Improvisation of Direct Tax Policies: Loopholes Plugged

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Abstract

This paper focuses on the gaps found in the direct tax policies in India. Income tax Act 1961 is a mature, refined and seasoned tax regime of India. However, there were and there are still many loopholes in the income tax rules which could have been generated due to lopsided view of the effect of the policy or due to generalisation of the policy or due to human errors. The paper focuses on finding the history of these gaps and analyse the ways of filling these gaps by the tax authorities. 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 have been extensively used to evade taxes and were plugged by applying different ways of bringing reforms.

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

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1. Introduction:

The Act related to Indian direct taxation marked its presence in a formalised manner in 1961 when Income Tax Act 1961 was enacted. This act became operational from 1st April 1962. Many upgradations were made thereafter. Policies were and are made to ensure the equity, administrative feasibility, efficiency and political acceptability. Policy makers never try to bring optimum tax policies rather they always strive to make a suitable policy for an economy. They draft a policy in a way so as to have minimal tax distortions. While framing the policy, intense analysis and discussion are done, effects of the said law are evaluated in depth and then such policies become a law after the constitutional formalities are completed. Administrative cost of the policy is analysed and its practical implementation is assessed. In general, the policies are made by analysing its general impact but sometimes these policies have a room that can be exploited by the exceptions. Often, intention of the tax policy is altered due to poor administrative mechanism. Thus, both administrative and law related reforms are made on an on-going basis to make the system more effective, result oriented and equitable. There are various reasons to bring reforms in an existing tax system. Some of them could be generating revenue, bringing equity, installing economic efficiency, increasing domestic and foreign investment and to follow an international regime of good fiscal governance (which include installing anti-corruption system, curbing tax evasion and making administrative reforms) (Barbone, 1999). The reforms are much required to keep the system updated. Surely, though, in a democratic polity, it is difficult to achieve this ideal and yet, the framework helps to keep the focus on further reforms. (Rao, 2005)

2. Literature Review:

Reforms are a part and parcel of the policy formulation but the central idea of policy formulation should be the administrative feasibility. This was highlighted by M. Govinda Rao

and R. Kavita Rao in their article 'Trends and Issues in Tax Policyand Reform in India'. They explained that "The most important aspect of the advice given to developing countries in designing their tax systems is that the administrative dimension should be kept at the centre rather than at the periphery of reform efforts." (Rao, 2005) Nicolas Kaldor in his article explained that "Whether the political or social urges which led to the recent reforms continue to prevail or not, I am convinced that the Indian tax system could not be frozen still at the point which it has now reached. If an effective tax structure is to be created, reform will have to be carried a great deal further; if on the other hand political forces were to become dominant which would effectively bar this development, there would be little point in preserving such a complicated system of taxation." (Kaldor, 1959). Nicolas Kaldor emphasised on a fact that the tax system should not be a static one and the reforms should be done in order to create an effective tax system. Amaresh Bagchi in his article 'India's Tax Reform: A Progress Report' published in Economic and Political Weekly explained that "Tax reforms invariably forms a key component of structural adjustment programmes of developing countries, and for the good reasons." (Bagchi, 1994). B. S. Sreekantaradhya in his book on 'Structure and Reform of Taxation in India' emphasised that reforms are important and for making reforms, an understanding of the tax structure is necessary. He expalined that "an understanding of the tax structure is necessary to think of the ways and means for reforming the tax system and so as to develop a simple, fair, coherent and integrated tax system which will serve the objective of helping the process of development of the economy." (Sreekantaradhya, 2002). In a report named 'Reports on India's Tax Reforms' framed by Vijay L Lelkar, 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. (Vijay L. Kelkar, 2003)

3. Objective of the Study

This paper aims to:

1. Undertake an analysis of various loopholes plugged in Direct Tax Policy of India in the time frame of five years i.e. 2012-2016

2. Analyse the ways in which these loopholes were plugged

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.

