced which should be replaced finally by a two-rate schedule (paras 6.18, 6.22). The middle rate in the three-rate schedule will become the lower rate in the two-rate schedule. One of the basic ideas behind these recommendations was that the majority of the taxpayers (i.e., except those who may be considered really rich) should be subjected to the same marginal rate (though the average rate would keep rising with the income). The Committee had explained at length the several advantages of applying a single marginal rate (paras 6.14, 6.15 of the Interim Report). These advantages could be reaped to a substantial extent by having a large middle slab. That is one of the reasons why we had suggested that the rate of 27.5 per cent (corresponding to 30 per cent in the schedule adopted by the Government) should apply to incomes in the range of Rs.50,000 to Rs.2 lakh. The second reason for recommending the level in excess of Rs.2 lakh for application of the top marginal rate of tax of 40 per cent was that inflation had eroded the value of money so much that Rs.1 lakh in 1990-91 was only worth about Rs.18,500 in 1967-68 prices or about Rs.20,300 in 1970-71 prices. The third reason was that the Committee, through a big change in the rate schedule, wished to convey to the taxpayers that a moderate-rate tax regime had indeed begun. Such a conviction on the part of the assessees, actual and potential, is necessary to induce a much higher degree of voluntary compliance than has been forthcoming so far.

2.7 For the reasons explained above, the Committee would like to urge that the top marginal rate of 40 per cent be applied to the excess of income over Rs.2 lakh. Simultaneously, the steps recommended in the later sections of this Report for the effective enforcement of income tax should be undertaken. Any possible loss in revenue that might arise from lowering the rate of tax on the income range between Rs.1 lakh and Rs.2 lakh could be made up by broadening the base through the taxation of perquisites

and removal of exclusions and exemptions on the lines suggested in the Interim Report.

2.8 In the Interim Report, we have dealt at length with the problem of taxation of the so-called "hard-to-tax" groups. Having discussed the various possibilities in the light of the experiences of several countries, we have put forward two schemes of simplified taxation: (a) a presumptive taxation scheme for small taxpayers deriving income from business below Rs.5 lakh and (b) an estimated income scheme for persons having business turnover of more than Rs.5 lakh or brokerage or commission received exceeding Rs.25,000 or receipts from other sources above Rs.10,000. The latter scheme however would be restricted to persons whose turnover/receipts do not exceed Rs.25 lakh (paras 6.132 to 6.137 of the Interim Report). The Government has accepted the proposal of the presumptive tax scheme with some modifications but has not accepted the estimated income scheme. We would like to point out that the estimated income scheme is an important segment of our entire set of recommendations. As has been repeatedly pointed out, many of the important problems in tax assessment and (scope for) harassment of small assessees arise in respect of the assessment of income from business of smaller assessees whose total turnover is less than Rs.20 or Rs.25 lakh. As we point out elsewhere in this Report, the income tax assessment of all assessees having income not exceeding Rs.2 lakh is done by Income Tax Officers. Much of the harassment takes place at the hands of these officers in respect of the assessees whose incomes fall below Rs.2 lakh. Nearly 77 per cent of the additional demand raised by the Department is quashed on appeal; however, the assessees have to spend time and money to get the overassessment cancelled. In Chapter 9 we are making recommendations for a more rigorous process of selection of Income Tax Officers. However, the majority of income taxpayers who derive income from businesses of various kinds would still have to endure harassment if the normal procedure of assessment is applied to them. That is one of the main reasons why we had recommended the estimated income scheme. We are sure that the assessees would welcome the scheme. We would earnestly urge the Government to reconsider the matter and implement the estimated income scheme which would substantially reduce complaints from assessees and at the same time enable the Government to collect revenue from a large number of small businesses.

Indirect Taxes

2.9 In Chapter 9 of the Interim Report, the Committee had underlined the need for making the system of indirect taxation broadly neutral in relation to production and consumption, widening the tax base by covering exempted commodities and making a beginning with the taxation of services. The ultimate objective of the reform of the Central excise is to move towards a full fledged VAT system at the Central level covering almost all commodities other than raw produce of agriculture and many, if not, most services. In order to prepare the ground for introducing the genuine VAT system at the manufacturing level, the Committee had suggested reduction in the multiplicity of rates of excise duties to 2 or 3 rates, say, at 10, 15 or 20 per cent. A selective excise duty on non-essential commodities or commodities injurious to health could be levied at 30,40 or 50 per cent. The maximum rate on a commodity should not exceed 50 per cent with a few exceptions like cigarettes. In short, the Committee recommended a simple, broad based indirect tax system which will have a few rates of duties at moderate levels, with the objective of moving towards a full fledged VAT for the commodities as well as services sector. Such a system would also be simple, eliminating disputes and minimising discretionary action by the tax collectors and attempts at evasion by the assessees.

2.10 The first step in this direction is to provide for a tax system with a more comprehensive base and limited exemptions, as without this, a tax regime with moderate rates cannot be contemplated without any

substantial loss of revenue. The Committee, therefore, identified about 30 commodities hitherto enjoying full exemption and suggested a levy of 10 per cent ad valorem on them. The Committee is of the view that it should not be difficult to cover more commodities manufactured mainly in the decentralised sector, provided a fairly low rate, say, 10 per cent is prescribed and rules for collection of excise duties are simplified so as to make the procedure less burdensome for the assessee and convenient for the Department to administer. With this objective in view, the committee formulated the Simplified Assessment Procedure (SAP) for the small scale sector and through that scheme the commodities manufactured in the decentralised sector were proposed to be brought under the excise net. The important procedural relaxations provided under this scheme include waiving of the requirements of filing price lists, of classification lists, and of clearance of goods on gate passes, the acceptance of the records maintained for sales tax - income tax purposes for verification of production figures and turnover in lieu of statutory central excise records, and investigation or audit of these units only with the approval of the Assistant Collector.

2.11 In Chapter 4 of this Report, the Committee argues the case for moving over to a system of VAT at the manufacturing level which could possibly be extended to the wholesale level. The recommendations made in the Interim Report, referred to in the preceding two paras, were designed both to make the existing system work better and to prepare the ground for the introduction of the VAT. In any case, the existing system with multifarious rates, riddled with total and partial (end use) exemptions, ever changing with notifications, has to be changed. Of course, the reduction in rates, the removal of concessions and the extension of coverage have to be undertaken simultaneously because only then all of them become possible. We wish to reiterate our recommendations in the Interim Report in this regard.

2.12 It is possible that there was not enough time for preparatory work to introduce the types of changes we have recommended for the excise tax system such as the taxation of selected services. However, we must point out that several changes introduced in the excise tax system in the 1992-93 Budget go against the substance and spirit of our recommendations.

2.13 The Committee also recommended the replacement of specific duties by ad valorem rates not only for introducing full fledged VAT at the manufacturing level but also for enhanced elasticity of revenue with respect to the national income and buoyancy in revenue on account of increase in prices. However, there could be some exceptions to this rule, like petroleum products, prices of which are administered by the Centre or some finished products including cigarettes, which do not enter into such value addition activities as are under the Central excise net. We would like to reiterate that the answer to the valuation problems lies in simplifying the law and rules relating to valuation, and not in switching over to specific duties.

2.14 As already said earlier, broadening the tax base is the key to moving towards a rational tax regime with moderate rates which is the *sine qua non* for an ideal VAT system. Having regard to the revenue needs of the Government, it is not possible to achieve an ideal VAT system in the near future without extending the tax net to many, if not most services. The future growth of revenue in a rational indirect tax regime that we want to achieve will depend significantly on our ability to tap the services sector which develops faster than the commodity sector as the economy grows. We would also like to reiterate that from the economic point of view, there is little difference between the taxation of commodities and that of services. Exclusion of services from indirect taxation is like excluding major commodity groups, the obvious result of which is distortions and anomalies in the incidence of taxation on the consuming public and higher rates than necessary on commodities subject to taxation.

We had, therefore, suggested a tax at 10 per cent covering advertising services, services of stock brokers, services of automobile insurance, services of insurance of residential property, personal effects and jewellery. In respect of residential telephone service, we had suggested that the telephone Department should collect an annual telephone service tax at the rate of Rs.1,000 per connection. For the purposes of this tax, connections in places other than the non-residential premises of public limited companies, non-profit organisations and government offices will be treated as residential telephones. We urge that the case for taxing these services be re-examined.

2.15 In the Interim Report, we had indicated that any tax on inter-regional trade within a national market is not considered a legitimate way of raising resources for the government and that the rule is strictly observed by countries which come together to form a common market or a free trade area (para 4.38). It was also pointed out that the levy of the consignment tax as demanded by the States taken together with the existing Central sales tax, both being levied at a maximum rate of 4 per cent, while not enabling the States as a whole to raise more revenues to a significant extent, would be in general inimical to the interests of the backward or less industrialised States and, what is more important, would lead to inefficient allocation of resources and consequent loss of welfare. This is because a tax at 4 per cent of the value of inter-State sales, together with a consignment tax, in addition to the tax embedded in the costs through the taxation of inputs in the producing States, acts as a strong barrier to inter-regional trade within the borders of the country and fragments the common market. Such fragmentation goes contrary to the attempts now being made to integrate the Indian economy with the world economy. Since large regional common markets and free trade zones are being formed in the world, the economies inherent in a large economy with free movement of goods and services must be fully exploited by us in order to compete successfully with industries in the regional blocs.

2.16 The Central sales tax and the proposed consignment tax are Central taxes because the power to levy any tax on transactions of goods in the course of inter-State trade falls within the jurisdiction of the Central Government. The very purpose of placing this power in the Union list is to ensure that inter-State trade and commerce will not be adversely affected to the detriment of national interest by any improperly designed levy. This being so, the Central Government cannot and should not agree to enact a law on consignments in the course of inter-State trade or agree to the continuation of the Central sales tax at the level of 4 per cent, without introducing conditions that would prevent the fragmentation of the national common market. We would like to reiterate our recommendations in the Interim Report that the imposition of the consignment tax should follow an agreement between the Centre and the States to the effect that the Central sales tax or the consignment tax imposed by the exporting State will be given credit by the importing State against the sales tax payable to it by the "importer", that the exporting State will credit the inter-State sales and consignment tax collections to a Central pool and that this pool will be shared among the States on the basis of an agreed formula. If such an agreement proves impossible to arrive at, then the level of the Central sales tax should be gradually brought down to 1 per cent and after that is done, the consignment tax should be levied at the same rate.

3

FURTHER REFORM OF DIRECT TAXES

Taxation of Corporate Profits

3.1 In Chapter 2 (para 2.13 of the Interim Report), we had pointed out that if there is only a tax on personal income and no tax on corporate profits, undistributed profits would escape taxation until they are realised through the sale of shares; even then the tax burden would be less than what falls on regular income since capital gains are generally given concessional treatment. For reasons of equity, therefore, companies have also to be subjected to income tax along with the tax on unincorporated entities. Such a tax would prevent the use of incorporation as a device to minimise personal income tax. It was also pointed out (para 2.15 of the Interim Report) that, while it is clear that company profits should be subjected to tax, it is difficult to devise a system of corporate profits tax that would be satisfactory from all the relevant points of view. One view is that corporations are distinct legal entities and that they can be taxed in their own right, apart from the tax that may be levied on the shareholders according to their respective abilities to pay. This view is the implicit basis of the "classical system" of corporate taxation under which a separate tax is levied on the total profits of a corporation and neither the shareholder nor the company is given any relief in respect of dividends on which the shareholders have to again pay tax. Although the classical system exists in a number of countries including India, Pakistan, Sri Lanka, Taiwan, Australia, Indonesia, Nigeria, the United States, the Netherlands, Belgium and Sweden, the view that corporations could be treated as entirely independent entities on whom substantial additional tax liability could be levied is not generally accepted. Corporate profits belong to shareholders and strictly speaking, the companies themselves have to be treated as conduits. Ideally, the mode of tax on company profits should be such as will apportion it among the different shareholders, according to their respective incomes including their share in the profits of the corporation concerned. In practice it is difficult to achieve this result. The only way to approximate it would be to apply "a modified partnership method by combining two rules: one, a rule that gives the corporation a deduction for dividends distributed, and two, a rule that gives corporations and shareholders the right to opt for a dividend to be deemed as distributed, although the corporation has kept the money."[1] This may be referred to as the full integration system wherein the tax on the corporation is fully transformed into a tax on the respective shareholders.

3.2 No country has attempted to apply these rules to the taxation of corporate profits. The practical difficulty in applying the rules arises from the fact that shares are constantly being traded and their ownership changes hands frequently and deeming distribution would be an extremely difficult task in practice. Besides, the requirement to pay tax on profits not actually received would create a liquidity problem for shareholders other than the rich ones.

3.3 While full integration is not feasible, the classical system provides for no integration at all. As a result there is the so-called economic double taxation of dividends, i.e., dividends are subjected to taxation first in the hands of the corporations and then again in the hands of the shareholders. This results in differentially high taxation of income from equity investment which could be criticised on grounds of both efficiency and equity. The economic double taxation of dividend also implies differential tax treatment of dividends/retained earnings, which gives a bias towards non-distribution inhibiting the flow of shareholders' savings into new

companies which in turn works in favour of the existing companies. The classical system also discriminates in favour of debt finance as interest payments are deductible from gross profits for corporate tax purposes.

3.4 While full integration is not feasible, attempts have been made to devise a system which would reduce the dividends/retained earnings differential. These systems can be divided into two categories: (a) those which provide for the reduction at the company level and (b) those which provide for it at the shareholder level. Reduction at the company level can be in either of the two ways: (i) through a lower rate of corporation tax on distributed profits than on retained profits (split rate system). This is the system which is applied in Austria, Germany, etc.; or (ii) through exempting a proportion of the distributed profits from the corporation tax (partial dividend deduction). This system has been applied in Finland, Iceland, Spain, etc.

3.5 There are two methods for providing reduction in the dividend/retained earnings differential at the shareholder level:

a. A tax credit is given to the shareholder which is added to the dividend received by him and his personal tax liability is calculated on the basis of the grossed up amount against which the tax credit can be set off. Usually, the amount of credit granted is a function of the corporation tax actually paid by the company (imputation system). This system is in operation in the United Kingdom and France (if the tax credit exceeds the shareholder's income tax liability, he will receive a refund from the Tax Department).

b. A tax relief is given against the dividend income to resident shareholders investing in the equity of domestic companies, irrespective of whether or not the corporation tax has been paid on the profits (partial shareholder relief). This system has been applied in Canada, Denmark, Japan, etc. The allowance is generally a proportion of the shareholder's dividend.

3.6 Partial integration can be carried further by exempting the entire distributed profits from corporate tax as in Greece and Norway or, at the shareholder's level, by giving credit to the shareholder to the full extent of the tax paid by the company on its distributed profits. As pointed out earlier, the partial integration systems are conceived of as devices to mitigate the deficiencies of the classical system, namely,

a. it discourages distribution of corporate profits with the consequence that companies with large cash flows expand at the expense of new companies;

b. it tends to encourage mergers and accentuate monopolistic tendencies to the disadvantage of the new enterprises;

c. it puts a premium on debt as opposed to equity financing, thereby discouraging risk taking while increasing the possibility of insolvency; and

d. the dividends/retained earnings differential also tends to distort the choice between the corporate and non-corporate forms of doing business, implying a distortion in the allocation of capital.

3.7 While it cannot be denied that the classical system tends to create the above non-neutralities, it has been argued that these disadvantages are outweighed by other factors. The first argument is that the classical system has the merit of simplicity, especially in international relations. Second, it has been argued that the non-neutralities are resulting more from other aspects of the tax system, such as the deductibility of nominal interest payments, the special treatment of capital gains and the relative effective rates of tax on corporate and personal income. Third,

it has been pointed out that it would not be justifiable to provide relief to the owners of existing shares, since that would provide them with big windfall gains, in view of the fact that while purchasing the shares, the factor of tax liability on dividends would have been discounted. Finally, it has been considered that the lowering of corporate tax rates significantly would render the dividends/retained earnings differential relatively unimportant in terms of affecting economic choices: if revenue considerations would permit only either reduction of the corporate tax rate or reduction in the dividends/retained earnings differential, the former should be preferred. This is the stance adopted by, for example, Belgium and Sweden.

3.8 The relative merits and demerits of the different partial integration systems, particularly the split rate system and the imputation system have been discussed extensively in the literature.[2] Industrial countries which have been experimenting with these systems have often moved from one system to another in the light of their experiences. A form of imputation system was in force in India with respect to the income tax on companies until 1960-61. It led to considerable administrative and compliance problems, because it in effect tied up the assessment of the tax liability of the shareholders with that of the company, so that whenever there was a reassessment of the tax on the profits of the company, the assessments of the shareholders had often to be reopened. There has been some rethinking on the split rate system by countries which had earlier adopted it, because it was felt that this system tended to give benefit to foreign investors or foreign companies which was really not intended. The system was also felt to give undue benefit to tax exempt entities who would not have suffered in any case from the double taxation of dividends. It appears that if some relief is to be provided for the double taxation of dividends, the simplest and fairest method, that would also not create any administrative problems in our context, would be for a proportion of the distributed profits to be exempted from the corporation tax. The Committee, however, does not recommend that the government should provide such a relief in the immediate future for three reasons: First, if the rate reductions in the corporate and personal income taxes recommended by us are adopted, the total burden of tax on dividend income would be considerably reduced from the level existing in the accounting year 1991-92. If the maximum marginal rate of personal income tax and the corporate profit tax rate (both inclusive of surcharge) are reduced to 40 per cent as recommended, then the total burden will be reduced from 62.26 per cent to 52 per cent. This should be taken along with the favourable tax treatment of capital gains recommended by us and implemented by the Government. In view of this, in the immediate future, relief in the taxation of dividends is not urgently called for. Secondly, we understand that a high-powered Committee appointed by the EEC under the chairmanship of Mr Rudding, the former Finance Minister of Netherlands, is examining the whole issue once again in the light of the experiences with several tax integration systems, and we believe that for aligning the Indian corporate tax system with those of our important trading partners it would be advisable to wait for the findings of this Committee and the changes in the corporate tax system that would be adopted on the basis of such findings. Thirdly, as pointed out earlier, given the revenue constraint, it is clearly preferable to bring down the corporate profits tax rate to giving relief for dividend/retained earnings differential. We, therefore, recommend that the classical system be retained for the present with the corporation tax rate on all domestic companies being fixed at 40 per cent which will be equal to the maximum marginal rate of tax on personal income. However, in the longer term, the classical system should be modified to provide for some mitigation of the double economic taxation of dividend income. The method adopted should be administratively simple and should as far as possible be in line with the reform generally adopted in the EEC

countries.

3.9 We have already recommended in the Interim Report (Chapter 6 para 6.18), that the rate of corporate profits tax should be reduced to 40 per cent "within the next three years". By that we meant "in the period 1992-93 to 1994-95". It would be advisable to remove the surcharge on the company tax in 1993-94, bringing the rate down to 45 per cent from 51.75 per cent. In 1994-95, the rate should be scaled down to 40 per cent. The rates of corporate profits tax in a number of industrial and developing countries are given in Table 3.1. From a study of the table, it will be seen that a rate of 35 per cent would definitely be attractive to foreign investors. However, a rate of 40 per cent could not be considered unreasonable, given the spread of rates found in different countries.

3.10 As is now well known, our general approach is that the best results, in terms of compliance (and, therefore, revenue), efficiency and equity, are obtained through a system incorporating moderate rates on a broad base. This approach has been endorsed by the Government (vide Finance Minister's speech introducing the 1992-93 Budget, Part B, p.17). In accordance with this approach, we had recommended in the Interim Report (Chapter 6 paras 6.50-6.54), that together with the lowering of the corporate profits tax rate to 40 per cent, several of the incentive provisions be withdrawn and others be rationalised. In all our discussions with the senior officers of the Department, it was pointed out to us that the incentive provisions and provisions embodying concessions were the major source of disputes (aside from what assessees consider undue disallowances or additions) and that the task of administration would be made much simpler, if these provisions were removed. There are several provisions such as Sections 35CCA, 35CCB, 35AC, which provide concessions to taxpayers engaged in business or profession, for making donations to associations and institutions, carrying out rural development or any scheme or project for promoting social and economic welfare. For one thing, it is extremely difficult for the Department to monitor these activities. Further, as stated in the Interim Report, "these provisions discriminate between associations/institutions approved under these provisions and those not so approved but carrying on the same socio-economic activity and between taxpayers engaged in business or profession and others. Moreover, as pointed out at the outset, the use of the tax system for promoting such objectives undermines the equity of the system, creates complications in administration and leads to all kinds of distortions and anomalies. For a thorough reform of the tax system towards simplicity and equity and substantial reduction of rates, it is absolutely necessary to eliminate all such incentives/concessions in the tax system except for the essential few."

3.11 We reiterate the recommendations made in paras 6.52 and 6.54 of the Interim Report. Implementation of these recommendations would simplify the tax system and its administration, reduce disputes, improve the equity of the system and give less room for tax avoidance through the "charity route". Some of the generous concessions providing for 100 per cent deduction were introduced when the basic corporate profits tax rate was 55 per cent and the top marginal income tax rate was 66 per cent or above. With the reduction in the tax rate to 40 per cent, restricting the deduction to 50 per cent would, of course, mean lower tax saving out of the concession, but as against this must be set the "tax saving" because of the lower tax rate. As between a larger concession and lower tax rate, the latter must be preferred, since a lower rate tax has the merits of generating less disincentive effect and of mitigating the other inherent defects of the income tax.

Depreciation Allowance

3.12 In business taxation, in addition to the recovery of current costs, the recovery of capital costs representing the costs of capital assets employed in production, namely, plant and machinery, office equipment and

building, has to be allowed for. However, the recovery has to be spread over a number of years during which the value of those assets may be said to gradually depreciate through wear and tear and through obsolescence. Thus, in computing net profits for a year, an appropriate reduction from the gross receipts on account of depreciation of capital assets has to be made.

3.13 A depreciation system should try to provide depreciation for tax purposes corresponding as closely as possible to economic depreciation which takes into account the wearing out of assets as well as obsolescence. If the actual depreciation granted deviates from economic depreciation, effective tax rates will vary between different assets and for the same kind of asset, over time. However, an accurate measurement of economic depreciation is technically very difficult and an attempt to arrive at it would create several administrative problems. Therefore, certain rules which are considered reasonable are generally applied. These relate to :

a. the measurement of cost;
b. the period over which depreciation should be spread; and
c. the percentage of the cost to be allowed to be recovered every year.

(b and c are inter-related.)

3.14 The calculation of depreciation on capital assets is crucial for the determination of taxable income. It is of course not possible to measure exactly the 'true' economic depreciation in the value of an asset every year, because that would depend on many changing factors and there is no measurable manifestation of the degree of depreciation. However, one could attempt at deriving an approximation to true economic depreciation by adopting a formula for the annual depreciation charge that would enable the recovery of the appropriate amount of money by the end of the useful life of the asset.

3.15 The appropriateness of the annual depreciation charge may be considered from two angles: tax equity and the interest of the national economy. From the point of view of tax equity, there should be no under- or over-statement of profits or income from business. This result may be said to be achieved, if the annual depreciation allowed enables the investor to recover in real terms the original sum of money expended on the acquisition of the asset, by the end of its useful life. From the point of view of the national economy, the sum of annual depreciation charges made available during the period of the useful life of the asset should be sufficient to enable the purchase of a new asset to replace the old one, as the latter ends its service life, so that the economy maintains intact the capital stock already built up. If prices remain stable, both of the above-mentioned objectives could be achieved by taking the original or historic cost as the basis for depreciation and enabling the producer to recover it over the period of the useful life of the asset concerned. Traditionally, the basis of calculating depreciation under the income tax law has been the original or historic cost of the asset. This practice is in consonance with the accounting convention that the cost of a capital asset should be spread over its life in a reasonable and systematic fashion. Problems arise because prices do not remain stable. In fact, there was a significant spurt in capital goods prices during the seventies and even later. Hence, there was a persistent demand that the basis of depreciation should be changed from historic cost to replacement cost, so that the producers would be able to provide adequate replacement for assets that are getting worn out: historic cost depreciation would simply not provide sufficient funds for replacement. It is, however, not easy to measure or estimate asset-wise replacement costs because of divergent price trends. In any case, while the depreciation allowance has to be availed of during the period of use of an asset, the cost of replacement will be known only at the time of replacement. In view of this, only a broad adjustment could be provided for taking care

of the rise in the prices of the assets.[3] The adjustment has taken the form of accelerated depreciation or higher depreciation allowances.

3.16 Under the Indian income tax, the historic cost has been the basis of granting depreciation as in most other countries. The depreciation regime was characterised by provisions for "normal" depreciation on the basis of historic cost and for several other additional allowances, partly to take care of inflation and partly to boost investment (presumably) and again partly to take care of the particular circumstances of given groups of taxpayers. The major types of allowances provided under the Indian Income-tax Act 1961, prior to the assessment year 1988-89, were: normal depreciation, initial depreciation, extra depreciation, extra shift allowance, additional depreciation, terminal or balancing allowance and rehabilitation allowance (some of these were tailor-made for some or the other category of assessees). When the Economic Administration Reforms Commission (EARC) considered this matter in 1982-83, all these allowances were in force. Not only were there several types of allowances, but the rate of normal depreciation also varied as between classes of assets. The attempt at calibrating the rates of normal depreciation to match the presumed period of service life of different types of assets and the introduction of a number of allowances to serve various objectives led to much avoidable complexity and added significantly to the difficulties of assessing business income. The complexity in the system of depreciation arose both from the additional allowances, confined to some types of assessees or some types of assets, and from the multiplicity of rates of the normal depreciation allowance. Also, often the grant of an allowance was made conditional, such as on whether the plant was installed after a particular year, whether the year concerned was the first year or the second year of installation and what the intensity of the use of the assets was. Depreciation was calculated in respect of each capital asset separately and not in respect of blocks of assets. This required elaborate book-keeping and the entire process of checking by the assessing officer was time-consuming. Obviously, the greater the differentiation in rates according to the date of purchase, type of assets, intensity of use, etc., the more disaggregated had to be the record keeping. Moreover, the practice of granting a balancing allowance or levying a balancing charge, as the circumstances warranted, necessitated the keeping of records of depreciation already availed of, by each asset eligible for depreciation. There was no doubt that the then prevailing system of depreciation needed to be drastically simplified.

3.17 The main concerns of EARC were to simplify the system of granting depreciation and to give due regard to the need to provide adequate funds for replacement in the face of inflation. It recommended the merger of additional depreciation, extra shift depreciation and extra depreciation with the normal depreciation. It further recommended that there should be only two rates of the consolidated normal depreciation for plant and machinery. The general rate for plant and machinery was fixed at 33 1/3 per cent, to allow for the merged elements and to help enterprises accumulate sufficient funds to replace capital assets in the context of rising capital goods prices. EARC's recommendations were against the background of a rate of tax of 55 per cent on corporate profits. There was a surcharge of 2.5 per cent which raised the effective corporate profits tax rate to 56.38 per cent.

3.18 The recommendations of EARC in regard to depreciation were adopted with effect from the assessment year 1988-89. Subsequently, the rate of corporate profits tax was reduced to 40 per cent in the 1990-91 Union Budget which also did away with the investment allowance as well as the alternative scheme of tax free deposits with the Industrial Development Bank of India (IDBI). In the Union Budget for 1991-92, the general rate of depreciation was reduced to 25

per cent from 33.33 per cent and the tax rate was raised to 45 per cent plus surcharge.

3.19 Several representatives of trade and industry have suggested to us to recommend the restoration of 33.33 per cent depreciation rate applicable to plant and machinery or some other measure which would augment funds that can be used for replacement of capital together with modernisation. In considering this plea, we must keep in mind our earlier recommendation that the corporate profits tax rate in respect of domestic companies be reduced from the present level of 51.75 per cent (inclusive of surcharge) to 40 per cent. It is true that when the corporate profits tax rate was reduced to 40 per cent in the 1990-91 budget, along with the abolition of investment allowance, the general rate of depreciation for plant and machinery level had been retained at 33.33 per cent. However, the marginal rate of personal income tax was still high then at 54 per cent inclusive of surcharge, and the depreciation rate is to be considered in relation to the tax on non-incorporated entities also. Since the top marginal income tax rate is to be reduced to 40 per cent, it is to be considered whether the present general rate of 25 per cent depreciation for plant and machinery would not be adequate. In this connection, the following flow of accrual of depreciation has been worked out with four alternative rates of depreciation - 20 per cent, 22.5 per cent, 25 per cent and 33.33 per cent.

3.20 Tables 3.2, 3.3, 3.4 and 3.5 show the flow of funds to a business through depreciation on plant and machinery granted at alternative rates of 33.33 per cent, 25 per cent, 22.5 and 20 per cent. In each case, the interest net of tax (at 40 per cent) earned on the depreciation reserve is also included. With 33.33 per cent rate of depreciation, the total funds accumulated including interest reach 110 per cent of cost at the end of five years. While the cumulative depreciation taken by itself amounts only to 98.3 per cent at the end of 10 years, the total funds accumulated would reach 185 per cent of the cost by that date. At the end of six years, the total funds at the disposal of the enterprise would be 125 per cent of the cost. With a rate of depreciation of 25 per cent, the accumulation reaches 125 per cent at the end of seven years - a year later than in the previous case. Similarly, accumulated funds exceed 100 per cent of cost at the end of six years, instead of at the end of five years with 33.33 per cent depreciation rate. At the end of 10 years the total funds accumulated reach 170 per cent. With depreciation rate of 22.5 per cent, the total funds accumulated amount to 104 per cent at the end of 6 years and 163 per cent at the end of 10 years.

3.21 If the depreciation rate is cut down to 20 per cent, accumulation exceeds 100 per cent at the end of seven years; it reaches 125 per cent at the end of eight years. Thus the main differences in terms of building up of depreciation reserve are as follows:

Rate of depreciation (%)	Accumulation of depreciation excluding interest at the end of 10 years (%)	Year in which accumulation exceeds 100 per cent (end of year)	Year in which accumulation reaches 125 per cent (end of year)	Accumulation at the end of 10 years (%)
33.33	98.3	5	6	185.0
25.00	94.4	6	7	170.0
22.50	92.2	6	8	163.5
20.00	89.3	7	8	155.9

3.22 In the light of the above computations, the Committee recommends that the general rate of depreciation on plant and machinery may be retained at 25 per cent, if, according to our recommendation, the tax rate on domestic companies is brought down to 40 per cent. In suggesting this, we have also kept in mind another recommendation of ours, namely, that the excise/countervailing duty on machinery be given Modvat credit over a period of specified number of years. This will have the effect of reducing the cost of machinery to business.

Deduction under Section 43B

3.23 Under the mercantile system of accounts, receipts and expenses are recorded on accrual basis. Accordingly, where a liability for an expense has already accrued, it is generally allowed for income computation purposes, as a deduction. Section 43B of the Income-tax Act makes a departure from this well-accepted principle in the case of sums payable by way of tax, duty, cess or fees under any law; contribution to provident funds, superannuation funds, gratuity funds or the funds for the welfare of employees, bonus and interest payable to public financial institutions, State Finance Corporations and State Industrial Development Corporations.

3.24 The Committee considered this matter in detail on the basis of several oral and written representations. We are firmly of the view that the use of tax law for such collateral purposes, quite apart from complicating the law, is unfair and unjust, as it militates against the principle of taxation of real income. However, considering the vital need to ensure prompt collection of revenue, the Committee would recommend that the provisions of Section 43B should be restricted to taxes, duties etc., levied under any law for the time being in force and that other items like contributions by the employer to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees, sums referred to in clause (ii) of sub-section (1) of Section 36 and interest on any loan or borrowing from any public financial institution should be taken out of the purview of Section 43B.

Reconstruction and Other Arrangements of Companies

3.25 The provisions of the Income-tax Act, in so far as they relate to liability to capital gain tax, do not apply to transfer in a Scheme of Amalgamation, by the amalgamating company to the amalgamated company and/or a shareholder in a Scheme of Amalgamation. Section 45(b) of the Gift Tax Act also provides that the Gift Tax Act shall not apply in respect of the gifts made by any company to an Indian company in a Scheme of Amalgamation. Provisions relating to Amalgamation of Companies are contained in Chapter V of the Companies Act which deals with Compromise, Arrangement and Reconstruction including Amalgamation. The provisions of the Companies Act relating to the Scheme of Amalgamation, Arrangement, Compromise and Reconstruction are similar. Under the relevant provisions of the Companies Act, in this regard, an application has to be filed in the High Court having jurisdiction, seeking a direction necessary to convene a general meeting of the Members, and where necessary, the creditors of the company. The procedure laid down ensures that before any scheme is approved, the High Court can take into account the views and objections, if any, of the Central Government, of the shareholders as well as of the creditors of the company, and under certain circumstances, of the Company Law Board. There is, therefore, no likelihood of the abuse of the scheme to defraud revenue, the shareholders or the creditors of the company. In view of this, the Committee suggests that no capital gain tax and/or gift tax should be levied in the case of Compromise, Arrangement and Reconstruction, as in the case of Amalgamation and suitable provision be made in the Income-tax Act and the Gift-tax Act in this regard. Suitable amendment can be made to Section 49 of the Income-tax Act to include such a mode of acquisition also therein so as to ensure that the transferee

under such a scheme does not avoid a tax on capital gains when he himself transfers an asset acquired under the Scheme.

3.26 Section 2(22) of the Income-tax Act defines "dividend". Sub-clause (a) provides that any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails release by the company to the shareholders all or any part of the assets of the company will be treated as "dividend". In order to remove any doubt or controversy as to the taxability of any shares or assets received by a shareholder in a Scheme of Amalgamation, Compromise, Arrangement or Reconstruction as dividend, it may be clarified that provisions of Section 2(22)(a) will not apply in the case of any Scheme of Amalgamation, Arrangement, Compromise and Reconstruction.

3.27 The aforesaid amendments will be conducive to the policy of the Government to reduce concentration of economic power and to encourage its wide dispersal.

Taxation of Non-residents Including Indian Branches of Foreign Companies

3.28 India has always recognised that foreign private capital and investment play an important complementary role in our economic development process, particularly through the transfer of resources, managerial and technical expertise and technology itself, which result in the expansion of productive capacity and employment as well as in the establishment of and access to export markets. However, for a variety of reasons, our policy in regard to entry of private capital was highly restrictive. In the context of greater integration or globalisation of the world economy, our restrictive policy has since undergone a major transformation. We now welcome foreign investment in a much larger area of economic activity with the minimum of fetters. The Committee considers that in this context we should examine our present direct tax regime for non-residents, including foreign companies.

3.29 Taxation has a significant impact on international investment and financing decisions. All aspects of host country taxation like the tax rates, the extent of transparency and simplicity of the tax regime and its responsiveness to the genuine concerns of the taxpayer are taken into account by the prospective investor.

3.30 In a situation where the investor has a choice of countries that have reasonably sound economies and stable political regimes, as exists today, we will have to be competitive in regard to all relevant considerations that the non-resident/foreign company would take into account when taking an investment decision. The Committee is of the view that the Government should keep this aspect in mind, while formulating non-resident tax policy.

a. Source rules and withholding provisions

3.31 In line with the almost universal practice in this regard, while we tax the total world income of all residents (other than those not ordinarily resident), it is only income received or deemed to be received in India or which accrues or is deemed to accrue in India, that is taxable in the case of non-residents. Elaborate source rules as to what income would be deemed to accrue or arise are laid down in Section 9 of the Income-tax Act.

3.32 As far as business income is concerned, taxable income of non-residents would include income accruing or arising through or from any business connection in India. In the case of residents of countries with which we have Double Taxation Avoidance Treaties, it is only if they have what is referred to as a Permanent Establishment, as defined in the Treaty concerned, that their business income will be taxable in India. Even then, the general rule is that only income attributable to that Permanent Establishment would be taxed here.

3.33 Similarly, there are source rules also for income from property, capital gains, etc., but they are not as significant as the rules regarding dividend, interest, royalty and fees for technical services. In the case of these four categories of income in the hands of a foreign company, taking into account the difficulty in computing the taxable or total income after deduction of expenses, tax at a lower rate than that applicable to their business or other income is levied on the gross receipts under these heads. Thus, in the hands of a foreign company, dividend and interest are taxed at 25 per cent and royalty and fees for technical services at 30 per cent. Following the principle of restricting source country taxation rights on such incomes in a treaty situation, these rates are lowered to the 10 to 20 per cent range in most of India's Double Taxation Avoidance Treaties.

3.34 Special provisions have also been enacted for computing profits and gains of certain businesses like shipping, exploration of mineral oils, operation of aircraft and of civil construction in certain turnkey power projects undertaken by non-residents or foreign companies. In these cases also, the intention is that disputes as to the quantum of income assessable in India should be minimised. However, the Committee noticed in the course of our discussions with various industry and trade associations as well as with officers of the Department, that there is a substantial difference of opinion between the taxpayers on the one hand and Revenue on the other, regarding the actual computation of the non-resident's income from these sources which would attract tax in India. This matter assumes great significance in view of the provisions of Section 195 of the Income-tax Act, 1962, which basically require that any person responsible for paying income other than interest on securities, salary or dividend to a non-resident (including a foreign company) shall, either at the time of credit of such income to the account of the payee or at the time of actual payment, whichever is earlier, deduct income tax thereon, at the rates in force.

3.35 The Section provides further that any person responsible for making such payment to the non-resident, who considers that the whole of the sum would not be income chargeable to tax in the case of the recipient, may make an application to the assessing officer, who would then determine the appropriate proportion of the receipt, that would become taxable. Tax need then be deducted only on the proportion so decided. The assessing officer's order in this regard is also appealable.

3.36 In the course of evidence before us, it was repeatedly alleged that in so determining the proportion taxable, most assessing officers take a very unreasonable view, both in regard to what part of the receipt would be taxable in India on the basis of receipt or accrual, including deemed accrual, and in regard to what proportion of gross receipts would constitute net income, after the deduction of expenses.

b. Turnkey projects

3.37 It is a well accepted principle that where a non-resident contractor undertakes a turnkey project, say, for providing facilities for exploration or production of mineral oil and gas, income accruing to it would have to be apportioned between various activities carried on by it, some of it within India and some outside. It is only in relation to the activities performed in India that income would accrue here. The broad principle laid down in Circular No: 1767 of July 1, 1987 issued by the CBDT is still valid, after the enactment of Section 44BB of the Income-tax Act. The aggregate amounts specified in sub-section (2) of Section 44BB can only be those in relation to activities performed within India. It is on such aggregate amounts that the percentage laid down in sub-section (1) of Section 44BB would apply.

3.38 In other words, while Section 44BB overrides the provisions for computation of business income contained in Sections 28 onwards, as provided therein, it cannot and does not vary the provisions of

Section 5 in regard to the scope of total income and of Section 9 which extends such scope through certain deeming provisions.

3.39 The Committee is of the view, particularly in the light of the need to attract foreign investment, that the determination of the proportion of income taxable in India should be done within a reasonable time and that the determination itself should be fair and just, both in regard to the proportion that would be taxable in India and in regard to the determination of deductions in computation, where no specific percentage has been laid down in the law itself. The Committee would also suggest that the Government may consider extending the estimated income approach contained in Sections 44B to 44BBB to further areas of business activity as that would reduce substantially areas of uncertainty and the resultant disputes. Simplicity, transparency and perceived fairness are essential to attract maximum foreign investment.

3.40 There is considerable merit in the suggestion made before us that the recipient of income (and not only the person responsible for paying it), should also be allowed to make an application to the assessing officer, under sub-section (2) of Section 195, to determine the appropriate proportion on which the "person responsible" should deduct tax. The Committee would, therefore, recommend that the provision may be amended suitably.

3.41 The Finance Minister had, in his 1992-93 Budget Speech, announced his intention to introduce the system of advance ruling, as a first step, in the case of non-residents. This is a very welcome move because foreign companies and other non-residents proposing to do business with or to invest in India can know the extent of taxation in advance and accordingly make their decisions. The Committee should, however, express its concern that no further steps, like giving the proposal the required legal sanction and instituting or constituting the body that would render such advance rulings have been taken. In this connection, it is necessary to ensure that action taken would be such as would inspire confidence in the public mind, regarding the competence and independence of the authority in charge of providing advance rulings.

c. Branch profits

3.42 Traditionally, several foreign companies had been carrying on their marketing (and even manufacturing) operations in India through their branches. However, thanks to the very restrictive policy in this regard and even in regard to the proportion of foreign participation in Indian subsidiaries or associates, branch functioning except in the Banking industry had almost disappeared. Under the new liberalised policy, however, many enterprises may set up branches in India in the future. In the case of foreign direct investment in Indian (domestic) companies, the company first pays the domestic corporate tax and the foreign shareholder is subject to withholding tax either at 25 per cent or at the lower percentage agreed to between India and his/its country of residence in a treaty. In the case of the branch, no dividend is declared in India and so the dividend out of Indian profits bears no Indian tax. Tax neutrality between the two modes of investment is generally sought to be achieved by either levying a branch tax over and above the regular corporate tax on the branch or by levying a higher rate of tax on foreign corporate bodies. India has chosen the second alternative. Our present foreign corporate tax rate is 65 per cent as against a domestic corporate tax rate (including surcharge) of 51.75 per cent in the case of widely held companies. Clearly, this difference is quite high even at the withholding tax rate of 25 per cent on dividends paid to foreign companies, taking into account the fact that as a general rule, only about half the after tax profit is distributed as dividend. (In fact, the effective average withholding rate for foreign direct investment would not exceed 15 per cent since we have a network of tax treaties covering a large number of developed

countries.) Assuming a domestic corporate tax rate of 40 per cent, the after-tax profit of the Indian company would be 60 per cent of pre-tax profit. Assuming that half of it is declared as dividend, the withholding tax, at 25 per cent would work out to 7.5 per cent of the pre-tax profit. Therefore, the differential between domestic and foreign corporate taxes should be around 7.5 percentage points and in any case should not exceed 10 percentile points.

d. Double taxation

3.43 A foreign company performing technical services for an Indian resident pays tax at 30 per cent of the gross fees for such technical services, in the absence of a double tax avoidance treaty. If its employees work in India beyond a certain number of days, then their salaries are also subject to tax in India. It was represented that such double taxation causes great hardship in several cases. The law should be amended to make it clear that such salaries will be exempt from Indian tax.

e. Exemption of interest paid abroad in some cases

3.44 A reflection of the earlier thinking favouring debt against equity in relation to foreign investment is seen in the provisions of Section 10(15)(iv) of the Income-tax Act wherein interest payable by the Government and various types of industrial undertakings and financial institutions on borrowing abroad is exempt from tax, subject to the conditions laid down in that Section. There is need to remove this bias in favour of debt financing through such fiscal intervention. Besides, the process of simplification and introduction of lower tax rates can be achieved only if such tax expenditures and incentive provisions are removed. The cost of such provisions in terms of revenue foregone is quite high. Besides, in the absence of tax sparing by the home country, the beneficiary of the tax concession is not the investor but the treasury of the developed country. For example, India has recently entered into a Double Tax Avoidance Agreement with the United States (US), a country which has consistently rejected the idea of tax sparing, that, is allowing credit against US tax otherwise due for tax waived or spared by India through incentive provisions like those contained in Section (10)(15)(iv) referred to above. It is, therefore, essential for the Government to consider whether the provisions of Section (10)(15)(iv) should continue resulting in substantial loss of revenue to us with no benefit or incentive being provided to the investor; the loss to Indian revenue being the gain to the treasury of the other country. This consideration becomes stronger, when tax rates are reduced.

f. Transfer pricing

3.45 A serious problem facing tax authorities around the world dealing with taxation of foreign investors is the question of Transfer Pricing. Transfer Pricing, as it is generally understood, refers to the value attached to transfers of goods, services and technology between related entities like a branch and headquarters or different branches of the same company or between a parent company and its subsidiary or brother-sister corporations with various degrees of common ownership or control. There is an abuse of the Transfer Pricing mechanism used between associated enterprises when the prices for goods or services are fixed, not on objective or market related considerations, but in such a way as to save tax by minimising profit in the country where the tax rate is higher. Transnational Corporations (TNCs) increasingly structure their foreign investments in a package consisting of equity participation, long-term debt, technological licences as well as management services. Technological progress in computerisation and telecommunications enables them to fine tune centralised decisions in regard to prices for the various constituents of their participation, taking into account the tax laws, tariffs, exchange control regulations, regulations regarding profit remittances, inflation levels and even the likelihood of political upheavals, or expropriations, etc., in

all the countries in which they operate. Besides, even if other Government policies like effective tax rates, tariffs, exchange control or profit remittance regulations were completely neutral, corporations would still choose the locations of generation of their profits, taking into account the comparatively high expenditure requirements, better investment prospects in terms of opportunity cost of money for company generated funds, overall business strategy and the like. TNCs are also averse to disclosing very high profits in developing countries for political and public relations reasons as well.

3.46 While there can be no doubt that a "correct" Transfer Pricing must be one which is fair to both the host countries and the TNC concerned, the difficulty arises because of the problems involved in arriving at an appropriate arm's length price. Almost always, there is a wide range of defensible transfer prices. Even tax administrations in developed countries have found it extremely difficult to establish adequate control against the abuse of Transfer Pricing. The Committee is, therefore, of the view that no useful purpose would be served by expending our modest resources in this direction at the moment. Perhaps, what is needed is to develop International Tax Information for which the best agency would be the UN Group of Experts on Tax Treaties between Developed and Developing countries. Prof. Stanley Surrey's idea regarding the setting up of what might be called 'Intertax', an institution analogous to 'Interpol' to facilitate the international flow of information needed for tax compliance should be revived. In this, our representative in the UN Group can take an active role. In the meantime, however, the Income Tax Department should seek to establish a reputation that India has firm views against abuses of the Transfer Pricing mechanism.

g. Income expressed in foreign currency

3.47 It was pointed out to us in the course of evidence before the Committee that Rule 115 of the Income-tax Rules, 1962, which prescribes the rate of exchange for conversion into rupees of income expressed in foreign currency, in the manner in which it is presently interpreted, is causing considerable hardship to non-resident taxpayers. The real purpose of Rule 115 is to enable quantification in Rupees, for the purpose of taxation of income in India of sums constituting income, expressed in foreign exchange. Where such quantification is already available by way of the number of rupees laid out to buy the foreign exchange or the number of rupees actually received on inward remittance, then resort to the Rule is not really contemplated. However, the Rule has been somewhat widely worded, leading to the unintended situation set out in the para below. Payments like, royalty and fees for technical services, are often expressed in dollars or other convertible currency. Where the income concerned has already been remitted during the accounting period, the rate of conversion should be that at which the foreign currency in question was actually purchased for the purpose of remittance. Similarly, where the non-resident is paid directly in foreign exchange abroad with no remittance from India, as often happens in the case of bilateral credits extended by foreign governments, the rate of conversion should be that applicable on the day the non-resident receives payment.

3.48 Thus, for example, if US$ 100 by way of royalty was remitted by a resident in India to a non-resident, say, in April 1991, and at that time the rate of exchange was $ 1 = Rs.18, the income assessable in the hands of the non-resident should be Rs.1,800 only. Instead, the application of the Rule which links the conversion to the last day of the "previous year" (accounting period) of the non-resident, particularly in a year like the one that ended on 31st March, 1992 would create considerable distortions. In the example cited above, if the rate of exchange on 31.3.92 is US $ 1 = Rs.30, although only Rs.1,800 was actually paid to the non-resident, the income assessable would be Rs.3,000. This would also cause hardship to the Indian resident because the deduction of

tax at source would have been made on the basis of rate of exchange prevailing at the time when the remittance was actually made or when the amount was credited to the account of the non-resident, whichever is earlier. The recent decision of the Bombay High Court in Chowgule and Co. Ltd vs Commissioner of Income Tax (CIT) [1992] 195 ITR 810 also supports the Committee's view in this regard.

3.49 As far as inward remittances are concerned, this anomaly was avoided by the insertion of sub-rule (2) in Rule 115 which reads as under:

> "Nothing contained in sub-rule (1) shall apply in respect of income referred to in clause (c) of the Explanation to sub-rule (1) where such income is received in, or brought into, India by the assessee or on his behalf before the specified date in accordance with the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973)."

3.50 A minor amendment of sub-rule (2) to provide for situations where the income is received by the assessee or on his behalf outside India before the specified date would solve this problem. The amended sub-rule (2) can read as given below:

> "Nothing contained in sub-rule (1) shall apply in respect of income referred to in clause (c) of the Explanation to sub-rule (1) where such income is received in, or brought into, India by the assessee or on his behalf or is received by the non-resident or on his behalf outside India before the specified date in accordance with the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973)."

3.51 In view of the magnitude of the devaluation of rupee that took place during the accounting period that ended on 31st March, 1992, the Committee would further recommend that taking into account this exceptional circumstance, the amendment should be given retrospective operation to cover income for the accounting period 1991-92, i.e., the income relevant to assessment year 1992-93.

Treatment of Losses

3.52 The present provisions regarding carry forward and set off of losses in the Income-tax Act are very complicated and cause considerable confusion in the minds of most persons. They also have the effect of further complicating an already somewhat difficult to understand return of income that taxpayers have to fill up every year. The Committee has already stressed the need for having a fairly comprehensive income concept for the purpose of taxation of income. To the extent that income from certain sources enjoys complete or partial exemption, there is a case for schedular treatment of losses. Exception may also be made in the case of losses arising from speculative activity. For example, in regard to capital gains, the need for the special provisions arises only because of the existing tax exemptions like that on inter-corporate dividends (Section 80-M); deduction of certain dividend, etc., incomes upto Rs.7,000 (Section 80-L) and exemptions in regard to certain interest incomes of public sector bonds. If these exceptions are removed from the statute, loss under the head 'Capital Gains' can also be freely set off against other incomes. However, the recent amendment to Section 71 and introduction of a new Section 71-A extend schedular treatment to loss from house property even though the income from house property continues to be given a non-schedular treatment for income tax purposes. To this extent, this recent amendment is not in consonance with either the scheme of comprehensive income taxation or schedular form of taxation.

3.53 Like exemption of income from taxation, schedular treatment of losses also violates the principle of both horizontal and vertical equity. Further, the condition that the business in which the loss carried forward to

a subsequent year was incurred should be carried on in that year also if such loss is to be set off against that year's business income forces uneconomic and unviable units to keep "alive" leading to inefficient allocation of scarce resources. These inequities in the existing scheme of set off and carry forward of losses need to be corrected.

3.54 In the light of the above, the Committee recommends as follows:

a. The amendment to Section 71 and introduction of a new Section 71A in the Income-tax Act by the Finance Act, 1992 extending schedular treatment to loss from house property should be revoked.

b. The losses carried forward for set-off in the subsequent years separately under each head of income like, 'income from house property', or 'profits and gains from business or profession' (other than losses from speculation business or from the activity of owning and maintaining race horses) and 'other sources' should all be allowed *inter se* set-off.

c. The condition that the business to which the loss relates should be carried on in the subsequent year in order that the business loss carried forward from the earlier year is allowed to be set off should be removed.

3.55 One exception to the general rule regarding carry forward and set off of business losses, which has been introduced as an anti-avoidance measure is contained in Section 79 of the Income-tax Act. Before its amendment in 1988, the Section in effect provided that in the case of a closely held company, the benefit of carry forward and set off of losses would be allowed only if the shareholders exercising 51 per cent of the voting power as on the last day of the relevant year remained unchanged in comparison to the last day of the year or years in which the loss was incurred or if the assessing officer is satisfied that the change in shareholding was not effected with a view to avoiding or reducing any liability to tax. The restriction in regard to set off of carried forward of loss laid down under Section 79 as it originally stood, thus, applied only when there was a substantial change in shareholding and such change had been effected with a view to avoiding or reducing any liability to tax. The second limb of the Section regarding the assessing officer's satisfaction that the change in shareholding was not effected with a view to avoiding or reducing the liability to tax was deleted from Section 79 by the Finance Act, 1988 with effect from 1st April, 1989. The result was that a mere change in substantial shareholding, even when there was no intention whatsoever to avoid or reduce tax liability, led to the closely held company losing the benefit of carry forward and set-off of accumulated losses and unabsorbed depreciation.

3.56 While the practice of buying losses through the acquisition of loss-making companies cannot be denied, the Committee is of the view that in the larger interest of the economy, the provision should either be deleted or should be restored to its original unamended form. This is because in the case of several sick industrial undertakings, the only hope for their revival is through new promoters replacing those who have failed before. The entry of such new promoters would automatically involve substantial change in shareholding and if such a change would result in the denial of the benefit of set off in regard to carried forward losses, revival of sick industrial undertakings atleast in the case of closely held companies would not be possible.

Treatment of Charities and Charitable Organisations under the Income-tax Act

3.57 In recognition of the useful and supplementary role that private charities perform in relation to relief of the poor, education, medical relief and other objects of general public utility, the income tax and other direct tax enactments contain various

provisions for exemption of tax in relation to charitable entities. The Committee does not propose to discuss in detail the present position of the law in this regard. However, in the course of our deliberations, the Committee has noticed that there is considerable scope for improvement in the matter of administration of the existing provisions. It has been stressed that there is much delay in dealing with applications for registrations under Section 12A of the Income-tax Act and for approval under clause (vi) of sub-section (5) of Section 80G. Even before such approval was specifically incorporated in the Income-tax Act by the Finance (No.2) Act 1991, the practice used to be for charitable organisations to seek and obtain the approval of the Commissioner concerned because in the absence of a specific statement regarding the Commissioner's approval, the donations would not be forthcoming.

3.58 At present the same Commissioner or Director of Exemptions considers the application for registration under Section 12A as well as the application for approval under Section 80G. The Committee would, therefore, suggest that in relation to any newly set-up charitable trust or institution, applications under Section 12A and under sub-section (5) of Section 80G should be processed together and with utmost expedition. In the course of evidence before the Committee, several organisations and individuals complained about great delays in granting approval under Section 80G. It was mentioned that such approvals for periods ending on the last day of the financial year are often granted towards the end of such financial year, rendering the approval practically worthless as the time to receive donations on the basis of the approval is very limited. The Committee would, therefore, recommend that all applications for approval under Section 80G should be promptly disposed of and at any rate within a period of three months from the date of receipt of application. The Committee would further suggest that approvals as well as renewals of approvals under Section 80G, once granted, should be valid for a period of five years beginning with the financial year in which the approval or renewal, as the case may be, is granted. This would considerably reduce infructuous administrative work on the one hand and unnecessary harassment on the other. The danger of abuse of such approvals for longer periods as suggested above, is minimal in view of the requirement that such charitable organisations shall file returns of income on an annual basis.

3.59 Sub-section (4A) of Section 11 provides that the exemption in relation to income of a trust or institution under that Section shall not apply in relation to profits and gains of a business unless the business is incidental to the attainment of the objectives of the concerned organisation and separate books of accounts are maintained in respect of such business. The Committee is given to understand that the question as to whether a particular business is incidental to the attainment of the objectives of the charity concerned has been the subject matter of several disputes. In order to reduce the area of dispute, atleast in relation to smaller cases, the Committee would suggest that where the income from business is not more than Rs. 5 lakh, such business income may, subject to other conditions being fulfilled, be exempt regardless of whether the business is incidental to the attainment of objectives of the trust or institution or not. This would cut out a lot of administrative work and the smaller charitable organisations would be spared the trouble of pursuing disputes in this regard.

3.60 Section 13 of the Income-tax Act lays down several circumstances under which the exemptions available under Section 11 or Section 12 would stand withdrawn. One of these is the enjoyment of certain types of benefits by those who may, for the sake of convenience, be referred to as "interested persons" Such persons are defined in sub-section (3) of Section 13 and include *inter alia* any person who has made a substantial contribution to the trust or institution. The substantial contribution itself

has been laid down as a sum exceeding Rs 25,000. It has been repeatedly urged before the Committee that strict application of this provision would have the result of denying exemption to several genuine charitable organisations which might provide certain benefits to "substantial donors" either on the same lines as those extended to others or otherwise. The benefits could include free stay or stay on concessional rent in any buildings owned by such organisations. The Committee is of the view that there is considerable merit in the submissions made before it. We would, therefore, suggest to the Government that this entire matter may be examined with a view to avoiding hardship in genuine cases. In the meantime, the Committee would recommend that the monetary limit of Rs.25,000 which is indeed very low should be enhanced to at least Rs.50,000. The Committee would further recommend that if the "interested person" gets only the same degree of benefit that others also get in matters like free or concessional rents, then such benefit should not have the effect of denying the exemption to the charitable organisations.

3.61 Sub-section (4A) of Section 139 of the Income-tax Act requires charitable organisations claiming exemptions under Sections 11 and 12 to file returns of the income within the time limit provided in that section. All non-corporate charitable organisations would, under the existing law, have to file their returns on or before 31st August of the assessment year concerned. Considering the fact that charitable organisations often depend on voluntary work which could cause delays, the Committee is of the view that organisations that are required to file the return of income under sub-section (4A) of the Section 139 may be allowed to do so on or before 31st December of the assessment year concerned. The Committee would also suggest that the income limit for audit laid down in clause (b) of Section 12A should be enhanced from Rs.25,000 to atleast Rs.50,000.

3.62 The deduction under Section 80G, in most cases, amounts to 50 per cent of the donations made to certain funds, charitable institutions, etc., subject to the further limit that such deduction shall not exceed 10 per cent of the gross total income as computed in the manner laid down. Several representations were made before the Committee, urging that the deduction of 50 per cent as referred to above is inadequate to attract substantial donations to worthy charities. The Committee is firmly of the view that while charity is indeed a desirable objective, there is no case for making it more attractive at the expense of Revenue. Therefore, the Committee considers that the present provisions in regard to the quantum of relief under Section 80G are quite adequate and further that the deduction of hundred per cent in respect of contributions should be restricted to the Prime Minister's National Relief Fund only.

3.63 Exemption for charity, it had been noticed, was freely abused as a tax evasion device by several persons. That resulted in the introduction of several "policing" or restrictive provisions in the law in this regard. Based on the dates from which various restrictive provisions were introduced in the Act, the provisions of the law are different for charities set up before or after certain dates: first day of June, 1973, first day of March 1983, etc. While the historical basis for these distinctions cannot be ignored, the Committee is of the view that effort should be made to make the law uniform for all charitable organisations, if necessary by giving adequate time to the older charities to fall in line with the present requirements regarding investment pattern, need for the trust or institution being wholly (and not only partly) for the benefit of public charitable or religious purposes, etc.

Interest Tax

3.64 There is no rationale for the interest tax. It is widely recognised that the interest rate, like any other price, should be allowed to play its legitimate role in the

allocation of financial savings. The interest tax enters as a wedge between the reward to the savers and the return on investments. We recommend abolition of this tax; the revenue lost thereby should be recouped by the levy of some of the taxes on services that we have recommended.

Gift Tax

3.65 An argument given for the abolition of the gift tax is that it is anomalous or redundant to continue it after the abolition of the estate duty. Of course, one could argue the opposite case and plead for the re-introduction of the estate duty or an inheritance tax. While a theoretical case can be made out for the introduction of the inheritance tax with a moderate single rate of tax, given the many practical problems that are likely to be created as under the erstwhile estate duty and given the fact that even the existing direct taxes are not being enforced efficiently, the Committee does not recommend that a tax on estates passing at death or inheritances should be contemplated in the near future. We should for the time being concentrate on bringing into existence a fairly clean, efficient and productive system of direct taxes containing only the four major elements, namely, tax on corporate profits, tax on personal income including the income of non-corporate business entities, the wealth tax on unproductive assets and the gift tax.

3.66 The Committee favours the continuance of the imposition of the gift tax. Even though the top marginal rate of income tax as well as the spread between the rates have been reduced, gift of assets to individuals other than minor children could still be used as a means of reducing the total tax liability of a family (either nuclear or extended). A tax on gifts is, therefore, necessary as a means of discouraging such transfers. Also the gift tax cannot be said to affect incentives or lead to any inequity.

3.67 The exemption level of Rs.20,000 was fixed in 1985. Considering the rise in prices and the increase in the threshold level for income tax, gifts in a year not exceeding Rs.30,000 may be exempted from the tax.

Taxation of Agricultural Income

3.68 We have received many representations to the effect that some way must be found to bring agricultural income within the ambit of the Central income tax. It is well known that the splitting of the Constitutional responsibility for taxing non-agricultural and agricultural incomes between the Centre and the States leads to the violation of the principle of horizontal equity, even if the State governments were independently taxing agricultural incomes, unless both the Centre and the States were levying proportional income taxes. But in fact, the States hardly levy any tax on agricultural income except for income from plantations. Thus virtual exemption from income taxation is given to most agricultural incomes. This not only leads to narrowing of the base and horizontal inequity, but also opens up a large loophole for the evasion of tax on non-agricultural income, since part of one's non-agricultural income can be passed off as agricultural income.

3.69 However, under the present circumstances, the States, at least a majority of them, are unlikely to agree to delegate their power to tax agricultural income to the Central Government. Apart from this political reality, some would argue that given the law stipulating ceilings on agricultural holdings, which are at least legally and formally observed, the yield of tax on agricultural income is unlikely to be substantial. There is also a fear that the rather unsophisticated agriculturists are likely to be harassed by the officials of the Income Tax Department even more than their urban counterparts. On the other hand, we find that the inclusion of agricultural income only for the determination of the rate of tax on a taxpayer's non-agricultural income has not served much purpose. We feel that some thing should be done to plug the loophole for evasion arising from the exclusion of agricultural income without subjecting

genuine agriculturists to unnecessary trouble and harassment. While agriculturists whose income consists of only agricultural income and small agriculturists who may have some non-agricultural income but whose agricultural income is, say, below Rs.25,000 per annum may not be brought within the tax net, there is no reason why one should not bring under tax, the agricultural income of non-agriculturists. It could be laid down that in the case of individuals or any other entities having income from non-agricultural sources above the exemption level and also income from agricultural sources above Rs.25,000, agricultural income in excess of Rs.25,000 accruing to the concerned entity should be aggregated with non-agricultural income and the tax should be levied on the total of such aggregated income. Suitable marginal relief should also be provided. Agricultural income for this purpose will not include income from plantations subject to taxation by the States. Since the calculation or determination of agricultural income is necessary even under the existing provisions, if a non-agricultural assessee has such an income, there would be no additional administrative work to the Department or trouble or harassment to the assessees. At the same time, genuine agriculturists and small agriculturists will be left out. In the interest of equity and for reducing evasion, the Committee recommends that the Central Government should obtain the cooperation and consent of the State governments for enacting a provision which would enable it (the Central Government) to bring under the purview of the Central income tax, agricultural incomes in excess of Rs.25,000 of those non-agricultural assessees whose non-agricultural incomes are above the exemption level. The entire tax yield attributable to the agricultural component of income could be distributed among the States on the basis of origin.

