THE SYSTEM OF TAX DEDUCTION AT SOURCE (TDS) : COVERAGE, FUNCTIONING AND SUGGESTIONS FOR REFORM

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Preface

This report forms a part of a series of reports being prepared at the National Institute of Public Finance and Policy (NIPFP) under the sponsorship of the United Nations Development Programme (UNDP) on tax administration at the Central, State and local government levels. This particular study on the scheme of tax deduction at source (TDS) of selected incomes at the Central government level examines the TDS structure in India, draws conclusions and makes apporpriate recommendations. A review of the relevant literature was undertaken. However, the study is based primarily on field visits to TDS offices of the Income Tax Department in Bangalore, Calcutta, Mumbai and New Delhi. Lessons from international experience were also drawn from meetings with Indonesian, Malaysian, and United States tax officials.

The Governing Body of the Institute does not bear any responsibility for the contents or views expressed in the Report. That responsibility lies mainly with the authors.

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Director

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Executive Summary

Findings and Recommendations

Tax deduction at source (TDS) is an instrument designed for quick and smooth collection of tax due to the authorities from the taxpayer. The objective of TDS could be said, in general, to be maximisation of revenue collection while minimising the cost of collection.[1] For example, it should be easier to deduct tax from all employees by one employer than for the tax administration to collect from each individual separately. This is so especially for wage and salary income; and this is why such income is subject to TDS in a wide cross section of countries.

The problem of tax evasion is a fundamental reason for expanding the scope of TDS. Tax evasion is a universal phenomenon. It takes place in all societies, all social classes, all professions, all industries, and all economic systems. It depends on the economic and tax structures, types of income, and social attitudes. The economic theory of tax evasion has limitations since it rests solely on attitudes towards risk, with full information regarding the tax administration's behaviour. In reality, the latter itself can vary, based on a well planned strategy or suffering from negligence or selective indulgence. Commonly, however, tax administration measures to contain tax evasion include withholding (TDS), presumptive and minimum taxes, selective auditing, penalties, and cross checks of returns filed by a taxpayer for different taxes such as the income tax and the value added tax (Shome, 1992).

While TDS is reputed to be a powerful instrument for addressing the problem of tax evasion, as a tax administration mechanism, it has both advantages as well as disadvantages. Any TDS system, unless it is designed to minimise these inherent flaws, will fail to facilitate tax administration or improve revenue collection ostensibly. Therefore, familiarisation with both advantages and disadvantages of TDS systems is important lest the expected benefits from TDS functions be lost. Among the advantages may be mentioned: (1) the intent of the law is more conveniently fulfilled since the tax flow should parallel income flow more closely than without TDS; (2) since tax is collected prior to receiving income, compliance is improved and enforcement costs are reduced; (3) because of improved cash-flow, government's day-to-day borrowing needs are eased; (4) among those within the TDS net, the tax burden is shared more equitably; and (5) since tax collection responsibility

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[1] In this sense, a tax administration is not very different from a firm, though it should be compared to a monopolistic firm. The tax administration has a given budget assigned to it by the state and with this budget its task is to maximise an output--tax revenue--taking into account certain important constraints. The allocation of resources within the tax administration is obviously important in determining this output. Under optimal conditions the tax administration would not be able to increase output by shifting resources across various activities, such as assessment, collection, and auditing. Needless to say, like a firm, the optimal state is rarely achieved, and the tax administration can typically improve revenue collection by shifting resources appropriately.

is shared by the collection agents, tax officers can devote more time and resources to other functions of tax administration such as expanding the universe of taxpayers, audit and scrutiny, and so on.

TDS in India has a wide scope by international standards. It covers (i) various kinds of income (on gross basis), (ii) royalty (iii) winnings, (iv) repurchase value of certain financial instruments, (v) withdrawals from specified savings schemes, (vi) payments to contractors/sub-contractors or non-resident sportsmen or sports associations, and (vii) purchase price of some specified products like liquor, timber and forest produce. The scheme applies to company as well as non-company taxpayers, as also to residents and non-residents. On the whole, TDS is not only fully operational, but the growing experience with it is also helping to improve the existing systems of assessment, verification and refund. The scope of TDS is likely to increase further. Indeed, it is desirable that it be so since it would improve equity. The contribution of TDS in income tax revenue however, has declined in the 1990s even as its coverage has widened. The main findings and recommendations in light of the discussion in following chapters are as follows.

Main Findings

- **Revenue significance of TDS**

  - There had been a substantial increase in the share of income tax collected through TDS during the 1980s that was followed by a decline in the 1990s in spite of widening the coverage of TDS during this period.

  - The share of TDS in net collection of income tax increased from about 26 per cent in 1980-81 to about 45 per cent in 1989-90 and declined subsequently to about 37 per cent in 1994-95.

  - The trends of rise or decline in the shares of TDS in gross collection of income tax are found to be similar to those in net collections of income tax.

  - The trends in the shares of TDS from all taxpayers, from companies and that from non-companies are found to be similar.

  - Had there not been an extension of the scheme of TDS, the share of TDS in total income tax collection would have substantially declined during the 1990s. The decline in the share of TDS during the 1990s, in spite of increases in the coverage of the scheme of TDS, requires an in-depth analysis.

  - The system of TDS does give rise to some refunds. The ratio of total refunds to gross (net) collection of income tax has varied between 11 and 22 (13 and 28) per cent.

  - The refund to TDS ratio of companies was found to be more than 100 per cent in many years, and was not less than 84 per cent in any of the years under consideration.

  - The refund to TDS ratio of non-companies did not exceed 40 per cent in any of the years under consideration and was around 21 per cent in some of the years.

- **Structure of the scheme of TDS**

  - The provision of thresholds (such as in the case of dividends and interest income) is detrimental to the operation of the scheme. This leaves scope for avoidance by bifurcating holdings appropriately.

  - Payments of rent and professional or technical fees by individuals and Hindu undivided families (HUFs) are exempted from TDS. This also leaves scope for manoeuvring arrangements for avoiding TDS.

  - The provision of obtaining a certificate from the Assessing Officer for receiving payments without TDS involves possible harassment of the small taxpayers. They are required to visit the income tax office as often as might be required if the tax were deducted at source and refund sought.

- **Coverage of the scheme of TDS**

  - In relation to countries visited during the study period, the coverage of TDS in India is broader than that in Malaysia while it is narrower than that in Indonesia. A variety of incomes, payments or receipts which are not covered in India, fall in the ambit of TDS in Indonesia.

  - Malaysia has managed to collect about the same percentage of its total income tax receipts as Indonesia (above 60 per cent) even with relatively narrow coverage.

  - There is a large scope in India for raising the share of TDS in total collection of income tax through proper monitoring of the scheme.

- **Implementation**

In the operation of the scheme of TDS, many deficiencies have been noted. The major deficiencies/problems are as follows:

  - Certain kinds of payments which are of the nature of perquisites, remain untapped even in the operation of the scheme of TDS.

  - Declarations filed for receiving payments of interest, dividends etc. without TDS remain unscrutinised. A sample check in Karnataka reveals substantial revenue potential in scrutiny of such declarations.

  - In the context of collection of tax on purchase price of specified goods, the interpretation of purchase price (to be taken as inclusive or exclusive of 'bid money') has created many problems.

  - Decentralisation of assessment and TDS jurisdictions in some of the regions has put excessive compliance burden on the deductors as with decentralisation, they are required to deal with two officers where enquiries overlap.

- There is lack of a comprehensive system for identifying non-filers from amongst those who are not on the income tax department's registers, as also from those on the registers. There is no system of preparing a comprehensive list of potential deductors.

- There is a significant gap between the number of tax deductors on the registers and the tax deductors who actually file the annual returns. Nonfilers from among those borne on the registers are not systematically pursued.

- Many of the Central and State government offices, local authorities, autonomous bodies and other institutions do not file any annual returns. Since the persons responsible are also Central or State government employees, the remedial action taken is at best lukewarm.

- There is lack of an efficient system for monitoring payment of TDS. Verification of TDS with that paid to the government account is done entirely on the basis of copies of challans furnished by the tax deductors.

- Checking of calculations in the tax returns is only on selective basis. Sample exercises done in Delhi and Karnataka indicate immense potential for raising additional revenue through proper checking of annual returns.

- Low priority is assigned to the work of TDS. For internal management, the Board calls for quarterly reports of TDS as against monthly report in the case of assessments and arrear reductions. There is no requirement of indicating the number of taxpayers covered by the statements. Also, sometimes, officials not considered suitable for assessment work, are entrusted with TDS work.

- There is absence of vital information in the statements filed by deductors. Permanent Account Numbers (PANs) of some of the persons from whom tax has been deducted at source are not reported in the TDS returns, partly due to delay in allotting PANs.

- Ensuring changes in the legal and procedural requirements to ensure efficiency in issuing refunds is an important pre-requisite for efficient implementation of the scheme of TDS.

- The work of monitoring TDS is being done more or less manually except in Karnataka, where computerisation has resulted in revenue gains.

Recommendations

Tax deduction at source is an important instrument in the hands of tax administration for influencing compliance with the tax laws. An improvement in implementation of the scheme of TDS can result in further increase in (i) its share in total collection of income tax, and (ii) total collection of income tax itself. This can be achieved through suitable enforcement strategies.

The department receives voluminous information from taxpayers and third parties that can be useful in enforcing tax laws. The benefit of availability of this information is often not fully availed due to lack of adequate infrastructure and manpower. While upgradation of technology and manpower skills is necessary for efficient operation of TDS, some improvement should be possible by adopting innovative techniques. What is required is a credible threat to taxpayers and tax deductors with meaningful action through appropriate schemes. Such schemes include use of selective but vital information, prudent allocation of manpower, verification of selective transactions, and in-depth analysis of selected likely defaulting cases.

The process of upgrading the technology and improving the manpower skills needs to be expedited and the available resources need to be prudently deployed. There is need for an overall policy formulation regarding the category of officers who would be deputed to man this task. Officers about to be promoted or those having an interest in technical upgradation of work should be preferred. The tendency for deputing the relatively less efficient officers to this task, should be curbed. The manpower requirement should be carefully determined not only on the basis of actual returns but also the number of potential payees who should be covered as this is the true reflection of the extent of possible work. Also, the overlap of inquiries by the officers having jurisdiction over the employers and the officer monitoring TDS should be minimised through administrative instructions. Once this is done, the working of the TDS cells could be streamlined on the lines discussed below.

- **Identification of non-filer deductors**

A comprehensive list of potential deductors should be prepared. For this purpose creation of separate cells not handling any other work should be considered. This being primarily a one-time exercise, it should be possible to disband the cells once the listing is completed. Subsequent updating from year to year should be assigned to those monitoring TDS. This list should be used for identifying non-filers, and then action should be taken against them through enforcement measures. Substantial information required for preparing a list of potential deductors is available within the department in the form of assessment records.

- **Detection of non-filer taxpayers**

Detection of non-filers is a tedious exercise. Any meaningful exercise can only be undertaken when PANs are allotted to all and the work of TDS as well as generation of control registers are fully computerised. Till then improvement can be achieved through insisting that PAN be indicated against all names by the deductors wherever available. Absence of PAN would then imply a non-filer to whom notice can be issued.

- **Identification of bogus exemption claims**

The payments below a threshold level are generally exempted from TDS. This provision leaves a large scope for avoiding TDS by bifurcating investments into small lots. A large number of declarations are filed every year for claiming payments without TDS. But the department has not yet examined these declarations even on test check basis to detect false

statements. The test check by Karnataka is an indication of the enormous revenue potential, in case verification of such declarations is undertaken systematically. In the absence of computerisation, a beginning should be made by examining declarations on a selective basis. From time to time, the declarations filed with selective companies should be picked up for examination. Defaulters should be identified, penalties sanctioned against them, and the active role of the department in performing this function should be given publicity. This would deter non-compliance not only by those who have been examined but also by others who will face a creditable threat from the department, if they default.

- **Checking of annual returns of TDS**

The verification of payment of TDS is being done on the basis of challans filed by the tax deductors. The pace of processing of challans, even though substantially computerised, needs to be improved to ensure that the collection register relating to TDS is generated and received in the ranges looking after this work well before the due dates for filing of the returns. Only if this is done can the payment be verified from the records of the department. With proper emphasis and deployment of adequate number of personnel in the computer sections or Central Treasury Units this task is not only possible to achieve, but must be achieved to bring the required degree of efficiency in monitoring the TDS and minimise scope for fraud.

The information in the annual returns of TDS filed by the employers should be checked in selected bigger cases to ensure that perquisites are correctly taxed. Selective scrutiny of cash reimbursements should also be done in such cases.

A comprehensive checking of calculations is not feasible without full computerisation. As long as that state is not reached, the checking of calculations will have to be limited in its scope and on selective basis. The selection of cases for checking calculations should be spread over all types of taxpayers but should cover higher percentage of cases with higher payments of tax. A careful selection of cases can have a deterrent impact on non-compliance. This is what is being attempted in Delhi. Targets need to be fixed and enforced at each Chief Commissioner's level. Use of locally available infrastructure and technical expertise should be encouraged as is being done in Bangalore.

- **Verification of TDS claims of individual taxpayers**

Individual taxpayers claim refunds or adjustments in their tax liability on the basis of certificates of TDS. These claims need to be verified. This will be possible once the TDS returns are computerised.

- **Computerisation of TDS work**

The state of computerisation in this area is generally unsatisfactory despite its importance from the point of view of increasing revenue collection. The computerisation programme being implemented in Delhi, Bombay and Madras, at present, is largely confined to allotting PAN and as such does not cover TDS. In Bangalore however, substantial degree of efficiency has been achieved in the operation of TDS by computerisation of TDS function through local effort. Until a comprehensive plan of computerisation of TDS function is

implemented as part of an overall computerisation programme, each CCIT should be encouraged to modernise the existing system by utilising locally available resources within the time frame of, say, one year. The Karnataka example could serve as a model. Budgetary support should be extended promptly as it is bound to be translated into much greater revenue gains even in the short run. Some norms regarding the nature of hardware and software to be utilised to ensure compatibility at the all India level could be issued by the Board.

- **Refunds**

There is lack of uniformity in the allocation of work for direct refunds in as much as independent circles exist in some of the CCIT charges while in others the work has been transferred to wards/circles having normal assessment jurisdiction. The system of having a separate refund ward/circle is more efficient. In bigger towns such separate wards/circles could be created in each DCIT's range or CIT's charge. It needs to be ensured that only cases with income from interest, dividend, etc. are received in these circles. Where any business income is shown, the claim must be filed with the assessing officer having normal jurisdiction so that the returns are subject to scrutiny.

Lack of accountability is seen as the main reason for delays in issuing refunds. There seems little supervision of this area of work by the range deputy commissioners or commissioners as they are pre-occupied with other tasks such as assessment, and arrear reduction which are given priority. An improvement in the system of refunds can be brought about through adequate supervision, insistence on payment of interest on delayed payment of refunds and by sending the refunds in windowed envelopes by registered post. Use of windowed envelopes would avoid, to a large extent, mailing empty envelopes by some unscrupulous elements in the administration. A study of refunds to the extent these relate to TDS is indicated to assess the efficiency of the TDS scheme as a whole and also the efficiency with respect to each source of income caused by TDS. Correcting steps should be taken as may be necessary in the light of this study.

In a regime of computers, eventually the tax returns should be received at the computer centres, processed to verify TDS claims, and refunds issued, before transferring the returns to the officers having assessment jurisdiction.

- **Internal reporting system**

Internal reporting system indicates the importance assigned to different functions. TDS as well as the issue of refunds have not received due attention in the existing reporting system. Reporting on TDS is quarterly while it is monthly for other tasks such as completion of assessments and reduction in arrears. There is no requirement for reporting on disposal of refund claims. Appropriate measures need to be devised to give necessary fillip to the operation of TDS. These might include: a monthly progress report requiring information on efforts made in preparing the register of potential deductors; actions taken against non-filers; verification of payments through Central Treasury Units; disposal of refund claims and the checking of calculations with a focus on the number of entries checked (and not just returns).

- **Legal provisions**

  - Use of forms : The existing scheme has been recently rationalised to reduce the number of forms required to be filed by the tax deductors. Some obsolete rules and forms have been deleted. The requirement to file monthly statements for salary earners has been removed. These changes have tended to reduce the burden on the tax deductors.

  - Issuing TDS certificates : Many taxpayers face hardship due to non-receipt of TDS certificates within prescribed time. Small income earners seeking refunds are particularly vulnerable. There is need to enforce timely issue of such certificates through levy of penalty as provided under the Income Tax Act.

  - Certificates for receiving payment without TDS: The provisions authorising the assessing officers to issue certificates enabling small income earners to receive payments without TDS are intended for the convenience of such taxpayers. In practice, however, issue of such routine certificates results in considerable harassment to the taxpayers. They are required to visit the income tax office as often as might be required if the tax were deducted at source and refund sought. There is need to put a time limit for disposal of all such applications. Issuing instructions for monitoring their receipt and disposal by the deputy commissioners of income tax (DCITs) should go a long way in imparting efficiency in this area.

- **Extending the coverage of TDS**

There is a case for enlarging the scope of TDS. But this should be done only after an efficient refund system and a system of cross-verification of TDS claims put in place. The scheme of TDS should be extended to activities where black money is invested. The scheme could be extended also to some other activities which can easily be tapped. Some of the activities which could be considered for this purpose are given below.

  - Transfer of immovable property : Any amount paid whether as advance or as part payment for the 'transfer' of immovable property or handing over of the possession of property should be subject to TDS. The tax deducted at source should be adjusted in the year in which a transfer takes place. This will prompt legal transfers. The responsibility for deducting tax at source should be that of the broker. In the absence of the broker the responsibility could rest with the buyer, who would then be required to apply for allotment of TAN.

  - Transactions of shares: The sale proceeds of shares should be subject to TDS at a moderate rate of 0.5 or 1 per cent. The responsibility for such deduction could be on the brokers. The receipt given to the seller should record tax deducted at source along with the commission deducted. This receipt could be treated as certificate of tax deduction at source. These certificates would be verifiable for the purpose of test at any time.

  - Compensation for cost of TDS: In order to encourage deductors to provide necessary support to facilitate the work of the Department, it would be desirable to compensate

them for their services. For example, the deductors may be allowed to retain the tax deducted/collected for a longer period (say about a month) before depositing it to the government account. This will also provide some operational flexibility to the deductors in complying with their obligations regarding the tax laws.

- TDS as final withholding: The opinion of the team is that, given the TDS experience in India, which includes efficiency of tax administration, taxpayer convenience and the deductors' responsibility as well as the evasion potential, there seems to be a case for TDS as a final withholding, for example, on bank interest and shares. There may be some cost in terms of equity; however, a survey by the tax administration on a profile of taxpayers with these sources of income should reveal the equity cost as marginal. Such a study should be speedily undertaken.