5. Discussion

1. Capital Gains Tax

(A) Explanation of the Law before the amendment:

The law relating to the capital gains tax, incidence of tax and residential status all combined together, gives an interpretation that when a transaction takes place between two non-residents of India who are outside India and the payment is also made outside India, then the tax incidence fall outside the jurisdiction of the Indian Taxation. Hence, there would be no tax liability in India. Same was held in case of Vodafone Company where Vodafone Company was a foreign company in India which was formed in

Netherlands and Hutchison Essar was an Indian company. Hutchison Company is again a foreign company which was formed in Hong Kong. Cayman Island was the 100% holding company of Hutchison Company which was incorporated in Mauritius. Cayman Island had 67% of shares and rest 33% shares were held by Essar Company. Cayman Island was a company situated in Mauritius, which was known as Tax Haven Country and on which the provisions of Double Tax Avoidance Agreement (DTAA) apply. India and Mauritius had Double Tax Avoidance Agreement under which the same income earned by a person who is residing in another country is not taxed twice, for example the income earned in India will not be taxed in India because the assessee resides in Mauritius and the same very income will be taxed in Mauritius. Also, Mauritius is a tax haven country in which the income on capital gains is not taxed for its citizens. The transaction took place in a manner where Hutchison Company sold Cayman Island to Vodafone Company. Vodafone (foreign company) made the payment to Hutchison Company (foreign Company) for the purchase of Cayman Island (foreign Company), thereby attracting no tax implications from India's point of view.

(B) Loophole in the policy:

From the above stated case, it was vividly clear that as a foreign company (Vodafone) has purchased an another foreign company (Cayman Island) from other foreign company (Hutchison) and according to the direct tax policies of India, if a non-resident of India generates some income outside India from an another non-resident of India, incidence of tax doesn't fall in India. Though, directly the incidence of tax fell outside India but indirectly the controlling interest of Hutchison Essar (an Indian Company) was sold through this transaction. Thereby saving tax on capital gains which would have otherwise become payable in India. Taking the benefit of this loophole a transaction of ten billion US dollars was made in the year 2007.

(C) The way in which loophole was plugged:

A show cause notice was served by Income Tax Department to Vodafone for non-deduction of TDS by Vodafone (Hong Kong) for the amount paid to Hutchison, under section 195 of Income Tax Act 1961. Vodafone took this matter to Mumbai High Court who rejected the petition. The matter was then taken to the Supreme Court of India where it was held that the Income Tax department does not have the jurisdiction to serve a show cause notice imposing penalty and demanding Rs11,000 crore towards non -deduction of TDS. "The government has no jurisdiction over Vodafone's purchase of mobile assets in India as the transaction took place in Cayman Islands between HTIL & Vodafone." Chief Justice S.H. Kapadia said. (Prabhakar, 2012)

Then the Government of India, in 2012 added an explanation vide Finance Act 2012 and made a retrospective change in the law which was made effective from 01/04/1962 and will be effective for subsequent assessment years. The explanation stated that any indirect transfers which derives a substantial value from the assets located in India are subject to tax in India.

2. Keyman Insurance Policy

(A) Explanation of the Law before the amendment:

Keyman Insurance policy defined in explanation to section 10(10D) is a life insurance policy taken by a person for the other person. Here, the first person should be an employer and second person should be an employee. Keyman insurance policy is taken by the employer on the life of that employee who is important to his business or on whom the business is heavily dependent. Keyman insurance policy is taken by the employer to cover the losses to the business on account of sudden death of that employee. In Keyman insurance policy, the premium is paid by the employer and hence the premium is treated as an expenditure related to business and profession and is allowed as a deduction in the assessment of taxable income. On the maturity of the said policy, the entire sum received by the employer including bonus will be treated as an income under the head 'income from business and profession' and will be taxable in the hands of the employer (assessee). The premium paid by the firm on the life insurance policy of its partner will also be taken as a revenue expenditure and will be treated as an allowable expenditure of the firm under the section 37(1) of the Income Tax Act, 1961. This was stated by the Mumbai Tribunal 'B' Bench in the case of ITO v. Modi Motors[2009] 27 SOT 476.

