III. TECHNICAL MATTERS RELATING TO INCOME-TAX

9. Our suggestions concerning certain legal and other matters of general importance, affecting most federal subjects (including taxes on income), which will arise in connection with federal financial integration in all States, have been set out in paragraph 11 of Chapter II in Part II of our Report. Those relating to legal matters are, however, reproduced below for convenient reference :— Matters affecting most "federal" subjects, including taxes on income.

" (5) Apart from the *constitutional* requirements in connection with the integration of federal finances in States—*vide* paragraphs 37 and 40 of Part I of our Report—certain important issues of a legal nature will arise in connection with the actual taking over of " federal" subjects in the States by the Centre.

This is a difficult subject upon which we are not qualified to offer competent advice. We have endeavoured, however, to indicate below the main features of what we conceive will be required in order to establish " continuity of proceedings" in regard to all " federal" subjects—whether relating to revenues, expenditure or Service Departments—at the point of their transition from the States to the Centre ; .....

(*a*) Almost every " federal" subject is dealt with in the States, as in the rest of India, under powers conferred by appropriate legislation consisting of relevant Codes, Acts, Ordinances and Statutory Rules and Regulations. Subject to the limitations indicated below,—which are designed to secure legal " continuity" of pending proceedings and " finality and validity" of completed proceedings under the pre-existing State legislation—,we think the whole body of State legislation relating to " federal" subjects should be repealed and the corresponding body of Central legislation extended *proprio vigore* to the States, with effect from the prescribed date or as and when the administration of particular " federal" subjects is assumed by the Centre.

(*b*) For the above purpose, as well as for future " federal" administration in States, it may be necessary specifically to extend not merely the legislative, but also the executive and administrative competence of the Centre, its officers and " authorities", and the judicial authority of its Courts, to the territories of the States.

(*c*) Such State Courts (except Courts of *final* appeal from orders of the State High Courts) as may in fact correspond to particular grades and classes of " British Indian" Courts (Civil and Criminal) may have to be statutorily " recognised" as " corresponding judicial authorities" for purpose of dealing with cases arising in the States under the " federal" laws of the Union of India ; and the Supreme Court in India will have to be made the Court of final appeal from decisions of the State High Courts to the same extent as in the case of Provincial High Courts .

(*d*) Those sections of the various Indian Acts and Ordinances which set out their territorial " extent of application" will require amending so as to include State territories with effect from the prescribed date.

(*e*) It will be necessary to provide that all matters and proceedings pending under, or arising out of, the pre-existing State Acts shall be disposed of under *those* Acts by, so far as may be, the " corresponding authorities", (nominated by the Chief Executive Authority) under the corresponding Indian Acts. "

Legal matters especially concerning Income-tax.

10. We now deal with certain other legal matters especially concerning income-tax.

(1) The recommendation made in the last two sub-paragraphs quoted above should be understood as requiring that all income, profits and gains accruing or arising in States, of all periods which are " previous years" of the States' assessment years 1949-50 or earlier should, subject to the provisions of Section 14(2) (*c*) of the Indian Income-Tax Act, be assessed wholly in accordance with the States' laws and at the States' rates, respectively, appropriate to the assessment years concerned, notwithstanding that some of these " previous years" may also be the " previous years" for the Indian assessment year 1950-51. In the last mentioned cases, no Indian assessment for 1950-51 should be made in respect of such income.

(2) As respects income, profits and gains of all subsequent periods, the assessment will be wholly in accordance with Indian law ; but as regards the rates applicable to such assessments, the proposals made in Section II of this Memorandum concerning the gradual raising of State rates to the level of Indian rates should be applied.

(3) In making assessments according to the Indian law in respect of income, profits and gains of periods referred to in sub-para (2) above, certain transactions of the periods upto the prescribed date (which, but for federal financial integration would be outside the ambit of the Indian law), should be dealt with, if possible, *not* in accordance with Indian law but in accordance with the State law concerned. The particular transactions referred to are those covered by Act XXII of 1949 and the undermentioned provisions of the Indian Income-Tax Act,

Section 18
Section 18A
Section 23A
Section 16(1) (*c*) and (3)

Our intention is that the benefit of the above proposal should be restricted only to the assessment of incomes accruing in the States up to the prescribed date. This can, perhaps, best be done by executive instructions.

