Tax Treatment of Small Saving Instruments

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The existing tax system on financial instruments is quite complex distorting the information efficiency of capital and debt markets and providing distorted arbitrage opportunities resulting in misallocation of financial resources. Therefore, the Committee, while analysing the existing tax provisions relating to Small Saving Schemes, would like to take a comprehensive view about the whole structure of taxation on financial savings/instruments. The basic approach of the Committee in this regard is:

(i) *to do away with the plethora of ad-hoc exemptions on varied instruments and introduce an element of homogeneity across instruments so that there is a level playing field and 'relative' returns on instruments do not get distorted by the tax structure;*

(ii) *to make a distinction between short to medium term instruments and long-term saving mainly in the form of old age security schemes, so that the incentives for long-term saving and accumulation of wealth for old age are preserved and protected; and*

(iii) *to do away with the distinction between income from capital gains and dividend/interest for purposes of tax levy so that the incidence of tax is uniform upon the 'total return' from instruments, eliminating arbitrage opportunities arising out of structuring of instruments in terms of coupons and maturity.*

While the Committee on Tax Policy and Tax Administration for the Tenth Plan (Shome Committee, 2001) has come out with reform proposals, this Committee, after a review of these proposals would like to suggest certain modifications in the tax reform in respect of financial savings/ instruments, summarized as below:

i) *Partial retention of existing tax benefits, under Section 88, for long term financial instruments, as against the recommendation of completely doing away with Section 88 of IT Act.*

ii) *Coverage of all short and medium term financial instruments under the scheme of Tax Deduction at Source (TDS). This scheme is proposed to be operationalised through a system under which a certificate would be issued to the holder of that financial asset for filing with Income Tax Department.*

iii) *For purposes of taxation, financial instruments could be classified into two categories viz., Short and Medium Term Savings instruments and Long term Savings Instruments.*

iv) *Scrapping of all the tax benefits currently available under Section 10(11) and Section 10(15) of IT Act.*

v) *Subjecting all withdrawals from long-term financial instruments, to tax at the rate of 10 per cent.*

vi) *Subjecting all premature withdrawals from long-term financial instruments, to tax at the rate of 20 per cent.*

vii) *Exempting the income of Institutions managing long term financial savings from corporate tax.*

viii) *Subjecting lump sum payments received by way of commutation of pension, to tax at a rate of 10 per cent.*

ix) *The distinction between capital gains income and interest/dividend income could be*

abolished in respect of all financial instruments and the tax could be levied upon the 'total return' from the respective instruments. This will eliminate distorted arbitrage opportunities arising out of structuring of a financial instrument.

With a view to promoting financial savings in the economy and also to channeling these financial resources into some specific sectors, the Union budget provides for various tax incentives on different financial instruments including small savings. These incentives cause an implicit cost to Government, violate the principles of equity and efficiency without generally enhancing savings at macro level. Therefore, the continuation of different tax incentives on various financial assets needs to be given a relook. However, it is necessary to distinguish between long-term savings and short and medium term savings insofar as the tax treatment is concerned. The tax treatment for long-term savings should differ, from short and medium term savings, considering the special role of these instruments in promoting long-term financial accumulation and social security.

Types of Incentives Available

Under the Indian tax system, the financial savings in some instruments are broadly provided three types of tax incentives, *viz.*, (a) deductions, (b) exemptions and (c) tax rebates. The provisions for tax deductions are contained in Section 80-L, provisions of tax exemption are detailed under Section 10 and the provisions of tax rebate are provided in Section 88.

Under Section 80-L, the existing tax provisions provide for exemption of income upto Rs.12, 000 (with an exclusive sub ceiling of Rs.3,000 for interest income arising from Government securities) from income tax on specified financial instruments. The financial instruments covered under this Section include bank deposits, Government securities, NSC, post office deposit, etc.

The income tax provisions as contained in Section 10(11) and 10(15) of Income-tax Act, 1961, provide for unlimited exemption of capital income from income tax, derived from some notified financial assets such as Life Insurance Policy, Employees Provident Funds, Public Provident Funds, etc.

The saving incentives in the form of tax rebate are covered under Section 88. Under this section, investment in specified assets such as NSC, NSS, Employees Provident Fund and Public Provident Fund, tax saving units of mutual funds, premia paid on life insurance and infrastructure bonds of IDBI and ICICI are eligible for tax rebate at 20 per cent with an overall limit of Rs.80,000 (containing an exclusive special sub-ceiling of Rs.20,000 for infrastructure bonds).

Categorisation of Financial Instruments for Tax Treatment

Empirically, the impact of tax concessions, in promoting macro economic savings, is evidenced to be different for different financial instruments. While the tax incentives tend to divert the flow of financial savings in favour of tax preferred financial instruments, it does not necessarily facilitate increased financial savings at macro level (Chelliah 2001).