Chapter 1

Introduction

Tax deduction at source (TDS) is an instrument designed for quick and smooth collection of tax due to the authorities from the taxpayer. The objective of TDS could be said, in general, to be maximisation of revenue collection while minimising the cost of collection. For example, it should be easier to deduct tax from all employees by one employer than for the tax administration to collect from each individual separately. This is so especially for wage and salary income; and this is why such income is subject to TDS in a wide cross section of countries.

Complications arise, however, when TDS is extended to other sources of income mainly with the objective of reducing tax evasion. In such cases, there are many accepted advantages to this facilitating mechanism. Nevertheless, disadvantages have also been attached to the actual TDS processes that have been put into practice across the world. India, in recent years, has extended the scope of TDS broadly across many sources of income. Indeed, about 48 per cent of non-corporate income tax is now collected through TDS. However, questions have arisen regarding the adequacy of taxpayer coverage and necessary computerisation for efficient functioning of the prevailing system, leave alone further expansion of its scope on the one hand, and of inadequate attention to taxpayer rights on the other. India's TDS system therefore calls for a critical examination.

An Executive Summary lists the main findings and recommendations. In what follows, Chapter 2 summarises the advantages and disadvantages of TDS systems while addressing selected general issues. Chapter 3 describes the TDS system as prevailing in India, and analyses the implementation and working of the prevailing TDS provisions in India. The recommendations are based on available theory, on field trips to Bangalore, Bombay, Calcutta and Delhi, and also reflect lessons learnt from the experiences of Indonesia, Malaysia and the United States, based on discussions undertaken with the tax authorities of those countries. A detailed description of the existing TDS system in India is given in Appendix

I. Descriptions of the international systems appear in Appendices II, III and IV. Back-to-office reports from field trips to Bangalore, Calcutta, New Delhi and Mumbai are also annexed to this report.

Chapter 2

TDS: General Principles and Evidence from the Literature

2.1 Links to Tax Evasion

The problem of tax evasion is a fundamental reason for expanding the scope of TDS. Tax evasion is a universal phenomenon. It takes place in all societies, all social classes, all professions, all industries, and all economic systems. It depends on the economic and tax structures, types of income, and social attitudes. The economic theory of tax evasion has limitations since it rests solely on attitudes towards risk, with full information regarding the tax administration's behaviour. In reality, the latter itself can vary, based on a well planned strategy or suffering from negligence or selective indulgence. Commonly, however, tax administration measures to contain tax evasion include withholding (TDS), presumptive and minimum taxes, selective auditing, penalties, and cross checks of returns filed by a taxpayer for different taxes such as the income tax and the value added tax (Shome, 1992).

The tax administration of a country plays an important role in the extent to which tax evasion prevails. However, how much revenue a country should allocate to the administration of taxes is not clear from individual country experiences. There is considerable variance among countries in the amount of resources allocated to tax administration as a share of national income or tax revenue. A low share is not necessarily better than a large one. A country could minimise collection costs by selecting those taxes that are easier to collect irrespective of their economic effects. For example, emphasis could be placed solely on the larger cities, large taxpayers or on search and seizure methods. This might result in the generation of tax revenue by sub-optimal methods and could conflict with other objectives of taxation such as neutrality and equity.

A tax administration should minimise its explicit cost of collection as well as the indirect costs borne by taxpayers and by the economy. These latter costs are often ignored since they do not appear in the balance sheet of the tax administration. They may be

categorised as: welfare costs, compliance costs, and "good relations" costs. The welfare cost per rupee collected may be defined as the excess cost to society of collecting this rupee of tax revenue. These costs have been estimated by various authors. For example, for the United States, some claim that the marginal cost of a dollar raised by the U.S. tax administration might have cost the country more than $1.50, indicating that the tax system is far from optimal. However, attempting to make the tax system optimal may raise other costs such as administrative and compliance costs, an area basically ignored by economists so far (Tanzi and Shome, 1993).

Compliance costs reflect the nature and state of functioning of the tax administration and are intrinsically linked to tax evasion. These costs refer to the cost to the taxpayers--in terms of lost time, added stress, payments to tax accountants and lawyers, visits to the tax office, and bribes--associated with a given tax payment. For some taxes and in particular environment taxes, compliance costs can be very large reflecting, for example, the extent of complications in tax laws and, somewhat relatedly, tax forms thereby necessitating the establishment of sizeable tax departments even in relatively small enterprises, the number of times taxes have to be paid, the non-availability of tax officers resulting in long queues, all contributing to the propensity to evade taxes. There seems to be a direct and positive relationship between the size of tax evasion and the cost of compliance.

"Public relations" costs are connected with the organisation of the tax administration: the number and pattern of use of employees, their salary levels, working conditions, and monitoring capacity over tax inspectors. A tax administration which hopes to improve taxpayer compliance and reduce tax evasion must make available to the taxpayer: information, forms, and instructions if not advice, and carry out these functions amicably, as well as ensure prompt refunds when due.

2.2 TDS: Advantages and Disadvantages

While TDS is reputed to be a powerful instrument for addressing the problem of tax evasion, as a tax administration mechanism, it has both advantages as well as disadvantages. Any TDS system, unless it is designed to minimise these inherent flaws, will fail to facilitate

tax administration or improve revenue collection ostensibly. Therefore, familiarisation with both advantages and disadvantages of TDS systems is important lest the expected benefits from TDS functions be lost. Among the advantages may be mentioned: (1) the intent of the law is more conveniently fulfilled since the tax flow should parallel income flow more closely than without TDS; (2) since tax is collected prior to receiving income, compliance is improved and enforcement costs are reduced; (3) because of improved cash-flow, government's day-to-day borrowing needs are eased; (4) among those within the TDS net, the tax burden is shared more equitably; and (5) since tax collection responsibility is shared by the collection agents, tax officers can devote more time and resources to other functions of tax administration such as expanding the universe of taxpayers, audit and scrutiny, and so on.

Among the disadvantages may be mentioned: (1) the inequity implied in the inability to capture potentially large taxpayers in the TDS net, and the relatively lower success in withholding tax on certain forms of income such as dividends or professional and self-employment income, (2) for a developing country in particular, the inadequacy of trained tax administrators may be further deepened by the addition of the TDS function needing extra staff, infrastructure and processing particularly to check bogus tax deduction claims, short deductions and short payments to the exchequer; (3) the possible excessive burden on the taxpayers in terms of obtaining certificates TDS from deductors, filling additional (and often complicated) tax forms, followed by long waits for refunds; and (4) the burden on deductors implied by the free service of withholding carried out for the tax department even when it may be difficult to obtain the necessary withholding forms and even while they may be subject to two scrutinies (audits) by the tax department: the usual as well as an additional one specifically for TDS.

The answer to what type of income should be subject to TDS depends on the particular circumstances of a country with respect to: (1) the prevalence of tax evasion; (2) departure from horizontal equity (wage and salary earners paying a higher proportion of income in taxes than the self employed or those earning rent, royalties or interest) and vertical equity (large businesses not being subjected to adequate taxation); (3) the size of potential revenue from untapped income sources; (4) the extent of small taxpayers who may be tapped for revenue

purposes; and (5) the availability of additional infrastructure to the tax administration as well as to the deductors for carrying out the extra responsibilities connected with TDS, or the ability to transform available infrastructure suitably and quickly enough to undertake TDS functions efficiently, for example to ensure accurate deductions and prompt refunds. In general, however, available literature on cross-country experiences indicates that TDS has been a successful tax administration instrument given its objectives.

2.3 Evidence from Cross-country Literature

Collection systems are important for minimising tax evasion. Despite some above-mentioned disadvantages, there is now evidence that evasion can be minimised through TDS. While wage and salary income is subject to TDS in many countries (van der Heeden, 1994), and achieves a good level of compliance, TDS for other sources of income is more limited, both in scope and the level of compliance achieved. For example, in general, it is accepted in the United States that the difference in tax evasion between independent contractors who are not subject to TDS and dependent workers whose taxes are withheld by employers is large. In an early paper on the U.S., Vitez (1983) found that, "There is no question but that the withholding and information reporting system operates as a most persuasive stimulant of voluntary compliance" (p.191). More recently, using responses to a questionnaire from 27 U.S. participants, Martinez-Vazquez, Harwood and Larkins (1992) provide experimental evidence to claim that, rather than contributing to tax compliance, "the main role of withholding, besides being an efficient collection device, may be to lessen the opportunities for evasion" (p.168).

Based on a comprehensive survey of the Canadian TDS system, Li (1995) has argued that "withholding should be given a greater role in the Canadian income tax system...(it) is more effective in reducing tax evasion than other enforcement measures because it restricts opportunities for non-compliance...(it) can also improve tax equity and generate additional revenue without requiring the introduction of any new taxes...a broad-based withholding regime would result in additional compliance costs; however, those costs would be greatly outweighed by the benefits" (p. 554). Soos (1990), after a review of several country experiences--Australia, Egypt, Indonesia, Ireland, Japan, Pakistan, the Philippines, United

Kingdom, and the United States--concludes that "a carefully structured system for withholding on business income reduces tax evasion by self-employed individuals and promotes other tax policy objectives" (p.109).

Chapter 3

Tax Deduction at Source in India

3.1 Overview

Deduction of income-tax at source has become one of the major tools in the hands of the income tax department for the purpose of collection of income tax. The scope of TDS has been enlarged, particularly in the late 1980s and during the reform process of 1990s. Withdrawals from National Savings Scheme, commission on sale of lottery tickets and income of offshore funds were brought in the ambit of TDS in 1991. The scheme was extended to certain incomes of non-residents in 1992-93. Rental income was subject to TDS in 1994. Similarly, the scheme was made applicable to various other kinds of income in 1995.

The incomes covered under the scheme of TDS include: salaries, fees for professional or technical services, interest, dividends, rent from real estate, capital gains of non-residents, and commissions from insurance and sale of lottery tickets. The winnings falling in the ambit of the scheme are those from lotteries, crossword puzzles or horse racing. The repurchase value of financial instruments to which the scheme applies relate to units of UTI or mutual funds for which income deduction has been availed of in the year of investment. Similarly, withdrawals from some such other savings schemes like National Savings Scheme are subject to TDS. A brief description of the structure of the scheme is given in Box I.1 in Appendix I including the incomes covered by TDS, the rates of deduction, the dates since when covered and the relevant section of the income tax act 1961. .

The rates of TDS vary depending on the source of income or type of recipient of income or payment. In general, the rates applicable to companies are found to differ from those applicable to non-companies. Also, the rates applicable to domestic companies differ from those applicable to foreign companies and the rates applicable to resident taxpayers differ from those applicable to non-resident taxpayers. TDS is creditable against the final tax liability of resident taxpayers, while it is final in the case of non-resident taxpayers.

3.2 Salient Features of the Scheme of TDS and A Critical Evaluation

The main features of the scheme of TDS are as follows:

1. Responsibility for deduction or collection of tax at source is fixed on specified persons.

2. Every specified person responsible for deduction of tax at source is required to obtain a tax deduction Account Number.

3. Time for payment of tax deducted or collected at source to the Government account is prescribed.

4. Certificates of TDS have to be issued to the tax payers on prescribed forms and within specified time.

5. Statements of payments without TDS have to be submitted on prescribed form and within specified time.

6. Tax has to be deducted/collected at the specified rates.

7. Conditions for less or no deduction of tax are specified.

8. Statements of TDS have to be submitted on prescribed forms and within specified time.

9. The year in which credit for TDS is to be given is specified.

10. Penal and other consequences for non-compliance are provided.

A critical evaluation of some of the provisions of the scheme of TDS is given below.

3.2.1 Depositing the tax deducted/collected with the government

The time allowed for depositing the tax deducted/collected to the government account varies with nature of income/payment (Box I.2, Appendix I). Broadly, the scheme provides for longer period for depositing of TDS where the amounts are credited to the accounts of recipients at the end of the year, for the entire period. Where the payment is on regular basis (such as salary) a period of one week from the end of the month of deduction/collection is allowed for depositing the TDS to the government account. As such regular payments are expected to be made on the last day of a month. Therefore, in these cases,, the period allowed for depositing TDS to the government account, in effect, amounts to one week. Also, for one-time payments like lotteries or winnings from crossword puzzles, the time permitted is only one week from the date of payment. However, in the case of salary, interest (other than interest on securities), and commission, the Assessing Officer may permit some deductors to make quarterly deposit of TDS.

The period of one week for depositing TDS to the government account seems to be short. It does not give the necessary flexibility to the deductors in managing their affairs. With a view to compensating the deductors, at least partly, for their cost of compliance, they may be allowed to retain the tax deducted/collected for a reasonably longer period.

3.2.2 Issuing of Certificates of TDS

The schedule of issuing certificates of TDS is given in Box I.3 in Appendix I. In general, a certificate of TDS is required to be issued within a period of one month from the end of the month during which credit has been given or payment made or cheque/warrant issued, as the case may be. In the case of salary, commission and brokerage, the certificate of TDS is required to be issued only annually, within a month from the close of the financial year. However, in the case of collection of tax on purchase price of specified goods, a period as short as 10 days is allowed for issuing the certificates.

Where quarterly payment of TDS is permitted, the certificate is required to be furnished within fourteen days from the date of deposit of tax to the government account.

Where more than one certificate is required to be furnished during a financial year, a payee may request for a consolidated certificate and the same is required to be issued within one month from the close of the financial year.

The scheme as given in the Appendix has frequent issue of certificate for interest, commission, and rent. As for other items the payment would be one-time, e.g., dividends, lottery/sportsmen/withdrawal from NSS etc. Normally interest and commission is credited on annual basis because of calculation problems. This leaves only rental income where frequent deduction and issue of certificates are necessary every month.

The credit of TDS in the case of taxpayers is given on the basis of certificates of TDS issued by deductors. There have been cases of refunds claimed by filing bogus certificates. The existing instructions to verify the genuineness of such certificates are seldom followed in the rush of work. The record keeping is such that this verification is time consuming. Remedial action is necessary to prevent such instances.

At the same time many taxpayers face hardship due to non-receipt of TDS certificates within prescribed time. Small income earners seeking refunds are particularly vulnerable. There is need to enforce timely issue of such certificates through levy of penalty as provided under the Income Tax Act.

3.2.3 Tax returns/statements to be filed by tax deductors

The tax deductors on their part also face difficulty in having to deal with one income tax officer for their normal assessment and with another for the return of TDS. (The schedule for filing returns of TDS appears in Box I.4 in Appendix I.) There is often overlap of enquiries by the two officers. While the assessing officer checks compliance with the provisions of TDS to ensure payment of due taxes as a part of the collection drive, the officer monitoring TDS often looks into the payments shown to detect under-reporting. Many, therefore, favour centralisation of the assessment and TDS jurisdiction with one officer. However, separation of the TDS and assessment jurisdictions is administratively desirable. It will, however, help if clear guidelines are issued to the concerned officers so that the

overlap of enquiries is minimised.

3.2.4 TDS at lower rates or no TDS in certain cases

A person who will not be in the tax net on the basis of his/her global income (or is under exempt income category) can receive payments without TDS on prior approval of the Assessing Officer or on filing a simple declaration (in certain cases) before the deductor that he/she will not be liable to tax on the basis of his/her global income. A person who is likely to have lower tax liability than the normal TDS may receive payments subject to TDS at rates lower than those specified, again with the prior approval of the Assessing Officer.

The provisions authorising the Assessing Officers to issue certificates enabling small income earners to receive payments without TDS are intended for the convenience of such taxpayers. In practice, however, issue of such routine certificates results in considerable harassment of the taxpayers. They are required to visit the income tax office as often as might be required if the tax were deducted at source and refund sought. There is need to put a time limit for disposal of all such applications. Issuing instructions for monitoring their receipt and disposal by the DCITs should go a long way in imparting efficiency in this area.

3.2.5 Penalties on and prosecution of deductors in default

Non-payment or short-payment of tax as required under the scheme attracts a simple interest of 15 per cent per annum on the short-payment of tax (irrespective of whether or not the deduction was made) from the date on which such tax was deductible to the date on which it is actually paid. In addition, the deductors are subject to penalties for non-compliance with their obligations under the scheme of TDS such as for non-deduction or short-deduction of tax, non-payment or short-payment of tax, late payment of tax, failure to issue certificates of TDS within a specified period, failure to deliver in due time a copy of a declaration relating to claim for payment of an amount without TDS or failure to furnish TDS returns. A deductor who fails to pay tax deducted/collected at source is also liable to rigorous imprisonment (Box I.7 in Appendix I).

3.3 Revenue Significance of TDS

Gross receipt/collection of income tax comprises TDS, advance payment of tax, payment on self assessment, payment against demand raised on regular assessment, payment of arrears, and payment of demands raised during settlement of pending cases. The system also gives rise to substantial refunds which could be attributed mainly to the operation of the schemes of TDS and advance payment of tax. Net receipt/collection of income tax is obtained as gross receipt minus refunds. Gross collection of income tax and TDS, amount of refunds, net collection of income tax, and the shares of TDS in both gross and net collections of income tax, for the period 1980-81 to 1994-95, are given in Tables 3.1, 3.2 and 3.3 respectively for all taxpayers, companies and non-companies. The breakup of TDS by sources of income is given in Table 3.4..

From Table 3.1, it would be noted that the trends of rise or decline in the share of TDS in gross collection of income tax (column 5) are similar to those in net collection of income tax (column 6). There has been a substantial increase in the share of income tax collected through TDS during the 1980s (columns 5 & 6). The share of TDS in gross collection of income tax increased from about 23 per cent in 1980-81 to about 37 per cent in 1989-90 with substantial jumps in 1987-88 and 1989-90. The amount of TDS from interest on securities increased from Rs.162 crore in 1986-87 to Rs.580 crore in 1987-88, and that of TDS from payments to non-residents increased from Rs.206 crore in 1988-89 to Rs.778 crore in 1989-90 (Table 3.4). Also, the amount of TDS from salary income increased from Rs.763 crore in 1988-89 to Rs. 1201 crore in 1989-90, and that from payments to contractors increased from Rs.485 crore in 1988-89 to Rs.845 crore in 1989-90. It, however, is important to note that in spite of widening the coverage of TDS in the 1990s, there has been a decline in the share of TDS (columns 5 & 6, Table 3.1).

From Tables 3.1, 3.2 and 3.3, it would also be noted that the trend in the share of TDS in gross collection of income tax is similar in respect of TDS from all taxpayers, from companies and that from non-companies. The share of TDS from companies in the gross collection of corporate income tax increased from about 16 per cent in 1985-86 to about 27 per cent in 1989-90 and declined subsequently to about 22 per cent in 1994-95. Similarly,

Table 3.1
Collections of Income Tax and Tax Deduction at Source

Year	Deducted at source (TDS) (Rs.Crore)	Gross collections (Rs.Crore)	Total refund (Rs.Crore)	Net collections (Rs.Crore)	TDS as %age of		Refunds as %age of		
					Gross collections	Net collections	Gross collections	Net collections	TDS
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1980-81	745	3185	368	2817	23.39	26.45	11.55	13.06	49.40
1985-86	898	3889	653	3236	23.09	27.75	16.79	20.18	72.72
1986-87	1496	6829	867	5962	21.91	25.09	12.70	14.54	57.95
1987-88	2276	7703	1078	6625	29.55	34.35	13.99	16.27	47.36
1988-89	2704	9794	1150	8644	27.61	31.28	11.74	13.30	42.53
1989-90	4350	11754	2031	9723	37.01	44.74	17.28	20.89	46.69
1990-91	4083	13463	2773	10690	30.33	38.19	20.60	25.94	67.92
1991-92	5976	17991	3409	14582	33.22	40.98	18.95	23.38	57.04
1992-93	6210	21164	3654	17510	29.34	35.47	17.27	20.87	58.84
1993-94	7283	24566	5387	19179	29.65	37.97	21.93	28.09	73.97
1994-95	9604	30537	4686	25851	31.45	37.15	15.35	18.13	48.79

Source: The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981, 1990 and 1995.