3.70 It should be pointed out that the provisions for the taxation of agricultural income by the Central Government that we have recommended would not affect those agriculturists who -

a. have agricultural income not exceeding Rs.25,000 per year; or

b. have non-agricultural income not exceeding Rs.28,000.

This means that agriculturists who have only agricultural income or who have also non-agricultural income but have agricultural income not exceeding Rs.25,000 will be left out. Thus, the tax will fall mainly on the larger non-agricultural assessees whose agricultural incomes exceed Rs.25,000.

TABLE 3.1

Corporate Income Taxation in Selected Countries:Tax Rates

Country	Assess-ment year	Corporate income tax rates: Domestic company (%)	Corporate income tax rates: Foreign company (%)	Remarks
(1)	(2)	(3)	(4)	(5)
Australia	1992	39	39	LTCGs are not taxed, excess retentions taxed at 50%.
Belgium	1993	39	43	In general, LTCGs are not taxed, lower tax rates apply if income is less than BF 13 million.
Brazil*	1992	30	30	Special tax of 40 to 60% on remitted amount is payable if average of remittances of three consecutive years exceeds 12% of registered foreign capital. Shareholders have the choice to treat withholding tax of 8% on total profits (irrespective of distribution) or with- holding tax on distributed profits at a higher rates as the final tax.
Denmark	1992-93	38	38	Withholding tax of 30% on dividends is final tax if domestic dividends do not exceed 30,600 DKr. per year for a single individual. Any dividends in excess of this figure are subject to an additional income tax of 15% imposed by assessment.

Notes: * With effect from the assessment year 1994, withholding tax on dividends is not to apply, thereby dividend will be exempt from income tax in the hands of shareholders.

LTCGs : Long Term Capital Gains

TABLE 3.1 (Contd.)

(1)	(2)	(3)	(4)	(5)
France	1993	34	34	LTCGs are taxed at 18%. An annual lump-sum minimum tax based on the corporations turnover is payable. A tax credit (avoir fiscal) of 50% of distributed dividends is given to the shareholders.
Germany	1993	50	46	Tax on distributed profits is 36% for which tax credit is allowed against income tax liability of a shareholder.
India	1993-94	45,50	65	In specified cases, royalties and technical fees received by foreign companies are taxed at 50%. Dividends received by corporate shareholders from domestic companies are eligible for 100% deduction subject to specified conditions and exemption from withholding tax is also available to non-corporate shareholders under certain circumstances.
Indonesia	1992	15-35	20	A final withholding tax at the rate of 20% is charged on gross income (including dividend) of non-residents. Withholding tax for residents is at the rate of 15%.
Japan	1993-94	37.5	37.5	If capital employed in the corporation is less than Yen 100 million, then first Yen 8 million of annual income is taxed at 28%. Option to the shareholders of choosing final withholding tax of 35% on dividends subject to certain conditions. A special temporary surcharge of 2.5% will apply to corporation tax in excess of 4 million for the years 1993-94 and 1994-95.
Korea	1992	20,34	20,34	Additional tax of 25% on excessive accumulated profits of unlisted large-scale corporations. Corporation income tax on distributed profits is treated as withholding tax on dividends on behalf of shareholders.

TABLE 3.1 (Contd.)

(1)	(2)	(3)	(4)	(5)
Luxembourg	1992	33	33	
Malaysia	1992	35	35	Corporate income tax on distributed profits is treated as withholding tax on dividends on behalf of shareholders.
Mexico	1992	35	35	Dividends paid out of profits already taxed are exempt or are subject to a final 35% tax if not so paid.
Nepal	1992	40	40	There is no corporate income tax on distributed profits.
New Zealand	1992	33	38	Corporate income tax on distributed profits is treated as withholding tax on dividends on behalf of shareholders.
Nigeria	1991	40	40	For companies engaged in agricultural production, etc., with annual turnover not exceeding N 500,000 the tax rate is 20%. Companies are liable to pay a minimum tax based on gross profit, net assets, paid-up capital and turnover. Enterprises engaged in agriculture or having at least 25% foreign equity capital are exempt from minimum tax.
Pakistan	1992-93	30	30	A minimum tax equal to 0.5% of turnover is payable. There is no corporate income tax on distributed profits.
Philippines	1992-93	35	35	No personal income tax on dividends received from domestic companies.

TABLE 3.1 (Contd.)

(1)	(2)	(3)	(4)	(5)
Singapore	1993-94	30	30	Shareholders receiving dividend from domestic companies are allowed a tax credit for the corporate tax attributable to the dividends received. No tax on capital gains.
Sri Lanka	1993-94	40,45	40,45	Small companies are taxed at lower rates. Tax is withheld on dividends payable to the shareholders for which a tax credit is allowed against their personal income tax liabilities.
Taiwan	1992-93	15-25	15-25	If a company does not distribute profits each year, the shareholders are, in effect, taxed as if they received a deemed dividend. System of withholding tax on dividends payable is prevalent.
Thailand	1993-94	30	30	Shareholders can choose to pay final withholding tax of 15% on dividends receivable from domestic companies. Alternatively, normal rate of withholding tax applies which does not exceed 15 per cent and they can avail of tax credit of 3/7th of the dividends against their personal income tax liabilities on dividends received.
U.K.	1992-93	35	35	Tax rate of 25% applies if income of the company does not exceed £250,000. No withholding of income tax on dividends, but the company paying the dividend is liable to pay advance corporate tax (ACT) amounting to 1/3rd of the dividends to be set off against its corporate tax liability (CT). The ACT payment is imputed to the shareholders as a tax credit against their income tax liabilities on the dividend plus credit.

TABLE 3.1 (Contd.)

(1)	(2)	(3)	(4)	(5)
U.S.A.	1990-91	15-34	15-34	Tax rate of 34% applies to income in excess of US$ 75,000. In addition, 5% tax applies on taxable income between $100,000 and $335,000.
Zambia	1992-93	45	45	A final tax of 30% is withheld on dividends payable to the resident shareholders.

Sources: The following publications of International Bureau of Fiscal Documentation:

i. European Taxation for Belgium, Denmark, France, Germany, Luxembourg and the United Kingdom.

ii. Corporate Taxation in Latin America for Brazil and Mexico.

iii. African Tax Systems for Nigeria and Zambia.

iv. Taxes and Investments in Asia and the Pacific for Australia, Indonesia, Japan, Korea, Malaysia, New Zealand, Nepal, Pakistan, Phillipines, Singapore, Sri Lanka, Taiwan, Thailand.

v. Tax News Service (upto April 1992) for updating the compilation based on the earlier publications.

TABLE 3.2

Funds in Hand on Account of Depreciation (33.33%) and Interest (15%) with Tax at 40%

(as per cent of cost)

Year end	Net worth of stock	Depreciation during year	Cumulative depreciation	Interest accrued (total)	Cumulative interest	Total funds in hand (depreciation + interest)
Initial position	100.00	0.333		9.00		
1	66.67	33.33	33.33			33.33
2	44.45	22.22	55.55	3.00	3.00	58.55
3	29.63	14.81	70.37	5.27	8.27	78.64
4	19.76	9.88	80.24	7.08	15.35	95.59
5	13.17	6.59	86.83	8.60	23.95	110.78
6	8.78	4.39	91.22	9.97	33.92	125.14
7	5.85	2.93	94.15	11.26	45.18	139.33
8	3.90	1.95	96.10	12.54	57.72	153.82
9	2.60	1.30	97.40	13.84	71.56	168.96
10	1.74	0.87	98.26	15.21	86.77	185.04

TABLE 3.3

Funds in Hand on Account of Depreciation (25%) and Interest (15%) with Tax at 40%

(as per cent of cost)

Year end	Net worth of stock	Depreciation during year	Cumulative depreciation	Interest accrued (total)	Cumulative interest	Total funds in hand (depreciation + interest)
Initial position	100.00	0.250		9.00		
1	75.00	25.00	25.00			25.00
2	56.25	18.75	43.75	2.25	2.25	46.00
3	42.19	14.06	57.81	4.14	6.39	64.20
4	31.64	10.55	68.36	5.78	12.17	80.53
5	23.73	7.91	76.27	7.25	19.42	95.69
6	17.80	5.93	82.20	8.61	28.03	110.23
7	13.35	4.45	86.65	9.92	37.95	124.60
8	10.01	3.34	89.99	11.21	49.16	139.15
9	7.51	2.50	92.49	12.52	61.69	154.18
10	5.63	1.88	94.37	13.88	75.56	169.93

TABLE 3.4

Funds in Hand on Account of Depreciation (22.5%) and Interest (15%) with Tax at 40%

(as per cent of cost)

Year end	Net worth of stock	Depreciation during year	Cumulative depreciation	Interest accrued (total)	Cumulative interest	Total funds in hand (depreciation + interest)
Initial position	100.00	0.225		9.00		
1	77.50	22.50	22.50			22.50
2	60.06	17.44	39.94	2.02	2.02	41.96
3	46.55	13.51	53.45	3.78	5.80	59.25
4	36.08	10.47	63.92	5.33	11.13	75.06
5	27.96	8.12	72.04	6.76	17.89	89.93
6	21.67	6.29	78.33	8.09	25.98	104.32
7	16.79	4.88	83.21	9.39	35.37	118.58
8	13.01	3.78	86.99	10.67	46.04	133.03
9	10.09	2.93	89.91	11.97	58.02	147.93
10	7.82	2.27	92.18	13.31	71.33	163.51

TABLE 3.5

Funds in Hand on Account of Depreciation (20%) and Interest (15%) with Tax at 40%

(as per cent of cost)

Year end	Net worth of stock	Depreciation during year	Cumulative depreciation	Interest accrued (total)	Cumulative interest	Total funds in hand (depreciation + interest)
Initial position	100.00	0.200		9.00		
1	80.00	20.00	20.00			20.00
2	64.00	16.00	36.00	1.80	1.80	37.80
3	51.20	12.80	48.80	3.40	5.20	54.00
4	40.96	10.24	59.04	4.86	10.06	69.10
5	32.77	8.19	67.23	6.22	16.28	83.51
6	26.21	6.55	73.79	7.52	23.80	97.58
7	20.97	5.24	79.03	8.78	32.58	111.61
8	16.78	4.19	83.22	10.04	42.62	125.85
9	13.42	3.36	86.58	11.33	53.95	140.53
10	10.74	2.68	89.26	12.65	66.60	155.86

4

STRUCTURAL REFORM OF THE EXCISE TAX SYSTEM

4.1 The Committee is of the view that there is no alternative to gradually transforming the present excise tax system, consisting of two parts, namely, (a) Modvat and (b) excise on gross value basis with no set off for some sectors, into a genuine VAT at the manufacturing level. Manufacturing under such a VAT should include also the "manufacture" of services although some services may be exempted on practical considerations. We would like to spell out the steps to be taken for bringing about such a transformation. Before we do that, however, it seems necessary once again to argue the case for a comprehensive non-cascading type of excises, although such a case is taken for granted in most countries today.

The Case for VAT

4.2 We have gained the impression that, in general, officers of the Excise Department have not been properly informed about the rationale and justification for introducing a non-cascading and non-distorting type of indirect tax. It is now agreed among fiscal experts all over the world that any extended system of indirect taxation, that is, a tax that applies to all or most commodities, will have to be in the form of either a retail sales tax or a VAT. The retail sales tax does not interfere with the processes of production, does not affect costs and has the further advantage of capturing the entire value added. However, a retail sales tax (that is, a tax that applies only to sales to non-producers) is found to be difficult to administer and may not be feasible for other reasons as well. The only rational alternative is a VAT.

4.3 It may be true to say that, administratively, it is easier to tax just the inputs and leave out the final products. However, the criterion of administrative convenience will have to be balanced against the other more important criteria such as a desirable pattern of incidence, minimisation of costs and of unintended interference with the choices of procedures. Besides, it is not possible to classify commodities into inputs and final products because that distinction depends also on the nature of use. A commodity purchased by a producer for use in manufacturing becomes an input, but the same commodity if purchased by a consumer becomes an output. As we show below, an extended system of excise or sales tax levied on a gross value basis, that is, one without the grant of credit for taxes paid on inputs, is undesirable from several points of view. If a VAT is to be avoided, then, as in the United States of America, excises must be confined to a few non-essential consumer goods such as tobacco, alcohol, motor cars and others. This is possible only if a major part of the tax revenue could be raised through direct taxes. Since that is not possible in India in the near future and since sales tax is leviable by the State governments, the Government of India has no alternative but to resort to an extended form of excise taxation.

4.4 An extended excise tax system of the cascading type, that is, one whose base at every stage includes the taxes paid at the earlier stages (gross value), can be shown to lead to four major types of undesirable consequences. First, such a system of taxation leads to an uncontrolled pattern of incidence on final products. With widespread taxation of both inputs and final products, it would not be possible to control the effective incidence of tax on different products and hence on different groups of consumers. The total effective incidence of any given final product at the end of the chain of production would be almost fortuitous and largely unknown to policy makers. It is only after a great deal of research that one could get an

idea of the pattern of incidence on consumers in different income or expenditure groups as at a given moment. But that pattern would keep changing with the changes in techniques of production, relative prices, etc. Nominal rates of taxes fixed for final products would give a misleading picture of incidence because the total effective incidence on different products could be vastly different. It is also to be noted that a heavy tax on an input for which no relief is given at later stages generally tends to be regressive. It places a greater burden (proportionate to price) on the varieties of products consumed by the poor than on those consumed by the rich. Theoretically, it is possible to offset this by varying the rates of tax on different varieties of the final product. However, in practice it would be extremely difficult to calibrate the rates on final products to get a desired pattern of incidence.

4.5 The second major defect of the extended system of cascading type of excises, such as that which existed before Modvat was introduced in 1986, is that the taxes on inputs levied at different rates lead to unintended changes in the relative prices of inputs and hence to changes in the proportions in which different inputs are used.[4] This result violates the rule that producers should not be unnecessarily made to change their decisions in regard to choice of inputs. Such interference could lead to serious economic distortions which the tax authorities or the Government cannot afford to ignore. Widespread taxation of inputs leads ultimately to an economically irrational tax structure, leading to inefficient use of resources.

4.6 The third major defect of an extended system of cascading type of excises is that it leads to avoidable increases in costs and the prices of inputs as well as of final products. Since the intention is to tax the final users, obviously, a system which can reach them without raising costs in the economy is to be preferred. But the cascading type of tax implies that the tax paid at earlier stages of production forms part of the cost of production at subsequent stages. Until the tax levied at the different stages are collected from the consumers/final users, it is borne by the producers and costs in the economy are increased thereby. Also, the final increase in price will be greater than the yield of the tax to the Government. This is because, when an input is subjected to excise and/or sales tax, the manufacturer who uses it needs a larger amount of working capital to maintain the necessary stock of inputs; hence the interest cost goes up. This happens at every stage and the increase in the price of the final product must compensate for that. Besides, a manufacturer, "works out his own profit margin as a percentage of his costs which include taxes, and arrives at a price by adding a higher quantum of profit. On this price, the excise on the finished product is worked out. Then comes the sales tax which is levied on the price inclusive of excise duty. Thereafter, the product goes to the wholesaler and then the retailer, each of whom once again, has to find a larger amount of finance which raises his costs and profit expectations. At each stage, the mark-up by producers and traders gets inflated because the profits which they seek to earn are related to the total capital which they employ, i.e., they would like to earn a certain rate of return on the capital employed, and the amount of capital employed, as explained above, inevitably increases, if the costs of inputs are raised on account of the indirect taxes levied on them. This snow balling or pyramiding effect, which is also referred to as 'cascading', raises the price of the final product to consumers by more than the sum total of the different taxes levied at intermediate stages. In other words, the increase in consumer prices due to cascading is not limited to what accrues to the Exchequer by way of revenue. The same amount of revenue may be raised with a smaller rise in the price of the final product and, therefore, a lower burden on the consumer, if a non-cumulative type of tax was imposed at the final stage of production, that is, on the finished product."[5]

4.7 It is sometimes argued by tax administrators in developing countries that

for administrative reasons the Government will have to content itself with taxing only inputs and a few selected final products. Taxing only inputs, such as raw materials and intermediate products, and exempting final products because they are produced by a large number of undertakings has all the drawbacks mentioned above, that is, fortuitous and uncontrolled incidence on final products and hence on consumers in different income groups, distortions in producers' choices and escalation in costs and cascading. And, of course, there is the further disadvantage that value added at the final stages of production will be left out and the rates have to be higher, which could induce greater evasion. Administrative convenience must no doubt be given due weight, but all other - quite important - social and economic considerations cannot be ignored. After all, the object is not to raise revenue at any cost or in the easiest way possible.

4.8 As in the case of income tax, so also in the case of excises and sales taxes, small "taxable units" will have to be exempt. In respect of Central excise, producers and manufacturers whose annual turnover is less than Rs.20 lakh are exempt. This rule has to be applied to all industries, possibly with a few exceptions. And there is no need or justification to hike up the tax on the raw material or inputs when the final product is not taxed because there are too many small producers. The tax burden in respect of such commodities may be low or lower than in respect of other commodities. That is only a necessary consequence of favouring small producers. As pointed out earlier, heavy taxes on inputs make the tax system regressive.

4.9 The fourth major defect of the extended excise tax system without set off for tax paid on inputs is that the burden of all the input taxes and the cost increases due to cascading will be carried by exports out of India, whereas most other countries are sending their exports free of all indirect taxes. It is well recognised in the realm of international trade that exports could and should be freed of all domestic indirect taxes. In order to try achieving this under the excise tax system on the gross value basis, a system of duty drawback has to be set up. But the accurate amount of duty to be given back is almost impossible to calculate. Apart from that and the large staff that would be called for, there would be inevitable delays and disputes. There seems to be insufficient appreciation that the cascading types of excise taxation combined with a similar type of sales taxes superimposed on it would, and does, act as a great hindrance to our export effort. One of the main reasons for France inventing and adopting the VAT was to boost exports.

4.10 If exports are to be completely freed of excises, then the tax burden on the final export product arising from the taxation of all inputs and from that of machinery must be removed through set-off. (The VAT will thus become a purely consumption tax.) As far as internal consumers are concerned, the tax on machinery, if not remitted, will, like the tax on current inputs, lead to uncontrolled and regressive incidence, distortions of producers' choices and cascading. It is, therefore, necessary to grant VAT credit also to the tax on machinery.

4.11 Thus credit for tax paid on inputs, meaning all materials and services used in production, is a necessary concomitant of an extended excise tax system. It is given in the interests of the economy, to ensure efficient use of resources, minimise costs and to augment or preserve competitiveness in the export markets. Our discussions with many officials gave us the impression that the purpose of granting Modvat credit was not generally understood and that it was often considered to be a relief to the producer. Since the economic justification for granting Modvat credit is not understood, the grant of credit is looked upon as a relief which could be denied at the officer's discretion. That perhaps explains why duty credit was denied to inputs in several cases on the ground that "this input is really not intended to be given credit" (e.g., "whitener" used in the

manufacture of sugar) or that the input concerned is not fully incorporated into the product (e.g., a battery fitted inside a clock, even when the tax base of the clock includes the cost of the battery plus the tax on it).[6]

4.12 As we had indicated in the Interim Report, in addition to the VAT at the manufacturing stage, there should be excises on a gross value basis on a few commodities, such as petroleum products, tobacco products and certain luxury goods. The rate structure for these goods has already been indicated. These excises would serve to achieve the objectives of sumptuary taxation as well as achieving a degree of progression in the taxation of consumption.

4.13 There would be some cases where taxes cannot be collected from the producers of final product for administrative reasons. In such special cases the final products may be exempted, but the producers may be given option to come voluntarily and pay the tax if that would be beneficial for them. The fact that some final products would have to be exempted from the VAT does not invalidate the case for VAT.

Transition to VAT at the Central Level

4.14 We urge that the following steps be taken simultaneously, over the next three to four years, in a phased manner:

a. Extension of excises to cover most manufactured goods at present exempted and some select services mentioned in the Interim Report;

b. Reduction in the level of rates on some commodities which are unduly high, such as plastic and synthetic resins, paints and dyes, glass and glassware, man-made filament yarn, tyres and tubes, motor vehicles, cosmetics and air-conditioning and refrigerating devices.

c. Gradual reduction in the number of rates moving them towards three rates between 10 and 20 per cent, for all goods that would be covered by the VAT system;

d. Extension of Modvat credit to all inputs that are used in the production of, or incorporated in, taxable commodities except for office equipment, accessories and furniture, building materials and a few others.

e. Extension of Modvat credit for machinery not fully at the time of purchase but in instalments during a subsequent period of years which could be laid down in the law; and

f. Extension of VAT to the more important services used by productive enterprises.

All these changes that we have suggested would transform the present mixed system of Modvat and excise on gross value basis into a VAT at the manufacturing level.

4.15 We are of the view that within the next five years all products other than petroleum and tobacco products and matches should be brought within the ambit of VAT, even if the producers at the last manufacturing stage cannot be taxed in all cases.

4.16 Although the extension of Modvat credit to inputs and machinery at present not eligible for such credit would lead to some loss of potential revenue, the extension of coverage to goods now exempted and to services would increase revenue considerably. For instance, a considerable amount of revenue could be derived from cycle tubes and tyres and other components because the larger part of the sales of those commodities are for replacement purposes. Similarly, taxation of services mostly used by households, such as residential telephone services would yield a large and increasing amounts of revenue from the urban as well as the rural sector.

4.17 We believe that it is safe to proceed on the assumption that the growth of the economy will pick up from the next year or so and along with it industry will start growing at 8 to 9 per cent per annum as during the latter half of the 1980s. Such a fast growth of industry would automatically lead to buoyancy in the revenue from the VAT and that should make possible adjustments in the rates and the extension of Modvat credit. The final aim is not just to raise revenue anyhow, but to design and enforce a tax system which would facilitate and promote growth of output and exports which in turn would provide increasing amounts of revenue.

4.18 As indicated in the Interim Report, to begin with, the taxation of select services should be kept outside the system of the present Modvat on commodities. However, when revenue considerations permit, the taxation of services could be extended to cover those which enter into production as inputs and taxes paid on them could also be made eligible for VAT credit.

4.19 At present, the four major sectors where the Modvat system does not apply are: petroleum products, tobacco products, textiles and matches. The Committee is of the opinion that, since in any case petroleum and tobacco have to be subjected to high rates and their use discouraged, they need not be brought under the proposed VAT system. In principle, matches should be brought under VAT, but given the nature of the industry, its relative insignificance and the fact that matches are more of a consumer product, the existing system of taxation may be allowed to continue for the time being. Textiles, on the other hand, constitute an important sector and enter significantly into all household budgets. They also form a significant proportion of our exports. It is highly important that the taxation of textiles should be on a rational basis.

The Structure of Excise Duty for the Textile Industry

4.20 The textile industry is the largest single industry in the country accounting for around 20 per cent of the total industrial output and providing employment to around 15 million people. Next to agriculture, it is the largest contributor to employment in the country. It is also the largest single contributor to India's export - the share being about 25 per cent.

4.21 The textile industry is complex and varied in structure with the khadi, i.e., hand spun and hand woven sector at one end of the spectrum and the sophisticated capital-intensive, high speed operation at the other end. There is also an intermediate segment comprising decentralised, small-scale powerloom units and the handloom sector. The textile mill industry is mainly concentrated in Maharashtra, Gujarat, Tamil Nadu and Uttar Pradesh, while handlooms are spread all over the country.

4.22 The growth of the textile mill industry is traced at Annexure 4.1. The primary product in the textile industry is yarn which is almost entirely manufactured by the organised sector, i.e., the textile mills. In 1990-91 there were about 285 composite mills and 777 independent spinning mills where yarn was produced. There are two broad categories of yarn - (i) spun yarn; (ii) filament yarn. The trend in the production of these two categories of yarn from 1984-85 onwards is shown in Annexure 4.2.

4.23 In the Spun yarn category, there are three varieties, namely, (i) cotton yarn, (ii) blended yarn, and (iii) non-cotton yarn - mainly cellulosic spun yarn.

4.24 The production of these three varieties of spun yarn during 1987-88 to 1990-91 is given in Annexure 4.3. Cotton yarn constitutes more than 80 per cent of the total spun yarn produced in 1990-91. The production of blended yarn is 12 per cent, while the share of 100 per cent non-cotton

spun yarn (mainly cellulosic spun yarn) is around 6.5 per cent.

4.25 The movement of prices of various varieties of yarn including filament yarn during the period 1987 to 1991 is shown in Annexure 4.4. The average price of blended yarn is nearly double the price of cotton yarn while the average price of 100 per cent non-cotton spun yarn is about 1-1/2 times the average price of cotton yarn. Thus in value terms, the share of production among various varieties of spun yarn is as follows:

Cotton	70 per cent
Blended	21 per cent
Non-cotton	9 per cent

4.26 In the synthetic textiles sector, the primary product is man-made fibre and filament yarn. The production of man-made fibre and yarn during 1987-88 to 1990-91 is shown in Annexure 4.5. The growth in the production of man-made staple fibres and man-made filament yarn from 1962-63 to 1990-91 is shown in Annexures 4.6 and 4.7.

Fabrics

4.27 The estimated production of cloth during 1990-91 was around 20 thousand million square metres. As per the revised conversion ratio, the production of fabrics in the decentralised sector during 1990-91 has been estimated at 17.6 thousand million square metres (85 per cent). The production of cloth in the composite mills sector was around 2.7 thousand million square metres (15 per cent) during the same year. The production of cloth in the mills sector and decentralised sector during the last ten years is shown in Annexure 4.8. The production of cloth in the mills sector and decentralised sector during the period 1951 to 1991 is shown in Annexure 4.9. The fibre-wise production of cloth in the mills sector, handloom sector and power loom sector during 1985-86 to 1989-90 is given in Annexure 4.10.

Excise Duty Regime

4.28 The textile industry has a unique excise duty regime in terms of both duty structure and coverage. Only the basic and primary products of the industry i.e yarn and fibres are subject to Central excise levy, while its entire range of value added products, viz., ready-made garments[7], processed fabrics and grey fabrics are exempted. Processed fabric is, however, chargeable to Additional Duty of Excise (Goods of Special Importance) Act, 1957, under which the Centre levies and collects this duty in lieu of sales tax and the proceeds are apportioned among the States. The duty structure of various kinds of yarn, fibres and man-made filament yarn is given in Annexure 4.11 and that of fabrics in Annexure 4.12.

4.29 The most important reason for collecting most of the excise duty at the yarn stage, exempting grey fabrics fully from excise duty, is said to be the problem of bringing about 13 lakh powerlooms under excise control. Many of these powerlooms are run in households, particularly in important textile centres like Surat, Bhiwandi and Ichalkaranji. Though processed fabrics are covered under the Additional Duty of Excise (Goods of Special Importance) Act, 1957, a number of exemptions have been provided for processed fabrics to restrict its coverage within administratively feasible limits. It is estimated that not more 20 per cent of the total cloth produced in the country comes under this duty net.

4.30 Thus the textile industry is an example, *par excellence*, of concentrating most of the tax at the input stage. This system has several disadvantages. To mention the most important, value added at later stages is not covered by the tax and hence the tax rate at the earlier stage has to be higher and there is unnecessary discrimination among products with differing proportions of value added at later stages. The cost of production, especially where the rate of duty on yarn is high, as for example on filament yarn, is unduly raised by the interest

on the duty paid on the earliest stage. There is no control on the pattern of incidence on final consumers of a product which figures prominently in the household budgets of the majority of citizens. What is worse, the input duty may form a larger percentage of the prices of the cheaper fabrics.

4.31 The textile industry plays a prominent role in our exports. The potential for increasing textile exports is still quite high. This is an industry whose exports must be fully freed of input taxes without going through the tortuous route of duty drawback. And that is possible only if the textile sector is brought under the Modvat scheme and then Modvat is gradually transformed into a full fledged VAT.

4.32 There are two other important reasons why steps must be taken to rationalise the excise duty regime for textiles. The first is that the excise duty structure must be harmonised with the import tariff regime. The Government is committed to reducing and rationalising import tariff. Within the next five years, import duties would be reduced across the board and even consumer goods would be allowed to come in subject to duty. If the existing excise duty regime is not reformed simultaneously with the proposed reforms in import tariff, domestic producers of fabrics would be hard hit, for the reason that while import of yarn will be subject to high countervailing duty, which would not be eligible for Modvat relief, the final products will not be subject to countervailing duty at such high rates. To avoid placing domestic producers of cloth at a disadvantage vis-a-vis imports, the import duty on fabrics will have to be kept much higher than needed for protection[8] - which will go contrary to the objective of tariff reform.

4.33 The second reason is that the Central Government persuaded the State Governments to give up their right to levy sales tax on textile fabrics in return for an additional excise duty on them, whose proceeds will be distributed to them. Through the exemption of grey fabrics and the shifting of the tax burden to the yarn stage, the States have argued that they have been subjected to a substantial loss of revenue. There seems to be much truth in the contention. While it is not considered feasible or worthwhile collecting duty at the fabric stage for the Centre, a duty at the processing stage has been levied only for the benefit of the States. For obvious reasons, the yield of the duty is rather modest.

4.34 It is, therefore, clear that the existing excise duty regime for the textile sector must be reformed in the direction of a VAT system. However, this can be done only in stages because of the peculiar nature of the industry with predominance of small producers and because of the high level of duties on synthetic yarn, especially filament yarn.

4.35 After a detailed study, the Committee has come to the conclusion that the first stage of reform should consist of (a) introduction of the Modvat scheme till the yarn stage in all sectors and (b) applying the Modvat principle to cotton textiles without subjecting grey fabrics to tax at the present time. We have chosen the cotton sector both because we believe that we have comparative advantage in this important sector and because the rate of duty on cotton yarn is not unreasonably high. As indicated later, Modvat principles could be applied to man-made and blended fabrics other than those made from filament yarn with the help of the same system as we are recommending for cotton textiles. It may be difficult to extend the Modvat system to fabrics made from filament yarn until the high duty rates on inputs could be brought down to levels comparable to those applicable to other varieties of yarn and fibre.

4.36 At present, the credit of duty paid on chemicals is available for discharging duty liability in respect of man-made staple fibres. After the fibre stage no credit is available. We recommend that Modvat should be extended down to the yarn stage in respect of the varieties of man-made yarn spun from

man-made staple fibres (including blended yarn). In other words, credit of duty paid on all inputs including man-made fibres should be made available for paying duty on yarn spun from such fibres. This will, however, require readjustment of the duty structure on staple fibres and spun yarn which could be done without sacrificing revenue.

4.37 We believe that it is possible to introduce immediately without much difficulty the principle of Modvat in respect of cotton textile industry even while continuing the exemption at the grey fabric stage.

4.38 As a pre-requisite for extending Modvat to cotton textile industry, it is necessary to rationalise the duty structure of cotton yarn. The Committee recommends ad valorem duty at a single rate for all counts of yarn. The main argument against switching over to ad valorem levy is the fact that the wholesale prices of yarn fluctuate, though in a narrow range, but almost daily. The solution to this problem is assessment on the basis of invoice price. Gross invoice price exclusive of the cost of transportation, excise duty, sales tax and other taxes should be taken as the basis of assessment. The question of admissibility of varying rates of discounts as deduction from the price may pose a problem. As an alternative, therefore, tariff values can be fixed particularly for important counts of yarn which are regularly traded. The captive consumption of yarn for the manufacture of dutiable fabrics will be exempt from excise duty as per normal Modvat rules. As regards captive consumption of yarn for the manufacture of exempted fabrics, say, controlled cloth, excise duty will be payable. In case tariff value has not been fixed for the particular count of yarn captively consumed, the assessment should be on the basis of an estimated value arrived at having regard to the tariff value of the nearest equivalent count of yarn or its sale price in the case of other manufacturers.

4.39 The estimated revenue implications of switching over to a single ad valorem rate of 4 per cent, 4.5 per cent and 5 per cent at the present level of production and price are indicated at Annexures 4.13 to 4.15, respectively. The average change in duty and the average change in the price of fabrics for each of the suggested rates are shown in columns 7 and 8 of these Annexures. Revenue neutrality could be achieved at around 4.5 per cent ad valorem [basic 3.5 per cent, Special Excise Duty and Additional Duty of Excise (Textile and Textile Articles) Act, 1957 - 30 per cent of the basic duty]. It is, however, necessary to mention that in case a single ad valorem rate is prescribed, there will be some increase in the prices of exempted fabrics woven from yarn upto 25 counts.[9] These fabrics include controlled cloth manufactured under the approved schemes of the Ministry of Textiles and distributed through fair-price shops. However, as indicated in the three Annexures referred to above, the change in price will be only marginal.

4.40 As stated earlier, the grey fabric stage will remain exempt from duty for the present. With this condition, the introduction of Modvat in cotton textiles will cause no problems as far as the composite mills are concerned. Against the tax payable at the processing stage, set off will be granted to taxes paid on yarn and other inputs like dyes, chemicals etc. For maintaining revenue neutrality and unchanged final incidence, the duty at the processing stage will have to be raised.

4.41 The application of the Modvat scheme to the fabrics processed by independent processors would not be so simple. They will not be able to produce duty paid documents in respect of yarn contained in the fabrics; They may also not be able to show any proof of duty paid on dyes and chemicals, if they have bought them from traders. Therefore, the duty paid on inputs would have to be estimated and a system of deemed credit would have to be introduced against the enhanced duty payable on the

processed fabrics.

4.42 Annexure 4.17 shows one of the possible methods of estimating the duty components of yarn and chemicals in cotton fabrics of different value slabs. The scope for evasion of duty by the independent processors will be considerably reduced, if the deemed credit is made available for discharging the duty liability of processed fabrics cleared in a particular week as a percentage of the duty of fabrics actually paid during the preceding week. As regards the procedure for availing of deemed credit, it may be made broadly similar to the existing money credit scheme. Obviously, the composite mills will avail of credit of actual duty paid on inputs or enjoy exemption for inputs manufactured and captively consumed as per normal Modvat rules.

4.43 It is obvious that deemed credit will not in every case be equal to the actual duty paid. The idea is to provide credit which on an average would approximate to the actual duty paid on inputs. From the economic and revenue points of view it does not really matter if the deemed credit is not estimated with a high degree of accuracy. But the real problem will be that once deemed credit is introduced on the basis of formulae based on assumptions, reasonable though they may be, the assessees might, and probably will, start questioning them and ask for changes. It is important not to open up an additional source for disputes.

4.44 We, therefore, suggest an alternative solution to the problem. The proposal is that Modvat credit for excise duty on all inputs used for the manufacture of cotton textile fabrics be provided to the composite mills and they will be asked to pay Union excise duty on the processed fabrics (in addition to the Additional Excise Duty in lieu of sales tax which they are now paying). The excise duty rate on the processed fabrics will be so fixed as to roughly neutralise the Modvat credit given in terms of incidence. Where the composite mills clear grey fabrics, excise duty on the yarn content will be payable and this will have to be estimated. This duty will be paid as duty on grey fabrics cleared by composite mills.

4.45 Since the independent processors will not be within the ambit of the Modvat scheme, the processed fabrics emanating from them will bear the duty on inputs. The total burden of such duty should be estimated using the same methodology as is done in arriving at the amount of deemed credit. The Union excise duty to be levied on the independent processors must be kept lower than that leviable on the composite mills by the amount of the estimated burden of duty on inputs. In such a case the independent processors cannot complain of discrimination in terms of higher duty. The Additional Excise Duty in lieu of sales tax is a tax falling only at the final stage and it should be treated separately from the Union excise duty and will not be part of the Modvat scheme.

4.46 We are suggesting that the Modvat scheme be extended to the composite mills in the cotton textile sector immediately because we wish to help in bringing about a boost in the export of cotton fabrics and garments from our country. Soon thereafter, the same system as we have recommended for the cotton textile sector should be applied to synthetic and blended fabrics other than those made from filament yarn.

4.47 We recognise the fact that most of the problems relating to extension of Modvat to textiles can be eliminated if the exemption operating at the grey fabric stage is removed. For this purpose, a scheme of payment of duty by the powerloom sector mills have to be devised in course of time. While the small scale units in that sector, say, those producing fabrics of a total value of Rs.50 lakh per year may continue to be exempted, the bigger units can be brought under the regular excise duty regime. The differential between the duty on grey fabrics and duty on yarn contained therein (on which Modvat would have been availed of) should be kept fairly low. Under this scheme all genuinely small powerloom units will be exempt and will not

have to deal with the Excise Department.

Extension of VAT to the Wholesale Stage

4.48 It is generally agreed that there are disadvantages in imposing a sales tax or a VAT confined to the manufacturing stage. For one thing, value added at the subsequent stages is left out of taxation, which itself creates discrimination among products. But what is more important, if a tax falls only at the manufacturing stage, there is an advantage in undervaluing taxable products at that stage because that would reduce tax liability. As we have seen, valuation of products for ad valorem levies is an important problem under excises and is the cause of many disputes. We deal with this problem later in the Report with a view to suggesting a consistent method of valuation that would be fair and would also minimise disputes. However, it may be pointed out that if the VAT system (i.e., the reformed Central excise) could be extended to the "wholesale stage", there would result a more rational system and the attempts at undervaluation would be considerably reduced and hence it would be possible to accept the invoice value in most cases.

4.49 By "wholesale" stage, we mean traders who buy from manufacturers and sell to other manufacturers or to traders. In practice, it will not be possible to identify traders by these characteristics. Also, even small traders might be buying from manufacturers and the intention is not to bring them under the extended VAT. Therefore, in practice, for purposes of this tax, we must define wholesalers to mean those with total turnover above a certain level, say, Rs.50 lakh or Rs.1 crore. They should be subjected to VAT in addition to the manufacturers. This would only mean that value added in their hands will be subjected to tax. Manufacturers who buy from these wholesalers will also be able to obtain credit for tax paid earlier. That would be another advantage. The total burden on commodities need not increase, since there would simultaneously take place a reduction in the level of rates.

4.50 The above proposal for the extension of VAT to the "wholesale" stage has to face two problems, however. The first is that the inclusion of "wholesalers" will considerably increase the number of VAT assessees and the Excise Department cannot cope with such an increase. The VAT at the wholesale stage will, therefore, have to be collected by the officers of the Sales Tax Departments of the States concerned. This could be done in close cooperation with the officers of the Central Excise Department. The amount of VAT collected at the wholesale stage can be allowed to be retained by the State where it is collected.

4.51 The States will thus have an additional source of revenue, distributed on the basis of origin; and in collecting that revenue, their own officers will play the major role. Nevertheless, the State governments might not agree to the extension of the Central excise to the "wholesale" stage because the power to levy a tax on the sale of goods lies within the Constitutional jurisdiction of the States. This is the second problem; and it can be overcome only with the cooperation of the States. The States could be persuaded to accept the levy of Central VAT upto the wholesale stage, because their own right to levy the sales tax on goods will in no way be circumscribed and at the same time they will get the entire revenue from the VAT at the wholesale stage.

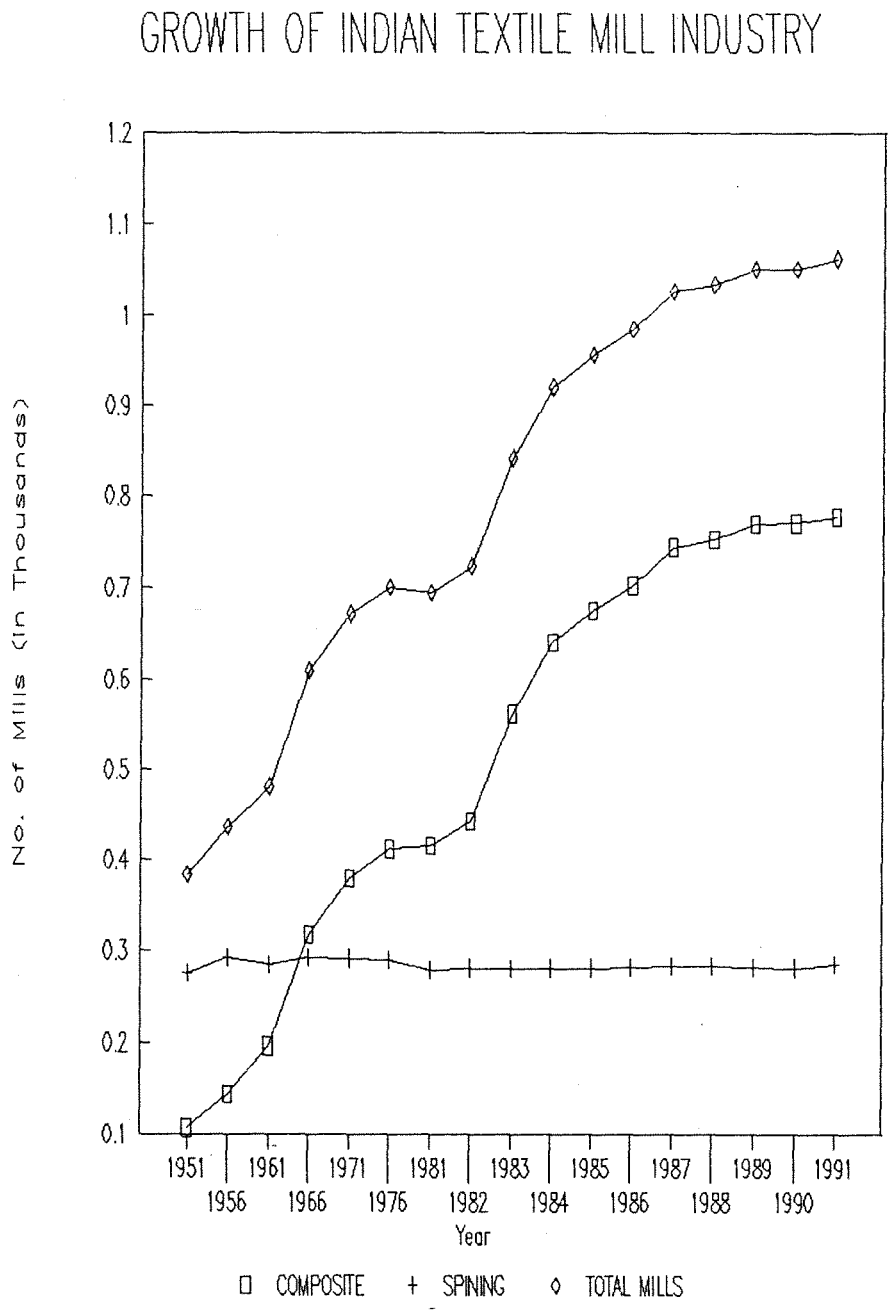
4.52 The States in general have preferred to levy the first-point sales tax on most goods. This tax could be converted into a form of State VAT within the manufacturing sector, if the taxable manufacturers are given the benefit of set-off for tax paid on all inputs including machinery. If concessions and most exemptions under the sales taxes are eliminated, as has been recommended for the excise tax, the tax could be levied at moderate rates. There may be no need for levying sales tax at more than two rates, since the distributional and other non-revenue objectives could be left to be performed by

the Central taxes which apply uniformly throughout the country.

4.53 The thorough going reform of the domestic indirect taxes levied by the Centre and the States that we have recommended above would give the country a far more rational tax system than what exists today. The changes in the conditions of levy of the Central sales tax that we have suggested in the Interim Report would further improve the equity and rationality of the system and prevent the fragmentation of the national economy. The ideal solution, from the economic point of view, would be to have a single VAT at the Central level, reaching down to the retail stage in replacement of most indirect taxes other than protective duties and sumptuary excise duties - the Central excise, the State sales taxes, the Municipal octroi, the goods and passengers tax and the electricity duty. The proceeds of the VAT will be shared among the three levels of Government. Having only two major taxes, the income tax and the VAT, would also mean greatly reduced cost of compliance to business and industry as well as lesser obstacles to the fast growth of the economy. For the smaller businesses in particular, the elimination of the obligation to deal with multiple tax departments would be a great boon.

4.54 While the reluctance of the State governments to give up or delegate their tax powers is understandable, it will be legitimate for trade and industry and the people in general to insist that the economic distortions caused by the sales tax structures should be removed. Given the imperative need to increase economic efficiency and to improve export competitiveness, the country cannot afford to let the Central and State governments continue with the complicated and distortionary tax structures that have grown up. Therefore, even if a single VAT extending to the retail stage is not feasible at the moment, it is imperative to carry out the second-best reforms which we have advocated.

ANNEXURE 4.1



Source: Compendium of Textile Statistics, 1991
Ministry of Textiles, Government of India.

ANNEXURE 4.2

Production of Yarn by Textile Industry

(In million kg.)

	Spun Yarn	Filament Yarn	Total
1984-85	1382	123	1505
1985-86	1454	149	1603
1986-87	1526	163	1689
1987-88	1555	191	1746
1988-89	1563	223	1786
1989-90	1639	224	1883
1990-91	1795	276	2071
1991-92 (Estimated)	1865	286	2151

Source: Compendium of Textile Statistics, 1991, published by the Office of Textile Commissioner, Ministry of Textiles, Government of India.

ANNEXURE 4.3

Break-up of the Production of Spun Yarn

(in million kg.)

	1987-88	1988-89	1989-90	1990-91
Cotton	1321	1302	1367	1467
Blended	152	170	177	213
100% Non Cotton	82	91	95	115
Total	1555	1563	1639	1795

Source: Basic Facts on Textile Industry (1990-91), Office of the Textile Commissioner, Ministry of Textiles, Government of India, Bombay.

ANNEXURE 4.4

Prices of Yarns including Filament Yarn

(Rs./Kg.)

Prices as on	Cotton hank yarn (Wt. Avg.)	Cotton cone yarn (Wt. Avg.)	Cotton hosiery cone yarn (Wt. Avg.)	Poly/ viscose blended (Wt. Avg.)	Poly/ cotton blended yarn (Wt. Avg.)	Viscose spun yarn 31 hanks	VFY (Wt Avg.)	NFY (Wt. Avg.)	PFY (76D)	POY (Avg.)*	Texturised Yarn (Avg.)*
March 87	27.01	33.10	32.35	79.60	85.50	38.00	70.16	185.23	163.33	154.00	169.78
March 88	38.69	45.07	44.83	92.20	84.83	44.60	90.16	156.93	137.50	121.00	148.47
March 89	41.31	50.85	47.13	76.29	103.00	60.00	108.04	171.76	184.00	139.67	164.22
March 90	47.32	56.41	52.52	105.21	125.44	73.20	127.69	253.99	190.00	155.56	173.86
March 91	48.01	55.31	53.18	104.87	119.13	71.52	110.99	207.67	198.00	172.00	179.64

Note: (*) = Simple Average.

Source: Compendium of Textile Statistics, 1991, published by the Office of Textile Commissioner, Ministry of Textiles, Government of India.

ANNEXURE 4.5

Production of Man-made Fibre and Yarn

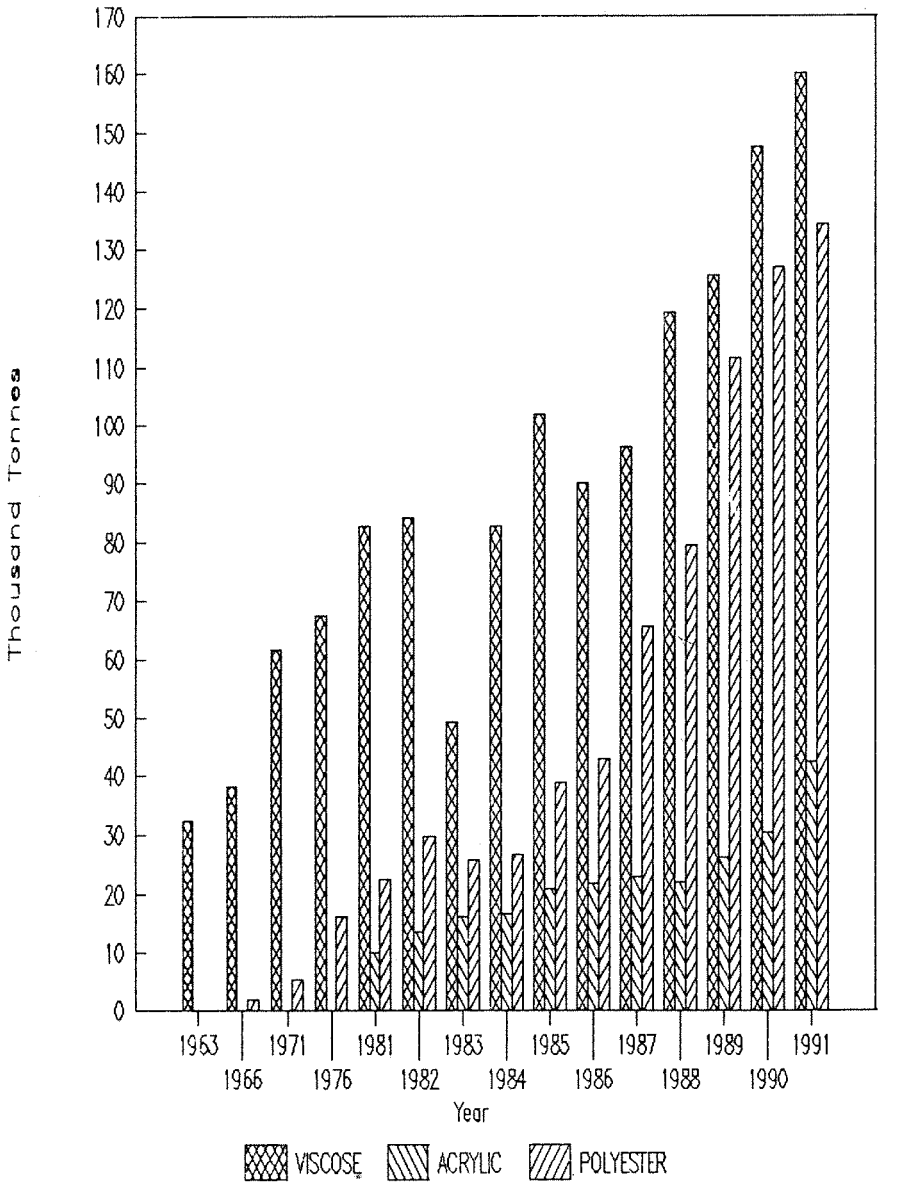
(in tonnes)

	Production				Installed capacity as on 31-3-91
	1987-88	1988-89	1989-89	1990-91	
Man-made Fibre:					
Viscose Staple Fibre (VSF)	119451	125702	147646	160173	176050
Polyester Staple Fibre (PSF)	79434	111579	127120	133529	230062
Acrylic Staple Fibre (ASF)	22092	26344	30480	42673	49250
Filament Yarn:					
Viscose Filament Yarn (VFY)	45933	44364	49238	50942	60413
Polyester Filament Yarn (PFY)	111456	142971	156484	185293	177360
Nylon Filament Yarn (NFY)	34316	35760	38731	39818	97600

Source: Compendium of Textile Statistics, 1991, published by the Office of Textile Commissioner, Ministry of Textiles, Government of India.

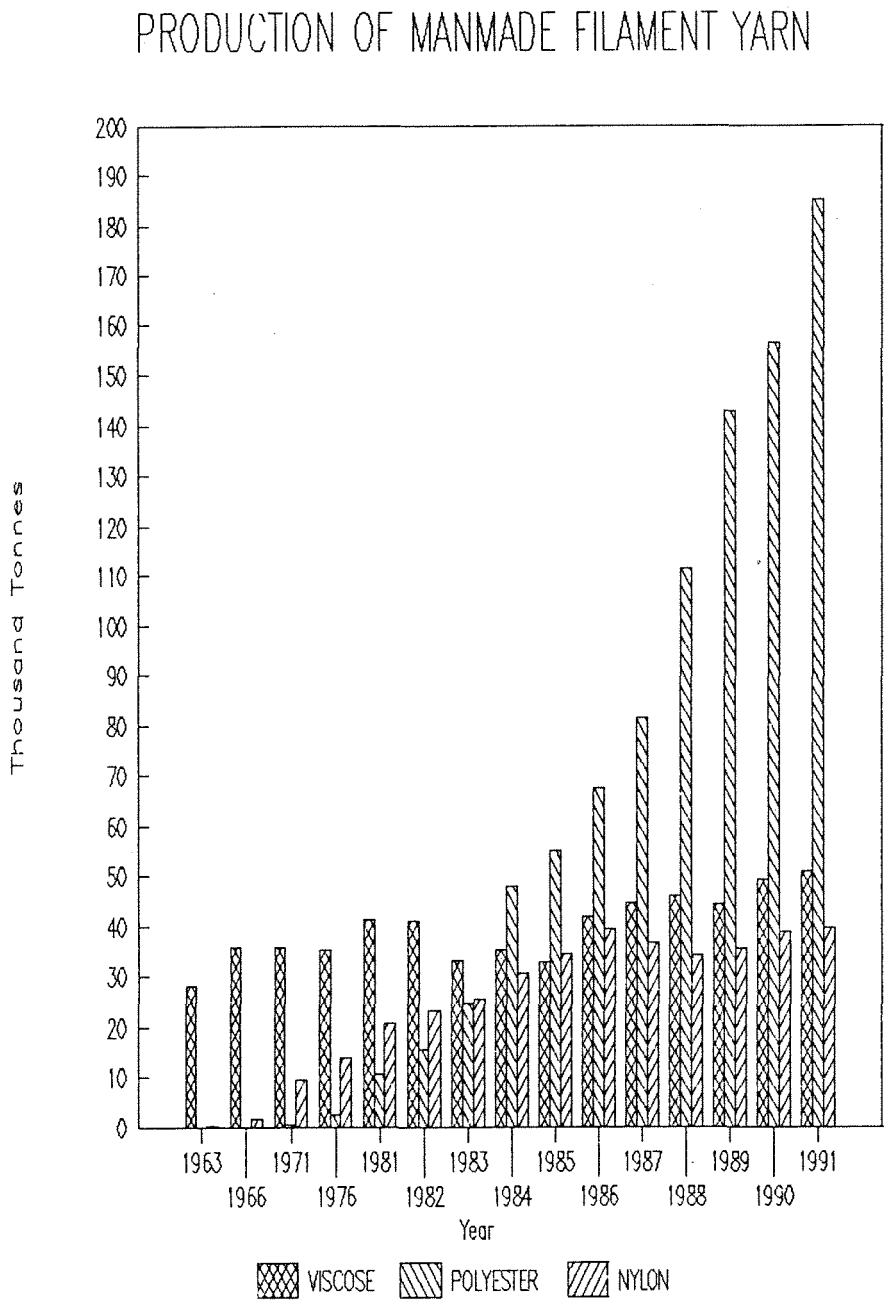
ANNEXURE 4.6

PRODUCTION OF STAPLE FIBRES



Source: Compendium of Textile Statistics, 1991
Ministry of Textiles, Government of India

ANNEXURE 4.7



Source: Compendium of Textile Statistics, 1991
Ministry of Textiles, Government of India

ANNEXURE 4.8

Production of Cloth

(1980-81 to 1990-91)

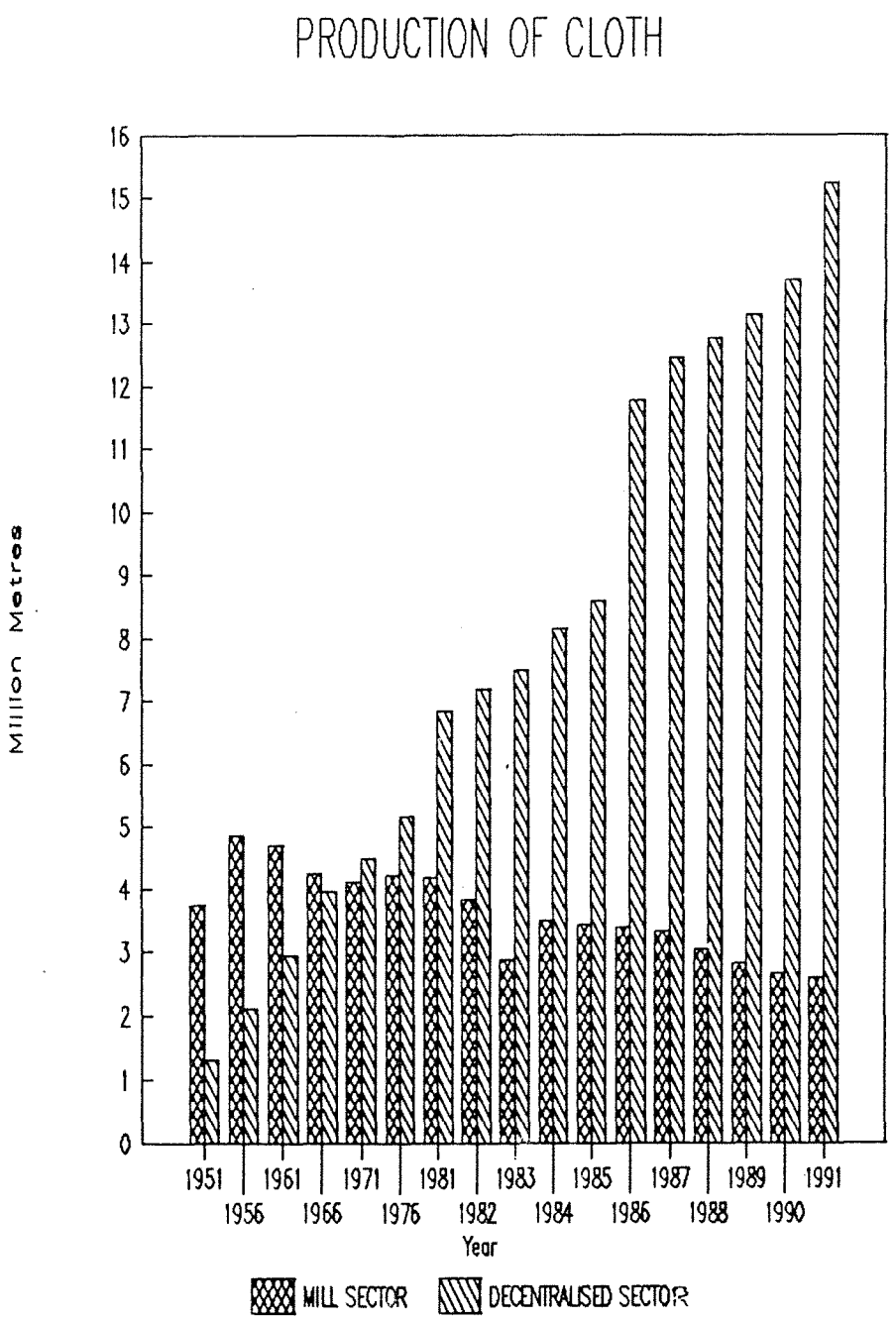
(million mtrs.)

Year	Mill sector	Decentralised sector	Total
1980-81	4168	6820	10988
1981-82	3808	7173	10981
1982-83	2871	7482	10353
1983-84	3490	8151	11641
1984-85	3432	8582	12014
1985-86	3376 (3544)	11769 (13669)	15145 (17213)
1986-87	3317 (3483)	12446 (14454)	15763 (17937)
1987-88	3027 (3178)	12758 (14799)	15785 (17977)
1988-89	2808 (2948)	13142 (15236)	15950 (18184)
1989-90	2649 (2781)	13709 (15941)	16358 (18722)
1990-91(P)	2590 (2720)	15228 (17634)	17818 (20354)

Note: The figures in brackets give the production in million sq.mtrs.

Source: Compendium of Textile Statistics, 1991, Ministry of Textiles, Government of India.

ANNEXURE 4.9



Source: Compendium of Textile Statistics, 1991
Ministry of Textiles, Government of India

ANNEXURE 4.10

Production of Cloth : Fibrewise

(in million sq.metres)

	Mill - Sector				Handloom - Sector				Powerloom - Sector			
	Cotton	Blended	100% non-cotton	Total	Cotton ded	Blended non-cotton	100%	Total	Cotton ded	Blended non-cotton	100%	Total
1985-86	2716	822	6	3544	4035	61	39	4135	4391	693	2999	8083
1986-87	2594	880	9	3483	4193	69	43	4305	4563	774	3295	8632
1987-88	2346	827	5	3178	4254	72	44	4370	4629	817	3439	8885
1988-89	2122	821	5	2948	4193	81	49	4323	4563	908	3901	9372
1989-90	2087	690	4	2781	4402	84	51	4537	4803	949	4036	9788

Source: Handbook of Statistics on Cotton Textile Industry (23rd Edition), Published by Indian Cotton Mills' Federation, Bombay.

ANNEXURE 4.11

Excise Duty Structure : Yarn and Fibres

(in Rs.)

Description	Basic & special excise duty	Total effective duty including additional duty on textile articles which is 15% of the basic duty
(1)	(2)	(3)
Cotton yarn not containing Synthetic Staple Fibres		
i. Plain Reel Hanks	nil	nil
ii. Cross Reel Hanks -		
Not exceeding 25 counts	nil	nil
Between 25 to 35 counts	0.345	0.39
Between 35 to 55 counts	1.035	1.17
Exceeding 55 counts	2.30	2.60
iii. Cross Reel Hanks other than those at above and Non-Hank form -		
Not exceeding 10 counts	0.575	0.65
Between 10 to 25 counts	1.38	1.56
Between 25 to 60 counts	2.76	3.12
Between 60 to 90 counts	5.75	6.50
Exceeding 90 counts	8.625	9.75
Cellulosic Spun Yarn not containing Synthetic Staple Fibre -		
i. Plain Reel Hanks	nil	nil
ii. Cross Reel Hanks -		
Not exceeding 25 counts	nil	nil
Between 25 to 35 counts	0.287	0.325
Between 35 to 45 counts	0.69	0.78
Exceeding 45 counts	1.38	1.56

ANNEXURE 4.11 (Contd.)