The tax incentives on financial instruments having short and medium term lock-in provisions are evidenced to be used more as a vehicle for tax avoidance, by recycling of existing savings, than as an instrument for financial accumulation. In contrast, the saving in financial instruments with long lock-in provisions is generally undertaken with an objective to smoothing future consumption, in the events of anticipated fall in earned income (particularly retirement), anticipated increase in consumption needs (such as children) as well as unpredictable increase in needs and unpredicted reduction in income. Accordingly, the tax induced financial flows into long-term instruments have a tendency to promote accumulation in financial assets or macroeconomic savings.

On the basis of impact of tax concessions on macroeconomic savings, different financial instruments could be categorized into (a) long-term financial savings, i.e., savings in financial assets having, say, more than 6 years of maturity and (b) short and medium-term financial savings, i.e., savings in financial assets having up to 6 years of maturity. The major financial instruments forming part of long-term savings particularly for old age security are Employees Provident Fund, Public Provident Fund, Public Pension Fund, etc., while financial instruments with short and medium-term redemption period include deposits, Government Securities, Relief Bonds, National Savings Certificate, National Saving Scheme etc. While the old age security schemes are meant to be illiquid and are not marketable instruments, the financial instruments in the nature of securities like bonds and debentures, shares and government securities should technically be treated as short to medium-term savings for tax purposes because of their high liquidity and marketability.

Existing Tax Provisions for Financial Instruments having Short and Medium term Maturity

Bank Deposits

Under existing tax provisions, interest from deposits, along with some other specified instruments, up to Rs.9,000 is free from tax under Section 80L. Since the year 1995-96, interest earnings exceeding Rs.10,000 per annum are subject to tax deduction at source at the rate of 10 per cent for individuals and 20 per cent for corporate bodies. From the year 1993-94, bank deposits are totally exempted from wealth tax.

Small Saving Schemes

Small saving schemes commonly referred to are post office deposits (savings bank deposits, time deposits, recurring deposits, and monthly income scheme), certificates issued by the Government (National Savings Certificates VIII, Indira Vikas Patra, and Kisan Vikas Patra) and National Saving Scheme. All small savings schemes, barring IVP and KVP, enjoy tax benefits. All post office deposits enjoy tax benefits under Section 80L of the Income

Tax Act. The National Saving Scheme (NSS) earlier enjoyed exemption under Section 80CCA whereby amount deposited could be deducted from income. This Section (80CCA) was withdrawn since 1992-93. Instead, investments under NSS were included in Section 88, which provides for a uniform 20 per cent tax rebate. However, the IVP and KVP, which do not enjoy

any tax benefits, carry attractive rates of interest.

Units of Mutual Funds

As regards tax benefits on units of mutual funds, earlier, only ULIP-71, which is operated by UTI in collaboration with LIC and GIC, enjoyed tax rebate. During 1990-91, investments in equity linked saving schemes of UTI and other mutual funds were allowed to be deducted from total income up to a maximum of Rs.10,000 under Section 80CCB. From the year 1992-93, investments up to maximum limit of Rs.10,000 in such schemes are allowed tax rebate under Section 88.

Traditionally, the income from units of mutual funds enjoyed tax benefit under Section 80L. From the year 1990-91, an exclusive exemption of Rs.3,000 was also made available for income from investments in mutual funds, including UTI. From the year 1998-99, income from mutual funds, including units of UTI, was totally exempted at the hands of investors, while mutual funds themselves were required to pay a tax at the rate of 10 per cent which was raised later to 20 per cent from the year 1999-2000 in respect of debt oriented schemes. However, equity oriented schemes, where 50 per cent or more funds are invested in equities, were exempted from the payment of tax for a period of three years from 1999-2000 to 2001-2002. From 1996-97, long term capital gains were exempted from capital gains tax if invested in specified securities, including units of mutual funds.

Government Securities

Under the existing provisions of Income Tax Act, the investment in Government securities enjoys tax concession under Section 80L. The interest income from Government securities up to Rs.12,000 (Rs.9,000 along with other notified instruments and Rs.3,000 exclusively for Government securities), is deductible from taxable income under this Section. The investment in Government securities is also exempted from wealth tax.

Shares of Company

The shares of Indian company have been provided preferential tax treatment since 1967, initially in the form of deduction under Section 80L. During the year 1990-91, Section 88A was introduced allowing tax rebate of 20 per cent with a maximum ceiling of Rs.5,000 for investment in equity shares, units of mutual funds, etc. From the year 1994-95, Section 88A was omitted and the exemption on eligible issues, along with other specified savings for the purpose of income tax, was introduced under Section 88. Investments in the listed shares are subject to capital gain tax. However, from the year 1993-94, indexation on capital gains was introduced permitting the treatment of shares, if held for more than 12 months, similar to long term capital assets (as against 36 months earlier) and thus having a lower rate of capital gains tax. In the Union Budget for 1999-2000, dividends received at the hands of investors are fully exempted from income tax, while companies were required to pay tax at a flat rate of 10 per cent which was later increased to 20 per cent since 2000-2001.