Table 3.2
Collections of Income Tax and Tax Deduction at Source from Companies

Year	Deducted at source (TDS) (Rs.Crore)	Gross collections (Rs.Crore)	Total refund (Rs.Crore)	Net collections (Rs.Crore)	TDS as %age of		Refunds as %age of		
					Gross collections	Net collections	Gross collections	Net collections	TDS
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1980-81	NA	NA	NA	NA	NA	NA	NA	NA	NA
1985-86	386	2370	450	1920	16.29	20.10	18.99	23.44	116.58
1986-87	425	3676	531	3145	11.56	13.51	14.45	16.88	124.94
1987-88	830	4137	704	3433	20.06	24.18	17.02	20.51	84.82
1988-89	841	5151	745	4406	16.33	19.09	14.46	16.91	88.59
1989-90	1685	6176	1462	4714	27.28	35.74	23.67	31.01	86.77
1990-91	1500	7275	1945	5330	20.62	28.14	26.74	36.49	129.67
1991-92	2348	10467	2614	7853	22.43	29.90	24.97	33.29	111.33
1992-93	2321	12103	2489	9614	19.18	24.14	20.57	25.89	107.24
1993-94	2772	14106	4046	10060	19.65	27.55	28.68	40.22	145.96
1994-95	3811	17179	3358	13821	22.18	27.57	19.55	24.30	88.11

Source : The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981, 1990 and 1995.

Note : NA: Not available. (The earliest year for which the breakup of tax deducted at source by corporate and non-corporate entities is available is 1985-86.)

Table 3.3
Collections of Income Tax and Tax Deduction at Source from Non-Companies

Year	Deducted at source (TDS) (Rs.Crore)	Gross collections (Rs.Crore)	Total refund (Rs.Crore)	Net collections (Rs.Crore)	TDS as %age of		Refunds as %age of		
					Gross collections	Net collections	Gross collections	Net collections	TDS
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1980-81	NA	NA	NA	NA	NA	NA	NA	NA	NA
1985-86	513	1519	203	1316	33.77	38.98	13.36	15.43	39.57
1986-87	1071	3153	336	2817	33.97	38.02	10.66	11.93	31.37
1987-88	1446	3566	374	3192	40.55	45.30	10.49	11.72	25.86
1988-89	1863	4643	405	4238	40.12	43.96	8.72	9.56	21.74
1989-90	2666	5578	569	5009	47.79	53.22	10.20	11.36	21.34
1990-91	2583	6188	828	5360	41.74	48.19	13.38	15.45	32.06
1991-92	3628	7524	795	6729	48.22	53.92	10.57	11.81	21.91
1992-93	3888	9061	1165	7896	42.91	49.24	12.86	14.75	29.96
1993-94	4510	10460	1341	9119	43.12	49.46	12.82	14.71	29.73
1994-95	5793	13358	1328	12030	43.37	48.15	9.94	11.04	22.92

Source : The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981, 1990 and 1995.

Note : NA: Not available. (The earliest year for which the breakup of tax deducted at source by corporate and non-corporate entities is available is 1985-86.)

Table 3.4
Tax Deduction at Source by Sources of Income

(Rs. Crore)

Year	Salary	Interest on securities	Dividends	Interest	Winnings from		Payment to contractors	Insurance commission	Payment to nonresidents	All Sources
					lottery or puzzles	horse races				
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1980-81	264	124	82	0	3	2	104	4	162	745
1985-86	NC	NC	NC	NC	NC	NC	NC	NC	NC	898
1986-87	468	162	122	287	23	2	344	17	70	1496
1987-88	657	580	140	328	45	6	382	26	112	2276
1988-89	763	698	207	262	37	20	485	25	206	2704
1989-90	1201	848	181	361	85	16	845	35	778	4350
1990-91	1309	1009	277	476	45	5	695	74	192	4083
1991-92	1601	1423	391	779	47	10	995	119	611	5976
1992-93	1562	1606	366	887	54	9	736	75	914	6210
1993-94	NA	NA	NA	NA	NA	NA	NA	NA	NA	7283
1994-95	2403	2302	578	1475	39	6	1359	67	1376	9604

Source : The data have been compiled from the reports of the Comptroller and Auditor General of India (Direct Taxes), Government of India, for the years 1981 to 1993, and 1995.

Notes :
1. NA: Not available. (The earliest year for which the breakup of tax deducted at source by corporate and non-corporate entities is available is 1985-86.)
2. NC: Not correct. (The sum of source-wise tax deduction at source does not tally with the reported total tax deducted at source.)

the share of TDS from non-companies in the gross collection of non-corporate income tax increased from about 34 per cent in 1985-86 to about 40 per cent in 1989-90 and in 1991-92 and declined subsequently to about 43 per cent in 1994-95.

From the above discussion it follows that, had there not been an extension of the scheme of TDS, the share of TDS in total income tax collection would have substantially declined during the 1990s. However, the current share of TDS in gross collection, that is about 37 per cent, is substantially higher as compared to that in 1980-81.

3.3.1 Impact of refunds

The above analysis is based on gross collection of TDS as the data on net collection of TDS (gross collection minus refunds) are not available. The scheme of TDS would require a major overhaul if it generates substantial refunds. The refunds affect adversely the net collection of tax and raise cost of compliance for all agents associated with the scheme, i.e. those subject to TDS, tax deductors/collectors and the government. Analysis of refunds generated by the scheme of TDS is not possible as the data on the same are not available. However, some inferences can be drawn on the basis of total amount of refund generated by the income tax system for which data are available separately for company and non-company taxpayers. For this purpose, three refund to tax ratios namely, refund to gross collection of income tax, refund to net collection of income tax and refund to TDS, are computed separately for company and non-company taxpayers, and for all taxpayers. These ratios are reported in Tables 3.1, 3.2 and 3.3 (columns 8 to 10).

From Tables 3.1, 3.2 and 3.3 (columns 8 to 10), it would be noted that there is no systematic trend of rise or decline in any of the refund ratios. It, however, is important to note that all the refund ratios for companies have been substantially higher than those for non-companies. The refund ratios for the former have been about twice the respective ratios for the latter. The refund to TDS ratio of companies was found to be more than 100 per cent in many years, and was not less than 84 per cent in any of the years under consideration (column 10, Table 3.2). On the other hand, the refund to TDS ratio of non-companies did not exceed 40 per cent in any of the years under consideration and, in fact, it was around 21 per cent in some of the years (column 10, Table 3.3).

Refunds arise only on account of excess TDS or relief allowed to taxpayers in appeal, reference of rectification. An analysis of refunds is required to determine how far TDS collected in one year is being refunded in the subsequent years.

3.3.2 Coverage of the scheme of TDS: a comparison

In the international perspective, TDS in India can be said to be moderate in terms of both its coverage and share in total income tax collection. Some of the countries (such as France, Hong Kong, Singapore and Switzerland) do not depend on TDS, while some others (such as Canada, Indonesia, Malaysia, Philippines and the USA) heavily depend on TDS. In the latter group of countries, the share of TDS in total collection of income tax of a country is not less than 60 per cent. In fact, it has been more than 80 per cent in Canada and the USA.

In relation to countries visited during the study period, the coverage of TDS in India is broader than that in Malaysia while it is narrower than that in Indonesia (see Appendices I, II and III). A variety of incomes, payments or receipts which are not covered in India, but fall in the ambit of TDS in Indonesia include withdrawals from pension fund, all imports, sale of certain goods (such as automobiles, cement, cigarettes, paper and steel) by the producers to their distributors, sale of petroleum products by the government company (PATRAMINA) to its distributors, supply of goods to the government departments, rental income from lease of movable assets (such as cars), receipts on account of sale of shares in the stock exchange market, and receipts on account of transfer of land and/or buildings including transfer of rights (such as on power of attorney). The payments to non-resident entertainers which are not subject to TDS in India or Indonesia, are subject to TDS in Malaysia though, in general, the coverage of the scheme of TDS in Malaysia is narrow.

It is interesting to note that the share of TDS in total income tax receipts in Malaysia is similar to that in Indonesia whereas the former has much narrow coverage as compared to the latter. This could indicate that substantial benefits of a scheme of TDS can be reaped through proper monitoring of the scheme even with narrow coverage. Thus, it would appear that, in India, there is large scope for raising the share of TDS through proper monitoring of the scheme. An increase in the share of TDS can be expected to increase total collection of income tax as it reduces scope for non-compliance.

Enlarging the scope of TDS could be used to further strengthen the enforcement of tax laws. The scope for extending the coverage of the Indian scheme of TDS would be discussed later.

3.4 Past Experience

3.4.1 Salaries

Under Section 192, TDS from salary is based on the tax due on the annual salary and is recovered in 12 equal monthly instalments. Relief under Section 89(1) where arrear or advance salary is received can be taken into account while determining the tax to be deducted at source. Similarly, any other taxable income (not loss) received can also be taken into account on the basis of information furnished by the employee together with the tax deducted at source from it. However, this is subject to the tax deduction at source not falling below the level applicable for salary alone. The deduction of tax at source from salary is, therefore, a straight forward exercise as annual income can be accurately determined. Yet, experience shows that there are problems in proper implementation of the provisions.

One problem in TDS from salaries is the non-disclosure of perquisites by employers. Column 6 of Form No. 24 and the Annexure to this Form require information on the value of perquisites given to each employee. Section 17(2) gives an inclusive definition of perquisites. The important perquisites are in the form of accommodation given free of rent or at concessional rent, conveyance for personal use, entertainment allowance, etc. While the rental value of accommodation is understated to show lesser value of perquisite the use of conveyance for personal use is seldom declared. For most of other benefits a system of reimbursement is adopted declaring these as official, and not personal, expenses and, therefore, not a perquisite to the employee. The benefits to employees often include 'under the table' payments. These are either from funds kept outside the books or are shown in the books as expenses incurred for the business under any of the heads like 'miscellaneous expenses', 'repairs', etc. which are impossible to verify entry by entry. Often resort to such mechanisms is sought to be justified by the inequity inherent in the rules under which employees of Central and State governments, public sector undertakings, R.B.I., etc., receive a highly favourable treatment especially in regard to the value of perquisite on account of accommodation. Under Rule 3, for unfurnished accommodation provided free of rent, the value of perquisite is limited to the rent fixed by the government for government employees

and 10 per cent of the 'salary' for others in above categories. For others, the value is 10 per cent of salary increased by the excess of fair rental value over 20 per cent of the salary. Thus perquisites remain substantially untaxed causing loss to revenue and creating inequity in the form of unequal burden of tax on employees depending upon whether same income is paid wholly in cash or partly in cash and partly in form of perquisites.

Under-the-table payments not reflected in the salary slips are clear instances of evasion by the employers with willing assistance of the employees. For the income tax administration the potential area of evasion remains the income from business or profession towards which the enforcement efforts are concentrated. The salaried employees are generally perceived to be declaring their incomes properly. In fact there is a strong lobby for reducing the tax rates for salaried employees precisely on the ground that those earning income from business or profession have greater opportunities for evading or avoiding tax while salaried employees not having such opportunities have to declare their entire income. As discussed above this is very often not true. But, the fact remains that enforcement efforts in this area are comparatively limited and there is significant loss to revenue on account of untaxed perquisites and 'under the table' payments.

The concept of 'perquisite' itself has often caused differences of perceptions. Two instances deserve mention. The first relates to 'Medical Expenses'. Many important executives both from private and Government sectors have been sanctioned funds by the employers for treatment abroad. Such payments were clearly 'perquisites' within the meaning of Section 17(2)(iv). However, efforts to levy income tax resulted in instant indignation as to how the income tax department could demand tax from the executives already undergoing the trauma of serious illness. The fact that such executives were among the privileged few who even after paying income tax were getting 60 per cent expense reimbursed while the vast majority was forced to incur such expenses entirely from their own resources was seldom highlighted. The new proviso to Sec. 17(2) introduced with effect from 1.4.91 exempts not only payments for medical treatment, travel and stay abroad for the employee or his family member but also the expenses for travel and stay abroad of one attendant. This exemption is available only to the employees having gross salary of less than Rs. 2 lakhs excluding the medical benefit.

Feasibility of introducing separate Fringe Benefits tax on companies has been often considered. Australian and Newzealand models are sometimes recommended. However, there

are no easy solutions as the basic information requirements under these legislations would remain about the same. It is, therefore, difficult to accept that information would be forthcoming under a separate legislation for 'fringe benefits' taxation of corporations when it is being systematically withheld or concealed under the Income Tax Act. There may, however, be a case to introduce such legislation provided the perquisites are valued on 'presumptive basis'. Thus number of residential accommodations owned or rented, number of cars available for personal use, etc., would straightaway result in a definite income 'imputation'. Designing such a model keeping in view all kinds of perquisite will not be easy.

Some legal issues arising out of TDS from salaries would be of interest. The Courts have held that while salary is taxable on accrual basis the TDS under Section 192 has to be on the basis of actual payment {10 ITR 199 (CAL)}. Also amount received as compensation for early termination of employment or wrongful termination does not represent salary (though taxable) and, therefore, tax cannot be deducted at source {(41 ITR 446) SC, (154 ITR 849)(CAL)}. Similarly, amount received as lumpsum for agreeing to join an employer for a fixed period was held to be partly for procuring the service, and thus of capital nature, while the remaining part was addition to salary on which tax is deductible at source. Calcutta High Court on petitions filed by Bank Officers Association also held that City Compensatory Allowance did not come within the definition of income and, therefore, no tax was to be deducted at source (176 ITR 223). However, as a result of introduction of sub-clause (iii) (b) in clause (24 of Section 2 of the Income Tax Act) by the Direct Tax Laws (Amendment) Act 1989, the intended position has been restored retrospectively.

3.4.2 Interest on securities

Tax on interest on securities deductible under Section 193 is at rates in force in each year. For 1996-97 the rates are:

- 10% for persons resident in India,
- 20% for non-residents.
- 21.5% plus surcharge @ 7.5% of the tax in the case of domestic company, and
- 55% for non-domestic company.

Among the problems faced was the postponement of interest by not crediting it to the

payee's account but to a separate 'interest payable' or 'suspense' account. Specific provision was, therefore, introduced by the Finance Act 1989 to provide for deduction even when the interest is credited in this manner (Circular No. 550 dt. 1.1.90). For securities registered in the name of a banking company on behalf of its constituents, initial instructions issued vide Circular No. 13 dt. 4.7.59 provided for deduction at rates in force as applicable to beneficial owners. Legal and practical difficulties arose as a result of which it was decided that the deduction would be at the rates applicable to the banking companies, which in return, would issue a separate 'sub-divided certificate' to each of the constituents. Similar procedure is to be followed in the case of securities registered in the name of executors or the trustee on behalf of their constituents [Circular No. 2-P (XXXIV-4) dt. 16.5.66].

Rule 31(1)(b) regarding issue of certificates of TDS on new form no. 16A created transitional problem for the banks having in their possession such certificates issued on old form no. 16. These were not accepted by the income tax department for giving tax credit. RBI refused to issue certificates on form no. 16A in view of the voluminous and infructuous work involved. The problem was finally solved only after the conditions were relaxed and credit permitted as one-time measure on the basis of certificates on old form no. 16. There is, however, a demand from the nationalised banks for exemption of this income from TDS. This is on the ground that the tax liability is much less than the tax deducted at source as a result of which refunds have to be obtained from the tax department, which takes a long time. The system of TDS also complicates trading in securities as at the time of purchasing the same, adjustment has to be made on account of the tax for the period during which securities were held by the sellers. Voucher system is prevailing in the trade to compensate the purchaser for TDS on interest for the period for which security was held by the seller. This makes the yield calculations very tedious. Also, the rate of deduction of tax at source differs between the nationalised and foreign banks. Interest earned by provident funds is exempt.

3.4.3 Dividends

The problem of nominee holder of shares has been resolved in the same manner as for interest on securities. {Circular No. 3-P(XXI-19) dt. 16.5.66}. The scheme operating at present does not present any operational problems but contains in itself scope of investment of undeclared funds in capital market. The lower limit can always be manipulated for bifurcating the holdings and ensuring that no tax is deducted at source. Also even though companies are required to furnish copies of declarations on the basis of which payment is

made without any deduction at source to the specified authorities verifying the correctness of the declarations in all cases is impossible in view of the voluminous work involved and absence of computerisation.

3.4.4 Interest other than interest on securities

Deduction of income tax at source is required from interest (other than interest on securities) payable to a resident under Section 194A, if it exceeds Rs. 10,000/- in case of 'term deposits' and Rs. 2500/- for others. Tax is deducted at the rates in force. For the financial year 1996-97 the rates are:

(a) 10% for person other than company resident in India, and

(b) 20% plus surcharge at the rate of 7.5% of the tax for domestic companies.

The legal debate in operation of this section includes interest paid to partners by a firm. It was subject to TDS before being included in the exemptions under the proviso to this Section with effect from 1.4.68. The Direct Tax Law (Amendment) Act 1987 removed the exemption with effect from 1.4.88 only to have it re-inserted retrospectively from this very date by the Direct Tax Law (Amendment) Act 1989. The disallowance of interest paid to partners while determining taxable income of a registered firm was the basis for argument in favour of its exemption from TDS.

Interest on deposits with banking companies or cooperatives has also, over the years, generated controversy. Originally it was subjected to TDS before being exempted with effect from 1.4.70 with the introduction of sub clause(vii) of clause (3) of Section 194A. The Finance Act 1991 substituted sub-clause (vii) with sub-clauses (vii) and (vii a), with effect from 1.10.91. As per the amended provisions tax was required to be deducted at source from interest on time deposits, which were also separately defined as deposits repayable on expiry of a fixed period. However, the amendment was withdrawn from 1.6.92. In the Finance Minister's speech before the Parliament on 30.4.92, it was clarified that the position was being restored as obtaining before 1.10.91 on account of a number of representations received from members of public, representative bodies and banks pointing out various difficulties, which had arisen on account of operation of these provisions. The problems in enforcing this provision include increase in refund claims and their disposal by the tax administration and issue of a large number of certificates for tax deduction at source by the Banks. For

taxpayers with income below the threshold it implies additional compliance cost in terms of filing of return and getting refund or complying with other formalities to obtain exemption from such deduction. Clause (vii) of Sub-Clause (3) of Section 194 A has again been substituted by Sub-clauses (vii) and (vii a) by the Finance Act 1995 excluding 'time deposits' with the banks or cooperative societies from the list of exemptions. The provisions are applicable for time deposits made on or after 1.7.95.

