INCOME TAX ACT OF INDIA: ISSUES AND EXPECTED REFORMS

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ABSTRACT
This paper focuses on the gaps found in the rules in Direct Tax policy of India. Income tax Act 1961 is a mature, refined and seasoned tax regime of India. However there are still many loopholes in the rules which could have been generated due to lop sided view of the effect of the policy or due to generalisation of the policy or due to human errors. The paper focuses on finding such gaps and strives to present the directions for further reforms. The methodology used for this paper is a literature review of the published materials. A broad search strategy was used using the key terms like income tax act, reforms in direct tax, loopholes in existing direct taxation system. The major contribution of the paper is to draw the attention towards the loopholes which are extensively used to evade the tax and should be immediately plugged by applying the reforms suggested through this paper.

Keywords: Loopholes, Direct Taxation policy, Income Tax Act 1961, Reforms, gaps in the policy, Issues

1. Introduction:
The major changes in the tax systems in all over world took place during last twenty years because of the development of economies and development of different ideologies. All over the world the drive of the reforms in taxation policy started in mid 1980s and were substantiated in 1990s. (Acharya, 2005) In an economy, reforms in taxation policy take place due to several reasons. Developed countries impose the tax reforms to make the policies more transparent. Developing countries usually bring reforms to meet its fiscal needs. (Panagaria, 2005) In rest of the economies the tax reforms are done to match the market necessities. (Barbone, 1999) Evolution of Indian Taxation system took place in accordance to the developmental goals of the economy. India, unlike the other countries did not respond to the market forces operating at that time. Reforms in Indian Taxation system were made in conformity of the international standards but not under its pressure. India pursued number of objectives such as increasing the saving and investment level and at the same time achieving the demands posed by the public on the government. There were political constraints, administrative constraints, inherited tax administration of English, multilevel fiscal levels, these all factors lead to generation of loopholes in Indian Taxation system.

2. Review of Literature:
In the article ‘Tax Reform in India’ written by Nicholas Kaldor in The Economic Weekly Annual in January, 1959, it was highlighted the areas where direct taxation system needs to be corrected. It also emphasised that “Even if these loopholes were plugged, the administration of the system will not become effective until far-reaching reforms are introduced for checking tax evasion.” (Kaldor, 1959). Amaresh Bagchi in his article ‘India's Tax Reform: A Progress Report’ published in Economic and Political Weekly in 1994 explained that “Tax reforms invariably forms a key component of structural adjustment programmes of developing countries, and for the good reasons. (Bagchi, 1994) M. Govinda Rao in his article ‘Tax System Reform in India: Achievements and Challenges Ahead’ 2005 explains that “the personal income tax continues to be narrow based. The improvement in revenue productivity although is often attributed to reduction in the marginal tax rates, was more
due to the administrative measure of extending the scope of tax deduction at source than better compliance from lower rates.” (Rao M. G., 2005). In another paper named ‘Trends and Issues in Tax Policy and Reform in India’ presented in INDIA POLICY FORUM 2006, it was highlighted by R. Kavita Rao of National Institute of Public Finance and Policy that “Because of the size of the country, its multilevel fiscal framework, the unique reform experience, and difficulties in calibrating reforms posed by institutional constraints, the Indian tax reform experience can provide useful lessons for many countries. The reforms, by themselves, are important enough reason for a detailed analysis of the tax system in India. Unfortunately, unlike in many developed countries where major tax reform initiatives were followed by detailed analysis of their impact, no serious studies analyzing the economic impact of tax reforms have been conducted in India.” (Rao R. K., 2006) In the article named “Is A New Revolution Coming? 2000, Das Gupta highlighted that the new way of bringing reform is through e-governance, it was elaborated that “The expectation is that such initiatives will reduce the discretionary power of local officials; reduce corrupt practices relating to taxation and the delivery of government services; reduce transaction costs; and increase transparency.” (Gupta, 2000). The First Report of the Tax Reforms Commission, (Karnataka, 2001) explained that tax revenues in Karnataka are substantially low and there is a need to bring the reforms in the areas like the tax base, i.e., coverage and exemptions, tax slabs, tax compliance and tax administration. In the report named ‘Reports on India's Tax Reforms’ framed by (Vijay L. Kelkar, 2003) it was suggested that in order to have control on tax evasion, the economics of tax evasion has to be altered. This could be done by simplifying the tax laws and reducing the tax rates.

