

TAX FREE THRESHOLD AND STANDARD DEDUCTION: ARE THEY HOLES IN TAX BUCKET?

Comprehensive income taxation: its aspects and Imperitives

IN THE economic model of India's Finance Minister, Manmohan Singh, there exists a firm fundamentalism concerning taxation of incomes. The fundamentalism is no doubt backed by a sound theory—the theory of Comprehensive Income Taxation.¹ The essence of this theory is twofold. *First*, the tax-base should be broadened. This implies that a larger part of personal incomes goes through the tax-mill and a larger number of income earners are brought into the tax-net. This also implies that tax-preferences in the form of deductions and exemptions should be severely curtailed so that the erosion of tax-base is arrested. *Second*, the rates must be kept low. This will encourage voluntary compliance and ensure fairness of the tax-burden.

The two aspects of the fundamentalism mentioned above are interdependent and justify each other. Experience shows that a larger amount of income passing through the tax-mill at lower rates would fetch more revenue collections than a much lower amount passing through the tax-mill at unrealistically high rates. Apart from higher revenue collections the broadbased low rate taxation of personal incomes would have also other salutary effects on the growth of the economy. The following further arguments could be advanced in favour of the fundamentalism as to the low rates of tax.

II Arguments that justify lower rates of tax

Lower tax rates will create better incentive to work and earn and thereby generate more goods and services and more employment opportunities. Lower tax-rates will leave a higher post-tax income in the hands of the tax-payer. A higher amount of post-tax income (discretionary income) will leave a wider choice to the tax-payer between consumption and savings and in his personal preferences in matters of savings and consumption. This will promote a more natural and flexible proportion of savings to consumption in the economic society. It is often forgotten that both consumption and savings are

1. Comprehensive Income Taxation (CIT) and Comprehensive Tax Base (CTB) have been the subject matter of detailed study in USA. The general tax-free threshold (standard deduction in their parlance) is pegged to subsistence levels and is a substitute for the aggregate of numerous itemised deductions, the former being only the lower limit. The general tax-free threshold was for a long time a mere \$1,000 and raised in 1977 to \$ 2,000. In the circumstances the question of any surplus out of the general tax-free threshold available with a tax-payer could not have arisen in USA. The discussion there is mostly over the limitations to be placed on deductions other than the tax-free threshold. The issues have been dealt with in depth in Joseph Pechman (ed.), *Comprehensive Income Taxation* (1977).

necessary for healthy growth of the economy. Higher consumption will fetch higher amount of indirect taxes. Besides, it will by itself promote consumerism and growth of consumer goods industry and employment in that sector. We can sum up saying that they also serve who earn and spend. On the other hand, higher savings will ensure higher flow of funds to the private sector through intermediary activities of banks and financial institutions and the capital market. For savings as well as consumption the tax-payer needs substantial discretionary income. A broadbased low rate tax on incomes has an inherent tax-neutrality and better meshes into a liberalised economic policy.

III Democratic realities of imposer-imposed dialectics

At the level of popular acceptance, however, the fundamentalism of low rates of tax will be welcomed only by those whose tax burden is reduced. Those who do not have to pay these taxes and who are in clear majority in Indian democratic society will oppose reduction in the rates of tax, dubbing the measure as pro-rich. With greater professionalism informing the tax policy formulations the majoritarian thrust is better contained and out of the imposer-imposed dialectics over the decades a sensible rate structure can be said to have emerged. It is a recent global development that professionalism backed by intellectual commitment to sound theory rules the fiscal world rather than majoritarian imposition. The majoritarian thrust in favour of taxing a few affluent persons at confiscatory levels is ineffective and out of fashion in the present world of fiscal policy.

As to the fundamentalism of broadening the tax base, its concretisation again will draw the ire of all tax-payers, particularly the salaried class. The dialectical outcome of pressures in this direction are to be found in the partial restoration of the deduction available to incomes from certain savings (Rs. 7,000 as per Finance Act 1992 and Rs. 10,000 as per Finance Act 1993) raising of the tax-free threshold (Rs. 30,000 as per Finance Act 1992 and Rs. 35,000 as per Finance Act 1994) and the enhancement of standard deduction for salaried income in terms of section 16 (to Rs. 15,000 as per Finance Act 1993). But it must be remembered that once low rates of tax are resorted to as a matter of tax policy, a Comprehensive Tax Base becomes logical and imperative. Low rates of tax and a Comprehensive Tax Base justify each other in terms of equity, apart from producing greater efficiency in conjunction.