The amendment has been introduced as an "effective method of widening the tax base" according to the Memorandum explaining the provisions of the Finance Bill 1995. This is expected to bring in more and more persons in the tax net and also improve correct reporting of income. Obviously the evasion opportunity for this source of income is a cause of concern resulting in re-introduction of the provision notwithstanding the earlier problems. It also needs to be recalled here that though various groups highlighted the difficulties the fact remains that interest on bank deposits was subject to TDS before 1.4.70 when sub-clause (vii) of Clause (3) was introduced for the first time. The lower limit of Rs. 10000, however, again gives scope for avoiding TDS, and consequently reporting of the income from this source, by breaking up deposits appropriately to reduce interest payable below Rs. 10,000/-.

Some interesting issues faced in implementing these provisions emerge from clarifications issued by the tax administration from time to time. Thus, it was clarified that the section applies even where interest is assessable as 'business income' as in cases of money lenders {F.No. 1(429)/67-TPL dt. 14.2.68 to BULSAR NAVSARI ITP ASSOCIATION BULSAR}. It was also clarified that where interest is paid by the consigner to their commission agents, tax has to be deducted at source notwithstanding the facts that the commission agents retain interest out of the money payable to the consigners {F.No.12/112/68-ITA III dt. 23.9.68 addressed to the Association of Taxpayers and Practitioners Calcutta}. In case of HUNDIES sent for collection through banks interest is also collected by the banks if the documents are received late. It was clarified that this interest is not payable to the bank but to the party and, therefore, tax has to be deducted at source (Circular No. 48 dt. 7.11.70). However, where Bill is discounted by the bank the subsequent realisation is by the bank and, therefore, no TDS is required (Circular No. 65 dt. 2.9.71). Sometimes deposits in banks are in a 'joint account' with one of the joint account-holders also having individual account. It was decided that the interest of the joint account will be aggregated with the interest in the account of the individual account holder for the purpose of Section 194 A. If there are more than one individual account holders the aggregation

would be in the hands of the individual having highest interest income. If contested and affidavits or statements are filed under the proviso to Section 194A(1) (Omitted with effect from 1.6.92) the aggregation was to be done in accordance with such affidavit or statement without prejudice to the right of the Assessing Officer to establish beneficial ownership (Circular No. 256 dt. 27.5.79). With the re-introduction of this provision with effect from 1.7.1995, it has been decided to aggregate interest of joint account with the interest due to the first named person of such joint account. It was also clarified that interest credited to 'interest payable' or 'suspense account' is a constructive credit to the account of the person and, therefore, liable to TDS (Circular No. 288 dt. 22.12.80). The explanation clarifying this position was introduced only with effect from 1.6.87. It was also clarified that interest paid on compensations for acquiring lands by State Authorities is liable to TDS (Circular No. 526 dt. 15.12.88).

3.4.5 Winnings from lottery, crossword puzzles or horse racing

Many issues required clarifications by the Central Board of Direct Taxes. Where the prize is partly in cash and partly in kind the total value has to be taken for tax deduction at source. But, where it is totally in kind no deduction is required. Where payment is made in instalments the deduction has to be made from each instalment on payment (Circular No. 428 dt. 8.8.85). For prizes given to a resident in the State of Sikkim for winnings of a lottery the draw for which is held in pursuance to an agreement entered into on or before 28.2.89 between the State of Sikkim and the organising agency no deduction is required as Section 10(26AA) exempts such income from tax provided the requirements of explanation to Section 10(26AA) are fulfilled. Some confusion was created on account of deduction of tax at source in cases of Indian residents by the income tax authorities of Sikkim prior to extension of Income Tax Act to the State of Sikkim on 1.4.90. The taxpayers claim for credit of this tax deducted at source could not be accepted as it was not under the Income Tax Act and no relief could be given under Section 90 as State of Sikkim was a part of India when the deduction was made. The result was taxing of such income net of the tax paid in Sikkim.

3.4.6 Payments to contractors and sub-contractors

The provisions of Section 194C regarding deduction at source from payment to contractors resident in India relate to contracts entered into with Central or State Government; local authority; any corporation established under any Central, State or Provincial Act;

Companies, any Cooperative Society, Authorities constituted under any law in India and dealing with need for housing accommodation; any trust or any University created under any law or approved by University Grants Commission.

This section was introduced with effect from 1.4.72. Deduction has to be at the rate of 2 per cent from the payments to be made to contractors (for contracts for advertising in print or electronics media the deduction is now at the rate of 1 per cent) and at the rate of 1 per cent for payments made to sub-contractors by contractors other than individuals or HUFs. The contract has to be for carrying out any work (including supply of labour). An explanation was inserted with effect from 1.6.88 to prevent postponement of the tax by crediting the amount to a 'suspense account' or any other account by deeming such credit as credit to the payee. With effect from 1.7.95 no deduction is to be made where the payment does not exceed Rs. 20000/-. The earlier limit since 1.6.82 was Rs. 10000/-.

This provision does not apply to contracts for 'sale of goods'. Contracts for construction of buildings or dams or laying of roads and airfields or railway lines or erection or installation of plant and machinery are covered being contracts for work and labour. The section also covers contracts granted for processing of goods supplied by the Government or any other specified person where the ownership of such goods remains at all time with the Government or such person. This includes contracts for fabrication of sea and river crafts where materials are supplied by the Government and the fabrication work is done by the contractor. Where the crafts are supplied by the contractor according to the specifications given by the Government or other specified persons and ownership passes only when such crafts are delivered this amounts to sale and as such payment is not subject to deduction Section 194C. Contracts to fix a moveable to another chattel or on the land, where the intention is not to sell the article but to improve the land or other chattel and the consideration is not for the transfer of chattel but for the work done and materials furnished the contract is one of work and labour and, therefore, covered under Section 194C [State of Punjab vs. Associated Hotels of India Ltd. - 29 STC 474(SC)]. The basic test is thus whether, in substance, the contract is one of work and labour or not. Contracts for rendering professional services by lawyers, physicians, surgeons, engineers, accountants, architects and consultants, etc. are not 'for carrying out any work' and thus not covered. Where material is supplied by the Government or other specified person at stipulated price the deduction will relate to the gross payment. Where the contractor has undertaken only to provide labour for work and ownership of material remains all the time with the Government or the other person the

payment to the contractor will only be for labour for work and deduction will be made without including cost of material (Circular No. 86 dt. 29.5.72).

Circular No. 93 dt. 26.9.72 issued by the Board also clarified that the provisions of Section 194 C will apply to oral contracts and contracts for work given on piece rate basis. Ordinarily transport contract cannot be regarded as contract for carrying out 'any work'. However contracts involving transport as well as loading and unloading are covered unless the element of labour provided for loading and unloading is negligible. This Circular also clarified that service contracts not involving the carrying out of any work are outside the scope of the provision. Deductions under Section 194C have to be made with reference to the total amount of payment and not 'income comprised in such payments'. Subsequently in Circular No. 295 dt. 6.3.81, it was reiterated that the deduction in a composite works contract where material is supplied at stipulated price has to be with reference to gross payment without excluding the cost of the material. Patna High Court's decision in the case of Associated Cement Company (120 ITR 444) was cited while clarifying that the decision of the Supreme Court in the case of Brij Bhushan Lal (115 ITR 124) related to the question of computing income and not to interpretation of Section 194C. The finding that the cost of stores and materials have to be excluded from the turnover while estimating profits of a contractor has no bearing in so far as the provisions of Section 194C (1) are concerned as deduction is not from profits but from total payments made to the contractor.

Clarifications were also sought in regard to Bidi Manufacturing Industry where generally the manufacturers provide raw material, i.e., leaves, tobacco, threads, etc. to the 'Munshis' who distribute the same to workers who work at home. At regular intervals 'Munshis' collect Biris and handover the same to the manufacturer. The manufacturer pays to Munshis who in turn pay to workers. The rates for Munshis and workers are fixed. The Board took the view (Circular No. 433 dt. 25.9.85) that there is implied contract between the manufacturers and Munshis. As such the provision of Section 194C would apply. Subsequently in view of Supreme Court's decision, on the writ petitions filed by P.M. Patel and Sons (AIR 1987 SC 447), holding that the Biri Workers who are employed through the medium of agencies like Munshis but who bring Biris to the factory for quality check and getting their payments are employees of the manufacturers entitled to the benefits of Provident Fund, etc. it was clarified that deduction under Section 194C to be made from payments to Munshis need not include payments to such home workers (Circular No. 487 dt. 8.6.87). Then again the question of application of the section to the works executed under National

Rural Employment Programme (NREP) and Rural Landless Employment Guarantee Programme (RLEGP) came up for consideration. The Board took the view that there is no contract between the village community/village agencies and the State Governments for the execution of such contracts and the scheme specifically bans employment of contractors or middlemen for the execution of work undertaken under these schemes. As such Section 194C would not be applicable (Circular No. 502 dt. 27.1.88). The question of payments made by State Road Transport Corporation to private bus owners came up for specific consideration of the Board. Reference was made to a specific contract wherein the owner of the buses was required to, inter-alia, give the same on hire with a driver and conductor for specified number of hours and also keep the bus in road worthy condition. The payment was to be made on fortnightly basis at a fixed daily rate plus a per kilometre charge as the variable cost. The Board took the view that this is actually a service contract (for carrying out any work) between the State Road Transport Corporation and the owner of the bus. The provisions of Section 194C are, therefore, applicable (Circular No. 98 dt. 26.9.72).

In the case of Associated Cement Company Ltd. Vs. CIT (120 ITR 444) the Patna High Court also held that Section 194 C is not violative of Article 31 of the Constitution. It was held that the contract for the supply of labour for loading packed cement into trucks and wagons is a contract for supply of labour for carrying out a work and is covered by Section 194C. The Madras High Court (188 ITR 84) followed the decision of the Supreme Court cited earlier while holding that the contract by a publisher whereby all material was given to the printer and the printer returned the periodical after printing the same on such material is a 'works contract'. Where a firm purchased certain quantity of scants of timber from the Government it is not a contractor within the meaning of Section 194C and therefore payments made by the firm to any person can not be treated as a payment made by a contractor to a sub-contractor {163 ITR 702 HP & 157 ITR (St) 31(SC)}.

The Supreme Court while upholding the judgement of the Patna High Court in the case of Associated Cement Company Ltd. held that the words 'any work' in sub section (1) of Section 194C mean 'any work' and not a 'work contract' which has a special connotation in tax laws. The word 'work' envisaged in the sub section has a wide import which covers 'any work' which one or the other of the organisations specified in the sub section can get carried out through a contractor under a contract. The Board took note of these views and also the earlier observations of the Patna High Court in this very case to the effect that "in a very broad sense the work done by one person is service rendered to another and indeed one of the

dictionary meanings of the word service is work", to conclude that the section would apply to all contracts including transport contracts, labour contracts, service contracts, etc. The views expressed in the earlier Circular Nos. 86, 93 and 108 were, therefore, modified and instructions were issued to the effect that the provisions shall apply to all types of contracts including transport contracts, service contracts, deferred contracts, broadcasting contracts, telecasting contracts, labour contracts, material contracts and work contracts. It was also clarified that service contracts would be covered and these would include services rendered by lawyers, physicians, surgeons, engineers. accountants, architects and consultants, etc. The transport contracts would also cover contracts for plying of buses, ferries, etc. alongwith the staff. It was also clarified that material contracts would mean contracts for supply of material where the principal contract is for the work and labour and not contract for sale of material (Circular No. 681 dt. 8.3.94).

This immediately led to a spate of writ petitions being filed on behalf of various organisations. The broad stand taken being that the Section is applicable only to payments made in any work and not payments made as fee for services rendered or commission paid to commission agents or brokers. The Delhi High Court (Taxman - Tax Reports - Vol. 76, p.432) accepted the interpretation on behalf of the taxpayers and held that Section 194 did not apply to payments made as fees for services rendered or commission paid to commission agents or brokers. SLP filed by the Department was dismissed by the Supreme Court with the observations that High Court has merely decided that Section 194C does not apply to brokers and, therefore, there is no reason to interfere. In a similar writ filed in the Bombay High Court in the case of Bombay Goods Association vs. Central Board of Direct Taxes it was held that the expression 'any work' does not cover service contracts or transport contracts (Taxman - Tax Reports - Vol.6, p.334). In another case of Chambers of Income Tax Consultants vs. Central Board of Direct Taxes, the Bombay High Court held that Section 194C is not applicable to payments of fees for professional services. While the outcome of this legal battle is yet to be finally decided the Finance Act 1995 has introduced Section 194J specifically bringing payments by way of fees for professional services or fees for technical services within the purview of TDS. These provisions have become effective from 1.7.1995.

3.4.7 Commissions, payments to non-resident sportsmen or sports associations and certain withdrawals

TDS from various kinds of payments is governed by Sections 194D, 194E, 194EE,

194F and 194G. In case of insurance commission, TDS is applicable only for payments to residents. In this case, the Board clarified that deduction has to be made at the time of credit of commission and on the basis of such credit without any adjustment of the debits relating to earlier credits (Circular No. 120 dt. 8.10.73).

3.4.8 Commission or brokerage relating to sale of goods

The provisions of Section 194H introduced with effect from 1.10.1991 led to an immediate uproar on account of the stated difficulty in implementation. Generally the taxpayers highlighted the difficulty faced by sellers who sell their goods through commission agents. How could they deduct tax at source when actually it is the commission agent who receives sale proceeds on account of sale of goods and remits the same to the seller after deducting his commission. Also requiring such sellers to deduct tax at source every time commission is credited or paid is cumbersome as such payments or credits occur a number of times during the year. The provisions were deleted with effect from 1.6.92, i.e., barely 8 months after introduction. The Finance Minister's speech dated 30.4.92 referred to the representations received from members of public and representative bodies pointing out difficulties which had arisen on account of these provisions. It appears that the similarity of the problem with that relating to Section 194A which remains in force has not received due attention.

3.4.9 Rental income

The provisions relating to TDS from rental income payable by persons other than individuals and HUFs (Section 194I) were introduced with effect from 1.6.94. The TDS becomes applicable only if the annual payment is estimated to exceed Rs. 1,20,000. Some doubts were raised about the scope of these provisions. The Board has clarified that TDS would be deductible from non-refundable deposits and warehousing charges. Where municipal or other taxes are paid by the tenant, no tax would be deductible on such sums (Circular No. 718 dt. 22.8.95). Where rent is paid to the government, TDS is not required. Where the payment is made to local authorities or statutory authorities, TDS is again not required if the payer is satisfied about the tax exempt status under Sections 10(20) or 10(20A) on the basis of certificates given by such authorities (Circular No. 699 dt. 30.1.95). Credit to a 'Suspense Account' or any other account is deemed to be credit to the payee requiring TDS.

3.4.10 Fees for professional or technical services

Fees for professional or technical services (Section 194 J) payable by persons other than individuals or HUFs have been brought in the ambit of TDS with effect from 1.7.1995, provided the amount payable in a year exceeds Rs.20000. In view of the practical difficulties involved, the Board has clarified that fees paid by foreign companies or foreign law or accountancy firms through regular banking channels to chartered accountants, lawyers and advocates or solicitors, resident in India, will not be subject to TDS. However, foreign companies or foreign law or accountancy firms, making such payments, are required to send quarterly statements giving names and addresses of the payees to Deputy Secretary, Foreign Tax Division, CBDT (Circular No. 726 dt. 18.10.95). Credit to a 'Suspense Account' or any other account is deemed to be credit to the payee requiring TDS.

3.4.11 Income of non-residents

The procedure for making remittances as laid down in the Press Note dated 17.5.88 issued by the Department of Economic Affairs, provides for deposit of tax at the prescribed rate and furnishing to the designated bank details of payments in the prescribed form certified by a chartered accountant along with income tax challan for payment. The designated bank thereafter would forward this certificate to the Reserve Bank of India which would permit remittance of the balance amount without requiring any 'No Objection' from income-tax authorities. Where there was claim for TDS at lower than the prescribed rate, the RBI insisted on a 'No Objection' from the Income-tax authorities. The procedure was simplified by Circular No. 695 dt. 29.11.94. As per the revised procedure, the authorities to whom application for authorisation of remittance is made will also verify the claim of the payer keeping in view the provisions of the Income Tax Act, the Double Taxation Avoidance Agreement (DATAA) and specific facts of the transaction.

Lumpsum payments to foreign suppliers for acquisition of right for use of systems of software, by those engaged in export of software for computer application, is not subject to TDS where such software is supplied by the manufacturer of computer hardware along with hardware itself (Circular No. 588 dt. 2.1.91). Where remittance is to a country in which Double Taxation Avoidance Agreement (DTAA) is in force, TDS has to be at the rate provided under the relevant Finance Act or under the DTAA, whichever is beneficial to the assessee (Circular No. 722 dt. 30.10.95).

3.4.12 Collection of tax from purchasers of specified goods

This provision was subject matter of extensive litigation on account of the presumption contained in Section 44AC estimating the income of such persons as a percentage of the purchase price. The Courts accepted that these provisions are an anti evasion mechanism as liquor contractors are generally 'fly-by-night operators" who obtain huge contracts in the name of fictitious persons or in the name of those having meagre resources but do not file any income tax return or pay any income tax. After the completion of period of contract such persons are not even traceable. The legal challenge to the taxation based on 'purchase price' was on the ground that this could not be an income tax as after purchase a person may earn income less than that presumed or may even suffer losses. The courts rejected this claim and emphasised the distinction between the nature of a tax and the mechanism evolved for collecting the same. On the question of presuming a fixed percentage of 'purchase price' as income the Kerala High Court upheld the constitutional validity of Section 44AC but the Andhra Pradesh High Court in the case of A. Sanyasi Rao commented adversely on the rates being sought to be justified on the basis of results shown for a few selected cases. It was also noted that in some states both the sale and purchase price were regulated earlier where the profits could not be as presumed under Section 44AC. The Court took the view that as an anti evasion measure, it was sufficient if Section 206C was enforced forcing such tax payers to come forward and file their income tax returns. Thereafter each case must be examined and the profits determined on the facts and the circumstances particular to that case. Instead of striking down the provisions of Section 44AC as unconstitutional the Court directed that the provisions should be read to mean that the wording 'notwithstanding anything to the contrary contained in Sections 28 to 43C referred only to deduction of tax at source and for normal income determination these would not apply. It was as a consequence of this decision that the provisions of Section 44AC were deleted by the Finance Act 1992 with effect from 1.4.93.