3. Objective of the Study:
This paper aims to:
- Undertake the analysis of the Indian Direct Tax Policies.
- Highlight the gaps in the Direct tax policy of India.
- Present the directions for further reforms.

(For the purpose of understanding, the laws pertaining to the policies are explained first, followed by the gaps in those policies, followed by possible solutions of the gaps)

4. Research Methodology:
The methodology used for this paper is a literature review of the published materials. A broad search strategy was used using the key terms like income tax act, reforms in direct tax, loopholes in existing direct taxation system. Further, answers to questions like how to save tax (loosely defined) were analysed thoroughly which were asked on interactive platform like ‘quora’. An open ended question regarding loopholes in Direct Taxation System of India was asked from consultants of tax management to analyse current loopholes in direct taxation system.

5. Discussion and Expected Reforms:
Gaps in the Income Tax Act 1961
The best tax system is the one which raises revenues, reform the corporate income tax, help low and middle income households, and redistribute the tax burden toward high income households. Our Indian Direct taxation system also aims at these objectives. Even though the laws are framed after a thorough analysis, series of discussions and after the legislative formalities are complied with, still lot of loopholes emerge in these policies. People often tend to take the advantage of these loopholes and tend to evade tax. These loopholes prove to be detrimental to the economy. An early detection of
loopholes and their rectification can increase the revenue generation of government. Few gaps in direct taxation system are highlighted for the same purpose:

1. Exemption on Sale of An Agricultural land:

A. Explanation of the law:
According to section 2(1) of Income Tax Act 1961 only urban agricultural land is regarded as the Capital Asset. Hence a rural agricultural land does not fall under the definition of ‘Capital Asset’. Profit on the sale of urban land will be known as capital gain and will be chargeable to tax. There are three exceptions to the rule of rural agricultural land
(a) If an agricultural land is situated within a distance of 2 kilometers from municipal or cantonment board limits having the population of more than 10,000 but upto 1,00,000
or
(b) If an agricultural land is situated within a distance of 6 kilometers from municipal or cantonment board limits having the population of more than 1,00,000 but upto 10,00,000
or
(c) If an agricultural land is situated within a distance of 8 kilometers from municipal or cantonment board limits having the population of more than 10,00,000

Then that agricultural land will be deemed as an Urban agricultural land. Hence would be a capital Asset and gain out of its transfer will be a capital gain and will be taxed.

B) Gaps in the policy:
The first gap in this rule is that there is no clarity to as how to calculate the distance from the municipal limits. The demarcation between the urban agricultural land and rural agricultural land becomes difficult. The point of contention is, whether the distance of the 2kms/6kms/8kms will be taken as a straight distance or it should be the distance according to the roads.
The other gap in this rule is, a rural agricultural land (beyond these limits of 2kms/6kms/8kms) which is used to grow vegetables for the namesake having its neighbourhood as a commercial, industrial or residential land will not be taken as capital asset and hence no capital gains tax will be imposed on it on its transfer. Though according to its location and utilisation it is not a rural agricultural land used primarily for agricultural purposes.
With the increase in prosperity and urbanisation the rate of these kind of rural lands are increasing at faster rate. These so called rural lands do not have the element of rural agricultural land anymore. These lands have become urbanised. People are misusing these loopholes to evade tax. A quick amendment to the current law is therefore required.

C) Expected reforms:
Taxation rules must be made clear in regard to how the distance should be calculated. Furthermore, the sanctity of a rural land should be determined not only on the basis of the distance rather it should be determined on the basis of collective factors such as nature of neighbourhood lands, the purpose for which neighbourhood lands have been used, purpose for which the land in question is being used, the intention of the owner owning that land and so on.

2. Loan or Advance by a closely –held company:
(A) Explanation of the law:
According to section 2 (22) (e) of Income Tax Act 1961, If any company in which public is not substantially interested has given loan to an equity shareholder who is beneficial owner of not less
than 10% of voting power of the company, in that case, such loan and advance will be treated as Dividend in the hands of the shareholder but to the extent of accumulated profits excluding capitalised profits and such dividend shall be taxable in the hands of shareholder and company is exempt from Additional Income Tax.

Income Tax Act went to give further clarification and explained that, on similar lines if any such loan and advances has been given to a concern in which such a shareholder has substantial interest then such a loan and advances will also be considered as dividend in the hands of such concern.