IV Predicament and responses of salaried class

The broadening of the tax-base can be achieved by:

(i) Keeping a low tax-threshold; and (ii) drastic cuts in tax preferences for approved savings and incomes from such savings. The salaried, unlike the non-salaried class, is virtually tax trapped. They have no opportunity to understate their incomes through various devices and they cannot escape the hard bites of taxation by income-shifting and income-splitting practices widely resorted to by

their brethren in the non-salaried class.² Over the years of their tax-trapped state the salaried class have witnessed, with dismay and a feeling of being wronged, successive governments wooing the evading tax-payers with amnesty schemes.³ Over the years they have standardised their pleas for mitigation. They are : (i) raise the tax-free threshold; (ii) increase standard deduction; (iii) increase tax-preferences for approved savings. Later in our discussion we will show that each one of the pleas is unwittingly subversive of a just and efficient tax order and helps the non-salaried class to avoid and evade taxes more than it mitigates the burden of the salaried class. Such avoidance and evasion will inexorably increase the tax burden on the compliant among the non-salaried tax-payers as well as the tax-trapped salaried tax-payers.

V Eclipse of excessive progressivity

The fundamentalism of low rates of tax which took shape in 1986⁴ has all but ousted the worn out fundamentalism of vertical equity concretised in highly progressive rate schedules. This is again a global phenomenon, USA taking the lead in 1984.⁵ Vertical equity fundamentalism had reached absurd heights in India in the Finance Act of 1973 when incomes in excess of Rs. 2,00,000 passed through the tax-mill in eleven squeeze brackets ranging from 11.50 per cent to 97.75 per cent.⁶ The savageness of the squeeze should have logically led to extinction of

2. Fragmentation of taxable income of an entity by siphoning off large chunks of profit through devices like payment of commission, rent, remuneration, salary, profit share, *etc.*, is a widespread practice. The provisions of ss. 64 and 40A of the Income Tax Act neutralise the benefits from such devices only to a limited extent. The evaluation of fair market value of goods and services which is involved in s. 40A renders the exercise quite counter-productive. Only very blatant devices get busted in the appellate circuit. Income from salary is not amenable to such fragmentation. These exercises in arbitrage practiced by non-salaried tax-payers massively skew the vertical equity of the rate schedules.

3. The government periodically woos tax-evaders by offering incentives like waiver of interests, excusing of penalties and non-prosecution in criminal courts. Often the surrender terms are so attractive that tax-evaders quietly and wisely wait for a suitable amnesty which is bound to appear at least once in a decade. The most recent one is the Amnesty Scheme of 1985 which ended on 31-3-87. Public circulars no. 423, 432, 439, 451, 453, 472 and 474 published in 1985 and 1986 went on offering concessions after concessions. Apart from these *ad-hoc* schemes there is a permanent provision—s. 273A in which a voluntary surrender of income which was concealed in a tax-return filed earlier earns pardon from penalties and prosecution. Under the existing law it is once in a life-time opportunity.

4. In 1986, (Finance Act 1986) the progressiveness in the rate schedule was drastically cut and the following rates and brackets were enacted:

| | | |
|-----------|--------|-----|
| First Rs. | 18,000 | Nil |
| Next Rs. | 7,000 | 20% |
| Next Rs. | 25,000 | 30% |
| Next Rs. | 50,000 | 40% |
| Balance | | |

5. This was an important policy measure introduced by the Reagan Administration culminating in the Tax Reform Act 1984. See, C. Eugene Steuerle, "The Prospects of Tax Reform" XXXVIII *National Tax J.* 291.

6. The rates of tax on personal incomes of individuals as per the Finance Act 1973 displayed a mind-boggling progressiveness as below:

| | | |
|-----------|-------|-----|
| First Rs. | 5,000 | Nil |
| Next Rs. | 5,000 | 10% |
| Next Rs. | 5,000 | 17% |

persons earning annual incomes of several *lakhs*; but it is a tribute to the resourcefulness and strong survival instinct of this species that they ducked the squeeze and not only survived but flourished. The ducking was achieved through devices of arbitrage like income-splitting and income-shifting and passing off of investments and expenditure as out of income within the tax-free threshold.