Interpretation of 'purchase price' also created many problems. It was agreed that amounts given for right to participate in auctions, etc., called bid money, cannot be included in the purchase price. Section 44AC was therefore amended w.e.f. 1.4.91 with the insertion of an explanation defining 'purchase price' as excluding amount paid or payable towards bid money in an auction or, as the case may be, the highest accepted offer in case of a tender or any other mode. This explanation was, at places, used to exclude a major portion of the sums paid by liquor contractors. State governments earning huge revenues through such contractors were not unwilling to cooperate with them. Thus, in one State, 30 per cent of the sum paid

was treated as 'Nirgam Mulya' and not purchase price, thus excluding it from the scope of TDS. A number of such disputes on interpretation of 'purchase price' continue to persist between the taxpayers and the tax administration with matters pending for decision by appellate authorities at all levels.

3.4.13 Common problems in implementation

While problems in implementation of different provisions relating to TDS have been highlighted it is necessary to bring into focus the problems faced in overall implementation of the scheme of TDS. As already pointed out such a scheme has the advantage of ease of collection, provides source information for detection of those who do not pay tax, and discourages non-compliance. The first common problem is the resistance offered by the concerned taxpayers in the garb of difficulties in complying with the provisions. Following instances merit mention:

(a) The objection to deduction of tax at source from commission and brokerage, despite the fact that problems cited also existed in case of interest payable by consigner to commission agent which is covered by Section 194A.

(b) The objection to tax deduction at source on 'bank deposits' despite the fact that the provision was in operation till 1.4.70.

(c) The challenge to extension of scope of Section 194C on mere technical grounds notwithstanding the fact that the government could bring in specific amendment as indeed it did with the introduction of Section 194J.

These instances indicate that the taxpayer's resistance is often on account of the consequence of such coverage and not on account of any genuine compliance problems.

As mentioned while discussing the provisions of Section 192, successful implementation of the scheme of TDS would require proper listing of payers, ensuring filing of prescribed returns, checking of such returns for ensuring that all required information is furnished, checking of calculations to detect under deduction and non-deduction, collection of amounts short deducted and levy of interest or fine under the provisions of the Income Tax Act. The very first step of listing is seldom comprehensively undertaken. No doubt, Section

203A was introduced, requiring tax deduction account numbers to be obtained by such taxpayers. But without comprehensive listing, the defaulters cannot be identified. The other checks are not undertaken in a comprehensive manner. Identification of non-filers through cross checking is not feasible with the available manpower and infrastructure, and is seldom undertaken.

The work relating to TDS has been given low priority. The general approach is to deploy more efficient officers and the staff for assessment work and only the recently promoted officers, or others considered less efficient, for the job of monitoring deduction of tax at source. Therefore, the concerned officers lack knowledge and experience or motivation to perform the task efficiently.

Many of the Central and State government offices, local authorities, autonomous bodies and other institutions do not file any annual returns. Since the persons responsible are also Central or State government employees, the remedial action taken is at best lukewarm.

Irrespective of the quality and the extent of manpower deployed for monitoring tax deduction at source, some areas like checking of calculations, cross matching with the registers maintained in the wards to detect non-filers who are liable to pay tax, etc. are impossible to perform without full computerisation. Computerisation of this area of work should have been accorded highest priority next only to allotment of Permanent Account Numbers. This is not the case.

Then again the anti-evasion aspect of TDS is lost everytime a lower limit is provided as in the case of dividends, interest on term deposits, etc. This is because the income earners wanting to avoid detection are ingenious enough to bifurcate their holdings appropriately. Such lower limits are, however, essential to take care of the small income earners whose incomes are either not taxable or if taxable the total tax liability is much less than the tax deducted at source. Requiring such individuals to file income tax returns and claim refunds is a hazardous task. There is tremendous potential for their harassment by some unscrupulous elements in tax administration. It also increases infructuous work for the Income Tax Administration. It has to be, therefore, ensured that the refund issuing mechanism becomes efficient so that a taxpayer would receive the refund sitting at home within a fixed time before it can be recommended that such lower limits should be removed. Ensuring changes in the legal and procedural requirements to ensure efficiency in issue of refunds is thus an important

pre-requisite for efficient implementation of the scheme of TDS.

The most important objective of a TDS scheme is to ensure compliance with income tax laws. It is generally agreed that the propensity to evade reduces once the income is subjected to TDS. This, however, does not mean that evasion of tax on such income does not take place. In cases of employees there are numerous instances of claim of deduction/rebate for savings which are made out of borrowed funds. Employees are known to have taken certificates of donation to claim tax relief under Section 80G from institutions which are willing to give certificates with cheques being exchanged for cash. The mechanism provides opportunity for undeclared income of the trustees to be brought into the trust fund in the garb of such fictitious donations. The experience of Section 206C and Section 44AC is another such example. The deduction of tax at source only made such persons file their tax returns. Most of the contractors claimed the entire tax paid as refund. The interpretation of 'purchase price' resulted in deemed income being reduced by as much as 30 per cent of what it would be if total money paid were treated as 'purchase price'. Then again the income estimation under Section 44AC was restricted to purchase of 'country liquor'. Huge losses were claimed on sale of Indian made foreign liquor (IMFL), a fixed quantity of which had to be purchased by each contractor. Since the sales were all in cash such claim of loss could seldom be investigated in detail to make any appreciable difference. The end result, therefore, was that a substantial portion of revenue collected at source was refunded subsequently. This was when Section 44AC was in force. With the deletion of this Section the operation of scheme of collection of tax at source is likely to become more ineffective. Any scheme of TDS has to, therefore, ensure that there is a reasonable mechanism for verification of the actual income as otherwise the benefit will remain marginal and temporary.

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Appendix I

Income Tax System of India With Special Reference to Tax Withholding at Source

I.1 Coverage of the Scheme of TDS

The scheme of TDS applies to (i) various kinds of income (on gross basis), (ii) royalty (iii) winnings, (iv) repurchase value of certain financial instruments, (v) withdrawals from specified savings schemes, (vi) payments to contractors/sub-contractors or non-resident sportsmen or sports associations, and (vii) purchase price of some specified products like liquor, timber and forest produce. The incomes covered under the scheme of TDS include: salaries, fees for professional or technical services, interest, dividends, rent from real estate, capital gains of non-residents, and commissions from insurance and sale of lottery tickets. The winnings falling in the ambit of the scheme are those from lotteries, crossword puzzles or horse racing. The repurchase value of financial instruments to which the scheme applies relate to units of UTI or mutual funds for which income deduction has been availed of in the year of investment. Similarly, withdrawals from some such other savings schemes like National Savings Scheme are subject to TDS. The scheme applies to company as well as non-company taxpayers, as also to residents and non-residents. A brief description of the structure of the scheme is given in Box I.1. It indicates incomes covered by TDS, the threshold limits, if any, the dates from which covered, rates of TDS and the relevant section of the Income Tax Act 1961. TDS is creditable against the final tax liability of resident taxpayers, while it is final in the case of non-resident taxpayers.

The scope of TDS has been enlarged, particularly in the late 1980s, and it has continued in the 1990s. Withholdings from National Saving Scheme, commission on sale of lottery tickets and income of offshore funds were brought into the ambit of TDS in 1991. The scheme was extended to certain incomes of non-residents in 1992-93. Rental income was subject to TDS in 1994. Similarly, the scheme was made applicable to various other kinds of income in 1995.

Box I.I
Structure of Income Tax Deduction at Source in India
(Financial Year 1996-97)

Nature of payment (Subjected to TDS with effect from)	Section of Income Tax Act 1961	Rate of deduction (per cent) for			
		Non-companies		Companies	
		Residents	Non-residents	Domestic[1]	Foreign
(1)	(2)	(3)	(4)	(5)	(6)
1. Salary and wages (from the beginning)	192	*[2]	*[2]	NA	NA
2. Interest: (from the beginning)					
a. On Securities[3]	193	10[4]	20	21.5	55
b. On other instruments	194A,195	10[4]	20/30[5]	20	20
3. Dividends	194, 195	20[4]	20	21.5	20
4. Winnings from lottery and crossword puzzle (1.4.72)	194B	40[6]	40[6]	40[6]	40[6]
5. Horse Races (1.4.78)	194BB	40[6]	40[6]	40[6]	40[6]

Contd.

1. From domestic companies, a surcharge at the rate of 7.5% on the tax computed at the specified rates is also charged.

2. Deduction of tax is made as per the applicable rate schedule.

3. These comprise government securities, debentures or other securities issued by or on behalf of any local authority or a corporation established by a Central, State or local Act and any debentures issued by a company, which are listed on a stock exchange in India.

4. Provided the amount payable during the financial year exceeds Rs. 10,000/- in the case of banking companies, cooperative societies, Unit Trust of India, specified Mutual Funds and housing finance companies (effective from 1st October, 1996), and Rs. 2,500/- in other cases.

5. The 20 per cent rate is applicable to only non-resident Indians provided investment is made in convertible foreign currency.

6. Provided the amount exceeds Rs. 2,500/- in the case of horse races and Rs. 5,000 in other cases.

Box I.1 (Contd.)
Structure of Income Tax Deduction at Source in India
(Financial Year 1996-97)

Nature of payment (Subjected to TDS with effect from)	Section of Income Tax Act 1961	Rate of deduction (per cent) for			
		Non-companies		Companies	
		Residents	Non-residents	Domestic[1]	Foreign
(1)	(2)	(3)	(4)	(5)	(6)
6. Insurance commission (1.4.73)	194D	10[7]	NA	21.5[7]	NA
7. Commission on sale of lottery tickets (1.10.91)	194G	10[8]	10[8]	10[8]	10[8]
8. Rent (1.6.94)	194I	15/20[9]	15/20[9]	20[10]	20[10]
9. Fees for professional services[11] (1.7.95)	194J	5[12]	NA	5[12]	NA
10. Fees for technical services[13] (1.7.95)	194J, 195	5[12]	30	5[12]	30/50[14]
					Contd.

7. Provided the amount exceeds Rs. 5,000/-

8. Provided one time payment exceeds Rs. 1,000/-.

9. Provided the amount payable in a year exceeds Rs. 1,20,000 and is payable by a person other than an individual or a Hindu Undivided Family (HUF). The rate is 15 per cent on rent payable to individuals or HUFs, and 20 per cent on rent payable to others.

10. Provided the amount payable in a year exceeds Rs. 1,20,000 and is payable by a person other than an individual or a Hindu Undivided Family (HUF).

11. Professional services means services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or internal decoration or advertising or such other profession as is identified by the board for the purposes of Section 44 AA or for this Section. According to rule 6F corresponding to Section 44AA(3), the section covers 'film artists' which are defined to include actors, directors, cameramen etc.

12. Provided the amount payable in a financial year exceeds Rs. 20,000/- and is payable by a person other than an individual or HUF.

13. Technical services means managerial, technical or consultancy services.

14. The rate of 50 per cent applies to payments in respect of agreements made before March 31, 1976.

Box I.1 (Contd.)
Structure of Income Tax Deduction at Source in India
(Financial Year 1996-97)

Nature of payment (Subjected to TDS with effect from)	Section of Income Tax Act 1961	Rate of deduction (per cent) for			
		Non-companies		Companies	
		Residents	Non-residents	Domestic[1]	Foreign
11. Royalty[15]		20	30	21.5	30/50[14]
12. Income in respect of units of a Mutual Fund specified under Section 10(23D) of:					
a. Residents (1.7.95)	194K	15[16]	NA	20[16]	NA
b. Non-residents (1.7.95)	196A	NA	20[17]	NA	20
13. Income of foreign financial corporations/offshore funds from units (referred to in Section 115AB) purchased in foreign currency (1.10.91) or long term capital gains arising from transfer thereof (1.6.93)	196B	NA	NA	NA	10
14. Income of a non-resident from bonds/shares (referred to in Section 115AC) purchased in foreign currency (1.6.92) or long term capital gains arising from transfer thereof (1.6.93)	196C	NA	10	NA	10
					Contd.

15. Royalty means consideration for (i) imparting with right or information relating to a patent, invention, model, design, secret formula or process or trade mark or similar property; (ii) imparting of information concerning technical, industrial, commercial or scientific knowledge or, experience or skill; (iii) transfer of rights in respect of copyright, literary, artistic or scientific work; and (iv) rendering of services in connection with activities (i) to (iii).

[16]16. Provided the annual payment exceeds Rs. 10,000.

17. In the case of a non-resident Indian or a non-resident HUF, no tax is to be deducted if the units have been acquired out of funds in an NRE account or by remittance of funds in foreign currency.

Box I.1 (Contd.)
Structure of Income Tax Deduction at Source in India
(Financial Year 1996-97)

Nature of payment (Subjected to TDS with effect from)	Section of Income Tax Act 1961	Rate of deduction (per cent) for			
		Non-companies		Companies	
		Residents	Non-residents	Domestic[1]	Foreign
(1)	(2)	(3)	(4)	(5)	(6)
15. Income of foreign institutional investor from securities (other than those covered U/S 115AB) (1.6.93)	196D	NA	NA	NA	NA[18]
a. Short-term capital gains		NA	NA	NA	NA[19]
b. Long-term capital gains		NA	NA	NA	20
c. Other					
16. Income of a non-resident by way of long-term capital gains		NA	20	NA	20
17. Payment on account of repurchase of units under notified equity linked schemes by Mutual Fund or UTI (Referred to in Section 80CCB) (1.4.91)	194F	20[20]	20[20]	NA	NA
18. Payment in respect of deposits under National Savings Scheme or deferred Annuity Plan of LIC (Referred to in Section 80CCA(2)(a)) (1.10.91)	194EE	20[21]	NA	NA	NA
19. Payments (referred to in Section 115BBA) to non-resident sportsmen (not citizens of India) or sports associations (1.11.89)	194E	NA	10	NA	10

Contd.

18. Taxable at the rate of 30 per cent but no tax deduction at source (TDS).

19. Taxable at the rate of 10 per cent but no TDS.

20. Provided the payee is an individual or HUF.

21. Provided the payment in a financial year is likely to exceed Rs. 2,500/-, and is not made to heirs of the taxpayer.

Box 1.1 (Contd.)
Structure of Income Tax Deduction at Source in India
(Financial Year 1996-97)

Nature of payment (Subjected to TDS with effect from)	Section of Income Tax Act 1961	Rate of deduction (per cent) for			
		Non-companies		Companies	
		Residents	Non-residents	Domestic[1]	Foreign
(1)	(2)	(3)	(4)	(5)	(6)
20. Payment to contractors (1.4.72)	194C(1)	1 or 2[22]	NA	1 or 2[22]	NA
21. Payment to sub-contractors (1.4.72)	194C(2)	1[23]	NA	1[23]	NA
22. On receipts from the buyer of[24]	206C				
a. Liquor for human consumption (other than Indian-made foreign liquor) and tendu leaves		15/10[25]	NA	15/10[25]	NA
b. Timber obtained under a forest lease		15	NA	15	NA
c. Timber obtained by any mode other than under a forest lease		5	NA	5	NA
d. Any other forest produce not being timber		15	NA	15	NA
23. Any other income		20	30	21.5	55

22. Provided the payment in a financial year is likely to exceed Rs. 20,000/-. In the case of advertising the rate is 1 per cent and otherwise 2 per cent.

23. Provided the payment in a financial year is likely to exceed Rs. 20,000/-

24. The tax so deducted has to be paid to the credit of the Central Government within seven days, and issue a certificate of TDS to the buyer within ten days from the date of debit or receipt of the amount. A person collecting tax from such buyers has to file half yearly returns for the period ending on 30th September and 31st March.

25. 10 per cent is applicable with effect from October 1, 1996.

I.2 Characteristics of the Scheme of TDS

The main features of the scheme of TDS are as follows:

1. Responsibility for deduction or collection of tax at source is fixed on specified persons.
2. Every specified person responsible for deduction of tax at source is required to obtain a tax deduction account number.
3. Time for payment of tax deducted or collected at source to the Government account is prescribed.
4. Certificates of TDS have to be issued to the tax payers on prescribed forms and within specified time.
5. Statements of payments without TDS have to be submitted on prescribed form and within specified time.
6. Tax has to be deducted/collected at the specified rates.
7. Conditions for less or no deduction of tax are specified.
8. Statements of TDS have to be submitted on prescribed forms and within specified time.
9. The year in which credit for TDS is to be given is specified.
10. Penal and other consequences for non-compliance are provided.

The persons responsible for deduction and payment of tax are defined in Section 204. Generally, the responsibility is of the payer. Where payer is a company, the principal officer of the company is responsible. In case of a foreign exchange asset which is not a short term asset, the responsibility lies with the authorised dealer. In case of collection of tax at source under Section 206 C the seller is responsible for collecting and remitting the tax.

With effect from 1.6.1987, every person deducting tax at source is required to obtain a tax deduction account number (TAN) (Section 203A). Under Rule 114A application for this purpose has to be filed on Form No. 49B before the authority specified in the Rule. Those deducting tax at source prior to 1.6.1987, were required to file the application by 30th

September 1987. Others are required to file it within one month of the end of the month in which tax was deducted or by 30th September 1987, whichever is later.

I.2.1 Depositing the tax deducted/collected with the government

The time and mode of payment of TDS to the Government account are prescribed under Rule 30. These are given below in Box I.2.

Box I.2
Time and Mode of Payment of TDS to the Government

1.	For deduction by or on behalf of Government (on any type of income or payment)	Same day
2.	In other cases	
	(a) For incomes covered by Sections 193, 194A, 194C, 194D, 194E, 194G, 194H, 194I, 195, 196A, 196B, 196C and 196D	
	i. Where amounts are credited by a person on the date upto which accounts of such person are made	Within 2 months from the end of the month of credit
	ii. In other cases	Within one week from the last day of the month of deduction/payment
	(b) For incomes/payments covered under other Sections such as 192, 194**B**, 194, 194EE, 194F and 206 C (i.e., salary, winnings from lottery/crossword puzzle/horse races, dividends payable to residents, withdrawals from specified savings schemes and sale of specified products)	Within one week from the date of deduction/ collection

Broadly, the scheme provides for a longer period for payment of TDS where the amounts, for the entire period, are credited at the end of the year. Where the payment is on a regular basis, the period allowed for payment is one week from the end of the relevant month. However, for one-time payments like lotteries or winnings from crossword puzzles, the time permitted is only one week from the date of payment.

In addition, according to Rule 30, the Assessing Officer (with the approval of Deputy Commissioner) may permit quarterly payment of TDS in the case of payments relating to salary, interest (other than interest on securities), commission or brokerage.

I.2.2 Issuing Certificates of TDS

The tax deductors/collectors, under Section 203, are required to issue certificates for TDS to those on whose behalf tax has been so deducted/collected, under Rule 31 and other provisions of the income tax act 1961. The forms to be used for issuing TDS certificates and the time within which these must be furnished are given in Box I.3.

From Box I.3, it may be noted that, in general, a certificate of TDS is required to be issued within a period of one month from the end of the month during which credit has been given or payment made or cheque/warrant issued, as the case may be. In the case of specified goods (covered under Section 206 C), the certificate has to be issued within ten days from the date of debit or receipt of the amount. However, in the case of salary and insurance commission, the certificate of TDS is required to be issued only annually, within a month from the close of the financial year. Another noticeable variation in the time limit for issuing a certificate of TDS is in relation to incomes covered by Sections 193, 194A, 194C, 194D, 194E, 194G, 194I, 195, 196A, 196B and 196C. In this case, if the amount is credited on the last day of the accounting year then the certificate of TDS can be issued within a week after expiry of two months from the end of the month in which amount is credited.