Bonds of PSUs and DFIs

The bonds issued by PSUs are of two types, *viz.,* taxable and tax-free. The provisions of tax free bonds as contained in Section 10(15)(iv)(h) of IT Act allows complete exemption of interest income arising from notified PSUs bonds .

The bonds issued by DFIs normally do not enjoy any tax benefits, except those bonds whose proceeds are intended to be deployed towards infrastructure projects (infrastructure bonds). The Infrastructre bonds were earlier allowed tax rebate up to maximum amount of Rs. 70,000 (increased to Rs.80,000 from 2000-01) under Section 88 or exemption from tax on capital gains arising from transfer of long-term capital assets under Sections 54 EA/54EB.

However, with withdrawal of benefits under Sections 54EA/54EB since 2000-01, tax benefits for infrastructure bonds are now available only under Section 88.

Relief Bonds

The Relief Bonds are issued by the Government of India for entities such as individuals, Hindu Undivided Families (HUF) and NRIs. The investment in Relief bonds enjoys two types of tax concessions, viz., (a) interest on the bonds is fully exempt from Income tax under Section 10 (15) and (b) the investment in this bond is fully exempt from wealth tax.

Corporate Debenture

Investment in debentures does not enjoy any tax rebate. Interest earned on them is fully taxable.

Company Deposits

Both financial and non-financial companies are permitted to raise deposits. The deposits thus raised do not enjoy any tax concession, and the interest income on these deposits is fully taxable.

Evaluation of Saving Oriented Tax Incentive Schemes for Short and Medium-Term Financial Instruments

The twin objectives for providing different types of tax concessions on different financial instruments, in various Union Budgets, have been (a) to promote macroeconomic savings and (b) to channelise flows of financial resources in favour of some specific sectors. While the tax concession seems to have achieved the latter objective, it has not faired satisfactorily in promoting financial accumulations particularly in respect of financial instruments having short and medium term maturity. The tax concessions, on these financial instruments, are often evidenced to be used more for tax avoidance purposes-through recycling of existing savings-than for financial accumulations.

Tax incentives involve various economic costs. These costs can broadly be identified as cost to the government - in terms of forgone revenue - and cost to the economy - in terms of adverse impact of tax concessions on allocative and market efficiencies and equity.

The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, 2000 (Chairman: Shri Parthasarathy Shome) has evaluated the impact of tax incentives on efficiency and equity. The observations of the Committee in this regard are placed as under.

Impact on Efficiency

Table 1 : Tax Benefits under Various Sections of the Income Tax Act

Instrument	Exemption of Income - Interest and dividend		Exemption from capital gains tax		Tax Rebate*
	Total exemption$$ (u/s 10)	Partial Exemption up to a limit @@ (u/s 80L)	Short-term	Long-term # (u/s 54EA, 54EB and 54EC) 88	Section 88
1. Bank Deposits	-	Rs.9,000	-	-	-
2. Mutual Funds	$$	-	-	-	@
3. LIC Policies	$$	-	-	-	-
4. Bonds by Fis	-	-	-	#	$
5. Shares	$$	-	-	-	$
6. Debentures of Companies	-	-	-	-	$
7. Small Savings					
(a) Post Office Deposits	-	Rs, 9,000	-	-	-
(b) Certificates VIII Issue ##	-	Rs. 9,000	-	-	-
(c) Approved Provident Funds including P.P.F.	$$	-	-	-	-
(d) National Savings Scheme, 1992	-	Rs. 9,000	-	-	-
8. Company deposits	-	-	-	-	-
NBFCs	-	-	-	-	-
NBNFCs	-	-	-	-	-

Exemptions and tax rebate available.

\- Exemptions and tax rebate not available.

\# Income from long-term capital asset (if held for more than 12 months) is taxed at a flat rate 20 per cent after indexation (10 per cent without indexation). Exemption from long-term capital gains were available under section 54EA and 54EB where the investor was willing to block the funds generated from sale of long-term assets in specified securities. However, exemptions under Section 54EA and 54EB were withdrawn in the Union Budget 2000-2001 and a new Section 54EC was introduced, whereby tax exemption on long-term capital gains is now available only if the gain are invested in specified long-term assets, i.e., bonds issued by the NABARD or the NHAI that are redeemable after three years.

\## Available only for National Savings Certificate (NSCs). No tax rebate is available on Indira Vikas Patra and Kisan Vikas Patra. In respect of NSG VIII issue, though the investor gets a rebate on the original investment as well as subsequent interest earned u/s 88 of I.T. Act, the interest income received every year is not exempt under Section 80L of the I.T. Act and is taxable under the head “Income from other sources”.

