

ANNEXURE

MEMORANDUM CONCERNING MATTERS RELATING TO TAXES ON INCOME

I. INTRODUCTORY

1. This Memorandum deals with—
- (1) The stages by which rates of Income-tax, Super-Tax, and Corporation Tax in States and Unions of States may be raised to the level of the corresponding Indian rates ;
- (2) Certain technical matters which will arise when Indian Acts and Ordinances relating to “ federal ” taxes on income are extended to Indian States and Unions of States in consequence of the integration of their “ federal ” finances with those of the Centre.
2. In this Memorandum, except where the context otherwise requires, the expression—
- (1) “ States ” should be understood as including “ Unions of States ; States ”, and as excluding those States whose administrations have been integrated with those of certain Provinces of India or into new Chief Commissioner’s Provinces.
- (2) “ Rates of tax ” should be understood to mean—
- (i) in relation to Companies, the maximum rate of Income-tax plus the maximum rate at which Corporation Tax is leviable upon Indian Companies in India, or upon locally registered companies in States, as the case may be ;
- (ii) in relation to all other assesses, the “ combined average-tax-rate curve ” for Income-tax and Super-tax (taken together) in respect of incomes of individuals*.
- (3) “ Prescribed date ” means the date from which federal financial integration becomes effective.
- (4) “ Pre-existing rates of tax ” means the rates of tax in force in States on the day preceding the prescribed date ; and where there are no taxes on income in any State, it shall mean the rates of tax in force in the Saurashtra Union—the lowest scale of rates—on the day preceding the prescribed date.
- (5) “ Amount of tax ” means the amount of Income-tax and Corporation Tax taken together.
- Scope of Memorandum.
- Definitions:
- Rates of Tax ;
- Prescribed date ;
- Pre-existing rates of tax
- Amount of tax.

II. GRADUAL RAISING OF STATE RATES OF INCOME-TAX

3. On the general question of introducing income-tax in States and the stages by which State rates should be raised to the level of Indian rates, we observed in paragraph 33 of Part I of our Report as follows :—

Income-tax in States ;
gradual raising of State rates to Indian level ;

“ We consider, accordingly, that Income-tax should be imposed throughout the territories of the Union of India, assessed

*Where a distinction is made—as in the Indian rates—between “ earned ” and “ unearned ” incomes, the rates relevant to the latter should be taken.

under a common federal law and uniformly administered directly by the Centre. We think, however, that the immediate application of the full Indian rates in areas in which Income-tax is not now levied, or in which the rates are low, will give rise to difficult problems both to the Governments and to private interests. We desire, however, to emphasise two points :

- (i) Income-tax should be introduced in all areas as from the date of federal financial integration, the rates being adjusted to local conditions as suggested in the Annexure ;
- (ii) the assessment and collection should be made by the Central Government's officers under the Indian Income-tax Act. "

States in which no income-tax levied.

4. Our first recommendation, therefore, is that in those States in which no Income-tax is now levied, it should be at once imposed with effect from 1st April 1950 or the prescribed date (whichever may be earlier), at rates not lower than the lowest pre-existing rates in the other States, *viz.*, those of the Saurashtra Union. If the date on which Income-tax is so introduced happens to be earlier than the prescribed date, the Income-tax Act under which this is done should conform as closely as possible to the Indian Income-tax Act.

Gradual raising of pre-existing rates of Tax : relevant considerations ;

5. Next, as regards the degree of gradualness required in raising the pre-existing State rates of tax to the level of Indian rates, the relevant considerations are the following :—

- (1) The pre-existing rates of tax are spread over a wide range, from those of the Saurashtra Union, which are below two-fifths of the Indian rates, to those of Cochin, which correspond to the Indian rates ;
- (2) No gradualness at all being possible in the case of States which have merged into Provinces or into new Chief Commissioner's Provinces, the degree of gradualness permissible in the case of continuing States is limited to such as would cause no serious discontent among the assesseees of the former, or indeed among the assesseees of the Provinces of India generally, on the ground of "discriminatory treatment" by the Centre.
- (3) The extent to which rates of tax are, or have been, *relatively* an effective factor (or operative cause) in stimulating or retarding industrial and commercial development in *particular areas* has generally been exaggerated. This is clear from a dispassionate consideration of the following :—
 - (a) Industrial and Commercial development in the Provinces of India has been more rapid, despite higher rates of taxation, than in States ;
 - (b) A close study of the circumstances in which certain "advanced" States out-stripped others in industrial and commercial progress shows that low rates of taxes (compared to those contemporaneously in force in the Provinces of India), or special concessions in the matter of taxation, were *not* the decisive, or even among the more important determining factors. The only exception to this is furnished by the undoubted "shift" of industry

and trade to some States during the later years of the recent World War, when "legitimate tax avoidance" doubtless constituted the chief incentive for locating industries in States.