Where quarterly payment of tax is permitted in respect of tax deducted from income by way of interest (other than interest on securities), insurance commission, commission or brokerage, the certificate is required to be furnished within fourteen days from the date of payment of income tax. Where more than one certificate is required to be furnished during a financial year, a consolidated certificate may be issued, on request from the payee, within one month of close of the financial year on Form No. 16A.

Box I.3
Form Numbers and Time Limits for Issuing Certificates of TDS

Nature of income/payment	Form No.	Time limit
1. Salary (Section 192)	16	Within a month from the close of the financial year
2. Insurance Commission (Section 194D)	16A	- do -
3. Interest, payment to contractors/sub-contractors, payments to non-resident sportsmen or sports associations, commission on sale of lottery tickets, rent, and income (other than salary) of non-residents (Sections 193, 194A, 194C, 194D, 194E, 194G, 194I, 195, 196A, 196B and 196C)	16A	a. Where amount is credited on the last day of the accounting year, within a week after expiry of two months from the end of the month of credit b. In any other case, within one month from the end of the month of credit/ payment
4. Dividend, winnings from lottery, crossword puzzle & horse races and withdrawals from specified savings schemes (Sections 194, 194B, 194BB, 194EE and 194F)	16A	Within a month from the end of the month of credit/ payment or issuing cheque/ warrant
5. Sale of specified goods (Section 206 C)	27D	Within 10 days from the date of debit or receipt of the amount

I.2.3 Tax returns to be filed by tax deductors

Annual returns of TDS are required to be filed under Sections 206 read with Rules 37 and 37 A. The details of the returns to be filed are as given in Box I.4 (Part A). Similarly, for collection of tax at source, half yearly returns are required to be filed under Section 206C(5) read with Rule 37E. These are given in Box I.4 (Part B).

Annual returns are also required to be filed where payments are made without deduction of tax at source. These are as follows:

	Income	Due date for return	Form No.	Rule	Section
1.	Insurance commission	30th June	26E	37	206
2.	Interest other than interest on securities	30th April	27A	37AA	206A+
3.	Dividend	30th April	27B	37B	206B+

+ Deleted w.e.f. 1.10.1996 (Finance Bill 1996).

I.2.4 TDS at lower rates or no TDS in certain cases

An Assessing Officer can authorise TDS at rates lower than those prescribed. These are for incomes covered under Sections 194C(4), 194J(2) and 197(1). The nature of forms, rules and sections under which the applications are required to be filed by the payees before the Assessing Officer are given in Box I.5.

The deduction at lower rate is authorised where the Assessing Officer is satisfied that the total income of the recipient justifies deduction at lower rates. Rule 28AA provides that the rate of deduction to be authorised would be the average rate of tax as determined by the total tax payable on estimated income of the year as reduced by the advance tax already paid and the tax already deducted at source as a percentage of the payment for which application is made or the average of the average rates of tax paid in three preceding years, whichever is higher.

Box I.4
Schedule of Filing Returns of TDS

	Income	Due date for return	Form No.
A.	**Annual Returns**		
1.	Salaries	31st May	24
2.	Interest on securities	30th June	25
3.	Dividends	30th April	26
4.	Interest other than interest on securities	30th June	26A
5.	Winnings from lotteries or crossword puzzles	31st May	26B
6.	Winnings from horse race	31st May	26BB
7.	Payment to contractors or sub-contractors	30th June	26C
8.	Insurance commission	30th June	26D
9.	Withdrawals from National Savings Scheme	30th June	26F
10.	Repurchase of Units by mutual funds/UTI	30th June	26G
11.	Commission/remuneration/prizes on sale of lottery tickets	30th June	26H
12.	Payment of rent	30th June	26J
13.	Commission or brokerage	30th June	26I
14.	Payments to nonresidents and foreign companies	Within 14 days of the end of quarter or where it is credited by a person as on date upto which accounts are made+ within 14 days from the end of two months from the month in which the income is credited.	27
B.	**Half-yearly returns**		
1.	Payments by buyers of alcoholic liquor	31st October and 30th April for 6 months ending on 30th September and 31st March	27EA
2.	Payments by buyers of timber obtained under forest lease	-do-	27EB
3.	Payments by buyers of timer other than forest lease	-do-	27EC
4.	Payments by buyers of any other forest produce not being timber	-do-	27ED

Box I.5

Application Forms for Obtaining Certificates for TDS at Lower Rates

	Income	Form No.	Rule	Section
1.	Salary, interest on securities, interest other than interest on securities, insurance commission, rent, units and interest or any other payment to nonresidents or foreign companies	No. 13	28(1)	197(1)
2.	Payments to contractors	No. 13C	28(2)	194C(4)
3.	Commission to persons stocking, distributing, purchasing or selling lottery tickets	No. 13D	28(4)	194G(2)
4.	Fees for professional or technical services	NA	NA	194J(2)

Note: NA: Not available

Section 195(3) also provides that payment without TDS. It can be authorised by the Assessing Officer on an application made by the payer, in the following cases:

	Income	Form No.	Rule
1.	Interest (not being interest on securities) or any other sums (not being dividend) paid to a foreign banking company	15C	29B
2.	Any sum (not being interest or dividend) paid to a non-resident or a foreign company other than a banking company	15D	29B

For availing this exemption, the conditions of Rule 29B(2) have to be satisfied. These require the person concerned to be an existing assessee who has filed returns which were due, is not in default in regard to payment of any tax, interest, penalty, etc. under the Income Tax Act and has not been subjected to penalty for concealment of income. In the case of persons other than a banking company, the additional requirement is that the business or profession

is carried on for at least 5 years preceding the date of application and the fixed assets shown in the books for the previous year preceding the date of application exceed Rs. 50 lakhs.

There are also provisions which entitle payees to receive sums without any TDS on furnishing of a simple declaration before the deductor. These are given in Box I.6.

Box I.6
Declarations for Receiving Payments without TDS

	Income	Form No.	Rule	Section
1.	Interest on securities	15F	29C(1)	197A(1)
2.	Dividend	15G	29C(2)	197A(1)
3.	Interest other than interest on securities received by a person other than a company or a firm	15H	29C(3)	197A(1A)
4.	Withdrawal from National Savings Scheme	15I	29C(3A)	197A(1)
5.	Income to a resident from units of a mutual fund specified under Sec.10(23D) or UTI to persons other than companies or firms.	15H	29C(3)	197(1A)

Rule 29C(5) requires copies of such declarations to be delivered to the chief commissioner of income tax having jurisdiction over the person responsible for paying TDS within 7 days from the end of the month in which the declarations are received.

Under Section 199, the credit for TDS is given in the assessment year in which the income is assessable. This section provides for adjustment of TDS in the cases of persons in whose hands income is assessable under Sections 61, 64, 93 and 94. These relate to transfer of income through a revocable transfer of assets, income of spouse of the individual from a concern in which he has substantial interest, transfer of income to non-residents and certain transactions in securities undertaken for avoiding tax. Thus where income is assessed in the hands of another person under circumstances covered by these provisions, credit for TDS is

also given to such other person. Where any security or share is owned jointly by two or more persons, the credit for TDS is given in proportion of the income assessable in the hands of the joint holders.

I.2.5 Penalties on deductors in default

Non-compliance with the requirements of the scheme of TDS such as non-payment or short-payment of tax deducted/collected, late payment of tax, failure to issue certificates of TDS within a specified period, failure to deliver in due time a copy of a declaration relating to claim for payment of an amount without TDS or failure to furnish TDS returns results in the person responsible for deduction being deemed as assessee in default. Non-payment or short-payment of tax (that is payable under the scheme) attracts a simple interest of 15 per cent per annum (under Section 201(1A)) on the short-payment of tax (irrespective of whether or not the deduction was made) from the date on which such tax was deductible to the date on which such tax is actually paid. In addition to this mandatory payment of interest on short-payment of tax, a 'deductor in default' is subject to other penalties depending on the nature of default which are described in Box I.7.

From Box I.7, it may be noted that the penalty of rigorous imprisonment is provided for only for failure to pay tax deducted/collected at source. In the case of failure to deduct tax or under-deduction of tax, a penalty of 100 per cent of the tax not deducted is provided for. Failure to issue certificates of TDS or to submit copies of declarations relating to payments without TDS or to file TDS returns within the specified period attracts a penalty varying from Rs. 100/- to Rs. 200/- for every day of default. However, in the case of failure to file TDS returns by the tax deductors/collectors in respect of Section 206 or 206 C, the amount of penalty can not exceed the amount of tax deductible or collectible as the case may be. The maximum penalty for failure to apply or late application for allotment of TAN is Rs. 5000/-.

Box I.7
Penalty/Prosecution Structure for Defaulters

Default		Penalty	
Nature of default	Section(s)	Nature of penalty	Section(s)
1. Failure to apply or late application for allotment of TAN	203A	up to Rs. 5000/-	272BB
2. Failure to deduct or under-deduction of tax	192 to 195 & 206C	100 per cent of the tax not deducted	271C
3. Failure to pay the tax deducted/collected at source	192 to 195 & 206C, Rule 30	Rigorous imprisonment for three months to seven years plus fine (with no monetary ceiling)	276B, 276BB & 221(1)
4. Failure to issue certificates of TDS	203 (Rule 31) & 206C(5)	Rs. 100/- to Rs. 200/- for every day of default.	272A(2)(g)
5. Failure to deliver in due time copies of declarations	197A Rule 29C(5)	- do -	272A(2)(f)
6. Failure to furnish TDS returns in the case			
a. Where payment is made without TDS on interest or dividend	206A/B, Rules 37AA & 37B	-do-	272A(2)(c)
b. Where tax has been deducted or collected	206, Rule 37; 206C(5A) Rule 37E	Rs. 100/- to Rs. 200/- for every day of default. However, in the case of sale of specified goods, the amount of penalty can not exceed the amount of tax deductible or collectible	272A(2)(c)

I.3 Experience with Prevailing Scheme of TDS

I.3.1 Salaries

Under Section 192, TDS from salary is based on the tax due on the annual salary and is recovered in 12 equal monthly instalments. Relief under Section 89(1) where arrear or advance salary is received can be taken into account while determining the tax to be deducted at source. Similarly, any other taxable income (not loss) received can also be taken into account on the basis of information furnished by the employee together with the tax deducted at source from it. However, this is subject to the tax deduction at source not falling below the level applicable for salary alone. The deduction of tax at source from salary is, therefore, a straight forward exercise as annual income can be accurately determined. Yet, experience shows that there are problems in proper implementation of the provisions.

Basically the task involves following actions:

- Preparing a comprehensive list of all employers,
- monitoring filing of the monthly and annual returns by them,
- verifying the payment of tax as shown,
- checking the accuracy of deductions, and
- recovering deficient tax, if any, with interest.

The first task itself is seldom performed and the control register of the Department generally lists only those employers who take the trouble of filing returns. Where listing is attempted it is seldom a comprehensive and continuous exercise. The claim of payment of taxes is rarely verified from the collection record. The task of checking correctness of the tax deducted is beyond the capacity of the available manpower and, therefore, performed only in an erratic manner by picking up some odd returns leaving the bulk unchecked. Where checking is done and the tax deducted is found to be deficient, the person responsible for payment is not pursued vigorously and only in rare cases penalties are imposed. The annual returns of TDS if properly filled could provide a large information base for identifying the employees not filing returns. But this has never been attempted systematically. Even when

attempted no worthwhile results could be achieved as the annual returns do not indicate the Permanent Account Numbers (PANs) of individual employees. This is despite the fact that Form No. 24 requires these details to be given in column 2. Thus identifying employees whose tax deduction is deficient and who are not existing assessees, involves not only calculation of tax liability in each case but also search through the registers maintained in salary circles to check whether returns are being filed by individual employees. Considering the large number of employees in such returns and the registers of the salary circles, manual cross matching is impossible.

Another problem in TDS from salaries is the non-disclosure of perquisites by employers. Column 6 of Form No. 24 and the Annexure to this Form require that information be provided on the value of perquisites given to each employee. Section 17(2) gives an inclusive definition of perquisites. The important perquisites are in the form of accommodation given free of rent or at concessional rent, conveyance for personal use, entertainment allowance, etc. While the rental value of accommodation is generally understated to show lesser value of perquisite the use of conveyance for personal use is seldom declared. For most of other benefits a system of reimbursement is adopted declaring these as official, and not personal, expenses and, therefore, not a perquisite to the employee. The benefits to employees often include 'under the table' payments. These are either from funds kept outside the books or are shown in the books as expenses incurred for the business under any of the heads like 'miscellaneous expenses', 'repairs', etc. which are impossible to verify entry by entry. Often resort to such mechanisms is sought to be justified by the inequity inherent in the rules under which employees of Central and State governments, public sector undertakings, R.B.I., etc., receive a highly favourable treatment especially in regard to the value of perquisite on account of accommodation. Under Rule 3, for unfurnished accommodation provided free of rent, the value of perquisite is limited to the rent fixed by the government for government employees and 10 per cent of the 'salary' for others in above categories. For others, the value is 10 per cent of salary increased by the excess of fair rental value over 20 per cent of the salary. Thus perquisites remain substantially untaxed causing loss of revenue and creating inequity in the form of unequal burden of tax on employees depending upon whether same income is paid wholly in cash or partly in cash and partly in form of perquisites.

Under-the-table payments not reflected in the salary slips are clear instances of evasion by the employees with the willing assistance of employers. For the income tax administration, the potential area of evasion remains the income from business or profession towards which the enforcement efforts are concentrated. The salaried employees are generally perceived to be declaring their incomes properly. In fact there is a strong lobby for reducing the tax rates for salaried employees precisely on the ground that those earning income from business or profession have greater opportunities for evading or avoiding tax while salaried employees not having such opportunities have to declare their entire income. As discussed above this is very often not true. But, the fact remains that enforcement efforts in this area are comparatively limited and there is significant loss of revenue on account of untaxed perquisites and 'under the table' payments.

The concept of 'perquisite' itself has often caused differences of perceptions. Two instances deserve mention. The first relates to 'Medical Expenses'. Many important executives both from private and Government sectors have been sanctioned funds by the employers for treatment abroad. Such payments were clearly 'perquisites' within the meaning of Section 17(2)(iv). However, efforts to levy income tax resulted in instant indignation as to how the Income Tax Department could demand tax from the executives already undergoing the trauma of serious illness. The fact that such executives were among the privileged few who even after paying income tax were getting 60% expense reimbursed while the vast majority was forced to incur such expenses entirely from their own resources was seldom highlighted. The new proviso to Sec. 17(2) introduced with effect from 1.4.91 exempts not only payments for medical treatment, travel and stay abroad for the employee or his family member but also the expenses for travel and stay abroad of one attendant. This exemption is available only to the employees having gross salary of less than Rs. two lakhs excluding the medical benefit.

The feasibility of introducing a separate fringe benefits tax on companies has been often considered. Australian and Newzealand Models are sometimes recommended. However, there are no easy solutions as the basic information requirements under these legislations would remain about the same. It is, therefore, difficult to accept that information would be forthcoming under a separate legislation for taxation of 'fringe benefits' given by

corporations, when these are being systematically withheld or concealed under the Income Tax Act. There may, however, be a case to introduce such legislation provided the perquisites are valued on 'presumptive basis'[1]. Thus number of residential accommodations owned or rented, number of cars available for personal use, etc., would straightaway result in a definite income 'imputation'. Designing such a model keeping in view all kinds of perquisite will not be easy.

Some legal issues arising out of TDS from salaries would be of interest. The Courts have held that while salary is taxable on accrual basis the TDS under Section 192 has to be applied on the basis of actual payment {10 ITR 199 (CAL)}. Also an amount received as compensation for early termination of employment or wrongful termination does not represent salary[2] and, therefore, tax from these payments cannot be deducted at source {(41 ITR 446) SC, (154 ITR 849)(CAL)}. Similarly, an amount received as lumpsum payment for agreeing to join an employer for a fixed period was held to be partly for procuring the service, and thus of capital nature, while the remaining part was addition to salary on which tax is deductible at source. The Calcutta High Court, on petitions filed by Bank Officers Association and Insurance Employees Association held that City Compensatory Allowance did not come within the definition of income and, therefore, no tax was to be deducted at source (176 ITR 223 and 176 ITR 225). However, as a result of introduction of sub-clause (iii) (a) and (iii) (b) in clause (24) by the Direct Tax Laws (Amendment) Act 1989, the intended position has been restored retrospectively. Similarly, the Punjab and Haryana High Court held (121 ITR 503) that the house rent allowance paid to employees even where the employee is occupying his own house is not liable to tax subject to limits imposed under Section 10 (13A) read with Rule 2 A. Special leave petition has been admitted by the Supreme Court against this judgement. As such the operation of this judgement is confined to the jurisdiction of Punjab and Haryana High Court.

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[1] However, in Canada, certain benefits in kind are valued at market prices and included in emoluments of employees for the purposes of TDS.

[2] However, in Canada, it is treated as taxable salary income.

I.3.2 Interest on securities

Tax on interest on securities is deductible under Section 193, at the rates in force in each year. For 1996-97 the rates are:

- 10% for persons resident in India,
- 20% for non-residents.
- 21.5% plus surcharge @ 7.5% of the tax in the case of domestic company, and
- 55% for non-domestic company.

There is no deduction where the taxpayer (not a non-resident) has not been previously assessed, total income is not likely to exceed exemption limit and nominal value of securities does not exceed Rs. 2500/- (Clause (iv) of Proviso to Section 193). Similarly where interest is payable on debentures to a resident and the amount does not exceed Rs. 2500/- no deduction is to be made under sub Clause (v) of this proviso if payment is made by account payee cheque. The proviso to this section lists other securities whose interest is exempt from TDS. These include National Defence Bonds, National Defence Loans, National Savings Certificates (IV Issue), Gold Bonds, Interest on notified debentures and interest paid to notified persons on securities of Central or State governments.

Among the problems faced was the postponement of interest by not crediting it to the payee's account but to a separate 'interest payable' or 'suspense' account. Specific provision was, therefore, introduced by the Finance Act 1989 to provide for deduction even when the interest is credited in this manner (Circular No. 550 dt. 1.1.90). For securities registered in the name of a banking company on behalf of its constituents, initial instructions issued vide Circular No. 13 dt. 4.7.59 provided for deduction at rates in force as applicable to beneficial owners. Legal and practical difficulties arose as a result of which it was decided that the deduction would be at the rates applicable to the banking companies, which in return, would issue a separate 'sub-divided certificate' to each of the constituents. Similar procedure is to be followed in the case of securities registered in the name of executors or the trustee on behalf of their constituents [Circular No. 2-P (XXXIV-4) dt. 16.5.66].