@ Any unit linked insurance plan of UTI and LIC Mutual Fund and contribution to equity linked saving scheme of any mutual fund are provided tax exemption on capital income under Section 80-L subject to maximum of Rs.10,000/-.

@@ Though partial tax exemption upto Rs.9,000/- is available individually with respect to item 1, 7(a), 7(b) and

7(d) an investor cannot claim an exemption of more than Rs.9,000/- on an aggregate even if he invested in more than one of these instruments.

$ Equity shares, debentures of a public company engaged in infrastructure (including power sector) only and bonds of FIs if proceeds thereof are intended to be deployed for infrastructure projects only).

$$ Maturity proceeds including income by way of interest in approved provident funds including P.P.F. and bonus in case of insurance policies are exempt from tax as capitalised income under section 10 of I.T. Act, 1961. Dividend income from shares of companies and units of mutual funds are also exempt u/s 10 of the Income-tax Act.

* Tax rebate is available under Section 88 of the Income-tax Act, 1961. The maximum amount of rebate available is Rs.12,000/- (i.e. 20 per cent of Rs.60,000/-). By investing in shares or debentures of infrastructure sector, a higher qualifying amount of Rs.80,000 and a tax rebate of Rs.16,000/- (i.e. 20 per cent of Rs.80,000/-) can be claimed. By investing only in shares/debentures of an infrastructure company and bonds of FIs if proceeds thereof are intended to be deployed for infrastructure projects, maximum rebate of Rs.16,000/- (i.e. 20 per cent of Rs.80,000/-) may be claimed.

While investment (or saving) under Section 88 is rewarded, disinvestment (dissaving) is not brought under charge. The incentives are available not necessarily for saving but also for mere diversion of funds, from one form of investment to another and that too for mere locking up these funds (i.e., surrendering the purchasing power to the government) only for a specified period of time. The netting principle is not applicable and dissavings remain untaxed. Therefore, there is a bias in favour of investment in short-term instruments. To this extent, it creates serious distortions in the allocation of savings. The tax rebate, for repayment of installments of housing loans made by taxpayers to specified institutions encourages debt as against "equity" financing. This increases the transaction costs in the economy and is, therefore, wasteful.

In any scheme of incentives for savings, it is desirable that the investments, which are being encouraged, should have broadly similar rates of return. Any variation in the rates should only be on account of differences in the holding period, risk or some overriding considerations of priority for a particular sector. While the major consideration behind the incentive schemes seems to have been to encourage investment in financial assets so as to direct savings to the public sector, there are arbitrary variations in rate of return even among such assets. The rates of return bear no systematic relation to the length of the holding period of assets. In effect, by delinking rates of return from holding periods, the public sector crowds out the private sector through offers of quick and perceptibly safer returns. To the extent there is wasteful use of resources by the public sector, such incentives exacerbate waste.

Deduction of net investment and allowing deduction of income from such investment are broadly equivalent in that each is sufficient to achieve treatment of savings as under a proportional expenditure tax. Yet, assets such as National Savings Certificates and provident funds enjoy both deductibility in investment (under Section 88) and of interest earning (under Section 80L and 10(11) or 10(12) respectively). This leads to inordinately high effective rates of return on these assets (Appendix Table 1 and 2). In turn, these serve as a benchmark for rates of return (discount rate) and therefore lead to high cost of borrowing across all sectors in the economy and to dampening of investment.

Finally, the special limits of Section 80L deductions applicable to government securities, create legally induced distortions in the allocation of savings as between these and other assets covered by Section 80L, irrespective of the intrinsic rates of return.

The granting of exemption from income tax for income from capital (as under Section 80L or Section 10) is equivalent to the expenditure tax principle but a progressive expenditure tax cannot be introduced through this route. Further, if exemption for capital income is given without limit under a progressive income tax, it amounts to having a progressive income tax only on work income. Hence, the introduction of public sector bonds and other instruments and exemption on these from income tax without any limit, as is the case under Section 10 of the Income Tax Act, leads to unjustified distortion.

Yet another distortion in terms of efficiency arises on account of a differential treatment of income from dividend/interest and capital gains. This introduces opportunities for distorted arbitrage arising between different maturities and different coupons and also leads to window dressing opportunities for tax purposes. Ideally, total return should form the basis for taxation.

(b) Impact on Equity

One consequence of the present scheme is that where the concessions take the form of deduction from income as in the case of Section 10, Section 80L and the provisions relating to rollover of capital gains tax, these favour upper bracket taxpayers disproportionately. The post-incentive rates of return vary substantially across taxpayers with different marginal tax rates. In general, the post incentive rate of return increases with the marginal tax rate of the saver. These provisions are therefore, regressive.

The provisions discriminate between taxpayers and non-taxpayers in as much as the rates of return are significantly lower for non-tax-payers.