The general rule in taxation in respect of life insurance policies is that the amount received on the maturity of a life insurance policy, including the sum allocated as bonus on such policy is exempt as an 'Income' of that assessee under section 10(10D). In other words, the amount received on maturity of any life insurance policy will not be included in 'Total Income' of an assessee.

However, by the virtue of an amendment which was made through the Finance (No. 2) Act, 1996, Section 10(10D) was amended and a sub clause (xi) was added to section 2(24) which clearly stated that the amount received on the maturity of Keyman Insurance policy will be treated as 'Income' in the hands of the employer (assessee) and unlike other life insurance policies, no exemption under section 10(10D) will be granted to the employer(assessee).

(B) Loophole in the policy:

From the stated law it was made very clear that the Keyman Insurance policy will not be treated on equal footing as compared to the other life insurance policies. Law makers abstractly defined that the premium paid by the employer on the life insurance policy taken by him on the life of his employee will be a revenue expenditure of business and will be allowed as an expenditure of business. Further, it was stated that the amount received on maturity of other life insurance policies is exempt as an income under section 10(10D) whereas this exemption is not allowed in case of the amount received on maturity on Keyman insurance policy in the hands of the employer.

Here is where the loophole persisted. If a keyman insurance policy is taken by the employer on the life of his employee and likewise the premium on such policy is paid by the employer, then the employer can claim the deduction of such premium as an expenditure of business. Thereby, reducing the income from business and profession. Later on if the employer assigns (transfers) this policy to the keyman (employee) or his family members before the maturity and remaining premium are paid by the employee or his family members then, the Keyman insurance policy will loose its character and Keyman insurance policy will become just like another life insurance policy.Thus, the amount on maturity of this policy including the bonus will be treated as the amount received on maturity of any life insurance policy. Thereby, keyman or his family members can claim an exemption under section 10(10D). This loophole was first used to deflate the income of business and profession by claiming the premium as an expenditure of business and then to avoid tax on the sum received on maturity by claiming an exemption under section 10(10D) of Income Tax Act, 1961.

(C) The way in which loophole was plugged:

With a view to plug the loophole and check such practices to avoid payment of taxes, the provisions of clause (10D) of section 10 of the Income-tax Act, 1961 have been amended through Budget 2013 (Shenoy, 2013) and this amendment became effective from 1st April 2014 onwards i.e. for assessment year 2014-15 and subsequent assessment years. The section now is read as the keyman insurance policy which have been assigned to the keyman or his family members during the term of the policy, with or without any consideration will be continued to be treated as Keyman insurance policy and hence the exemption under section 10(10D) of Income Tax Act 1961 will not be available to the assessee.

3. Charitable or Religious Organisations

(A) Explanation of the Law before the amendment:

Section 11 and section 10 (23C) of the Income Tax Act, 1961 read together explains the cost of acquisition of an asset to be an application of income while computing income for charitable or religious organisations. The same sections however, allows depreciation on said assets as well to qualify as a deduction from the income of not-for-profit organisations.

Other interpretation held under section 11 and section 10(23C) read in conjunction allows specific exemptions to the charitable organisations on the basis of mandatory income application on certain charitable activities failing which the special exemptions are not granted and income is taxed.

(B) Loophole in the policy:

The loophole in the policy regarding the first fact presented above is that the cost of acquisition of the asset acquired for charitable and religious purposes is considered to be a deduction from the income of the charitable organisations. Such cost of acquisition is thus treated as an expense that reduces income of the charitable and religious organisations. On the other hand, depreciation on such capital assets acquired is also considered to be a deduction from the income of the charitable organisations. This allows double deduction from the income in the hands of charitable organisations. Moreover, another effect of this loophole is that, when this capital asset is written off as a capital expenditure with the amount of cost of acquisition, then by claiming depreciation on such asset, a cash surplus is created with these charitable organisations that goes unaccounted in the books of accounts.

