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TOWARDS A FRINGE BENEFITS TAX

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A good number of fiscal theorists argue that unsystematic exemptions, concessions and allowable deductions have led to a narrow income tax base. Fringe benefits, very often referred to as perquisites, constitute the core of such deductions. The impact of these deductions is felt in terms of inequity, erosion in the tax base and high marginal tax rates to obtain a desired amount of tax revenue.

The tax treatment of fringe benefits has only very recently caught the attention of taxpayers and tax authorities. Taxpayers are interested in fringe benefits because there could be a substitution between cash and non-cash components of the wage-mix which could be taken advantage of when marginal tax rates are high. Tax authorities are interested in the treatment of fringe benefits for the reason that their increased provision leads to the shrinkage of the tax base.

It is interesting to note that the inability to include fringe benefits in full in the tax base was admitted at a time when the notion of the taxable income was in its formative stages. The issue of fringe benefits came for hearing before the House of Lords in the case Tennant Vs. Smith (3. T.C. 158 H.L.), where the value of perquisites in-kind which could not be converted into money was held as non-taxable. In India this decision was superseded by the Income Tax Act passed in 1922. Further the Income Tax Act of 1961 made perquisites in cash as well as in-kind taxable, subject to certain conditions and overall limits. The Act does not define perquisites as such: only certain items have been included in that expression.

It is well recognised that an ideal tax base should include in full the consumption value of in-kind compensation. The accretion approach requires inclusion of all the sources of potential consumption regardless of whether or not actual consumption takes place and regardless of the forms in which consumption occurs. It comprises those conventional items that are arbitrarily thought of as income; wage, salary, business profit, rent, royalty, interest and also certain unconventional items such as fringe benefits. Their exclusion from the tax base amounts to a departure from the accretion principle. The present system does not fully tax them. The companies providing fringe benefits to their employees claim tax deductions. At the recipient level too these benefits are not fully taxed. Thus, their provision enjoys a double tax benefit, first at the company level and then at the recipient level.

II

The recent arousal of interest in the study of fringe benefits may be attributed to a desire on the part of governments to broaden the tax base and to minimize the inequity existing in the present system. It has been noticed that there is a tendency to offer a high proportion of fringe benefits in relation to cash compensation especially to employees in the top tax brackets.

It is now increasingly being realised that a considerable amount of tax revenue is lost due to either the exclusion or only a partial inclusion of fringe benefits in the tax base. Governments today are therefore much interested in bringing into the tax net the whole gamut of fringe benefits. The general complaint that the direct tax system has ceased to be

equitable and fair has also led to an increased interest in the study of fringe benefits.

The nature and extent of fringe benefits have varied from time to time. A number of factors have contributed to the dramatic growth in the provision of fringe benefits such as its preferential treatment under the personal income tax laws, savings that are possible by the group purchases of certain benefits such as insurance, efforts on the part of employers to reduce labour turnover by offering attractive perquisites in the face of rising costs of labour turnover, unionization, rising incomes pushing taxpayers into the high tax brackets and so on.

In the U.S. the growth of fringe benefits and the consequent shrinkage of the tax base attracted the attention of the Kennedy Administration in 1962. An attempt was made to put restrictions on entertainment expenses. The Carter Administration proposed important restrictions on the deductions of business perks. The 1976 Tax Reforms Act placed restrictions on the travels to foreign countries for business and personal meetings. Similarly the Blueprints for Basic Tax Reforms (1977) advocated the inclusion of the value to an employee of all financial terms of his employment including the value of fringe benefits. The Treasury Department Report to the President (1984) points out that the tax-free character of fringe benefits causes employees to overconsume these benefits relative to their actual desire or, in many cases, need for them. Such overconsumption distorts the allocation of resources and raises prices for services available in non-taxable form. The spiralling costs of health care in the U.S. in recent years may be attributable in a significant way to the overconsumption of health care by employees. According to the Report a serious consequence of the current exclusion of fringe

benefits from the income is the erosion of the tax base. As the base narrows the rates of tax on nonexcluded income must increase in order to maintain the same level of tax revenue. The Report thus calls for repealing the exclusion of most fringe benefits so as to reverse the shrinkage of the tax base.

In Japan fringe benefits tax deductions are not available for firms with capital investment of more than Y 50 million. In Belgium the government is trying to eliminate tax deductions for fringe benefits. This is one of the broad aims of the programme to simplify the tax system. Among all countries, however, Australia and New Zealand are the only two which have introduced a fringe benefits tax as a part of their tax reform programme.

III

Conventionally, fringe benefits are taxed at the individual level. It is the individual only who is benefited most from the provision of fringe benefits. Strictly from the accretion point of view fringe benefits add to the spending power of the individual recipient. He is better-off than before and also as compared to others who do not receive such benefits.