Incidentally, they had the last laugh, the government bringing down marginal rate (the maximum rate) to 40 per cent in the Finance Bill 1994.⁷ In the budget speech of 1993, the finance minister was even apologetic about not abolishing the surcharge of 4.8 per cent which would have brought the marginal rate down to 40 per cent. He made amends in the Finance Bill 1994. While this is the fate of the high marginal rate, a fall from 97.75 per cent, to 40 per cent, the number of rate slabs which is one index of tax-progressivity has come down to a low of three in 1992 from a high of eleven in 1973.⁸ In terms of the range of rates, which is another index of tax-progressivity, the range has come down to 20 per cent in 1994 from 86.25 per cent in 1973.⁹ In its Report, the Raja Chelliah Committee observes:¹⁰

The Committee had recommended in the Interim Report that as a first step towards rationalisation of the rate structure of personal income-tax a three slab rate structure should be introduced which should be replaced by a two-rate schedule (para 6.18, 6.22). The middle rate in the three-rate schedule will become the lower rate in the two-rate schedule....

VI Exercises in arbitrage: tax payer exploitation of facilities

While the virtual death of vertical equity fundamentalism will have the salutary effect of discouraging income-shifting and income-splitting arrangements, thus reducing the tremendous burden of investigation and litigation on the

| | | |
|----------|----------|-----|
| Next Rs. | 5,000 | 23% |
| Next Rs. | 5,000 | 30% |
| Next Rs. | 5,000 | 40% |
| Next Rs. | 10,000 | 50% |
| Next Rs. | 20,000 | 60% |
| Next Rs. | 20,000 | 70% |
| Next Rs. | 20,000 | 75% |
| Next Rs. | 1,00,000 | 80% |
| Balance | | 85% |

Further a surcharge at 15 per cent was leviable on income tax, bringing the effective marginal rate to 97.75 per cent.

7. The rates of tax on incomes of individuals proposed in the Finance Bill 1994 are:

| | | |
|------------|------------|-----|
| On first | Rs. 35,000 | Nil |
| On next | Rs. 25,000 | 20% |
| On next | Rs. 60,000 | 30% |
| On balance | | 40% |

8. See, *supra* notes 6 and 7.

9. See, *supra* note 6. The lowest rate was 10% plus 15% surcharge, i.e., 11.5%. The highest was 85% plus 15% surcharge, i.e., 97.75%. Thus the range was 86.25%.

10. (1992) 1979 I.T.R. 181.

administrative machinery, retention of an un-individualised and high tax-free threshold will continue to offer massive encouragement to such arrangements. To illustrate, if an income of Rs. 2,00,000 of one assessable unit is split into incomes of Rs. 50,000 each of four assessable units the tax-free threshold is increased to Rs. 1,40,000 from Rs. 35,000.¹¹ By funding real living expenses by undeclared incomes the groups manage to show merely Rs. 35,000 to Rs. 40,000 as living expenses while enjoying the benefit of non-taxation of an amount of Rs. 1,40,000 enabling them to obtain a tax-free annual capitalisation of Rs. 1,00,000.¹² Such income splitting is the essence of tax-planning as the *cognoscenti* in tax-planning are well aware. The device is widely and systematically resorted to for the twin purposes of, (i) facilitating declaration of high amounts of tax-free incomes in order to explain away even the understated investments and living expenses; and (ii) ducking the murderous rates of tax inherent in a highly progressive rate schedule. Some of the entities set up for the purpose of income-splitting manage to receive income assessable under the head 'salaries' and thereby obtain the bonus of further tax exemption on Rs. 15,000 per entity.