- (c) It is well known that there are ample capital resources in States, especially in those areas which have had no income-tax at all, (or have had it at very low rates, indifferently administered); nevertheless, they are precisely the areas where industrial and commercial development has been significantly low.
- (4) Income-tax is a tax on profits; and its amount is, therefore, dependent upon the amount of profits. If particular areas, being unsuited for industrial and commercial development, show low profit-returns, the tax payable is also correspondingly low. But the taxable capacity of two or more assesseees with the *same* amount of total income cannot obviously be different. In these circumstances, the case for extending any special or discriminatory concessions to assesseees in States (by way of a generous measure of gradualness in reaching the Indian level of rates), beyond those already admissible (in respect of *new* industrial ventures) under the Indian Income-tax Act, uniformly throughout the country, is decidedly weak. Moreover, the consideration of any such claim would be beyond our terms of reference; for it raises large and important issues of fiscal policy, *viz.*, whether special tax concessions (in the form of low rates or otherwise) can in fact effectively stimulate trade, industry and commerce, and if so, the extent to which such concessions may legitimately be confined to particular areas (including States *and* parts of Provinces, alike) for deliberately fostering industrial and commercial developments there, in the general national interest.

The considerations set out above indicate that the degree of gradualness which would be justified in this matter is far less than is commonly believed, or than we have been pressed to concede by the interests concerned. This does not mean, of course, that there should be an abrupt change-over to the full scale of Indian rates; for in India itself those rates were reached gradually, except for the sudden spurt in 1947. Apart from this, there is the obvious necessity to avoid any serious maladjustment of private and "corporate" finance in the States, such as would result from the sudden raising of rates to a high level. This last point has two aspects:

firstly, as regards the incomes earned or accrued up to the prescribed date;

secondly, as regards the incomes accruing thereafter

It is doubtful whether the former can be expected equitably to bear any material raising of the tax rates at all,—especially in those areas in which Income-tax was only recently introduced or in those where rates were only recently enhanced; and as regards the latter—incomes accruing after the prescribed date—clearly a measure of gradualness in reaching the Indian level would be justified.

6. We recommend accordingly that the various pre-existing State and the rates of tax should be raised to the full level of Indian rates by varying ~~the~~ **scheme proposed.**

stages as shown in the Table below and according to the "instructions" set out thereunder.

Indian assessment year, assuming 1-4-1950 to be the prescribed date	Rebate to be allowed from the amount of tax payable at Indian rates, when the pre-existing State rates of tax are :—			
	Two-fifths of the Indian rates, or less	Three-fifths of the Indian rates or less, but above two- fifths	Four-fifths of the Indian rates or less, but above three- fifths	Over four- fifths of the Indian rates
(1)	(2)	(3)	(4)	(5)
1950-51	D	D	D	D
1951-52	D	D	D	D
1952-53	40%	20%	10%	<i>Nil</i>
1953-54	20%	10%	<i>Nil</i>	
1954-55	10%	<i>Nil</i>		
1955-56	<i>Nil</i>			

INSTRUCTIONS :—

- (1) Pre-existing State rates should be grouped into four categories, *separately for Companies and "others"*—(*vide* paragraph 2 above)—as in Cols. (2) to (5) of the Table, with reference to the corresponding Indian rates for the assessment year in which the prescribed date falls,—(1950-51, if the prescribed date should be 1-4-1950).
- (2) In so grouping the pre-existing rates, the following principles should be observed—
 - (a) The group in which each State's pre-existing rates *substantially* fall (having due regard to their range as a whole upto, say, income groups of Rs. 5 lakhs) should be the decisive consideration. The best technique for this purpose is to draw *large-scale* graphs (on the *same* sheet) of :
 - (i) Indian rates 1950-51 (full, 80%, 60% and 40% average-rate curves) ;
 - (ii) Pre-existing State rates (average rate curves).