(1)	(2)	(3)
iii. Cross Reel Hanks other than those at above and Non-Hank form -		
Not exceeding 25 counts	0.69	0.78
Between 25 to 35 counts	1.38	1.56
Exceeding 35 counts	2.30	2.60
Others	13.80	15.60
Artificial Staple Fibre and Tow	13.80	15.60
Polyester Staple Fibre	12.075	13.65
Acrylic Staple Fibre	13.80	15.60
Polyamide Staple Fibre	52.325	59.15
(a) Polypropylene staple fibre	**15.8125**	**17.875**
(b) Other synthetic staple fibre	**39.8475**	**45.045**
Polyester Cotton Blended Yarn containing PSF between 40-70% and not containing any other textile material	6.90	7.80
Polyester Viscose Spun Yarn Containing PSF between 40 - 70%	13.80	15.60
Polyester Acrylic/Wool Blended Yarn (PSF Predominant)	13.80	15.60
Polyester Cotton Blended Yarn containing less than 40% PSF	6.90	7.80
Polyester-Viscose Blended Yarn containing less than 40% PSF	13.80	15.60
Polyester-Viscose/Cotton Spun Yarn with more than 70% PSF	13.80	15.60
Yarn of Acrylic Staple Fibre not containing or containing not more than 1/6th by weight of other Synthetic Staple Fibre	nil	nil

ANNEXURE 4.11 (Contd.)

(1)	(2)	(3)
Yarn of Acrylic Staple Fibre containing or not containing Cotton or Cellulosic Fibre but containing more than 1/6th by weight of other Synthetic Staple Fibres	13.80	15.60
Yarn containing 50% or more by weight of Polypropylene	nil	nil
Acetate Yarn -		
Below 350 deniers	10.35	11.70
350 to 1100 deniers	4.8875	5.525
Above 1100 deniers	3.45	3.90
Other Cellulosic Filament Yarn (Viscose Rayon) -		
Below 350 deniers	17.25	19.50
350 to 1100 deniers	6.555	7.41
Above 1100 deniers	4.60	5.20
Polyamide (Nylon Filament Yarn (Texturised or non-Texturised) -		
750 deniers and below	63.25	71.50
Above 750 deniers	22.1375	25.025
Polyester Filament Yarn (Texturised or non-Texturised)	71.30	80.60
Polypropylene Filament Yarn	28.75	32.50

ANNEXURE 4.12

Excise Duty Structure - Fabrics

Sl. No.	Description of goods	Rate
(1)	(2)	(3)
1.	Cotton fabrics not containing polyester and whose value per square meter -	
	a. does not exceed Rs.10	20 Paise per sq.mtr.
	b. exceeds Rs.10 but does not exceed Rs.25	50 Paise per sq.mtr.
	c. exceeds Rs.25 but does not exceed Rs.40	50 Paise per sq.mtr. plus 5% ad valorem
	d. exceeds Rs.40	Rs.2.50 per sq.mtr. plus 20% of the value exceeding Rs.40
2.	Man-made fabrics whose value per square metre -	
	a. does not exceeds Rs.40	50 Paise per sq.mtr. plus 5% ad valorem
	b. exceeds Rs.40 but does not exceeds Rs.100	Rs.2.50 per sq.mtr. plus 20% of the differential amount between the value of the Fabrics per sq.mtr. and Rs.40 per sq.mtr.
	c. exceeds Rs.100	20% ad valorem
3.	Cotton fabrics processed without the aid of power or steam.	nil
4.	Cotton fabrics processed by an independent processor approved in this behalf by the Government of India on recommendation of the Development Commissioner for Handlooms.	40% of the duty leviable under Heading No.52.06 (Sl.1 above) of the schedule read with any notification for the time being in force.
5.	Cotton fabrics processed by a factory owned by a registered handloom co-operative society or any organisation set up or approved by the Government for the purpose of development of handlooms.	nil

ANNEXURE 4.12 (Contd.)

(1)	(2)	(3)
6.	Fabrics woven on handlooms and processed by a factory owned by a State Government Handloom Development Corporation or an Apex Handloom Co-operative Society approved, in either case, in this behalf by Government of India on the recommendation of the Development Commissioner for Handlooms.	nil
7.	Specified Processed Fabrics	nil
8.	Controlled cloth, Poly Vastra etc.	nil

ANNEXURE 4.13

Cotton Yarn - Estimated Revenue at 4 Per Cent Ad Valorem

Counts	Average price (Rs./Kg.)	Estimated production of dutiable yarn (in '000 tonnes)	Existing duty incidence (Rs./Kg.)	Average ad valorem duty incidence (%) million)	Estimated revenue at 4% ad valorem duty (Rs. in	Average change in (Rs/Kg)	Average change in price of fabrics (in Rs. per sq. mtr.)*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Upto 10	37	81	0.65	1.76	120	0.83	0.07
11-25	52	375	1.56	3.00	780	0.52	0.04
26-35	55	210	3.12	5.67	462	-0.92	-0.07
36-40	60	155	3.12	5.20	372	-0.72	-0.06
41-60	80	90	3.12	3.90	288	0.08	0.01
61-80	100	39	6.5	6.50	156	-2.5	-0.20
80 and above	140	20	9.75	6.96	112	-4.15	-0.33
Total	524	970	27.82	32.99	2290	-6.86	-0.55

Note: * Revised conversion ratio of 12.40 sq. metres of fabric per Kilogram of yarn has been taken for estimating the average change in price of fabric consequent to the change in duty of yarn.

ANNEXURE 4.14

Cotton Yarn - Estimated Revenue at 4.5 Per Cent Ad Valorem

Counts	Average price (Rs./Kg.)	Estimated production of dutiable yarn (in '000 tonnes)	Existing duty incidence (Rs./kg.)	Average ad valorem duty incidence (%)	Estimated revenue at 4% ad valorem duty (Rs. in million)	Average change in (Rs./kg.)	Average change in price of fabrics (in Rs. per sq. mtr.)*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Upto 10	37	81	0.65	1.76	135	1.015	0.08
11-25	52	375	1.56	3.00	878	0.78	0.06
26-35	55	210	3.12	5.67	520	-0.645	-0.05
36-40	60	155	3.12	5.20	419	-0.42	-0.03
41-60	80	90	3.12	3.90	324	0.48	0.04
61-80	100	39	6.5	6.50	176	-2	-0.16
80 and above	140	20	9.75	6.96	126	-3.45	-0.28
Total	524	970	27.82	32.99	2578	-4.24	-0.34

Note:* Revised conversion ratio of 12.40 sq. metres of fabric per kilogram of yarn has been taken for estimating the average change in price of fabric consequent to the change in duty of yarn.

ANNEXURE 4.15

Cotton Yarn - Estimated Revenue at 5 Per Cent Ad Valorem

Counts	Average price (Rs./Kg.)	Estimated production of dutiable yarn (in '000 tonnes)	Existing duty incidence (Rs./Kg.)	Average ad valorem duty incidence (%) million)	Estimated revenue at 4% ad valorem duty (Rs. in	Average change in (Rs/Kg)	Average change in price of fabrics (in Rs. per sq. mtr.)*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Upto 10	37	81	0.65	1.76	150	1.2	0.10
11-25	52	375	1.56	3.00	975	1.04	0.08
26-35	55	210	3.12	5.67	578	-0.37	-0.03
36-40	60	155	3.12	5.20	465	-0.1	-0.01
41-60	80	90	3.12	3.90	360	0.88	0.07
61-80	100	39	6.5	6.50	195	-1.5	-0.12
80 and above	140	20	9.75	6.96	140	-2.75	-0.22
Total	524	970	27.82	32.99	2863	-1.62	-0.13

Note:* Revised conversion ratio of 12.40 square metres of fabric per kilogram of yarn has been taken for estimating the average change in price of fabric consequent to the change in duty of yarn.

ANNEXURE 4.16

Estimated Revenue from Cotton Yarn at Proposed Rate of 3 Per cent and 5 Per cent

Counts	Estimated production of dutiable yarn (in '000 tonnes)	Proposed ad valorem incidence (%)	Average ex-factory price (in Rs./Kg.)	Estimated revenue (Rs. in million)
(1)	(2)	(3)	(4)	(5)
upto 20	350	3	47	494
21 and above	620	5	65	2015
Total				2509

ANNEXURE 4.17

Extension of Modvat to Cotton Textile Industry - Basis of Calculation of Deemed Credit for Independent Processors.

1. The fundamental basis for computation of deemed credit is the conversion ratio i.e. 12.40 sq.mtrs of cotton fabric is woven from 1 kg. of cotton yarn. This ratio has been fixed by the Textile Ministry in consultation with the industry and used by the industry as well as the Government for various purposes.

2. According to the classification made by the Office of the Textile Commissioner, coarse fabrics are woven from yarn upto 17 counts. Medium fabrics are woven from yarn upto 40s counts while fine fabrics are woven from counts of yarn between 41 to 60 and superfine fabrics from yarn of higher counts.

   On the basis of above classification the following assumption is made.

   a. Fabrics of value below Rs.10 are woven from yarn of counts upto 20.

   b. Fabrics of value between Rs.10 and 25 are woven from yarn of counts between 20 and 40.

   c. Fabrics of value between Rs.25 and 40 are woven from yarn of counts between 40 and 80.

   d. Fabrics of value more than Rs.40 are woven from yarn of counts more than 80.

3. Once the average price within the aforesaid count slabs is determined, the duty incidence for the yarn content per sq. metre of fabric can be worked out by the following formula -

   Deemed credit, say for fabrics of value not exceeding Rs.10

$$= \frac{\text{(Average wholesale price of yarn of count upto 20) X 4.5 per sq.metre}}{100 \text{ X } 12.40};$$

   (If 4.5 per cent ad valorem is the levy on cotton yarn)

   Similarly deemed credit for fabrics of higher value slabs can be determined from the average price of the corresponding count slabs of yarn on the basis of the assumptions at para 2 above.

4. The expenses on account of dyes and chemicals depend on the quality of fabric processed as well as the nature of printing. Some fabrics are not printed at all in which case obviously the expenses on account of dyes and chemicals will be less. It is gathered from the processors in Ahemadabad and Surat that the cost of dyes and chemicals per square meter of dutiable fabrics varies from Rs.0.75 to Rs. 2.00. Taking an average duty of 20 per cent ad valorem, the deemed credit for dyes and chemicals may be calculated.

5

PROBLEMS RELATING TO TAX ADMINISTRATION

Problems Common to the Administration of Direct and Indirect Taxes

5.1 With the limited time at its disposal, the Committee has not been able to study in a comprehensive manner all problems relating to tax administration. However, it was not possible to ignore tax administration altogether because the success of tax reform depends very much on the manner in which taxes are administered. In what follows we have concentrated our attention on the major problems that in our view require immediate attention as well as problems brought to our notice by the representatives of both the assessees and the officers of the Department. We have specially taken note of problems which affect (a) efficiency in tax collection and tax compliance and (b) relations between the tax collector and taxpayer.

5.2 As we have indicated in the Interim Report, the administration of the major Central taxes leaves much to be desired. Both the Department of Excise and Customs and the Income Tax Department are, so to speak, caught in a "vicious circle". They are called upon to implement complex legislation and enforce high rates; the officers find that multiple rates and numerous concessions lend themselves to differing interpretations and classifications and hence lead to disputes; and they are not sure of support, if Audit should consider them at fault; overassessments and disallowances are common and so are disputes, and litigation is prolonged with no prospect of a verdict to be obtained from a High Court before the expiry of 15 years or so in many cases. At the same time, since the methods of administration have not been modernised and the information system is weak, evasion cannot be checked. Being bogged down in routine work and disputes, the Departments have not been able to spare enough attention and time to build up an adequate information system and to improve the enforcement of taxes. This is particularly true of the Income Tax Department. Evasion is more often attempted to be checked by adding new provisions which further complicate the legislation and create dissatisfaction among honest taxpayers. The Government on its part has been raising rates and has consented to the plea of the Departments to change the tax laws continuously. This leads to further disputes and the cycle repeats itself. There is widespread agreement that the scale of evasion as well as the degree of corruption have been rising; all the infructuous work represented by prolonged litigation costs the Government and the country dearly, besides putting the assessees, particularly the honest ones, to unjustified trouble and considerable expense taking their attention and energies away from productive activities.

5.3 This is not to say that the Departments have not made any attempts at improving administration, speed up assessments and to redress genuine grievances of the taxpayers. But what has been achieved falls far short of what is required. Indeed, if we wish to bring about any significant improvement in the state of affairs relating to tax administration we would have to bring about thorough-going changes in recruitment, personnel policy, matters of administration and in appellate procedures. Also simplification of the law and moderation in rates must be accompanied by the adoption of modern methods of communication, information gathering and storing and widespread use of electronic data processing in all aspects of tax administration.

5.4 In order to judge what kind of changes should be brought about, we must look at the root causes for the present unsatisfactory state of affairs in the field of

tax administration. These are to be found in -

a. high rates of taxes;

b. a multiplicity of duty rates leading necessarily to classification of dutiable goods into numerous rate categories;

c. recurrent changes in the law brought about at budget time, generally, conceived in secrecy and proposed and enacted without adequate public consultation and debate;

d. multifarious exemptions, concessions and deductions introduced in the tax laws for achieving the many and growing non-revenue objectives through the tax system and constant changes in the provisions incorporating them;

e. amending rates and granting exemptions throughout the year through the issue of notifications;

f. the practice of fixing targets of tax revenue collection on bases not necessarily related to potential collection in a year - e.g., on the basis of expenditure needs which are allowed to grow much faster than the economy;

g. fear of Audit - first, this leads, according to evidence tendered before us by the officers, to a tendency to over-assessment and to err on the side of revenue and secondly, it leads the Departments to issue demand notices even when the Board thinks or decides that the officer concerned has not erred. If the matter is not settled between the Board and Audit soon - which usually is not - the sword of Democles hangs over the assessee. The undue fear of Audit is partly due to the attitude of Revenue Audit;

h. lack of accountability - an officer who habitually over-assesses, or threatens to over-assess and collects an illegal tribute, apparently does not suffer in anyway. Even if the additional demands raised by an officer are routinely held invalid by the appellate authorities, the officer can be unconcerned, since there is no commensurate punishment;

i. the assessees are often advised by their counsel to contest even reasonable demands raised. On their part, the officers also find it or think it safer to go in for appeal to higher authorities even though they lose in a majority of cases before the Tribunal;

j. either because of the fear of Audit or because of the general tradition developed during the years when the economy was relatively static, the Department tends to pursue relentlessly the possibility of short-term revenue gains even if that leads to considerable infructuous work relating to prolonged litigation;

k. the reward system vitiates the attitudes of the officers;

l. most of the work of the Department is concentrated on returns filed and with the returns of tax deducted at source (TDS); collection of information and tracing of those not filing returns is neglected;

m. the administration of the Departments themselves is not conducive to efficient functioning or building up of morale. Honest officers are the ones who lose. Political interference is also an important cause of lack of discipline; and

n. the training of officers has been neglected; they are not made to face examinations. The selection for filling up higher posts is getting to be done more and more on the basis of seniority while methods have not been devised to weed out officers who are clearly

known to be corrupt.

5.5 The above-mentioned basic causes must be tackled for bringing about a significant improvement in tax administration and tax enforcement leading to reduction in the scale of evasion and greater satisfaction among the taxpayers without whose cooperation no tax system can hope to succeed. In this connection we reiterate our recommendations in the Interim Report regarding the changes in the tax structure which still remain to be implemented:

a. The rates of personal direct taxes have been brought down; however, further downward adjustment is needed as per our recommendations. Also, many of the concessions and exemptions still remain on the statute book. These must be progressively removed. Similarly, as recommended in the Interim Report, the rate of the corporate profits tax must be brought down as recommended and many of the exemptions and concessions granted to businesses must be withdrawn (paras 6.50 to 6.54). In the case of indirect taxes, the levels and number of rates should be significantly reduced along with the removal of most exemptions. While a beginning has been made in respect of customs in the 1992-93 Budget, practically nothing has been done in this direction in regard to excises.

b. There must be an end to the practice of issuing notifications for changing the effective rates of tax from time to time in between two Budgets. While in theory there would be a case for retaining this power in order to deal with emergencies, in practice the Government finds itself unable to resist pressures to make changes to accommodate various lobbies.

5.6 Other measures needed to effect a significant improvement in tax administration and enforcement are spelt out below:

a. Stability

5.7 Changes in the provisions of tax laws should be made to the minimum extent, say, once in five years after full public debate except for special cases where an immediate change is required. An adverse court decision should not also be considered a justification for an immediate change in the tax law. The Government should announce that the practice of introducing changes and concessions in each year's Budget is being given up and only the structural reform will be carried out as per a given agenda. Even the agenda on reform can be announced in advance. The practice of inviting representations and Budget suggestions every year to be considered for incorporation in the Budget for the next year should be stopped. The Tax Research Bureau whose establishment we are recommending later in the Report (Chapter 9) should receive all suggestions and study them. On the basis of such study of suggestions made as well as on the basis of its own research, the Bureau can formulate the proposals for change which should be circulated to the public for debate and discussion. Even then the proposals for change should be minimum. After full debate those minimum changes could be introduced, if found absolutely necessary, once in five years. It is also important that the temptation to change the law to take care of every eventuality, even though it may be a remote possibility and to counter every possible type of evasion should be resisted. Tax administration and tax laws can never be made simple if one proceeds on the assumption that every taxpayer is a potential evader, i.e., evasion and not compliance is the dominant motive of every assessee. Certainly, attempts should be made to plug loopholes for large scale evasion. It is neither profitable nor feasible to plug every little loophole in order to prevent every possible petty act of avoidance or evasion. Attempts to do so often lead to undesirable results or cause hardship to honest assessees. A good example of such an attempt is the provision in the Income-tax Act (Section 13) which makes a charity lose its tax exempt status if a donor

who has given just Rs.25,000 should enjoy even a small privilege because by giving that amount of money he would become an interested person.

b. Target fixing

5.8 It is understandable that in budget making some target for revenue collection will have to be fixed. However, if expenditure growth is uncontrolled, unrealistically high revenue targets get to be fixed in an attempt to contain the Budget deficit. Once an aggregate target is fixed for a revenue source, it is subdivided and sub-targets are distributed among the assessing officers. Assessing officers will, of course, get an incentive to speed up assessments as a result of the high target given to them; but if the target is unrealistically high, they can only hope to achieve it through overassessments, levy of penalties, etc. We cannot overemphasise the harassment caused to the assessees as a direct result of the fixation of unrealistically high targets. While an officer who exceeds his targets could be commended, it is important that the target should be fixed realistically, keeping in view the expected rate of growth of the economy and the likely rise in prices. For judging the ability and work of an officer, other types of targets or tests should be considered. Emphasis must be shifted to the number of assessments completed, the quality of assessment, minimum of overassessment/ underassessment, the number of additional assessees brought within the tax net judged by a three year average, minimum of complaints from the assessees, etc.

c. Accountability

5.9 Ways must be found to hold the officer accountable for the kinds of assessments he makes. Under the present procedure an assessing officer, whether he be a Superintendent of Central Excise or an Income Tax Officer, can overassess, raise additional demands without sufficient grounds and yet remain unconcerned and unaffected if his overassessments and additional demands or orders confirming demands raised by him are dismissed as untenable by the Tribunal. In fact, there is a tendency on the part of some of the assessing officers to recommend to the Commissioner/Collector that almost every case in which the Commissioner (Appeals) or the Collector (Appeals) has not sustained the additional demands created by them should be referred to the Tribunal because they stand to lose nothing if the Tribunal also should rule against their action. The assessing officers should be made accountable for their actions by being blamed for raising demands which are not upheld by the Tribunals. If the percentage of demands not upheld is higher than a reasonable figure, say, 50 per cent, the officer should be given a black mark and reprimanded. On the other hand an assessing officer should be protected and defended if he has obeyed instructions of the Board and followed court rulings even though Audit might raise objections about his actions. No officer should be blamed or given an adverse remark merely because Audit has raised objections. Explanations should be called for only in cases of gross negligence of facts or overlooking of points of law or palpable mistakes.

d. Changing the perception of the officers regarding their work

5.10 We referred earlier to the need for the better training of the officers of the Tax Departments. Apart from technical training, the officers have also to be given orientation courses with a view to changing their view regarding the scope of their work. While the assessing officers might have to concentrate on assessment work first, all of their time should not be spent in dealing with the assessees who have filed returns. In fact, computerised assessment should help them to spare enough time to keep themselves up-to-date in regard to tax provisions and case laws and in identifying non-filers and bringing them into the tax net. The officers should also be advised and trained to keep in mind the broader, social and economic aspects and consequences of taxation. They

should be encouraged to bring to the notice of the higher authorities any anomalies or provisions causing hardship to the assessees or hindrance to the smooth flow of economic activities. It is essential that officers selected to be appointed to senior posts should be given a thorough grounding in the economic aspects of taxation and made aware of the changing international practices.

5.11 The attitude and performance of the officers will depend much on the system of rewards and punishments. We recommend that the present system of rewards be changed. Rewards based on assets recovered or on the value of smuggled goods recovered not only tend to induce the officers to show results even at the expense of being unfair to the assessees sometimes, but also put a premium on rather short-term gains. The rewards in fact get unfairly distributed. An officer who is conscientious and speedy in his assessment work, is scrupulous in avoiding overassessment and lays the ground work for broadening the base through roping in new assessees goes unrewarded in terms of immediate monetary gain. Even in the long run he may not gain because under the existing system, seniority seems to be the main criterion for advancement. We recommend that monetary rewards could be considered in exceptional cases particularly those involving risk to one's life subject to a maximum of three to five times of the monthly emoluments of the officer. But the bulk of the rewards should be credited to a fund to be used for welfare activities for the officers or for distribution on an annual basis among all officers performing well in several areas. The Committee understands that even at present there is a welfare fund being operated by the CBEC from out of the proceeds of confiscated goods. Our suggestion is that the bulk of the amount being distributed to the officers participating in the search and seizure operations should also be credited to this fund. There may be a case for creating a similar fund for the benefit of officers of CBDT. Rewards in the form of commendations, favourable remarks in the Confidential Reports (CRs) and accelerated promotions should be given to honest officers whose overassessments and underassessments are minimum, who complete assessments in time and who continuously widen the base. Those who fail in these tasks should be given adverse remarks.

5.12 The existing system of performance appraisal in both the departments leaves much to be desired. In spite of all attempts to bring about objectivity in the matter of grading of officers, it continues to be highly subjective. It is this consideration which has prompted the Committee to suggest a system of examination for selection of officers at certain levels. The Committee would, all the same, urge that the need for exercising due care in the matter of performance appraisal should be emphasised and proper training should be imparted to all officers in evaluating the work of subordinate officers.

5.13 Neither of the two Departments has a long-term or medium-term well-worked out plan for raising the general standard of performance, minimising overassessments, getting more assessees in, improving the information system and tax related statistics, cutting down the number of appeals and disposing of pending suits and prosecutions in a quick manner so as to clear the slate. On the side of the Department, it must be said, however, that too much of their time is taken up by the task of putting through numerous amendments and changes in the law, issue of notifications, dealing with a very large number of audit objections, etc. Once we introduce relative stability in the law and give up the notification raj, the top officers of the Department could spend more time in building up an efficient system of tax administration.

e. Grievance redressal machinery

5.14 The existing grievance redressal machinery should be activated and the Cells attending to this work should be manned by officers specially selected and suitably trained. There are Advisory Councils

operating in the field and at the Central level. The Committee is informed that the Councils do not regularly meet. While there are reported to be instances where the assessees do not make full use of this forum, that by itself should not be the reason for doing away with such institutions. Considering the fact that these Councils provide a forum for the taxpayers to get their grievances ventilated, their functioning should be of interest to the two Boards and it should be closely monitored.

f. Taxpayer education and publicity

5.15 There have been sporadic efforts by the two Departments to bring out pamphlets to educate the tax paying public. While some of the pamphlets are quite attractive and useful, many of these are found to be drab and full of officialese. In case the necessary expertise is not available from within the Department, other expert agencies should be engaged for preparing and publishing tax education pamphlets. There is also a need for boosting the publicity campaign of the two Departments, so that there is greater awareness, among the tax paying public, of the activities of the Departments collecting taxes from them.

The Role and Impact of Receipt Audit by C&AG

5.16 In both Excise and Customs and Income Tax Departments, there is a system of internal Receipt Audit which covers the majority of the cases assessed. Internal audit has necessarily to be supplemented by external audit conducted by the C&AG. The Receipt Audit by C&AG has played an important role in ensuring accountability and helping the Tax Departments identify lapses and mistakes which could be rectified as well as avoided in the future. It must also be pointed out that C&AG audit personnel do painstaking work towards the fulfilment of the responsibilities placed on the shoulders of the C&AG by the Constitution.

5.17 A review of the working of the audit system and of Audit's approach and attitude does, however, reveal some problems and consequences which in fact tend to militate against the long-term growth of the economy and the growth of revenue itself as well as impose hardship on assessees. While within the ambit of the Receipt Audit, the C&AG has to scrutinise and appraise the actions of the two Tax Departments in relation to the assessments strictly on the basis of the existing laws and rules, the best results are obtained with the C&AG and the Tax Departments working harmoniously and with goodwill.

5.18 The Tax Departments and the assessees both represented to us that often the manner in which C&AG audit is approaching its work and its refusal to accept the views even of the two Boards regarding the intention of particular laws enacted by Parliament under the guidance of the executive branch of the Government cause hardship to the assessees and have led to infructuous work and an excessive fear of Audit that tends to distort the decisions of the assessing officers.

5.19 The following seem to be the common complaints:

a. Audit tends to raise too many objections and several of them not of very significant revenue implications. Many of the objections are finally not accepted by the Board or dropped from the Audit Reports to be submitted to Parliament and scrutinised by Public Accounts Committee (PAC). What this means to the assessees is brought out later in this chapter.

b. Audit often goes to the extent of interpreting the law even when the Board concerned is of the view that the intention of the law is contrary to Audit's view and that consequently no mistake has been committed by the assessing officer.

c. While it would appear that the emphasis of the work of Audit should be on the examination of the adequacy of laws, rules, systems and procedures and that the mistakes found in individual cases should be used to suggest improvements in rules and procedures, it tends to place excessive emphasis on the revenue aspect in individual cases.

d. Since public revenues have to be protected, perhaps it is justifiable to pay greater attention to short levies and under-assessments: however, Audit pays unduly little attention to cases of misapplication of law leading to over-pitched assessments which not only cause harassment to the assessee but also lead to long drawn out disputes.

e. Audit parties, in excise cases, often visit factories not only to check documents (which, in any case, can be obtained through the Range Officers) but also to verify stocks, etc. This means that Audit wishes to undertake investigation work which in reality belongs to the Tax Department. Visits of the Audit parties to the factories, and we are told sometimes even to factories of small scale producers, are not only beyond the required ambit of Audit but tend to cause hardship to assessees, and add to the problems caused by the visits of lower level tax personnel themselves.

5.20 In respect of income tax, the number of Receipt Audit objections received, of Draft Paras (DPs) sent to the Ministry and of DPs included in the Report are as follows:

Audit Report	Number of objections	DPs received by the Ministry	DPs included in the Report
1985-86	-	1102	702
1986-87	-	1190	647
1987-88	-	1355	763
1988-89	22199	1442	945
1989-90	22482	-	-
1990-91	22651	-	-

5.21 In the last few years, Receipt Audit has been sending a large number of DPs to the Ministry for comments. This number has increased from 864 in 1985 to as many as 1907 in 1990. Many of these DPs are only repetitive in nature. These require calling for information from the field and are thus time consuming and the Ministry gets bogged down in furnishing its comments. For example, in 1990, out of the 1907 DPs to which the Ministry was required to furnish comments, only 701 cases were finally included i.e., only 37 per cent. It is argued by the Department that if the Receipt Audit sends only selected DPs and those which threw some light on the various facets of law and procedure, then considerable time of the Ministry would be saved, which can be better utilised for other matters.

5.22 There is no doubt that the Receipt Audit has been doing yeoman service in pointing out the mistakes committed by the assessing officers and helping in reducing them. However, the revenue effect of the audit objections is not as much as is depicted in the Audit Reports. A study conducted by the Directorate of Income Tax (Audit) to assess the actual gain to revenue as a result of reported DPs in the Audit Report 1986-87, reveals that the projected tax effect does not necessarily result in actual gain to revenue. A few objections are accepted for technical reasons. Some are infructuous and others show only potential/notional tax effect. Out

of the 533 DPs analysed, and involving revenue of Rs.69.29 crore, only 214 were accepted. The real gain to revenue was about 12.26 per cent of the projected tax effect.

5.23 The position in respect of Receipt Audit objections in Excise and Customs is in no way different from what is said above. The number of objections received, the DPs sent to the Ministry and those finally included in the Audit Report during the period 1988-89 to 1990-91 are given below:

Year	Number of object-ions	DPs received by the Ministry	DPs included in the Audit Report
1988-89	9625	532	235
1989-90	8515	555	271
1990-91	8121	527	249

5.24 Elaborate procedures have necessarily to be followed in dealing with audit objections. Hence, if a large number of Audit objections are raised, many of them with not significant revenue implications, there is considerable loss to the Exchequer through expenditure of time and effort spent by the Departments in dealing with these objections. In fact, it is stated that one Member of each Board is kept fully busy dealing only with Audit objections and DPs during a major part of the year.

5.25 Under a parliamentary system of Government, the legislature is guided by the Executive in enacting laws. This is particularly so in respect of Money Bills which can emanate only from the Government. This being so, the intention of the Executive in formulating legislation, recommending it to Parliament and getting Parliament to pass it must be given due weight, as otherwise the Government would be forced to do what it does not, as a matter of public policy, want to do. Where a law has been misapplied by an assessing officer and there is no dispute regarding the interpretation of law, certainly Audit will be justified in holding that there has been or would have been loss of revenue. However, if at the level of the Board it is determined that the intention of law is precisely what the assessing officer has done, Audit could not justifiably maintain that revenue has been lost. At the most, Audit could point out that perhaps the wording of the law should be changed to make the intention of the Government clearer and this suggestion could be referred to the Law Ministry. In actual practice, Audit tends to insist in several cases that the Board's views will not be accepted by it or taken to be the intention of the Government and that consequently the opinion of the Attorney General must be obtained. In relation to income tax, a case that might be mentioned relates to the definition of 'industrial undertaking' for purposes of granting exemption under Section 10(15)(iv) relating to the interest paid on foreign borrowings for industrial purposes. This concession was made available consciously as a matter of policy to Shipping and Airlines. Audit raised the objection that these two sectors cannot be considered as industries. The Department's position was however upheld by the Attorney-General.

5.26 Again, in respect of income tax, Audit has been asking the Department to reopen cases that have been satisfactorily subjected to summary assessment on the plea that going beyond the scope of summary assessment, Audit has been able to find "errors" in assessments. Now, as is well-known, instructions have been given to assessing officers regarding what kinds of errors should be checked and what is the scope of *prima facie* adjustments under the scheme of summary assessment. The assessing officers cannot go beyond the instructions given. Audit can certainly check whether the instructions regarding summary assessment have been followed by the assessing officers or not. The dual system of summary and scrutiny assessments has been introduced after a careful calculation of cost-benefit ratios of alternative systems of

assessments. A view has been taken after due consideration in our country, as in many other countries with a very large number taxpayers, that, in the long run, the income tax revenue (net of cost) and its growth will be higher if effort is concentrated on a sample of scrutiny assessment cases and if the majority of returns are accepted after checking for arithmetical errors and other palpable mistakes such as excessive claims in regard to concessions or claim for a larger percentage of depreciation than is permitted by law. If Audit chooses to convert a summary assessment case into a scrutiny assessment case, begins to investigate to see if the various statements made in the return are correct, given the previous year's return (for example, the level of written down value of assets given in the current return and so on), it is possible that some errors will be found. If then the Audit claims that the assessing officer has acted in a manner prejudicial to revenue and asks for remedial action in terms of re-assessment, the whole scheme of summary assessment is jeopardised. This would be clearly against the interests of long-term growth of revenue. Furthermore, the assessee can legitimately claim that if he were to be subjected to scrutiny assessment that should have been done in the very first instance; it is certainly not fair to reopen his case after a lapse of years. In any case, it cannot be stated with certainty that Audit's point of view will be upheld by the appellate authorities. Picking up cases for scrutiny assessment in this way in an arbitrary manner only adds to the workload of the Department without commensurate increase in revenue. It is necessary that Audit should accept the basic system of assessment that has been adopted by the Government as a matter of policy after due consideration. We are strongly of the view that the Government should present the total picture to Parliament and explain the rationale for adopting the dual system of summary and scrutiny assessments and desist from taking remedial action, if Audit should insist on converting summary assessment into scrutiny assessment on its own.

5.27 In respect of excises also, there have been cases where Audit has insisted on its own interpretation of law even when that goes clearly against well-announced Government policies. One, for example, is that of cone yarn and hank yarn. Hank yarn is used by handloom weavers and as a matter of policy, the Government has exempted hank yarn from excise, whereas cone yarn used by power loom weavers and composite mills is subject to duty. Now it happens that sometimes yarn is spun around cones and then converted to hank yarn. This could be due to several reasons but the point is that what is sold is hank yarn and not cone yarn and the Department has rightly desisted from collecting duty. But Audit has insisted that since cone yarn has come into existence, duty must be levied. If duty is levied (which is currently at specific rates based on weight and count) that will be passed on to the buyer of that consignment of hank yarn which has been made out of cone yarn. That would defeat the very object of the policy and yet Audit is insisting that duty should be levied. Even if there is a technical flaw here, the principle of harmonious construction would certainly justify that hank yarn in this case be exempted even without any change in the law.

5.28 The point that we are trying to make is that the life of the tax assessor and the assessee is made more difficult than is necessary because of the adherence of Audit to technical positions and the primacy it gives to short-term revenue considerations. It has to be remembered that the harassment to the assessees goes against the voluntary tax compliance scheme and will be detrimental to the faster growth of revenue.

5.29 The role of Revenue Audit has been discussed by a number of Committees in the past. In the context of Income Tax Revenue Audit, the Direct Taxes Enquiry Committee (Wanchoo Committee) observed in December 1971 that the officers feel that their judicial discretion is being interfered with by the Revenue Audit trying to impose its own interpretation of law. Taxpayers are

aggrieved that assessing officers, on account of the fear of Revenue Audit, always try to err on the safer side, driving them to unnecessary appeals and causing avoidable hardship to them. The Committee observed that they would trace both the grievances to the fear complex that seems to have developed among assessing officers as a result of the higher authorities within the Department calling for explanation from them for every lapse. The Committee recommended that the CBDT and Commissioners of Income Tax should ordinarily settle audit objections after securing the necessary information but without calling for 'explanation' from the Income Tax Officer. 'Explanations' should be asked for only in cases of palpable mistakes or gross negligence or where binding judicial decisions or departmental instructions have not been followed. What is stated about the audit of direct tax receipts is equally true of indirect tax receipts.

5.30 Similarly, the Administrative Reforms Commission in the report on Finance Accounts and Audit commented on the audit of revenue receipts as follows:

> "The divergence of opinion with regard to the interpretation of the tax laws and rules and regulations is occasionally a source of friction between the Audit and the Revenue Departments. It should be recognised that nothing should be done to dilute the responsibility of the executive in the matter of the application of tax laws. However, we understand that cases do continue to arise in which the Audit Department presses for the acceptance of their own interpretation of points of law. We do not consider it necessary or desirable for Audit to enter into controversies with the Revenue authorities on questions of interpretation of the law, though a lively and cordial discussion may at times be useful. In the first place, the decision on points of law is subject to challenge in Courts of Law and secondly, the Revenue authorities have to take certain decisions to execute the policy of Government. In our opinion, doubts with regard to the interpretation of the law should be finally settled by Audit in consultation with the highest administrative authority, namely, the Central Board of Direct Taxes and the Central Board of Excise and Customs, as the case may be."

5.31 The officers who appeared before us have also expressed the view that the questioning by Audit of the assessment decisions of a quasi-judicial nature by the Departmental officers has given rise to a wide-spread sense of fear and has resulted in a distinct tendency on the part of the officers to make high-pitched assessments, taking decisions in favour of revenue even in cases where they think proper decisions should go in favour of the assessee.

Dealing with Audit objections

5.32 Both the Departments have worked out well-defined arrangements for dealing with Receipt Audit objections and they are by and large similar. The following procedures have been prescribed by the Income Tax Department for dealing with audit objections.

5.33 In the course of Receipt Audit, the Accountant General's (AG's) Audit Party issues separate Audit Memos (Half Margin Notes) for each objection raised. The assessing officer furnishes replies to the Half Margin Notes of Receipt Audit within three days of their receipt. The facts and figures are either accepted after checking or, if scrutiny reveals discrepancy, the same is pointed out to the Receipt Audit Party without any loss of time. On the last day of audit the gazetted officer-in-charge of the Receipt Audit Party discusses the draft Local Audit Report (LAR) with the assessing officer who clears his doubts, if any. Thereafter, the draft LAR is edited by the Deputy Accountant General (DAG) and sent to the assessing officer, Deputy Commissioner (Audit), and the Commissioner as the final LAR. The

assessing officer's report on each of the objections in the LAR is required to be prepared within 30 days of the receipt of the same.

5.34 The Deputy Commissioner (Audit) forwards one copy of the assessing officer's report to the Sr.DAG/DAG concerned within a fortnight of its receipt, along with his own comments. Objections for which the Department does not have an arguable case are readily accepted. In other cases, the Deputy Commissioner (Audit) finds it advantageous to discuss the issue involved with the Sr.DAG/DAG concerned before sending his comments. In a case where difference of opinion persists between the Sr.DAG/DAG and the Deputy Commissioner (Audit), the latter will report the full facts of the case to the Commissioner, within a fortnight of the receipt of DAG's comments.

5.35 The Commissioner is required to take a final decision on the issue indicated by the Deputy Commissioner (Audit) within a fortnight of the receipt of the note. Keeping in view the directions of the Commissioner, the Deputy Commissioner (Audit) finally informs the DAG suitably regarding acceptance, or otherwise, of the objection.

5.36 After considering the assessing officer's reply, the comments of the Deputy Commissioner (Audit) and the DAG's comments, the AG would then refer the case to the Commissioner, for his views on the 'objections' he intends proposing to the C&AG for inclusion as DPs. In the light of the comments of the Commissioner, the AG makes his recommendations to the C&AG regarding DPs to be included in C&AG's Audit Report.

5.37 The C&AG sifts all such recommendations received from the AGs, and then the select list of DPs is sent to the Ministry of Finance for comments. The CBDT thereafter forwards these DPs to the Commissioner concerned and the Director of Income Tax (Audit) and calls for reports from the Commissioner in a prescribed proforma. Commissioners are required to send their reports to the Board in three weeks and the Board, in turn, has to send its comments to the C&AG within six weeks. Based on the report of the Commissioner, the Ministry send their comments to the C&AG specifically indicating the acceptance or non-acceptance of the audit objection and the remedial action taken, where objections are accepted. After consideration of the same, the C&AG finalises the Audit Paras for inclusion in C&AG's Audit Report for the year which is placed before Parliament and followed up by its consideration by the PAC.

5.38 If the assessing officer, after due discussion, accepts the Audit's point of view he will take remedial action after getting instructions from Commissioner/Deputy Commissioner depending upon the amount of revenue involved. If the amount of revenue is small, the assessing officer can take remedial action on his own. This will take the form of issue of notice for reopening of the case concerned. If the assessing officer does not accept the Audit objection and the matter is referred to the higher authorities, then often remedial action is initiated in order to prevent time barring of the case. This is done even if the Department has not so far accepted the objection and may not accept it at all. The instructions of the Board seem to be that priority should be given for taking remedial action in all cases which are likely to get time barred even though the Department has not accepted the Audit's point of view when the action is being initiated. The assessees are thus put to unnecessary trouble and harassment and if a reassessment is made, the assessee may appeal and the Commissioner (Appeals) may knock down the additional demand in which case the Department will be bound to file a case against the decision in appeal. There may be similar cases where assessments have been completed and it might become necessary to reopen all those assessments. At the end, if the Department at the level of the Board decides not to accept the Audit objection all 'remedial action' cases will have to be dropped.

5.39 As regards excise and customs, the present position is that as soon as an Audit objection pointing out short levy is received by the customs and excise officers in the field, a show cause notice is issued to the assessee asking him to state why the duty liability cannot be fixed at the higher level as indicated by Audit. This is, of course, done without reference to whether or not the officers concerned are in agreement with the point raised by Audit. It is found that no final decision is taken on many show cause notices when the Department is not in agreement. In the meantime, the assessee is burdened with the show cause notice which has been issued in order to make sure that the additional demand if finally considered necessary, does not get time-barred. In the case of indirect taxes, it has to be remembered that the incidence of tax is usually shifted to the consumer. Once the sale is completed, it is well nigh impossible for the assessee to recover the extra duty demanded by the Department. Further, the very possibility of a demand being raised by the Department at a future date can be quite a burden to the assessee. The present system violates one of the cardinal principles of taxation, namely, certainty. It also appears to be against the basic principles of law to issue a show cause notice stating "that it appears that there is a short recovery of duty", when the issuing authority does not itself feel so.

Role of Audit

5.40 The Committee appreciates the view that it is well within the jurisdiction of the PAC, a Parliamentary Committee, to question a ruling given by the Board. Where, however, Parliament has chosen to delegate some of its powers to the executive and the executive exercises that power, it will not be correct to hold that the consequence of the wrong exercise of the delegated powers could fall on the assessees. If this position is accepted, the nature of the action to be taken in case of audit objections, where there is a difference of opinion between Audit and the Department will become clear. As far as the assessee is concerned, the assessment made by the properly authorised officer should be final and it should not be subjected to any change with retrospective effect except to the extent that there is an error in assessment as perceived by the officer and there is a provision in the law rectifying the error. While recognizing the important role the external audit is playing in regard to tax collection, the Committee would like to stress that the difference of opinion between the Department and Audit should not result in an audit phobia developing in the tax collection machinery, with the consequence that assessment tends to be always high pitched and in favour of revenue. The Committee would strongly urge the Government to review the present system and devise ways and means by which assessment done genuinely by the properly authorised officers do not get upset because of the difference in view between the Department and the external audit.

5.41 In outlining the response of the Department to audit objections and the procedures followed in dealing with them including the issue of notices of additional demand of tax, we have indicated that taken together and with delays in dealing with such matters, they cause considerable hardship to the assessees, generate infructuous work and lead to avoidable disputes. Keeping these undesirable consequences in view, we recommend:

a. Direct taxes:

i. As far as audit objections accepted by the assessing officer are concerned, the existing procedure should be followed and remedial action in the form of issue of demand note, etc., should be initiated within one month from the date of receipt of audit objection.

ii. In regard to audit objections not accepted by the assessing officer, while the matter is being discussed and sorted out by the higher authorities and the audit officers, remedial action in the form of issue of demand notice should

be taken only in respect of cases which would be time-barred within three months from the time the assessing officer communicates disagreement with Audit. In other cases, remedial action must be taken only under instructions from the higher authorities to do so, and they should issue such instructions only if they agree with Audit.

5.42 It follows from what we have said above that the process of consultations among the field formation, C&AG and the CBDT should be completed within a period of three months from the date of receipt of audit objections. This means remedial action will get time-barred if the CBDT does not issue instructions within that period. It is only proper that the adverse consequences of any delay in the issue of instructions should fall on the Department and not on the assessees.

b. Indirect taxes:

5.43 Once an audit objection is received at the Range level or Divisional level in the case of excise matters and at corresponding levels in customs matters, it should be processed on a top-priority basis and unless it is found acceptable, no demand or show cause notice should be issued at that stage. Where the Divisional officer feels that the decision taken is correct and is in accordance with the Board's directions, if any, on the subject, he should make an immediate reference, in any case not later than two weeks from the receipt of the audit objection, to the Collector who should get the matter examined in his office. Where at that level the objection is found acceptable on the ground that the Assistant Collector has overlooked certain instructions or decisions of the Board, the Tribunal or Court, these should be brought to his notice so that the necessary show cause notice can be issued. If, however, the Collector is in agreement with the views expressed by the Assistant Collector, he should make an immediate reference by the quickest possible method to the Board. The action at the Collector's level should be completed within two weeks of receipt of the reference from the Assistant Collector. The Collector may also have discussions with the AG if any clarification is called for, or if it is considered that the audit officers have issued the objection without proper understanding of the facts of the case.

5.44 There should be proper infrastructural arrangement in the Board's office to deal with all such references on a priority basis and to take a quick view on the subject. If the objection is still found unacceptable, the matter should be discussed with the C&AG's officers and the correct position explained to them. If, however, it is found that the officers have acted on the basis of the Board's instructions but after discussion with the Audit, it is conceded that the Audit's point of view is correct, the Board will immediately modify its instructions in terms of Section 37-B of the Central Excises and Salt Act, 1944 and Section 151-A of the Customs Act, 1962. These instructions will have only prospective effect and no attempt should be made to reopen assessments already completed. This will be in keeping with the philosophy behind Section 11-C of the Central Excises and Salt Act, 1944 and Section 28 A of the Customs Act, 1962 according to which the Central Government through issue of an order can decide not to proceed to collect duties not recovered or short recovered because of a general practice and an understanding between the assessee and the Department regarding the former's duty liability.

5.45 Action at the Board's level should be completed within one month of receipt of the report from the Collector.

5.46 If there is sufficient appreciation on the part of the Department regarding the adverse effect that the present system has brought about on the tax collection and the undue burden it has placed on the assessee, it is not difficult for the Board to work out procedures on the lines suggested in the preceding paras.

Penalties and Prosecution

a. Income tax

5.47 The Income-tax Act provides for prosecution of persons for a range of offences which include wilful attempts to evade tax as well as a number of other tax violations like failure to pay tax deducted or collected at source and failure to produce accounts and documents. For some of the offences prosecution can be launched under the Indian Penal Code. However, the prosecution lauched can be compounded by the CBDT.

5.48 The position in regard to launching, disposal and pendency of prosecutions is as follows:

Period	No. of complaints filed			No. of complaints disposed of	Balance pending
	Tax evasion	Others	Total		
1986-87	1426	3832	5258	396	14165
1987-88	562	6799	7361	433	21093
1988-89	721	6707	7428	781	27740
1989-90	595	8334	8929	638	36031
1990-91	844	2942	3786	2309	37508

5.49 Over the years, the prosecutions launched have increased substantially while the disposals have remained at a very low level. As a result, the pendency of prosecutions in the Courts has increased progressively. The average time for disposal of a prosecution case is quite long and, therefore, the effectiveness of prosecution in deterring evasion is considerably diluted.

5.50 We note that there are a large number of prosecutions which have been launched in respect of technical offences such as delay in depositing tax deducted at source and that often the amounts involved are not very large. We are given to understand that the proportion of prosecutions against technical offences is coming down; nevertheless they are sufficiently large to cause concern and to necessitate a change in approach. First of all, it is necessary for the Department to concentrate on large cases and to be selective in launching prosecutions where cases are strong so that with conservation of effort and concentration on strong cases the Department could be successful, and through the punishment of the guilty can produce the desired deterrent effect. Second, we would suggest that in respect of most of the technical violations of the law a late fee or penal interest should replace discretionary penalty or attempt at punishment through successful prosecution. The imposition of late fee or penal interest should be statutorily laid down and be automatic. Since it would be automatic, the level of penalty should be moderate. Third, there should be substantial delegation of power to compound to the Chief Commissioner, who should compound if he is satisfied that that would be in the best interests of revenue. Fourth, if it is decided to launch a prosecution in a particular case, the job must be taken up seriously and must be executed efficiently. Sufficiently qualified counsel should be hired wherever necessary to supplement the Departmental Representative and the necessary documents should be provided to him in time. The Department should follow the twin strategy of reducing the number of prosecutions launched, particularly for technical offences,

and bringing down the existing pendency of prosecutions in the Courts. Towards this end we recommend:

a. In the case of offences referred to in Sections 276B and 276BB an automatic penalty in the form of additional interest of an appropriate magnitude should be imposed; the rate of interest should vary with the length of the period of default. A possible scale of interest charges would be as follows:

   i. Where the period of default does not exceed six months, half per cent of the amount outstanding [taxes, fines and all interest other than additional interest and interest under Section 220(2)] for the period of default;

   ii. Where the period of default exceeds six months but does not exceed twelve months, one per cent of the amount outstanding for the period in excess of six months; and

   iii. Where the period of default exceeds twelve months, two per cent of the amount outstanding for default in respect of the period in excess of twelve months.

   Section 276B and 276BB empowering the launching of prosecution for failure to pay tax deducted at source should be withdrawn. However, if the tax deducted at source along with interest and additional interest imposed remains unpaid after a specified period time, the person could be considered to be in default of payment of tax and the Department could consider launching prosecution for wilful attempt to evade payment of tax.

   The discretionary penalty under Section 221(1) of the Income-tax Act for default in making payment of tax should be replaced by an additional interest in the nature of an automatic penalty whereby all persons who fail to make payment of any arrear [i.e., tax, interest other than interest under Section 220(2) or penalty] arising under the Act within the statutory time allowed for payment of such arrears, should be deemed to be an assessee in default from the date following the expiry of the statutory time period. He should thereafter be liable to pay along with the amount of arrears and the amount of interest payable under Section (2) of Section 220, additional interest at the appropriate rates to be sp cified, which could be the rates mentioned in (a) above.

c. The existing scheme of automatic penalty against late filers and non-filers in the form of penal interest under Section 234A and prohibition to carry forward the loss [Section 139(3)] should both be replaced by a new system of an automatic penalty in the form of a late fee:

   i. If an assessee has paid all the tax due, but delays filing the return by more than a month but less than six months, a penalty in the form of a late fee of Rs.500 should be imposed on him; if the delay is more than six months but less than a year the late fee should be Rs.1,000 and if it is more than one year it should be Rs.5,000 (thereafter the late fee arrear should be treated as arrear interest);

   ii. If the return is not filed in time and there is tax due, then besides the additional interest on the amount of tax due, the penalties mentioned in (i) above for late filing should also be imposed; and

   iii. If those earning income from business and professions having turnover exceeding the amounts specified for the obligation to file a

return do not file a return but also do not have income exceeding the exemption level, they should again be asked to pay only the penalty mentioned in (i) above.

d. The discretionary penalty under Section 271(1)(b) of the Income-tax Act also should be replaced by a fine/late fee in the nature of an automatic penalty:

   i. At the rate of rupees fifty for every week of failure to comply with a notice under Section 142(1). However, this fine should not be levied in cases where part information is furnished in response to notice under Section 142(1) or where adjournment is granted by the tax administration on its own, or where the notice under Section 142(1) requires the taxpayer to furnish the return of income; this should be raised to rupees one hundred after the 4th week.

   ii. At the rate of rupees one hundred per week of default reckoned from after the 15th day of the order appointing the auditor under Section 142(2A) to the day when the taxpayer's communication submitting himself for audit is received by the Tax Department. This should be increased to rupees five hundred per week after 4 weeks of default.

e. The discretionary penalty under Section 271B of the Income-tax Act for failure to get accounts audited or obtain audit report as required under Section 44AB or furnish such report along with return under Section 139(1) or in response to notice under Section 144(1) should be replaced by a late fee in the nature of an automatic penalty of an appropriate magnitude in line with our suggestions above.

f. The discretionary penalty under Section 272A(2) of the Income-tax Act should be replaced by a system of late fee in the nature of an automatic penalty at rates specified in (a) above.

5.51 With a view to reducing the number of prosecutions launched for technical offences, we recommend:

a. The prosecutions under Section 276C(2) should be launched only if the assessee fails to make the payment of tax for a considerable period, say over one year and not merely because the statutory time period for payment of tax has lapsed. This is because for the first year, additional interest will be charged.

b. Even where the prosecutions are launched for technical offences in accordance with the scheme recommended by us, the Department should generally take a liberal view in compounding prosecutions for such technical offences.

5.52 We consider that reducing the number of pending prosecutions is an important step towards preparing for the new system of automatic penalties and reduced scope and need for launching prosecutions. Towards this end, we recommend the scaling down of compounding fees and the launching of a drive for compounding in respect of prosecutions for technical offences.

5.53 The power to compound should be delegated to the Chief Commissioner/ Director General for all prosecutions for technical offences. In cases where tax evasion is involved, the power to compound should be delegated to Chief Commissioner/Director General except where the amount of tax evaded exceeds, say, Rs.1 lakh. In tax evasion cases, it could be required that the compounding would be done by Chief Commissioner in consultation with a Commissioner.

b. Excise and Customs

5.54 As regards prosecutions under the Customs Act, the position in regard to launching, disposal, pendency, number of persons convicted and number of persons acquitted is as follows:

		1988-89	1989-90	1990-91
1.	No. of offence cases	65035	61394	62392
2.	No. of prosecutions launched	2538	1925	1981
3.	No.of disposals	1307	910	662
4.	No.of persons	946	751	571
5.	No.of persons acquitted	361	159	91

5.55 The Central Excise and Customs Department has issued from time to time detailed guidelines for launching prosecutions. According to the latest guidelines, prosecutions could be launched only with the prior approval of the Principal Collector of the jurisdiction and subject to, inter-alia, the following conditions:

a. the offence is not merely of technical in nature, or

b. the additional claim for duty is not based solely on a difference of interpretation of law and notifications issued thereunder, or

c. the value of the goods seized or duty evasion involved is not less than the limit prescribed in these guidelines, and

d. the Department should have evidence to prove that the person, company or individual had guilty knowledge of the offence or had fraudulent intention of committing the offence or in any manner possessed *mens rea*.

5.56 The above guidelines have ensured that prosecutions are launched only in cases of serious violations of law with fraudulent intention and this along with the requirement of garnering adequate evidence to show personal culpability of the accused have limited the number of prosecution cases to reasonable limits. In customs, the success rate of prosecutions has been quite impressive.[10]

5.57 In Central excise, the total number of prosecutions pending decision in the Courts is only around a thousand as on 1.3.1992. In 1991-92, 55 complaints were filed by the Department while the number of prosecutions decided by the Courts was 61, out of which the accused were convicted in only 24 cases. As we have observed in the preceding Section in regard to prosecution under the Income-tax Act, the Courts have been taking inordinately long time to decide the prosecution cases as a result of which the deterrent effect of prosecutions is diluted to a considerable extent. In order to increase the deterrent effect of prosecution in cases of fraudulent evasion of excise duty, we recommend the following:

a. the prosecution in Central excise should be limited to cases of suppression of production and surreptitious removal of excisable goods, cases of under valuation where fraudulent intention of evasion of duty is established and cases where the same person commits offence repeatedly;

b. the existing duty limit of Rs.1 lakh for filing prosecution should be enhanced

to Rs.5 lakh;

c. the Collector should get the cases fit for prosecution processed within one month of the date of the adjudication order and the Principal Collector should decide about granting sanction for prosecution within a period of two months from the date of submission of the Collector's recommendations;

d. the prosecution cell should be headed by a Deputy Collector who should be made responsible for ensuring that the complaints are filed in the Court within a period of four months from the date of the order of adjudication, for briefing the Public Prosecutor and for ensuring that the cases are listed for hearing within a reasonable time;

e. the prosecution cell should be manned by at least one expert with adequate legal knowledge and experience who should assist the Public Prosecutor in presenting the Department's case in the Court of Law. For this purpose all the Collectorates should take measures to get atleast one Superintendent having a degree of law and adequate experience in legal matters appointed as Assistant Public Prosecutor. At present only a few Collectorates have such departmental officers as Assistant Public Prosecutor. The special pay for these experts should be increased suitably so as to attract good officers for this post.

Settlement Commission

5.58 The Wanchoo Committee (1971) recommended the setting up of a mechanism for quick and final settlement of complicated tax cases, which would otherwise become enmeshed in protracted litigation. However, that Committee also emphasised that the scheme should not become an escape route for tax evaders who had been caught and who were likely to be heavily penalised or prosecuted. Its recommendations in this regard led to the insertion of provisions for settlement of income tax and wealth tax cases and the creation of the Settlement Commission.

5.59 Originally, any assessee in whose case tax proceedings were pending could approach without any conditions the Settlement Commission for settlement. However, subsequent legislative amendments have placed some restrictions: the condition that the assessee should make a full and true disclosure of income which had not been disclosed before the assessing officer, the requirement that additional amount of income tax payable on income disclosed in the application should exceed Rs.50,000 and the stipulation that in a search case, which has resulted in the seizure of any books of accounts, other documents or assets, a settlement application cannot be made before the expiry of 120 days from the date of seizure.

5.60 Till March, 1979, the Commissioner could veto the admission of a settlement application on the grounds of establishment or likelihood of establishment of concealment of income in the case. The Finance Act, 1979 diluted this power by empowering the Settlement Commission to overrule his objection (after giving the Commissioner an opportunity of being heard), if it was not satisfied with the correctness of the objections raised. However, because of the difference in perception between the income tax authorities on the one hand, and the Settlement Commission on the other, regarding the intended connotation of the expression "concealment of particulars of income on the part of the applicant .... has been established or is likely to be established by any income tax authority, in relation to the case", appearing in Section 245D(1A) of the Income-tax Act as it stood prior to its amendment by the Finance (No.2) Act, 1991, objections raised by the Commissioner against admission of settlement applications were overruled in most cases by the Settlement Commission. Besides, the process

of deciding admissibility of settlement applications consumed a lot of time as the Settlement Commission could not summarily accept or reject the Commissioner's objection and was required to allow a reasonable opportunity to be heard both to the Commissioner and to the applicant. Perhaps for these reasons, the Finance Act, 1991 withdrew, with effect from 27th September, 1991 the Commissioner's power to object to an application being made to the Settlement Commission.

5.61 The procedure now is that on receipt of a settlement application, the Settlement Commission is required to call for a report from the Commissioner and decide the admissibility of the application on the basis of the report, having regard to the nature of the case or the complexity of the investigations involved. As per a provision inserted by the Finance Act, 1991, the Commissioner is required to report within one hundred and twenty days of the receipt of the communication from the Settlement Commission. If he fails to do so, the Settlement Commission can make an order without a report. No application can be rejected unless a hearing has been given to the applicant. A settlement order is passed after hearing the applicant and the Commissioner (either in person or through an authorised representative) and the examination of records and evidence.

5.62 The Settlement Commission can grant immunity from prosecution for any offence under the Income-tax Act or the Indian Penal Code or any other Central Act in force and also, wholly or in part, from the imposition of any penalty under the Income-tax Act with respect to the case covered by the settlement, if it is satisfied that the applicant had co-operated in the proceedings and made a full and true disclosure of his income and the manner in which such income had been derived. However, it cannot grant immunity in a case where the proceedings for prosecution for an offence were instituted before the date of receipt of the settlement application. Immunity granted to an applicant can be withdrawn in certain circumstances.

5.63 Given the fact that there is a tendency for several tax disputes to arise leading to court cases and that such cases often take an inordinately long time to conclude, it is necessary to have an institution such as the Settlement Commission. In some advanced countries like the United Kingdom (UK), senior officers of the Revenue Department at different levels have been given the power to settle cases of dispute involving different amounts of tax. This has enabled the British tax authorities to keep the number of court cases relating to tax disputes to a low level. In India, since the power to settle cases has not been granted to the senior officers of the Department, the Settlement Commission can play a very useful role. However, under the existing provisions relating to the Commission and with the power of the Commissioner to object to the sending of application to the Settlement Commission having been withdrawn, the recourse to the Settlement Commission is offering an easy escape route to tax evaders.

5.64 When evasion of a large magnitude is unearthed, the assessee concerned can apply to the Commission for the settlement of his case, make a full confession and obtain immunity from prosecution under several Acts. This can happen even when a large amount of tax has been evaded and the Department has a really strong, if not fool-proof,case against him. What is more, there is nothing in the law which can prevent the same individual from approaching the Settlement Commission once again after the lapse of a few years, if he happens to be caught again. It will be agreed that while there must be a mechanism for speedy settlement of disputes which do not involve fraud or wilful intention to evade substantial amounts of tax, the legal provisions governing the operation of such a mechanism should not be such that those who indulge in large-scale tax evasion could never be prosecuted and punished with due severity. Almost total removal of deterrence is neither

fair nor will it be conducive to ensure better tax compliance.

5.65 Although, strictly speaking, no one should be allowed to get away with tax evasion, given the present circumstances, it is perhaps necessary to give tax evaders one chance to come clean. Such a facility is already available under Section 273A of the Income-tax Act. Under this Section, the Commissioner or Chief Commissioner can reduce or waive the penalty imposable or imposed for tax evasion, if he is satisfied that the assessee has made a full confession, has co-operated in the enquiry relating to the assessment of his income and has made arrangements for the payment of the assessed tax and any interest due. The benefit of this scheme is available to a taxpayer only once in his life time. Since the Act provides this facility to every taxpayer who has erred in the past, there can be no justification for letting the Settlement Commission be used by tax evaders as another "amnesty scheme".