The second fact presented above had a loophole in which it was explained that if a charitable organisation fails to spend a particular percentage of its income towards certain charitable activities in that case the specific exemptions allowed to charitable organisations will be withdrawn and the income will be taxed. The policy failed to mention that whether these charitable organisations to whom specific exemptions are withdrawn are eligible to avail the general exemptions or not. Due to this when a charitable organisation fails to have specific exemptions, it goes for availing general exemptions. Thereby defecting the purpose of Section 11 as well as section 10(23C).

(C) The way in which loophole was plugged:

Government of India through union budget 2014 brought amendments to section 10(23C) and section 11 by stating that when acquisition of an asset has been claimed as an application of income, no deduction or allowance by way of depreciation will be allowed on that asset. (Bhatia, 2014). Government went further to elaborate on the loophole of specific exemptions vis-a-vis general exemptions given to charitable organisation and stated that if the charitable institution is approved or registered under the law then no other general exemption [except for exemption for agricultural income under section 10(1)] will be available.

4. Double Tax Avoidance Agreement

(A) Explanation of the Law before the amendment:

Double tax avoidance agreement is entered between two countries to save the assessees from the incidence of double taxes on the same income. Through double tax avoidance agreement, an assessee who earned income in one country and resides in another country will not be taxed in one of the countries for the same income. In the light of rules given under incidence of tax and residential status of an assessee, an income can get taxed in India. In a hypothetical example, a non-resident of India (citizen of Australia) had a house property in India on which he receives rental income, in this case even though he is a non-resident of India, he is liable to pay tax on that income in India. Now, if Government of Australia also has rules to tax such income, then that assessee will end up paying taxes twice on the same income. Had there been a Double tax avoidance agreement between two countries i.e. India and Australia, he would not have been taxed twice for the same rental income.

The Double Tax Avoidance Agreement between India and Mauritius was signed three decades before. According to this agreement's interpretation, capital gains on the sale of shares of a subsidiary company in India will not be taxable in India if they are sold by selling entire shares of underlying holding company incorporated in Mauritius.

(B) Loophole in the policy:

The loophole in the policy was that, since Mauritius is a tax haven country where taxes are not imposed on capital gain income on sale of shares made by its citizens, the assessee resulted in paying no taxes at all on account of capital gains earned on sale of shares neither in India nor in Mauritius. The gaps in the tax policy and mismatches in tax rules between both the countries made this loophole, which was heavily exploited.

(C) The way in which loophole was plugged:

Finally on May 10th 2016, the 30 years old treaty between India and Mauritius was amended and it was held that no entity will get away without paying taxes in either country. (India, 2016)

According to the treaty- 'All investments up to March 31, 2017 will remain under the old regime i.e. 'double non-taxation'. They will neither be taxed in India nor in Mauritius. Between 2017 and 2019, capital gains would be taxed at 50 per cent of the domestic tax rate subject to the fulfilment of the Limitation of Benefits. The full rate would apply after 2019.' (Venkataraman, 2016)

5. Conclusion

Plugging of loopholes present in the policies is necessary in order to bring improvements in the system. Sometimes, coming up with the new tax policies is not required since the economy could be better administered by plugging the loopholes present in the existing system. As huge tax base is eroded due to these loopholes, government and tax authorities have made the changes and rectification in direct taxation policies on a continuous basis to tackle various gaps in the framing of policies, administrative system and collection of taxation. India being a developing country, comes up with new rules and policies in light of changes in the economic environment and thereby generating gaps in policies in its due course. Framing the policies, implementing them, finding the gaps in the policies through its practical implementation and plugging the loopholes is ultimately the essence of the improvisation of the system.

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