The main difficulty in taxing fringe benefits at the individual level is that their provision would require yearly valuation which is by no means an easy task. It becomes necessary to take into consideration tastes, preferences, likes and dislikes of the recipients. A few might complain that fringes were thrust upon them as a part of the marketing strategy of the company without much regard to their tastes and preferences. Further, it

would be necessary to evolve a common criterion for the valuation. This again would not be easy. In those cases where taxes are not deducted at source the taxation of fringe benefits at the individual level would add to the compliance problem. Recipients would be required to keep a detailed account of benefits enjoyed. They would need to have a perfect knowledge of the retail and discount prices of the benefits so as compute the gain and add it back to their incomes.

Alternatively, the taxpaying unit could be the company. In providing fringe benefits companies (employers) stand to gain. They `tie-up´ employees by offering attractive fringe benefits and thereby minimize their labour turnover cost. They could use fringe benefits as a weapon of `selective discrimination´ when the law does not permit `open discrimination´ in the selection of employees.

Requiring employers to pay the fringe benefit tax would clearly be administratively easier to implement. It would be easier to calculate the value of the perquisites on which tax could be imposed. For example, if a fleet of motor cars is always available to a group of employees it is not necessary to calculate the individual benefits received by each employee. The tax liability in respect of a single company can be checked by a reference to only one tax return rather than returns filed by thousands of employees. Further, taxing employers rather than employees has both political and policy advantages. There are at any point of time many more employees than employers. By bringing in a small number of taxpayers into the net the government might hope to provoke less of an adverse voters´ reaction. From the policy point of view the advantage would be that employers could be encouraged to shift from non-monetary to cash remuneration.

Imposing the whole of the compliance burden of the provision and valuation of fringe benefits to the employers might help to achieve this policy goal. Finally, since the fringe benefit tax is likely to be a relatively complex instrument, employers would be more suited to cope with the record keeping and returns that would be necessary.

IV

Tax authorities around the world have recently taken a serious note of the rapid growth of fringe benefits. It is pointed out that the present tax systems are unfair, inefficient and unnecessarily complicated. In the coming years many of the developed and developing countries are likely to have low personal and corporate income tax yields. Since there are limited possibilities of reducing the size of budgets, these countries would need to broaden the tax base by reducing the number of permissible deductions and extending the taxation of fringe benefits. In India too such an attempt ought to be made. Here fringe benefits are taxable in the hands of employees by virtue of section 17 of the Income Tax Act 1961. These are included in the total taxable income and therefore are not taxed separately. Rule 3 gives the method of computation of certain specific perquisites such as residential accommodation, furnished or unfurnished; motor car for personal use; other conveyance for personal use; gas, water and electricity charges paid for personal use. Sections 40(c) and 40A(2)(a) also deal with some other types of fringe benefits. Section 40A(5) places an upper limit of Rs. 90,000 on salaries and 1/5th or Rs. 1,000 per month on any expenditure resulting in the direct or indirect provision of perquisites.

There is no tax on employers on account of fringe benefits allowed to the employee though certain expenses are discouraged by restricting the permissible deductions. These are entertainment allowance, advertisement expenditure and travelling allowance.

Keeping in view the enormous sums involved in the provision of fringe benefits and the inequity that has crept into the system a case for the introduction of a fringe benefits tax could be developed arguing that the taxation of fringe benefits at the company level would discourage companies to provide more of non-cash benefits and that they would be encouraged to switch over to cash benefits. As and when high cash benefits are provided to the employees their taxable incomes go up and more of them would creep into high tax brackets. The gain is obvious.

When companies start switching over to cash benefits or when more of the non-cash benefits are brought into the tax net the tax base would clearly be more comprehensive than before. It would help to reduce tax rates for a target amount of revenue. This would be in conformity with the world wide trend in favour of low marginal rates. The comprehensive tax base would also be expected to help keep economic distortions to a minimum.

The introduction of a fringe benefits tax would help us remove the anomalies that exist in the pay structure of the employees of different public sector enterprises, government departments and the private corporate sector. A recent study has pointed out a number of anomalies in the pay structure of the public sector enterprises. Consider for example, the case of house building loans. Employees of the State Bank of India can borrow an amount of Rs. 2.50 lakh or fifty times their basic salaries. The

rate of interest charged is 11 per cent and the number of instalments permissible for repayment is 120. Further, within the banking sector, the employees of other banks get a house building loan of Rs. 1.25 lakh or seventy times the basic salary. They pay a 5 per cent interest and the number of instalments is 120. The anomaly within the banking sector is quite clear. In sharp contrast to this school teachers and college lecturers, for example, do not enjoy this facility. Further, similar discrepancies could be noted with regard to other facilities such as consumption loans, leave travel concessions, festival advances, house rent allowances and so on.