VII Two holes in tax bucket

The salaried class who do not have the opportunity of splitting income will justifiably continue to lobby for three avenues of mitigation standardised by them, viz., (i) raising the tax-free threshold; (ii) increase in standard deduction; and (iii) increase in tax-preferences for approved savings and incomes from such savings. That one or more of the pleas are bound to be accepted is demonstrated by the enhancement of standard deduction under section 16 of the Income Tax Act to Rs. 15,000 for working men and Rs. 18,000 for working women (Finance Act 1993). The standard deduction, contrary to popular belief, has nothing to do with the expenses incurred for performing the duties of employment. On the contrary, the Finance (No. 2) Act of 1980 specifically removed the tag of 'expenses incurred for performing the duties of employment' attached to the standard deduction under section 16. The deduction is available, (i) even to pensioners who obviously have to spend nothing to earn their pension; (ii) to all employees, desk persons as well as sales and field persons alike; and (iii) regardless of any claim of actual

11. Here is an illustration:

Profit of entity A is, say, Rs. 2,50,000. Salary of Rs. 65,000 is paid to entity B; interest of Rs. 50,000 is paid to entity C; Rent of Rs. 35,000 is paid to entity D. Each of the entities A,B,C and D is entitled to a basic exemption of Rs. 35,000, i.e., Rs. 1,40,000 in the aggregate. The reported living expenses of A,B,C, and D who are living together is Rs. 40,000. This will lead to a tax-free capitalisation of Rs. 1,00,000. Also see, *supra* note 2.

12. See, *supra* note 11. It is physically impossible to monitor the actual living expenses of a unit except through highly inquisitorial methods. See, *infra* note 16. Either through suppression of business receipts or inflation of business expenditure or passing off in the accounts of personal expenditure as business expenditure it is possible to limit the reporting of living expenses to Rs. 40,000 per annum or even less. Besides, considerations of tax neutrality in the matter of allocation of living expenses among members of family and dependents living together makes it highly desirable that the reported living expenses of an individual should be accepted and given a deduction. Such a step also makes it quite unnecessary to make 'family' the unit of income taxation, a proposal which is bound to be strongly resented in a culture of individual economic rights, particularly of women.

expenditure. A tax-payer may declare that he spent nothing for performing the duties of employment and that the amount to be availed of as deduction under section 16 was utilised for making investments and still get the deduction.¹³ The real purpose of allowing this deduction appears to be to make the non-salaried tax-payer carry a handicap of Rs. 15,000 for enjoying the opportunities of understanding income, income-shifting and income-splitting. The provisions of section 16, however pragmatic, are by no means a legitimate substitute for effective administrative and legislative strategies for countering tax evasion. The provisions are nakedly intended for a collateral purpose and this is not being very honourable. In the light of the above mentioned facts it is plain carelessness or amnesia on the part of the legislative draftsman to state, contrary to the express provisions of section 16, that "considering the high cost of expenditure incidental to the employment of salaried persons the Bill [the Finance Bill 1993] proposes to amend section 16 of the Income Tax Act in order to enhance the general ceiling of standard deduction".¹⁴ This statement contained in the Explanatory Memorandum to the Finance Bill of 1993 is to be deplored for its manifest inaccuracy. Like myriad tax-preferences the provisions of section 16 seriously detract from the ideal of neutrality and erode the tax-base. What is worse, and this needs particular attention, they enable other tax payers to collude with the salaried tax-payers to explain the investments by the former as having come as gifts or borrowals from a number of salaried tax-payers with incomes of about Rs. 50,000 per annum with little or no tax liability.¹⁵ From decades of experience the tax administration is fully aware of the evidentiary burden of disproving such claims and the ultimate fate of exercises of the administration in this area. Besides the problem of erosion is, as mentioned earlier, further exacerbated by most tax-payer groups in business and industry so arranging the relationships and contracts within their fold as to ensure that a large number of its members earn income under the head 'salaries' and get the benefit of deduction of the standard deduction of Rs. 15,000 or Rs. 18,000 as the case may be, besides the tax-free threshold of Rs. 35,000.

VIII Scheme of individualised deduction-parameters

There is absolutely no justification for granting the tax-payer any deduction exceeding the reported living expenses out of reported incomes. In any scheme of

13. Many salaried assesseees present a cash flow picture which clearly shows 'nil' expenditure for the purpose of employment but they are still entitled to deduction of Rs. 15,000/18,000. They can manage capital accretion of Rs. 25,000 per annum. Also see, *infra* note 15. Quite a few of them show very low amounts of living expenditure and meet the difference between actual and reported expenditure from unreported incomes. After all, unreported incomes are not the monopoly of businessmen.