To curb any misuse of the gaps in the rule, Income Tax Act also explained that any such loan and advances given to any person on the behalf of such shareholder will also be considered as dividend in the hands of such shareholder.

(B) Gap in the policy:
The rule explained above lacked a clarification about a scenario where loan and advance of a particular amount is given by a closely held company to the shareholder of the other closely held company. In return that closely held company will give loan and advances of the same amount to the shareholder of first closely held company. In such a way each closely company will have an even out situation where no shareholder has to actually return the loan and advance to the other company. In this scenario such loans and advances given to the shareholders of the each closely held company will not be deemed as ‘Dividend’ in the hands of shareholders and hence will not be taxed as income.

This can be illustrated with the help of an illustration
In a hypothetical situation assume that there are two companies which have the status of closely held company named as ABC ltd. and DEF Ltd. Assume that there are three shareholders in each closely held company i.e. shareholder A, B, C in ABC Ltd. and shareholder D, E, F in DEF Ltd. The rule can be exploited if the loan and advance of say Rs. 1 crore each has been given by ABC Ltd. to three D, E, F (shareholders of DEF Ltd.) and similarly the same amount of Rs. 1 crore loan and advance each is given to A, B, C (shareholders of ABC ltd.) by DEF Ltd.. In this scenario, actually no amount is to be repaid to any company as the balance is sought out. Since the shareholders does not have substantial interest in the other closely held company, thus these loan and advances will be treated as loan and advances and not ‘Dividend’ in the hands of the shareholders. Hence these shareholders are not liable to pay the tax on such loans and advances.

(C) Expected reforms:
Of late, this loophole is being exploited up to its best in current market scenario. Due to such a loophole there is a huge loss of revenue to the economy. This policy should include the rule that if two or more than two closely held companies give the corresponding loans and advances to the shareholders of other closely held company. Such loan and advances will also come under the ambit of definition of ‘Dividend’ and hence will be taxed.

3. Exemptions under Capital Gains:
(A) Explanation of the law:
When an assessee transfers his capital assets on profit, it will have the Capital Gains. The long term and short term capital gains are taxed under section 50 to 54 of Income Tax Act 1961. The capital gains in general, are huge in nature. Hence the tax liability is also huge and due to this, people tend to evade tax on such gains. In order to control such malpractice, tax authorities have introduced various exemptions for capital gains under Sections 54, 54B, 54D, 54EC, 54F, 54G, 54GA, 54GB etc.
One such exemption is Under Section 54B in which exemption is allowed to an individual or Hindu Undivided Family provided the assessee has either Long Term Capital Gains or Short Term Capital Gains on transfer of an agricultural land which was being used by the assessee or his parents for the agricultural purposes for the period of at least 2 years immediately before its transfer.

The said exemption under section 54B is allowed only when an assessee purchases one or more agricultural land (from the capital gains from sale of original agricultural land) within the period of 2 years after the date of transfer of original land. If the date of filing return comes before the date of investment, the assessee can deposit the sum from his capital gains from the sale of his original land under Capital Gains Accounts Scheme 1988 by opening an account in a bank or post office. The said amount should be withdrawn within 2 years from the date of transfer of agricultural land, for making an investment within that prescribed time limit. Otherwise, the amount unutilised shall be treated as Long Term Capital Gain of the year in which time period has expired. Furthermore, agricultural land so purchased must not be transferred within period of 3 years otherwise exemption earlier allowed shall be withdrawn by computing capital gains by special manner i.e. Cost of Acquisition of new agricultural land will be reduced by amount of exemption allowed earlier.

(B) Gap in the policy:
Basic idea behind giving this exemption was to increase the investment in agricultural land. But the loophole in the above explained rule made the policy, a technique to get an escape from capital gain tax. According to Income Tax provisions capital gain occurs only if the ‘Capital Asset’ is transferred in gain. As per section 2(14), the definition of capital asset does not include Rural Agricultural land in India. It explains that agricultural land in rural area in India shall not be considered as capital asset i.e. agricultural land in urban area in India shall be considered as a capital asset. The above explained policy describes that if an assessee sells his agricultural land and purchases another agricultural land from the capital gains arisen from sale of original agricultural land, then he is eligible to claim an exemption under section 54B. Now consider an example where an assessee transfers his urban agricultural land and purchases a rural agricultural land in order to avail the exemption under section 54B. After availing an exemption an assessee can dispose off the rural agricultural land before the expiry of prescribed time limit (3 years from the sale of original agricultural land). This is because the agricultural land in rural area in India is not considered as capital asset and hence capital gains on the sale of such an asset are not going to be taxed anyhow. Now, even if exemption allowed earlier is withdrawn by reducing the ‘Cost of Acquisition’ of new agricultural land, thereby increasing the amount of capital gain on sale of new rural agricultural land, will not make any difference to the assessee as capital gains tax is exempt on rural agricultural land. The economy thereby will be in lose-lose situation where on one hand economy giving the exemption on capital gains to the assessee to promote the investment in the agricultural land, which actually assessee is not making.