To the extent exemption is allowed for roll over of capital gains, the scheme is biased in favor of taxpayers with income on capital gains. Therefore, the scheme distorts horizontal equity. Further, since the large taxpayers generally have a larger proportion of their incomes from capital gains, the rollover provisions are biased in favour of the rich thereby distorting the vertical equity of the tax structure.

Inequity also arises from asymmetric information about the various tax concessions for savings. To the extent information is available with a taxpayer, he is able to avail of the tax concession. This problem is particularly aggravated in the absence of any meaningful taxpayer education and assistance program by the tax administration.

Suggestions

Considering the economic cost associated with continuance of tax incentives, and in the general interest of neutrality of tax incentives on promotion of macro economic savings (in respect of short and medium term financial instruments), it is therefore, suggested that -

a) All the tax incentives on short and medium term financial assets as provided under Section 80L, Section 88, Section 10(11) and Section 10(15) of Income Tax Act may be withdrawn.
b) With a view to preventing the scope of tax evasion, the capital income on financial assets

with short and term maturity could be subjected to tax deduction at source (TDS). The applicable tax rate for this purpose could be the minimum income tax rate, which are currently 10 per cent. A certificate to this effect could be provided to the holder of that financial instrument for the purpose of filing to Income Tax Department along with income tax return. The income tax authority, on the basis of this certificate could realize unpaid part of tax revenue, if any, from the holder of such financial asset. Accordingly, it is proposed that the scope of Section 194(A) of Income Tax Act, currently subjecting the interest income from the bank deposits (time) exceeding Rs. 10,000 under TDS, could be (i) enlarged by covering the capital income from all the short-term financial instruments and (ii) no lower limit may be prescribed for coverage of such capital income under TDS.

c) The tax incidence should be on total return, irrespective of whether it is from dividend/interest or capital gain.

Tax Treatment of Long Term Financial Saving

The tax treatment for financial instruments having long-term maturity should differ from that of short and medium term maturity, considering the special role of these instruments in promotion of long-term financial accumulation and social security. Best practice tax policy for long term savings instruments avoids the double taxation of savings inherent in the income tax. Under this tax system, consumption expenditure, instead of income, is used as a tax base.

Funded pension and insurance schemes could be technically taxed at three stages-contributions or accretion, investment earnings or accumulation and benefit payments or withdrawals. There are two alternative ways of devising an income tax which uses consumption as a tax base, viz., - (a) either the contributions is taxed, while investment income and benefits are not or (b) the contributions and investment income are exempted while the benefits are taxed. The first is known as TEE (taxed, exempted and exempted) while the second is EET (Exempted, exempted, taxed) method. Both these methods avoid double taxation of saving and provide equal tax incentives, as detailed in a simple numerical example (Table 2).

The table 2 has been calculated on assumption of a single tax rate at 30 per cent, rate of return on saving at 10 per cent, and that a single contribution, derived from income of Rs.100 is fully saved for one year and then withdrawn.

It may be observed that under EET, the contribution is fully exempted from income tax allowing the saving of entire income of Rs.100. No tax is charged on the investment income, but withdrawals are fully taxable. Under this tax system, an individual having income of Rs.100 can either choose to spend now, paying Rs.30 as income tax and consume goods worth Rs.70 or save Rs.100 now and consume goods worth Rs.77 (Rs.70+Rs.7) one year later. It may be noted that in either of the cases, the individual is indifferent, as the extra consumption of Rs. 7 after one year represents interest income (at the rate of 10 per cent) over his forgone current consumption (Rs. 70).

Under TEE, tax exemption on saving is not permitted, while the withdrawals are fully tax exempt. Accordingly, the post tax saving of an individual, with same income of Rs.100 would be lower at Rs.70. However, the future consumable income, in both the cases, remains the same at

Rs. 77.

Table 2: Impact of Income tax under EET and TEE methods

	EET	TEE
Income	100	100
Income tax paid	-	30
Tax paid saving	100	70
Income on saving	10	7
Saving on withdrawal	110	77
Tax on withdrawal	33	-
Benefit withdrawn	77	77

It may be noted that use of consumption as a tax base, eliminates the problem of double taxation of saving. Accordingly, the twin principles of fiscal neutrality, viz., (a) imposition of tax should not distort the choice between different forms of saving i.e., neutrality of relative rate of return on different financial instruments in pre and post tax periods and (b) tax should not distort the choices between consumption and saving, i.e., neutrality of tax between present and future consumption, are entirely followed under this type of tax treatment of long-term saving.

Existing Tax Provisions for Long Term Savings

(i) Statutory Provident and Pension Funds:

The statutory provident and pension funds are defined contribution plans under which employers and employees are mandated to make equal contributions under Employee's Provident Fund (EPF) and Employee's Pension Scheme (EPS). Employee's contributions receive tax rebate at a rate of 20 per cent of the amount contributed up to a maximum of Rs.60,000 (i.e. a maximum tax relief of Rs.12,000/-) under Section 88. Investment income of the provident fund as well as withdrawals from the fund is fully tax exempt.