(4) It will be necessary appropriately to modify certain provisions of the Indian Income-tax Act for the purposes indicated below :—

(*a*) The definition of " British India" in Section 2(3A) of the Indian Income tax Act will require to be so modified as to include specifically and without any antecedent limit of time the territories of the States integrating with the Centre on federal finance. Unless this is done, it will be

impossible effectively to administer the Act from the prescribed date, since many of its most important provisions *e.g.*, those relating to computation of income, have reference to the state of affairs in the " previous year", and others, *e.g.*, those relating to " residence", have reference to the state of affairs in several years preceding the assessment year.

There will be no danger of the suggested amendment enabling Indian assessments to be made for any year earlier than 1950-51, since the amendment of Section 1(2) of the Act—its "extent of application"—will be effective only from the prescribed date.

(*b*) The provisions of Section 4(b) (iii) of the Indian Income-tax Act will require modification in relation to States so as *not* to render taxable incomes arising without the State (other than in the Provinces of India) in periods perior to the prescribed date and remitted *to the States in any previous year* (before or after the prescribed date), to an extent more than they would have been taxable under the State law itself.

(*c*) Section 14(2)(c) of the Indian Income-tax Act must be deleted in respect of States integrating on federal finance for assessment purposes with effect from the Indian assessment of periods subsequent to the "previous years" of the *States'* assessment years 1949-50 ; but power should be retained for the use of the *principle* there stated in connection with the proposal gradually to assimilate State rates to Indian rates set out in Section II of this Memorandum.

Other Technical matters concerning Income-tax:

11. Certain other technical matters which will arise in connection with Income-tax are dealt with below :—

Remittances.

(1) (i) Under the Indian Income-tax Act, incomes, profits or gains accruing or arising in Indian States are not taxable in India, unless they are received in, remitted to or brought into "British India", or are *deemed* to have accrued or arisen or been received in "British India", in the "previous year". This position must continue unchanged in respect of transactions upto the close of the "previous years" of the *States'* assessment years 1949-50.

(ii) Remittances *to* the States from "British India" (or anywhere else) *prior* to the end of the "previous years" of the *States'* assessment years 1949-50 would have significance only in relation to the pending assessments of *the States*. Their relevance to the corresponding Indian assessments would be, not *qua* remittances, but only *qua* "information", *e.g.*, as material (under Section 34) disclosing possible escapement of income which might (had its existence been known) have been *otherwise* taxable under the Indian Income-tax Act in any case.

(iii) Funds which may be already (physically) in the States at the close of the "previous years" of the *States'* assessment years 1949-50 should not be treated as "remitted" to "British India" subsequently by the mere fact of financial integration as a consequence merely of the changed definition of "British India".

(iv) Any movement of funds to/from the States from/to the present "Bristish India" *after* the end of the "previous years" of the *States'* assessment years 1949-50 should have no significance *qua* remittances, being merely an internal movement of funds within "British India" (as redefined). If, however, such remittances *from States* happen to be out of the profits accruing or arising in the States *after* the close of the "previous years" of the States' assessment years, 1949-50, they will be relevant for *rate* purposes, since, under the scheme of gradual raising of State rates set out in Section II of this Memorandum, such profits (if remitted to India) would be assessable at the full Indian rates.

We would suggest the issue of instructions in the above sense by the Central Board of Revenue at the earliest opportunity; we apprehend that in the absence of some such specific instructions there is some danger of a misunderstanding concerning this highly technical matter.

Double Income-tax Relief;

(2) Where double-taxation has already occurred, or may (perhaps) inadvertently occur even after federal financial integration , we recommend that relief should continue to be given in accordance with the existing D.I.T. Relief arrangements. Technically, double-taxation must necessarily occur, even after financial integration, in respect of the *States'* assessments for 1949-50 and earlier years, since all such assessments (whether already completed or pending at the prescribed date) will be made according to the State laws (in respect of incomes assessable in States), and according to the Indian law (in respect of incomes assessable in "British India" as at present defined) ; in all such cases suitable arrangements will have to be made for granting relief promptly (if double-taxation has already occurred), or for giving credit for the amount of relief due (if double-taxation is liable to occur) in connection with pending assessments.