Rule 31(1)(b) regarding issue of certificates of TDS on new form no. 16A created transitional problem for the banks having in their possession such certificates issued on old form no. 16. These were not accepted by the Income Tax Department for giving tax credit. RBI refused to issue certificates on form no. 16A in view of the voluminous and infructuous work involved. The problem was finally solved only after the conditions were relaxed and credit permitted as one-time measure on the basis of certificates on old form no. 16. There is, however, a demand from the nationalised banks for exemption of this income from TDS. This is on the ground that in many cases the actual tax liability is much less than the tax deducted at source. Consequently, refunds have to be obtained from the tax department, which takes a long time. The system of TDS also complicates trading in securities as at the time of purchasing the same, adjustment has to be made on account of the tax for the period during which securities were held by the sellers. Voucher system is prevailing in the trade to compensate the purchaser for TDS on interest for the period for which security was held by the seller. This makes the yield calculations very tedious. Also, the rate of deduction of tax at source differs between the nationalised and foreign banks. Interest earned by provident funds is exempt.

I.3.3 Dividends

Deduction of income tax at source from dividend payable to a shareholder who is resident in India is required under Section 194 only where the amount exceeds Rs. 2500. Rates are prescribed from year to year. For 1996-97 the rates are:

- 20% for persons other than companies, and
- 21.5 plus surcharge at the rate of 7.5% of the tax for domestic companies.

With effect from 1.10.1991, the scope of this section has been restricted to residents in India, with 'non-residents' and foreign companies being covered by Section 195 which was simultaneously amended for this purpose. No deduction is required where a public limited company pays dividend not exceeding Rs. 2500 by an account payee cheque.

The problem of nominee holder of shares has been resolved in the same manner as for interest on securities. {Circular No. 3-P(XXI-19) dt. 16.5.66}. The scheme operating at

present does not present any operational problems but contains in itself scope of investment of undeclared funds in capital market. The threshold for applying TDS can always be used to avoid TDS by bifurcating the holdings. Also even though companies are required to furnish copies of declarations on the basis of which payment is made without any deduction at source, verifying the correctness of the declarations in all cases is impossible in view of the voluminous work involved and absence of computerisation.

I.3.4 Interest other than interest on securities

Deduction of income tax at source is required from interest (other than interest on securities) payable to a resident under Section 194A, if it exceeds Rs. 10,000/- in case of 'term deposits' and Rs. 2,500/- in other cases. Tax is deducted at the rates in force. For the financial year 1996-97 the rates are:

(a) 10% for person other than company resident in India, and

(b) 20% plus surcharge at the rate of 7.5% of the tax for domestic companies.

In order to prevent postponement, explanation 3 was inserted with effect from 1.6.87 requiring TDS even where interest is credited to "interest payable" or "suspense account" or any other similar account. Sub-clause (iii) of Clause (3) of Section 194A exempts interest credited to banking companies; cooperative societies engaged in banking; financial corporations; establishments under Central, State or Provincial Act, Life Insurance Corporation of India, Unit Trust of India, companies or cooperatives engaged in the business of insurance and any other institution, etc., which may be notified for this purpose.

The legal debate in operation of this section includes interest paid to partners by a firm. It was subject to TDS before being included in the exemptions under the proviso to this Section with effect from 1.4.68. The Direct Tax Law (Amendment) Act 1987 removed the exemption with effect from 1.4.88 only to have it re-inserted retrospectively from this very date by the Direct Tax Law (Amendment) Act 1989. The disallowance of interest paid to partners while determining taxable income of a registered firm was the basis for argument in favour of its exemption from TDS.

Interest on deposits with banking companies or cooperatives has also, over the years, generated a controversy. Originally, it was subjected to TDS before being exempted with effect from 1.4.70 with the introduction of sub clause(vii) of clause (3) of Section 194A. The Finance Act 1991 substituted sub-clause (vii) with sub-clauses (vii) and (vii a), with effect from 1.10.1991. As per the amended provisions, tax was required to be deducted at source from interest on time deposits which were defined as deposits repayable on expiry of a fixed period. However, the amendment was withdrawn from 1.6.92. In the Finance Minister's speech before the Parliament on 30.4.92, it was clarified that the position was being restored as prevalent before 1.10.91 on account of a number of representations received from members of public, representative bodies and banks pointing out various difficulties, which had arisen on account of operation of these provisions. The problems in enforcing this provision include increase in refund claims and their disposal by the tax administration and issue of a large number of certificates for tax deduction at source by the banks. For taxpayers with income below the threshold it implies additional compliance cost in terms of filing of return and getting refund or complying with other formalities to obtain exemption from such deduction. Clause (vii) of Sub-Clause (3) of Section 194A has again been substituted by Sub-clauses (vii) and (vii a) by the Finance Act 1995 excluding 'time deposits' with the banks or cooperative societies from the list of exemptions. The provisions are applicable for time deposits made on or after 1.7.95.

The amendment has been introduced as an "effective method of widening the tax base" according to the Memorandum explaining the provisions of the Finance Bill 1995. This is expected to bring in more and more persons in the tax net and also improve correct reporting of income. Obviously the evasion opportunity for this source of income is a cause of concern resulting in re-introduction of the provision notwithstanding the earlier problems. It also needs to be recalled here that though various groups highlighted the difficulties, the fact remains that interest on bank deposits was subject to TDS before 1.4.70 when sub-clause (vii) of Clause (3) was introduced for the first time. The threshold of Rs. 10,000, however, again gives scope for avoiding TDS, and consequently reporting of the income from this source, by breaking up deposits appropriately to reduce interest payable below Rs. 10,000/-.

Some interesting issues faced in implementing these provisions emerge from clarifications issued by the tax administration from time to time. Thus, it was clarified that the section applies even where interest is assessable as 'business income' as in cases of money lenders {F.No. 1(429)/67-TPL dt. 14.2.68 to BULSAR NAVSARI ITP ASSOCIATION BULSAR}. It was also clarified that where interest is paid by the consigner to their commission agents, tax has to be deducted at source notwithstanding the facts that the commission agents retain interest out of the money payable to the consigners {F.No.12/112/68-ITA III dt. 23.9.68 addressed to the Association of Taxpayers and Practitioners Calcutta}. In case of HUNDIES sent for collection through banks interest is also collected by the banks if the documents are retired late. It was clarified that this interest is not payable to the bank but to the party and, therefore, tax has to be deducted at source (Circular No. 48 dt. 7.11.70). However, where Bill is discounted by the bank the subsequent realisation is by the bank and, therefore, no TDS is required (Circular No. 65 dt. 2.9.71). Sometimes deposits in banks are in a 'joint account' with one of the joint account-holders also having individual account. It was decided that the interest income from a joint account will be aggregated with the interest income from the individual account of the joint account holder, for the purpose of Section 194 A. If there are more than one individual account holders the aggregation would be in the hands of the individual having highest interest income. If contested and affidavits or statements are filed under the proviso to Section 194A(1) (Omitted with effect from 1.6.92) the aggregation was to be done in accordance with such affidavit or statement without prejudice to the right of the Assessing Officer to establish beneficial ownership (Circular No. 256 dt. 27.5.79). With the re-introduction of this provision with effect from 1.7.1995, it has been decided to aggregate interest of joint account with the interest due to the first named person of such joint account. It was also clarified that interest credited to 'interest payable' or 'suspense account' is a constructive credit to the account of the person and, therefore, liable to TDS (Circular No. 288 dt. 22.12.80). The explanation clarifying this position was introduced only with effect from 1.6.87. It was also clarified that interest paid on compensation for acquiring land by State authorities is liable to TDS (Circular No. 526 dated 15.12.88).

I.3.5 Winnings from lottery, crossword puzzles or horse racing

The deduction of tax at source from winning of a lottery or a crossword puzzle in excess of Rs. 5,000 and from horse racing in excess of Rs. 2,500 is provided under Sections 194B and 194BB respectively. The deduction is at rates in force which, for 1996-97 are 40 per cent for all persons with surcharge of 7.5% of the tax in cases of domestic companies.

Many issues required clarifications by the Central Board of Direct Taxes. Where the prize is partly in cash and partly in kind the total value has to be taken for tax deduction at source. But, where it is totally in kind no deduction is required. Where payment is made in instalments the deduction has to be made from each instalment (Circular No. 428 dated 8.8.85). For a prize given to a resident in the State of Sikkim for winning of a lottery, the draw for which is held in pursuance to an agreement entered into on or before 28.2.89 between Sikkim and the organising agency, no deduction is required as Section 10(26AA) exempts such income from tax provided the requirements of explanation to Section 10(26AA) are fulfilled. Some confusion, in cases of Indian residents, was created on account of deduction of tax at source by the income tax authorities of Sikkim prior to extension of the Income Tax Act to the State of Sikkim on 1.4.90. The taxpayers claim for credit of TDS could not be accepted as the Income Tax Act did not apply to the State, and no relief could be given under Section 90 as it was a part of India when the deduction was made. The result was taxing such income net of the tax paid in Sikkim.

I.3.6 Payments to contractors and sub-contractors

The provisions of Section 194C regarding TDS from payment to contractors, resident in India, relate to contracts entered into with Central or State Government; local authority; any corporation established under any Central, State or Provincial Act; any company, cooperative society, or authority constituted under any law in India for dealing with the need for housing accommodation; or any trust or university created under any law or approved by University Grants Commission.

This section was introduced with effect from 1.4.72. Tax has to be deducted at the rate of 2 per cent from the payments to be made to contractors except in the case of contracts for advertising in print or electronics media for which the rate is 1 per cent. The payments

made to sub-contractors by contractors other than individuals or HUFs are subject to TDS at the rate of 1 per cent. The contract has to be for carrying out any work (including supply of labour). With a view to prevent postponement of the tax by crediting the amount to a 'suspense account' or any other account, an explanation was inserted with effect from 1.6.88 for deeming such credit as credit to the payee. With effect from 1.7.1995 no deduction is to be made where the payment does not exceed Rs. 20,000/-. The earlier threshold since 1.6.1982 was Rs. 10,000/-.

The provisions of Section 194C do not apply to contracts for 'sale of goods'. These apply to contracts for construction of buildings or dams or laying of roads and airfields or railway lines or erection or installation of plant and machinery, being contracts for work and labour. These apply also to contracts granted for processing of goods supplied by the Government or any other specified person where the ownership of such goods remains, at all times, with the Government or such person. These contracts include contracts for fabrication of sea and river crafts where materials are supplied by the Government and the fabrication work is done by the contractor. Where the crafts are supplied by the contractor according to the specifications given by the Government or other specified persons and ownership passes only when such crafts are delivered this amounts to sale and as such payment is not subject to deduction Section 194C. A contract to fix a moveable to another chattel or on the land, where the intention is not to sell the article but to improve the land or other chattel and the consideration is not for the transfer of chattel but for the work done and materials furnished, is taken as the contract for work and labour and, therefore, is covered under Section 194C [State of Punjab vs. Associated Hotels of India Ltd. - 29 STC 474(SC)]. The basic test is thus whether, in substance, the contract is one for work and labour or not. Contracts for rendering professional services by lawyers, physicians, surgeons, engineers, accountants, architects and consultants, etc. are not 'for carrying out any work' and thus, these are not covered in Section 194C. Where material is supplied by the Government or another specified person at a stipulated price, the deduction will relate to the gross payment. Where the contractor has undertaken only to provide 'labour for work' and ownership of material remains, all the time, with the Government or the other person, the payment to the contractor will only be for 'labour for work' and deduction will be made without including cost of material (Circular No. 86 dated 29.5.72).

Circular No. 93 dated 26.9.72, issued by the Board also clarified that the provisions of Section 194C will apply to oral as well as piecemeal contracts for work. Ordinarily, transport contract cannot be regarded as contract for carrying out 'any work'. However, contracts involving transport as well as loading and unloading are covered unless the element of labour provided for loading and unloading is negligible. This Circular also clarified that service contracts not involving carrying out of any work are outside the scope of this Section. Deductions under Section 194C have to be made with reference to the total amount of payment and not 'income comprised in such payments'. Subsequently in Circular No. 295 dated 6.3.81, it was re-iterated that the deduction in a composite works contract where material is supplied at a stipulated price has to be with reference to gross payment without excluding the cost of material. In this context, Patna High Court's decision in the case of Associated Cement Company (120 ITR 444) was cited, while clarifying that the decision of the Supreme Court in the case of Brij Bhushan Lal (115 ITR 124) related to the question of computing income and not to interpretation of Section 194C. The finding that the cost of stores and materials have to be excluded from the turnover while estimating profits of a contractor has no bearing in so far as the provisions of Section 194C (1) are concerned as deduction is not from profits but from total payments made to the contractor.

Clarifications were also sought in regard to Bidi Manufacturing Industry where generally the manufacturers provide raw material, i.e., leaves, tobacco, threads, etc. to the 'Munshis' who distribute the same to workers who work at home. At regular intervals 'Munshis' collect Biris and handover the same to the manufacturer. The manufacturer pays to Munshis who in turn pay to workers. The rates for Munshis and workers are fixed. The Board took the view (Circular No. 433 dated 25.9.85) that there is an implied contract between the manufacturers and Munshis. As such the provision of Section 194C would apply. Subsequently, in view of the Supreme Court's decision on the writ petitions filed by P.M. Patel and Sons (AIR 1987 SC 447) that the Biri Workers who are employed through the medium of agencies like Munshis but bring Biris to the factory for quality check and receive payments from the manufacturers are the employees of the manufacturers entitled to the benefits of Provident Fund, etc. it was clarified that deduction under Section 194 C to be made from payments to Munshis need not include payments to such home workers (Circular

No. 487 dated. 8.6.87). Then again the question of application of this Section to the works executed under National Rural Employment Programme (NREP) and Rural Landless Employment Guarantee Programme (RLEGP) came up for consideration. The Board took the view that there is no contract between the village community/village agencies and the State Governments for the execution of such contracts and the scheme specifically bans employment of contractors or middlemen for the execution of work undertaken under these schemes. As such Section 194C would not be applicable (Circular No. 502 dated 27.1.88). The question of payments made by State Road Transport Corporation to private bus owners came up for specific consideration of the Board. Reference was made to a specific contract wherein the owner of the buses was required to, inter-alia, give the same on hire with a driver and conductor for specified number of hours and also keep the bus in road worthy condition. The payment was to be made on fortnightly basis at a fixed daily rate plus a per kilometre charge as the variable cost. The Board took the view that this is actually a service contract (for carrying out any work) between the State Road Transport Corporation and the owner of the bus. The provisions of Section 194C are, therefore, applicable (Circular No. 98 dated 26.9.72).

In the case of Associated Cement Company Ltd. Vs. CIT (120 ITR 444), the Patna High Court also held that Section 194C is not violative of Article 31 of the Constitution. It was held that the contract for the supply of labour for loading packed cement into trucks and wagons is a contract for supply of labour for carrying out a work and is covered by Section 194C. The Madras High Court (188 ITR 84) followed the decision of the Supreme Court cited earlier while holding that the contract by a publisher whereby all material was given to the printer and the printer returned the periodical after printing the same on such material is a 'works contract'. Where a firm purchased certain quantity of scants of timber from the Government, it was held that it is not a contract within the meaning of Section 194C {163 ITR 702 HP & 157 ITR (St) 31(SC)}.

The Supreme Court while upholding the judgement of the Patna High Court in the case of Associated Cement Company Ltd. held that the words 'any work' in Sub-Section (1) of Section 194C mean 'any work' and not a 'work contract' which has a special connotation in tax laws. The word 'work' envisaged in the Sub-Section has a wide import which covers

'any work' which any organisation specified in the Sub-Section can get carried out under a contract. The Board took note of these views and also the earlier observations of the Patna High Court in this very case, to the effect that, "in a very broad sense the work done by one person is service rendered to another and indeed one of the dictionary meanings of the word service is work". It concluded that Section 194C would apply to all contracts including transport contracts, labour contracts, service contracts, etc. The views expressed in the earlier Circular Nos. 86, 93 and 108 were, therefore, modified and instructions were issued to the effect that the provisions shall apply to all types of contracts including transport contracts, service contracts, deferred contracts, broadcasting contracts, telecasting contracts, labour contracts, material contracts and work contracts. It was also clarified that service contracts would be covered and these would include services rendered by lawyers, physicians, surgeons, engineers. accountants, architects and consultants, etc. The transport contracts would also cover contracts for plying of buses, ferries, etc. alongwith the staff.

This immediately led to a spate of writ petitions being filed on behalf of various organisations in support of the view that Section 194C is applicable only to payments made for any work, and not for payments made (as fees) for services rendered or commission paid to commission agents or brokers. The Delhi High Court (Taxman - Tax Reports - Vol. 76, p.432) accepted the interpretation on behalf of the taxpayers and held that Section 194C did not apply to payments made as fees for services rendered or commission paid to commission agents or brokers. SLP filed by the Department was dismissed by the Supreme Court with the observations that the High Court has merely decided that Section 194C does not apply to brokers and, therefore, there is no reason to interfere. In a similar writ filed in the Bombay High Court in the case of Bombay Goods Association vs. Central Board of Direct Taxes, it was held that the expression 'any work' does not cover service contracts or transport contracts (Taxmann - Tax Reports - Vol.6, p.334). In another case of Chambers of Income Tax Consultants vs. Central Board of Direct Taxes, the Bombay High Court held that Section 194C is not applicable to payments of fees for professional services. While the outcome of this legal battle is yet to be finally decided, the Finance Act 1995 has introduced Section 194J specifically bringing payments by way of fees for professional or technical services within the perview of TDS. These provisions have become effective from 1.7.1995.

The provisions of Section 194C had also created some doubt as to whether these are applicable where payment is made to the Indian agents of foreign shipping lines. The Board clarified the position regarding TDS from payments made to foreign shipping companies or their agents. According to this clarification, the TDS under Section 194C is confined to payments made to a resident. There is no overlapping with the provisions of Section 172, which governs computation of profits from shipping business of non-residents. Even where payments are made to shipping agents of non-resident ship owners or charters for carriage of passengers etc., shipped at a port in India, the provisions of Section 194C or 195 will not apply.

I.3.7 Commission on insurance and sale of lottery tickets

Tax deduction at source from payment of commission on insurance or on sale of lottery tickets is governed by Sections 194D and 194G respectively. The payer is required to deduct tax at the rate of 10 per cent. In the case of commission on sale of lottery tickets, no tax is to be deducted unless the amount exceeds Rs. 1,000. In the case of insurance commission, no tax is to be deducted unless the amount exceeds Rs. 5,000 and is paid to a resident. In this case, the Board has clarified that the deduction is to be made at the time of credit of commission and it should be based on the payment in the current year without any adjustment for the earlier years (Circular No. 120 dated 8.10.73).

I.3.8 Payment to non-resident sportsmen or sports associations

Payments (referred to in Section 115BBA) to non-resident sportsmen (not citizens of India) or sports associations are subject to TDS with effect from 1.11.1989, under Section 194E. Tax is required to be deducted at the rate of 10 per cent and there is no threshold.