14. See, Memorandum explaining provisions of Finance Bill 1993 reported in (1993) 200 I.T.R. 144.

15. Here is an illustration:

| | |
|-----------------------|----------|
| | Rs. |
| Income from salary | 50,000 |
| Less: living expenses | 25,000 |
| Annual surplus | 25,000 |
| Surplus for 4 years | 1,00,000 |

a flat tax-free threshold like the present one of Rs. 35,000 the criterion of 'ability to pay' which is central to any equitable basis of direct taxation is totally eclipsed. Each real unit of income earning splits itself into multiple taxable entities and the income of the real unit suffers tax at a low effective rate. Only the salaried class are left out in the cold. Self-serving pleas of untaxed surplus are massively encouraged by the existing imponderable gap between the tax-free threshold in *all cases* and reported living expenses in *individual cases*. The burden of disproving the extent of any gap claimed in individual cases is really daunting and an unproductive burden on the tax administration. In the process litigation proliferates. All this will result in systemic inefficiency. A model scheme of individualised deduction which should replace the existing flat tax-free threshold will have to be constructed on the following parameters:

- (a) Reported living expenses of the tax-payer;
- (b) a percentage—say 50 per cent of the reported taxable income of the tax-payer;
- (c) aggregate of all the untaxed incomes of the tax-payer;
- (d) avoidance of any inquisitorial proceedings to determine the actual living expenses of a tax-payer;¹⁶ and
- (e) a reasonable upper limit for the individualised deduction.

IX Individualised deduction: a concrete scheme

Keeping in view the above parameters a formula for the individualised deduction may be enacted as under:

(i) the individualised deduction may be limited to the excess, if any, of the reported living expenses of the tax-payer over the aggregate of all his untaxed incomes.

(ii) The upper limit of such individualised deduction should be Rs. 36,000 (indexed to WPI of 31-3-1994).

(iii) In case of persons with reported taxable income exceeding Rs. 72,000 (indexed to WPI of 31-3-1994) 25 per cent of such excess, limited to Rs. 12,000 (indexed to WPI of 31-3-1994) should be added to the aforesaid limit of Rs. 36,000 (indexed to WPI of 31-3-1994).

16. All inquisitorial power, particularly power given on a mass scale, is bound to be misused. Hence it is imperative that concealed income reflected as unreported expenditure is identified on a highly selective basis by senior officers with minimum transgression of the citizen's privacy. Further, all claims of withdrawal of funds ostensibly for living expenditure must be accepted without scrutiny so that the tax law does not become an odious instrument of inquisition and harassment to a large body of tax-payers when placed in the hands of thousands of assessing officers. Since our scheme effectively forecloses claims of untaxed surpluses being available for investment/expenditure, the withdrawn funds cannot reappear as reported expenditure or investment. The amounts might be spent (unreported), but then benefit from such a device is only a carry over facility.

(iv) "Reported living expenses" should include all personal expenditure including vehicle maintenance and personal life insurance. All special personal deductions and exemptions should be dispensed with, whether based on the nature of income or on the nature of application of income.

(v) The income brackets in the rate schedule should be reduced to two as recommended by the Raja Chelliah Committee and tax rates at 20 per cent on the first Rs. 1,20,000 and 30 per cent on the balance.

X What such a concrete scheme could achieve

As imputed incomes go to reduce the living expenses incurred in cash the vexed exercise of discovering and evaluating imputed incomes may be dispensed with.

The above scheme will ensure that in the tax-world there is no circulation (or claim of circulation) of untaxed surplus derived out of a tax-free threshold and standard deduction. A predictable tax-payer's response to such a scheme of individualised deduction would be to withdraw funds from the sight of the tax collector and report the living expenses upto the allowable limit. Such withdrawn funds would be either spent away on special occasions without actually reporting such expenditure or invested with the risk of meeting found out. As the withdrawal of funds ostensibly for meeting living expenses will act as estoppel against future claims of availability of the same funds for investment, such spurious claims are neatly inhibited. As nobody's investment or expenditure can be explained away as out of untaxed surplus of the tax-payer or of somebody else, such over reporting of living expenses will prove counter-productive.

The holes in the tax-bucket may be at least partially closed.

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