Immunities from Taxation:

(3) (*a*) We recommend that all taxation immunities now enjoyed by (1) Rulers, and (2) Political pensioners (former subordinate Chiefs) should be protected. A list of such persons, the amounts involved and the exact nature and terms of the immunities enjoyed by them should be furnished by the States to the Central Government.

Rulers ;

So far as the *Rulers* (and their successors) are concerned, the problem is largely political and should be settled on that basis; but broadly speaking, what is involved is—

(i) the continuance of the immunities from "federal" taxation which they now enjoy in "British India", with the *addition* that their privy purse shall also be totally exempt from taxation (by outright exclusion from "total income");

(ii) the continuance of the immunities from "federal" taxation which they *now* enjoy in the States, with the *limitation* that such immunities should be restricted to their incomes from such *present sources* only (including properties) as may be declared to be their " Personal and Private Property".

Political pensioners;

As regards *Political Pensioners*, our recommendation involves the continuance of the immunities from "federal" taxation which they now enjoy in the States, with the *limitation*

that such immunities will extend only during the life-time of the present incumbents, *unless* it be that similar political pensioners in India enjoy perpetual immunity from "federal" taxation.

(*b*) With regard to any *Industrial Corporations* now in enjoyment of such immunities, it will be necessary to examine the principal items of the taxation concessions granted to them. Each case must be dealt with on merits, the general objective being to continue in their favour for some reasonable period, not exceeding ten (or fifteen) years, the existing concessions, if they happen to be more favourable than those admissible under the Indian Income Tax Act itself (*e.g.*, in the case of newly established industrial enterprises). Industrial Corporations;

(*c*) Industrial and Commercial enterprises wholly owned and operated by States at present enjoy immunity from federal taxation *within* their respective territories. As regards the incomes, if any, accruing or arising to these enterprises within "British India", however, their liability to Indian Income-tax and other federal taxes is governed by the Government Trading Taxation Act, 1926, which provides that they shall be chargeable in respect of such income, State Government's Immunity from "Federal" Taxation;

(i) to Income-tax, as if they were "companies";

(ii) to any other tax, as if they were "individuals" or "associations of individuals".

In other words, their position in respect of liability to federal taxation is not dissimilar to that of Provinces under Section 155 (1) of the Govt. of India Act, 1935. If , therefore, federal financial integration in respect of any State should become effective under the present Govt. of India Act, no special difficulty will arise, since the present degree of immunity will effectively continue under Section 155(1) of that Act.

But Article 266 of the Draft Constitution will, if enacted, introduce a radical change ; it will make the income of such enterprises liable to federal taxation, irrespective of the place ("within the territory of India") of its accrual. This is subject only to the very limited exemption contained in the "Explanation" to Article 266. The problem so arising will, however, affect not only the Indian States and Unions, but also the Provinces; and we have no doubt it will accordingly be examined in all its bearings in the Constituent Assembly of India before this Article is enacted into Law. It is not, therefore, necessary (nor, perhaps, would it be p oper) for us to express any opinion on the merits of the proposed Article 266 of the Draft Constitution. We cannot, however, overlook the fact that if it should be enacted in its present form, it will have adverse consequences upon the finances of Indian States, to the extent that they are now dependent upon the tax-free income from those enterprises; in some States such income is considerable.

We recommend, therefore, that should Article 266 be enacted in its present form, the *existing* State-owned and operated enterprises should be exempted from federal taxes on income to the extent to which they *now* enjoy such immunity in

the States and under the Government Trading Taxation Act, 1926, in "British India".

(*d*) If the continuance of any of the immunities referred to in the preceding sub-paragraphs cannot (as we think) be ensured by executive instructions or statutory (exemption) Notifications, necessary powers should be taken by appropriate legislation.

Income-tax Investigation Commission;

(4) Except in Travancore, there is no Income-tax Investigation Commission in any State. Should the Travancore Commission still be functioning at the time of federal financial integration, all cases pending with it should be taken over by the Indian Commission. The disposal of those cases will, however, (as in the case of pending assessments) have to be in accordance with the pre-existing Travancore Law.