5.66 We, therefore, recommend the following changes in the provisions relating to the functioning of the Settlement Commission:

5.67 As a general rule, the jurisdiction of the Settlement Commission should be restricted to the settlement of complicated cases involving disputed facts and questions of law, which might otherwise result in protracted litigation. Accordingly, the provisions of sub-section (1A) of Section 245D, which allowed the Commissioner to object to applications to the Settlement Commission being proceeded with, which were deleted by the Finance (No.2) Act, 1991, should be re-introduced. However, along with the re-introduction of this provision other changes in the law as indicated below should also be made:

a. At present, an application cannot be made to the Settlement Commission unless, *inter alia*, the additional amount of income tax payable on the income disclosed in the application exceeds Rs.50,000. The Committee is of the view that the amount of Rs.50,000 is too low in current prices and that therefore it should be increased at least to Rs.1 lakh. This would ensure that relatively unimportant or insignificant cases do not take up the limited time available to the Benches of the Settlement Commission.

b. To ensure that the power to object to an application being sent to the Settlement Commission is exercised judicially, it should be stipulated that the objection could be made only by an officer not below the rank of Chief Commissioner. Furthermore, the Chief Commissioner (or any designated officer of higher rank) should make an objection only where there is adequate evidence of wilful intention to conceal income or perpetration of fraud by the assessee and where the suspected or detected evasion of income is not less than Rs.10 lakh.

c. In cases where the Chief Commissioner after due consideration and after satisfying himself that the conditions set out above in (b) are fulfilled, makes an objection to the application being proceeded with, it should be incumbent on the Settlement Commission to reject the application. The Settlement Commission should not be given the power to override the objection made by the Chief Commissioner.

5.68 The changes we have suggested would ensure that the power to object to an application being heard by the Settlement Commission would be exercised at a very senior level, and the Department would raise an objection only if the officer concerned is convinced that the Department has a strong case and that there has been perpetration of fraud or wilful intention to conceal income. Additionally, no objection could be raised in smaller cases. It follows that while the Settlement Commission would be playing a useful role by quickly settling a large number

of disputes which do not involve large-scale evasion, the law would not be providing an easy escape route for large-scale tax evaders.

5.69 While presenting the Union Budget for 1992-93, the Finance Minister announced the intention of the Government to set up a Settlement Commission for settling disputes involving indirect taxes, along the same lines as the Settlement Commission for direct taxes. We recommend that the provisions defining the scope and functioning of the proposed Settlement Commission for indirect taxes should be the same as those recommended in this section.

The Imperative Need for Computerisation

5.70 In the last few years, the impact of the electronic computer and automatic data processing (ADP) has been revolutionary particularly in tax administration. The most immediate benefit to the tax administration to be obtained from ADP relates to its functions as an incredibly efficient processing system. Further, it provides not only an increased capacity for handling paper, but also furnishes the administrator with the means for integrating all of his data processing functions as well. It is capable of performing a combination of operations on facts stored in its internal memory and of producing results that satisfy many different needs. This integrated processing of information enables the tax administrator to perform at one time various tasks which otherwise would have been handled on a piecemeal basis under a manual or mechanical system. Thus, integrated data processing in itself is a valuable time saver and this coupled with the speeds at which the computer processes occur, results in efficient data handling.

5.71 Among the more difficult and tedious of the many tasks of tax administration is record keeping, which today employs many people, large space and requires much equipment. Hundreds of thousands of records can be stored in a single reel of magnetic tape. Also, it can be modified or extracted as quickly as needed. Finally, once the significant portions of a document have been placed on magnetic tape and the accuracy of the record has been established, references to the original source document will become less essential and infrequent. These documents, therefore, need no longer occupy valuable working space for long periods.

a. Direct taxes

5.72 As indicated in Chapter 6, the comprehensive use of the computer will enable the Department to accomplish its tasks in a far more efficient manner:

i. The efficiency of the collection function is enhanced through the determination of the true balance of each taxpayer's account and the possibility of recording of each transaction relating to tax payment, regardless of where it occurs.

ii. The ADP greatly facilitates the posting operations of payments and liability so that the status of accounts can be kept updated.

iii. The ADP greatly facilitates follow-up and recovery actions because of ease of calculation and availability of current data without much manual work. Similarly, the task of refunds is facilitated.

iv. The use of computer facilitates the processing and storing of information received/collected from taxpayers, persons required to supply particular classes of information, the Central Information Bureau (CIB) and the Investigation Directorate. The Taxpayers' Master File (TMF) and the computerised storage of all information received enables the Department to have at its finger tips, so to speak, comprehensive and valuable information on taxpayers and their economic transactions, which can be retrieved without difficulty. The

Department's knowledge of, and ability to deal with, taxable entities is thus increased manifold.

v. The ADP enables the development and use of a proper method of choosing samples for scrutiny assessments as explained in Chapter 6 in the Section on scrutiny assessment.

5.73 There is little doubt that no worthwhile improvement in the enforcement of taxes and reduction in the hardship and trouble caused to the assessees can be achieved without full-fledged computerisation. However, before the design of computerisation and the choice of hardware and software is decided upon, it is necessary to determine the contours of the revamped and reorganised tax administration system, along the lines we have recommended. The design of computerisation including the choice of hardware and the software requirements must be worked out with care with the help of experts who have set up and have worked upon such systems. A group of officers of the Department must be associated with the whole exercise. Therefore, we strongly urge that:

a. technical assistance from the multilateral financial institutions be first availed of;

b. a reputed Indian consultancy agency could be hired to work with the experts supplied by this multilateral agency;

c. a group of officers from the Department should participate in this exercise; and

d. if help from multilateral institutions is not to be availed of, a reputed foreign private consultancy agency could be hired.

5.74 In this connection, we learn that a neighbouring country, namely, Sri Lanka, has successfully completed a programme of computerisation of its tax administration with the assistance of multilateral agencies. It would be worthwhile for some of the officers of the Income Tax Department qualified in this area to acquaint themselves with the computerisation programme and the improvements brought about in tax administration in countries which have completed such programmes.

5.75 In order to augment the pool of technical manpower in the Department, all new recruits to the Department whether at the officer level or at the staff level, should be required to undergo a compulsory and successful training in computers before being confirmed in their jobs. As regards the existing officers and staff, since a large number of computer training centres exist in the country, the Government should require the officers and the staff to undergo training before their next promotion but not later than two years from now. The expenditure on these training courses should be reimbursed to the staff and the officers by the Government.

b. Indirect taxes

5.76 The CBEC had embarked upon a major computerisation programme in the Customs Department in 1986. As at present, computers have been installed in all the major customs houses and cargo complexes at Bombay, Calcutta, Madras and Delhi and in the Customs House at Cochin. These are inter-linked through the host mainframe at Bombay and the all-India network has been established through the Department of Telecommunication's (DOT) satellite data circuits. Considerable data on imports and exports are being stored in this system. The foreign trade statistics is being prepared on the basis of the customs computerised data and this has almost totally removed the time lag in the publication of trade statistics.

5.77 A pilot project for computerisation of Central excise operations was completed in 1986 at the Central Excise Collectorates at Delhi and Madras. In 1990-91 it was decided to computerise the remaining Central Excise

Collectorates through the National Informatics Centre (NIC). Accordingly, a Memorandum of Understanding was signed in June 1991 by the Department with the NIC for the implementation of computerisation in phases so that 17 systems were to be installed by March 1992 and the remaining systems by December 1992. The Committee understands that there has been some time over-run in regard to the first phase. By now, the systems have been installed only in eleven Collectorates and their connectivity with the divisions is yet to be established. In other words, these are still not operational.

5.78 From the discussions the Committee had with the Collectorates of Customs, it became clear that the existing facility in the Custom Houses is not being fully utilised. This is partly because of lack of involvement of senior officers in this matter and partly because of hesitation on the part of the Department to replace the manual system with the computerised system. The Committee would recommend that professional assistance from a consultancy agency should be availed of to gain maximum benefits from the facilities already installed and proposed to be installed.

5.79 In Central excise the number of documents to be processed has been growing from year to year. Thus, the number of gate passes dealt with by the Department was 266 lakhs in 1988-89, whereas, currently it will be of the order of 400 lakhs. Apart from the other operations like checking of Modvat availed of by assessees, faster assessment and preparation of revenue returns, computerised processing of documents has to be thought of as a necessity, as within a short time it will become impossible to process the documents manually because of the enormous volume involved. From this point of view, the computerisation project in Central excise should be expedited and a complete system placed in position within the shortest possible time.

5.80 We have already stressed in the Interim Report the need for enhancing the pace with which computerisation is proceeding in the Customs and Central Excise Departments. The Committee would again urge that the Board may bestow special attention on this matter and ensure that there is no further time over-run in establishing a complete network in the Department. The project to link minor ports and other customs stations with the Customs network via the Central excise network will have to be given a concrete shape and the network commissioned without any further delay. Other infrastructural support by way of staff, training, etc., should also be promptly provided. The senior officers of the Department will have to be involved in the project and there should be total commitment on the part of the Board in regard to computerisation.

Office Accommodation and Facilities

5.81 In the Interim Report, we had drawn attention to the fact that accommodation for the tax offices and the facilities available are woefully inadequate. In this regard, the position in the Income Tax Department is much worse than in the Excise and Customs Department. The former has to deal with a very much larger number of assessees, and correspondingly more space is needed for officers and records as well as for providing facilities to the assessees. Records cannot be properly maintained if for want of space and the necessary office equipment, files have to be kept in heaps on the floor or even on the tops of the limited number of shelves that could be put into cramped space. Visitors' rooms cannot be set aside for assessees and with more than one income tax assessing officer sitting in the same room, confidential conversation with an assessee becomes impossible. The difficulties are shared by both the Departments, but the situation, as pointed out above, is worse in the Income Tax Department.

5.82 A positive view has to be taken about office accommodation and facilities. It is to be recognised that while luxurious accommodation and amenities would not be

justifiable, proper office facilities and adequate space are essential for bringing about any significant improvement in tax administration.

5.83 Office accommodation must be designed in a functionally efficient manner so as to promote smooth working and productivity. Keeping in view the administrative re-organisation that we have recommended and what the Government might be planning otherwise and keeping in mind also the requirements of the planned computerisation programme, the required office should be estimated for Ranges, Charges and smaller offices in towns and the interior designing should be worked out by experts in this area. We recommend that:

a. more office space should be acquired/hired as a matter of priority;

b. to start with in selected areas with the highest potential for revenue, an attempt should be made to provide square feet space per officer which is conservatively worked out to be the optimum; and

c. on a pilot basis office facilities should be provided at the optimum level, and then observing the effect on productivity, officer morale and taxpayer satisfaction, the enhanced facilities may be made available gradually to all offices.

5.84 The programme of action in this matter that we have recommended would not demand expenditure of large sums of money immediately. We note that the budget provision for 'capital outlay on public works' was not fully utilised in both 1990-91 and 1991-92 by the two Departments. The sum provided amounted to Rs. 120 crore, which would be sufficient to increase at an adequate rate both office and residential accommodation. However, the budgetary allocation for capital outlay on public works is only Rs. 25 crore for 1992-93. We urge that this should be increased to Rs. 50 crore.

Residential Accommodation

5.85 Of this, part would have to be spent on augmenting residential accommodation. The degree of satisfaction in regard to such accommodation is fairly low at the level of junior officers. In the prevailing circumstances, it would not be desirable to subject tax officers, particularly at the junior levels, to the necessity of spending a very large part of their salaries on accommodation available in the free market. It is best to enable them to lead a fairly comfortable life and then subject them to strict discipline.

5.86 We believe that the expenditure on the above two accounts would prove to be wise investment leading to higher growth of tax revenues.

6

PROBLEMS OF ADMINISTRATION AND ENFORCEMENT OF DIRECT TAXES

6.1 For implementing Government's tax policy effectively, it is essential to have an efficient tax administration which promotes timely and voluntary compliance by all those legally obliged to pay taxes. The tax administration's efficiency depends on how it is able to coordinate and adapt in time the tax information systems, the organisational structure and the human factor which together determine the level of voluntary compliance by taxpayers.

6.2 The existing direct tax administration is characterised by the following problems:

a. *Over-lapping of functions*: between the secretariat set-up in the CBDT and its attached offices, between the collection function of the assessing officer and the Tax Recovery Officers (TROs), between the information collection function of the TDS wing and the Central Information Branch (CIB), and between the information collection function of the CIB and the survey wing in the Directorate of Income Tax (Investigation).

b. *Lack of real control in the execution of tasks*: control registers like, the blue book, the daily collection register, the arrear collection register, the appeals register, the audit objections register, the rectification register, the register relating to tax deduction at source and the general index register, are generally incomplete and deficient. Hence, the actual volume of the task to be performed is indeterminable and therefore, the execution of the tasks lacks real control.

c. *Inefficient manual systems*: given the large volume of information collected both from the internal and external sources, the manual process of collation, dissemination and verification of information in a satisfactory or adequate manner is virtually impossible. The manual process of control mechanism (various control registers) breeds inefficiency, harassment to taxpayers and corruption. The consequence is that the tax administration loses its effectiveness in identifying non-compliance and redressing taxpayers' grievances.

d. *Scattered and deficient guidelines*: examples are the deficient guidelines on *prima facie* adjustments and on the method of selection of cases for scrutiny.

e. *Inefficient processes without continuity*: there is a lack of satisfactory arrangement for departmental representation before judicial authorities and the absence of any effective follow-up action on tax-fraud investigations towards the ultimate objective of getting conviction of habitual and big tax evaders.

f. The information gathered is scattered and unreliable.

g. *Phase-out problems*: this relates, in particular, to the absence of any continuous exercise to weed out unwanted records and replace outdated procedures (e.g., the requirement to verify challans submitted by the taxpayer with those sent by the bank to the Department, the requirement to send advice of refunds above Rs.1000 to the Reserve Bank of India).

h. *Deficient facilities which damage the tax administration's image*: this refers to lack of infrastructure facilities for

taxpayer education and convenience as well as for raising the morale of the tax administration.

6.3. These problems cannot be solved piecemeal with partial solutions but rather a global solution is required with the three fundamental objectives of (a) modernising the administrative system in order to achieve better taxpayer control; (b) correcting structural failures that result in an overlap of functions, and lack of continuity and effectiveness of the processes; and (c) promoting deconcentration.

Taxpayer Identification and Control

6.4 The identification and registration of taxpayers is absolutely essential for developing an efficient tax compliance control system. Taxpayers, both potential and effective, can be identified through information from various sources both internal and external. Internally, the information about potential taxpayers could be obtained from the documents available within the tax administration such as income tax returns and annexures. A review of the annexures that business firms are obliged to submit together with their income tax returns, would reveal payments to third parties, like professionals who have rendered a service, the enterprises that have received compensation, the persons who have received a commission on sales and the persons from whom large purchases have been made. Externally, the information about potential taxpayers could be obtained from other tax agencies, chambers of commerce and industry, trade and professional associations, bank and credit institutions and large corporations.

6.5 Once the names of the taxpayers, potential or effective, have been obtained, they must be carefully registered, by using indexes and an adequate identification system in such a manner that the names and addresses may be rapidly confronted. However, as both names and addresses may be changed, it is advisable to use identification numbers of taxpayers.

a. Identification system

6.6 In many countries, such an identification number is either the social security number or the citizen's identity card number. This number must in any case be one permanent number. Ideally, the identification system should cover all natural and non-natural persons in the country so that all transactions could be traced to their source and such information stored appropriately for use in enforcing or increasing tax compliance. In India, in the absence of a social security number or a citizen identity card, an alternative identification system needs to be developed. To begin with, the identification system should cover all persons (individuals, firms, companies, etc.) engaged in economic activities above a certain level or in possession of economic wealth which has the potential of yielding income so that all potential and effective taxpayers[11] in the country would be allotted an identification number.

6.7 An effective system of identification numbers should automatically cover all potential assessees even if they are not assessees or filers at present; and the numbers should permanently identify assessees. There should be limited scope and penalties for fraud through 'benami' numbers or multiple numbers. Quoting identification numbers at the time of undertaking a wide variety of transactions should be compulsory. Assessees should have an incentive to obtain numbers. This could be done, for example, by making eligibility to engage in certain transactions, services or investments contingent on the assessee having an identification number. The numbers should be obtainable without difficulty. Furthermore, identification of assessees with particular taxpayer numbers should be possible with no difficulty at every income tax office. Records of taxpayer numbers should be tamperproof. For achieving this, a master list could be kept at a central location in computerised form.

6.8 A unique code of identification for the income tax payers, i.e., the Permanent Account Number (PAN) was first introduced in 1972. From 1.4.1976 both the allotment and the quoting of PAN in certain types of transactions and also in correspondence with the Income Tax Department have been made a statutory obligation. At present, the following persons are either eligible for allotment of, or have been allotted, a PAN:

i. Persons allotted PANs prior to the commencement of the Taxation Laws (Amendment) Act, 1975.

ii. All persons whose total income during any previous year exceeded or exceeds the income tax exemption limit.

iii. All persons carrying on any business whose total sales, turnover or gross receipts exceed, or are likely to exceed, Rs.50,000 in any previous year.

iv. All persons in receipt of income derived from property held under trust or any other legal obligation wholly for charitable or religious purposes if the total income exceeds the income tax exemption limit.

6.9 Under the existing system, while an obligation is cast on the aforesaid categories of persons to apply in Form No. 49A for a PAN, the assessing officer has also been empowered to allot PAN to any person by whom tax is payable even if no application in Form 49A has been received.

6.10 The existing system of PAN is subject to deficiencies which inhibit the development of a sound identification system for covering both potential and effective taxpayers. The scope of the system is too narrow in terms of its coverage of potential taxpayers. It does not extend to all persons engaged in substantial economic activities or in possession of economic wealth which has the potential of yielding income, with the result that even if quoting of the PAN is made a statutory obligation, only a small percentage of the transactions would contain PAN. Further, a large number of taxpayers have been allotted more than one PAN due to the absence of any standard format for uniquely identifying an existing taxpayer from the blue book and also because of the movement of taxpayers from the jurisdiction of one assessing officer to another without corresponding communication of PAN and the absence of an on-line PAN directory on an all-India computer network. Above all, the Income Tax Department has not succeeded in giving the number even to all the actual income taxpayers.

6.11 In view of the above, the Committee recommends the restructuring of the identification system along the following lines:

i. The existing system of PAN should be substituted by a new Taxpayer Identification Number (TIN) which should be allotted to and obtained by all persons and institutions (individuals, Hindu undivided families, Association of Persons, companies, firms, etc.) -

   (a) covered by the existing regulations as indicated in para 1.7, except that those whose business turnover or gross sales is less than Rs.2 lakh will be exempt from the obligation, instead of those with turnover less than Rs.50,000 as stipulated now;

   (b) having shop establishment licence in all cities and towns with population in excess of one million;

   (c) registered as an industrial unit;

   (d) having Central sales tax or local sales tax numbers;

   (e) who are members of any professional association;

   (f) who are owners of trucks/buses/ taxis/cars;

(g) possessing credit cards;

(h) liable to pay municipal/property taxes;

(i) selling goods exceeding Rs.1 lakh to the Government or public sector company or a public limited company;

(j) intending to file a tender with the Government or public sector company or public limited company for an amount exceeding Rs. 5 lakh;

(k) who are sharebrokers, small saving agents, LIC agents, UTI agents, mutual fund agents, etc.;

(l) applying for fixed deposits in a bank above Rs.50,000;

(m) applying to a bank for drafts or telegraphic transfers for amounts above Rs.50,000; and

(n) any other person desirous of obtaining a permanent account number.

ii. All natural persons referred to above should, on application, be issued a photo-pass containing all relevant information relating to identification. In the case of an individual, the name of the holder, father's name, address, date of birth and the TIN should be indicated on the photo-pass. All non-natural persons should be issued a pass without any photograph, containing all relevant information relating to their identification.

iii. The work relating to the allotment of TIN should be on an all-India computer network with an on-line TIN directory so as to eliminate possibilities of fraud through benami or multiple numbers. Since a large number of persons are required to obtain TIN, it is necessary to build up a system of allotment on demand. In the absence of an all-India computer network within the Income Tax Department, it will not be feasible to allot TIN on demand for some time to come. The Department should, therefore, in the transition, explore the possibilities of using either the National Informatics Computer Network (NICNET) of the Planning Commission or any other all-India computer network for this purpose.

6.12 In order to ensure that all the potential taxpayers and those that are likely to have important business transactions would obtain a TIN, the following rules and regulations will have to be introduced:

i. Shopping establishments in cities with population of one million and above: Licences should be issued to them only on their owners getting a TIN. Those already licensed may be asked to get a number immediately and submit it to the concerned licensing Department. Their licences should not be renewed unless they have obtained the TIN.

ii. Registered industrial units: No renewal should be given or new licence issued without the TIN.

iii. Dealers having or asking for local sales tax or Central sales tax numbers should have TINs. Existing dealers should be issued 'C' Forms and 'D' Forms only after they obtain their TIN.

iv. Members of professional associations: It should be laid down that all professional associations should require their members to obtain TIN and quote it in their application form for renewal of membership. New members should be required to obtain a TIN within six months, if they do not already have one.

v. Owners of trucks, buses and cars: Municipal authorities should be asked to require such owners to get their

registration certificates re-validated after obtaining a TIN. New vehicles should be registered only if the application contains the TIN.

vi. Credit cards: Application for credit cards must contain the TIN. The credit card companies may be asked to print the TIN on the credit cards.

vii. Selling goods to the public sector: Those who sell goods worth more than Rs.1 lakh to the government or a public sector company or a public limited company should be required to furnish their TIN.

viii. Agents for LIC, Mutual Funds, Small savings collections, etc: They should be required to obtain a TIN before being appointed as agents.

ix. Applicants for shares and debentures: All applicants for shares where the application is for more than 2,000 shares or 500 debentures should per force quote their TIN. Without that number the application should be rejected. Other applicants must be asked to state in the application form their TIN, if they have one; if they do not give their TIN, they should be required to solemnly affirm that they are not taxpayers and do not have income liable to tax. Similarly, those who buy/sell shares or debentures in the secondary market must be required to state in the share/debenture transfer form their TIN if they are buying/selling not less than 2000 shares or 500 debentures. Others who buy/sell shares/debentures should be required to give their TIN or solemnly affirm that they are not income taxpayers and have no TIN, as the case may be.

x. Fixed deposits in banks and other financial institutions, public deposits with companies: Any one wishing to make a deposit of Rs.50,000 or more should have a TIN which should be furnished. Those who make fixed deposits in amounts less than Rs.50,000 should be required to give their TIN or solemnly affirm that they are not income taxpayers and do not have income liable to tax.

b. Taxpayer master file

6.13 A statutory obligation should be cast on all TIN allottees to quote their TIN in all important economic transactions. Thereafter, the various information pieces received from numerous sources by the Department (we understand the CIB receives information from 85 sources) could be sorted out according to TIN. Then, all the information pieces relating to a TIN could be bunched to identify potential taxpayers.

6.14 After the establishment of a system of identification of taxpayers, it is necessary to develop the basic and essential control instrument of tax administration i.e., the taxpayer master file (TMF). A TMF is a data base whose purpose is (a) to fully and unequivocally identify and locate all individuals and/or corporations, who by law must file and pay tax and (b) to keep taxpayer identification data as well as other information of tax interest up-to-date. The File may be established either through a taxpayer census or through taxpayer returns. It is of utmost importance that once the Master File is established, continuous and permanent procedures be implemented to keep the file up-to-date with information from internal and external sources. The main function of the TMF is to serve the other systems as the main source of basic taxpayer data. That is, the other systems may have access to the TMF data, according to their own needs, either through a printed list or direct computerised access through a screen.

6.15 For achieving the above objectives, the Committee recommends that:

i. The existing system of general index register (GIR) should be replaced by a TMF.

ii. The TMF should contain the names, addresses, TINs, and liability to file returns of income/wealth/gift/ expenditure/information/TDS.

iii. To begin with TMF should contain the above-mentioned basic information on persons -

(a) filing returns of income/wealth/ gift;
(b) who are non-filers of return but have discharged their tax liability through tax deduction at source by their employers; and
(c) filing information returns.

iv. Over time, the TMF should be extended to include all new taxpayers voluntarily filing returns. Further, non-filers identified from amongst the potential taxpayers on the basis referred to in para 6.104, and those in the zone of exemption limit should be pursued through issue of notice under Section 142(1) of the Income-tax Act. Those who are established to be taxpayers should be added to the TMF.

v. A person should be removed from the TMF on fulfilment of the cumulative conditions that his income is below the taxable limit continuously for a period of three years and he is not liable to file any information return. Such persons should be removed from the TMF.

c. Verification system

6.16 At first blush, it might appear that the safest way to make sure that all taxpayers accurately report their taxes is to check each return carefully with reference to the information contained in the return and information collected from all other independent sources. However, this approach is not only impossible in the light of our limited resources but impractical from a financial standpoint, since many taxpayers are honest and since countless cases arise where the cost of conducting the audit exceeds the expected return.

6.17 The verification system should be designed to allocate the available resources in a manner which will maximise the yield from the system in relation to its operating cost. At the same time, the desire to use personnel and facilities economically must not conflict with the basic responsibility of the tax administration for eliminating, or at least minimizing, the more glaring forms and acts of tax evasion.

6.18 Since a careful scrutiny of every return submitted is well nigh impossible when the number of taxpayer is large, as in the case of income tax, in most countries a system of self-assessment prevails. Most returns are dealt with summarily, without interacting with the taxpayer, by making adjustments for normative and mathematical errors: normative, dealing mainly with legal limits and incoherences between magnitudes, and mathematical, dealing with errors in the operation and, particularly, in the application of the rates. An important characteristic of this system, which has a positive direct influence on the fight against fraud, is its timeliness, i.e., the administration takes up the taxpayers' statements in the return within a relatively short period of time, and therefore, the impact is very great. However, in order to induce compliance through letting each assessee know that he or she could be subjected to strict scrutiny and to increase the general effectiveness of the tax administration, a small proportion of the returns are selectively subjected to intense verification exercise (scrutiny). The method of identifying the returns for intensive scrutiny varies across countries depending upon several factors including the level of automation.

6.19 We use the term 'verification' to cover both summary and scrutiny assessments. The verification process, commonly known in India as assessment, embodied in Section 143 of the Income-tax Act, has changed over time. Section 143 of the Income-tax Act was recast in 1971;

amended further in 1975, 1976, 1980 and 1988; completely recast in 1989 and further amended in 1991. Numerous circulars issued by the CBDT regarding specific points clarify the scope of assessments under the various sub-sections, especially under Section 143(1) which deals with summary assessment.

i. Summary assessment

6.20 The summary assessment scheme under Section 143(1) was introduced in 1971 to cope with the growing workload of the Income Tax Department. Instead of scrutinizing all returns filed, this introduced the practice whereby assessing officers were required to check a filed return for arithmetical mistakes, as well as to disallow those adjustments claimed by the taxpayer to reduce tax liability that were *prima facie* inadmissible, and insert adjustments (not made or claimed by the taxpayer) that were *prima facie* admissible. The distinguishing characteristic of a summary assessment was that the presence of the taxpayer at the time of assessment was not required. If the assessee objected to a 143(1) assessment demand, the case was automatically assessed under 143(3) with a hearing being given to the assessee.

6.21 Initially, all returns declaring an income of upto Rs.25,000 were covered by the summary assessment scheme. The monetary limits defining the demarcation between summary and scrutiny assessment were revised upward in later years, partly because of inflation and partly to keep the workload of the Income Tax Department within manageable limits. The limit was raised to Rs.2 lakh in 1986-87. Until 1985, those returns falling within the prescribed limit were excluded from the ambit of scrutiny assessment except for a small number of randomly sampled cases.

6.22 The authority given to the assessing officers concerning *prima facie* adjustments was withdrawn in 1980. Assessing officers were required from 1980 onwards to restrict adjustments solely to arithmetical mistakes. There appears to have been some confusion within the Income Tax Department concerning the precise authority granted to assessing officers under Section 143(1). It was not until May 1985 that the CBDT issued a circular clarifying that only the arithmetical accuracy of filed returns was to be checked. The circular clarified that except for the sample of 5 per cent of the returns selected for scrutiny, no form of checking other than for arithmetical accuracy was required. A further circular in July 1986 also instructed assessing officers not to reopen completed summary assessments in the light of information becoming available later [which was carried out previously under Section 143(2)(b)]. In 1987, the right of an assessee to appear before the assessing officer, if he disagreed with a 143(1) assessment, was withdrawn.

6.23 The provision for random scrutiny under 143(3) of 5 per cent summarily assessed cases was introduced by the CBDT in 1985. This was done in view of the extremely limited examination of returns and accompanying documents under summary assessment. The CBDT hoped that, in intensive scrutiny cases, there would be no scope for audit objections and rectifications of assessment orders. It also hoped that each assessing officer could identify about a half-dozen evaders against whom prosecutions could be launched. These hopes were not fulfilled.

6.24 Following the severe criticism of the summary-cum-random sampling assessment scheme by the C&AG and the Assistant Commissioners, the law was once again amended by the Direct Tax Laws (Amendment) Act, 1988 with effect from the assessment year 1989-90. The salient features of the existing procedure for assessment are as follows:

(a) The requirement of passing of assessment order in all cases, where return of income is filed, has been dispensed with. The issue of acknowledgement slip in token of

receipt of return to the assessee will be the end of the matter, if he has correctly paid tax and interest, if any, due on the basis of the return.

(b) The Department undertakes checking of the returns of income and the accompanying documents to ascertain whether any *prima facie* adjustments are required to be made to the returned income/loss.

(c) In cases where *prima facie* adjustments are made to the income/loss declared in the return of income, an intimation is required to be sent to the taxpayer informing him about the *prima facie* adjustments so made. If on the basis of the adjusted total income, any tax or interest is due from an assessee, that is also specified in the intimation and the taxpayer is required to pay such tax or interest. This is treated as a notice of demand. In the event of any refund being due, it is granted to the assessees along with the intimation.

(d) In a case where the total income, as a result of *prima facie* adjustments, exceeds the total income declared in the return by any amount, an additional income tax at the rate of 20 per cent of the tax chargeable on such excess amount is levied. The additional income tax is also leviable in a case where loss declared in a return is reduced or is converted into profit as a result of the *prima facie* adjustments.

(e) In all the above situations, the taxpayer or his authorised representative is not required to be called to the office of the assessing officer. The past records are also not to be consulted while making the *prima facie* adjustments.

(f) A *prima facie* adjustment made in contravention of the provision of law is a mistake apparent from record within the meaning of Section 154, as amended by the Direct Tax Laws (Amendment) Act, 1987.

6.25 Currently, therefore, the new assessment scheme comprises a summary assessment of all returns after correcting for arithmetical mistakes and *prima facie* errors and scrutiny assessment of returns, where returns are being selected non-randomly in accordance with instructions issued by the CBDT.

6.26 The new summary assessment scheme was the most intensely debated subject during all evidence before the Committee whether by officers of the Department or representatives of trade and industry. We, therefore, consider it important to place on record the numerous viewpoints on the scheme and various problems associated with it.

6.27 The CBDT during the course of evidence before the Committee argued that the Department was duty bound to take cognisance of the arithmetical errors or *prima facie* inadmissible claims. It was neither necessary nor feasible to call every taxpayer who had filed a return merely to correct arithmetical errors or to indicate *prima facie* inadmissible claims. The new scheme of summary assessment allowing for *prima facie* adjustments and levying of additional tax and enabling immediate collection of taxes was a deterrence to non-compliance. The fact that adjustments were being made in only three per cent of the cases indicated the positive impact of the scheme on voluntary compliance. If the system of correcting arithmetical errors and *prima facie* inadmissible claims without calling the taxpayer were to be dispensed with, it would lead to a general fall in the level of voluntary compliance. The Board was of the view that there was no alternative to the existing scheme of summary assessment in dealing with the increasing work-load. As the system stabilises over time, the percentage of cases warranting *prima facie* adjustments would further decline.

6.28 An alternative strategy advocated by officers of the Department during the course of evidence before us was that the system of making *prima facie* adjustments should be totally done away with, since the new system of summary assessment had increased the work-load of the Department without any commensurate revenue gain. This view argues that the time devoted to making *prima facie* adjustments should be more fruitfully devoted to identifying new taxpayers and investigating cases of tax fraud.

6.29 The Committee recognises the need to discourage non-compliance and also improve the productivity of the tax administration. We also recognise the fact that the Department is duty bound to correct arithmetical errors and *prima facie* inadmissible claims to prevent fall in the general level of voluntary compliance. The existing method of correcting the arithmetical errors and *prima facie* inadmissible claims without interface with the taxpayer is one of the better strategies for promoting voluntary compliance. If the alternative strategy advocated within the Department were to be accepted, cases where *prima facie* inadmissible claims have been made will have to be given consideration in laying down the guiding principles for selecting a case for scrutiny. This would result in a large number of cases without any potential for tax evasion, being picked up for scrutiny merely because certain *prima facie* inadmissible claims have been made. An equally large number of potential tax evasion cases would automatically have to go out of the scrutiny net, the overall number being a near constant. In the case of the taxpayers falling in the former category, while the taxpayer would be subject to greater compliance cost and possibly harassment, the tax administration inspite of in-depth investigation would not benefit by way of any increased revenue other than that attributable to *prima facie* adjustments. To the extent of reduction of the genuine scrutiny potential, the element of deterrence would also suffer. There would, therefore, be an efficiency loss both for the taxpayer and the tax administration under the alternative strategy.

6.30 In view of the above, the Committee recommends the continuation of the existing basic scheme of summary assessment after correcting for arithmetical errors and genuine *prima facie* inadmissible claims and levying additional tax.

6.31 However, the Committee recognises that all is not well with the existing scheme. Under the existing scheme of summary assessment, the following problem areas have been identified:

(a) Scope of *prima facie* adjustment

6.32 At present, the provisions of Section 143(1)(a) read with the first proviso thereto, enable the assessing officer to make several adjustments including addition in regard to the loss carried forward, deduction, allowance, or relief claimed in the returns, which the assessing officer considers *prima facie* inadmissible. The CBDT has issued a large number of instructions including a 201-page booklet to enable the assessing officer to identify the claims of the taxpayer which are *prima facie* inadmissible. A study conducted by Directorate of Organisational and Management Studies (DOMS), an attached office of the CBDT, indicates that the relative importance of the different Sections of the Income-tax Act invoked for making *prima facie* adjustments are as follows:

Section of the Income-tax Act	Number of cases	Percentage of cases
10	30	4.34
16	24	3.47
32	14	2.02
37(2A)	14	2.02
43B	265	38.02
45-54	16	2.32
70-80	12	1.73
Chapter-VIA (80C, 80CCA, 80G, 80HHC, 80L, 80M)	146	21.10
115	9	1.30
Miscellaneous	162	23.41
	692	100.00

6.33 Further, the study indicates that of the total number of returns processed under summary assessment, *prima facie* adjustments were made only in 3.82 per cent of the returns. Of the total number of cases in which *prima facie* adjustments were made, applications for rectification for *prima facie* adjustments were received in 24.61 per cent of the cases. In other words, the taxpayer was not in agreement with the *prima facie* adjustment made in one out of every four cases.

6.34 As will be seen from the table above, about 60 per cent of the *prima facie* adjustments being made are under Section 43B and Chapter VIA of the Income-tax Act. Further, it is learnt that 75 per cent of the applications for rectification of *prima facie* adjustment also relate to these. Hence, it is necessary to evolve ways and means to solve the problems arising from Section 43 and Chapter VIA deductions. It is learnt that these adjustments in the latter case are primarily on account of non-filing of appropriate evidence along with the return.

6.35 The CBDT has instructed the assessing officers through a circular that where either the Act, or the Rules or the Notes to the Return require filing of certain particulars/evidence in respect of a claim along with the return of income and such particulars/evidence do not accompany the return, the claim is *prima facie* inadmissible. Further, assessing officers have also been instructed by the CBDT not to entertain applications for rectification and not to allow the deduction even if the requisite evidence in the form of challans, etc., was subsequently furnished. The justification offered for such a measure was that such a view was necessary from the administrative angle as otherwise it would inculcate a sense of indiscipline amongst the taxpayers and increase infructuous work for the Department.

6.36 As a counter to the views of the CBDT, taxpayers, and representatives of trade and industry associations argue that particulars/evidence are only supportive of a claim and absence thereof does not necessarily imply incorrectness of the claim. It is further argued that it is in recognition of this principle that the law recognises the possibility of a defective return and provides for rectification of the defect in the return of income. Therefore, where the return of income is not accompanied by certain particulars/evidence required under the law in respect of a claim, such return should be

appropriately treated as defective and necessary opportunity must be given to the taxpayer to rectify the defect under the existing provisions.

6.37 The right of the assessing officer to make adjustment to the income or loss returned by the assessee on the ground of "lack of evidence", has come under scrutiny by the Delhi High Court in SRF Charitable Trust vs Union of India (1992) (193 ITR 95). It pointed out that the Income Tax Officer has the power to make an adjustment to the income or loss declared in the return if, and only if, on the basis of the information available in the return, accounts or documents, the deduction, allowance or relief claimed is *prima facie* inadmissible. The Court has categorically said that the conclusion that the claim of the assessee is inadmissible must flow from the return as filed and no power is given to the Income Tax Officer to disallow a claim for the reason that there is no proof in support thereof. The Court also said that the proof in support of the claim may be an evidence from correspondence, from the books of account or other documents and that the law did not require that in support of a claim made in the return for deduction or non-taxability of a receipt, all the proofs available and original documents had to be filed along with the return. If an Income Tax Officer desires to examine any further evidence, he can certainly issue a notice under Section 143(2), but he cannot, arbitrarily, disallow the claim for lack of proof.

6.38 The principles laid down by the Delhi High Court have also been followed by the Bombay High Court in deciding a batch of writ petitions filed by JCT Limited and Khatau Junker Limited. The Bombay High Court also held that the disallowance of the assessee's claim under Section 143(1)(a) for alleged lack of proof would not only be totally *ultra vires* of the powers of the Income Tax Officer but would also be in total excess of jurisdiction.

6.39 The CBDT has now issued a new circular wherein it has been clarified that proof of payment need not be in the form of challans, etc., but that a certificate from a practising Chartered Accountant would suffice. However, the CBDT has preferred to stand by its directive restraining assessing officers from entertaining applications for rectification. We consider that the Board should reconsider this issue urgently, in the light of the two recent High Court decisions referred to above. (See recommendation in this regard in para 6.47).

6.40 Other important reasons for *prima facie* adjustments are, inter alia -

(i) The existence of several confusing and conflicting guidelines by the CBDT on the scope of *prima facie* adjustments.

(ii) Improper classification of assets into blocks of assets for the purposes of claiming depreciation;

(iii) Incorrect audit report in respect of claims for deductions like those under Section 80HHC;

(iv) Incorrect set off and carry forward of unabsorbed losses arising primarily on account of the confusing scheme of adjustment of losses; and

(v) Improper return format leading to uneven interpretation, extensively widening the scope of *prima facie* adjustments.

6.41 The CBDT has issued several instructions to enable the assessing officers to identify the claims of the taxpayer which are *prima facie* inadmissible. It is an admitted fact that these guidelines need to be made more specific and precise with a view to ensuring uniform application of the law all over the country.

6.42 Incorrect claims of depreciation are also generating a number of *prima facie* adjustments. These incorrect claims arise either on account of improper block

classification of assets or arithmetical mistakes in computing the quantum of depreciation. To the extent that the incorrect claims are on account of arithmetical mistakes, such claims are, no doubt, *prima facie* inadmissible. However, where there is a disagreement by the assessing officer with the block classification of the assets by the assessee, the depreciation claim cannot be *prima facie* inadmissible. The scope of *prima facie* adjustment surely cannot extend to differences of opinion.

6.43 Under the income tax law, a number of tax incentives are contingent on the taxpayer furnishing in the prescribed form, along with the return of income, the report of an accountant certifying that the deduction has been correctly claimed. In effect this amounts to the accountant determining the quantum of the deduction on the basis of the information furnished by the taxpayer. The taxpayer merely adopts the same in the return of income. Given the correctness of the information furnished by the taxpayer to the accountant, the responsibility for the correctness of the quantum of the deduction, therefore, lies squarely on the accountant who should bear the consequences of any *prima facie* mistake in the quantification. The taxpayer cannot be faulted on this count. At worst, the taxpayer could be held responsible for furnishing incorrect information to the accountant or incorrectly copying the quantified figure relating to the deduction from the audit report.

6.44 The existing scheme of set-off and carry forward of losses is extremely cumbersome and it is even difficult for the tax administrator with years of experience to correctly sequence the set-offs of losses. In fact a large number of audit objections also arise on this account. It is surprising that only a small percentage of *prima facie* adjustments relate to set-off and carry forward of losses.

6.45 A number of errors in the computation of total income also arise because the arithmetical steps for the computation of total income are not logically sequenced as also due to the lack of adequate information given to the taxpayer about the scope of *prima facie* adjustments. In this regard it is necessary to design the return form in a manner whereby specific information about the various claims can be sought from the taxpayer along the lines of a check sheet. The specific information must include the necessary and sufficient conditions for making any claim and the arithmetical steps for computation thereof.

6.46 The present design of the return form is based on the assumption that the taxpayer is fully aware of what, according to the Department, are the necessary or sufficient conditions for making a claim and other nuances of the tax law. Such an assumption is unwarranted. The present return form leaves much to be desired from the point of view of assisting the taxpayer in computing the income correctly.

6.47 Keeping the above considerations (in paras 6.34 to 6.46) in view, the Committee recommends the following:

(i) The existing scheme of summary assessment, to be made after correcting for arithmetical errors and *prima facie* inadmissible claims should be continued.

(ii) The first proviso to sub-section 1 of Section 143 defining the scope of the term '*prima facie*' should be amended. It should be defined to mean:

(a) an incorrect claim, if such incorrect claim is apparent from the existence of other information on the return,

(b) an entry on a return of an item which is inconsistent with another entry of the same or another item on such a return,

(c) an omission of information which is required to be supplied on the return to substantiate an entry on the return, and

(d) an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed, if such limit is expressed -

(i) as a specified monetary amount, or
(ii) as a percentage, ratio, or fraction

and if the items entering into the application of such limit appear on such return.

(iii) The return of income must clearly indicate, against the relevant item of claim or in the worksheet relevant to the claim, the need for furnishing evidence in support of the claim. The nature of the evidence necessary in support of the claim must also be specified in the return. This evidence should, however, be only for the purposes of processing under summary assessment and should be without prejudice to the degree of proof that may be required to be furnished by the taxpayer under scrutiny assessment. Once the necessary evidence is filed along with the return, the sufficiency of the evidence should be considered or questioned only under scrutiny assessment.

(iv) In stipulating the evidence required to be filed along with the return of income, caution must be exercised to prevent undue burden of compliance on the taxpayer. Attempt should be to secure only minimal necessary evidence.

(v) Audit reports required under various provisions of the Income-tax Act should be merged into a single audit report which should be comprehensive. For example, Form No. 3CD (relating to statement of particulars in the case of a person carrying on a business, which is required to be given along with the audit report in Form No. 3CA) could be amended to seek information on whether payments covered under Section 43B of the Income-tax Act have been made by the due date of filing of return. In that case, the need for separate certificates from accountants as evidence in support of a claim would not be necessary.

(vi) The return form should be re-designed along the lines of a check sheet to seek specific information and also to provide for logical sequencing of the arithmetical steps for the computation of income. This will help demarcate the scope of *prima facie* adjustments.

(vii) In the case of depreciation, the incorrect block classification of assets should not be corrected through *prima facie* adjustments. Further, a separate standardised format should be prescribed for depreciation claims, to be appended to the return by only those taxpayers who make such a claim.

(viii) A claim made on the basis of an audit report given by an Accountant should be corrected if *prima facie* inadmissible but no additional tax should be levied in such cases. Where the Auditor makes more than a specified number of mistakes, he should be debarred from practice for a certain minimum period.

(ix) The Department should release annually a booklet codifying the instructions/guidelines on the scope of *prima facie* adjustments as is being currently done in respect of guidelines issued to Drawing and Disbursing Officers (DDOs) for tax deduction at source from salary payments. The booklet must contain examples of

prima facie adjustments drawn from actual instances reported by the assessing officer. These examples should cover instances to highlight both what can be and cannot be treated as being *prima facie* inadmissible.

(x) The existing scheme of set off and carry forward of losses should be rationalised along the lines indicated in the section on Taxation of Corporate Profits in Chapter 3.

(xi) While the assessing officer should continue to make *prima facie* adjustments in respect of claims not backed by requisite evidence, the same should be rectified if the requisite evidence is subsequently furnished by the taxpayer.

(b) Delay in disposal of application for rectification of *prima facie* disputes

6.48 Prior to the amendment by the Finance Act, 1992, there was no provision for seeking immediate judicial remedy against incorrect *prima facie* adjustment by the assessing officer. A taxpayer, aggrieved by the *prima facie* adjustment, was first required to make an application to the assessing officer to rectify the *prima facie* adjustments made by him. On rejection of the rectification application, the taxpayer could seek remedy before a judicial forum both against the *prima facie* adjustment and the rejection of the rectification application. While conceptually the procedure does appear to be sound, in practice the procedure had been found to be quite unsatisfactory, because not many assessing officers are willing to admit the incorrectness of their decisions and correspondingly to rectify the *prima facie* adjustments and because of the absence of any time-limit for the disposal of the rectification applications.

6.49 At present, the *prima facie* adjustment can be made by an assessing officer within two years from the end of the relevant assessment year. The *prima facie* adjustment so made can be rectified by the assessing officer either *suo moto* or on receipt of an application from the taxpayer. This can be done within four years from the end of the financial year in which the *prima facie* adjustment is made. The position is summarised below:

(i) Previous year ending 1.3.92

(ii) Relevant assessment year ending..... 31.3.93

(iii) Date by which *prima facie* adjustment can be made 31.3.95

(iv) Date by which the *prima facie* adjustment can be rectified.....31.3.99

6.50 During the course of public hearing, it has been pointed out by the taxpayers that the rectification applications filed before the assessing officers are not disposed of early. This is partly due to the reluctance on the part of the assessing officer to admit his own mistakes, and partly due to the fact that the assessing officer is over-burdened on account of concentration of many functions of tax administration on him. While, technically, an assessing officer may be justified in keeping a rectification application pending for four years, such delay leads to uncertainty in the minds of the taxpayers and also becomes a source of corruption. It has, therefore, been suggested that the better course for redressal of grievance against *prima facie* adjustments would be to allow a direct appeal by the taxpayers against *prima facie* adjustments.

6.51 The Committee, in its Interim Report, recommended the need to provide for direct appeal against *prima facie* adjustment. The Government, however, through an amendment by the Finance Act, 1992, has provided for direct appeal against *prima facie* adjustments, only if the rectification application is not disposed of by the assessing officer within three months.

6.52 Keeping all relevant considerations in view, the Committee recommends that the existing time schedule for making *prima facie* adjustments and rectification thereof should be revised along the following lines:

(i) No *prima facie* adjustment should be allowed to be made after six months from the end of the month in which the return is received.

(ii) The assessing officer should not be allowed to make any *suo moto* rectifications of summary assessment after three months from the end of the six month period for *prima facie* adjustment under summary assessment.

(iii) The taxpayer should not be allowed to make an application for rectification of *prima facie* adjustment after two years from the end of the assessment year in which the return is filed.

(iv) The application for rectification of *prima facie* adjustment should be required to be disposed of by the assessing officer within three month from the end of the month in which the application is received. Failure to dispose of the application within the stipulated time should be tantamount to acceptance of the contentions of the taxpayer. The Committee is aware that through an amendment by the Finance Act, 1992 'direct' appeal against *prima facie* adjustment has been provided only if the rectification application is not disposed of by the assessing officer within three months. However, we are of the view that this indirect remedy is totally inadequate. There should either be a provision for appeal against *prima facie* adjustment, as was recommended by us in our Interim Report, or as suggested above, the applications for rectification which are not disposed of within, say, three months, should be considered as accepted and effect should be given to them accordingly, within a further period of one month.

(c) The scheme of additional income tax

6.53 At present, a taxpayer is liable to pay 20 per cent of the tax payable on the *prima facie* adjustments as additional income tax. This additional income tax is levied without regard to the intention underlying *prima facie* inadmissible claims. Hence, taxpayers have questioned the validity of this scheme on grounds of arbitrariness, etc.

6.54 Another issue arising from the scheme of additional income tax relates to the instruction by the CBDT to its field formations to the effect that first, *prima facie* adjustments, if any, should be carried out, additional tax, if any, should be levied and intimation to this effect should be sent to the taxpayer. It is only thereafter that the proceedings for scrutiny of the case should be initiated. During the course of evidence by representatives of trade and industry, it was argued that if a case were to be identified for scrutiny, it should not be necessary to first make *prima facie* adjustments, if any, in the return. These could be made at the time of scrutiny assessment.

6.55 With a view to encouraging voluntary compliance, reducing the discretionary power of the tax administrator so as to eliminate opportunities for bribery and favouritism, reducing administrative costs of processing and checking the expected excuses that would be submitted for almost every case of arithmetical error and *prima facie* inadmissible claim, it is necessary to build-in a system of automatic sanction. The additional income tax is intended to be such a sanction. The automatic sanction has to be kept at a reasonable level so as to represent a proper trade-off between the interests of the tax administration and those of the taxpayer, while at the same time offering some deterrence to a large group of taxpayers. We consider the rate of additional tax at 20 per cent to be sufficient and reasonable. Also, in the interest of an equitable tax system, it is necessary that any scheme of sanction must be applied uniformly. Hence, taxpayers

committing the same default should be subject to the same sanction. A taxpayer should not escape the rigours of the sanctions merely because his case is identified for in-depth scrutiny. Therefore, the Committee recommends the continuation of the existing scheme of levy of additional income tax under Section 143(1A) and also the existing policy of first completing every case under the summary assessment scheme and thereafter initiating proceedings for scrutiny assessment.

ii. Scrutiny assessment

(a) Objectives

6.56 Had the number of assessees been limited, every assessment would have been a detailed or scrutiny assessment, as for example in the case of excises in general. Because of the large and increasing number of assessees, in the case of income tax, the Government has to depend largely on voluntary, or rather, induced voluntary compliance, by the assessees and not on the detailed scrutiny of all returns. This being so, one of the main objectives of scrutiny assessment should be to increase the degree of compliance by making every taxpayer feel that (a) his or her case could be taken up for scrutiny at any time and (b) non-reporting or concealment of part of income would be found out or guessed and so a scrutiny may be undertaken. The other major objective is to increase revenue yield by getting an opportunity to probe into cases where evasion or part concealment of taxable income is taking place.

6.57 Given these two objectives, in selecting cases for scrutiny assessment, there must be a combination of the criteria of randomness and probability of evasion. The device of assigning differing scores to various assessees for the purpose of choosing the sample, as is done in the USA, for example, is an attempt to combine these criteria. Since the element of randomness is present in such a system, evasion will not be there to be detected in all cases. One other preliminary remark that we would like to make is that in a situation where the tax administration has not been fully or adequately computerised, while the selection of the sample by a central computer will not be possible, clear-cut tests or characteristics should be laid down for selection and that the selection should never be done at the level of the officer who is going to carry out the scrutiny assessment.

(b) The existing system

6.58 Under the rules in force now, there is to be 100 per cent scrutiny of all company and all non-company cases where the income or loss is Rs.5 lakh or above; there is to be sample scrutiny in other cases.

6.59 The procedure for selection of cases for scrutiny as in the year 1991-92 is as follows:

6.60 Assessees have been classified into the following categories with their respective sample sizes and levels of selection:

Category	Income/loss range	Level of officers selecting the samples	Size of sample
Category A:			
Non-company	Below Rs.2 lakh	Income Tax Officers	120 cases each Income Tax Officer
Company	Below Rs.50,000		
Category B:			
Non-company	Rs.2 lakh - Rs.9,99,999	Assistant Commissioners	Between Rs.2 lakh and Rs.5 lakh: no percentage or size laid down. Above Rs.5 lakh, 100% of cases
Company	Rs.50,000 - Rs.9,99,999		
Category C:			
Non-company Company	Rs.10 lakh and above	Deputy Commissioner (Assessment)	100% of cases
Category D:			
	All search and seizure assessments	Assistant Commissioner	All cases

6.61 The criteria for selection of non-company cases of income/loss of less than Rs.5 lakh were simplified in 1991-92 with a view to reducing the discretion of the assessing officers as well as the supervisory officers, in supersession of all earlier instructions on the subject.

(i) It was laid down that apart from the set-aside and re-opened assessments, only cases satisfying the following criteria were to be selected for scrutiny -

(a) cases where refunds exceed Rs.1 crore, whether already issued or not;

(b) cases where adverse information has been received from CIB, survey or other sources;

(c) glaring cases of tax evasion/ avoidance; and

(d) after allowing for the above cases, to make up for the annual quota of scrutiny cases, the higher income/ loss cases were to be taken in descending order of the returned income/loss.

(ii) The selection of cases was to be done on a regular basis to avoid shortage of cases in the beginning or middle of the

year and bunching of cases towards the end.

(iii) With a view to improving the quality of assessment, each Commissioner was required to monitor investigation in 20 cases including at least 5 search and seizure cases.

6.62 The scheme of selection of cases for scrutiny as devised by the CBDT is said to be primarily geared to the objective to reduce the discretionary power of the assessing officer in selecting cases so that the opportunities for showing favouritism and getting illegal gratification could be minimised. This is indeed an important objective and to an extent the discretion of the officer is reduced by the criteria laid down, particularly criteria (a) and (d). The criterion "glaring case of tax evasion/avoidance" allows for free play of discretion and judgement. Even in respect of criterion (b), it would be necessary to say clearly what types of information should necessitate inclusion of a case in the scrutiny list.

6.63 We should record that several complaints were made to us by trade and industry representatives that the lower level staff were still (in several cases) trying to get money out of the assessees through promises to take their names off the scrutiny list. This pernicious practice, which defeats the very purpose of instituting scrutiny assessment and lowers the image of the Department in the minds of the public, must be eliminated. The two basic reasons which open up the scope for such practice are that the selection is made at the level of the assessing officer himself and the criteria laid down leave room for discretion.

6.64 The stipulation that all non-company cases with income of Rs.5 lakh and above should be chosen leads to attempts to show that the assessees' incomes have not reached Rs.5 lakh, i.e., to deliberate understatements. Since the officers are to choose assessees for scrutiny in the descending order of income returned, apart from cases where special information has become available, cases with incomes close to Rs.2 lakh and Rs.5 lakh tend to get selected repeatedly. This means in an Assistant Collector's circle, those with incomes in the range Rs.2 - 3 lakh have very little chance of being selected. Similarly, in the wards, those with incomes substantially below Rs.2 lakh have little chance of being selected in the normal course. Thus the existing system of selection does not satisfy the condition of giving all assessees an equal or fair chance of being selected. It is also seen that no regular procedure has been devised to incorporate any information learned from statistical analysis of evasion trends.

6.65 We had pointed out earlier that it was desirable to introduce the criterion of randomness because one objective was to keep all assessees "on their toes". This idea seems not to have been communicated to the assessing officers so that they seem to proceed on the assumption that if a case has been taken up for scrutiny, there must be some under-reporting or attempt at evasion. The tendency is, therefore, to make additions to the demand. Furthermore, if an addition is made by an officer and if that is sustained on appeal by the Tribunal, the officer is given an award. In the opposite case, if the additional demand is knocked down on appeal, the officer concerned does not have to suffer any serious consequence. This asymmetry tends to lead to high pitched assessments. As pointed out elsewhere in the report, nearly 77 per cent of the additional demand is extinguished on appeal.

(c) Suggested procedures

6.66 Changes in the methods of choosing cases for scrutiny assessment and in the attitude of the officers towards such assessment are both needed. It is necessary to use the available resources to the best advantage distributing them in an optimum manner across categories. We recommend that the percentages of assessees to be selected for scrutiny should be as follows:

(i) roughly 3 per cent of non-company assessees with income/loss below Rs.2 lakh;

(ii) 4 per cent of non-company assessees with income/loss from Rs.2 lakh upto Rs.9,99,999;

(iii) 33 per cent of non-company assessees with income/loss of Rs.10 lakh and above;

(iv) 20 per cent of company assessees with income/loss below Rs.1 lakh;

(v) 100 per cent of all company cases with income/loss of Rs.1 lakh and above; and

(vi) 100 per cent of all search and seizure cases.

N.B. The income/loss should be gross total income as increased by the amount of unabsorbed losses carried forward from earlier years for set-off against current year's income.

6.67 Where 100 per cent or 33 per cent of cases are taken up for scrutiny, for obvious reasons, no special procedures for selection are needed. In the first category each case will be taken up each year and in the second category each case will be taken up every 3rd year. But for the other categories, the procedure for selection becomes important.

6.68 The selection should be strictly impersonal, should leave little room for discretion and must be based on weighted random sampling. In the sample selection, certain characteristics of particular trades or professions and items of information received will be used to give weights or scores to various cases in a non-discretionary way to increase the chances of those cases being selected according to their respective scores. Finally, the selection should be made centrally or at a few centres which are not associated with the assessment work.

6.69 In the long run, the Income Tax Department ought to aim for a system based on a scoring rule as advocated by expert committees earlier and as used in advanced countries such as the USA. In the USA the returns received are automatically checked for arithmetical accuracy and routinely cross-matched with third-party information. Based on statistical studies of individual taxpayer files scrutinised in the past under the Taxpayer Compliance Measurement Program (TCMP), the computer develops a method of assigning scores to different pieces of information contained in the taxpayer's return as well as information received from third-party sources. These scores are used along with the information available about each taxpayer to construct an aggregate score, called a Discriminant Function (DIF) score. The selection of taxpayers whose returns are to be audited is based to a large extent upon the assigned DIF scores. The formula by which these scores are computed is kept a closely guarded secret. The formula is frequently updated on the basis of new information received from TCMP studies. In the short run a scoring system based on a TCMP does not appear to be feasible in the context of a very poor level of computerisation of the Department. However, immediate steps should be initiated to undertake a TCMP study on a pilot basis.

6.70 In order that proper procedures for the selection of cases for the purpose of scrutiny assessment could be devised, it is urgently necessary to proceed speedily with the computerisation of the operations of the Income Tax Department. The various components of the computerised information system that must be built up have been indicated in an earlier section of this chapter. The creation of a TMF must be given top priority. It is only when the Department has such a file that a sophisticated selection procedure for scrutiny assessment can be adopted.

6.71 Till a proper score system can be developed, one has to be satisfied with some improvement in the existing system. Given

the percentages of cases to be selected as recommended by us, it is the selection of cases from among non-company assessees with income/loss of less than Rs.10 lakh that needs to be given the greatest care - these assessees constitute the majority of taxpayers and the percentage of cases to be selected is so small that the manner of selection becomes all important. Among these assessees, those who have opted for the Estimated Income Scheme or the Presumptive Tax Scheme can be kept aside. For the rest of the filers in this category, the following procedure may be adopted:

6.72 A set of presumptive factors which can be taken as indicators of tax evasion should be identified. The Chief Commissioner/Commissioner of a Charge should prescribe the system of assigning scores to these factors. The assessees should be required to supply certain specific information (not exceeding 10 in number and not involving any additional work or computation on their part) in a form to be attached to the return. This form should be required to be filed by all taxpayers who derive income from business or profession and do not opt for the estimated income scheme recommended by us. The salaried assessees and those with other sources of income should be asked to fill in a different form with less details. The form should be typewritten so as to facilitate automatic reading of the data through *optical character recognition*, thus eliminating the need for costly and delayed manual transcription and verification processes. These forms should be passed on to the Deputy Commissioner of the Range. He would add information obtained from CIB sources. After taking all items of information into account, the Deputy Commissioner will work out the total number of scores to be given to each return. The selection for scrutiny assessment will be done at the level of Deputy Commissioner.

6.73 Where a total of 4 per cent of cases is to be chosen for scrutiny, 3 per cent should be based on the descending order of scores and one per cent on pure random sampling. If the total sample is to comprise 3 per cent, then 2 per cent should be on the basis of descending scores and one per cent on the basis of random sampling. In the case of company assessees with income/loss less than Rs.1 lakh, 5 per cent out of the 20 per cent sample should be chosen on the basis of random sampling.

6.74 The Commissioner would send to the Deputy Commissioner the information he has obtained giving evidence of evasion by certain assessees with the instruction that the returns of these assessees should be taken up for scrutiny. In such a case the names of these assessees would be substituted for sampled assessees by suitably reducing the size of the sample.

6.75 The entire sample should not be chosen at one stroke at the beginning of the assessment year. The selection process could be carried out in two (or perhaps even three) stages so that the late filers could also be included in the list for selection with their respective scores. All cases of non-filers should be scrutinised by an officer not below the rank of an Assistant Commissioner. If after scrutiny the total income of the taxpayer continues to be non-taxable, this finding must be taken note of along with other information on him, in identifying non-filers in the subsequent year. As regards assessees with income from business who have opted for the Estimated Income Scheme, there should be no scrutiny assessment for the first three years in each case. After that period there should be scrutiny of one per cent sample chosen randomly merely to check the accuracy of the gross turnover. For the purpose of scrutiny assessment, a set of clear questions must be framed and the assessee must be asked to provide the answers to these questions. Only if the answers are found unsatisfactory, should the assessee be asked to come to the office of the assessing officer with his books of account.

6.76 The method of group or team assessment which we are recommending later in this Chapter would serve to reduce

harassment and also tend to reduce the degree of arbitrariness in assessment at the lower levels. We have been told that when the scrutiny assessment is being carried out by the Income Tax Officers, very often the assessees are called to office too many times under one pretext or another. Strict instructions should be issued by the appropriate authorities that such harassment of the assessee would be severely reprimanded. All the information needed should be asked for at one time; then on the basis of analysis of the information supplied, the assessee could be asked to come once more with some additional information. There should not be any further request for the assessee to go to the office of the Income Tax Officer.