For the purpose of evaluation of existing tax treatment of Employee's Provident Fund Scheme, the contribution from employee/employer, to the scheme, could be categorized into two groups, viz.,

(a) When the contribution exceeds the specified limit of tax rebate, as contained in Section 88. In this case, the tax status of savings under EPF would be TEE since the excess contribution over specified limit would not be eligible for any tax rebate, and therefore is fully taxable.

(b) When contribution is within the specified limits under Section 88. This category could further be divided into two sub categories, viz.,

i) When the tax rate applicable to income of contributor is less than or equal to the rate by which the tax rebate is made available under Section 88 (i.e. 20 per cent). In this case, the tax status would be EEE, as contribution to EPF is fully exempted from income tax.

ii) When the tax rate applicable to income of contributor exceeds the rate by which the tax rebate is made available under Section 88. In this case the tax exemption available on contribution would be only partial. There fore, tax status of savings could be categorized as tEE, where t stands a lower tax rate.

Notwithstanding these specific cases, the tax status of savings under EPF could generally be categorized as EEE, given the easy provisions for tax exempted premature withdrawals and practical possibilities of reinvestment of same withdrawals again into EPF, to obtain tax rebate for the second time on the same savings.

In case of Employee's Pension Fund Scheme, annuities or pension are taxable while the amount received by way of commutation of pension is fully exempted from taxation. Accordingly, in case of non-utilization of commutation option, the tax status of savings under EPS would be EET, otherwise it would be EEt as only partial commutation of pension is permitted.

(ii) Public Provident Fund (PPF)

Introduced in 1968-69, the PPF is expected to provide an old age income security for unorganized sector workers. It is an individual account system under which members are allowed to open PPF account either with some designated nationalized banks or with post offices. The minimum and maximum permissible accretions in this account are respectively Rs.100 and Rs.60,000 in a year. The tax treatment of accretions, accumulations and withdrawals are the same as applicable to EPE. Accordingly, the tax status of contribution to this account is equivalent to that of EPF.

(iii) Employers' Voluntary Sponsored Superannuating Funds:

Under this scheme, the employer could establish an irrevocable trust fund, which provides death insurance benefits and annuity (pension) to the employee on his retirement. This scheme also offers the facility to commute pension up to a certain limit for lump sum payment. During the accumulation period, the trustees themselves may either manage the funds or enter into contract with LIC. However, upon retirement the trustee of the self managed funds are required to purchase annuities from LIC.

The contribution by employer, up to 15 per cent of the employees' salary, is treated as business expense and is fully exempted from tax. The employee may also contribute to the scheme, in which case they receive a tax rebate under Section 88. The income of the trust is fully tax exempt if managed by trustees themselves. In this case the tax status of contribution to the fund would be:

(a) EET if employee does not use commutation facility, or
(b) EEt when commutation of pension is undertaken.

When the trustee enters into agreement with LIC for management of fund, the tax status of contribution to the fund changes to either EtT or Ett depending upon utilization of commutation

by the employee. The change in tax status of contribution to fund, when managed by LIC, reflects the impact of corporate tax on LIC's actuarial surplus. Since the marginal rate of corporate tax is less than income tax, the impact is reflected by t.

(iv) **Voluntary Personal Pension Plans:**

Although managed by LIC, the investment income of this scheme is not subject to corporate tax on LIC's actuarial surplus, however, annuity benefits are taxed, so it is EET. Since this product is designed by LIC in such a way that only interest income is used as annuity and the principal is paid at maturity, this scheme can effectively be transformed into EEt.

Evaluation and Suggestions

Under the existing income tax provisions, the long-term financial saving of the households is generally exempted from taxation at all the three stages of savings, *viz.*, contribution, accumulation and withdrawals. This extra liberal tax treatment of long term savings is neither justified in terms of principles of fiscal neutrality nor in terms of promoting financial savings, considering the implicit revenue cost to the government. Accordingly, it is proposed that the different types of long-term savings of the households should homogeneously be subjected to either of EET or TEE type of tax regime. While both types of tax regimes perfectly neutralize the impact of double taxation of savings (inherent in income tax), the psychological impact of EET in providing inducement for financial accumulation- as tax benefits is offered at the contribution stage itself- is expected to be greater than TEE. Further, approximately two thirds of OECD countries also follow EET system, with some variations, for taxation of savings.

There exist three alternative forms in which implementation of EET type of tax regime could be carried out in Indian case. These are placed as under:

(a) Full adoption of EET method: Under this form, the contribution of households in long-term financial instruments and income of institutions managing these long-term savings (accumulation) would have complete exemptions from direct taxes, while all withdrawals would attract income tax without any concessions.