The equity principle requires that the anomalies should either be removed or the facilities should be made available to all types of employees. When neither is possible then a serious attempt should be made to make these anomalies bear a cost at the company or employer level.

The introduction of a fringe benefits tax should be seriously considered when there is a marked difference among the central government employees, employees of public sector enterprises and others in the computation of the value of fringe benefits on account of rent free accommodation. The real question is: Is such a distinction justified? For example, is the exclusion of the value of free or concessional fares to the railway and airline employees or leave travel concession to other government employees to be justified when others in the private sector have to pay for these services? A tax on these benefits would make their provision and use less attractive than before and could help to recover at least a part of the amount spent on them.

The introduction of a fringe benefits tax would discourage inefficient allocation of resources. Of course it would be a difficult task to monitor the actual use of concessional loans and other facilities but one can certainly claim that in the case of loans for the purchase of luxury products there is some element of an inefficient allocation. The State Bank of India provides to its employees a loan amount of the value of five times the monthly basic pay subject to an upper limit of Rs. 20,000 or 80 per cent of the cost of the luxury item. In New Zealand the provision of conveyance loans and a very liberal deduction of the same at the company level led to an increased demand for cars (Prebble 1988). Similarly in India the Standard 2000 car is exclusively marketed for corporate use. The luxurious furnishings of the residences of directors, Company chairman and other executives are usually done at the company's expense. These are but a few indicators of inefficient allocation of resources.

A fringe benefits tax could be an additional source of revenue for the government. Taking into consideration the enormous amounts involved and the large number of companies resorting to their provision, a tax at a nominal rate of even one or two per cent could yield a fair amount of revenue. Further the rate structure could be made to vary with the cost of their provision. In that case, as compared to the other taxes on companies and their products, some element of graduation could be introduced.

The introduction of a fringe benefits tax would help us to shift the base gradually from income to consumption on cash flow basis. Since it is found that a full-fledged expenditure tax is difficult to administer, the equity and efficiency gains associated with this tax could be realized in an indirect way and one such route is the taxation of fringe benefits.

There are, however, equally worthy arguments which do not support the introduction of a fringe benefits tax at the company level. It could be maintained that the taxation of fringe benefits would achieve the goal of horizontal equity only when the employees are taxed. While the existing Act covers the legal position exhaustively the real problem lies in its implementation. In our system there is a provision for submission of annual returns by employers under section 206. The information which could be obtained from companies for the levy of a fringe benefits tax can also be used to ensure a proper taxation of such benefits in the hands of employees. However, the administrative advantage of introducing the tax at the level of employees is debatable. It should also be recognised that if the benefits are valued at market prices it would not be possible to recover the tax from employees.

In the light of the above observations it may be said that the consideration of horizontal equity has always fundamentally guided the formulation of tax policy. The prime concern of theorists and tax administrators has usually been to ensure a system where the equity criterion is met. Within the tax system there are certain gray areas which come in the way of realizing the goal of equity. These areas are the definition and measurement of income, inflation indexation, administration etc. So far as the definition of income is concerned it does not fully meet the requirements of the equity criterion. Its measurement too is full of defects. Because of the unclear definition and defective measurement the impression is gaining ground that the personal income tax as it exists today falls far short of being an equitable tax. Similarly the tax laws do not define fringe benefits but only offer a comprehensive list of what constitute these benefits. When it is noticed that their exclusion or partial

inclusion adds to the inequity then their inclusion in full and consequently their comprehensive taxation could at least restore some equity.

While the principle of equity requires that fringe benefits should be taxed the important issue is to choose a suitable taxpaying unit. The compliance, valuation and other administrative aspects as discussed above heavily tilt the balance in favour of the company as the taxpaying unit. Companies are better equipped with their professional and administrative skills to administer the provision of fringe benefits. When the flow of benefits gets taxed at the company level it amounts to their indirect taxation at the employee's level. The argument that it would be difficult to collect a fringe benefits tax from employees when the market value of fringes is taken into account, in fact, goes in favour of choosing the company as a taxpaying unit. Companies, because of their command over resources, are in a better position to pay this tax. After all they have an option. They might reduce the expenditure on fringe benefits or shift the burden to their employees by way of higher cash benefits.

We, therefore, conclude by stating that the time has now come to introduce a fringe benefits tax. Between an individual and a company, the latter would be the more suitable taxpaying unit. We should try to make the tax base as comprehensive as possible by covering all types of fringe benefits.

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