6.77 As of now, Deputy Commissioners are complaining that given their various responsibilities the load of assessment work on them is too heavy. Since they have to complete 80 scrutiny assessments in a year, even if they spend only two days per assessment on the average, they would have to spend 160 working days on assessment work alone. This, they argue, is too heavy a load which tells on the quality of their assessment. The number of assessees is increasing, and will increase even though the threshold level may be partially indexed to inflation. On the other hand, we cannot afford to increase the staff proportionately. This problem would have to be tackled both through higher productivity and through the reduction of volume of scrutiny assessment work. Higher productivity and greater efficiency can be achieved in any substantial way only through computerisation. For more reasons than one, that must receive top priority. Apart from this, if the suggestions we have made regarding different sample sizes in para 6.66 above are accepted, the relative volume of scrutiny work will come down. In addition, we would recommend that the Board should seriously consider adopting a rule that if an assessee shows an increase of 10 per cent of taxable income over the previous year, he may be omitted from scrutiny assessment unless the Commissioner gives specific instructions for scrutiny on the basis of clear evidence of evasion which he has received from the CIB. This rule can be applied to all cases with income below Rs.5 lakh.

Taxpayer Information System

6.78 Verification requires both familiarity with the applicable provisions of law and information concerning taxpayers themselves, their sources of income, number of dependents, deductible expenditure, etc. The latter requirement - information concerning taxpayers - is essential for securing additional revenue.

a. Collection of information

6.79 The sources of information used by the tax administration to build up an information system may be classified into three main categories:

i. Taxpayer declaration;
ii. Information returns; and
iii. Information and evidence collected by the Tax Department during the course of investigation.

i. Taxpayer declaration

6.80 Under the system of self-assessment, the taxpayer forms the basic source of information. The taxpayer provides information to the tax administration through returns and accompanying documents. These returns contain valuable information on the assessee and his activities. All this information can potentially be used to help gauge the taxes due from the assessee. In this regard, it is necessary to address the problem of the design of the return form, filing requirements and policy, making returns available and sanctions against non-filing of taxpayer declaration.

6.81 If the tax return is to be used as the primary source of information, one must get the taxpayer to give accurate information in the return. A provision for punishment in the

law for giving "false" information may be necessary, but since the ordinary citizen cannot be expected to understand all the complexities of the tax law, all the mistakes in the return cannot be straight away attributed to a wilful intention to conceal the truth: failure to understand instructions or accounting practices could also be the cause. The tax administration should, therefore, strive to make the task of the taxpayer in filling the tax form easy. This can be done through a proper design of the tax form and the supply of adequate explanatory material and guidelines in the form itself or in the annexure.

6.82 The tax return form should conform to the following specific design principles:

(a) The form should allow the assessee to display all computations and not simply report incomes, deductions, etc. Clear guidance as to necessary computations must be incorporated in the return. This should be done by way of line by line computational instructions in the form and detailed notes on filling the return.

(b) There should be minimal duplication of information called for in different parts of the return (aside from acknowledgements).

(c) The form should minimise the need for the assessees to write "not applicable", in case certain parts of the return do not apply.[12]

(d) The form should have a Modular Design. Certain parts (e.g., for capital gains) need to be filled in only if the assessee has such income.

(e) Clear instructions should be given as to the kind of supporting evidence that is required to be attached and where.

(f) The return proper should have a consecutive link numbering from beginning to end. Notes on filling in the return should, therefore, be keyed to the unique line numbers.

(g) The return should be filled in by starting at the beginning and moving, line by line, to the end. Thus (except for acknowledgements) 'no shuffling back and forth' will be required.

6.83 In the light of what we have said above, as against the existing four different return forms applicable to different categories of taxpayers, the returns of income should be in the following forms :

Form 1: For taxpayers having profits and gains from business and opting for the presumptive income scheme;

Form 2: For taxpayers having profits and gains from business and opting for the estimated income scheme;

Form 3: For other taxpayers having income from business or profession;

Form 4: For taxpayers (not having income from business or profession);

Form 5: For companies;

Form 6: For Trusts;

Form 7: Special simplified form for salaried employees with a small amount of other income who would submit a statement to the employers in that form or send it to the Tax Department themselves, at their option.

N.B. An outline of Form 1 and Form 2 has already been given in our Interim Report. The model of Form 7 is given in Appendix II. The National Institute of Public Finance & Policy has been requested to prepare the outlines of the

other forms which could be used as a base, if our recommendation in this regard is accepted.

6.84 The Department should take steps to ensure that forms are easily available to the taxpayers. Forms 1, 2 and 4 should be made available in the major Post Offices in cities/towns, banks accepting payment of taxes, and all tax offices. Further, Form 7 should be sent to all DDOs for circulation amongst taxpayers. Forms 1 and 2 should be printed, at least every fortnight during the return filing season, in the local dailies so that taxpayers could use the paper cutting as the return forms.

6.85 The legally imposed requirement that the taxpayer must file a return on time is the most important single feature of income tax law from the point of view of its implementation. Without the return a generally applicable tax on net income is hardly conceivable. Hence, the need for establishing a system of sanctions against late filers and non-filers. In designing a system of sanctions, the Department should keep in mind the need to limit the discretionary power of the tax officers who would implement the sanctions. If the discretionary penalties are to be substituted by automatic penalties, care has to be taken to see that the penalties are fixed at a reasonable level, because they cannot be waived or reduced. Finally, the sanction should vary with the length of delay and have some relation with the amount of income or of tax liability.

6.86 Under Section 139(1) of the Income-tax Act, every person whose total income during the previous year exceeds the maximum amount not chargeable to tax is liable to file a return of income by the due date. However, the scope of the existing legal requirements for filing a return of income is not sufficiently broad. For example, a person who has suffered a loss need file a return only if he wants the loss to be carried forward to the subsequent year. Similarly, an exporter because of exemption of export profits is not required to file a return of income. The consequence is that such taxpayers can settle many questions in their favour, not file a return and also not be subjected to early verification. Further, the existing rules lead to the rise of 'in-again-out-again' taxpayers, thereby causing additional costs of administration.

6.87 The Income-tax Act provides for sanction against late filing and non-filing of returns. These sanctions take the form of either penal interest, or prohibition of the benefit of carry forward of loss or prosecution in extreme circumstances. A taxpayer who has sustained a loss under the head 'profit and gains from business or profession' or under the head 'capital gains' and claims that the loss should be carried forward, is required to file a return of income by the due date stipulated under Section 139(1). If the return of income in such cases is filed after the due date, the carry forward of loss is prohibited. Further, the Income-tax Act provides for sanction against late filers and non-filers by way of a mandatory interest at the rate of 2 per cent of the tax determined (as reduced by an advance tax paid or tax deducted at source) for every month or part of the month, for delay in furnishing the return of income. Section 276CC provides for prosecution of a person who wilfully fails to furnish a return of income under Section 139(1). Such person is liable to rigorous imprisonment for a term between six months and seven years where the tax sought to be evaded is more than Rs.1 lakh and between three months and three years in any other case. However, a person is not liable to prosecution if he files the return of income before the expiry of the assessment year or the tax payable by him on the total income determined on regular assessment, as reduced by the advance tax, if any, paid and any tax deducted at source does not exceed Rs. 3,000.

6.88 The effect of the above provisions is that where a person has paid all his taxes by way of advance tax or tax deducted at source, there is no 'penalty' for late filing or non-filing of return whereas, if a person discharges his tax liability after the

income-earning-year he is penalised. Further, since filing of a return entails cost to the taxpayer, and scrutiny of tax returns is generally restricted to those filed with the tax administration, the structure of the sanction against non-filers as it exists today encourages non-compliance amongst filers as they become aware of what the non-filers are getting away with.

6.89 In view of the above, the Committee recommends the following:

(a) Return of income should be required to be filed by -

(i) all persons whose total income during the previous year exceeds the maximum amount not chargeable to tax except salaried employees whose income from other sources is totally exempt under the law (e.g., under Section 80-L) or does not exceed Rs.15,000 on which tax has been deducted by the employer at the proper rate. Such salaried taxpayers will be required only to submit a simple statement in a special Form (Form 7 referred to earlier), if their taxable income exceeds Rs.50,000;

(ii) all companies irrespective of the level of income;

(iii) all persons (other than companies) carrying on business whose total turnover exceeds Rs.5 lakh irrespective of the level of income;

(iv) all persons (other than companies) carrying on a profession whose gross receipts exceed Rs.1 lakh irrespective of the level of income; and

(v) all trusts under Sections 11 to 13.

In the subsequent year, even if the taxpayer does not fall in any one of the categories in (i) to (v) above, he must continue to file the return of income for three consecutive assessment years. If after such three years, the taxpayer continues to remain outside the purview of (i) to (v), has no outstanding recovery of tax dues and has no appeals pending at any level, he should, in the fourth year, apply in a prescribed form for removing his name from the TMF.

(b) As against the existing provisions, if a loss return is filed after the due date, the benefit of carry forward of loss should be allowed to the taxpayer.

ii. Information returns

6.90 Another, more widely used, device to collect information are the "information returns". Information returns are declarations filed with the tax administration by persons required to report details of their financial dealings with other taxpayers. Information returns often require listing of all transactions of a certain kind, e.g., payments of corporate dividends or transactions beyond a magnitude of other kinds with other taxpayers during a certain period. A wide variety of sources of information can be imagined which could be reached by the tax administration through the device of information returns. Persons could be required, for instance, to file information returns on sums beyond a certain amount, say, Rs.25,000, paid during the year for the services of any particular doctor, lawyer or accountant. Such information helps in promoting compliance by such self-employed professionals, whose income is often difficult to ascertain. Nevertheless, there are severe practical limits on the use of information returns to aid the tax administration. The burden of supplying information may be strongly resisted by the public, especially if such information is sought from individuals rather than large business firms. The task of enforcing compliance with information requirements may add significantly to the tax administration's already heavy burden of enforcing taxpayers' obligations to file declarations of their own taxable transactions.

Finally, the task of actually utilising the information obtained in an effective program of cross-checking data may greatly complicate the tax administration's problem of handling voluminous data. Perhaps the mere awareness that transactions are being reported to the tax administration through information returns will induce many taxpayers to report their own tax liabilities accurately. However, if no effort is actually made by the tax administration to process the information provided on information returns, this intimidation effect will probably lose much of its impact.

6.91 Under the Income-tax Act, deduction at source is required from salaries paid to employees (under Section 192), interest on securities (under Section 193), dividends (under Section 194), certain payments to contractors, subcontractors (under Section 194C) and non-residents (under Section 195), and winnings from horseraces (under Section 194BB), lotteries and crossword puzzles (under Section 194B), provided that the amounts paid exceed stipulated sums. The deductor is required to file with the TDS circles in the Department annual returns relating to deduction of tax at source. These information returns should form one of the most important sources of information.

6.92 Further, under the extant procedure, the CIB functioning within the Directorate of Income Tax (Investigation), spread all over the country, collects from predetermined sources information relating to financial transactions from various external and internal sources. Sources of information to be tapped in a financial year, as also annual quantitative targets for verification of information, are laid down by the CBDT in the Annual Action Plans for the Investigation Directorates. The Deputy Director of Income Tax (Investigation), in consultation with the Director of Income Tax (Investigation), is empowered to revise the ceilings of the monetary limits fixed by the Board for collection of information. Currently, about 85 external sources are listed in the Long Term Action Plan for Survey formulated by the CBDT. In addition, eleven internal sources of information from various divisions of the Department are also listed, pertaining to the outcomes of searches and surveys, transfers of immovable properties, as well as information regarding incomes, expenditure and wealth of individuals. Sections 133B (power to call for information) and 131 (power regarding discovery, production of evidence, etc.) constitute the main legal base for the process. Under Section 133(6) of the Income-tax Act, firms, companies, dealers, brokers, agents, banks, etc., can be called upon to provide the names and addresses of persons engaged in transactions with them. The information so collected is collated, verified and then disseminated by the CIB to the assessing officers for taking action in the respective cases during assessment proceedings.

6.93 The process starts with the collection of information, mainly from external sources. However, there are several hurdles in this area. First, the practice of prescribing the source of information to be tapped in the Annual Action Plan means that the sources of information to be tapped are subject to change every year. Sources are, therefore, tapped on an ad-hoc basis rather than on an on-going basis. This breaks the continuity in the flow of information. Secondly, the flow of information is not automatic in the sense that the CIB first issues letters to various agencies, calling for information under sub-section (6) of Section 133 of the Income-tax Act. Though the Annual Action Plan for the Director of Income Tax (Investigation) identifies the sources of information to be tapped during the year, the specific firms, dealers, brokers, banks, companies, etc., required to be tapped for this purpose are left to the discretion of the officer in the field formation, with the result that the coverage of most sources tapped is incomplete. Thirdly, even where information is called for under Section 133(6), not all agencies respond promptly. In such cases summons under Section 131 are issued. Even then, many agencies try to stall

or even resist communication of information. Refusal to part with information by banks and some other financial institutions is a case in point. This strains CIB's resources and delays verification and dissemination of information. Fourthly, because of limited manpower and infrastructure - including, importantly, the lack of automation and also the long delays in furnishing information, the CIB is not able to collect information from even the major external sources every year. The inability to collect annually comprehensive information from all or at least the major sources dilutes the efficacy of CIB verifications.

iii. Information gathered during investigation

6.94 As in other countries, in addition to information from taxpayers' return and other information returns, a large volume of information also gets collected during assessment, searches and seizures and survey operations. Towards identification of non-filers, Section 133B empowers Deputy Commissioners (Income Tax), Assistant Directors (Income Tax), assessing officers and also Inspectors of Income Tax if authorised by the assessing officers, to enter any building or place, within the limits of his jurisdiction, at which a business or profession is carried on and require any proprietor, employee or other person who may be attending to the business or profession, to furnish information in a form prescribed for this purpose (Form 45D). Information in Form 45D covers various aspects of business or profession: its nature and the year in which it was started, the number of employees, a list of the books of accounts maintained, nature and number of bank accounts, gross sales or receipts, value of stock, particularly of cars and other vehicles owned by the business or profession and income from all sources.

6.95 However, the efforts of the Directorates of Income Tax (Investigation) are mainly geared towards achieving quantitative targets for conducting surveys. While a target for detecting new assessees has been laid down for Chief Commissioners' charges which do not conduct surveys under Section 133B, there is no such target for Directorates of Income Tax (Investigation), the agency which actually conducts such surveys. As a result, the qualitative aspect (reflected in terms of the final outcome of a survey) does not get adequate attention. Furthermore, in many Directorates, surveys are not evenly spread throughout the year. Most surveys are conducted in a hurry towards the end of the year. This affects the quality of surveys. Another outcome of the practice of setting quantitative targets for door-to-door surveys is the re-surveys conducted within a short period of time merely to achieve such targets. The CBDT has, however, recently issued instructions to the effect that re-survey of an area should be made only after a reasonable interval of time, depending on the phase of commercial development and the number of new businesses set up in the area. During the course of re-survey of the same area, only such premises may be covered as were not covered by an earlier survey.

6.96 Under the existing scheme for identification of non-filers, excessive reliance seems to have been placed on door-to-door survey under Section 133B of the Income-tax Act. This leads to excessive interface of the Inspectors in the Department with the public at large leading to complaints of harassment from the public and corruption which we understand have a basis in fact. As they say, familiarity breeds contempt. Hence, more often than not, the public ire against harassment and corruption manifests itself in physical assault on the staff and officers of the Department, particularly during search and seizure operations. The need to undertake door-to-door survey to identify non-filers arises from the existing pathetic condition of the third party information matching system in the Department.

6.97 Search and seizure operations carried out under Section 132 of the Income-tax Act also provide valuable information on incomes, assets and

transactions of the assessees whose premises are searched. Such information should also be incorporated into the information pool in the Department.

6.98 Under Section 133A(1), surveys can be conducted at any place of business or profession during which books of accounts and other documents available can be inspected. However, even senior officers cannot also check and verify the cash, stocks and other valuable articles found. The officers conducting the survey can also record statements. Other Sections of the Act empower the Department to make enquiries and obtain information about the nature and scale of expenditure on a function or ceremony. Although these provisions suffer from certain limitations, a considerable amount of relevant information can be collected in the above ways. However, there is no system of continuous and automatic flow of information from the banks, Government agencies and other important sources. Nevertheless, the information obtained is quite substantial.

b. Collation of information

6.99 If the large volume of information that any tax administration receives is to be meaningfully utilised for determining under-reporting or non-reporting of income in tax returns, it is necessary that the information is properly collated. At present, because of lack of computerised information system, the information collected by the Income Tax Department through the CIB is entered manually in the prescribed register of the information receipts in CIB. Further, in the absence of a broad-based permanent identification system, sorting of information is by use of names and addresses. The result is that not only the CIB is handicapped in tapping even the major information sources every year but also consolidation of all information on a particular person from all the sources is not currently possible. This may lead to acceptance by the Department of questionable claims and unexplained financial dealings in a case. The CIB can detect tax evasion (or if the affected person is not an existing assessee, detect a non-filer) only if it collects and verifies information in respect of all or at least most of the CIB sources and is able to bunch all the information pieces for simultaneous verification/follow up action in assessment. It may not be able to detect tax violations in the given case if either verified information is only for a limited number of information pieces or the collection and verification process is spread over a number of years, making it difficult to ensure their simultaneous utilisation in assessment within the limitation period.

c. Dissemination of information

6.100 Timely dissemination of information collected at different levels in the tax administration is a vital link in an efficient information system. Today, there are two basic problems associated with dissemination of information collected by the CIB: first, not all information collected by the CIB is transmitted to the assessing officer and secondly, there is a considerable time lag between collection of information by the CIB and dissemination thereof to the assessing officer. The CIB and assessing units function almost independently of each other and there is little co-ordination between their activities. The CIB is satisfied if it is able to achieve the annual quantitative target and the assessing officer is not worried if no useful CIB information comes to him before selecting assessments for scrutiny or framing assessments. This sometimes leads to a situation where information in a case reaches the assessing officer after the selection process is over and the relevant assessment has been finalised. Even if assessments can be reopened on the basis of the CIB information, it leads to delay in finalisation of assessments, generates repetitive work and public grievance.

d. Verification of information

6.101 Finally, the task of actually utilising the information obtained in an

effective programme of cross-checking data may greatly complicate the tax administration's problem of handling voluminous data. In India, the information collected is verified by that branch of the tax administration which is engaged in collecting information. However, the determination of the increased tax liability is only by the assessing officer.

6.102 The information collected by the Income Tax Department is grossly under utilised. Even the small portion which is verified, has not led to any satisfactory results in terms of deterrence against non-compliance particularly due to the lengthy and time consuming process of verification.[13]

6.103 A final issue regarding collection and verification of information is that the focus of the efforts of the CIB is on maximising the number of verifications as this is the only prescribed Action Plan target for it and constitutes the main basis on which its performance is evaluated. As a result, quality (for example, amount of tax evasion detected, number of tax evaders detected and number of new assessees identified) gets neglected. We were given to understand that, in the CIB, verification is generally not evenly phased out throughout the year and there is a bunching of effort towards the end of the year. This affects the quality of verifications.

6.104 In the light of the deficiencies mentioned above, the Committee recommends the following:

a. On information collection:

i. Instead of specifying the sources of information to be tapped every year, the CBDT should prescribe a long-term plan indicating the sources from which information should be gathered. In this regard, the Board should be empowered to make rules to require some classes of persons to furnish information in respect of certain major items, in a prescribed proforma.

The classes of persons should include persons who are authorised to issue licences and sales tax exemption forms, give telephone connections, etc., mentioned under the scheme of TIN. For example, to begin with, the person responsible for registering industrial units should be required to furnish an annual return containing details of all registered units. In the subsequent years, they could be required to furnish details of only the new registrations during the year. Similarly, the telephone authorities could be required to furnish details of the new telephone connections each year. Since the responsibility would be cast upon the information return filer to file the relevant information return by the due date, the existing problem of identifying the information return filers and having to issue summons for collection of information would be considerably reduced. Further, information from a particular source would be uniform across the country and a continuous flow would be ensured over time.

ii. The information must be procured in a prescribed form. These forms should be type-written so as to facilitate automatic reading of the data through optical character recognition, thus eliminating the need for costly and delayed manual transcription. The filer could also be given the option of furnishing the information on a computer floppy.

iii. The information returns should be required to be sent directly to the CIB.

iv. On conduct of a search and seizure under Section 132 of the Income-tax Act and a survey under Section 133A of the Income-tax Act, the concerned income tax authority should be required to send to the CIB, within, say, 15 days,

First Information Reports regarding the operations. In the case of search, the report should contain the names and the addresses of the premises in respect of which authorizations have been issued, the respective TINs, the amount seized from each premise, details of restraint warrants, etc. The First Information Report on Survey should also contain similar details.

v. An internal procedure should be evolved to collect information from returns of income by selected categories of assessees, with incomes above a certain level. Such information would relate to source-wise composition of gross total income, details of sales above a specified limit effected during the year, purchases above a specified limit effected during the year, loan transactions (both given and taken) above a specified limit, the closing stock, etc.

b. On collation:

i. Towards collation of the information collected, the Department should construct the following files which should form the mainstay of the information system:

(a) Taxpayer History File;
(b) Survey File;
(c) Taxpayer Scrutiny Assessment File;
(d) Information Mis-matching File; and
(e) Non-filers File.

ii. The Taxpayer History File should be maintained by the CIB. The record for each TIN holder should contain the year-wise information contained in the (a) Information returns furnished by various agencies; (b) Statement of wealth; and (c) Return of income (both of self and other taxpayers). In addition, this file should also contain information which reflects adversely on the taxpayer compliance behaviour, namely, information on:

(a) whether a stop-filer notice was issued with date;

(b) whether a non-filer notice was issued with date;

(c) whether the case was selected for scrutiny;

(d) whether any notice under Section 148 for re-opening of assessment was issued with date;
(e) whether any notice under Section 263 has been issued;

(f) whether any enhancement notice was issued by the appellate authorities;

(g) whether any instances of mis-matching on cross-verification of information have been identified;

(h) whether a search operation has been conducted during the year in any of the premises occupied by the TIN holder; and

(i) whether a survey operation has been conducted during the year in any of the premises occupied by the TIN holder.

To avoid duplication, the information on points (c) and (e) to (i) should be recorded only as 'yes' or 'no', since details can be obtained from other relevant files.

iii. The Survey File should be constructed on the basis of both the First Report on Survey Operation and the Final Report on Survey Operation. This file should be maintained in a computer by the Directorate of Income Tax (Investigation).

iv. The Taxpayer Scrutiny Assessment file should be constructed on the basis of the Report on scrutiny assessment furnished by the assessing officer, separately for each scrutiny assessment case. This file should be maintained by the CIB. The information available in this file should be used to review the effectiveness of the scrutiny assessment in terms of direct revenue gains and also to evolve a long-term strategy for scrutiny assessment.

c. On verification and dissemination

i. The CIB should not be required to undertake any form of verification directly with any taxpayer/TIN holder either for identifying non-filers or detecting under-reporting of income.

ii. Through a scientific analysis of the records of the non-filers in the Taxpayer History File (particularly, through comparison with the records of similarly placed filers), the Intelligence wing in the Directorate of Income Tax (Investigation) should identify non-filers. On identification of non-filers, the Intelligence wing should send a list of the non-filers along with their PINs and addresses to the respective Deputy Commissioners (Range) for issue of notices and to the CIB for constructing the Non-filer File. The Non-filer File should contain such details as date of issue of non-filer notice, returned income and assessed income.

iii. Similarly, through cross-verification of information contained in the different records, the Intelligence wing should seek to detect under-reporting of income by filers. On mis-matching of any information, the Intelligence wing should first segregate all cases of mis-matching where secret enquiries need to be carried out and forward them to the Investigation wing of the Directorate of Income Tax (Investigation). All other cases of mis-matching should be sent to the respective Deputy Commissioners (Range) for further necessary action.

iv. On selection of a case for scrutiny, the assessing officer must first obtain, through the CIB, a copy of the record of the taxpayer in the Taxpayer History File. Based on the information contained in the record, the questionnaire for obtaining information from the taxpayer should be framed. Further, the information collected during the assessment proceedings must be duly cross-verified by the assessing officer, through the Intelligence wing, with the information contained in the various records in the Taxpayer History File. Where cross-verification is not possible due to failure to update information, the Intelligence wing must first seek to update the information through the CIB.

Tax Account Information System

6.105 The Tax Account Information System consists of manual and computerised procedures and data bases which would enable the Department to keep up-to-date tax information for each taxpayer with respect to debits, credits, cancellations, interest, readjustments, payment arrangements and other taxpayer transactions with the administration. This would be used to detect and report delinquent accounts and to provide timely information to the other subsystems on the taxpayer's overall tax situation. The current account file will show tax accounting entries.

6.106 The Tax Account Information System generally comprises two files, namely, the Tax Account File and the Recovery File.

6.107 All data on payments made by taxpayers at the collection offices and the data on payment arrangements which change the characteristics of the originally registered

debits are entered in the Tax Accounts File in order to keep an up-to-date account on each taxpayer from which one may determine pending amounts, whether delinquent or not, for each fiscal period.

6.108 From the Tax Accounts File the information on delinquent taxpayers could be extracted to form the Recovery File on the basis of which recovery action can be initiated. The Recovery File must also keep information on follow-up action for direct control and supervision of the recovery process and its efforts. The Recovery File must also handle other matters such as payment arrangements, which must be reported to the Tax Accounts File in order to keep the corresponding file up-to-date.

6.109 We discuss the organizational structure relating to collection and recovery of taxes later in this Chapter (paras 6.131 to 6.133). The existing system of maintaining the Tax Accounts File and the Recovery File in the Income Tax Department is outdated and unproductive. At present, the following registers are maintained which have a bearing on collection and recovery: (a) Current Demand and Collection Register; (b) Arrear Demand and Collection Register; (c) Daily Collection Register; (d) Registers in Central Treasury Union (CTU); (e) Registers in TDS wing; and (f) Registers in Recovery wing.

6.110 On completion of assessment, the assessing officer records the details of prepaid taxes, tax payable on assessed income and the balance amount recoverable/ refundable in the Current Demand and Collection Register. Where a refund is due, the same is required to be issued along with the assessment order.

6.111 On intimation to the taxpayer of the balance amount payable by him, the taxpayer either disputes his tax liability by filing an application for rectification before the assessing officer or an appeal before the appellate authority or makes the payment in the designated bank through a challan. Where the rectification application is accepted by the assessing officer, necessary rectification order to this effect is passed and the original entry in the Current Demand and Collection Register is altered by striking off the original entry, initialling thereon and recording the revised amount of current demand, if any.

6.112 At the beginning of every year, the Arrear Demand and Collection Register is required to be drawn up in every ward. This register is maintained assessment year-wise and comprises the entries in the Current Demand and Collection Register and the Arrear Demand and Collection Register of the immediately preceding year, where demand is outstanding. Any adjustment through rectification or recovery is made by striking off the original entry, initialling thereon and recording the revised amount of arrear demand, if any.

6.113 The Daily Collection Register records details of all cash collections during the year. As is well-known, all tax payments (except adjustment of refund against demand) are required to be made through challans in the designated bank. The challans contain four copies: the first copy for the assessing officer to be routed through the bank and the CTU, the second copy for the bank, the third copy for enclosing with the return of income, and the fourth copy for the taxpayer. Under the existing practice, the designated bank while acknowledging receipt of payment of taxes, is required to retain two copies of the challan and return the other two copies to the taxpayer. The bank sends a scroll of all payments received, along with one copy of each challan to the CTU which in turn, after recording in their Daily Collection Register, sends to the assessing officer in the ward/circle a scroll of challans relating to the ward/circle along with copies of the challan. On receipt of the challans along with the scrolls, the details of payments received from different taxpayers are again recorded in the Daily Collection Register of the ward/circle and the challans are required to be placed in the corresponding file of the taxpayer. Subsequently, while giving credit to the

taxpayer's claim for payment of advance tax, the copy of challan enclosed with the return of income is required to be cross-verified with the copy on record (i.e., the copy received from the bank through the CTU).

6.114 Over the years, the number of taxpayers has increased. Consequently, the volume of challans to be handled at different stages has increased manifold. The system is now under considerable strain and on the verge of collapse. Challans from the banks are being received by the assessing officers after months. The practice of contacting taxpayers for ascertaining details of payment of advance tax to fulfil budget targets is common. Further, the challans that are received do not find their way to the relevant assessment records of the taxpayers, nor is appropriate credit given against the outstanding demand. The problem is further compounded by the objections raised by the Revenue Audit to the credit being given for prepaid taxes without cross-verifying the challan in the return with the copy received from the CTU. The consequence is that the taxpayer is subjected to considerable harassment through repeated recovery notices[14] and frequent payment of speed money. The existing system is, therefore, unacceptable. The situation will worsen with further increases in the number of employees.

6.115 As would be apparent, the existing system entails duplication of work. This coupled with the fact that the system is manually operated, leads to considerable time-lag in transmitting the information from the designated bank to the assessing officer. The time-lag, therefore, needs to be reduced considerably to minimise taxpayer harassment. Furthermore, since the assessing officer is unable to place the challans in the relevant files of the taxpayers, the process must be virtually reversed.

6.116 The existing system is also characterised by the primitive practice of altering permanent official records on every occasion of adjustment of the arrear demands. Besides loss of valuable work-time of the limited manpower, the infructuous annual exercise of constructing new Arrear and Demand Collection Register is also fraught with the danger of loss of revenue on account of omissions and commissions in manually copying each entry in the Current and Arrear Demand and Collection Registers of the immediately preceding year. In fact, during the course of evidence, the Committee was given to understand that the figures of arrear demand reported to the Government are far from accurate.

6.117 Further, in the absence of any collation of all the debits and credits over the tax-paying years of a taxpayer, there is no easy method of ascertaining a taxpayer's liabilities/claims at any point of time. This leaves considerable scope to the tax administration, particularly at the staff level, for both harassment of the taxpayer by ignoring the credits and defrauding revenue by ignoring debits. In fact, obtaining a tax clearance certificate from the Income Tax Department is almost a nightmare. At the managerial level, while there is some estimate of the total number of entries in the Arrear Demand and Collection Register pending tax recovery, it is impossible at present to know either the total number of delinquent taxpayers, or the amount collectible.

6.118 To solve the above-mentioned problems, the Committee would like to recommend changes in procedure and a reorganisation of work in the Department along the following lines:

a. The plethora of registers relating to collection and recovery maintained by the assessing officer/TRO and CTU and the practice of officially "tampering" with the entries in the registers to give effect to re-adjustment, etc., must be given up.

b. All matters of collection and recovery of taxes should be centralised with the Directorate of Collection and Recovery, whose role and new structure we

recommend in paras 6.131 to 6.133. This Directorate should construct the following files which should form the mainstay of the Tax Account Information System:

i. Tax collection file
ii. TDS file
iii. Tax account file
iv. Account (Rectification) file
v. Account (Appeal Effect) file
vi. Refund file
vii. Recovery file
viii. Tax clearance certificate file.

The files at (i) and (ii) should be maintained by the collection wing of the Directorate of Collection and Recovery, files (iii), (iv) and (v) by the taxpayer account information wing and files (vi), (vii) and (viii) by the recovery wing.

c. *Tax Collection File*: The first step towards constructing this file should be to identify from the TMF all taxpayers who are liable to pay advance tax. Each record in this file should contain, in respect of each advance taxpayer, the information relating to payment of advance tax and self-assessment tax contained in the scroll received from the nodal bank. This file should be periodically reviewed to identify advance tax defaulters for appropriate action under **Section 210** of the Income-tax Act.

d. *TDS File*: This file should contain the list of all those who have to deduct tax at source. Details of payments of tax deducted at source should be kept in the file. On the basis of this information necessary action should be taken in cases of short or delayed payments.

e. *Taxpayer Account File*: This file should be maintained by the Taxpayer Account Information wing of the Directorate of Income Tax (Collection and Recovery). This file should be maintained in a **ledger form** where each record should, in relation to a taxpayer, contain up-to-date information with respect to debits, credits, cancellations, taxes, fines, interest, readjustments, payment arrangements and other taxpayer transactions with the administration. This file should be created in the following manner:

i. The name, address, etc., of all TIN holders must be obtained from the agency entrusted with the responsibility of issuing the TIN.

ii. On completion of assessment whether under Section 143(1) or 143(3), the assessing officer should send to the Taxpayer Account Information Wing (TAIW) a weekly assessment scroll and all intimations under Section 143(1) where a refund is due. This scroll should contain all the necessary details: TIN and name of the taxpayer; assessment year; date of assessment and assessed income; tax on assessed income; additional tax, if any, interest payable; advance tax paid; TDS; self-assessment tax; net payable/ refundable.

iii. The information relating to payment of advance tax and self-assessment tax contained in the assessment scroll in respect of a taxpayer should be first verified with the Tax Collection File. If the claim by the taxpayer for pre-paid advance tax and self-assessment tax is found to be at variance with the information contained in the Tax Collection File, the TAIW should send an intimation to the taxpayer indicating the discrepancy. Thereafter, the information contained in the assessment scroll, relating to the debits and credits, as revised by the

information contained in the Tax Collection File should be transferred to the record of the taxpayer in his File.

iv. The credit balance or the debit balance, as the case may be, at the end of every week should be transferred to the Refund file or the Recovery file, as the case may be. Thereafter, the refunds should be issued along with the intimations under Section 143(1) received from the assessing officers. Subsequently, on issue of refund or on recovery, the necessary debit and credit entries should be recorded in this file.

v. Where a refund arises in pursuance of an order under Section 143(3), such order should not be sent to the TAIW.[15] However, the order under Section 143(3) should clearly indicate to the taxpayer that the necessary refund shall be issued separately by the Directorate of Income Tax (Collection and Recovery).

vi. Where an order of re-assessment or rectification or penalty is passed or appeal effect given, the assessing officer should send a separate scroll indicating the relief or the additional liability as the case may be. The debits and credits under each head (i.e., tax, additional tax, interest on different counts, penalty, etc.) arising on account of re-adjustment or re-assessment or imposition of penalty should be entered.

f. *Account (Rectification) File* : This file should contain information relating to the effect on the taxpayer liability of any rectification under Section 154 of the Income-tax Act, whether on application by the taxpayer or by the assessing officer on his own motion or the basis of audit objection. (For this purpose, all rectification applications by taxpayers should be received, in a prescribed proforma , by the TAIW and the information contained in the proforma should be recorded in this file. Thereafter, these applications should be sent to the respective Assistant Commissioners (Range) who should, after taking necessary action, send the rectification scroll to the TWAI.) The Assistant Commissioners (Range) should send periodically rectification scrolls indicating in each taxpayer's case the quantum of relief or increase in the liability as the case may be, and also the fact whether the rectification arises out of an application by the taxpayer or by the assessing officer on his own motion or on the basis of audit objection. The information contained in this scroll should be recorded in this file and the debits or credits, if any, arising out of the rectification should be recorded in the Taxpayer Account File.

g. *Account (Appeal Effect) File*: This file should contain information relating to the change in the taxpayer liabilities as a consequence of any appellate order. The Assistant Commissioner (Range) should send periodically, to the Directorate of Collection and Recovery, the appeal effects scroll indicating, in each taxpayer's case, the quantum of relief as a result of the appellate order. The information contained in the appeal effect scroll received from each range should be recorded in this file.

h. *Refund File*: This file should be constructed from the tax account file. The information relating to credit balance, as on the close of the previous week in each record of the tax account file should be used to create a list of taxpayers eligible to receive refund. These refunds should then be issued by the Directorate immediately.

i. *Recovery File*: This file should also be constructed from the tax account file and contain the information relating to credit or debit balance as on the close of the previous week. On the basis of this record, action for recovery should be initiated.

j. *Tax Clearance File*: All applications for Tax Clearance Certificates should be received by the recovery wing. Each record in this file should contain information, that will be given in the application. After verification of the account of the applicant, the clearance certificate should be issued by the recovery wing.

6.119 These files to be maintained in computers, while serving the information needed for decision making at different managerial levels, would also replace a number of registers maintained at different levels in the Department for the purpose of collection and recovery. Further, the considerable time hitherto lost in the annual exercise of drawing up the arrear collection and demand register could now be utilised for better arrear reduction through intensive recovery efforts. Equally importantly, the taxpayer will not be put to trouble because the Challan sent by the Bank to the Department is not traceable in the assessment officer's files.

Reassignment of Responsibilities

6.120 As is known, under the CBDT are the various Directorates [Income Tax, Investigation, Income Tax (exemption, audit, recovery, etc.)]. The field organisation, or subordinate officers whose responsibilities cover assessment and collection are not under the Directorates, but report directly to the Board. The responsibilities of the subordinate officers in the Department manned by officers ranging from Chief Commissioner to Income Tax Officer encompass determination of taxes due, collection of taxes, revision and rectification of mistakes, redressal of taxpayer grievances, appeals, imposition of penalties, prosecution of tax offenses, inspection, audit and vigilance.

6.121 The assessing officer is the pivot around which the Income Tax Department revolves. The assessing officers combine in themselves the multifarious functions of assessment, collection, redressal of taxpayer grievances, taxpayer assistance, and furnishing of information for managerial decision-making. The consequence is that much of the time of officers and staff even in assessing charges is spent on duties other than assessment. It is, therefore, not surprising that the quality of scrutiny assessment leaves much to be desired.

6.122 The allocation of duties and responsibilities in respect of collection and recovery of taxes again casts heavy burden on the assessing officer. The practice of assigning budget targets to assessing officers without reference to the potential, to say the least, is arbitrary in approach, since direct tax collections are dependent on the performance of the economy over which the assessing officer has no control; only in the long run the effectiveness of the tax administration could have an impact on collections. At best, the tax administration could be assigned a target only for arrear collections. The responsibility for arrear collection, however, lies not only with the assessing officer but also with the TRO.

6.123 In fact, in this regard it is interesting to note the gradual shift in the allocation of responsibility between the assessing officer and the TRO. Prior to 1.4.1989, the assessing officer was solely responsible for recovery of a demand upto a period of two years from the end of the financial year in which the demand was created. Immediately before completion of two years, the assessing officer was required to send a certificate of recovery to the TRO. Subsequently, recovery became the joint responsibility of the assessing officer and the TRO. From 1.4.1989, the TRO is required to draw up the certificate of recovery on his own motion at any time after the taxpayer is

deemed to be in default and once the certificate is drawn, recovery is the sole responsibility of the TRO. Till such time as a certificate of recovery is drawn up, recovery is the sole responsibility of the assessing officer. Strictly speaking, the TRO should take up the responsibility of recovery immediately after the taxpayer is deemed to be in default. This does not happen in practice. The Board has by instruction directed that the assessing officers should draw up the recovery certificates for the signature of the TRO. However, it is not clear when this certificate of recovery should be drawn up i.e., whether immediately after the expiry of the initial 30 days for payment of demand or only after making reasonable efforts for recovery. Therefore, the delineation of responsibility between the assessing officer and TRO continues to be unclear with the assessing officer continuing to be assigned an Annual Action Plan target for arrear reduction. The TRO, though a specialised institution created solely for recovery of taxes, has yet not been given the whole responsibility of recovery of taxes.

6.124 Yet another instance of holding the assessing officer responsible for a task in respect of which a separate specialised authority has been created is collection of TDS. This is done perhaps so because the assessing officer alone can, based on the returns of income received, identify persons responsible for deduction of tax at source and is thus in a position to verify whether TDS has been deducted and deposited with the Government by the due date. We are also informed that the Income Tax Officer (TDS) is required to maintain a register of all persons liable to deduct tax at source. This being so, we do not see any rationale in assigning the assessing officer and the Income Tax Officer (TDS) the joint responsibility for monitoring collection of TDS. Similarly, the casting on the assessing officer the responsibility for collecting advance tax to meet budget targets is unreasonable.

6.125 The joint responsibility of the assessing officer and the TRO/Income Tax Officer (TDS) for collection and recovery leads to mis-utilisation of scarce trained personnel through duplication of work, particularly, maintenance of multiple registers and initiation of recovery proceedings against the same taxpayer by both the authorities. In fact, very often, while the TRO and his staff remain under-utilised, the assessing officer and his staff are over-burdened. It is an annual routine for the assessing officer and his staff to spend the first two months of any financial year constructing the arrear demand and collection register. As a consequence, the quality and the quantity of output at the assessing officer level suffers.

6.126 Sample studies of time allocation of staff in assessing charges show that, on the average, 26 per cent of the time of assessing officers is spent on non-assessment duties. Furthermore, only about 27 per cent of the time of assessing officers is spent on in-depth (scrutiny) assessments. The percentage of time spent on scrutiny in circles is higher by about 10 percentage points than in other charges. In investigation circles, where the case workload is lower, the time spent on assessment duties decreases and the time spent on other duties increases. Thus, 38 per cent of time was devoted to other duties by Assistant Commissioners in investigation circles. The time spent on non-assessment duties by the other staff is higher in general than that spent by the assessing officers (at 34 per cent). The same disturbing pattern across types of charges is found in the time allocation of other staff. (These findings relate to the year 1990-91.)

6.127 Inspectors of Income Tax are supposed to be "the eyes and ears" of the Department, serving essentially to keep assessing officers abreast of key information relating to assessees in their charges. It is therefore a cause for concern that, on the average, only 18 per cent of the time of Inspectors was spent on field enquiry. Inspectors were utilised more for tax recovery

work (33 per cent) and for other, within the office, duties (49 per cent). Furthermore, the field enquiry time of Inspectors was the least (8 per cent) in investigation circles.

6.128 Thus, in the charges sampled, less than 33 per cent of the manpower time available in the Department as a whole is spent on actual assessment work. Furthermore, in assessment charges, 20 per cent of the time is spent on tasks which result in no direct impact on taxpayer compliance or on improvement in the information available on taxpayers.[16]

6.129 Even though the findings are based only on a sample study of the working of the ranges/assessing officer charges in the Department, discussions with tax administrators and professionals confirm the fact that there is considerable degree of congestion of workload at the assessing officer level since a significantly large proportion of the time available to the assessing officer is spent in discharging non-assessment functions. Hence, there is need for distribution of work amongst the officers and the other staff along the functional lines.

6.130 The Committee is aware that the functional scheme, whereby the collection and recovery functions were separated from the assessment function, was given an experimental trial by the Department in the late 1960s and was given up soon after. This was primarily on the consideration that all the assessment records had to be shifted to and fro between the assessment wards and the collection and recovery wing. Further, in the experiment in the late 1960s the collection and recovery wing was required to liaison frequently with every assessing officer. This was warranted by the fact that all cases were subjected to scrutiny assessment resulting often in rectification, appeal effect, central scrutiny report or penalties. Each of these actions called for changes in the tax liability and hence the need for too frequent liaison of assessment with collection and recovery. As a consequence, the entire system of record management was thrown into disarray. However, it is not difficult to seek a solution to this problem of record management. On the completion of assessment, the information regarding assessed tax, amount paid and balance payable/refundable could, more appropriately, be transmitted from the Assessment Wing to the Collection and Recovery Wing through the medium of assessment scrolls (and not through physical movement of assessment records as in the experiment in 1967). Similarly, information relating to any change in the tax liability subsequently arising from rectification and appeal effect could all flow through the scroll system. Further, the preparation of the scrolls should not cause any difficulty if the aid of computers is availed of.[17] Moreover, the procedures for assessment have undergone extensive changes. Almost 97 per cent of the cases are completed under summary assessment without reference to the past records of the taxpayers and after making *prima facie* adjustments in only 3 per cent of the cases with only 50 per cent of these cases being subjected to further rectifications. There is also a shift in the penalty system from discretionary penalties to automatic penalties. Scrutiny assessment is now confined to only 3 per cent of the cases. As a result of these changes the need for frequent reference to assessment records would be reduced considerably, as also the need to make rectifications, prepare Central scrutiny reports, levy penalties and consequently make changes in the tax liability of the taxpayer. Hence the frequency of exchange of information between the assessment wing and the collection and recovery wing would be reduced significantly.

6.131 Based on the above considerations, the Committee recommends that the existing system of combining in an assessing officer all the functions of collection and recovery, summary assessment, scrutiny assessment and miscellaneous functions (like, rectifications, appeal effects, imposition of penalties, dealing with audit objections, reporting, etc.) should be replaced by a new system based on functional classification of

jobs. Under the new system, the collection recovery and refund functions performed by the assessing officers, the collection functions performed by the CTUs, the TDS functions by the Income Tax Officer (TDS) and the recovery functions by the TRO should be assigned wholly to the Directorate of Income Tax (Collection and Recovery). For this purpose, this Directorate headed by a single Director General, should have its office in each city/town where an income tax office is located. The span of control of the Director General should extend over five Directorates of Income Tax (Collection and Recovery) with the jurisdiction of each extending over a well-identified geographical area. The span of control of the Directorate of Income Tax (Collection and Recovery) should extend over the following wings within such geographical area:

a. Collection Wing;
b. Recovery Wing; and
c. Refund Wing.

6.132 While in metropolitan cities and other big towns, both officers and staff should be separately assigned to this Directorate, in smaller towns the Officers performing the assessment function could be assigned the additional responsibility of the office of the Directorate, but the staff could be separately assigned.

6.133 The co-ordination between the Assessment Wing and the office of the Directorate of Income Tax (Collection and Recovery) will be done by the Chief Commissioner/Commissioner/Deputy Commissioner (Range), as the case may be, but the line of command for the officers in this Directorate will be within the Directorate. For example, the office of the Directorate of Income Tax (Collection and Recovery) at Bombay may be headed by a Director of Income Tax. The co-ordination between the Director and the Commissioner (Admn) should be done by the Chief Commissioner under whose jurisdiction the concerned Commissioner (Admn) falls, but the Director would be responsible only to the Directorate. On completion of assessment, the information regarding assessed tax, amount paid and balance payable/refundable should be transmitted from the assessing officer to the Directorate of Income Tax (Collection and Recovery) through the medium of assessment scrolls (and not through physical movement of assessment records). Similarly, information relating to any change in the tax liability subsequently arising from rectification and appeal effect could all flow through the scroll system.

6.134 A change is called for in the allocation of the work of scrutiny assessment. With a view to pooling of experience, improving the effectiveness of assessment, increasing the level of supervision and thereby ensuring greater accountability, it is necessary to change over from the present system of single officer based assessment by Deputy Commissioner (Assessment), Assistant Commissioners and Income Tax Officers to a system of group assessment in which the work of the assessing officers could be more effectively supervised by senior officers. Each group should consist of one Deputy Commissioner and a designated smaller number of Assistant Commissioners and Income Tax Officers, along with complementary staff. The Deputy Commissioner would decide the allocation of the files for scrutiny among the officers working under him. He would also be responsible for supervising closely the scrutiny assessment work of those officers, although the officers themselves will be finally responsible for the assessment. We understand this system is in a sense already in vogue in the Central Circles where large cases are assessed. It must be ensured that a uniform degree of supervision, to the desired extent, is given in all those circles. It would be highly desirable that, in course of time, the same system is extended to cover the smaller cases also. However, if all scrutiny assessment cases are brought under the system of group assessment, there would be a need to increase substantially the number of posts of Deputy Commissioners in the Department, since Assistant Commissioners and Income Tax Officers can be asked to

work only under the supervision of a Deputy Commissioner. If our recommendation that the number of search and seizure operations should be drastically reduced is implemented, there would be a substantial saving in the required number of posts of Deputy Director (Income Tax) as well as Assistant Commissioners and Assistant Directors (Income Tax). The released posts of Deputy Director (Income Tax) could be converted to Deputy Commissioner and the post of Assistant Commissioners/Assistant Directors (Income Tax) could be upgraded to the level of Deputy Commissioner. The extra number of Deputy Commissioners thus obtained could be used to extend the system of group assessment. Assuming that the reduction in the number of services releases the services of 20 Deputy Directors and 200 Assistant Commissioners/Assistant Directors, there might perhaps be need for the creation of an additional 60 to 75 posts of Deputy Commissioners in order to extend the system of group assessment to all scrutiny cases, according to the sample sizes laid down by us. We believe that the creation of these extra posts would be worthwhile in terms of improvement in the quality of assessment, reduced harassment to the smaller taxpayers and increased public confidence in the system of scrutiny assessment.

6.135 It is possible that the reassignment of functions that we have recommended would necessitate some consequential reorganisation of the field formation. A Deputy Commissioner (Range) might be asked to co-ordinate the work of the Assistant Commissioners/Income Tax Officers in the range, where the latter could be assigned the responsibilities on a functional basis without any further subdivision of the Range into Circles and Wards. We have not been able to examine this question in depth. We would suggest that the CBDT might consider this matter to ascertain whether any drastic reorganisation would be called for by our recommendation for the separation of the assessment and recovery functions.

Search and Seizure

6.136 Searches and seizures are used by the Income Tax Department as a method of gathering direct evidence of income and wealth tax evasion. Section 132 of Income-tax Act gives power to certain categories of empowered officers to authorise any Deputy Director, Deputy Commissioner, Assistant Director, Assistant Commissioner or Income Tax Officer to -

"(i) enter and search any building, place, vessel, vehicle or aircraft where he has reason to suspect that such books of account, other documents, money, bullion, jewellery or other valuable article or thing are kept;

(ii) break open the lock of any door, box, locker, safe, almirah or other receptacle for exercising the powers conferred by clause (i) where the keys thereof are not available;

(iia) search any person who has got out of, or is about to get into, or is in, the building, place, vessel, vehicle or aircraft, if the authorised officer has reason to suspect that such person has secreted about his person any such books of account, other documents, money, bullion, jewellery or other valuable article or thing;

(iii) seize any such books of account, other documents, money, bullion, jewellery or other valuable article or thing found as a result of such search;

(iv) place marks of identification on any books of account or other documents or make or cause to be made extracts or copies therefrom;

(v) make a note or an inventory of any such money, bullion, jewellery or other valuable article or thing:"

[Section 132 (1)(B)]

The empowered officer can authorise the search only if *he has reason to believe* that -

"(a) any person to whom a summons under sub-section (1) of Section 37 of the Indian Income-tax Act, 1922 (11 of 1922), or under sub-section (1) of Section 131 of this Act, or a notice under sub-section (4) of Section 22 of the Indian Income-tax Act, 1922, or under sub-section (1) of Section 142 of this Act was issued to produce, or cause to be produced, any books of account or other documents has omitted or failed to produce, or cause to be produced, such books of account or other documents as required by such summons or notice, or

(b) any person to whom a summons or notice as aforesaid has been or might be issued will not, or would not, produce or cause to be produced, any books of account or other documents which will be useful for, or relevant to, any proceeding under the Indian Income-tax Act, 1922 (11 of 1922), or under this Act, or

(c) any person is in possession of any money, bullion, jewellery or other valuable article or thing and such money, bullion, jewellery or other valuable article or thing represents either wholly or partly income or property which has not been, or would not be, disclosed for the purposes of the Indian Income-tax Act, 1922 (11 of 1922), or this Act (hereinafter in this Section referred to as the undisclosed income or property),"

[Section 132 (1)]

6.137 It is clear from the above sub-section 132 (1) that a search may be authorised only if the empowered officer has reason to believe that a person to whom a summons or notice has been issued to produce books of account or other relevant documents has omitted or failed to produce them or that the said person will not, or would not, produce the books of account and other documents or that any person is in possession of money, bullion, jewellery, etc., which wholly or partly represents income or property which has not been or would not be disclosed for purposes of the income tax. This being so, the objective of the search must be to get hold of the documents referred to above or money, bullion, jewellery, etc., secreted by the person concerned. And the search can be authorised only if there is clear evidence to lead the empowered officer to believe that at least one of the conditions of Section 132(1) is fulfilled. During the course of the search or seizure, the authorised officer may "examine on oath any person who is found to be in possession or control of any books of account, documents, money, bullion, jewellery or other valuable article or thing and any statement made by such a person during such examination may thereafter be used in evidence" in any proceeding against him.

6.138 The power to search and seize thus enables the Income Tax Department to get hold of direct and tangible evidence of possible tax evasion. The possibility that a business premise or residence may be "raided" for purposes of search and seizure could also be expected to act as a deterrent against attempts at large-scale tax evasion. The Income Tax Department has been resorting to this method of tackling evasion on a fairly substantial scale. The number of searches during the years 1987-88 to 1991-92 have been as follows:

Year	Number of searches	Value of seizure (Rs. crore)
1987-88	8464	145
1988-89	7505	153
1989-90	3984	128
1990-91	5474	228
1991-92	3468	180

It may be noted that during the last two years the value of direct seizure per search has been only Rs.4 to 5 lakh. Additional disclosure of

wealth or income as a result of the search is not included in the above figures. Hence the total yield per search was probably somewhat higher. Nevertheless it could be stated that additional revenue that could be raised through this method is not as significant as is popularly imagined. Furthermore, it should be pointed out that additional revenue can accrue only if either the assessee concerned confesses that he has concealed the entire amount unearthed or if a suit against him for enforcing payments of the additional amount succeeds.

6.139 During the years 1985-87 the conduct of raids became highly visible and reached a crescendo. After those years, the productivity of, and final gain from, the raids do not seem to have been evaluated. The raids are being organised and conducted more or less along the same lines as during the years 1985-87. The search and seizure operations would have a deterrent effect, particularly if they are conducted after considerable background work and gathering of reliable information and if they are followed fairly quickly by successful prosecution of the offenders, who would not only be fined but also be subjected to a certain period of imprisonment. But in practice the search and seizure operations do not seem to be producing a deterrent effect to the desired extent. This can be seen from the fact that tax evasion is practised even now on a very large scale. The failure for the search and seizure to produce the expected deterrent effect must be partly attributed to the fact that the Department is powerless to conduct such a search in respect of "protected" persons. Since this fact has become fairly well known, the search operations have lost some of the moral sanction and large-scale evaders perhaps believe that they could also seek protection. However, the failure to obtain the desired result in terms of deterrence must also be attributed in part to the inherent defect in the design and execution of the search and seizure operations.

6.140 In the circumstances prevailing in our country today, it is necessary - however unfortunate that may be - to continue to empower the Income Tax Department to conduct searches and seizures in cases where there is clear evidence that large-scale evasion is being practised with impunity and that the assessee is either not cooperating by the production of documents or that he would not voluntarily reveal all the relevant documents or the wealth that he has accumulated out of the tax evaded income. However, it seems quite clear that there are several deficiencies which must be rectified and that safeguards would have to be erected against excesses in the course of search operations about which we have received complaints from several quarters. A search and seizure operation involves the invasion of the privacy of an individual or family. The right to privacy and the guarantee that an intrusion into the privacy of an individual would be prevented is a fundamental right in a constitutional democracy and as valuable as any of the other fundamental rights. In the USA, Courts have held that the right to privacy cannot be violated except for the strict purpose of discovering evidence of a criminal act. Constitutional barriers have been erected both at the federal and at the State levels against unreasonable invasion of privacy. It is well recognised in the USA as well as in India that the right to be free from unreasonable searches is a constitutional right - indeed it is the essence of constitutional liberty. (See in this connection Corpus Juris Secundum, Volume 79, page 777).

6.141 While in the public interest the empowered officers of the Income Tax Department should continue to have the power to enter, under proper authorisation, any place of residence or business to conduct searches with a view to procuring evidence against tax evasion as strictly stipulated in the law, given the invaluable gift of personal liberty and freedom which the Constitution of India confers on each citizen, it is extremely important to provide safeguards against possible excesses by the executive branch of the Government. At the same time, the safeguards we build-in should not come in the way of the Income Tax Department

effectively taking action to track down evasion.

6.142 Before we consider changes in the provisions of the law that may be necessary, we would like to point out that searches and seizures cannot be an effective substitute for building up a comprehensive information system. In fact, the senior officers of the Department with whom we have had discussions on the subject agreed with us that if only the Department had a satisfactory information system and there was cooperation from other agencies such as banks and financial institutions, the reliance on the method of search and seizure could be considerably cut down. We would urge that the long-term objective should be either to eliminate search and seizure or to use the method only in very few exceptional cases, say, 4 or 5 in a year. This method must be resorted to only when large-scale evasion is involved and the Department is confident that a successful prosecution can be launched. In fact, for cases of evasion beyond a certain level a special court can be set up which should lead to the quick disposal of the case against the assessee who could anticipate heavy fine and imprisonment if found guilty. For the time being, as the information system is being built up, we would suggest that the objective should be to make searches and seizures conducted far more effective than they are and for this purpose we believe that it is necessary to drastically cut down the number of searches per year and confine them to large cases about which sufficient information has been patiently gathered. To begin with, the number of searches could be brought down to 400 to 500 to be gradually reduced further as the information system is built up.

6.143 To give an idea how things stand in this respect, while 4000 to 5000 searches are conducted every year[18], we notice that as on 1st April, 1990-91, 26,897 assessments relating to search and seizure cases were outstanding. If searches continued to be conducted on the present scale the number of pending assessments will go up further. As regards the absorption of manpower, as many as 256 Assistant Directors (Investigation) (at the level of Assistant Commissioners) are engaged in conducting searches and as many as 235 Assistant Commissioners are doing the assessments of the seizure cases. So the services of total 491 Assistant Commissioners are being absorbed by the work relating to seizures as against 494 Assistant Commissioners engaged in regular assessment work. For this expenditure of manpower the total additional amount that can be expected to be got out of search cases would perhaps not exceed Rs.100 crore per year.

a. Level of authorisation

6.144 Section 132 (1) vests the power to authorise an officer of the Income Tax Department to conduct search with the "Director General or Director or the Chief Commissioner or Commissioner or any such Deputy Director or Deputy Commissioner *as may be empowered in this behalf by the Board.*" (Italics added). The officer so empowered can authorise upon his satisfaction that a search is justified in terms of the provisions of Section 132, any Deputy Director, Deputy Commissioner, Assistant Director, Assistant Commissioner or Income Tax Officer to conduct the search.

6.145 Considering the fact that an unreasonable search will lead to the violation of right to privacy and hence the right to freedom of a citizen which will be unjustified, it would be desirable that the authorisation for such a search should be obtained from an appropriate judicial authority. However, there may be practical difficulties in getting the authorisation from judicial authorities (who may not all be familiar with the technical aspects of income tax), which would adversely affect the effectiveness of the search. So the officers of the Income Tax Department themselves would have to issue the authorisation, but the authority empowered to issue the authorisation for search must be of a very senior rank and the choice of the rank should

not be left to the discretion of the Board, i.e., the Executive Branch of the Government. The rank of the officer must be specified in the Act itself. It is recommended that Section 132(1) be amended to say that only an officer of the level of Chief Commissioner or where in a charge there is no officer of the level of Chief Commissioner, the senior most Commissioner or an Officer of equivalent rank can authorise search under that Section. We note that according to Section 132(1)(A)&(B), the empowered officer can authorise officers of the level of Deputy Commissioner, Assistant Commissioner and Income Tax Officer to conduct a search. It may be that in practice an Income Tax Officer or two or more Income Tax Officers would not be asked to conduct a search by himself or by themselves; they might only be part of the team headed by the Assistant Commissioner or the Deputy Commissioner. However, as the law stands, an Income Tax Officer by himself can be authorised to conduct an independent search. We strongly urge that the relevant Section be amended to say that only an officer of the level of Deputy Commissioner and Assistant Commissioner can be authorised to conduct a search under this Section. The amended Section could provide that, if necessary, one of or more Income Tax Officers may be authorised to join the team headed by the Assistant Commissioner or the Deputy Commissioner.

b. Objectives of search and seizure

6.146 The Mysore High Court in the case of C. Venkata Reddy Vs Income Tax Officer [(1967) 66 ITR 212] observed that Section 132 of the Income-tax Act was intended to achieve two limited objectives, (1) to get hold of evidence bearing on the tax liability of a person which the said person is seeking to withhold from the assessing authority, and (2) to get hold of assets representing income believed to be undisclosed income and applying so much of them as may be necessary in discharge of the existing and anticipated tax liability of the person concerned.

6.147 It is necessary to keep these limited objectives in view when discussing the scope of the action of the officers of the Income Tax Department who conduct a search under Section 132. The major focus of the search must be to unearth documents revealing concealed income and relevant for the assessment of tax as well as assets such as money, bullion, jewellery and other valuable articles. Section 132 itself provides that the officer conducting a search may, during the course of search or seizure, examine on oath any person who is found to be in possession or control of books of accounts, money, bullion, jewellery, etc. and that any statement made by such person during the examination may be used in evidence in any proceedings under the Income-tax Act. However, it is obvious that the recording of the statement is not part of the main purpose of conducting a search. In actual practice, it would appear that considerable effort is expended by the officers in extracting a statement from the person concerned which would amount to a confession. Recording a statement is unauthorisedly converted into an interrogation, often with hints of intimidation. The confession that is asked for may not be only about the documents and assets found in the premises but also about other matters such as the names of associates, etc. Getting the information becomes such a full-fledged objective in itself that, as one understands, several methods are used to extract confession such as direct or indirect intimidation, cajoling and unreasonable behaviour, and if one seeks permission from the officer to contact any one else or to leave the premises in order to attend to urgent matters, such permission is not granted. Strictly speaking, the assessee or the person who is in the building at the time of search should be asked to make a statement on oath in relation to the assets and documents that are in the house in the course of a search, or if the search is not very long, at the end of the search. Once this statement has been recorded, the assessee should be free to leave if he so desires. The limited objectives of search to which we referred earlier do not require the continued presence of an assessee.

Apart from unearthing concealed documents and assets, the search parties would seem to be putting emphasis on getting a confessional statement from the person concerned. This may be because, if the person makes a full and true confession regarding the extent of income and assets found in the premises he would be spared from any penalty or prosecution but would have to pay only the tax due on the income. In such a case, the Department quickly collects the tax amount without going through lengthy litigation. We believe that the provisions for a confession which rescues the assessee from penalty and prosecution and for giving awards to the officers directly related to the tax collected tend to distort the manner of behaviour of the officers who conduct the search. We have received complaints of confession having to be made under duress. More often than not, the person whose premises are being searched is prevented from leaving those premises even if he claims that he has urgent work to do. One argument given by some of the officers whom we examined is that if a person is allowed to leave he would tamper with evidence or go to banks and empty lockers which might also contain concealed assets. However, Section 132 does not concern itself with such matters; it is confined to the task of searching the premises. It does not by any means authorise an officer conducting a search to extract information from an assessee regarding bank lockers he may have through coercion or intimidation.