The appropriate group for each State's rates can then be read-off at a glance.
 - (b) Where the pre-existing rates apply to "total incomes" which include Agricultural Income (*e.g.*, Hyderabad and Travancore), such rates (other than Company rates) should be grouped under the next *higher* groups than those to which they would otherwise belong (on a simple comparison of rates).

- (3) The grouping, once made, should be final.
- (4) The process of gradually reaching the full level of Indian rates should take the form of a gradually diminishing scale of Rebates from the amount of tax otherwise payable under the Indian law and at the full Indian rates of tax of *the assessment year concerned*. In other words, assessments would be made in complete accordance with the Indian law ; and the tax so payable would first be computed according to the Indian rates for the assessment year concerned. From the amount of tax so determined, a rebate would be allowed in accordance with the scale of rebates indicated in the Table, calculated in the manner indicated in sub-paras. (5) and (6) below.
- (5) Subject to what is stated in (6) below, the rebates to be allowed should be computed as follows :—
- (a) For 1950-51 } A rebate equal to the difference (shown as
and 1951-52 } “D” in the Table) between—
- (i) the amount of tax payable according to the Indian law and rates for the assessment year in question, determined as above ;
- and
- (ii) the amount of tax payable according to the pre-existing State rates applied to the total income as determined for (i)*.
- (b) *For subsequent years.* A rebate of an amount, calculated at the percentage indicated in the Table, from the amount of tax otherwise payable according to the Indian law and rates for the assessment year in question.
- (6) The amount of rebate so computed under 5(a) or (b) above would be *worked down* by the factor $\frac{X}{Y}$ where Y = the total income ; \bar{Y}
- where X = the portion thereof which, had the provisions of the present section 14(2)(c) of the Indian Income-Tax Act continued to be operative, would have been entitled to the exemption there provided.

The resultant amount would thus be the rebate finally admissible.

7. Such a plan, read with the recommendation made in paragraph 4 above and the definitions set out in paragraph 2 above—will ensure the following :—

Comments
on the
Scheme.

- (1) With effect from the prescribed date, there will be Income-tax in all States ;
- (2) the pre-existing rates will be “ frozen” for the first two assessment years, thereby ensuring that all incomes earned or accrued in the States upto the prescribed dates will be assessed at the pre-existing rates ;

* If, as may happen for some income brackets in Cochin, the amount of tax payable at the pre-existing rates should exceed that payable at the Indian rates, no rebate would be admissible; and the assessment would be finalised at the Indian rates.

- (3) *thereafter*, there will be gradual assimilation of pre-existing rates to the Indian rates prevailing in the assessment year concerned, at a varying pace depending upon the divergence between the pre-existing rates and the 1950-51 Indian rates ; the pace may also vary for companies as compared with other assessees of the same State ;
- (4) the process by which this will be achieved takes the form of a varying scale of rebates (diminishing year by year) to be allowed from the tax otherwise payable at the Indian rates. This method has three practical advantages :—
- firstly, simplicity ;
- secondly, complete abandonment of any calculations by reference to pre-existing rates ;
- thirdly, any changes in Indian rates effected by the Finance Acts of the years concerned would have their appropriate effects upon the net tax payable by assessees having income accruing or arising in States ;
- (5) The scheme applies only to incomes to which, but for federal financial integration, the provisions of Section 14(2) (c) of the Indian Income-tax Act would apply ; that is to say, income, profits and gains which would, in any case, be taxable at the full Indian rates will continue to be so taxed.
- (6) Taking 1st April 1950 as the prescribed date, and assuming that Indian rates of tax in 1950-51 and the pre-existing State rates of tax remain as they are now, the periods required in accordance with our plan for gradually raising the latter to the level of the former would be as shown below :—

STATE	PERIOD OF GRADUAL- NESS IN YEARS	
	For Com- pany Rates.	For other Rates.
Cochin	2*	2*
Travancore	3	2
Mysore	2	4
Hyderabad	4	3
Patiala & E.P. States Union	2	3
Saurashtra Union	5	5
Madhya Bharat Union	5	5
Rajasthan Union	5	5
Vindhya Pradesh Union	5	5

8. We consider that the plan is simple and equitable; that it provides the necessary measure of gradualness to the extent justifiable ; and that it will be accepted by the Governments of all States. We recommend its adoption.

* This is merely theoretical ; effectively, Cochin rates are already at, (and, for some income brackets, even above), the Indian level ; assessments will, therefore be made at the lower of the two rates.