(b) Modified form of EET: Under this form, the contribution of households in long-term financial instruments would be exempted from income tax *albeit* with an upper limit. The rate of tax exemption available on such contribution would depend upon the tax bracket in which the incomes of respective individuals/ HUF are placed. Full tax exemption would be provided to accumulation of income, however, all withdrawals would be subjected to income tax without any concessions.

(c) Adoption of EET method in a modified form: In this form, tax concession on contribution would be provided in form of a tax rebate (may be under Section 88), i.e., contributions up to an upper ceiling would have tax concession at a fixed rate irrespective of the income of the contributor. Full tax exemption would also be provided on the accumulation (income of institutions managing the long-term savings), however, all withdrawals would be subjected to income tax at a rate by which the tax concession was

extended on contribution.

It may be suggested that the option (a) may not be feasible considering the provision for unlimited tax exemption on contribution. Such exemption would allow rich households, with high disposable income, to shift their current tax liabilities, without any limits, for future tax payments.

Besides violating the principles of vertical equity, this arrangement would also reduce significantly the current tax accruals to the Government, putting Government finances under pressure.

Out of options (b) and (c), the option (c) is more acceptable in term of principles of equity. Under the option (b) all withdrawals, irrespective of the income of the contributor and the rate of income tax concession availed on contribution, might be subjected to income tax at the highest rate (on account of bunching of payments). However, under the option (c), withdrawals would be subjected to income tax at the same rate by which the tax concession was availed by the households on contribution. Thus from viewpoint of equity, the option (c) appears to be more feasible. Nevertheless, for Indian context, it is proposed that following modifications could be considered in option (c) before implementation:

(i) The tax concession on contribution may be provided under Section 88 of IT Act, providing tax rebate at a rate of 20 per cent on investment up to Rs.60,000.

(ii) Considering the socio-economic structure of Indian economy and inadequate social safety provisions, it is proposed that the rate of income tax at the time of withdrawal may be kept lower than the rate by which the tax concession was conferred on contribution. It is, accordingly, proposed that all withdrawal at the time of maturity could uniformly be taxed at a rate of 10 per cent.

(iii) Under this system of taxation, the capital income at the stage of accumulation should be fully tax exempted. Accordingly, it is proposed that the capital income of institutions, managing long-term financial saving of the households, should also be fully exempted from corporate tax.

(iv) The introduction of EET system, with immediate effect, would subject all withdrawals, from long-term financial savings, to income tax. Accordingly, the incidence of income tax would also get spilled over on the past contributions of the households, notwithstanding the fact that historically the long-term financial savings have generally enjoyed tax immunity on withdrawals. With a view to limiting the coverage of proposed income tax up to the fresh accretions in long-term savings only, it is proposed that the existing long term saving schemes may be categorized into ‘old’ and ‘new’ schemes. While the ‘old’ scheme would stop accepting any fresh accretions from immediate effect, the past saving in these schemes would continue to enjoy the existing tax concessions on withdrawals till the redemption of the scheme. The ‘new’ schemes, for long-term saving would, however, be subjected to proposed tax regime with immediate effect.

(v) With a view to promoting financial accumulations and also to eliminating the possibilities of misusing of premature withdrawals facility, for the purpose of tax avoidance, it is proposed that all premature withdrawals except in the case of death of the beneficiary, could be subjected to income tax at a rate of 20 per cent i.e. at the rate on which the tax

concession was availed of on contribution in long term financial saving. Premature withdrawals, in the event of premature death of the beneficiary, should, however, be subjected to concessional tax treatment at a rate of 10 per cent, which is at par with tax treatment of withdrawal on maturity.

(vi) Under the existing tax arrangements, while the amount received by commutation of the pension is completely exempted from tax, the pension (annuity) is not. Accordingly, it is proposed to subject the commutation of pension to income tax at a uniform rate of 10 per cent.

Summary

The existing savings oriented tax concessions tend to distort the information efficiency of capital and debt markets resulting in misallocation of financial resources. Further, these saving oriented tax incentives cause an implicit cost to Government, violate the principles of equity and efficiency without generally enhancing savings at macro level. Therefore, the continuation of different tax incentives on various financial assets needs to be given a relook. However, it is necessary to distinguish between long-term savings, and short and medium term savings insofar as the tax treatment are concerned. The tax treatment for long-term savings should differ, from short and medium term savings, considering the special role of these instruments in promoting long term financial accumulation and social security.

Considering the economic cost associated with continuance of tax incentives, impact of these tax concessions in promoting macro economic savings and internationally accepted tax system for long term financial assets, following suggestions are made in this regard:

(a) Doing away with all existing tax benefits provided under Section 88 barring those which pertains to long term financial instruments.