6.148 We believe that there is considerable truth in the complaint that undue pressure is often brought to bear upon the person whose premises are searched to make the confession and reveal several matters not directly concerned with the search. Clearly, questions on such matters can be put to an assessee[19] but statements should not be obtained under duress. It is to be remembered that a statement made by a person in the course of a search can be used as evidence against him. This being so, it is essential to ensure that he is not compelled, directly or indirectly to incriminate himself. With this objective in view, we recommend that the assessee whose premises are searched should be given the right to have a lawyer present during the search. In order to ensure impartiality, it could be stipulated that the assessee could call any one of the lawyers on a panel approved and appointed by the Ministry of Law in consultation with the judiciary. The panel should not be chosen by the Income Tax Department which should have no control over it. The lawyer should be present during the entire search; but he should not be allowed to speak or instruct the assessee when a statement is being recorded. His main function would be to ensure that the assessee is not being intimidated or coerced and that no indignity is being heaped upon him. It would be for the assessee to decide on what to say and what not to say, but at the end of the statement, the lawyer can point out the questions to which he takes objection. A copy of the statement should be handed over to the assessee.

c. Refusal of permission to leave

6.149 It has been brought to our notice that as a routine matter the search party refuses permission to persons, found in the premises when the search party arrives, to leave the premises until the search party completes its job. The owner of the premises or his representative, if the owner is not present, has of course the duty to record a statement and until such a statement is made, he or she would have to be present, but once the statement has been recorded, the person should be free to leave. Restricting the movement of a person or confining him or her to a premise amounts to an arrest. The Income Tax Department does not have the power of arrest. The ground rules announced by the then Finance Minister in the year 1987 on the floor of Parliament, for protecting the rights of the people, specifically lay down that the income tax authorities shall have no power to arrest. Nevertheless, the general practice seems to be that all persons found in the premises at the time of the search are kept in detention/confinement in the house/building and none of them is permitted

to leave the premises. It is obvious that refusal to give permission to leave is an illegal act. The denial of permission has perforce to be given effect to through sheer intimidation. The Delhi High Court in the case of L.R. Gupta Vs Union of India and others [(1992) 194 ITR] observed, "The Income Tax Act does not give any power to Income Tax Department to arrest an individual. The Department certainly has the power of recording the statement of a person in accordance with law. Petitioner No.1 could, therefore, be legitimately required to be present for the purpose of recording his statement. Once his statement was recorded, there was no reason or justification for the Officers of the Department exercising jurisdiction which they did not possess, viz. preventing petitioner No.1 from attending to his work. An authorisation which is issued under Section 132(1) only enables the officers of the Department to conduct search and seizure. Under Section 131, they have, inter alia, the authority and the power to enforce the presence of a person for the purpose of examining him on oath. There is no power contained in the Act or the Rules whereby the movement of a person against whom search is ordered can be restricted. By refusing to give permission to the petitioner to attend to his work in effect, it amounted to his confinement which is not permissible in law."

6.150 Presumably, because of this clear verdict, the Government sought to amend Section 132 of the Income-tax Act vide clause 59 of the Finance Bill, 1992 to the following effect:

> "(2A) Any person who is found in the building, place, vessel, vehicle or aircraft, which is being searched, shall personally attend during such search:
>
> Provided that the authorised officer may, if he is of the opinion that it is necessary or expedient so to do, permit any such person to leave subject to such conditions as he may deem fit:
>
> Provided further that where any person is refused permission by the authorised officer under the first proviso, such officer shall record reasons therefor and communicate the same to such person".

6.151 This proposed amendment was later withdrawn by the Finance Minister.

6.152 We have considered this matter with care and have also consulted eminent jurists. We are of the opinion that the ground rules laid down which stipulate that the Income Tax Department should have no power of arrest should continue to prevail. Since the object of the search is to unearth documents and assets there is no justifiable reason to stipulate that any person who is found in the premises being searched should personally attend to it. The person can volunteer to make a statement early during search and once the statement is completed he should be free to leave. We realise that the power to confine a person within a building would weaken his resistance and add to the effective intimidation but this is precisely what we should try to avoid in any civilised society. We therefore recommend that the existing provisions of Section 132 should not be strengthened in any way to give power to the Income Tax Department to confine any person in a building or premises that is being searched.

6.153 Sometimes the search party has a suspicion or fear that if a person found in the premises is allowed to leave, he or she may tamper with evidence outside. Such tampering with evidence can take place even after the search is over. In any case, if there be any suspicion or fear of such tampering, the Department can always try to monitor the movements of the person who is going out.

d. Supplying information to the assessee

6.154 After the search is over, it would be proper for the search party to handover to the person concerned a copy of the statement of the owner of the premise which was obtained on oath.

e. Sufficiency of evidence

6.155 Section 132(1) stipulates that the empowered officer can authorise a search if he has reason to believe that what is stated in sub-clause a, b, or c of Section 132(1) applies in a particular case. In other words, he must be satisfied that there is sufficient evidence to show that the assessee concerned has omitted or failed to produce any books of accounts or documents that he was asked to produce through the issue of a summons or notice under the relevant provisions of the Income-tax Act, or that he will not produce such documents or books of accounts if he is called upon to do so, or that he has in his possession money, jewellery, bullion and other valuable things which represent tax evaded income or wealth. It is important that this requirement should be taken seriously. In the past, particularly in the mid-eighties, the Department got their officers to carry out raids on "top" or successful professionals of different categories in different years, e.g., high-income earning doctors in one year, such lawyers in another year and so on. There could be suspicion that many doctors or lawyers or architects with high incomes are not paying their due taxes. But that would by no means be an acceptable legal ground for conducting raids on them. In each case, the empowered officer must satisfy himself that at least one of the conditions laid down in Section 132(1) is satisfied. It is clear that organising such "mass" or group raids contravenes the provisions of Section 132. Besides, all successful professionals cannot be taken to be tax evaders. The Department must sift or attempt to identify the honest and dishonest taxpayers. We hope that the Government would ensure that in future a raid will be authorised only when the empowered senior officer has satisfied himself on the basis of concrete evidence that a search and seizure operation will be justified under the provisions of Section 132.

f. Damage to property

6.156 In the course of such a search, the property belonging to the owner of the premises is often damaged by the search party, e.g., it is common for the search party to rip open mattresses or to break walls or remove tiles. We would urge that with a view to minimising such damage, every search party should use a metal detector to find out if articles are concealed behind walls, within mattresses, etc. If damage is done but no concealed articles are found then the Income Tax Department would be duty bound to repair the damage and to restore the articles to the previous state. As things stand now, we understand the search party causes the damage and just walks away. Such behaviour should be immediately put an end to.

6.157 In conclusion, we would like to reiterate that a search and seizure operation should be initiated only after sufficient evidence has been built up so that there would be a reasonable chance of establishing concealment of income and evasion of tax and obtaining a conviction. If a true confession is voluntarily made, the assessee, as has been clarified; does not have to pay any penalty in respect of income claimed to be income of that year. However, there is no need or justification for the searching officer to induce or insist on a true confession. If the statement made under oath by the person concerned is contrary to, or does not correspond with, the facts unearthed by the search, he should suffer the consequences. The desire to induce or extract a confession will be weakened considerably if the practice of giving a percentage of the tax collected on the basis of the search as a reward to the search party officers is put an end to. We strongly urge that the system of giving rewards on this basis be given up forthwith. As suggested elsewhere if some appreciation is to be shown, a certain amount of money may be credited to the Staff Welfare Fund.

6.158 Nothing we have said in this Section is to be construed to mean that tax evaders should be treated with any leniency. Indeed, all of the improvements in the information system and the re-organisation of work within the Department, which we have

recommended, are intended to strengthen enforcement and track down tax evasion. In fact, we have envisaged a four-pronged strategy to curtail tax evasion:

a. Substantial reduction in tax rates with broadening of the base;

b. A comprehensive information system, a system of identification of taxpayers and reorganisation of the work of the Department towards greater efficiency;

c. Dealing strongly with tax evaders, particularly the large ones; and

d. Improving the morale of the officers, weeding out and punishing corrupt officers and rewarding merit in terms of career advance.

We have dealt with (a) and (b) earlier in this report and the Interim Report. We deal with (d) in Chapter 9. We would like to suggest here two ways in which tax evaders could be made to feel that they cannot get away easily once tax evasion is detected. The first is to prevent an assessee who has been found to be indulging in tax evasion to take recourse to the facility of the Settlement Commission almost as a matter of routine. If assessees know in advance that if every time they are caught indulging in tax evasion through concealment of income or other kinds of fraud, they could throw themselves at the mercy of the Settlement Commission and get immunity from all prosecution provided they pay the amount determined by the Commission, it means virtually that there would be no fear of punishment. We are therefore recommending, in the Section on the Settlement Commission, that the Chief Commissioner should have the power to determine whether a case could be taken to the Settlement Commission, given the circumstances of the case.

6.159 Another important instrument of deterrence we would suggest is speedy prosecution of cases of large tax evasion. For this purpose, it is necessary to set up a special court whenever within a specified region there has arisen a case of suspected tax evasion amounting to not less than Rs.3 crore, or two or three cases of evasion of Rs.1 crore or above, aggregating to Rs.3 crore or more where the evidence of evasion is strong. Specially trained and highly competent lawyers should be employed by the Department for these cases. And there must be a provision for mandatory sentence of imprisonment for a term, if the assessee is convicted.

Advance Tax

6.160 Prior to the amendment by the Finance Act, 1992, tax payers, other than those whose tax liability was fully discharged by TDS, were required to discharge their liability by advance tax in three instalments: 20 per cent of the tax liability in the income earning year by the 15th of September, another 30 per cent by the 15th of December and the balance of 50 per cent by 31st March. The taxpayer was liable to pay interest for delay/shortfall in the payment of instalments of advance tax except that if at least 90 per cent of the tax liability had been paid as advance tax by the 31st of March, no interest was payable on the 10 per cent shortfall. According to this arrangement, the relative proportions of advance tax payable on different dates amounted to discharging 50 per cent of the tax liability within the first nine months and the other half of the liability at the end of the next three months. In this sense, it can be considered a fair arrangement although even with such an arrangement, a number of assesses had to pay interest on the deficiency in the proportions of tax paid in the first two instalments if they received higher incomes unexpectedly in the last quarter or the profits from business suddenly increased for unanticipated reasons. The amendment introduced by the Finance Act, 1992, which has increased the proportion of the first instalment from 20 to 30 per cent means that there would be greater probability of having to pay interest on shortfall in the first two instalments owing to unforeseen income arising particularly in the last quarter.

While it is necessary to ensure that the revenue flows to the Government are evenly spread throughout the year, the assessee should not be subjected to high penalties even when there are genuine difficulties in foreseeing the total income that will accrue in a year. To the extent that the new provision requires a high proportion of tax on total income, which cannot be estimated precisely, to be paid within the first six months it makes compliance difficult. It is proper to require that at least 90 per cent of the tax liability should be discharged by the end of income earning year, but the earlier instalments cannot in fairness be related to an unknown quantum of income. The Committee, therefore, recommends that interest under Section 234C should not be levied in cases where the first and the second instalments of payment of tax by the assessee are each equal to 30 per cent of the tax liability on the basis of the returned income of the immediately preceding assessment year; interest should be chargeable if payments fall short of 90 per cent of tax on the basis of current year's income.

6.161 Under Section 234B of the Income-tax Act, a taxpayer is liable to pay interest for shortfall in the payment of advance tax. To the extent that the shortfall is equal to or less than 10 per cent of total tax liability, no interest is chargeable. However, if the shortfall is more than 10 per cent, interest is chargeable on the entire shortfall and not the shortfall in excess of 10 per cent. During the course of evidence before us, a number of instances were brought to our notice where interest under Section 234B had been charged even if the shortfall was less than 10 per cent. Since the law stipulates otherwise, we recommend that the Board should issue suitable clarifications to the field formation clearly setting out the legal position in this regard.

Direct Taxes Code

6.162 Another matter of considerable importance that the Committee was requested to consider is the question of the direct taxes code, of which a draft has already been prepared. We have given serious consideration to this problem. The objective sought to be achieved by a single direct taxes code is uniformity and simplicity with regard to the legislation concerning direct taxes. This is desirable objective. However, the Committee is of the view that before enacting the direct taxes code the Government should first consider the Committee's recommendations and take a final view in that regard. Otherwise the code itself would have to be amended almost immediately after its enactment for the purpose of introducing the changes accepted by the Government on the basis of the Committee's recommendations.

6.163 While it cannot be denied that our direct tax laws have become very complex over the years, they have also during this period gained from the benefit of interpretation by High Courts and the Supreme Court. Thus, several words, expressions and sections have come to acquire specific meaning and connotation in the minds of all concerned: tax administrators, taxpayers and tax practitioners. Therefore, the new law, with changes in terminology in the interest of simplicity, would come to be settled only after prolonged litigation in regard to the meaning of the new provisions.

6.164 That apart, it is quite likely that the new expressions used and the re-arrangement of the provisions might have the combined effect of inadvertently amending the existing law. Besides, the law regarding wealth tax is in a state of flux. It is quite likely that this law might need considerable amendment based on the experience of the working of the new provisions.

6.165 In view of the above, the Committee recommends that the entire matter regarding the introduction of a direct taxes code should be postponed till such time as the law, after implementation of this Committee's recommendations, has stabilised. Further, before undertaking codification, the arrangement of the Sections

in the code and the language used therein should be referred to a Committee of Experts to ensure that unintended changes in the provisions do not occur.

6.166 The draft code as vetted and amended by the Committee should then be given wide publicity. The public debate and informed comments or opinions resulting therefrom should be taken into account before finalising the code.

7

PROBLEMS OF ADMINISTRATION OF INDIRECT TAXES

7.1 The administrative structure of the Central indirect taxes was fashioned when excise duties covered a limited number of commodities and the level and number of rates of customs duties were also quite limited. While some notable changes in procedures such as the introduction of the "Self Removal Procedure" were effected, the system of administration and procedures is no longer capable of coping with the vastly expanded scope of excises - which have now been converted into a virtual manufacturer's sales tax with a partial incorporation of the VAT principle. On the side of customs, the administrative structure would seem to be sound, but the procedures often prove to be an obstacle to the speedy or even timely movement of goods across the border without hassle. It has to be conceded that the system of obtaining illegal payments from the assessees, e.g., by unscrupulous officers through corrupt practices such as regular monthly payments arrangements in excises, could not have come up and be continued but for the flaws in procedures and administration.

7.2 It is perhaps true to say that the Excise and Customs Department is not beset with as many problems and deficiencies as the Income Tax Department. For example, the system followed does not lead to large arrears in collection, and there is also less of over-assessment as compared to income tax. The reconciliation of tax liability and its discharge is also done much better. In general, we heard from the assessees less of complaints about excises than about income tax. Nevertheless, there have emerged a number of problems which require speedy remedial action.

7.3 A basic problem in excises is that the procedures of assessment and collection are outmoded. Progress in India in this matter has been slower than in the rest of the world in this sphere. There must be very few countries indeed in the world where now the collection of a broad-based domestic indirect tax requires prior approval of valuation and classification and clearance of every separate consignment of goods out of the factory is on the strength of a preauthenticated gate pass. Apart from this, it would seem that over the years a number of appendages have been added to the basic structure, which have led to the erosion of efficiency in the tax system as a whole. Additional responsibilities and schemes were introduced without following a systemic approach. This has resulted in the evolution of complicated procedures. Meanwhile, the monitoring system has become weaker.

7.4 The problem areas which the Committee has identified are :

a. a complicated code of rules and procedures in the Central Excise Act and Rules;

b. procedures not getting updated with the changes in the administrative structure;

c. inadequate inspection system;

d. outmoded reporting and monitoring system;

e. lack of training of officers particularly in specialised functions and improper placement of officers;

f. frequent changes in the rates and procedures without adequate preparation at the field level;

g. classification of goods for assessment of duty;

h. valuation in Central excise;

i. short recovery and refund;

j. huge pendencies in respect of provisional assessments;

k. lack of customs expertise in Central Excise Collectorates;

l. poor testing facilities in the customs and excise laboratories;

m. a tendency to overassess for fear of audit;[20]

n. inordinate delay in the disposal of appeals at the level of the Tribunal; and

o. inability of the manual system to cope with the increase in the number of documents to be processed and lack of commitment on the part of the system as a whole to computerisation;

Updating and Simplification of Procedures

7.5 In 1985, a major attempt was made to restructure the Department along with three other major changes. These were:

a. Adoption of commodity classification based on Harmonised System of Nomenclature (HSN) not only for customs tariff but also for Central excise tariff,

b. Introduction of Modvat, and

c. Computerisation.

7.6 These, as also the reorganisation of the administrative set up of the Department, were attempted all at once with speeds unfamiliar to Governmental working. The result was that while the first two were introduced in the system, computerisation lagged behind particularly in Central excise where it was essential for the checking of the Modvat credits. Reorganisation lapsed into a 'cadre review' with creation of posts with some unevenness.

7.7 Over the years, a large number of changes in the procedures and new schemes of exemptions have been introduced and with these, the job requirements of many cadres have undergone changes. Some of these additions have been on an ad-hoc basis. Customs work relating to Inland Container Depots, Aircargo Complexes and 100 per cent Export Oriented Units can be cited as illustrations, as also the supply of non-duty paid material domestically manufactured against advance licences and refund of Modvat credit in the case of exports in Central excise. While there is some flexibility within the Department to undertake newer duties and responsibilities, it is necessary that there should be a stock-taking on a regular basis, say every year, and the system geared up as a whole. This would necessitate making changes in training curricula, audit procedures, anti-evasion measures, computer software, inspection methodology, etc. We would recommend that such an updating may be attempted every year when all aspects including changes in the duty structure in the course of reform and the corresponding changes in the procedures can be reviewed, reassessed and amalgamated in the system. One way of making this exercise would be through a workshop to be organised by the Training Academy, where there could be participation by the policy makers and middle level officers in the field. The Annual Conference of Collectors cannot be expected to go into the details, though some broader aspects can be discussed at the Conference also.

7.8 Attempts were made in the past to draft a comprehensive Central excise bill incorporating the substantive portions of the rules, but these were given up and particular provisions were included in the statute from time to time. Now, a Committee has been appointed by the Government to prepare a common customs and excise code. This exercise would result in a review of most of the existing procedures in customs and Central excise and, we hope, would help in updating them with reference to the existing administrative set up and the changes likely

to be brought about after considering the recommendations contained in this Report. We are sure that the newly formed Committee will also take into account the available information sharing and communication facilities including computerisation.

Inspection and Monitoring

7.9 We attach considerable importance to the need for reactivating the inspection system and would like to deal with this matter in some detail. In a revenue administration, in which wide powers have been delegated to comparatively junior officers, it is essential that there should be an efficient scheme of performance audit by way of inspection. Inspection ensures accountability, helps closing up the gap in the perceptions of the role of the inspected office in the minds of the officer inspected and that in the mind of the inspecting officer and ensures proper priority in the work by the former. It also helps in checking corruption and leakage of revenue. Strengthening the inspection machinery should be one of the main concerns of the CBEC. The Committee understands that there was a fairly good system of inspection in the Central Excise Department, which has got considerably diluted over the years. The main reasons are:

a. frequent changes in the rates of duties;

b. introduction of new schemes of exemptions and new procedures, overburdening the system;

c. not providing adequate staff to deal with additional responsibilities thrust on the system;

d. consequent diversion of staff from inspection and audit to other day-to-day work;

e. manuals getting out of date fast and revision not keeping pace with the changes;

f. information exchange system not moving with the communication facilities: telex, fax, etc; and

g. most important of all, lack of appreciation on the part of the senior officers of the importance of inspection, and the inability of the Board to ensure the prescribed frequency of inspection and follow-up action.

7.10 There has recently been an increase in the number of senior level officers of and above the rank of Deputy Collectors of Customs and Central Excise. Want of inspecting officers cannot, therefore, be the reason for not strengthening the inspection machinery. We would strongly urge that a good inspection system should be designed for both customs and Central Excise Departments. There should be clarity regarding the methodology of inspection and its objectives. Apart from ensuring that revenue gets collected at the appropriate rates and that there is no evasion, inspections should aim at checking corruption, ensuring that all instructions issued by the Government and Board are followed, that the officers have the right attitude towards revenue collection and that they maintain proper relations with the assessees. The Board with the assistance of Principal Collectors should ensure that the schedule of inpsections is strictly adhered to and that there is proper follow-up action.

7.11 As the Government has set up a Committee to evolve a common code of indirect taxes keeping in view the objective of simplifying and streamlining the existing laws and procedures, it is likely that the Committee's recommendations, if accepted by Government, would necessitate changes in the existing procedures. Computerization would also bring in a number of changes in the procedures. We note that a number of useful manuals prepared sometime in the past have become totally out of date. It is necessary that these are updated taking into account modifications in the procedures likely to be brought about in the near future.

7.12 The existing reporting system was evolved at a time when the communication facilities were not what they are today. A comprehensive review of the monitoring system at the Board's level should be undertaken to make it faster and more purposeful. A new Management Information System may be worked out. The system should take into account the availability of facilities such as telex, fax, wireless and computer network.

7.13 Once the computer network is established, the reporting system can be simplified considerably as any information required for the purpose of monitoring can be tapped from the computer at the level of the Board or the Principal Collector or the Collector, eliminating the present system of the formations sending reports periodically. What will have to be ensured is that the required data are promptly fed into the database.

Training

7.14 The infrastructure for in-house training facilities in the Customs and Excise Departments has been built up over a period of time. However it cannot be said that the training being imparted to the officers is either adequate or that the officers performing particular jobs are fully trained. This, we feel, is due to the failure to have a clearly defined training policy or well-designed training programmes. The Committee is of the view that the time has come to assess the training needs of the officers of the Customs and Excise Department afresh and to draft a training policy and work out details of training modules. There should also be an exercise to identify the training needs of different officers. A few standard training modules which all officers posted to particular jobs should necessarily undergo will have to be designed. The placement policy should be reviewed to see that by and large officers posted are adequately trained to carry out the duties and responsibilities attached to the post.

Publication of Draft Notifications regarding Changes in Procedures

7.15 While there may be a case for bringing about changes in the rate of duty without prior notice, modification of changes in procedures can be brought about after giving an opportunity to the assessees to give their views on the proposed changes. The Committee would recommend that the changes in the procedure of duty collection which may not have any revenue implications may be first published as draft notifications inviting comments of the assessees and finalised after taking into account their views.

7.16 The Committee is informed that there are a large number of court cases relating to the date from which a change in the rate of duty brought about through a notification, would become effective. The legal position is that a notification takes effect from the date of its publication in the official gazette. Where there has been delay in the publication of the official gazette, the Courts have held that the notification would take effect only when it was actually published. The Committee has already recommended that the system of making changes in the rates of duty through notifications should be given up. The Committee recognises the fact that in the case of indirect taxes, there would be serious harm to revenue if duty adjustments are made effective from a specified future date. Where it becomes inevitable to change the rate through a notification, it should be ensured that it is published on the same date in the official gazette and that there is no legal ambiguity regarding the date on which it comes into operation.

Classification

7.17 The importance of bringing about uniformity of assessment practices in the case of indirect taxes has been emphasised in the Interim Report[21] . The two aspects which are relevant in this context are classification and valuation of excisable and imported goods.

7.18 In regard to classification we had recommended that a Tariff Guide containing directions of the Board in respect of all goods manufactured in the country and imported from abroad may be brought about and that the assessing officers should be bound by the directions of the Board. The Committee is happy to note that a few such directions have already been issued by the Board in exercise of the powers under Section 37B of the Central Excises and Salt Act, 1944. The Committee is confident that once such a Guide is made available to the assessing officers and efforts made to keep it up-dated, the number of disputes on classification of excisable goods would be drastically reduced. There may be some problems in settling cases of classification of imported goods which do not figure in the Tariff Guide. The details of such imports should be obtained from the custom houses from time to time and decisions on their classifications taken quickly to ensure that the goods could be cleared without much delay. Alternatively, the Principal Collectors of Customs could be authorised to issue tariff instructions and uniformity brought about in regard to such instructions through discussions in periodical conferences of the Principal Collectors.

7.19 The problem of classification would in any case come down substantially, once the excise and customs duties are restructured according to our recommendations. For the goods that come under the proposed VAT, there would be only three rates; in addition there would be three rates of sumptuary excises. As for customs there would not be more than four or five rates. With such a simplified rate structure, there should be very little scope for classification disputes.

Valuation in Central Excise

7.20 Issues relating to valuation are the most contentious matters in the entire indirect tax system. A large number of disputes with high revenue implication are pending in the Supreme Court, High Courts and the Tribunal. After a long history of litigation, the Supreme Court finally clarified that when a statutory measure for assessment of the tax is contemplated, it need not contour along the lines which spell out the character of the levy itself, and a broader based standard of reference may be adopted for the purposes of determining the measure of the levy.[22] Though excise levy is on production and manufacture of goods, the imposition of duty could be at the stage which the law considers most convenient to impose as long as a rational relationship with the nature of the tax is maintained. The nature of the excise duty is not to be confused with, or tested with reference to the measure by which the tax is assessed. The standard adopted as the measure of assessment may throw light on the nature of the levy but is not determinative of it. Any statutory standard which maintains a nexus with the essential character of the levy can be regarded as a valid basis for assessing the measure of the tax.[23]

7.21 Though the position of law regarding the nature and scope of Section 4 vis-a-vis the charging Section i.e. Section 3 of the Central Excises and Salt Act, 1944, has been propounded finally by the Supreme Court, the precise scope of the various provisions in Section 4 and the valuation rules with regard to admissibility or otherwise of the deduction of various expenses for the purpose of arriving at assessable value are still not clear. In fact, inspite of the decision of the Supreme Court in Bombay Tyres International's case regarding the admissibility of certain deductions, namely, marketing and selling organisation expenses, including advertisement and publicity expenses and other expenses incurred by the assessee upto the date of delivery, average freight and insurance charges, cost of secondary packing, storage charges, interest on inventories and outward handling charges, a later decision of the Supreme Court[24] was found to be inconsistent with the law laid down in the Bombay Tyres International's case. It may be pertinent to mention that in the Madras Rubber Factory (MRF) case, the dispute was regarding the admissibility of the following

deductions claimed by MRF for the wholesale price, namely,

a. TAC/Warranty discount,

b. Product discounts i.e. (a) Prompt payment discount, (b) Year Ending discount and (c) Campaign discount,

c. Interest on finished goods and stocks carried by the manufacturer from the date the stocks are cleared till the date of the sale,

d. Over-riding commission as trade discount,

e. Interest on receivables (sundry debtors for sales),

f. Cost of distribution incurred at duty-paid sales depots,

g. Turnover discount to Government,

h. Secondary packing cost on tread rubber,

i. Discounts to Government and other Departments.

7.22 The decision of the Supreme Court in this case[25] was, however, challenged by the Department and their review petition was allowed by the Court following the *prima facie* finding 'that in respect of certain items an inconsistency is present in the impugned judgment when regard is had to the law laid down by this Court in Union of India vs. Bombay Tyres International'. The Court accordingly recalled the judgment with the direction to list the cases for fresh consideration[26]. The final decision in the matter is still awaited.

7.23 Having regard to this background, the Committee had made certain specific recommendations in the Interim Report[27] in regard to the assessable value within the framework of the existing law. One of them related to the fixation of tariff values in terms of sub-section (2) of Section 3 of the Central Excises and Salt Act, 1944. In a recent decision, the Supreme Court has admitted the plea made by the Government in the Century Manufacturing Company's case[28] and declared, that Section 3(2) and the notifications issued thereunder were valid and constitutional. In the light of this judgement, the Government can take recourse to fixation of tariff values in suitable cases, such as sugar, acids, gases, caustic soda, and aerated water. We had also suggested assessment of certain selected goods notified under the Standards of Weights and Measures Act, 1976 on the basis of maximum retail price fixed thereunder.

7.24 In the Interim Report[29], the Committee had also observed that as the Modvat or the VAT gets extended and becomes the main plank for raising revenue from domestically produced goods and services, it would be necessary to move over to a system of assessment on the basis of invoice value. We had recommended that a beginning may be made, by way of experiment, with the use of invoice value for assessment of excise in respect of selected commodities, which are mostly eligible for Modvat, in the sense that they are sold to taxable manufacturers. This could cover mostly industrial inputs. In the light of the experiences gained in assessing industrial inputs on the basis of invoice price, the procedural details regarding adopting this measure for other commodities may be worked out. We would like to emphasise that ultimately the Department has to adopt invoice value as the measure of assessment in most cases covered by Modvat or later VAT.

7.25 Under the Self Removal Procedure (SRP), the value of excisable goods for the purpose of payment of excise duty is the value declared in the price list filed by the manufacturer under rule 173C of the Central Excise Rules, 1944 and approved by the Department. Different forms of price lists are filed depending upon various considerations, namely, whether the goods are sold at the factory gate or supplied to the customers on

contract basis or sold to related persons, etc. In the price lists so filed the manufacturer declares the 'normal price' i.e., the wholesale price at which he ordinarily sells his goods at the time and place of removal to buyers who are not related persons. The assessee also declares the various expenses which are deductible from the wholesale price and derives an assessable value exclusive of these expenses. The Assistant Collector of Central Excise is required to approve the price list after ascertaining the veracity of the assessee's claims through market enquiries, if necessary. Upon such approval of the price list, the manufacturer pays excise duty on such approved value till he changes the sale price in which case he is required to submit a fresh price list. The total number of price lists filed by the assessees is about 350,000 per year. Considerable time is spent on mere processing of these papers even in a routine manner. Only in a few cases, market enquiries are actually conducted. We are informed that with the limited staff available, the nature of enquiries being made regarding the assessees' claims for deductions from the wholesale price is not satisfactory.

7.26 If invoice is accepted as the basis for assessment of Central excise duty, there will be no need for filing of price lists and therefore the time and effort spent in processing price lists could be more effectively used for market enquiries and investigation of cases of undervaluation. Though the provision for submission of price lists under Rule 173C may have to be retained for goods which will continue to be valued in terms of Section 4, the provision for approval of price lists seems to have outlived its utility. We are therefore of the view that the balance of convenience lies in doing away with the practice of approval of price lists and providing a fixed time limit of, say, two months from the date of filing of the price list by which time the Assistant Collector of Central Excise shall raise objections,if any, failing which the price declared by the assessee shall not be questioned by the Department for the purpose of assessment. In other words, the assessee shall submit the price lists only for noting and there will be no need for any further communication from the Department unless the Assistant Collector of Central Excise comes to a *prima facie* finding that the price declared by the assessee does not correspond to the 'assessable value' as arrived at in terms of Section 4 of the Act. The Assistant Collector shall finally decide the issue, unless it is sub-judice, within a period of one month from the date of raising the objections.

7.27 It should be possible to switch over completely to the mode of assessment based on invoice price if value-added tax system is adopted and the rates of duties are reduced to a more reasonable level. The investigation and enforcement machinery has to be more alert and the prosecution provisions have to be strengthened. Ultimately, the Department has to adopt, as already stated, the invoice value as the measure of assessment in all cases covered by Modvat (and later VAT) excepting those goods which can be assessed to duty on the basis of tariff value and on the basis of maximum retail price fixed.[30] If the invoice value is adopted, as the basis of assessment, the question might still be raised as to whether various discounts should be allowed as has been claimed in the past. When VAT is adopted, it is best to follow international practice in this regard. It would also be necessary to move away from one to one correspondence between individual units of goods cleared and the invoices raised at the depots, in the case of depot sales.

Short Recovery and Refunds

7.28 The normal period for issue of a show cause notice in regard to duties not levied or short levied is six months from the date of payment of duty. In the case of indirect taxes the incidence of the tax ultimately gets shifted in most cases to the consumer and once the goods have changed hands, it would not normally be possible for the assessee to collect the differential duty if demanded by the Department at a later date. Recently the law has been amended to provide that no refund of customs and excise

duties would be granted unless the incidence of higher duty has not been passed on by the assessee to any other person. This is based on the doctrine of 'unjust enrichment'. Particularly in the context of this provision, it has to be ensured that the assessment practices do not result in undue impoverishment of the assessee. In the circumstances, we would recommend that time for demand of duty short recovered may be brought down from six months to three months.

7.29 There were several representations before the Committee in regard to the amendment relating to refund of customs and excise duties referred to in the earlier paragraph. The system which has been evolved of creating a Consumer Welfare Fund into which will be credited all amounts of duties paid by the manufacturer or borne by the buyer if he had passed on the incidence to any other person, in the Committee's view, creates complications in the tax system which are better avoided. The possibility of such enrichment will be considerably reduced, if the period for which the refund can be granted is reduced to three months. This would be in line with the recommendation regarding reducing the period for demanding duty short recovered to three months. It is understood that the legality of the provisions introduced with effect from 1st August, 1991 has been the subject matter of litigation in various courts. The Bombay High Court has decided in one case that the doctrine of unjust enrichment has no application where the imported goods are either consumed by the importer or used by him in the manufacture of other products.[31] The same consideration may also apply to excisable goods captively consumed within the factory production. The Government could consider modifying these provisions after the Courts decide the basic question of the legality of the provision.

7.30 In the Finance Act, 1992 the level of the officer exercising the powers of issue of show cause notice for demanding duty for the extended period of five years under the proviso to sub-section (1) of Section 11A of the Central Excises and Salt Act, 1944 and Section 28 of the Customs Act, 1962 has been changed from the Collector to proper officer. The Committee has received representations from some organisations to the effect that this will result in indiscriminate use of the powers, which should be used only in cases of suppression of facts or collusion, fraud, etc. It was precisely in view of these considerations that the law was amended in 1985 to provide that the decision to invoke the proviso should be taken at the level of the Collector. Considering the revenue bias often discernible in the case of many officers at the lower level, it is not surprising that in very many cases the legal provisions are stretched to bring them within the ambit of the proviso, as it refers to short recovery by reason of 'contravention of any of the provisions of the Act'. There will be a more judicious application of this provision if the decision to invoke the proviso is taken at a higher level. It is understood that the Board has issued instructions that notwithstanding the amendments, only Collectors of Customs and Central Excise (Judicial) will invoke the proviso in question. The Committee would suggest that the position in the law prevailing before the amendment in this Finance Act should be restored.

Pendency of Provisional Assessments

7.31 In the case of Central excise, there is a huge pendency at present of provisional assessment cases and many cases have been pending for a long time. We would recommend that a time limit of six months may be fixed for finalisation of provisional assessments except in exceptional cases like those relating to variation clauses in contracts. There could be similar time limits for finalisation of classification lists and price lists. While it may not be necessary to incorporate these time limits in the statute, the executive instructions in this regard should be strictly enforced. The provisional assessment should become the final assessment at the end of six months, if the assessing officer does not issue a notice of revision within that time limit.

Customs Expertise in Central Excise Collectorates

7.32 The Committee observes that there are a large number of vacancies in the cadre of appraisers. This may be consequent to unrealistic estimation of the requirement of direct recruits at the level of appraisers. Steps may be taken to get these vacancies filled as early as possible. The Committee would urge that in order to implement the tax reforms which the Committee has recommended, it is of utmost importance that the personnel, particularly at the assessment level, should have the necessary expertise.

7.33 The customs work is fast moving into the interior of the country with the setting up of air cargo complexes, Inland Container Depots, Container Freight Stations, 100 per cent Export Oriented Units, etc. The customs work within the Central Excise Collectorates are mostly attended to by the Central excise officers. There is immediate need for improving the level of customs expertise available in the Central Excise Collectorates. While there may be a case for providing promotion avenues to the Central excise officers who have shown a flair for customs work within the Central Excise Collectorates by promoting them as Appraisers, there may also be a case for directly recruiting Appraisers for attending to this work. The Committee recommends that regional cadres of customs Appraisers who would be transferable within the Collectorates of the region should be created.

7.34 With the improving of the customs expertise in the Central Excise Collectorates, there would be better arrangement for audit of customs documents relating to Inland Container Depots, Container Freight Stations, air cargo complexes, etc. This is an area where the present arrangement seems to be unsatisfactory.

Testing Facilities in Chemical Laboratories

7.35 In spite of the recommendations of a number of Committees, including the Indirect Taxation Enquiry Committee, the testing facilities within the Central Excise and Customs Department remain woefully inadequate. The main reasons for this state of affairs are: (i) inability of the Board in following a stable personnel policy for the Central Revenue Laboratory and Central Revenue Chemical Services; (ii) absence of modern equipment and methodology of testing; and (iii) lack of interaction between technical experts and the tax policy makers in regard to policy changes in tax rates and procedures and the consequent changes in the frequency of testing, testing methodology etc. The Committee is of the view that this matter should be looked into in all its aspects and measures evolved to make the Central Revenue Laboratory a competent test house for the Department.

Other Points

7.36 We would also like to discuss some other points relating to administration of indirect taxes, where improvement is called for:

a. Procedure of collection of excise duty on matches and cigarettes

7.37 The growth of excise duty collections from matches as a percentage of total revenue has been steadily declining from 2.21 per cent in 1968-69 to 1.09 per cent in 1973-74, 0.18 per cent in 1989-90 and 0.15 per cent in 1992-93 (Budget estimates). The duty on matches is collected through banderols and the cost of collection in the case of matches tends to be high. The Committee feels that considering the relative significance of the revenue from matches, the feasibility of doing away with banderolling of matches should be examined.

7.38 Cigarettes on the other hand account for a substantial portion of the Central excise revenue and its share in the total revenue has been constant over the years, around 9 per cent. [The actual collections have gone up from Rs.107.39 crores in 1968-69 to Rs.1009.25 crores in 1984-85 and Rs.2650 in 1992-93 (BE)].

There have been a number of reports of evasion of duty on cigarettes. This commodity lends itself easily to the system of collection of duty through banderolling. The feasibility of such a system should be examined.

b. Excise documentation

7.39 It is on the basis of the revenue shown as paid in the gate pass that Modvat credit is taken by the user of the commodity covered by the document. The statutory form of gate pass for removal of excisable goods should provide for the indication of the total duty paid in words. This is essential as this may minimise the chance of the figures of duty on the gate passes getting fraudulently changed.

7.40 Factories producing some manufactured commodities like tyres and polyester stable fibre, are placed under physical control. In these cases the clearance document is Application For Removal (AR-1). These commodities have been kept under physical control because of the high incidence of duty and persistent reports regarding duty evasion. Otherwise, these commodities are in no way different from other commodities covered under SRP (In fact, the aforesaid commodities were earlier covered under SRP). While control could be exercised at the time of removal of the goods from the factory, there is no reason why the documentation and assessment procedure should be different from what is applicable to other commodities under SRP. It is also necessary to review the present system of control to see whether it has resulted in better compliance on the part of the assessees than what could be ensured when these commodities were covered by the SRP.

c. Reversal of Modvat credit on inputs

7.41 In regard to inputs where the credit is taken under Modvat, there is a provision in excise law that in case such inputs are cleared as such it should be subjected to duty, as if they were manufactured by the user of the input. This creates unnecessary complications in the working of the system and avoidable disputes between the Department and the assessees. The Committee is of the view that in the case of such clearances, it should suffice if the credit taken initially is merely reversed. There is very little chance of the assessees misusing such a facility.

d. Clearance of imported goods

7.42 A suggestion was received that certain categories of importers like public sector undertakings and reputed firms who have repetitive imports could be permitted clearance of imported goods on the basis of their own declaration without any hold up at the port. The assessment can be completed on the basis of the documents, after examining the goods if necessary at the premises of the importers. The Committee has endorsed this view. We are happy to note that this and some other matters which the Committee had occasion to discuss with the Collectors of Customs have already been given effect to by the CBEC.[32]

7.43 In the context of India ratifying the GATT Valuation Code, information regarding the international prices of commodities annually imported has assumed greater significance. While even as it is considerable information is being collected through individual initiative, a formal system for this purpose ought to be evolved. A useful input for this purpose would be provided by our Embassies and High Commissions. The commodities in regard to which there should be a continuous watch of the trends in prices should be selected and arrangements made for keeping updated information in the computer data bank.

7.44 The delayed clearance of air cargo is many a time due to the delay in the receipt of intimation by the importers from the airlines or the Container Corporation of India, even though the delay in the eyes of the importer is attributable to the customs. There should be adequate interaction between the

Customs and the agencies involved, in order to ensure that such delays are minimised.

7.45 The Committee is of the view that the period of warehousing has to take into account the needs of the consuming industry and the high level of financing cost. We would recommend that in the present circumstances a minimum period of three months would be a more reasonable period for the importing public as against the existing period of one month.

7.46 The value limit for import of parcels by post, free of duty was fixed some time back. There may be a case for upward revision of this limit. In this context, the Committee notes that the limit for duty free import of baggage items has recently been enhanced from Rs.2400 to Rs.3000.

7.47 At present, baggage in excess of the duty free limit of Rs.3,000 is taxable at 255 per cent. This rate might be brought down in the course of the restructuring and reducing of the import tariff. Meanwhile, learning from the beneficial results obtained from the limited Gold Import Scheme, we would recommend that the Government should introduce a special scheme in respect of baggage of those who are returning to India after a stay abroad of at least six months. The rate of duty on the dutiable goods contained in the baggage of these passengers in excess of Rs.3,000, should be 100 per cent if paid in foreign currency, upto a limit of Rs.1 lakh. Such a scheme will enable the Government to earn foreign exchange, while giving adequate protection to domestic industry.

7.48 In regard to the incorporation of tariff and exemption notifications in the computer data bank, there was divergence of view among the Collectors of Customs with whom this matter was discussed. The Committee, however, would recommend that the Harmonised System of nomenclature which is available in the form of floppies with the Customs Cooperation Council can in any case be fed into the computer. In addition an alphabetical index of all goods imported indicating the customs classification and current rates can also be evolved, which should be available on tap in all of the terminals throughout the country. This will greatly facilitate the customs classification. Whenever new imports requiring a classification are noticed, the matter should be taken up at the highest level and the Board's rulings incorporated in the index promptly. A similar data bank in regard to the value ranges of important products can also be set up once the information in this regard based on past imports is fully fed into the computer.

e. Dissemination of information relating to international customs experience

7.49 There is inadequate appreciation among the senior officers of the Customs Department about the international customs law and customs procedures. One of the reasons for this is the lack of information in regard to these matters, which is available in the publications of foreign customs administrations and of the Customs Cooperation Council. We would recommend that an International Division may be set up in the Board under a senior officer not below the rank of a Director for collection and dissemination of information relating to international experience in customs administration and dissemination of the information among the custom houses. This division may also deal with the international conventions relating to customs matters.

f. Computerised manifest clearance

7.50 The supply of manifests by shipping agents in computer diskettes or floppies has been accepted in principle and one of the custom houses has already initiated the process of acceptance of such manifest. The clearance of manifest can also be effected through the computer once the entire manifest and clearance particulars are fed into the computer. This will remove the delay in the manifest clearance and the subsequent action if any against the steamer agent.

g. Field security at the airports

7.51 During our discussion, the Collectors of Customs referred to the inadequate arrangement for field security at the airports which over a period of time have become huge, with a large number of operations such as loading, unloading and transhipment, taking place at various points simultaneously. There was a general agreement that at the airports the security would have to be tightened considerably in order to safeguard revenue. This would require provision of adequate manpower and modern gadgets like closed-circuit televisions (CCTVs). The accountability of field security from the customs angle will have to be squarely placed on one officer in each shift so that the omission, if any, in regard to this matter does not go unpunished. The revenue potential in this matter is very high according to the perception of the Collectors. Similarly, there has to be proper check on uncleared goods lying in the docks and the airports. The same consideration will also apply to expeditious disposal of confiscated goods.

h. Drawback

7.52 The suggestion to transfer the drawback work to the Ministry of Commerce seems to have been given up. There are complaints in regard to the delay in the fixation of drawback rates - both all industry rates and brand rates. The Board may consider to what extent the computer facility can be made use of for expediting the drawback rate fixation.

i. Augmenting staff for additional work

7.53 We learn that there is invariably a delay in augmenting the staff strength whenever additional work was placed on the Collectorates. The Committee feels that there should be automatic sanction of staff on the basis of norms to be evolved wherever a new unit like Inland Container Depot (ICD), air cargo complexes and Container Freight Station (CFS) are established. The Committee was informed that a beginning had already been made in this regard in the case of one of the newly created units.

8

APPEALS AND APPELLATE PROCEDURES

The System of Appeals and its Working

8.1 The direct taxes laws and the customs and Central excise laws provide for an elaborate appeal system to protect the interests of the taxpayers. Briefly the structure is as follows:

a. First appeal against the order of the assessing officer lies, in customs and Central excise matters, to the Collector (Appeals) and in the case of direct tax matters, to Deputy Commissioner (Appeals) or Commissioner (Appeals) depending on the quantum of taxable income as well as the form of organisation of the taxpayer.

b. First appeal against the order-in-original of Collectors or Commissioners, as the case may be, lies to Customs, Excise and Gold (Control) Appellate Tribunal (CEGAT) or Income tax Appellate Tribunal (ITAT).

c. Appeal against the order of Collector (Appeals) or Commissioner (Appeals)/Deputy Commissioner (Appeals), as the case may be, lies to the CEGAT or ITAT, respectively.

d. The disputed questions of law, if any, arising from the order of the Tribunal are referred to the High Court for decision. Appeals against the decisions of the High Courts lie to the Supreme Court.

e. However, in respect of classification and valuation matters under the customs and Central excise laws, appeal against the orders passed by the five Special Benches of the CEGAT lie to the Supreme Court directly.

8.2 After hearing various chambers, associations, departmental officers, lawyers and the Presidents of CEGAT and ITAT expressing dissatisfaction over the existing arrangements for dispensation of Appellate remedies, the Committee has identified the following specific problem areas:

a. A large number of pendencies in the Tribunal in the case of appeals under the customs and Central excise laws and huge pendencies at all appellate levels in the case of appeals under direct tax laws;

b. Absence of any clear-cut guidelines to guard against frivolous appeals;

c. Lack of adequate facilities to appellate authorities and members of the Tribunals;

d. Inadequate infrastructural support to Departmental Representatives who are often pitted against very senior experienced lawyers representing the assesses; and

e. Selection of unsuitable personnel as Departmental Representatives and absence of requisite training programmes.

8.3 Since, as the saying goes, justice delayed is justice denied, it is important that all stages of the appeal process be expeditious. Many countries impose a time limit at the Departmental stage in the law for the disposal of an appeal and it is for the most part met. Unfortunately, to the detriment of the appeals system, there are much longer delays at the Court stages. In recognition of the seriousness of this situation, many Governments authorise the appointment of special judges, etc., to increase the efficiency of the court system.

8.4 The Committee notes with satisfaction that the rate of disposal of appeals at the level of Collectors (Appeals), customs and Central excise has been higher than the rate of receipts since 1988-89. The information received from the CBEC regarding appeals received and disposed of during 1988-89 to 1990-91 are given below:

Year	No. of appeals received	No. of disposal
1988-89	5315	6329
1989-90	5190	5781
1990-91	3813	5113

8.5 In the case of direct taxes, however, the pendency of first appeals has increased considerably from 96,858 as on 1.4.1986 to 1,58,604 as on 1.4.1992, though the average disposal by Commissioner (Appeals) has increased from 536 per annum to 653 per annum during the period 1986-87 to 1991-92, while the number of Commissioner of Income tax (Appeals) has increased from 105 to 141 during the same period. Given this state of affairs, taxpayers cannot hope to get a decision earlier than a minimum of 18 months. Generally, in all cases before the Commissioner (Appeals) any point arising once tends to be repeated year after year. If, therefore, a dispute arises on any such point, it generates repetitive appeals. We must also note that there is considerable resentment against the unreasonable or unhelpful behaviour of some of the Departmental appellate authority.

8.6 If the first appellate order were to be forthcoming not later than six months and assuming it is against the Department, a decision could be taken on whether a second appeal needs to be filed well before the assessment for the subsequent year is finalised. If the first appellate order is accepted, the assessing officer would not repeat the additions in the subsequent year. Similarly, in many cases the taxpayer would also come to accept the views of the Department after he has lost in the first appeal.[33] In either case, repetitive appeals to the Commissioner (Appeals) would be avoided.

8.7 It is to be recognised that long delays in the disposal of appeals created uncertainty in regard to interpretation of tax laws thereby inhibiting voluntary compliance. Further, the ambiguity in the tax laws (for which, of course, the administration is responsible) being the cause for a large number of appeals, there is an in-built bias against small taxpayers who do not have easy access to expensive and expert tax advice. The instructions of the Board to dispose of high-demand appeals on a priority basis further increases the compliance burden on small taxpayers in so far as the average time taken to dispose of smaller appeals increases substantially, thereby, imposing higher interest burden on the smaller taxpayers.

8.8 It is necessary to institute an appeals system through which justice would be forthcoming expeditiously, particularly at the first appellate stages. We, therefore, recommend that the average time for disposal of appeals relating to both direct taxes and indirect taxes should not exceed a period of six months at the first appellate stage. In the case of direct taxes, the existing average time for disposal is about eighteen months. We recommend the creation of a suitable number of additional temporary posts of Commissioner (Appeals) for a period of two to three years to reduce the average time for disposal to not more than six months. Within that period, the implementation of the recommendations we make here would, we hope, substantially reduce the number of appeals preferred.

8.9 The taxpayer or the Department aggrieved by the order of the first appellate authority files a second appeal to the ITAT or CEGAT, as the case may be. The pendency position in both the Tribunals is quite alarming. The position relating to institution, disposal and pendency of appeals in the ITAT is as follows:

Year	Opening balance	Insti-tution	Dispo-sal	Pend-ency
1988-89	114747	74748	452481	44247
1989-90	144247	78673	588851	64035
1990-91	164035	75384	497551	89664

8.10 The pendency position in respect of appeals preferred to CEGAT is as follows:

Year	Opening balance	Insti-tution	Dispo-sal	Pend-ency
1988-89	29062	14875	9492	34445
1989-90	34445	18374	13012	39807
1990-91	39807	15574	15537	39844

8.11 The pendency position is worsening with the net addition of about 25,000 cases per year in ITAT and about 6500 cases per year in CEGAT, to the already staggering level of pendency. Even if the net addition were to come down to 50 per cent, it would take at the minimum 8 to 10 years to liquidate the existing pendencies in both the Tribunals at the current rate of disposal. It is, therefore, doubtful whether these institutions are in a position to provide remedial justice to the assessee or the Department unless immediate measures are taken to improve the efficiency of these institutions and to change the procedures, where needed.

Huge and Rising Pendencies

8.12 The huge pendencies in the Tribunals are attributed to the following:

a. **Repetitive appeals**: The long delays in High Courts and the Supreme Court have a snow-balling effect on the institution of appeals at the lower level. An example on hand is the issue relating to whether in determining the 'actual cost' under Section 43(1) of the Income-tax Act for the purpose of allowing depreciation and investment allowances, the subsidy received from the Government is to be deducted from the cost of the asset. We understand that about 10,000 cases are pending with the Madras Bench of the ITAT on this issue, on which a final verdict is yet to be given by the Supreme Court. Similarly, a number of appeals on valuation disputes in Central excise are pending with Collector (Appeals) and CEGAT on specific issues which are to be decided by the Supreme Court in the MRF case.[34]

b. **Under-staffed Benches**: Even though 38 benches have been sanctioned in the ITAT, the number of effective Benches functioning as on 1.1.90 was 28 which further went down to 26 as on 1.1.91. If only all the Benches were to function simultaneously, the number of pendencies in the ITAT would have been about 40 per cent less. In the case of CEGAT, there are vacancies of five members - 3 technical members and 2 judicial members for more than one year. There was a long delay in the appointment of the President of CEGAT and the appointment was finally made only after a direction by the Supreme Court.

c. **Seeking of frequent adjournments both by the Department and the taxpayer**: Very often the Department seeks adjournment primarily because the Senior Authorised Representative is either busy at some other Bench, or because the records have not been received from the assessing officer, or because the paper books have not been delivered in time. Similarly, even taxpayers seek adjournments on the plea that their Representative is busy at some other Bench or Court.

d. **Lack of co-ordination between the Chief Departmental Representative and the Collectors/Commissioners**: In many cases the Bench seeks further information from the field formation to

have full appreciation of the relevant facts. The office of the Chief Departmental Representative (CDR) often finds it difficult to collect the required information from the field formations. This has been one of the important causes for delay in the disposal of the appeals.

e. **Lack of mechanism to prevent filing of petty appeals, etc**: Lack of mechanism or rules to prevent filing of appeals by the officers of the Department even where the amount involved is small as also the tendency of the Department to appeal against the orders of the Tribunals, instead of changing the law with prospective effect, if the intention of the law is different.

8.13 While many of these problems would have certainly affected the efficiency of the Tribunal, the Committee is of the view that the problem of huge pendencies and denial of quick justice can be effectively tackled only by striking at the root of the problem, i.e., generation of too many appeals. With the implementation of our recommendations on changes in the tax structure which would have the effect of reducing the institution of appeals at the first appellate stage, the preferment of appeals to the ITAT/CEGAT would also be reduced consequently.

Remedial Measures

8.14 About 60 per cent of the appeal cases in the Central Excise and Customs Department relate to classification and valuation disputes,. We have already dealt in considerable detail with the existing problems in regard to classification and valuation matters in paras 7.17 to 7.27 of Chapter 7. It could be expected that our recommendations to amend the laws and procedure relating to classification and valuation matters and our earlier recommendations of bringing down the tax rates and reducing the number of rates, and removal of all end use based notifications will result in substantial reduction in the number of appeal cases. Similarly, in direct taxes, our recommendations relating to the presumptive tax scheme, estimated income scheme and elimination of a number of tax concessions would substantially reduce the institution of appeals.

8.15 The Committee strongly feels that appeals should not be preferred by the Department in a routine manner. Clear-cut guidelines should be given by the Board to the Collectors/Commissioners to the effect that an appeal should be preferred to the Tribunal only when substantial questions of law are involved and the Department is likely to win having regard to the case laws on the same matter or similar matters. The Collectors/Commissioners should be held accountable for the wastage of time and resources of the Department and the Tribunals by making frivolous appeals.

8.16 The CBDT has prescribed a monetary limit of Rs.10,000 as the tax liability for filing Departmental appeals to ITAT. We suggest that this limit should be increased to Rs.25,000. The CBEC should also prescribe the same monetary limit. These limits shall apply only to disputes which relate to procedural matters and where no substantial question of law is involved. It may be mentioned here that during the course of our meeting with the CBEC, the latter reacted favourably to the proposal for prescribing a monetary limit in respect of customs/excise duty involved of Rs.25,000, so that cases which involve duty below the limit would not be taken to the CEGAT by way of second appeal.

8.17 The Boards should ordinarily accept the decision of the Tribunal unless the decision is seen to be erroneous having regard to the intention of the legislature and the decisions of the Court on the same question of law. Once the decision of the Tribunal is accepted by the Boards, a corresponding amendment of law may be made if necessary. Where amendment of law is not considered

necessary, suitable instructions should be given to the field formations to ensure that such disputes do not occur in future.

8.18 The above measures will reduce the institution and pendency of appeals in the two Tribunals.

8.19 According to the figures furnished by the CBEC, the Department has in 1990-91 lost in 1200 cases while 1386 appeals were preferred before CEGAT. Though these two figures alone do not indicate the percentage of the Department's appeals dismissed by the Tribunal, we have been given to understand that in the majority of cases before CEGAT and ITAT, the Departments fail to substantiate their cases. Apart from the reasons already discussed in the preceding paras, another important factor is the lack of adequate infrastructural support to the Departmental Representatives. The tasks that these Departmental Representatives have to perform are made more difficult by inadequate support from the Collectors/Commissioners. In most of the cases, the concerned files or the cross objections of the Collectors/Commissioners are not sent in time to the office of the CDR. Very often, even the appeal memoranda are incomplete. On top of this, the Departmental Representatives have to argue against very senior and more experienced counsels representing the assessees. Adequate time is also not available to the Departmental Representatives to go through the case records and case laws for arguing on an average 6 to 7 cases per head per day. This has given rise to disappointment and frustration even among the best of the Departmental Representatives. Lack of incentives and the feeling that fighting for the Department is an unrewarding task have made it difficult for the Department to find willing candidates for the job. As a result, a number of Departmental Representatives in the two Tribunals are unwilling officers who do not often have the requisite knowledge, skill and aptitude.

8.20 Obviously, there has to be a substantial improvement in the quality of personnel in the office of the CDR for safeguarding the interests of revenue. The Government can get much more by giving a little, by way of incentives, to the Departmental Representatives. We, therefore, recommend that a special pay should be given to the Departmental Representatives at the same rate as given to the faculty members in the training establishments. This will make the Departmental Representatives more motivated and help in presenting the Department's case more effectively before the Tribunals. Government revenue will be in safer hands as special pay will surely attract better talent in the Department, who by virtue of their merit, experience and professional qualifications will be more equipped to meet this challenging task. Since the National Court of Direct Taxes and the Central Revenue Tribunal are to be set up, it may be a good idea to gradually build up a specialised sub-cadre within the two revenue services, manned by revenue officers having a special flair for legal and judicial work. Periodical training programmes at least of one month's duration should be arranged for these officers as a continuing programme for this specialised work in the two Departments.

8.21 It is also necessary that the judicial cells in CBEC and CBDT prepare suitable computer programmes with the help of experts for codifying all case laws on different points of law in direct and indirect taxes and circulate the same to the field formations. The office of the CDR should have a computer cell which will update the codification work from time to time. The Departmental Representatives should be able to draw upon the information on relevant case laws provided to them by this cell for arguing their cases.

8.22 Needless to say that the improvement in the quality of work of the Departmental Representatives alone will not be sufficient. It is equally important that the Collectors/Commissioners effectively

coordinate with the office of the CDR so that all facts and legal points are brought to the notice of the Departmental Representatives arguing their cases. Concerned files and all relevant papers including a brief note surveying the judicial decisions on the same matter or similar matters should be sent to the office of the CDR well in time. The Boards should issue appropriate instructions to the Collectors/Commissioners to this effect. In order to ensure more effective cooperation from the Collectors/Commissioners, we suggest that a very senior Collector/ Commissioner should be posted as the CDR in CEGAT/ITAT. The CDR in the apex Tribunal should be of the rank of Principal Collector/Chief Commissioner.

8.23 It is understood that there are four vacancies in the post of members in CEGAT. We are surprised to learn that 50 per cent of the posts of private secretaries and stenographers attached to CEGAT members are lying vacant. We would urge the Government to immediately fill up the vacant posts of members, private secretaries and stenographers. The members of the Tribunals should be provided with some furniture and a modestly equipped library of books at their residences, as is done in the case of judges, to enable them to work at home.

Setting up of Tribunal under Article 323-B

8.24 While examining the need for decentralisation of the system of administration of justice and establishing other tiers or systems within the judicial hierarchy among others to reduce the volume of work in the Supreme Court and the High Courts, the Law Commission of India also had the occasion to examine the judicial procedures and the existing vertical hierarchy of Tribunals and Courts involved in tax litigation. The Commission's 115th Report on Tax Courts observed that while the time lag between the date of assessment order and the order of the ITAT disposing of the appeal was about three years, the delay really occurred after the decision was rendered by the ITAT, when either the assessee or the revenue moved an application for reference and the matter landed in the High Court. The bottleneck was at the level of reference under Section 256 (1) or Section 256(2), as the High Court was unable to handle the references within a reasonable time. Hence, it recommended the setting up of a Central Tax Court with an all-India jurisdiction which will, inter-alia, "introduce an all-India perspective in the matter of interpretation of tax laws" and eliminate conflicting decisions amongst various High Courts, thereby reducing the inflow of cases to the Supreme Court.

8.25 The Government has delayed setting up the Central Tax Court, as recommended by the Law Commission. The pendency of cases relating to direct tax matters in the High Courts has further increased since the submission of the 115th Report of the Law Commission. The archaic procedure under Section 256(1) and Section 256(2) of the Income-tax Act continues to exist in the statute. The announcement by the Finance Minister in this year's Budget speech, of the Government's decision to set up the National Court of Direct Taxes and to amend, for customs and excise matters, the Central Revenue Appellate Tribunal Act, 1986 and set up the Tribunal is, therefore, very timely. These two Tribunals proposed to be constituted under Article 323-B of the Constitution of India will replace the jurisdiction of the High Court to hear reference applications on points of law.

8.26 During the course of hearing before us, it was argued by the Presidents of both ITAT and CEGAT that the existing Tribunals should be elevated to take on the role of an Article 323-B Tribunal, if it is ultimately decided to constitute one. Their contentions were based on the following:

a. It would be far more economical and time saving to convert the existing Tribunals into an Article 323-B Tribunal than to set up an altogether new institution, duplicating infrastructural and other facilities;

b. Over the years, the decisions of the Tribunals have found a wide measure of acceptability thus bringing about finality to many issues, implying thereby, that the Tribunals are competent to take on the role of an Article 323-B Tribunal.

8.27 The Committee does not favour this line of approach. What is much more important than bringing about some economy is the faster dispensation of justice in tax matters. Considering that cases involving huge amounts of revenue yet to be collected are pending in the High Courts and the Tribunals, and considering also the wastage of time and effort of the tax collection machinery in processing these cases, it will only be in the interest of revenue to think of an arrangement which brings about quicker settlement of disputes. Moreover, if the existing Tribunals are elevated to Article 323-B Tribunals, the backlog of four to five year's cases pending in the Tribunals along with the large number of cases pending in the High Courts would be transferred to them and the infant institutions will be saddled with an unbearably huge pendency from the date they commence functioning. In order to reduce the pendency, additional facilities will have to be created. Further, the intention is not that one stage of appeal should be cut out. With the ITAT/CEGAT and the Article 323-B Tribunals in existence, the assessee will have the facility of appealing against the decision of the Commissioners/Collector (Appeals) once on facts and then again once on questions of law.