(C) Expected reforms:
The above explained loophole can be rectified by improvising the language of the section 54B, where the exemption should be available to the assessee who sells an urban agricultural land & incurs capital gains on it and invests the same capital gain by purchasing an urban agricultural land. Thus by adding “urban” into the explanation, the definition will become specific and will get narrowed down to the extent that there will be no scope of exploitation of the policy.
4. Cost of acquisition:

(A) Explanation of the law:
The cost of acquisition means the actual expenditure done to acquire an asset. Cost of acquisition is important to determine the amount of capital gain or capital loss in case of transfer of an asset. There are several rules in Income Tax Act in regard to the determination of Cost of acquisition such as:

(a) If an asset is acquired before 01.04.1981 then cost of acquisition shall be the expenditure incurred by the assessee for acquiring the asset or its fair market value as on 01.04.1981, whichever is higher.
(b) If the asset is acquired with effect from 01.04.1981 onwards, the cost of acquisition shall be expenditure incurred by the assessee for acquiring the asset.
(c) In case of bonus shares, cost of acquisition will be nil, but if the bonus shares are issued prior to 01.04.1981, their cost of acquisition shall be market value on 01.04.1981
(d) The cost of acquisition for self acquired intangible assets is nil. Such acquired intangible assets are:
   - Goodwill of a business
   - Right to carry on any business
   - Right to manufacture, produce or process any article or thing
   - Trade mark
   - Stage carriage permits

(B) Gaps in the policy:
The above explained provisions related to cost of acquisition are given in detailed form in Income Tax Act 1961. Cost of acquisition forms a base to determine the magnitude of the capital gain or loss of the Capital Asset.
Income tax Act 1961 clearly defines that the Cost of Acquisition for the self-acquired intangible assets such as Goodwill of the Business will be nil, but the Act remains silent upon the self-acquired Goodwill of a Profession. Thereby, while computing the Capital Gains in case of sale of goodwill of the profession, the value of cost of acquisition is not taken as NIL. Thereby creating a loophole in case of sale of goodwill of profession. The effect of this particular loophole is pacified with the other loophole. The other loophole is that, the taxation rules are silent about the Capital gains calculated on sale of Goodwill of Profession. Thus, the connotation of this silence is taken as ‘no capital gains’ on sale of goodwill of the profession.
As a result, the capital gains on sale of goodwill of business is taxed whereas there is no capital gains tax in case of sale of goodwill of a profession.

(C) Expected reforms:
The loophole in calculation of capital gains tax in case of sale of the goodwill of a profession has to be plugged, thereby assuring the level playing field for both ‘Business’ and ‘Profession’. The rules should be made same in relation to the cost of acquisition of goodwill of Business and cost of acquisition for the goodwill of profession. Also, there must be same rules in relation to the calculation of capital gains tax in case of sale of goodwill for both Business and Profession.

6. Conclusion:
Envisaging an entire scenario, then making rules related to it and then applying those rules all across the country definitely leaves the scope of the loopholes. The taxation rules are made in the light of its general applicability across the nation. However at times minute and sometimes major loopholes get generated due to loose ended language or human errors. Thus, taxation policies need to be changed from time to time to plug the loopholes. At times, taxation policies are reformed to make them
compatible with the globalisation and internal structure. These policies should aim in curbing the tax evasion, achieving equity, revenue generation, minimising corrupt practices, improving tax administration and compliance. The policies should be corrected from time to time to meet the structural changes. This has to be an on-going activity. Tax reforms are considered to be an important tool to curb corruption at various ends. The taxation policies of any nation have to be volatile in nature in order to go hand in hand with the changes imposed on an economy due to internal and external factors. The loopholes need to be plugged soon in order to curb the tax evasion, loss of revenue to the nation and to curb corrupt practices.

References