(b) Coverage of all short and medium term financial instruments under the scheme of Tax Deduction at Source (TDS). This scheme is proposed to be operationalised through a system under which a certificate would be issued to the holder of that financial asset for filing with Income Tax Department.

(c) For purposes of taxation, financial instruments will be classified into two categories viz., Short and Medium Term Savings instruments and Long-term Savings Instruments.

(d) Scrapping of all the tax benefits currently available under Section 10(11) of IT Act.

(e) Subjecting all withdrawals from long-term financial instruments, to tax at the rate of 10 per cent.

(f) Subjecting all pre mature withdrawals from long-term financial instruments, to tax at the rate of 20 per cent.

(g) Exempting the income of Institutions managing long term financial savings from corporate tax.

(h) Subjecting lump sum payments received by way of commutation of pension, to tax at a rate of 10 per cent.

(i) The distinction between capital gains income and interest/dividend income could be abolished in respect of all financial instruments and the tax incidence could be upon the ‘total return’ from the respective instruments. This will eliminate distorted arbitrage opportunities arising out of structuring of a financial instrument.

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Annexure 1 : Maximum Possible Rate of Return Available on Select Financial Instruments for Different Income Tax Brackets (Without any Surcharge)

NAME OF INSTRUMENTS	RELEF U/S 10/80L/88	HOLDING PERIOD	MARGINAL INCOME TAX RATE	SINCE 02.09.1993 14.01.2000	SINCE 15.01.2000 TO 28.02.2001	SINCE 01-03-2001
			0 %	12.386	11.831	11.303
1. NSC (VIII Issue)	88,80L	6 year	10%	18.841	18.168	16.159
			20%	19.358	18.663	16.586
			30%	19.966	19.244	17.086
			0%	12.264	11.29	9.834
2. Public Provident Fund	88,10(12)	15 year	10%	13.45	12.376	10.769
			20%	14.636	13.461	11.705
			30%	15.822	14.548	12.641
			0%	12.568	11.629	10.234
3. Public Provident Fund (with permissible withdrawals)	88, 10(12)	15 year	10%	21.801	20.899	19.565
			20%	24.888	23.927	22.505
			30%	28.352	27.315	25.779
			0%	10.921- 13.098	8.243-10.921	7.714-9.308
4. Post-Office Time Deposits	80L	1-5 year	10%	14.230-14.561	9.159-11.900	8.571-10.167
			20%	15.016-15.585	10.304-13.078	9.642-11.204
			30%	15.601-17.239	11.776-14.524	11.019-12.484
			0%	10.25	9.202	8.681
5. Relief Bond	10(15)	5 year	10%	11.18	10.053	9.491
			20%	12.301	11.081	10.471
			30%	13.679	12.349	11.682

			0%	11.0	10.5	9.0
6. NSS	88	4 year	10%	14.815	14.269	12.626
			20%	13.17	12.591	10.844
			30%	10.904	10.275	8.371

ANNEXURE 2: Rate of Return on Select Financial Instruments for Different Income Tax Brackets Without Any Tax Benefits under Sections 10, 80L and 88 of Income Tax Act

NAME OF INSTRUMENTS	RELEF U/S 10/80L/88	HOLDING PERIOD	MARGINAL INCOME TAX RATE	SINCE 02.09.1993 14.01.2000	SINCE 15.01.2000 TO 28.02.2001	SINCE 01-03-2001
			0%	12.386	11.831	11.303
1. NSC (VIII Issue)	88,80l	6 year	10%	10.648	10.172	8.753
			20%	9.464	9.042	7.78
			30%	8.281	7.912	6.808
			0%	12.264	11.29	9.834
2. Public Provident Fund	88,10(12)	15 year	10%	11.08	10.206	8.899
			20%	9.895	9.121	7.965
			30%	8.712	8.038	7.031
			0%	12.568	11.629	10.234
3. Public Provident Fund (with permissible withdrawals)	88,10 (2)	15 year	10%	10.394	9.468	8.088
			20%	8.332	7.406	6.023
			30%	6.352	5.413	4.008
			0%	10.921-13.098	8.243-10.921	7.714-9.308
4. Post-Office Time Deposits	80 L	1-5 year	10%	9.829-12.039	7.419-10.009	6.942-8.512
			20%	8.737-10.938	6.595-9.065	7.714-7.691
			30%	7.645-9.792	5.770-8.088	5.400-6.844
			0%	10.25	9.202	8.681
5. Relief Bond	10(15)	5 year	10%	9.385	8.414	7.93
			20%	8.492	7.601	7.159
			30%	7.569	6.763	6.364
			0%	11	10.5	9
6. NSS	88	4 year	10%	10.082	9.617	8.226
			20%	9.133	8.706	7.429
			30%	8.15	7.762	6.608

* Prepared under guidance of Shri K. Kanagasabapathy, Adviser-in-Charge, Monetary Policy Department, Reserve Bank of India.