8.28 The Committee is, therefore, of the view that the decision of the Government to set up a National Court of Direct Taxes and to revive the Central Revenue Tribunal for Excise and Customs which will replace the jurisdiction of the High Court should be implemented without any further delay. With the setting up of these Tribunals under Article 323-B of the Constitution, there will be no scope for conflicting decisions as on referential applications to High Courts. The Committee suggests that these two Tribunals should be integrated into one apex body i.e. the National Revenue Tribunal (NRT) with two separate wings for direct taxes and for Central excise and customs. Such an arrangement will have certain inherent advantages like having common infrastructural facilities. The judicial members for this Court could be appointed for both the direct and indirect taxes. Since the choice will be wider, a larger number of candidates will be available for these posts.

8.29 At present the appeal against the orders of Special Benches of the CEGAT in classification and valuation matters lie to the Supreme Court and not to the High Courts. The Committee is of the view that there need not be any difference in regard to the channel of appeal against the orders of the two Tribunals, i.e., CEGAT and ITAT, once the NRT comes into being. Appeals against the orders of Collectors in respect of classification and valuation matters should be filed before the Special Benches of CEGAT as at present, but the appeal against the decision of these Special Benches in such matters should lie with the NRT.

8.30 The Committee is also of the view that the Department of Revenue should not have any administrative control over the CEGAT and the proposed new Tribunal and that the Ministry of Law should be charged with the administration of these two institutions, just as that Ministry is administering the ITAT now. Simultaneously, the terms and conditions of service of the Members of CEGAT and ITAT should be equated.

8.31 Each Bench of the new appellate Body should comprise atleast one Member (Judicial) and one Member (Accounts)/ Member (Technical). The eligibility conditions for appointment as members and President should be prescribed keeping in view the functions of these bodies, the eligibility conditions for appointment of members in the ITAT, CEGAT and High Courts.

8.32 Since these new appellate bodies would be performing the functions of a High Court in so far as they relate to tax matters (except writ matters) and also hearing appeals against the judgement delivered by the Presidents, ITAT and CEGAT, the terms and conditions of service of the members of NRT should be on par with those of the Judges of the High Court. Similarly, the terms and conditions of the service of the Chairman of NRT should be on par with those of the Chief Justice of a High Court.

8.33 Further, the existing rather cumbersome procedure of reference under sub-section (1) and (2) of Section 256 of the Income-tax Act on a point of law from the ITAT to the High Courts should be replaced by a simple scheme, whereby, the NRT should have jurisdiction to entertain appeals against the orders of the ITAT or CEGAT, as the case may be, only on questions of law or mixed questions of facts and law. In so far as the findings of facts are concerned, the decision of the ITAT and the CEGAT shall be final. Every appeal filed before the NRT should be subject to an admission procedure as provided under Section 100 of the Code of Civil Procedure. This will help remove procedural bottlenecks in rendering speedy justice.

8.34 In respect of the orders of the first Appellate authority, Tribunals and High Courts, the judicial branch in both the Boards or any other specified Directorate, should obtain from the field formations the following information in brief:

a. Name of the taxpayer;

b. Assessment year;

c. Facts of the case;

d. Decision of the appellate authority;

e. Whether appeal filed against the order of the appellate authority or not; and

f. Reasons for the decision at (e) above.

The above information should be collated to analyse the uniformity in the application of the law across the regions, the geographical spread of the dispute and the impact of a particular dispute on the number and categories of taxpayers and the revenue effect thereof. This will also enable the Boards to take appropriate remedial action through suitable instructions to the field formations or through necessary changes in the law. For example, if a Commissioner in Bombay on a particular issue has decided not to file a second appeal and another Commissioner in Calcutta has taken a contrary decision, it will enable the Board to issue instructions clarifying the correct legal position, thereby imparting uniformity in the application of the law across the country.

8.35 As regards the existing pendencies in ITAT and CEGAT, additional Benches may be created for a specified period to hear these appeals. The number of Benches in the Tribunals may be reviewed after the creation of the NRT and it should be ensured that it is adequate to dispose of the appeals within a reasonable period of six months or so. The Government may also consider introducing a similar admission procedure in the case of appeals filed before CEGAT and ITAT too, as such a procedure may result in quicker disposal of cases and result in lowering the load on these Tribunals.

8.36 The above recommendations have been designed to instal an efficient appeal system which is so necessary to reduce arbitrary decision-making of the tax authorities and corruption in the tax administration. The cost of an elaborate and efficient appeal system should not be weighed only against the direct benefits that may or may not accrue from it but also against the indirect benefits that accrue through greater public confidence in the tax system and consequent improved voluntary compliance.

Tax Disputes with Public Sector Undertakings

8.37 We would like to comment on one more point relating to appeals and appellate procedures. We understand that the Supreme Court has in a recent case[35] taken adverse notice of the public sector undertakings (PSUs) pursuing litigation in Courts, wasting public time and resources. The Court has observed that it shall be the obligation of every Court and every Tribunal, where a dispute between the Government of India and a PSU is raised, to demand a clearance for litigation (if it has not been so pleaded) from a Committee consisting of representatives of the Ministry of Industry, Bureau of Public Enterprises and the Ministry of law. The Court has ruled that in the absence of such a clearance, the case would not be proceeded with. The Cabinet Secretariat has accordingly constituted a Committee consisting of six Secretaries including the Finance Secretary. This Committee will examine cases referred to it by the Ministry/Department or the PSUs through their administrative Ministry/ Department and will give clearance, if it considers that the cases are fit for litigation.

8.38 It appears that in one case the CEGAT has held that the ratio of the Supreme Court's decision regarding not hearing matters in respect of PSUs will not apply to cases where a regular judicial order has been passed and the right of filing a case as provided by the statute is being exercised by an assessee, whether it be a PSU or a private enterprise.

8.39 With respect, we would like to comment that so far as tax disputes are concerned, the new arrangement may not bring about any saving of public time or resources. It is unlikely that the six Secretaries would be able to meet simultaneously and frequently to deal with complex cases relating to tax liabilities of PSUs. In taxation, it is essential that the disputes get settled expeditiously and the references to the Committee to get clearance for litigation is bound to cause delay. Granting of clearance for litigation presupposes handing down of binding decisions. Such decisions, particularly in the case of indirect taxes, would affect not merely the undertakings but also the consumers and users of the products manufactured by the undertakings. In taxation, there is no scope for arbitration. The taxation laws provide for the machinery for deciding appeals and it should be open to all assessees to make use of this appellate machinery without any incumberance.

8.40 While it is conceded that it would be a waste of public resources if PSUs were to enter into prolonged litigation with the Government Departments, the solution has to be found otherwise, than by providing a clearance procedure. We would recommend that:

a. the appellate Tribunals may continue to deal with and decide tax appeals relating to PSUs even without the clearance from the Committee of Secretaries; and

b. a machinery may be set up within each Board to go into the question, on its own or on an application by a PSU of the maintainability of the stand taken at lower levels regarding the tax liability of that particular PSU and to issue directions whether or not the stand would need revision.

8.41 We would like to add that decisions whether or not to pursue a tax dispute should not be influenced by considerations such as the possible view which Audit - whether it be the Receipt Audit or Commercial Audit - would take in particular matters.

9

PERSONNEL POLICIES AND ADMINISTRATIVE STRUCTURE

9.1 It is a truism to say that even the best of tax systems cannot be expected to yield beneficial results unless the country has a corps of qualified, well trained and highly motivated tax officers to administer it without fear or favour. It will be agreed that the adjectives used in the preceding sentence are all appropriate, and that ideally the staff of the Tax Department should have the attributes mentioned therein.

9.2 In reality the state of affairs in the two Departments as already indicated in this regard, leaves much to be desired. We must hasten to add that there are many excellent officers with deep understanding of the tax laws in both the Departments. It would also be true to say, that by and large, lack of knowledge of procedures and law is not an important weakness. However, there are signs of lowering of standards. And in several other respects, there are deficiencies which stand in the way of adequate performance in terms of effective enforcement, taxpayer satisfaction, minimisation of disputes and minimum hindrance to productive economic activities.

Recruitment, promotion and evaluation of performance

9.3 The methods of recruitment and promotion upto the level of Assistant Commissioner/Assistant Collector in Income Tax and Excise and Customs Departments are as follows:

9.4 In both the Departments, the Inspectors are next in higher rank to the clerical staff, namely, the Lower and Upper Division Clerks and the Stenographers. In Excise and Customs, the lowest executive level of the posts of Inspector/Preventive Officer/Examiner are filled to the extent of 25 to 50 per cent by means of promotion from the clerical cadre, subject to passing a Departmental examination and the balance through direct recruitment on the basis of competitive examination conducted by the Staff Selection Commission. In the Income Tax Department, 33 per cent of vacant posts of Inspectors are filled through promotion and the balance 67 per cent through direct recruitment. Promotions are given mainly on the basis of seniority, subject to the passing of the Departmental examination. However, the standard of the examination has been greatly diluted over the years. This is a major weakness in the system.

9.5 In Excise and Customs Department, the next higher layer is formed by the Superintendent/Appraiser and in the Income Tax Department by the Income Tax Officer. Vacancies at this level are filled entirely through promotion from the rank of Superintendents and Inspectors in the case of excise and income tax but in customs, part of the vacancies are filled through competition. The promotions are based on seniority and CRs.

9.6 Vacancies at the next higher level of Assistant Commissioners/Collectors are filled by promotion and through an open competitive examination in equal proportions. The promotions are by selection according to the merit cum seniority principle and merit is judged just on the basis of CRs.

9.7 We thus find that promotions are based mainly on seniority and CRs, and at one stage the promotees should have cleared a Departmental examination. We do not think that the methods of promotion in vogue are such as to induce high quality performance or to recognise and reward merit. It is necessary to introduce changes in these methods to tone up the administration and to make the staff at all levels feel that rewards can be earned only through good and diligent performance of duties.

9.8 Insistence on good performance should start at the bottom of the hierarchy and continue upto the very top. We recommend that the Departmental examinations for those to be promoted from a lower post to a higher post within the Department should be of a much higher standard than it actually is at present and that the examinations should be conducted by an external agency or one of the Directorates under each Board. There should be proper invigilation which should be by officers of the other Tax Department. Much greater secrecy should be introduced in regard to the valuation of examination papers. In fact the examinees should have no way of knowing who the examiners are.

9.9 We attach great importance to the selection of Income Tax Officers because they are in charge of assessing the majority of income tax payers. In Chapter 6, we have suggested a system of group assessment, which would bring the Income Tax Officers under greater discipline. Nevertheless, it is necessary to ensure adequate knowledge of law and procedure as well as the essentials of accounting. The same considerations apply to the promotion to the ranks of Superintendents and Appraisers in the Excise and Customs Department. We are of the view that CRs by themselves cannot be considered to be the test of merit, unless they become more reflective of the actual proficiencies and deficiencies than they are now. We recommend that in considering suitability of candidates for promotion to this rank, a combination of criteria should be used: Seniority, the results of an examination only for Departmental candidates and the results of an interview and CRs.

9.10 We understand that CRs have lost much of their value because it has become rare for the superiors to record bad performance arising from lack of ability or knowledge, or lack of application. Since it is difficult to prove corrupt practices, even when it is known that there is lack of integrity, nothing is usually said about it in the C.R. We realise that it is not easy for the Revenue Departments alone to bring about a substantial change in the manner in which substandard performance and serious weaknesses are being commented upon or skipped over in the CRs of Government servants. However, it is certainly possible to pick out the most honest, diligent and intelligent officers and through the proper wording of CRs indicate in a "negative" way which officers and staff do not possess these qualifications. We stress this point because, as is obvious, honest, hardworking and intelligent officers constitute the basic foundation for good tax administration and in a Department which collects thousands of crores of rupees, it is of the utmost importance that honest and diligent officers are not only supported but also sufficiently rewarded. For this to happen, the CRs must become an important tool for identifying and promoting them and ensuring that men of lesser ability or doubtful integrity do not get promoted to senior positions.

9.11 Promotions within Group A Central Services are based on seniority and the record of performance as shown in the CRs. In order to qualify for promotion, performance must have been evaluated as "very good", but it appears that there is a tendency to award this categorisation even to undeserving officers as a matter of course. Nevertheless, accelerated promotions are being granted, though only occasionally, within the Revenue Services. We would strongly recommend that, if the CRs are used as we have suggested as a tool for distinguishing and picking out officers of outstanding merit, a higher proportion of promotions than at present should go to officers of outstanding merit, subject to their satisfying other conditions, above the level of Assistant Commissioner/Assistant Collector.

Tackling Corruption

9.12 The lower the rates of taxes, *ceteris paribus*, the less the reward for tax evasion and correspondingly less desire or need to pay bribes to protect oneself against punitive action by revenue officers. Every concession and relief provided in the law can be used to

extract illegal tribute by simply arguing that the relief or concession is not applicable and cannot be granted. Multifarious rates also create scope for evasion as well as corruption. For these and other equally important reasons, explained in the Interim Report, we have recommended a limited number of moderate rates, simple laws defining a broad base with very few exemptions, deductions and concessions. The speech of the Union Finance Minister introducing the Central Government Budget for 1992-93, has indicated that the Government has endorsed the broad approach of the Committee in formulating tax reform proposals. If the major proposals are implemented, the levels of evasion and corruption would go down. However, as emphasised repeatedly, stricter enforcement leading to fear of detection is essential for cutting down evasion significantly. Similarly, generating fear of punishment and of severance from service in very serious cases is necessary to bring down corruption.

9.13 We recommend a three-pronged approach on this matter. First, the Vigilance machinery should be used more purposively. General instructions such as that all instances where action against assessees were dropped should be automatically reported to Vigilance are not of great avail and indeed they are said to discourage officers from being fair to the assessees. From the figures furnished by the CBEC, for instance, it is seen that in more than 66 per cent of cases the Vigilance machinery is engaged in initiating disciplinary action in respect of petty cases not involving corruption. It is generally agreed among the senior officers that within the Departments really corrupt tax officers get clearly identified; only it is difficult to find proof beyond doubt. The Chief Commissioner/Principal Collector should informally get to know the names of the really corrupt officers within his jurisdiction. He could have informal discussion with those Commissioners/ Collectors who are themselves persons of integrity. Then every year he should send to the Vigilance the names of a few officers who have the worst record in terms of corruption through a secret memo. We are told that the arrangement is that the Chief Commissioner (or the senior most Commissioner) and the Vigilance work out an agreed list of officers who should be specially kept under surveillance. However, this does not seem to be working as expected. The Head of the Departmental Vigilance should be selected with care, and he should be instructed to build up a strong case against those engaged in corrupt practices in a substantial way. When a strong case has been built up, the Central Bureau of Investigation should be asked to take over the case. Action of this kind should be taken with great care, discrimination and impartiality.

9.14 The second important way of getting rid of really corrupt officers is to invoke the provision FR 56J which enables the Government to terminate the services of an officer on the completion of 50 years of age without assigning any reason. It appears that this provision was challenged in the Court but that it has been upheld. We recommend that this provision should be made use of by both the Departments. Since the basic idea is to provide a means of deterrence, the number of officers identified to be sent out of service in any one year should be only very few. We cannot over-emphasise the importance of taking this action and the impact it may have on the behaviour of the officers.

9.15 Thirdly, appointment to sensitive posts and where scope for corruption is large must be made with great care and only the most honest and able officers should be given those posts. Transfers and appointments to the so-called "lucrative posts" through political patronage must be completely stopped. Proper guidelines could be laid down by the political authority, but the power to transfer must be with the Boards and the designated authorities at the different levels.

9.16 It has been pointed out to us that some really inefficient or corrupt officers could do considerable damage before they reach the age of 50. Some of these officers

could be proceeded against on the basis of information gathered by Vigilance. Others must be sent to positions where the scope for making illegal money will be very little. Action in this regard must be quite visible so as to send the right signals.

9.17 Once this regime is put into operation, we are sure that the entire atmosphere would change. While corruption cannot be cut down to zero, a considerable restraint would be imposed on the average officer and, what is equally important, honest and diligent officers would receive great encouragement.

9.18 In order that the scheme outlined above may operate successfully, it is essential that the entire task of transfers and postings must be within the jurisdiction of the Boards. The political authority may be kept informed of what is being done, but a self-denying ordinance on the part of Ministers is called for. If, in a very special case, say, on an appeal on humanitarian grounds, the Minister wishes to support the case for a transfer, then the instruction must be given in writing with full explanation for the action taken.

9.19 As we shall recommend later, the members of the Board should be given senior status. No one of them should be given extension beyond the retirement age except to the extent recommended in para 9.25 and none should be eligible after retirement for appointment to remunerative posts under the Government or in the public sector such as membership of bodies like the Settlement Commission or Chairmanship of public enterprises. Once appointed to the Board, the Chairman and members should continue until retirement. These regulations will make it possible for them to act impartially, independently and without fear.

Recruitment to Group A Revenue Service, Training of Officers and Promotion Prospects

9.20 We feel that the age limit for the Revenue Service examination should be lower than in the case of other Services. The chances of bringing about the correct attitudinal changes in the recruits is far greater if the age of entry is lower. We stress this point as the question of attitudes in officers is of far more importance when it comes to collection of revenue for the State.

9.21 At the level of Deputy Commissioner/Deputy Collector the officers should be subjected to rigorous training for at least a minimum period of three months.[36] In the training course the officer should be made to understand through proper study the broader social aspects and the economic consequences of taxation. They should also be made to realise the trade off between administrative ease on the one hand and equity and economic rationality on the other. They should be made to familiarise themselves with case law, common points of disputes and complications in tax law which could be removed. One of the objectives of the course must be to enable the young officers to suggest ways of improving the working of the Tax Departments with a view to minimising disputes, giving more satisfaction to the taxpayers without at the same time sacrificing revenue. At the end of the course, officers should be made to take an examination. The performance of officers in the examination should be an input for consideration for promotions in future. The services of an institution like NIPFP could be utilised for conducting some of the courses mentioned above.

9.22 If the training is to benefit the officers and the Department, the trainers should be selected with care and must be people of outstanding ability and knowledge. The extent of damage that can be done if the wrong type of officers get posted as trainers cannot be over-emphasised. In short, training should not be an exercise in interaction between 'sparables' and 'sparables'.

9.23 It is important that the morale of the honest and competent officers in the two Departments is kept high by providing enhanced opportunities for deputations to

Central Ministries particularly at middle and higher levels on par with what is available to the best among the organised civil services. The officers of the Revenue Service in the course of their work get opportunities to interact closely with industries, manufacturing of all kinds, international trade, shipping, banking, insurance and various service establishments. It is only proper that the experience of these officers should be adequately utilised and they should be given more opportunities to work at the middle and senior level positions in economic Ministries. While their working experience and knowledge as revenue officers will be useful for these Ministries, the Revenue Department will also be benefited when they come back to their parent Department with a wider horizon of knowledge and better appreciation of the overall economic policies of the Government.

9.24 We understand that the revenue service officers hardly get sufficient exposure to tax laws, procedures and administrative practices in other countries which have efficient tax systems and administration. As a matter of policy, promising officers of the two revenue services should be given adequate opportunities of studying at first hand the taxation system in other countries, particularly those that have carried out tax reforms and modernised their tax administrations.

Constitution of the Boards and their Autonomy

9.25 We would like to point out that the quality and performance of the Revenue Departments would crucially depend on the ability, integrity, knowledge and status of the two Revenue Boards, namely, the CBDT and CBEC. It is essential, therefore, that the best of the senior officers get recruited to the Board. If our earlier recommendation that merit be given much greater weight in promotion from the very bottom layer is implemented, the top officers would by and large be very able and diligent persons. Even then when a vacancy in the Board is to be filled considerable weight must be given to merit, though seniority should be also an important consideration. A rule should be adopted that amongst the four senior most people, the most meritorious will be chosen to fill a vacancy that arises in the Board subject to the condition that the candidate should have at least 12 months of service left. However, once appointed, the officer concerned should be allowed to have a minimum tenure of two years as member of the Board. Among the Board members, normally, the chairmanship should go to the senior most officer who should have at least one year of service left. This condition should be relaxed in the case of members who have put in at least three years of service in the Board and therefore, will be in a position to settle into the new job without much preparation and study.[37] Once appointed, the Chairman should be allowed to continue for a minimum period of one year or till the end of his service, whichever is longer.

9.26 As at present, all the financial powers are with the Revenue Department. The Boards themselves have no financial autonomy and have to have each item of proposed expenditure approved by a Revenue Department officer outside the Boards. The Boards have represented to us that they are seriously hamstrung by the requirement that approval for every bit of expenditure has to come from an "external" authority which is not directly involved in tax collections. Though the Chairman of the Board is of the rank of Special Secretary, all papers that he wishes to submit to the Minister (even on purely administrative matters) have to be routed through the Revenue Secretary. We recommend that the two Tax Departments together should continue to constitute the Revenue Department and work together as far as tax policy is concerned because the Central tax system should be viewed, fashioned and managed as a harmonious whole and not in two separate compartments. Tax policy formulation requires more than the knowledge of the existing tax laws and experience in tax administration. A weakness of the existing system is that there is not

sufficient economic input into the formulation of tax policy. Hence, there should be at the top, a coordinating machinery which would bring in economic inputs for the formulation of tax policy.

9.27 We recommend that (a) the two Boards should be given financial autonomy with separate financial advisers working under the supervision and control of the respective Chairmen; (b) the Chairmen of the two Boards should be given the status of Secretary to the Government of India and the members the rank of Special Secretary; and (c) the post of Revenue Secretary should be abolished.

9.28 With the abolition of the post of Revenue Secretary some arrangement would have to be made to ensure supervision and coordination of the activities of the two Boards. While alternative institutional arrangements could be considered, it is necessary to ensure that two basic conditions will be satisfied: the first is that the two Boards or the Tax Departments should not act independent of each other; as we have stressed earlier, it is extremely important that the tax system is structured and managed as a harmonious whole and that other inputs besides knowledge of tax administration are brought into the formulation of tax policy. The second consideration is that the Boards should have financial autonomy and that the Chairmen should have a sufficiently high status. We would recommend that the two Chairmen should be directly accountable to the Finance Minister insofar as matters relating to tax administration are concerned. However, the Finance Secretary should exercise overall supervision and coordination of the activities of the two Boards. His role could be particularly important in relation to the formulation of tax policy and changes in the tax law. Proposals in this regard would be submitted by the Finance Secretary to the Ministers. Before such a submission the proposals would have to be thoroughly considered and studied by a specialist body whose creation we are recommending.

9.29 We recommend that a Tax Council be constituted with the Finance Secretary as the Chairman and with the Chairmen of the two Boards, Member (Budget, CBEC), Member (Legislation, CBDT), Secretary (Economic Affairs) and Chief Economic Adviser as Members of the Council. All matters relating to tax policy and changes in law should come to the Tax Council and proposals in this regard would be submitted by the Finance Secretary to the Ministers. This Council would be serviced by a Tax Research Bureau consisting of experts.

9.30 The Tax Research Bureau should be engaged in conducting research in problems of tax policy. It could carry out its own research as well as promote and support research in autonomous institutions. The Bureau should consist of two economists, two Revenue Service officers, two chartered accountants and a tax lawyer, besides a few research assistants. It would be preferable to bring experienced experts in their respective fields on deputation for two or three years at a time for work in the Bureau. The Fiscal Policy Unit of the Department of Economic Affairs could also work under the Bureau. The Bureau will work under the general directions of the Tax Council and will report to the Finance Secretary or one Member of the Council designated by him.

10

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Introduction (Chapter 1)

10.1 In this Report, the Committee has dealt with and made recommendations on issues in the following five broad areas:

a. Corporate profits tax including the taxation of foreign entities, problems relating to business taxation, the interest tax, taxation of agricultural income, the gift tax and charitable organisations;

b. Further reform of the system of domestic indirect taxes, particularly at the Central level;

c. Improvements in tax administration, procedures, removal of harsh and complicated provisions and appellate procedures;

d. Major problems relating to tax administration;

e. Revenue Audit.

Recommendations in the Interim Report (Chapter 2)

10.2 We would first like to reiterate some of our earlier recommendations in the Interim Report which have not been so far implemented.

a. Direct Taxes: For broadening the base and improving the fairness of the income tax system:

   i. the perquisite value of rent-free or concessional rent residential accommodation provided should be taken to be equal to 20 per cent of the salary or the actual expenditure by the employer, if lower, for those employees whose annual income under the head 'Salary' exceeds Rs.36,000. The taxable perquisite value could be the above perquisite value as reduced by the sum of rent paid and house rent allowance foregone;

   ii. 15 per cent of leave travel allowance, sitting allowances received by members of Parliament and State Legislatures and the fringe benefits implicit in the concessional interest rate charged on loans granted to employees for the acquisition of durable goods and houses should be included in taxable income;

   iii. the allowances exempted from tax under sub-clause (ii) of clause (14) of Section 10 of the Income-tax Act should be limited to 10 per cent of the salary.

In order to induce greater voluntary compliance and to subject the majority of taxpayers to the same marginal rate, the middle rate of 27.5 per cent should be applied to income in the range of Rs.50,000 to Rs.2 lakhs. However, since the Government has fixed the rate 30 per cent last year, it may be retained at that level for the time being.

To remove many of the problems in tax assessment and the scope for harassment of small assessees in respect of the assessment of income from business of smaller assessees whose total turnover is less than Rs 20 or Rs 25 lakh, the estimated income scheme which is an important component of our recommendations relating to hard-to-tax groups should be implemented.

b. Indirect Taxes : We reiterate the recommendations for adopting a simple broad-based domestic indirect tax system with a few rates of duties covering almost all commodities other than raw produce of agriculture and many, if not most, services. For moving towards such a system:

i. The multiplicity of rates of excise duty should be reduced to 2 or 3 rates at 10, 15 or 20 per cent, barring the selective excise duty on non-essential commodities or commodities injurious to health which could be levied at higher rates say 30, 40 or 50 per cent (excluding cigarettes and petroleum products);

ii. The tax base should be enlarged by including services within the tax net and by withdrawing exemption notifications. The selected services identified by the Committee and about 30 commodities hitherto enjoying full exemption should be brought under the extended excise system; and

iii. The law and procedure relating to valuation should be simplified and specific duties should be replaced by ad valorem duties in respect of most goods.

For preventing the fragmentation of the common market, the imposition of the consignment tax should follow an agreement between the Centre and the States to the effect that the Central sales tax and the consignment tax imposed by the exporting State will be given credit by the importing State against the sales tax payable to it by the "importer", that the exporting State will credit the inter-State sales and consignment tax collections to a Central pool and that this pool will be shared among the States on the basis of an agreed formula. If such an agreement proves impossible to arrive at, then the level of the Central sales tax should be gradually brought down to 1 per cent and after that is done, the consignment tax could be levied at the same rate.

Further Reform of Direct Taxes (Chapter 3)

Taxation of Corporate Profits - Domestic Companies

10.3 It is difficult to devise a system of corporate profit tax that would be satisfactory from all the relevant points of view. In India, we follow the classical system which treats corporations as a distinct taxable entity, and thus leads to the double taxation of dividends. Briefly speaking, the following are the deficiencies of the classical system: (a) it discourages distribution of corporate profits and thus affects free flow of funds into new companies; (b) it tends to encourage mergers to the disadvantage of new enterprises; (c) it puts a premium on debt as opposed to equity financing; and (d) the dividend/ retained earnings differential tends to distort the choice between corporate and non-corporate forms of doing business. Hence, the need for integration of corporate tax with personal taxes.

10.4 Full integration system wherein the corporation tax is fully transformed into income tax on the respective shareholders is, however, fraught with insurmountable practical difficulties. Partial integration systems have been adopted in various countries with a view to reducing the dividends/retained earnings differential. In India, the earlier system of partial integration (in vogue till 1960-61) led to considerable administrative and compliance problems. We think that the simplest and fairest method of giving relief from the double taxation of dividends would be to exempt a proportion of the distributed profits from the corporation tax. For the present, we do not recommend

even this for three reasons viz., (i) the total burden of tax on dividend income in any case would be considerably reduced if the corporate and personal income tax rates as recommended by us are adopted; (ii) the whole issue could be re-examined after the findings of the Rudding Committee appointed by the EEC are available; (iii) given the revenue constraint, it is preferable to bring down the corporate profit tax rates to reduce dividend/retained earnings differential.

10.5 The Committee would, therefore, recommend the retention of the existing "classical system" of taxation for the present with the lowering of the corporate tax for all domestic companies to 45 per cent in 1993-94 from the present level of 51.75 per cent by the abolition of surcharge and to 40 per cent in 1994-95. This rate of 40 per cent would not be unreasonable for foreign investors given the spread of the present tax rates in different countries.

10.6 At the same time, the Committee would reiterate its recommendations made in the Interim Report for withdrawal of the concessions under Sections 35CCA, 35CCB, 35AC for making donations to associations and institutions carrying out rural development or any scheme or project for promoting social and economic welfare. This would simplify and improve the equity of the tax system, give less room for tax avoidance and reduce disputes.

Depreciation Allowance

10.7 As in many other countries, depreciation under the Indian Income-tax Act is allowed as a percentage of the historic capital cost of the assets. The replacement cost method of allowing depreciation has not found favour in many countries including India for the reasons that it is not easy to measure or estimate asset-wise replacement costs because of divergent price trends and the cost of replacement is known only at the time of replacement while the depreciation allowance has to be availed of, during the period of use of the asset. Thus, only broad adjustment could be provided for taking care of the rise in the price of the assets. Following the recommendations of the Economic Administration Reforms Commission (EARC), the system of granting depreciation was simplified and the general rate of depreciation of plant and machinery was fixed at 33.33 per cent in 1988-89, merging the various types of depreciation available and to provide sufficient funds to replace capital assets in the context of rising capital goods prices. EARC's recommendations were against the background of a rate of tax of 55 per cent on corporate profits and the top marginal rate of 66 per cent on personal income. The general rate of depreciation was reduced to 25 per cent in the 1991-92 Budget when the corporate tax rate was fixed at 45 per cent.

10.8 We have assessed the funds that will flow to a business if depreciation on plant and machinery (along with interest net of tax) is granted at alternative rates of 33.33 per cent, 25 per cent, 22.5 per cent and 20 per cent. It was seen that with the adoption of the depreciation rate at 25 per cent, the business enterprise would be able to recoup the total cost of the asset within a period of about 5-1/2 years. This is considered quite reasonable by the Committee when it is seen along with its recommendation for lowering the corporate tax rate to 40 per cent. In view of this, the Committee would like to recommend the retention of the general rate of depreciation on plant and machinery at 25 per cent.

Deduction under Section 43B

10.9 Section 43B makes a departure from the well accepted principle of allowing deduction for business expenses on an accrual basis. We are of the view that the use of tax law for collateral purposes, quite apart from complicating the law, is unfair and unjust as it militates against the principle of taxation of 'real' income. However, considering the need for prompt collection of revenue, we recommend that Section 43B should be restricted to taxes, duties, etc. Other items of

expenditure like contributions to provident fund or gratuity fund or any other fund for the welfare of the employees, sums referred to in clause (ii) of sub-section (1) of Section 36 and interest on any loan or borrowing from any public financial institution should be taken out of the purview of Section 43B.

Reconstruction and Other Arrangements of Companies

10.10 Under the present provisions of the Income-tax Act and the Gift Tax Act, capital gains or gift, if any, is exempt from tax in a Scheme of Amalgamation of companies. However, such exemptions are not allowed in the case of Compromise, Arrangement and Reconstruction of companies. The provisions of company law in these cases are similar to the provisions in the case of Amalgamation. The Committee is of the view that there is no likelihood of the abuse of the scheme of Compromise, etc. to defraud revenue, shareholders or the creditors of the company in view of the procedures laid down in chapter 5 of the Companies Act, which empower the High Court to take into account the views and objections of the Central Government, shareholders and the creditors of the company before any scheme is approved. We, therefore, recommend that no capital gains tax or gift tax may be levied in the case of Compromise, Arrangement and Reconstruction. We would also suggest that for removing doubts on the taxability of shares or assets received by a shareholder in a scheme of Amalgamation, Compromise, Arrangement and Reconstruction, necessary clarification may be issued that the provisions of Section 2(22)(a) of the Income-tax Act would not apply in such cases.

Taxation of Non-residents including Indian Branches of Foreign Companies

10.11 Taxation has a significant impact on international investment and financing decisions. Simplicity, transparency and perceived fairness are essential to attract the much needed foreign investment. The Committee is, therefore, of the view that the determination of the proportion of income taxable in India and the deductions in computations should be done within a reasonable time and be fair and just where no specific percentages have been laid down in the law itself. The estimated income approach contained in Sections 44B to 44BBB could be extended to further areas of business activity as that would considerably reduce areas of uncertainty and resultant disputes.

10.12 The Committee would also recommend the amendment to provision under sub-section (2) of Section 195 for enabling the recipient of income also to make an application to the assessing officer for determining the appropriate proportion of income on which tax is deductible.

10.13 The Committee notes that although the intention to introduce the system of advance ruling has been announced in the 1992-93 Budget Speech of the Finance Minister, no further follow-up measures have been taken to implement the intention. The Committee would recommend expeditious action in this regard.

10.14 The Committee considers that the difference between the tax rate on domestic companies (at present 51.75 per cent including surcharge) and the tax rate on foreign companies (at present 65 per cent) is quite large even at the withholding tax rate of 25 per cent on dividends paid to foreign companies. With the reduction in the rate of tax on domestic companies to 40 per cent there will be scope for reduction in the tax rate on foreign companies. The effective average withholding tax rate would not often exceed 15 per cent given the network of tax treaties with almost all developed countries. However, taking the withholding tax rate of 25 per cent the differential between the rates on domestic and foreign companies should be around 7.5 percentage points assuming that half of the after tax profit is distributed as dividend. In any case, this differential should not exceed 10 percentile points.

10.15 The Committee would consider that, as a further measure for attracting foreign investment and foreign technical know-how, double taxation of the foreign company in respect of both the fees obtained for the technical services and the salaries paid to its personnel staffed in India beyond a certain number of days needs to be avoided. The law should be amended for exempting the salaries paid to such personnel from Indian tax irrespective of the length of their period of stay.

10.16 Under Section 10(15)(iv) of the Income-tax Act, interest payable by the Government, financial institutions and industrial undertakings on borrowings abroad is exempt from tax. In the absence of any provision for tax sparing by the home country, the beneficiary of the tax concession is not the investor but the home country. In effect, there is transfer of resources from the host country treasury to the home country treasury. We, therefore, recommend the discontinuance of the provisions in Section 10(15)(iv).

10.17 The Committee noted that there is hardship to non-resident taxpayers in respect of tax liability on account of the interpretation given to Rule 115 of the Income-tax Rules, 1962 for conversion of foreign exchange payments made for royalty, fees, etc., into rupees for purposes of assessing tax. The Committee would, therefore, suggest that where the income has already been remitted, the conversion rate should be the rate at which the foreign currency was actually purchased. Where the non-resident is paid directly in foreign exchange abroad with no remittance from India, the conversion rate should be that applicable on the day the non-resident receives payment. The Committee would recommend the adoption of this amendment with retrospective effect to cover the income for the accounting year 1991-92 on account of the magnitude of the rupee devaluation which took place during that year.

Treatment of losses

10.18 The Committee is of the view that the inequities in the existing scheme of set off and carry forward of losses need to be corrected. We, therefore, recommend as follows:

a. the newly introduced Section 71A in the Income-tax Act extending scheduler treatment to loss from house property should be revoked;

b. the losses carried forward for set off in the subsequent years separately under each head of income like, 'income from house property' or 'profits and gains from business or profession' (other than losses from speculation business or from the activity of owning and maintaining race horses) and 'other sources' should all be allowed *inter se* set off;

c. the condition that the business to which the loss relates should be carried on in the subsequent year in order that the business loss carried forward from the earlier year is allowed to be set off should be removed.

Further, in the larger interest of the economy, the provisions of Section 79 of the Income-tax Act should either be deleted or should be restored to its form as it existed prior to its amendment by the Finance Act, 1988.

Treatment of charities and charitable organisations

10.19 For rationalising the provisions of the Income-tax Act in regard to charities and charitable organisations, the Committee recommends the following:

a. Application under Section 12-A and sub-section (5) of Section 80G should be processed together and with utmost expedition, that is, within a period of three months from the date of receipt of

the applications;

b. Approvals granted and renewals of approvals should be valid for 5 years;

c. Where the income from any business accruing to a trust/institution is not more than Rs.5 lakh, the trust/ institution may continue to be given the exemption irrespective of whether the business is incidental to the attainment of the objectives of the trust/institution or not;

d. The restrictive provisions contained in Section 13 of the Income-tax Act for the withdrawal of exemptions available under Section 11 or 12 need to be reviewed, for avoiding hardship in genuine cases. The monetary limit of Rs.25,000 prescribed in respect of substantial contributions may be raised to Rs.50,000;

e. The last date for filing returns in the case of charitable organisations claiming exemptions under Section 11 and 12 of the Income-tax Act may be fixed at 31st December instead of 31st August as at present;

f. The income limit for Audit laid down in clause (b) of Section 12A may be enhanced from Rs.25,000 to Rs.50,000;

g. There is need to make the law uniform for all charitable organisations irrespective of the dates on which they were set up.

Interest Tax

10.20 The Committee recommends the abolition of the interest tax as it acts as a wedge between the reward to the savers and return on investments.

Gift Tax

10.21 The Committee recommends the continuance of the levy of gift tax, since it discourages transfer of assets for reducing the total tax liability of a family. The exemption limit may, however, be raised to Rs.30,000 from the present level of Rs.20,000.

Taxation of Agricultural Income

10.22 The Committee is of the view that while agriculturists whose income consists of only agricultural income or agricultural income, say, below Rs.25,000 per annum and non-agricultural income below the income-tax exemption limit may not be brought within the income tax net. The agricultural income in excess of, say, Rs.25,000 accruing to the non-agriculturists should be brought under the tax net to promote equity and reduce scope for tax evasion. We recommend that in the case of individuals or any other entities having income from non-agricultural sources above the exemption level and also income from agricultural sources above Rs.25,000, agricultural income in excess of Rs.25,000 accruing to the concerned entity should be aggregated with non-agricultural income and the tax should be levied on the total of such aggregated income. Agricultural income for this purpose will not include income from plantations subject to taxation by the States. The Central Government should obtain the cooperation and consent of the State governments for enacting a provision which would enable it (the Central Government) to bring under the purview of the Central income tax, agricultural incomes in excess of Rs.25,000 of those non-agricultural assessees whose non-agricultural incomes are above the exemption level. The entire tax yield attributable to the agricultural component of income could be distributed among the States on the basis of origin.

Structural Reform of the Excise Tax System (Chapter 4)

The Case for VAT

10.23 The Committee is of the view that the present excise tax system has to be

gradually transformed into a genuine VAT at the manufacturing level particularly because the Government of India has no alternative at least in the near future but to resort to an extended form of excise taxation. Manufacturing under such a VAT should include also 'manufacturing' of services although some services may be exempted for practical considerations.

10.24 An extended excise tax system of the cascading type can be shown to lead to four major types of undesirable consequences. First, the total effective incidence on any given final product at the end of the chain of production would be almost fortuitous and largely unknown to policy makers. Second, it interferes with the producers' choice of inputs, thereby leading to severe economic distortions. Third, it leads to avoidable increases in costs and prices of inputs as well as of final products through the phenomenon of cascading. Fourth, such a cascading type of extended excise tax system combined with a similar type of sales tax superimposed on it acts as a great hindrance to our export effort.

10.25 If exports are to be completely freed of excises, then the tax burden on the final export product arising from the taxation of all inputs and from that of machinery must be removed through set-off. The tax on machinery, if not remitted, will also like the tax on current inputs lead to uncontrolled and regressive incidence, distortions of producers' choices and cascading. It is, therefore, necessary to grant VAT credit also to the tax on machinery.

Transition to VAT at the Central Level

10.26 We urge that the following steps should be taken simultaneously, over the next three to four years, in a phased manner, to reform indirect taxes:

a. Extension of excises to cover most manufactured goods at present exempt and some select services mentioned in the Interim Report;

b. Reduction in the level of rates on some commodities which are unduly high;

c. Gradual reduction in the number of rates moving them towards three rates between 10 and 20 per cent, for all goods that would be covered by the VAT system;

d. Extension of Modvat credit to all inputs that are used in the production of, or incorporated in, taxable commodities except for office equipment, accessories and furniture, building material and a few others;

e. Extension of Modvat credit to machinery not fully at the time of purchase but in instalments during a subsequent period of years which could be laid down in the law; and

f. Extension of VAT to the more important services used by productive enterprises.

Textile Industry

10.27 The textile industry is an example par excellence of concentrating most of the tax at the input stage. This system has several disadvantages. To mention the most important, value added at later stage is not covered by the VAT and hence the tax rates at the earlier stage have to be higher and there is unnecessary discrimination among products with different proportions of value added at later stages. The cost of production is unduly raised by the interest on the duty paid at the earlier stages. What is worse the input tax may form a larger percentage of the prices of the cheaper fabrics.

10.28 There are two other important reasons why steps must be taken to rationalise the excise duty regime for textiles. First, if the existing excise duty regime is not reformed simultaneously with the proposed reforms in customs tariff and import policies, domestic producers of fabrics would be hard hit. The second reason is that as the States

have argued, they have been subjected to a substantial loss of revenue though the exemption of grey fabric and shifting of the tax burden to the yarn stage.

10.29 Therefore, the existing excise duty regime for the textile sector must be reformed in the direction of a VAT system. However, this can be done only in stages because of the peculiar nature of the industry with the predominance of small producers and because of the high level of duties on synthetic yarn, especially filament yarn.

10.30 The first stage of reform should consist of (a) introducing the Modvat scheme till the yarn stage in all sectors and (b) applying the Modvat principle in cotton textiles without subjecting grey fabrics to tax at the present time. The cotton sector is chosen first because India has comparative advantage in this important sector and because the rate of duty on yarn is not unreasonably high.

10.31 We believe that it is possible to introduce the principle of Modvat in respect of cotton textile industry immediately without much difficulty except that the grey fabric stage will continue to be exempt for the time being.

10.32 With the condition that the grey fabric stage will remain exempt from duty for the present, the introduction of Modvat in cotton textiles will cause no problems as far as the composite mills are concerned. As per normal Modvat rules, they are not required to pay duty on the yarn captively produced and consumed while on other inputs brought from outside, set off will be granted against the tax payable at the processing stage. For maintaining revenue neutrality and unchanged final incidence, the duty at the processing stage will have to be raised.

10.33 Since the grey fabrics will remain exempt from duty for the present, the duties paid on inputs would have to be estimated and the system of deemed credit would have to be introduced against the enhanced duty payable on the processed fabrics.

10.34 Once deemed credit is introduced on the basis of a formula based on assumptions, reasonable though they may be, the assessees might, and probably will, start questioning them and ask for changes. We, therefore, suggest an alternative solution to the problem. The proposal is that Modvat credit for tax on all inputs used for the manufacture of cotton textile fabrics be provided to the composite mills and they will be asked to pay Union excise duty on the processed fabrics (in addition to the Additional Excise Duty in lieu of sales tax which they are now paying). The excise duty rate will be so fixed as to roughly neutralise the Modvat credit given in terms of incidence. Since the independent processors will not be within the ambit of the Modvat Scheme, the processed fabrics emanating from them will bear the duty on inputs. The total burden on such duties should be estimated using the same methodology as is done in arriving at the amount of deemed credit. The Union Excise Duty to be levied on the independent processors must be kept lower than that leviable on the composite mills by the amount of burden of duty on inputs. In such a case the independent processors cannot complain of discrimination in terms of higher duty. The Additional Excise Duty in lieu of sales tax is a tax falling only at the final stage and it should be treated separately from the Union excise duty and will not be part of the Modvat scheme.

10.35 We are suggesting extension of Modvat for the cotton textile sector immediately to give boost to export of cotton fabrics and garments. Soon thereafter, the same system should be applied to synthetic and blended fabrics other than those for fabrics made of filament yarn. The entire textile sector industry may be brought under the proposed VAT regime with suitable modifications as indicated above for the decentralized sector only after a period of, say, five years by which time it would be possible to bring down excise duty on filament yarn at similar level to others.

Extension of VAT to the Wholesale Stage

10.36 We would have more rational indirect tax system if the VAT, that is, the reformed Central excise, could be extended to the wholesale stage. By wholesale stage we mean traders who buy from manufacturers and sell to other manufacturers or traders. For purposes of this tax, we may define wholesalers to mean those whose total turnover exceeds certain level, that is, Rs. 50 lakh or Rs 1 crore. They should be subject to VAT in addition to excises payable by the manufacturer. This means only the value added at their hands would be subjected to tax. Manufacturers who buy from these wholesales will also be able to obtain credit for tax paid earlier. Apart from capturing the value added at the hands of the wholesalers, this would provide adequate safeguard against the attempts at under-valuation by the manufacturer to reduce excise liability which is the cause of many disputes in excise. Administratively, it will be convenient if VAT at the wholesale stage is collected by the Sales Tax Department of the States concerned in close cooperation with the officers of the Central Excise Department. The amount of VAT collected could be allowed to be retained by the State where it is collected. The Central VAT can be levied with the cooperation of the States who can be persuaded to accept this levy because their own right to levy the sales tax on goods will in no way be circumscribed and at the same time they will get the entire revenue from VAT at the wholesale stage.

Sales Tax

10.37 As regards sales tax, the Committee is of the view that this tax could be converted into a form of State VAT within the manufacturing sector. There may be no need for levying sales tax at more than two rates since the distributional and other non-revenue objectives could be left to be performed by the Central taxes which apply uniformly throughout the country.

Problems Relating to Tax Administration (Chapter 5)

10.38 The administration of the major Central taxes leaves much to be desired. The root causes for the present unsatisfactory state of affairs in the field of tax administration are: (a) high rates of taxes; (b) multiplicity of duty rates; (c) changes in the law brought about in secrecy and enacted without adequate public consultation and debate; (d) multifarious exemptions, concessions and deductions introduced in the tax laws for achieving many and growing non-revenue objectives and constant changes in the provisions incorporating them; (e) amending rates and granting exemptions throughout the year; (f) the practice of fixing somewhat unrealistic targets of tax revenue collection; (g) fear of Audit; (h) lack of accountability of the assessing officers; (i) tendency to go in for appeals without proper application of mind; (j) relentless pursuit of cases of small short-term revenue gains through prolonged litigation; (k) inappropriateness of the present reward system; (l) inadequacy of the information system; (m) ineffective functioning of the administration and interference in administration by political authorities; and (n) lack of proper and adequate training of officers.

10.39 Apart from what we have already recommended in the Interim Report regarding the changes in the tax structure, some of which have been reiterated in earlier paragraphs, the following are the other measures needed to bring about a significant improvement in tax administration and enforcement:

a. **Stability** - The Government should announce that the practice of introducing changes and concessions in each year's budget is being given up and only the structural reform will be carried out as per a given agenda. The Tax Research Bureau (TRB) whose establishment we are recommending later in the Report should receive all suggestions and study them. On the

basis of such study and its own research, the Bureau can formulate proposals for change which should be circulated to the public for debate and discussion. After full debate these minimum changes could be introduced, if found absolutely necessary, once in five years.

b. **Target fixing** - We cannot overemphasise the harassment caused to the assessees as a direct result of the fixation of unrealistically high targets. It is important that the target should be fixed realistically keeping in view the expected rate of growth of the economy and the likely rise in prices.

c. **Accountability** - The assessing officers should be made accountable for their actions. If the percentage of demands not upheld by the Tribunals is higher than a reasonable figure, say, 50 per cent, the officer should be given a black mark and reprimanded. On the other hand an assessing officer should be protected and defended if he has obeyed instructions of the Board and followed case laws even though Audit might raise objections about his actions.

d. **Changing the perception of the officers regarding their work** - (i) **Training**: The assessing officers should be advised and trained to keep in mind the broader, social and economic aspects and consequences of taxation. It is essential that officers selected for appointment to senior posts are given a thorough grounding in the economic aspects of taxation and made aware of changing international practices; (ii) **Rewards and Punishment**: The attitude and performance of the officer depends much on the system of rewards and punishments. We recommend that instead of giving rewards to individual officers, the bulk of the rewards should be credited to the fund already created in Central Excise and Customs Department for welfare activities for the officers or for distribution on an annual basis among all officers performing well in several areas. We suggest that a welfare fund, similar to what exists in the Excise and Customs Department, may be created for the benefit of the officers of the Income Tax Department too. Rewards in the form of commendations and accelerated promotions should be given to honest and competent officers. Similarly, adverse remarks should be given to officers who fail to complete assessments in time or widen the base or habitually make over-assessments or under-assessments.

e. **Grievance redressal machinery** - The existing grievance machinery and the advisory councils should be activated as these agencies provide a forum for the taxpayers to get their grievances ventilated.

f. **Taxpayer education and publicity** - There is also a need for boosting the publicity campaign of the two Departments, so that there is a greater awareness in the minds of the tax paying public regarding the activities of the Department collecting taxes from them. If considered necessary, expert agencies could be consulted in preparing and publishing tax education pamphlets.

The Role and Impact of Receipt Audit by C&AG

10.40 The following seem to be the major complaints:

a. Too many objections are raised and only a few of these objections finally stand. As a result, the assessees are put to unnecessary trouble and harassment.

b. Audit often interprets the law and sticks to their interpretation, even when the Board clearly opines that the intention of law is contrary to the Audit's view.

c. It tends to place excessive emphasis on the revenue aspect in individual cases.

d. It pays unduly little attention to cases of over-pitched assessment causing long drawn-out disputes and harassment to the assessee.

e. Visits of Audit parties to the factories add to the hardship caused by the visits of lower level tax personnel.

10.41 Questioning by Audit of assessment decisions of a quasi-judicial nature by the Departmental officers has given rise to a wide-spread sense of fear and has resulted in a distinct tendency on the part of the officers to make high-pitched assessments. These do not yield any fruitful result, since, finally most of these assessments are set aside by the appellate authority.

10.42 The Committee is of the view that the action taken by the properly authorised officer should be final as far as the assessee is concerned and it should not be subjected to any change with retrospective date except to the extent there is an error in the assessment as perceived by the officer. The difference in opinion between the Department and the Audit should not result in an audit phobia developing in the tax collection machinery with the consequences that assessments tend to be always high-pitched and in favour of revenue. The Committee would therefore, recommend the following:

a. Direct taxes

i. in cases where audit objections are accepted by the assessing officer, the demand notices may be issued within one month from the date of receipt of the objection.

ii. where the audit observations are not accepted by the assessing officer and referred by him to higher authorities, the demand notice may be issued only for those cases which would get time barred within three months of the date of reference.

iii. in other cases, no show-cause notices should be issued until clear decisions are obtained by the assessing officers from the higher authorities.

b. Indirect taxes

Where the Range/Divisional officer accepts the audit objection, similar action as for direct taxes should be taken. If, on the other hand, the objection is not accepted no demand or show-cause notice should be issued. Where the Range/Divisional officer is not in agreement with the audit observation, a reference should be made by him within two weeks to the Collector who would in turn either communicate his agreement with the audit observation to the Range/Divisional officer for issuing the show-cause notice or refer the matter to the Board within two weeks. If the objection is still found unacceptable, the correct position should be explained to the C&AG's officers. If the Audit's point is conceded, the Board should immediately modify its instructions with prospective effect. This action at the Board's level should be completed within one month. Where, based on the audit objection, change in procedure or instruction is considered necessary, such a change should be brought into effect with prospective effect.

Penalties and Prosecutions

10.43 It is seen that the prosecution cases initiated under the Income-tax Act and Central excise Act take unduly long time for ultimate disposal. The effectiveness of prosecution as a deterrent punishment is therefore considerably diluted. For improving matters in this regard, we recommend the following:

a. **Direct Taxes**

i. the Department should concentrate on large cases and be selective in prosecutions;

ii. prosecution cases, when they are launched, should be taken up seriously by engaging competent Counsel for expeditious disposal. Serious efforts should be made to bring down the existing pendency of prosecution cases;

iii. the general power for launching prosecution for failure to pay in time the TDS under Section 276B and 276BB should be withdrawn and replaced by a specific power for launching prosecution in those cases only where the tax with interest and additional interest remains unpaid after a specified period of time;

iv. the Department should impose late fee or penal interest for technical violations such as those contained in Sections 276B and 276BB of the Income-tax Act instead of launching prosecution proceedings. The levy of such penal interest should be statutorily laid down and automatic;

v. the discretionary penalties under Sections 221(1), 271(1)(b), 271(B) and 272A(2) of the Income-tax Act may be replaced by the imposition of additional interest/late fee;

vi. automatic penalty in the form of a late fee may be imposed in place of penal interest under Sections 234A and 139(3);

vii. the Department should launch prosecutions under Section 276C(2), only if the assessee fails to make the payment for over one year and where prosecutions are launched for technical offences, should compound the prosecutions;

viii. there should be substantial delegation of powers to the Chief Commissioners/Directors General for compounding the penalties, where necessary; and

ix. the levy of penal/additional interest/fine should be as per the scales indicated by us earlier in this Report.

b. **Central excise**

i. prosecutions should be limited only to cases of suppression of production, surreptitious removal of excisable goods, under-valuation where fraudulent intention of evasion of duty is established and repeated offences;

ii. the existing duty limit of Rs.1 lakh for launching prosecution should be increased to Rs.5 lakh;

iii. complaints should be filed in the Court within a period of 4 months from the date of the order of adjudication; and

iv. the prosecution cell should be strengthened by placing a Deputy Collector as the officer in charge and manning it with officers having adequate experience in legal matters.

Settlement Commission

10.44 Unlike in some advanced countries like UK, the power to settle cases has not been granted to the senior officers of the Indian Income Tax Department. Given the fact that Courts ordinarily take long time to decide tax matters, it is useful to have an institution like the Settlement Commission for quick and final settlement of complicated tax cases.

10.45 However, it is necessary to provide adequate safeguards in the law to ensure that the Settlement Commission does not become an easy escape route for tax evaders. We, therefore, recommend the following:

a. Only complicated cases involving disputed facts and questions of law should be settled;

b. The Committee is of the view that the present limit of Rs.50,000 as income tax payable, the cases above which are referred to the Settlement Commission, is too low and it should be increased to at least Rs.1 lakh;

c. The power to object to an application to the Settlement Commission should be given to an officer not below the rank of Chief Commissioner. This will ensure judicious application of this power; and

d. The Settlement Commission should not be given the power to over-rule the objection made by the Chief Commissioner.

10.46 In regard to the proposed Settlement Commission for settling disputes involving indirect taxes, we recommend that the provisions defining its scope and functioning should be the same as those mentioned above.

Computerisation

10.47 No worthwhile improvement in the enforcement of taxes and reduction in the hardship and trouble caused to the assessees can be achieved without full-fledged computerisation. We recommend that technical assistance from the multilateral financial institutions could be availed of, as regards the design of the computer system or if no such assistance is available, an internationally renowned consultancy agency could be hired. A team of officers from the Department should be associated with this exercise.

10.48 In the indirect taxes side, we understand, that the existing facility in the Customs Houses is not being fully utilised. This is partly because of lack of involvement of senior officers in this matter and also hesitation on the part of the Department to replace the manual system by the computerised system. The Committee recommend that professional assistance from a leading consultancy agency should be availed of, to gain maximum benefits from the facility already installed and proposed to be installed.

Office and Residential Accommodation

10.49 Another matter concerning attention for improving the tax administration machinery is the provision for suitable office and residential accommodation for the officers and staff. Office accommodation must be designed in a functionally efficient manner keeping in view the reassignment of assessment functions that may be necessary in view of our recommendations and the planned computerisation programme in both the Departments. The degree of satisfaction in regard to residential accommodation particularly for the junior officers should be increased.

Problems of Administration and Enforcement (Chapter 6)

10.50 The existing direct tax administration is characterised by several major problems: overlapping of functions, lack of real control in the execution of tasks, inefficient manual processes, scattered and deficient guidelines, inadequate arrangements for Departmental representation in legal disputes, lack of a sound information system and deficient facilities which damage the tax administration's image. A global solution to these problems is necessary with the three fundamental objectives of: (a) modernising the administrative system in order to achieve better taxpayer control; (b) correcting structural failures that result in an overlap of functions, scattered or deficient guidelines and lack of continuity and effectiveness of the

processes; and (c) promoting deconcentration.

Taxpayer Identification and Control

10.51 The identification and registration of taxpayers is absolutely essential for developing an efficient tax compliance control system. Taxpayers, both potential and effective, can be identified through information from sources both internal and external. Once these are identified, they must be carefully registered by using indexes and an adequate identification system so that names and addresses of the taxpayers can be cross-verified. Since names and addresses can be changed, it is necessary to use unique identification numbers for taxpayers as a substitute for their names and addresses.

10.52 The identification system should cover all persons (individuals, firms, companies, etc.) engaged in substantial economic activities or in possession of economic wealth which has the potential of yielding income so that all potential and effective taxpayers in the country would be allotted an identification number which could be required to be quoted compulsorily at the time of undertaking a wide variety of transactions. The existing identification system in the form of Permanent Account Number (PAN) is deficient in so far as its coverage of potential taxpayers is too narrow, multiple numbers have been issued to a single person and the system is not available in an on-line PAN directory on an all-India computer network. To remove these shortcomings, the Committee recommends the restructuring of the existing identification system, the existing PAN may be replaced by a new Taxpayer Identification Number (TIN) which should be allotted to, and obtained by, all persons and institutions (individuals, HUFs, AOPs, companies, firms, etc.), *inter alia*, who have shop establishment licences in all cities and towns with population in excess of one million, who are registered as industrial units, who have Central sales tax or local sales tax numbers, who are members of any professional association, who are owners of trucks/buses/taxis/cars, who have credit cards, who are share brokers or small saving agents, who are applying for fixed deposits above Rs.50,000 in a bank or applying to a bank for drafts or telegraphic transfers for amounts above Rs.50,000, and who are selling goods exceeding Rs.1 lakh to the government or a public sector company or a public limited company, and any other persons desirous of obtaining TIN. These persons should be issued a photo-pass containing all relevant information relating to the identification of the entity concerned. The work relating to the allotment of TIN should be through an all-India computer network with an on-line TIN directory so as to eliminate possibilities of fraud through *benami* or multiple numbers. Further, since a large number persons are required to obtain TIN, it is necessary to build up a system of allotment on demand. Until an all-India computer network within the Income Tax Department is developed, the Department should explore the possibilities of either using the National Informatics Computer Network (NICNET) of the Planning Commission or any other all-India computer network for this purpose.

10.53 In order to ensure that a large number of persons obtain the identification number, it is necessary to make the permission for certain transactions, services or investments or carrying on certain trades or professions contingent on the person having a tax identification number. For this purpose, the Committee recommends *inter alia*, non-renewal of industrial license, non-issuance of 'C' Forms and 'D' Forms to dealers, non-renewal of membership of professional associations, non-renewal of registration of vehicles, rejection of applications for 2000 shares or 500 debentures or more, if the statutory requirement to quote TIN is not fulfilled.

10.54 Once a broad-based identification system is developed within the country, a statutory obligation should be cast on all TIN allottees to quote their TIN in all specified economic transactions. Then, all the information pieces relating to a TIN could be

bunched to identify potential taxpayers. All potential and effective taxpayers should be registered in the Taxpayer Master File (TMF) which is the basic and essential control instrument of tax administration. The TMF should include only the taxpayers' basic identification and addresses, and the taxes they are obliged to pay. It is of utmost importance that once the TMF is established, continuous and permanent procedure be implemented to keep the file up-to-date on the basis of information from both internal and external sources. Towards developing an effective TMF, the Committee recommends the revival of the General Index Register (GIR) in the form of TMF, which should contain the basic items of information, number, name, address, TIN, liability to file various returns of the persons' income, wealth, gifts made, expenditure and tax deductions at source. It should also contain the names of persons who are non-filers of returns but have discharged their tax liabilities through tax deducted at source by the employer. Overtime, the TMF should be extended to include all new taxpayers voluntarily filing returns and non-filers who are subsequently established to be taxpayers. A person should be removed from the TMF on the fulfilment of the cumulative conditions that his income is below the taxable limit continuously for a period of three years and he is not liable to file any information return.

Verification System

10.55 The verification system should be designed to allocate the available resources in a manner which will maximise the yield from the system in relation to its operating cost. However, this must not conflict with the basic responsibilities of the tax administration for eliminating or at least minimising the more glaring forms and acts of tax evasion. Hence, the need for dealing with most returns in a summary manner without interacting with the taxpayer, by making adjustments for normative and mathematical errors. However, in order to induce compliance through letting each taxpayer know that he or she could be subjected to strict scrutiny and to increase the general effectiveness of the tax administration, a small proportion of returns needs to be selectively subjected to intense scrutiny.

10.56 Currently, the assessment procedure comprises a scheme of summary assessment of all returns after correcting for arithmetical mistakes and *prima facie* errors, and levying of additional tax, if there is an addition to income by the assessing officer and that of scrutiny assessment of a sample of returns selected non-randomly in accordance with the instructions issued by the CBDT.