The Indian Commission has already the power to call for such information as it may require from any person—including Banks—in the States. This power has been conferred upon it by legislation recently passed in the States. It will be for the Commission to decide whether such State legislation should be replaced by the Indian Acts under which it functions in the Provinces of India; if so, the Indian Acts should be extended in their territorial application to include the States also.

No State-assessments (other than those already under investigation in Travancore) should be referred for investigation to the Indian Commission, since all such assessments of 1949-50 or earlier years and, therefore, all cases of evasion in States in those years, would be governed by the laws of the States.

Collections under "PAYE" and "provisional" assessment schemes.

(5) There should be no financial adjustments between the Centre and the States in respect of collections made by the States before the prescribed date under provisions of the State Laws corresponding to those of the Indian Income-tax Act in regard to "advance payment" of tax under the "Pay-as-you-Earn" Scheme, or "provisional assessment" of tax in anticipation of final assessments. But credit for such collections should be given to the assessees concerned in the ordinary way when their relevant final assessments are made by officers of the Central Government after the prescribed date.

Income-tax "Divisible Pool";

(6) We have dealt with the "divisible pool" of Income-tax in paragraph 34 of Part I of our Report, which is reproduced below for convenient reference :—

"At this stage, we invite the attention of the Government of India to the need for taking up, as soon as possible, the revision of the existing distribution to Provinces of the proceeds from taxes on income. This was specially brought to our notice by the Goverment of Bombay. Areas which were formerly Indian States have recently been added to the Provinces of Bombay, Bihar, Orissa, Madras, East Punjab and the Central Provinces. There are, further, the changes in the existing basis of distribution recommended by the Expert Committee on the Financial Provisions of the Union Constitution (paragraphs 50-56 of its Report).

After orders are passed on the proposals contained in our Report and financial integration takes effect in States, further

revision will become necessary. In this connection, we recommend that there should be no departure whatever from accepted principles (such as may be applicable, from time to time, to provinces) in connection with States, neither as regards the proportion of the net proceeds of income-tax which should constitute the divisible pool, nor as regards the proportion thereof which may be allocated to individual States. And there should be no separate divisible pool for the Stats, except where, over a transitional period, the rates of ieo metax may (as proposed by us) be lower than the full ncdian rates; some *ad hoc* temporary arrangements would bIn permissible in such cases only."

"Royalties" computed by reference to Profits.

(7) In some of the covenanting States of Rajasthan Union, a system of "Royalties" is in force in connection with certain industrial enterprises; similar arrangement may exist in other States also. These, in so far as the "Royalties" are computed by reference to the *Profits* of such concerns, should be dealt with as follows:—

"Royalties" computed by reference to income or profits are of the nature of taxes on income and so cannot continue to be imposed by the States after federal financial integration becomes effective. After the prescribed date, they will be substituted by income-tax in the ordinary sense. The bearing of this upon any pre-existing concessions in the matter of "income-tax" will require careful consideration, for it may well be that the conversion of such Royalties into "federal" income tax may render the continuance of any of the pre-existing concessions superfluous.

Any profit-sharing arrangements between States and particular industrial concerns, *after* payment of "federal" taxes on income, will of course remain unaffected by what has been said above.

IV. OTHER TAXES ON INCOME AND TAXES ON CAPITAL, ETC.

Excess Profits Tax.

12. (1) Excess Profits Tax has been abolished in all States where it was originally levied, but there may be some cases still pending under the old State Excess Profits Tax Acts. They will have to be disposed of by officers of the Central Government in the same manner as pending cases under the Indian E.P.T. Act; the law and rates applicable will, however, be those of the State concerned.

Liability to the assessees in respect of returnable E.P.T. deposits and in connection with any refundable portion of the E.P.T. previously levied by the States will have to be taken over by the Centre; similarly the liability to give credit for collections made against "provisional" assessments.

In any State in which there was no Excess Profits *Tax* but only Excess Profits *Deposits*, the most practical arrangement would be to leave it to such States to return these Deposits to the persons concerned in accordance with the pre-existing Laws.

Capital Gains Tax

(2) As Capital Gains Tax has been abolished in India, there will be no question of levying such a tax in respect of capital gains accruing in States prior to the prescribed date.