Summary assessment

10.57 The new summary assessment scheme was the most intensely debated subject during all evidence before the Committee, whether by officers of the Department or by the representatives of trade and industry. While some advocated the acceptance of returned income without any *prima facie* adjustment or additional tax, others advocated only corrections in the anomalies of the scheme. After consideration of the divergent views, the Committee recommends the continuation of the existing scheme of summary assessment after correcting for arithmetical errors and genuine *prima facie* inadmissible claims and levying additional tax. However, the Committee recommends the removal of the anomalies in the scheme arising on account of the lack of a clear definition of the scope of *prima facie* adjustments and delay in the disposal of applications for rectification of *prima facie* disputes. After consideration of the various issues relating to these anomalies, the Committee recommends the following:

a. The existing scheme of summary assessment after correcting for arithmetical errors and *prima facie* inadmissible claims should be continued.

b. The first proviso to sub-section 1 of Section 143 defining the scope and meaning of the term '*prima facie*'

should be amended. It should be defined to mean:

i. an incorrect claim, if such an incorrect claim is apparent from the existence of other information on the return;

ii. an entry on a return of an item which is inconsistent with another entry of the same or another item on such a return;

iii. an omission of information which is required to be supplied on the return to substantiate an entry on the return; and

iv. an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed, if such limit is expressed -

(a) as a specified monetary amount; or
(b) as a percentage, ratio, or fraction.

and if the items entering into the application of such limit appear on such return.

c. The return of income must clearly indicate, against the relevant item of claim or in the worksheet relevant to the claim, the need for furnishing evidence in support of the claim. The nature of the evidence necessary in support of the claim must also be specified in the return. This evidence should, however, be only for the purposes of processing under summary assessment and should be without prejudice to the degree of proof that may be required to be furnished by the taxpayer under scrutiny assessment. Once the necessary evidence is filed along with the return, the sufficiency of the evidence should be considered or questioned only under scrutiny assessment.

d. In stipulating the evidence required to be filed along with the return of income, caution must be exercised to prevent undue burden of compliance on the taxpayer. Attempt should be to secure only minimal necessary evidence.

e. Audit reports required under various provisions of the Income-tax Act should be merged into a single Audit report which should be comprehensive. For example, Form No. 3CD (relating to the statement of particulars in the case of a person carrying on a business, which is required to be given along with the Audit report in Form No. 3CA) could be amended to seek information on whether payments covered under Section 43B of the Income-tax Act have been made by the due date of filing the return. In that case, the need for separate certificates from accountants as evidence in support of a claim would not be necessary.

f. The return form should be re-designed along the lines of a check sheet to seek specific information and also to provide for logical sequencing of the arithmetical steps for the computation of income. This will help demarcate the scope of *prima facie* adjustments.

g. In the case of depreciation, the incorrect block classification of assets should not be corrected through *prima facie* adjustments. Further, a separate standardised format should be prescribed for depreciation claims, to be appended to the return by only those taxpayers who make such a claim.

h. A claim made on the basis of an Audit report given by an accountant should be corrected if *prima facie* inadmissible, but no additional tax should be levied in such cases. Where the Auditor makes more than a specified number of mistakes, he should be debarred from practice for a certain minimum period.

i. The Department should release annually a booklet codifying the instructions/guidelines on the scope of *prima facie* adjustments as is being currently done in respect of guidelines issued to Drawing and Disbursing Officers (DDOs) for tax deduction at source from salary payments. The booklet must contain examples of *prima facie* adjustments drawn from actual instances reported by the assessing officers. These examples should cover instances to highlight both what can be and cannot be treated as being *prima facie* inadmissible.

j. The existing scheme of set off and carry forward of losses should be rationalised along the lines indicated in the Section on Taxation of Corporate Profits in Chapter 3.

k. No *prima facie* adjustment should be allowed to be made after six months from the end of the month in which the Return is received.

l. The assessing officer should not be allowed to make any *suo motto* rectifications of summary assessment after three months from the end of the six month period for *prima facie* adjustment under summary assessment.

m. The taxpayer should not be allowed to make an application for rectification of *prima facie* adjustment after two years from the end of the assessment year in which the return is filed.

n. The application for rectification of *prima facie* adjustment should be required to be disposed of by the assessing officer within three months from the end of the month in which the application is received. Failure to dispose of the application within the stipulated time should tantamount to acceptance of the contentions of the taxpayer. The Committee is aware that through an amendment by the Finance Act, 1992, 'direct' appeal against *prima facie* adjustment has been provided for, only if the rectification application is not disposed of by the assessing officer within three months. However, we are of the view that this indirect remedy is totally inadequate. There should either be a provision for appeal against *prima facie* adjustment, as was recommended by us in our Interim Report, or as suggested above, the applications for rectification which are not disposed of within, say, three months, should be considered as accepted and effect should be given to them accordingly, within a further period of one month.

10.58 During the course of evidence before the Committee, a large section of the taxpayers questioned the validity of the additional income tax on grounds of arbitrariness, etc., and the instructions of the CBDT to its field formations to the effect that in respect of all returns, first, *prima facie* adjustments, if any, should be carried out, additional tax, if any, should be levied and intimation to this effect should be sent to the taxpayer, and only after that any proceedings for scrutiny of selected cases should be initiated.

10.59 With a view to encouraging voluntary compliance, reducing the discretionary power of the tax administration so as to minimise opportunities for bribery, and reducing the costs of checking the expected excuses that would be submitted for almost every case of arithmetical error and *prima facie* inadmissible claims, it is necessary to build in a system of automatic sanction in the nature of additional tax. The Committee, therefore, recommends the continuation of the existing scheme of levying additional income tax under Section 143(1A) of the Income-tax Act. Further, in the interests of an equitable tax system, it is necessary that taxpayers committing the same fault should be subjected to the same penal consequences. Therefore, the existing policy of first completing every case under the summary assessment scheme and only,

thereafter, initiating proceedings for scrutiny assessment should be continued.

Scrutiny Assessment

10.60 Given the objective of scrutiny assessment, in selecting cases for scrutiny assessment, there must be a combination of the criteria of randomness and probability of evasion. The device of assigning differing scores to various taxpayers for the purpose of chosing the sample, as is done in the USA, for example, is an attempt to combine these criteria. Since the element of randomness is present in such a system, evasion will not be there to be deducted in all cases. Further, in the absence of computerisation of the tax administration, the selection of the sample by a central computer will not be possible. Hence, clear-cut tests or criteria should be laid down for selection and the selection should never be done at the level of the officer who is going to carry out scrutiny assessment.

10.61 Under the rules in force, there has to be a hundred per cent scrutiny of all company and non-company cases where the income or loss is Rs.5 lakh or above; there has to be sample scrutiny in other cases on the basis of the guidelines laid down by the CBDT. The scheme of selection of cases for scrutiny as devised by the CBDT is said to be primarily geared to the objective of reducing the discretionary power of the assessing officer in selecting cases so that the possibility for showing favouritism and getting illegal gratification would be minimised. However, one of the criteria "glaring cases of tax evasion/avoidance" allows for free play of discretion and judgement. Several complaints were made to us by trade and industry representatives that the lower level staff were still (in several cases) trying to extort money through promises to take the taxpayer's name off the scrutiny list. This pernicious practice must be eliminated. The two basic reasons which open up the scope for such a practice are that the selection is made at the level of the assessing officer himself and the criteria laid down leave room for discretion. Further, the element of randomness is also missing in the existing method of selection. Also, no regular procedure has been devised to incorporate any information learned from the statistical analysis of evasion trends. Keeping in view the pitfalls in the existing scheme of selection of cases for scrutiny, the Committee recommends the following procedure for selection of scrutiny cases:

a. The percentage of assessees to be selected for scrutiny should be as follows:

   i. roughly 3 per cent of non-company assessees with income/loss below Rs.2 lakh;

   ii. 4 per cent of non-company assessees with income/loss from Rs.2 lakh upto Rs.9,99,999;

   iii. 33 per cent of non-company assessees with income/loss of Rs.10 lakh and above;

   iv. 20 per cent of company assessees with income/loss below Rs.1 lakh;

   v. 100 per cent of all company cases with income/loss of Rs.1 lakh and above; and

   vi. 100 per cent of all search and seizure cases.

   N.B. The income/loss should be the gross total income as reduced by the amount of unabsorbed losses carried forward from earlier years for set-off against the current year's income.

b. Where 100 per cent or 33 per cent of cases are taken up for scrutiny, for obvious reasons, no special procedures for selection are needed. In the first category each case will be taken up each year and in the second category each case will be taken up every 3rd

year. But for the other categories, the procedure for selection becomes important.

c. The selection should be strictly impersonal, should leave little room for discretion and must be based on weighted random sampling. In the sample selection, certain characteristics of particular trades or professions and items of information received will be used to give weights or scores to various cases in a non-discretionary way to increase the chances of those cases being selected according to their respective scores. Finally, the selection should be made centrally or at a few centres which are not associated with the assessment work.

d. While in the long run, the Income Tax Department ought to aim for a system based on a scoring rule as advocated by expert Committees earlier and as used in advanced countries, such as USA, in the short run a scoring system based on a Taxpayer Compliance Measurement Programme (TCMP) design does not appear to be feasible in the context of a very poor level of computerisation of the Department. However, immediate steps should be initiated to undertake a TCMP study on a pilot basis.

e. Till a proper score system can be developed, one has to be satisfied with some improvement in the existing system. Given the percentages of cases to be selected as recommended by us, it is the selection of cases from among non-company assessees with income/loss of less than Rs.10 lakh that needs to be given the greatest care - these assessees constitute the majority of taxpayers and the percentage of cases to be selected is so small that the manner of selection becomes all important. Among these assessees, those who have opted for the Estimated Income Scheme or the Presumptive Tax Scheme can be kept aside. For the rest of the filers in this category, the following procedure may be adopted.

f. A set of presumptive factors which can be taken as indicators of tax evasion should be identified. The Chief Commissioner/Commissioner of a Charge should prescribe the system of assigning scores to these factors. The assessees should be required to supply certain specific information (not exceeding 10 in number and not involving any additional work or computation on their part) in a form to be attached to the return. This form should be required to be filed by all taxpayers who derive income from business or profession and do not opt for the estimated income scheme recommended by us. The salaried assessees and those with other sources of income should be asked to fill in a different form with less details. The form should be typewritten so as to facilitate automatic reading of the data through *optical character recognition*, thus eliminating the need for costly and delayed manual transcription and verification processes. These forms should be passed on to the Deputy Commissioner of the Range. He would add information obtained from Central Information Branch (CIB) sources. After taking all items of information into account, the Deputy Commissioner will work out the total number of scores to be given to each return. **The selection for scrutiny assessment will be done at the level of Deputy Commissioner.**

g. Where a total of 3 per cent of cases is to be chosen for scrutiny, 2 per cent should be based on the descending order of scores and one per cent on pure random sampling. If the total sample is to comprise 4 per cent, then 3 per cent should be on the basis of descending scores and one per cent on the basis of random sampling. In the case of company assessees with income/loss less than Rs.1 lakh, 5 per cent of the 20

per cent sample should be chosen on the basis of random sampling.

h. The entire sample should not be chosen at one stroke at the beginning of the assessment year. The selection process could be carried out in two (or perhaps even three) stages so that the late filers could also be included in the list for selection with their respective scores. All cases of non-filers should be scrutinised by an officer not below the rank of an Assistant Commissioner. If after scrutiny the total income of the taxpayer continues to be non-taxable, this finding must be taken note of, along with other information on him, in identifying non-filers in the subsequent year. As regards assessees with income from business who have opted for the Estimated Income Scheme, there should be no scrutiny assessment for the first three years in each case. After that period there should be scrutiny of one per cent sample chosen randomly merely to check the accuracy of the gross turnover. For the purpose of scrutiny assessment, a set of clear questions must be framed and the assessee must be asked to provide the answers to these questions. Only if the answers are found unsatisfactory, should the assessee be asked to come to the office of the assessing officer with his books of account.

Taxpayer Information System

10.62 Adequate information concerning taxpayers is essential for scoring additional revenue. The sources of information used by the tax administration to build up an information system may be classified into three main categories: taxpayer declarations, information returns, and information and evidence collected by the Tax Department during the course of investigation.

10.63 Under the system of self-assessment, the taxpayer forms the basic source of information. The taxpayer provides information to the tax administration through returns and accompanying documents. These returns contain valuable information on the taxpayer and his activities. All this information can potentially be used to help gauge taxes due from the taxpayer. In this regard, it is necessary to address the problems of the design of the return form, filing requirements, making returns available and sanctions against non-filing of taxpayer declaration. The Committee, after examining these issues, recommends the following:

a. As against the existing four different return forms applicable to different categories of taxpayers, the return of income should be in seven different forms details of which are contained in para 6.84;

b. The Department should take steps to ensure that forms are easily available to the taxpayers. Forms 1, 2 and 3 should be made available in the major Post Offices in the cities/towns, banks accepting payment of taxes, and all tax offices. Further, Form 7 should be sent to all Drawing and Disbursing Officers for circulation amongst taxpayers. Forms 1 and 2 should be printed, at least every fortnight during the Return filing season, in the local dailies so that taxpayers could use the paper cutting as the Return forms.

c. Return of income should be required to be filed by:

   i. all persons whose total income during the previous year exceeds the maximum amount not chargeable to tax except salaried employees whose income from other sources is totally exempt under the law (e.g., under Section 80-L) or does not exceed Rs.15,000 on which tax has been deducted by the employer at the proper rate. These salaried taxpayers will be required only to submit a simple statement in a special Form (Form

7 referred to earlier), if their taxable income exceeds Rs.50,000;

ii. all companies irrespective of the level of income;

iii. all persons (other than companies) carrying on business whose total turnover exceeds Rs.5 lakh irrespective of the level of income;

iv. all persons (other than companies) carrying on a profession whose gross receipts exceed Rs.1 lakh irrespective of the level of income; and

v. all Trusts under Section 11 to 13.

In the subsequent year, even if the taxpayer does not fall in any one of the categories in (i) to (v) above, he must continue to file the return of income for three consecutive assessment years. If after such three years, the taxpayer continues to remain outside the purview of (i) to (v), has no outstanding recovery of tax dues, and has no appeals pending at any level, he should, in the fourth year, apply in a prescribed form for the removal of his name from the TMF.

d. As against the existing provisions, if a loss return is filed after the due date, the benefit of carry-forward of loss should be allowed to the taxpayer.

Further, on consideration of the various issues and problems relating to collection, collation, dissemination and verification of numerous pieces of information relating to both potential and effective taxpayers, the Committee recommends a new taxpayer information system along the lines indicated in para 6.105.

Tax Account Information System

10.64 The existing information system for collection and recovery of direct taxes is inefficient and unproductive in so far as it depends on manual and repetitive processes and an outdated system of storing information relating to collection and recovery. After consideration of the various issues and problems associated with the information system for collection and recovery, the Committee recommends a new information system known as the tax account information system. This new system will consist of manual and computerised procedures and databases which would enable the Department to keep up-to-date tax information for each taxpayer with respect to debits, credits, analysis, interests, readjustments, payment arrangement and other taxpayer transactions with the administration. This would be used to detect and report delinquent accounts and to provide timely information to other Wings in the Department on the taxpayers' overall tax situation. The method of building this system is described in detail in para 6.119.

Re-assignment of Responsibilities

10.65 The assessing officer is the pivot around which the Income Tax Department revolves. The assessing officers combine in themselves the multifarious functions of assessment, collection, redressal of taxpayer grievances, taxpayer assistance, and furnishing of information for managerial decision-making. The consequence is that much of the time of officers and staff even in assessing charges is spent on duties other than assessment. It is, therefore, not surprising that the quality of scrutiny assessment leaves much to be desired.

10.66 The allocation of duties and responsibilities in respect of collection and recovery of taxes again casts a heavy burden on the assessing officer. The practice of assigning budget targets to assessing officers without reference to the potential, to say the least, is arbitrary in approach, since he has no control over current collections. At best, he could be assigned a target only for arrear collections. The responsibility for arrear

collection, however, lies not only with the assessing officer but also with the Tax Recovery Officer (TRO).

10.67 Yet another instance of holding the assessing officer responsible for a task in respect of which a separate specialised authority has been created is collection of TDS. The Income Tax Officer (TDS), in any case, is required to maintain a register of all persons liable to deduct tax at source. Hence, there is no rationale in assigning the assessing officer and the Income Tax Officer (TDS) the joint responsibility for monitoring collection of TDS. Similarly, the casting of responsibility on the assessing officer for collecting advance tax to meet budget targets is unreasonable. Further, the joint responsibility of the assessing officer and the TRO/Income Tax Officer (TDS) for collection and recovery leads to mis-utilisation of scarce trained personnel through duplication of work, particularly, maintenance of multiple registers and initiation of recovery proceedings against the same taxpayer by both the authorities. In fact, very often, while the TRO and his staff remain under-utilised, the assessing officer and his staff are over-burdened. It is an annual routine for the assessing officer and his staff to spend the first two months of any financial year constructing the arrear demand and collection register. As a consequence, the quality and the quantity of output at the assessing officer level suffers.

10.68 Sample studies of time allocation of the assessing officers and staff in assessment charges as well as discussions with tax administrators and professionals confirm the fact that there is considerable degree of congestion of workload at the assessing officer level, and therefore, a significantly large proportion of the time available to the assessing officer is spent in the discharge of non-assessment functions. Hence, the need for the distribution of work amongst the officers and staff along functional lines.

10.69 The Committee is aware that the functional scheme, whereby, the collection and recovery function were separated from the assessment function was given an experimental trial by the Department in the late 1960's, but was given up soon after primarily on the consideration that all the assessment records had to be shifted to and fro between the assessment wards and the Collection and Recovery Wing, throwing the entire system of record management into disarray. However, since then, the procedure for summary assessment and the volume of scrutiny assessment have substantially changed. Further, it is not difficult to seek a solution to the problem of record management. On completion of assessment, the information relating to assessed tax, amount paid and balance payable/refundable could more appropriately be transmitted from the Assessment Wing to the Collection and Recovery Wing through the medium of assessment scrolls and not through the physical movement of the assessment records as in the experiment in the late 1960's.

10.70 Based on the above considerations, the Committee recommends that the existing system of combining in an assessment officer all the functions of collection and recovery, summary assessment, scrutiny assessment and miscellaneous functions (like rectifications, appeal effects, imposition of penalties, dealing with audit objections, reporting, etc.) should be replaced by a new system based on functional classification of jobs. Under the new system, the collection, recovery and refund functions performed by the assessing officers, the collection functions performed by the Central Treasury Units (CTUs), the TDS functions by the Income Tax Officer (TDS) and the recovery functions by the TRO should be assigned wholly to the Directorate of Income Tax (Collection and Recovery). For this purpose, this Directorate headed by a single Director General (DG), should have its office in each city/town where an income tax office is located. The span of control of the DG should extend over five Directorates of Income Tax (DITs) (Collection and Recovery) with the

jurisdiction of each extending over a well-identified geographical area. The span of control of the DIT (Collection and Recovery) should extend over the Collection Wing, Recovery Wing, and the Refund Wing within such a geographical area.

10.71 While in metropolitan cities and other big towns, both officers and staff should be separately assigned to this Directorate, in smaller towns the Officers performing the assessment function could be assigned the additional responsibility of the office of the Directorate, but the staff could be separately assigned.

10.72 The co-ordination between the Assessment Wing and the office of the DIT (Collection and Recovery) will be done by the Chief Commissioner/Commissioner/ Deputy Commissioner (Range), as the case may be, but the line of command for the officers in this Directorate will be within the Directorate. On completion of assessment, the information regarding assessed tax, amount paid and balance payable/refundable should be transmitted from the assessing officer to the DIT (Collection and Recovery) through the medium of assessment scrolls (and not through physical movement of assessment records). Similarly, information relating to any change in the tax liability subsequently arising from rectification and appeal effect could all flow through the scroll system.

10.73 A change is called for in regard to the allocation of the work of scrutiny assessment. With a view to pooling of experience, improving the effectiveness of assessment, increasing the level of supervision and thereby ensuring greater accountability, it is necessary to change over from the present system of single officer based assessment by Deputy Commissioner (Assessment), Assistant Commissioners and Income Tax Officers to a system of group assessment in which the work of the assessing officers could be more effectively supervised by senior officers. Each group should consist of one Deputy Commissioner (Assessment) and a designated smaller number of Assistant Commissioners and Income Tax Officers, along with complementary staff. The Deputy Commissioner would decide the allocation of the files for scrutiny among the officers working under him. He would also be responsible for supervising closely the scrutiny assessment work of those officers, although the officers themselves will be finally responsible for the assessment. We understand this system is in a sense already in vogue in the Central Circles where large cases are assessed. It must be ensured that a uniform degree of supervision, to the desired extent, is given in all those circles. It would be highly desirable that, in course of time, the same system is extended to cover the smaller cases also. However, if all scrutiny assessment cases are brought under the system of group assessment, there would be a need to increase substantially the number of posts of Deputy Commissioners in the Department. As the number of searches and seizures are reduced, some posts of Deputy Director of Income Tax (Investigation) engaged in work connected with search and seizure could be converted and the posts of Assistant Directors/Assistant Commissioners now engaged in the same work can be released and their posts upgraded. In addition some new posts might have to be created. The Committee believes that the creation of the extra posts would be worthwhile in terms of improvement in the quality of assessment, reduced harassment to the smaller taxpayers and increased public confidence in the system of scrutiny assessment.

Search and Seizure

10.74 Searches and seizures are used by the Income Tax Department as a method of gathering direct evidence of income and wealth tax evasion. Section 132 of the Income-tax Act gives powers to certain categories of empowered officers to authorise any Deputy Director/Commissioner, Assistant Director, etc., to enter and search any premises or persons in those premises if the empowered officer has reason to suspect that books of account or money or other valuables

are kept in those places. A search can be authorised only if the authorising officer has reason to believe that the person concerned has not produced the documents when asked to do so or would not produce the documents or the person is in possession of money or other assets which represent income or property which has not been or would not be disclosed.

10.75 From the provisions of Section 132 it is clear that a search can be authorised only if on the basis of sufficient evidence the officer concerned has reason to believe that the money or assets have been secreted in the premises or that documents that would not be produced are kept there. Second, the main object of the search is to unearth the documents and/or assets.

10.76 The Income Tax Department has been resorting to this method of tackling evasion on a fairly substantial scale (in recent years 3500 to 5500 searches per year). The search and seizure operations would have a deterrent effect if they are conducted after gathering reliable information and if they are followed quickly by successful prosecution of the offender. In practice, the search and seizure operations do not seem to be producing the deterrent effect to the desired extent.

10.77 In the circumstances prevailing in our country it may be necessary - however unfortunate that may be - to continue to empower the Income Tax Department to conduct searches and seizures where there is clear evidence that a tax evader has concealed in certain premises, documents and assets which cannot be reached except through a search. However, since the right to privacy is a fundamental right without which the gift of personal freedom will lose its meaning, it is extremely important to provide safeguards against possible excesses by the executive branch of the Government so that unreasonable invasion of privacy and the violation of other fundamental rights could be prevented.

10.78 While searches and seizures would be required to some extent, they cannot be a substitute to the building up of a comprehensive information system which alone would make possible the effective enforcement of taxes. As the information system is built up, the number of searches and seizures should be gradually cut down. As things stand, nearly 27,000 assessments relating to searches and seizures cases are pending and too many Assistant Commissioner level officers are tied up in this work (that is, seizure and assessment of seizure cases), considering the extra revenue produced.

10.79 The Committee wishes to make the following recommendations to make search and seizure operations effective, to prevent excesses and to prevent the restrictions being placed on the rights of individuals beyond a reasonable degree:

a. Section 132(1) should be amended to say that only an officer of the level of Chief Commissioner or where in a charge there is no officer of the level of Chief Commissioner the senior most Commissioner, can authorise a search under that Section. That section should also be further amended to say that only an officer of the level of Deputy Commissioner or Assistant Commissioner can be authorised to conduct a search and that he could be assisted by Income Tax Officers.

b. The major focus of the search must be to unearth documents, revealing concealed income as well as assets such as money, jewellery and other valuable articles. Section 132 authorises the search officer to record a statement by any person found in the premises which may be used in evidence before any Court proceedings. Since interrogation is not a part of the object of the search, it must be ensured that the assessee is not interrogated under intimidation and is not coerced into making a confessional statement. For this

purpose it is necessary to permit the assessee to call a lawyer to be present when he makes the statement. The lawyer can be one of the members of a panel approved by the Ministry of Law. Besides, the provision for paying part of the additional tax collected on the basis of the search and confession as a reward to the members of the search party must be removed.

c. Since the Income Tax Department does not have the power to arrest and the ground rules announced on the floor of the Parliament in 1987 specifically lay down that the income tax authorities shall have no power to arrest, the general practice of the search party preventing an assessee whose premises are searched from leaving the building to attend to his work must be discontinued. After the person has made the statement required he should be allowed to leave. There is no justification for amending Section 132 as was proposed in the Finance Bill, 1992.

d. After the search is over the search party should hand over to the persons concerned copies of statements made on oath by them.

e. In the course of a search, the property belonging to the owner of the premises is often damaged by the search party. In order to minimise damage every search party should be asked to use metal detectors first to find out if articles are concealed in walls, within mattresses, etc. If damage is done but no concealed articles are found, then the Income Tax Department should be required by law to repair the damage done and to restore the articles to their previous state.

f. If search and seizure are to become an important instrument of deterrence, there must be speedy prosecution of cases of large scale evasion unearthed by the search party. It would be desirable to set up a Special Court whenever within a region there are large cases of suspected tax evasion together amounting to not less than Rs.5 crore.

Advance Tax

10.80 With the amendment introduced by the Finance Act, 1992, which has increased the proportion of the first instalment from 20 to 30 per cent, there would be greater probability of having to pay interest on shortfall in the first two instalments owing to unforeseen income arising particularly in the last quarter. To the extent that the new provision requires a high proportion of tax on the total income, which cannot be estimated precisely, to be paid within the first six months it makes compliance difficult. In order to mitigate the hardship caused by this amendment, the Committee recommends that interest under Section 234C should not be levied in cases where the first and the second instalments of payment of tax by the assessee are each equal to 30 per cent of the tax liability on the basis of the returned income of the immediately preceding assessment year. Interest should continue to be chargeable if payments by 31st March fall short of 90 per cent of tax on the basis of current year's income.

Direct Taxes Code

10.81 The objective sought to be achieved by a single direct taxes code is uniformity and simplicity with regard to the legislation concerning direct taxes, which is desirable. However, the Committee is of the view that before enacting the direct taxes code the Government should first consider the Committee's recommendations and take a final view in that regard so that the code is not required to be amended after its enactment.

10.82 In view of the above, the Committee recommends that the entire matter regarding the introduction of a direct taxes

code should be postponed till such time as the law, after implementation of this Committee's recommendations, has stabilised. Further, before undertaking codification, the arrangement of the Sections in the code and the language used therein should be referred to a Committee of Experts to ensure that unintended changes in the provisions do not occur.

10.83 The draft code should be given wide publicity so that public debate and informed comments or opinions arising therefrom could be taken into account before finalising the code.

Problems of Administration of Indirect Taxes (Chapter 7)

10.84 The problem areas which the Committee has identified are :

a. a complicated code of rules and procedures in the Central Excise Act and Rules;

b. procedures not getting updated with the changes in the administrative structure;

c. inadequate inspection system;

d. outmoded reporting and monitoring system;

e. lack of training of officers particularly in specialised functions and improper placement of officers;

f. frequent changes in the rates and procedures without adequate preparation at the field level;

g. classification of goods for assessment of duty;

h. valuation in Central excise;

i. short recovery and refund;

j. huge pendencies in respect of provisional assessments;

k. lack of customs expertise in Central Excise Collectorates;

l. poor testing facilities in the customs and excise laboratories;

m. a tendency to overassess for fear of Audit;

n. inordinate delay in the disposal of appeals at the level of the Tribunal; and

o. inability of the manual system to cope with the increase in the number of documents to be processed and lack of commitment on the part of the system as a whole to computerisation.

Updating and simplification of procedure

10.85 When the Department undertakes newer duties and responsibilities, it is necessary that the system is geared up as a whole by making necessary changes in training curricula, audit procedure, anti-evasion measures, computer software, inspection methodology, etc. We would recommend that such updating may be attempted every year. One way of making this exercise would be through a workshop to be organised by the Training Academy, with participation by policy makers and middle level officers in the field.

10.86 We hope that the exercise to prepare a common customs and excise code already started by the Committee of Experts, would result in a review of the existing procedures and help in updating them with reference to the existing administrative set up and changes likely to be brought about after considering the recommendations contained in this Report.

Inspection and monitoring

10.87 It is important that the inspection system is reactivated to ensure accountability of the various levels of revenue

administrators. The Board, with the assistance of Principal Collectors, should ensure that the schedule of inspection is strictly adhered to and that there is proper follow-up action.

10.88 It is necessary that Departmental manuals are updated taking into account modifications in the procedures likely to be brought about in the near future.

10.89 The Committee would also urge the government that a new management information system may be worked out using the modern communication facilities already available with the Department. With the establishment of the computer network, the present system of submission of periodic returns could be dispensed with.

Training

10.90 The Committee is of the view that the time has come to assess the training needs of the officers of the Customs and Excise Department afresh and to draft an appropriate training policy and work out details of training modules.

Publication of Draft Notification regarding Changes in Procedures

10.91 We would suggest that every proposed change in the procedure of duty collection may be first published as draft notification inviting comments of the assessees and other concerned and finalised after taking into account their views. The Committee would urge that it should be ensured that the notifications are published on the same date on which they are issued so that there is no legal ambiguity regarding the date on which they come into operation.

Classification

10.92 The problem of classification will be reduced considerably with the simplified rate structure and the issue of a Tariff Guide containing directions of the Board in respect of all excisable and imported goods which will be binding on assessing officers.

Valuation in Central Excise

10.93 In regard to valuation of excisable goods the precise scope of the various provisions in Section 4 and the valuation rules with regard to admissibility or otherwise of the deduction of various expenses for the purpose of arriving at assessable value are still not clear. In fact, the Supreme Court had to recall its judgment in Assistant Collector of Central excise *vs* MRF Ltd. [1987 (10) ECR 625 (S.C.)] because of the inconsistency in the impugned judgment with the law laid down by the Court in the Supreme Court's earlier decision in the case of Union of India *vs* Bombay Tyres International Ltd.[1983 ECR 1627D (S.C.)].

10.94 Having regard to this background, the Committee had made certain recommendations in the Interim Report. One of them related to the fixation of tariff value. The Supreme Court has recently decided the Century Manufacturing Company's case in favour of the Government. We suggest that the Government can take recourse to fixation of tariff value for suitable commodities such as sugar, acids, gases, caustic soda and aerated water. We had also suggested assessment of certain selected goods notified under Standards of Weights and Measures Act, 1976 on the basis of maximum retail price fixed thereunder.

10.95 The Committee had observed that as the Modvat or the VAT system gets extended and becomes the main plank for raising revenue from domestically produced goods and services, it would be necessary to move over to a system of assessment on the basis of invoice value. To start with, invoice value can be adopted for industrial inputs. However, ultimately the Department has to adopt the invoice value as the measure of assessment in all cases covered by Modvat (and later VAT) except the goods which can be assessed to duty on the basis of tariff value and on the basis of maximum retail price. As regards allowing various discounts from the

invoice price to arrive at assessable value, we suggest that the international practice may be adopted in this regard. It would also be necessary to move away from one to one correspondence between individual units of goods cleared and the invoices raised at the depots, in the case of depot sales. If invoice is accepted as the basis for assessment of Central excise duty, there will be no need for filing of price lists and, therefore, the time and effort spent in processing price lists could be more effectively used for market inquires and investigation of cases of under-valuation.

Short Recovery and Refunds

10.96 We recommend that the time limit for demand of duty short-paid or short-levied should be brought down from six months to three months. Similarly, the period of refund may also be reduced to three months which will also ensure that the number of cases of unjust enrichment is limited to the minimum. The Government may take a view in this matter after the Court decides the legality of the provision enacting the doctrine of unjust enrichment.

10.97 Considering the revenue bias often discernible in the case of many officers at the lower level, Section 11A of Central Excises and Salt Act and Section 28 of the Customs Act were amended in 1985 giving the power of demanding duty for the the extended period of five years to Collectors to ensure its more judicious application. This power has however, been given back to the 'proper officer'. The Committee would suggest that the position in the law, prevailing before the amendment in this year's Budget, should be restored.

Pendency of Provisional Assessments

10.98 The Committee would recommend that a time limit of six months may be fixed for finalisation of provisional assessments except in exceptional cases like those relating to variation clauses in contracts. There could be similar time limits for finalisation of classification lists and price lists in the case of Central excise duties.

Customs Expertise in Central Excise Collectorates

10.99 We recommend that the existing vacancies in the cadre of appraisers should be filled up and regional cadres of customs appraisers, transferable within Central excise collectorates of the region, should be created. This is necessary for handling increasing quantum of customs work in Central excise collectorates.

10.100 **Other Points**

a. **Procedure of collection of excise duty on matches and cigarettes**: The Committee feels that considering the relative insignificance of the revenue from matches, the feasibility of doing away with bandrolling of matches should be examined. Cigarettes on the other hand account for a substantial portion of the Central excise revenue and this commodity lends itself easily to the system of collection of duty through bandrolling. The feasibility of such a system should be examined.

b. **Excise documentation**: The statutory form of gate pass for removal of excisable goods should be suitably amended to indicate the total duty paid in words. This is essential as this may minimise the chance of the figures getting fraudulently changed with a view to getting a higher amount of Modvat.

The Committee is of the view that while control should be exercised at the time of removal from the factories, there is no reason why assessment procedure and documentation should be different for commodities subjected to physical control such as tyres, PSF etc., from what is applicable to other commodities under Self Removal Procedure.

c. **Reversal of Modvat credit on inputs**: In regard to clearance of inputs in respect of which the credit is already taken under Modvat, it should suffice if the credit taken initially is merely reversed.

d. **Clearances of imported goods**: Learning from the beneficial results obtained from the limited Gold Import Scheme, we would recommend that the Government should introduce a special scheme in respect of baggage of those returning to India after a stay abroad of at least six months. The rate of duty on the dutiable goods contained in the baggage of these passengers in excess of Rs.3,000, should be 100 per cent if paid in foreign currency, upto a limit of Rs.1 lakh (value of goods). Such a scheme will enable the Government to earn foreign exchange, while giving adequate protection to domestic industry. The value limit of import of parcels by post free of duty was fixed quite sometime back. The Committee, therefore, feels that there should be an upward revision of this limit.

Having regard to the need of the consuming industry and the high level of financing cost, we recommend that the period of warehousing should be increased to a minimum period of three months from the existing period of one month.

In regard to the incorporation of tariff and exemption notifications in the computer data bank, the Committee would recommend that the Harmonised System of nomenclature which is available in the form of floppies with the Customs Cooperation Council can be fed into the computer. In addition an alphabetical index of all goods imported, indicating the customs classification and current rates can also be evolved, which should be available on tap in all of the terminals throughout the country. This will greatly facilitate classification of goods for purposes of customs duty.

e. **Dissemination of information regarding international customs experience**: We recommend that an international division may be set up in the Board under a senior officer not below the rank of a Director for collection and dissemination of information relating to international experience in customs administration and to deal with international conventions relating to customs matters. This division could also collect and transmit publications of the Customs Cooperation Council and foreign customs administrations among the Custom Houses.

f. **Computerised manifest clearance**: The Committee is of the view that the delay in manifest clearance could be reduced if the shipping agents supply the manifest in diskettes or floppies which could be processed in the computer.

g. **Field security at the airports**: The security at the airports and docks would have to be tightened considerably in order to safeguard revenue. This would require provision of adequate manpower and modern gadgets like closed-circuit televisions.

h. **Drawback**: We suggest that the Board may consider to what extent the computer facility can be made use of, for expediting the drawback rate fixation.

i. **Augmenting staff for additional work**: The Committee feels that there should be automatic sanction of staff on the basis of norms to be evolved wherever a new unit like Inland Container Depot (ICD), air cargo complexes and Container Freight Station (CFS) are established.

should be given to the field formations to ensure that such disputes do not occur in future.

10.110 We feel that there has to be a substantial improvement in the quality of Departmental Representatives for safeguarding the interests of revenue. The Government can get much more by giving a little, by way of incentives, to the Departmental Representatives. We, therefore, recommend that a special pay should be given to the Departmental Representatives at the same rate as given to the faculty members in the training establishments. This will make the Departmental Representatives more motivated and help in presenting the Department's case more effectively before the Tribunals. Government revenue will be in safer hands as special pay will surely attract better talents in the Department, who by virtue of their merit, experience and professional qualifications will be more equipped to meet this challenging task.

10.111 The work facilities for the Departmental Representatives also need to be improved. The Departments should codify all case laws on different points of law with the help of computer experts. The computer cell in the office of CDR should provide the necessary details of relevant case laws to Departmental Representatives for arguing their cases. The Collector/Commissioner should send the concerned files and a brief note surveying relevant judicial decisions on the same matter or similar matter well in time. In order to ensure more effective cooperation from Collector/Commissioner, we suggest that a very senior Collector/ Commissioner should be posted as Chief Departmental Representative in CEGAT/ ITAT. The CDR in the apex Tribunal should be of Principal Collector/Chief Commissioner's grade.

10.112 The vacancies in the post of Members of the Tribunals and their secretarial staff should be filled up immediately.

10.113 We urge that the decision of the Government to set up a National Court of Direct Taxes and to revive the Central Revenue Tribunal for excise and customs should be implemented without any further delay.

10.114 The Committee, however, suggests that these two Tribunals should be integrated into one apex body, called the National Revenue Tribunal (NRT) with two separate wings for direct taxes and for Central excise and customs. Such an arrangement will have some inherent advantages like having common infrastructural facilities. The judicial members for this Court could be appointed for both the direct and indirect taxes. Since the choice will be wider, a larger number of candidates will be available for these posts.

10.115 The Committee is of the view that the Department of Revenue should not have any administrative control over the CEGAT and the proposed new Tribunal, and the Ministry of Law should be charged with the administration of these two institutions, just as that Ministry is administering the ITAT now. Simultaneously, the terms and conditions of service of the Members of CEGAT and ITAT should be equated.

10.116 The Committee is of the view that there should not be any difference in regard to the channel of appeal against the orders of the two Tribunals, i.e., CEGAT and ITAT, once NRT comes into being. Appeals against the orders of Collectors in respect of classification and valuation matters should continue to be filed before the Special Benches of CEGAT but the appeal against the decision of the Special Benches in such matters should lie with NRT.

10.117 Each bench of the new appellate body should comprise at least one Member (Judicial) and one Member (Accounts)/Member (Technical).

10.118 Since the new Tribunals would be performing the same functions of a

Appeals and Appellate Procedure (Chapter 8)

10.101 The Committee has identified the following problems, in regard to the system of appeals:

a. huge pendencies at all appellate levels of the appeals under direct tax laws; large number of pendencies in CEGAT of appeals under customs and excise laws;

b. absence of clear-cut guidelines to guard against frivolous appeals;

c. inadequate infrastructural facilities and support to appellate authorities and members of the Tribunals as well as to the Departmental Representatives; and

d. selection of unsuitable personnel as Departmental Representatives and the absence of requisite training programmes for them.

10.102 The Committee is of the view that the average time for disposal of appeals at first appellate stage should not exceed a period of six months. In the case of direct taxes, the pendency of appeals before the first appellate authority has increased to more than 1.5 lakh. We, therefore, suggest that a suitable number of temporary posts of Commissioner (Appeals) may be created for a period of two to three years to reduce the average time for disposal to not more than six months.

10.103 The pendency position in the two Tribunals is worsening with the net addition of about 25,000 cases per year in ITAT and about 6,500 cases per year in CEGAT to the already staggering level of pendencies.

10.104 The huge pendencies in the Tribunals can be attributed to the following : (i) too many appeals without application of mind; (ii) repetitive appeals; (iii) under-staffed Benches; (iv) seeking of frequent adjournments by both the Department and the taxpayer; and (v) lack of co-ordination between the Chief Departmental Representative (CDR) and the Collectors/Commissioners.

10.105 The Committee is however of the view that the problem of huge pendencies and denial of quick justice cannot be effectively tackled unless we strike at the root of the problem, namely, generation of too many appeals. With the implementation of our recommendations on changes in the tax structure which would have the effect of reducing the institution of appeals at the first appellate stage, the institution of appeals to the ITAT/CEGAT would be reduced consequently.

10.106 If the first appellate order goes against the Department, it should take a decision whether a second appeal needs to be filed well before the finalisation of assessment for the subsequent year. In case the first appellate order is accepted, the assessing officer would not repeat the additions in the subsequent year and thus repetitive appeals to the Tribunal would be avoided.

10.107 The Committee strongly feels that appeals should not be preferred by the Department in a routine manner. The Collector/Commissioner should be held accountable for the wastage of time and resources of the Department and the Tribunals by making frivolous appeals.

10.108 The CBDT has prescribed a monetary limit of Rs.10,000 as the tax liability for fing Departmental appeals to ITAT. We suggest that this limit should be increased to Rs.25,000. The CBEC should also prescribe the same monetary limit. These limits shall apply only to disputes which relate to procedural matters where no substantial question of law is involved.

10.109 The Boards should ordinarily accept the decision of the Tribunal and once it does so, a corresponding amendment of law should be made or a suitable instruction

Collector should informally get to know the names of the really corrupt officers within his jurisdiction. He could have informal discussions with those Commissioners/ Collectors who are themselves persons of integrity. Then every year, he should send to the Vigilance the names of a few officers who have the worst record in terms of corruption through a secret memo. When a strong case has been built up, the CBI should be asked to take over the case.

10.126 The second important way of getting rid of really corrupt officers is to invoke the provision FR 56J.

10.127 Thirdly, appointment to sensitive posts and where scope for corruption is large must be made with great care and only the most honest and able officers should be given those posts. Transfers and appointments to the so-called "lucrative posts" through political patronage must be completely stopped. Proper guidelines could be laid down by the political authority, but the power to transfer must be with the Boards and the designated authorities at different levels.

10.128 In order that the scheme outlined above may operate successfully, it is essential that the entire task of transfers and postings must be within the jurisdiction of the Boards. The political authority may be kept informed of what is being done, but a self-denying ordinance on the part of Ministers is called for.

Recruitment to Group 'A' Revenue Service, Training of Officers and Promotion Prospects

10.129 We feel that the age limit for the Revenue Service examination should be lower than in the case of other Services. The chances of bringing about the correct attitudinal changes in the recruits is far greater if the age of entry is lower.

10.130 At the level of Deputy Commissioner/Deputy Collector the officers should be subjected to rigorous training for at least a minimum period of three months. In the training course the officer should be made to understand through proper study the broader social aspects and the economic consequences of taxation. Obviously the trainers should be selected with care. The services of an institution like the National Institute of Public Finance & Policy (NIPFP) could be utilised for conducting some of the courses mentioned above. Promising officers of the two revenue services should also be given adequate opportunities of studying at first hand the taxation system in other countries, particularly those that have carried out tax reforms and modernised their tax administration.

10.131 It is important that the morale of the honest and competent officers in the two Departments is kept high by providing enhanced opportunities for deputations to Central Ministries particularly at the middle and higher levels on par with what is available to the best among the organized civil services.

Constitution of the Boards and their Autonomy

10.132 As regards filling the vacancies in the Board, a rule should be adopted that amongst the four senior most people, the most meritorious will be chosen to fill a vacancy that arises in the Board subject to the condition that the candidate should have at least 12 months of service left. However, once appointed, the officer concerned should be allowed to have a minimum tenure of two years as member of the Board. Among the Board members, normally, the chairmanship should go to the senior most officer who should have at least one year of service left. This condition should be relaxed in the case of members who have put in at least three years of service in the Board, and therefore, will be in a position to settle into the new job without much preparation and study. Once appointed the Chairman should be allowed to continue for a minimum period of one year or till the end of his service, whichever is longer.

High Court in so far as they relate to tax matters (except writs), the terms and conditions of service of the members of these Tribunals should be at par with those of the judges of the High Court. Similarly, the Chairman of the new appellate body should enjoy the status of the Chief Justice of High Court.

10.119 In order to guard against institution of frivolous and unnecessary appeals, we recommend that there should be an admission procedure as provided under Section 100 of Civil Procedure Code before any appeal is instituted in ITAT/CEGAT and the National Revenue Tribunal.

10.120 We also suggest the creation of additional Benches in CEGAT and ITAT for a specified period to clear the backlog of pending appeals.

10.121 In a recent case, the Supreme Court has observed that in the case of a dispute between the Government and public sector undertakings (PSUs), a clearance for litigation from an Inter-Ministerial Committee has to be obtained but for which no Court or Tribunal would admit such dispute for hearing. While we appreciate that prolonged litigation between Government Departments and PSUs means only wasteful expenditure, we are of the view that the solution has to be found otherwise than by a clearance procedure. While the Appellate Tribunal may continue to deal with appeals relating to issues even without the clearance from this Committee, a machinery may be set up within two Boards to go into the question of maintainability of the stand taken at lower levels regarding the tax liability of the PSUs and to issue proper directions.

Personnel Policies and Administrative Structure (Chapter 9)

Recruitment, Promotion and Evaluation of Performance

10.122 In Central Excise and Customs as well as Income Tax Departments, the promotions, by and large, are by selection according to the merit-cum-seniority principle and merit is judged solely on the basis of Confidential Reports (CRs). We are of the view that the CRs by themselves cannot be considered to be the test of merit unless they become more reflective of the actual proficiencies and deficiencies than they are now. We think that it is possible to pick out honest, diligent and intelligent officers through the proper wording of CRs and indicate in a "negative" way which officers and staff do not possess these qualifications. We recommend that in considering the suitability of candidates for promotion to an important position like Income Tax Officers a combination of criteria should be used - seniority, the results of a Departmental written examination and an interview and CRs.

10.123 The Departmental examination for promotion from a lower post to higher post should be of a much higher standard and conducted in greater secrecy, than now, either by an external agency or by one of the Directorates under the Boards.

10.124 Honest, hard-working and intelligent officers constitute the basic foundation for good tax administration and in a Department which collects thousands of crores of rupees, it is extremely important that honest and diligent officers are not only supported but also sufficiently rewarded. We would strongly recommend that, if the CRs are used as we have suggested as a tool for distinguishing and picking out officers of outstanding merit, a higher proportion of promotions to ranks above the level of Assistant Commissioner/Collector should go to officers of outstanding merit, subject to their satisfying other conditions.

Tackling Corruption

10.125 We recommend a three-pronged approach on this matter. First, the Vigilance machinery should be used more purposely. The Chief Commissioner/Principal

10.133 We recommend that (a) the two Boards should be given financial autonomy with separate financial advisers working under the supervision and control of the respective Chairmen; (b) the Chairmen of the two Boards should be given the status of Secretary to the Government and the members the rank of Special Secretary; and (c) the post of Revenue Secretary should be abolished.

10.134 Though the two Chairmen will be accountable to the Finance Minister in so far as matters relating to tax administration are concerned, the Finance Secretary should exercise overall supervision and coordination particularly in relation to the formulation of tax policy and changes in the tax law. We recommend that a Tax Council be constituted with the Finance Secretary as the Chairman and with the Chairmen of the two Boards, Member (Budget, CBEC), Member (Legislation, CBDT), Secretary (Economic Affairs) and Chief Economic Adviser as Members of the Board. All matters relating to tax policy and changes in law should come to the Tax Council and proposals in this regard would be submitted by the Finance Secretary to the Ministers. This Council would be serviced by a Tax Research Bureau consisting of experts. The Bureau should consist of two economists, two Revenue Service officers, two chartered accountants and a tax lawyer, besides a few research assistants. It will conduct research in problems of tax policy under the general direction of the Tax Council and will report to the Finance Secretary or one Member of the Council designated by him.

APPENDIX I

LIST OF ORGANISATIONS AND INDIVIDUALS WHO SUBMITTED MEMORANDUM OR GAVE EVIDENCE BEFORE THE TAX REFORMS COMMITTEE

Organisations

1. M/s Modi Enterprises, Modinagar
2. M/s S.S. Kothari & Co., New Delhi
3. Taxation Bar Association, Hoshiarpur
4. Federation of All India Exporters, New Delhi
5. Federation of Indian Plywood & Panel Industry, New Delhi
6. M/s Harinagar Sugar Mills Limited, Bombay
7. M/s Khandu Ballal, Bombay
8. M/s Millipore (India) Pvt Limited, Bangalore
9. ANZ Grindlays Bank
10. Traders Action Committee for Taxation Matters, Delhi
11. Indian Spinners' Association, Bombay
12. M/s Waters (India) Pvt Limited
13. Indian Chamber of Commerce, Calcutta
14. Associated Chambers of Commerce & Industry of India, New Delhi
15. Federation of Indian Chambers of Commerce & Industry, New Delhi
16. Confederation of Indian Industries, New Delhi
17. All India Manufacturers Organisation, Bombay
18. Federation of Indian Export Organisations, New Delhi
19. Punjab Haryana & Delhi Chamber of Commerce & Industry, New Delhi
20. All India Life Insurance Employees' Association, Bombay
21. The Divisional Chamber of Commerce & Industries, Kota
22. Bengal National Chamber of Commerce & Industry, Calcutta
23. M/s ITC Limited, Calcutta
24. Federation of Rajasthan Trade & Industry, Jaipur
25. M/s MRF Limited, Madras
26. Bombay Chamber of Commerce & Industry, Bombay
27. Association of Company Secretaries, Calcutta
28. M/s G.P. Agarwal & Co, Calcutta
29. The Federation of Andhra Pradesh Chamber of Commerce & Industry, Hyderabad
30. Association of Man-made Fibre Industry of India, Bombay
31. Chamber of Chartered Accountants, Delhi
32. M/s Dalmia Cement (Bharat) Limited, New Delhi
33. M/s Kerala Lottery Agents Association, Thiruvananthapuram
34. M/s BOI Shareholding Limited, Bombay
35. M/s Skefko India Bearing Co., Limited, Bombay
36. Delhi Hindustani Mercantile Association, Delhi
37. Merchant's Chamber of Commerce, Calcutta.
38. M/s Lucas-TVS Limited, Madras
39. M/s Gandhi Special 07 Tubes Limited, Bombay
40. Federation of Indian Textile Engineering Industry, Bombay
41. National Centre for Human Settlements & Environment, Bhopal
42. Institute of Chartered Accountants of India, New Delhi
43. The Automotive Tyres Manufacturers Association, New Delhi
44. M/s Godfrey Phillips India Limited, New Delhi
45. Indian Merchants Chamber, Bombay
46. Bombay Industries Association, Bombay
47. M/s N.C. Begani Co., Raipur
48. Hindustan Chamber of Commerce, Madras
49. M/s Voltas Limited
50. M/s Procter & Gamble India Limited
51. Indian Plastic Federation, Calcutta
52. M/s Frick India Limited, New Delhi
53. The Stock Exchange, Bombay
54. Federation of Small & Medium Industries. Calcutta
55. Refrigerant Gas Manufacturers Association, New Delhi
56. Thermax Limited, Bombay
57. Chamber of Nidhis, Madras
58. Delhi Exporters Association, Delhi
59. Hindustan Computers Limited, NOIDA
60. Price Waterhouse, Calcutta
61. M/s Dhoddy Manufacturers Association, Bombay
62. M/s Davy Powergas India Private Limited, Bombay

63. Non-Ferrous Recycling Industries Association, Bombay
64. M/s Tata Tea Limited, Calcutta
65. M/s Kaveri Engineering Industries Limited, Tiruchirapalli
66. M/s Larsen & Toubro Limited, New Delhi
67. M/s Southern small Scale Cosmetics & Toiletries Manufacturers Association, Madras
68. The Madhya Pradesh Textile Mills Association, Indore
69. The Institute of Company Secretaries of India, New Delhi.
70. Bombay Chartered Accountants Society, Bombay
71. The Chamber of Income Tax Consultants, Bombay
72. All India Federation of Cloth Retailers' Associations, New Delhi
73. Andhra Pradesh Forest Contractors Association, Hyderabad
74. South India Chamber of Commerce & Industry, Madras
75. Calcutta Junior Chamber, Calcutta
76. Federation of Association of Cottage & Small Industries, Calcutta
77. M/s SmithKline Beecham Consumer Brands, New Delhi
78. Indian Aluminium Company, Limited, Calcutta
79. Gujarat Fluorochemicals Limited, New Delhi
80. The Bengal Income Tax (Gazetted) Services Association, Calcutta
81. Corporate & Tax Laws Research Centre, Amritsar
82. Constitution, Public Laws and Finances Research Centre, Amritsar
83. India Cine Agencies, Madras
84. The Wool Merchants' Association, Beawar
85. Indian Revenue Service Association, Calcutta
86. Indian Electrical & Electronics Manufacturers' Association, Bombay
87. Organisation of Plastic Processors of India, Bombay
88. Indian Cotton Mills' Federation, Bombay
89. CEGAT Bar Association, New Delhi

Individuals

1. Shri N.A.Palkhiwala, Advocate, Bombay
2. Shri Bansi Mehta, Chartered Accountant, Bombay
3. Shri Hari Bhakti, Chartered Accountant, Bombay
4. Prof. U. Venkateswarlu, M.P. Lok Sabha
5. Shri Raj K. Tandon, New Delhi
6. Dr. D. V. Kapoor, New Delhi
7. Shri A.D. Kanabar & others, Bombay
8. Shri Praful Patel, London
9. Shri S.S. Bagai, New Delhi
10. Shri P.N. Shah, Bombay
11. Shri V.D.Agarwal, Delhi
12. Shri Y.M. Agarwala, Bombay
13. Shri V.R. Dalal, Bombay
14. Dr. S. Krishnamurthy, New Delhi
15. Shri Jagdish Arora, Consultant, Varanasi
16. Shri K. Ramanathan, New Delhi
17. Dr. N. Vittal, Secretary, Deptt of Electronics, New Delhi
18. Shri G. Krishnamurty, President, Income-tax Appellate Tribunal
19. Dr. Gauri Shankar, Advocate
20. Shri D.B.Lal, President, Indian Revenue Service Association
21. Shri S. Ramamurthy, Chairman, CBDT
22. Shri K K Dwivedi, Chairman, CBEC
23. Shri A.M. Sinha, Member, CBEC
24. Shri Tarun Roy, Member, CBEC
25. Shri C. Bhujangaswamy, Member, CBEC
26. Shri M.M. Bhatnagar, Member, CBEC
27. Shri S.A. Govindaraj, Member, CBEC
28. Shri S. Ramamurthy, Member, CBDT
29. Shri K.R. Gupta, Member, CBDT
30. Shri A.R. Rao, Member, CBDT
31. Shri Harish Chandra, President, CEGAT
32. Shri S.K. Bhatnagar, Vice President, CEGAT
33. Shri K.S. Venkataramani, Member, CEGAT
34. Shri N.K. Bajpai, Member, CEGAT
35. Shri P.C. Jain, Member, CEGAT
36. Shri S.V. Maruthi, Member, CEGAT
37. Shri G.A. Brahma Deva, Member, CEGAT
38. Shri P.K. Kapoorl, Member, CEGAT
39. Ms. Jyoti Balalsundaram, Member, CEGAT
40. Shri Rakesh Mohan, Economic Adviser, Ministry of Industry
41. Shri Anand Bordia, Collector of Customs, New Delhi
42. Shri K.L.Verma, Collector of Central Excise, New Delhi
43. Shri V. Lakshmikumaran, Advocate
44. Shri B.C.Rastogi, President, Indian Customs & Central Excise Service (Group-A), Officers' Association
45. Shri Akhilesh Mithal, Grindlays Bank, New

D. STATEMENT OF TAX

PARTICULARS	AMOUNT(RS.)	PARTICULARS	AMOUNT(RS.)
15. Tax on total income		20. Tax deducted at source:	
16. Less: Rebate under section 88		a. Salaries	
17. Balance (Rows 15 - 16)		b. Interest	
18. Surcharge, if any		c. Dividends	
19. Total tax (Rows 17 + 18)		21. Refund due (Rows 19 - 20a - 20b - 20c)	

E. CERTIFICATE OF DEDUCTION OF TAX FROM SALARIES

Name and Address of Employer (IN BLOCK LETTERS) _____

Certified that a sum of Rs. _____ **has been deducted at source from income chargeable under the head 'salaries' paid to Shri/Smt/Kum** _____ **and has been paid to the credit of the Central Government as per details in Form No. 24 filed/to be filed with** _____

Signature _____
Full Name _____
Designation of person responsible for deduction of tax _____

Stamp of the office

F. VERIFICATION

I _____ **(name in full and block letters) son/daughter/wife of** _____ **solemnly declare that to the best of my knowledge and belief the information given in this return and the annexures and statements accompanying is correct and complete and that the amount of total income and other particulars shown therein are truly stated and relate to the previous year(s) relevent to the assessment year 19** ____ **-** ____**.**

I further solemny declare that during the said previous year(s) -

(a) no other income accrued or arose to or was received by me from any asset held in my name or in the name of any other person;

(b) there is no other income, including income of any other person, in respect of which I am chargeable to tax under the Income-tax Act, 1961.

I further declare that I am making this return in my capacity as _____**(designation) and that I am competent to make this return and verify it.**

Place _____
Date _____

(Name and Signature)

NOTES AND REFERENCES

1. Recommended by the Carter Commission in Canada. Quotation from Leif Muten, "Income Tax Reform" in Tanzi, Vito (ed.), (1992) Fiscal Policies in Economies in Transition, IMF, Washington D.C., p.180.

2. See for instance, (1) McLure, Charles Jr (1979) Must Corporate Income be Taxed Twice? Studies of Government Finance, The Brookings Institution, Washington, D.C. (2) Norr, M. (1982) The Taxation of Corporations and Shareholders, Kluwer Law and Taxation Publishers, Deventer, Netherlands. (3) Organisation for Economic Co-operation and Development (1973) Company Tax Systems in OECD Member Countries, Paris.

3. Current cost accounting has also been advocated to take care of the problem of rise in prices of capital goods. Such accounting, however, raises broader issues and would require adjustments to other variables such as interest payments. There is also no unanimity regarding the most appropriate method of current cost accounting.

4. If the use of an input is to be discouraged because it is scarce or absorbs foreign exchange or for some other reason, it would be legitimate to levy a tax on it to raise its price. That would be an intended change.

5. Government of India, Ministry of Finance, Report of the Indirect Taxation Enquiry Committee, Part II, January, 1978, p.78.

6. Indeed, the Board itself, we understand, has given instructions that set off for duty credit is not to be granted to the battery in this case.

7. In para 9.6 of the Interim Report, the Committee recomended a levy of Central excise duty of 10 per cent ad valorem on ready-made garments.

8. A higher protective duty will be necessary merely because of the domestic duty structure.

9. In case it is found difficult to fix a single ad valorem rate for cotton yarn with immediate effect, a dual rate - 3 per cent for yarn upto 20 counts and 5 per cent for higher counts - may be fixed. This will not involve any substantial variation in the revenue yield as may be seen from Annexure 4.16.

10. 78.4 per cent in 1988-89. The number of persons convicted as a per cent of the total number of persons whose cases have been decided was 86.8.

11. A potential taxpayer is one whose earnings are not yet at a taxable level but who may become liable to tax with the passing of time. An effective taxpayer is one who is liable to pay tax but may or may not have fulfilled his obligations.

12. One possible way could be by indicating at the beginning of each part the following:

"DOES THIS PART APPLY TO THE ASSESSEE? YES/NO.
IF YES, FOLLOW-ON."

13. In the CIB, the verification process starts with the issue of an enquiry letter (sent by ordinary post) to the concerned person, confronting him with the information collected and seeking his explanation in the matter. The system is deficient in as much as it basically depends on the response of the affected person, who has a motive for stalling inquiries, concealing information or even furnishing false information. There is no system for independent checking of information. Income tax officials maintain that prompt responses are received in only a small fraction of cases. Though summons under Section 131 can be issued to defaulters, even this process is time consuming.

14. It is of course ridiculous to ask the taxpayer to pay once again the tax he has already paid, because the Department due to its own deficiency in book-keeping cannot cross-verify the payment. But that is what the instructions by the Board require, since Audit would not accept the unverified challan issued by the Bank. The possible harassment to millions of taxpayers seems of no consequence!

15. Refunds under Section 143(3) are likely to arise only in exceptional cases since as per the present practice all cases are to be compulsarily processed for summary assessment and refund if any is required to be issued unless held back with the approval of the Commissioner.

16. These findings are of the study conducted for us by the NIPFP and reported in Income Tax Enforcement in India : A Preliminary Analysis, Direct Taxes Cell, NIPFP, 1992.

17. Even if it is not possible for some reason to input in the computer all the information relating to assessed tax, amount paid and balance payable/refundable, the Department could get computer printouts of blank scrolls with names of taxpayers and their TIN. The information relating to each taxpayer could then be filled up manually.

18. It is possible that the search of each separate premise of an assessee may be counted as a separate search so that the number of assessees searched may not be as large as indicated by the number of searches recorded.

19. Sub-section (4) of Section 132 of the Income-tax Act.

20. This and the next two points are dealt with in detail in Chapters 5 and 8.

21. See paragraphs 10.13 to 10.15

22. Union of India vs. Bombay Tyres International 1983 (14) E.L.T. 1896 (SC).

23. Ujagar Prints and Ors. vs. Union of India 1988 (19) ECR 578 (SC).

24. Assistant Collector of Central Excise vs. MRF Ltd. 1987 (10) E.C.R. 625 (SC).

25. See note 24.

26. Assistant Collector of Central Excise and others vs. MRF Ltd. 1989 (22) E.C.R. 481 (SC).

27. Paragraphs 9.42 to 9.46.

28. Union of India vs. Century Manufacturing Co. Ltd., IT 1992 (3) S.C.382 decided on the 14th May, 1992.

29. Para 9.40.

30. See paragraph 7.23.

31. Solar Pesticides Pvt.Ltd vs Union of India, 1992(57) ELT 201 (BOM).

32. The Committee had the benefit of discussion of some of these matters with the Collectors of Customs at the concluding session of their conference at Bangalore on June 2, 1992.

33. About 60% of the decisions of the first appellate authority in the income tax are accepted by both the taxpayer and the Department.

34. Assistant Collector of Central Excise vs MRF Ltd., 1989(22) ECR 481(SC).

35. Civil Appeal Nos. 2058-ST of 1988 in the case of ONGC vs. Collector of Central Excise decided on 11th October, 1991.

36. It has been alleged that the Departments are unable to spare officers for training because they are all needed for day-to-day work. We would suggest that this question may be further examined and if it is found that officers cannot easily be spared for training, the strength of the officers at the level of Deputy Commissioner/Deputy Collector be increased by the number of participants usually asked to attend such courses so that the necessary training courses can be conducted.

37. If the Government accepts this recommendation, it may be implemented with reference to the new entrants to the Board.