I.3.9 Certain withdrawals and repurchase of units

Withdrawals from National Savings Scheme or deferred Annuity Plan of LIC (referred to in Section 80CCA(2)(a)) are subject to TDS with effect from 1.10.1991, under Section 194EE. Tax is required to be deducted at the rate of 20 per cent. No tax is to be deducted

if the payment is made to heirs of the taxpayers or if the amount of payment in a year does not exceed Rs. 2,500.

Payments on account of repurchase of units of notified equity linked schemes by Mutual Funds or UTI (referred to in Section 80CCB) are subject to TDS with effect from 1.4.1991, under Section 194F. Tax is to be deducted at the rate of 20 per cent.

I.3.10 Commission or brokerage relating to sale of goods

Section 194H, that was operational during 1.10.91 and 31.5.92, provided for deduction of tax at source from commission, brokerage etc. Persons other than individuals or HUFs were required to make the deduction at the time of credit or payment. The usual provision barring use of 'suspense account', etc. for deferment of payment was incorporated in the explanation. The definition of 'commission' or 'brokerage' specifically excluded professional services and included services rendered in the course of buying or selling of goods or in relation to any transaction relating to any asset, article or thing. The payments not exceeding Rs. 2,500/- or payments to certain persons or classes of persons notified by the Central Government were exempted.

Professional Services were also specifically defined on the lines of the definition in Section 44AA. This Section when read with Rule 6F, prescribed the books of accounts and documents required to be maintained by persons carrying on business or profession. This provision led to an immediate uproar on account of the stated difficulty in implementation. Generally, reference was made to the difficulty faced by sellers who sell their goods through commission agents. How could they deduct tax at source when actually it is the commission agent who receives sale proceeds on account of sale of goods and remits the same to the seller after deducting his commission. Also requiring such sellers to deduct tax at source every time commission is credited or paid was cumbersome as such payments or credits occur a number of times during a year. The provisions were deleted with effect from 1.6.92, i.e., barely 8 months after introduction. The Finance Minister's speech dated 30.4.92 referred to the representations received from members of public and representative bodies pointing out difficulties which had arisen on account of these provisions. It appears that the similarity of

the problem with that relating to Section 194A which remains in force has not received due attention.

I.3.11 Rental income

Rental income has been subject to TDS with effect from 1.6.1994, under Section 194I. TDS becomes applicable if the amount of rent payable in a year exceeds Rs. 1,20,000 and is payable by a person other than an individual or a HUF. Tax is to be deducted at the rate of 15 per cent from the rent payable to individuals or HUFs and at the rate of 20 per cent from the rent payable to other persons.

Some doubts were raised about the scope of these provisions. The Board has clarified that tax would be deductible even from non-refundable deposits and warehousing charges. Where municipal or other taxes are paid by the tenant, no tax would be deductible on such sums (Circular No. 718 dated 22.8.1995). Where rent is paid to the government, TDS is not required. No tax is to be deducted from payments to be made to local authorities or statutory authorities, provided the payer is satisfied about the tax exempt status of these authorities under Sections 10(20) or 10(20A) on the basis of certificates furnished by these authorities (Circular No. 699 dated 30.1.1995). Credit to a 'Suspense Account' or any other account is deemed to be credit to the payee requiring TDS.

I.3.12 Fees for professional or technical services

Fees for professional or technical services payable by persons other than individuals or HUFs have been brought into the ambit of TDS with effect from 1.7.1995, under Section 194J. Tax is to be deducted at the rate of 5 per cent from payment of fees to residents and at the rate of 30 per cent from payment of fees (for technical services) to non-residents. No TDS is required unless the amount of fees payable in a year exceeds Rs.20,000. In view of certain practical difficulties involved, the Board has clarified that fees paid through regular banking channels to chartered accountants, lawyers and advocates or solicitors, resident in India, will not be subject to TDS. However, foreign companies or foreign law or accountancy firms, making such payments, are required to send quarterly statements giving

names and addresses of the payees to Deputy Secretary, Foreign Tax Division, CBDT (Circular No. 726 dated 18.10.1995). Credit to a 'Suspense Account' or any other account is deemed to be credit to the payee requiring TDS.

I.3.13 Income in respect of units of Mutual Funds

Income in respect of units of Mutual Funds specified under Section 10(23D) or Unit Trust of India is also subject to TDS with effect from 1.7.95. The payments to residents are covered under Section 194K while those to non-residents are covered under Section 196A. In the case of residents (Section 194K), tax is to be deducted at the rate of 20 per cent from payments to companies and at the rate of 15 per cent from payments to other taxpayers. No tax is required to be deducted from a resident unless the aggregate of payments in a year, to such a resident, is estimated to exceed Rs. 10,000. In the case of non-residents (Section 196A), tax is to be deducted at the rate of 20 per cent. Exemption from TDS is provided where the units of UTI have been acquired by a non-resident Indian or by a non-resident HUF from UTI out of the funds in a non-resident (external) account maintained with any bank in India or by remittance of funds in foreign currency in accordance with the provisions of Foreign Exchange Regulation Act 1973. Credit to a 'Suspense Account' or any other account is deemed to be credit to the payee requiring TDS.

I.3.14 Income of non-residents

Interest (other than interest on securities) or any other sum chargeable under the Income Tax Act (not being income chargeable as salary) is subject to TDS at the time of credit or payment (whichever is earlier) to non-residents (other than companies) or foreign companies, under Section 195. In case of interest payable by the government or by a public sector bank, TDS is required only at the time of payment. Credit of interest to any account whether called 'interest payable account' or 'suspense account', etc. is deemed to be credit of income to the account of payee. Section 195A provides for aggregation where tax is payable by the payer. In other words, the income is taken to be the amount which after deduction of due tax is equal to the amount actually paid or payable to a non-resident or foreign company.

The procedure for making remittances as laid down in the Press Note dated 17.5.88 issued by the Department of Economic Affairs provides for depositing tax at the prescribed rate and furnishing to the designated bank, the details of payments in the prescribed form certified by a Chartered Accountant along with income tax challan for payment. The designated bank thereafter, would forward this certificate to the Reserve Bank of India which would permit remittance of the balance amount without requiring any 'No. Objection' from Income-tax authorities. Where there was claim for TDS at a rate lower than the prescribed rate, the RBI insisted on a 'No Objection' from the Income-tax authorities. The procedure has been simplified with effect from November 1994 (Circular No. 695 dated 29.11.94). As per the revised procedure, the authorities to whom application for authorisation of remittance is made will also verify the claim of the payer keeping in view the provisions of the Income Tax Act, the Double Taxation Avoidance Agreement (DATAA) and specific facts of the transaction.

Lumpsum payments to foreign suppliers for acquisition of right to use software, by those engaged in export of software for computer application is not subject to TDS where such software is supplied by the manufacturer of computer hardware along with hardware itself (Circular No. 588 dated 2.1.91). Where remittance is to a country in which Double Taxation Avoidance Agreement (DTAA) is in force, TDS has to be at the rate provided under the relevant Finance Act or under the DTAA, whichever is beneficial to the assessee (Circular No. 722 dated 30.10.95).

I.3.15 Income of overseas financial organisations

Income of foreign financial corporations (offshore funds) from units (referred to in Section 115AB) purchased in foreign currency, or long term capital gains arising from transfer thereof is subject to TDS, under Section 196B. The former is subject to TDS with effect from 1.10.1991 and the latter is subject to TDS with effect from 1.6.1993. Tax is to be deducted at the rate of 10 per cent.

I.3.16 Income of non-residents from bonds or shares

Income of a non-resident from bonds or shares (referred to in Section 115AC) purchased in foreign currency or long term capital gains arising from transfer thereof is subject to TDS under Section 196C. The former is subject to TDS with effect from 1.6.92 and the latter is subject to TDS with effect from 1.6.93. Tax is to be deducted at the rate of 10 per cent.

I.3.17 Income of foreign institutional investors

Section 196D introduced with effect from 1.6.1993 provides for TDS from income of foreign institutional investors in respect of securities referred to in Section 115 AD(1)(a). Tax is to be deducted at the rate of 20 per cent. Deduction at a rate lower than the specified rate is not permitted as Section 197(1) does not cover these sources of income. Capital gains arising from transfer of these securities are not subject to TDS.

I.3.18 Collection of tax from purchasers of specified goods

Under Section 206C, sellers of specified goods (such as liquor - other than Indian made foreign liquor, timber obtained through forest lease or otherwise and forest produce) are required to collect TDS while collecting the purchase price from the buyers of these goods. The definition of 'buyers' includes those who obtain these goods in sale by way of auction, tender or by any other mode. Public Sector Companies or buyers obtaining such goods in the further sale are excluded. The 'seller' is also defined to mean Central Government, State Government or any other local authority, or a corporation or an authority established under a Central, State or Provincial Act, or any company, firm or cooperative society. These provisions are operational with effect from 1.6.1988. The tax rates for deduction of tax at source are 5, 10 and 15 per cent.

The provision of estimating income of buyers of specified goods, as a percentage of their purchase price, under Section 44AC, was the subject matter of extensive litigation on account of the underlined presumption. The Courts accepted the view of the Department that

these provisions are an anti evasion mechanism as liquor contractors are generally 'fly-by-night operators' who obtain huge contracts in the name of fictitious persons or in the name of those having meagre resources but do not file any income tax return or pay any income tax. After the completion of period of contract such persons are not even traceable. The legal challenge to the taxation based on 'purchase price' was on the ground that this could not be an income tax as after purchase, a person may earn income less than that presumed or may even suffer losses. The courts rejected this claim and emphasised the distinction between the nature of a tax and the mechanism evolved for collecting the same. On the question of presuming a fixed percentage of 'purchase price' as income, the Kerala High Court upheld the constitutional validity of Section 44AC but the Andhra Pradesh High Court in the case of A. Sanyasi Rao commented adversely on the rates being sought to be justified on the basis of results shown in respect of a few selected cases. It was also noted that in some states, for a certain period, both the sale and purchase prices were regulated, where the profits could not be as presumed under Section 44AC. The Court took the view that as an anti evasion measure, it was sufficient if Section 206C was enforced forcing such taxpayers to come forward and file their income tax returns. Thereafter, each case must be examined and the profits determined on the basis of facts and circumstances specific to the taxpayer. Therefore, instead of striking down the provisions of Section 44AC as unconstitutional, the Court directed that these provisions should be read to mean that the wording 'notwithstanding anything to the contrary contained in Sections 28 to 43C' referred only to deduction of tax at source, and these provisions would not apply for determining normal income of the buyers. Consequently, the provisions of Section 44AC were deleted by the Finance Act 1992 with effect from 1.4.1993.

Interpretation of 'purchase price' also created some problems. The Department agreed with the view that the amounts paid for acquiring right to participate in auctions, etc., called bid money, should not be included in the purchase price. Accordingly, an explanation on 'purchase price' was inserted in Section 44AC in 1991 with effect from 1.4.91. The explanation clarified that the 'purchase price' will not include the amount paid or payable towards the bid money in an auction. This explanation was at places used to exclude a major portion of the sums paid by liquor contractors. State governments earning huge revenues through such contractors were not unwilling to cooperate with them. Thus it was that in one

State, 30 per cent of the sum paid was treated as 'Nirgam Mulya' and not purchase price thus excluding it from the scope of deduction of tax at source. Many cases pertaining to dispute on interpretation of 'purchase price' are pending with the appellate authorities.

Appendix II

Income Tax System of Indonesia With Special Reference to Tax Withholding at Source

II.1 Introduction

Indonesia has a population of about 185 million. Its per capita income is around Rupiah 1.67 million (US $ 800). About 200 languages are spoken in Indonesia (National language is Indonesian) and it has about 1300 islands.

Indonesia is a federation with 27 provinces (each having a separate flag). Tax revenue collection is highly centralised while expenditure responsibility is highly decentralised. All major taxes such as income tax, value added tax (VAT), excise (on selected commodities, e.g. liquor, tobacco and sugar), sales tax (on luxury commodities such as cars), and land & buildings tax (PBB: Pagak Bumi dan Bangunan), are Central levies. The major tax of provinces is vehicles tax (on ownership and transfer). There are about 30-40 minor local taxes such as dog tax.

About 80% of Central tax revenue is transferred to provinces and local bodies. Land & buildings tax is levied and collected by the Centre, and distributed to provinces and local bodies in the ratio of 78:32. Revenue transfers to the local bodies account for more than 90 per cent of their total expenditure.

Until 1978, oil revenue and foreign debt were the major sources of revenue of the government of Indonesia. Following the sharp fall in oil prices since 1978, the government felt that too much dependence on oil revenue should be dispensed with. Consequently, the tax system was revamped in 1983 with a view to improving tax yield (on sustainable basis) and simplifying the tax system. All the major taxes, namely, income tax, sales tax, excise, and land & buildings tax were overhauled. Both the categories of taxpayers, namely,

individuals and companies were subject to the same rate schedule of income tax. The number of income tax rates was reduced from 14 (varying from 2.5 to 50 per cent) to 3 (15, 25 and 35 per cent) and tax holidays were withdrawn. Multi-point sales tax with no credit for taxes paid at earlier stages was replaced by VAT with a single rate of 10 per cent. The system of excise duty was substantially simplified with reduction the number of chapters from 137 to only 18. With a view to improving tax administration, Indonesia embarked upon computerisation of Department of Inland Revenue, in 1985. In 1986, local and national taxes on land & buildings were integrated into a national tax.

Revamping of the tax system and efforts at improving tax administration were considered to have served the objective of raising revenue. However, in the early 1990s it was felt that further reforms are necessary for enhancing revenue, encouraging foreign investment in Indonesia, encouraging location of industrial units in less developed areas of the country, mitigating possibilities for tax evasion, and exposing the industry to international competition. Consequently, Indonesia embarked upon another major tax reform, in 1994.

The main characteristics of 1994 reform included: lowering of income tax rates, liberalisation of depreciation provisions, introduction of tax incentives for encouraging investment in specified sectors/regions, broadening the tax base and reduction in possibilities for tax evasion through measures like enlarging the scope of tax withholding at source. Scope of withholding tax was enlarged to cover (i) interest income from deposits or savings accounts with banks located outside Indonesia provided the deposits with such banks were placed through banks domiciled in Indonesia, and (ii) security transactions in the stock market. Further, withholding tax rate on transfer of land and/or buildings was increased from 3 per cent to 5 per cent. It was made final for individual taxpayers while for companies it continued to be 5 per cent and creditable.

The prevailing scheme of tax withholding at source in Indonesia has a wide coverage. Tax withheld at source accounts for about 60 per cent of total collection of income tax.

The main objective of this study is to briefly describe the structure and operation of the scheme of tax withholding at source in Indonesia.

Plan of this study is as follows. Salient features of the income tax system of Indonesia are given in Section II.2. A description of the scheme of tax withholding at source in Indonesia is given in Section II.3. Main characteristics of the audit process followed in Indonesia are contained in Section II.4. Information system (external) and its application in enforcing income tax laws are discussed in Section II.5. Concluding remarks are given in Section II.6.

II.2 Salient Features of the Income Tax System of Indonesia

Indonesia has only two types of tax entities: individuals and companies. The same rate schedule comprising three rates (10, 15 and 30 per cent) applies to both categories of taxpayers. It follows classical system of income taxation. However, inter-corporate dividends are exempt in the hands of recipient companies. Indonesia has about 5 million income tax payers which account for about 3 per cent of the population of Indonesia.

An individual is allowed an exemption of Rupiah 1.728 million which is about the same as the per capita income of Indonesia. In addition, a deduction of Rupiah 0.864 million is allowed for a dependent spouse and for each dependent child (maximum 3 dependents). Dependents may include parents and parents-in-law. For new taxpayers, banks and State owned companies, monthly payment of tax is based on their estimated income in the current year.

Tax enforcement strategies practised in Indonesia include: (i) withholding of tax at source, (ii) system of advance payment of tax, (iii) system of self assessment of tax, (iv) taxation of fringe benefits, (v) computerisation of Department of Inland Revenue, (vi) creation and utilisation of an adequate taxpayer information system and (vii) an effective audit system. Fringe benefits other than those relating to working conditions necessary to perform the job are taxed through disallowance of expense deduction to the companies.

Tax incentives are given for encouraging investment in notified less developed regions or specified industries and to preserve environment. These are given in the form of accelerated depreciation, carry forward of losses for a longer period, withholding taxes at rates

lower than those specified, and allowing fringe benefits as deductible expense.

II.3 Tax Withholding at Source

Tax withholding system of Indonesia has wide coverage. It is applicable to various sources of income and a variety of transactions. Included in its ambit are wages and salaries, interest, dividend, royalties, rewards and prizes, rental income, fees for services rendered, fees or commissions of independent salesmen, all imports, supply of goods and services to the government, receipts on account of sale of shares, and receipts on account of transfer of land and/or buildings. Box II.1 gives the structure of tax withholding system of Indonesia. On some of the transactions tax is withheld on gross basis and on others on net basis. In certain cases tax withheld is final and in other cases it is creditable.

Under certain circumstances, the taxpayers are allowed to receive payments with no withholding or withholding at a rate lower than that specified subject to prior approval of the Department. Newly established loss making companies or those with carry forward losses could apply and obtain a certificate from the Department for receiving payments with no withholding or withholding at a rate lower than that specified.

Final withholding of tax applies also to some receipts of the residents that is not consistent with the progressive rate structure. These include receipts on account of fees or commissions, sale of shares in the stock exchange market and sale of land or buildings.

Tax withholders are required to deposit the tax withheld with the government within 15 days. In case of failure in depositing the tax within the specified period, an interest at the rate of 2 per cent per month is charged for the period of delay.

In case of short-payment of tax withheld, 100 per cent of the amount of tax short-paid is charged as penalty.

Box II.1
Structure of Tax Withholding at Source in Indonesia

Source of income/type of transaction		Withholders	Tax base (Gross/ Net)	Tax rate (%)	Credi-table(c)/ Final (f)
A.	**Article 21: Employee-employer relationship**				
1.	Income[1] of individuals from labour relationship such as salary, wages and honorarium	Employers/ Institutions	G	15	C
2.	Income[1] of individuals from provision of services such as consultancy, management and technical (w.e.f. 1995)	Payers	G	15	C
3.	Immediate withdrawal from a pension fund (PF)	Pension funds	G	10	F
4.	Regular withdrawal from a PF	Pension funds	G	10	C
5.	Fees or commission of independent salesmen of household goods and agents of insurance companies	Companies/ traders	G	10	F
B.	**Article 22: Imports and goods supplied to the government**				
1.	All imports by (CIF value)				
	a. Licensed importer	Department of Customs and Excise	G	2.5	C
	b. Unlicensed importer[2]	- Do -	G	7.5	C
					Contd...

[1] Received or accrued.

[2] Most of these may be small enterprises, difficult to trace later.

Box II.1 (Contd.)
Structure of Tax Withholding at Source in Indonesia

Source of income/type of transaction	Withholders	Tax base (Gross/ Net)	Tax rate (%)	Creditable (c)/ Final (f)
2. Goods[3] supplied to the government	Government departments/ State-owned companies	G	1.5	C
3. On sale of certain commodities by the producers to their distributors, such as automobiles, cement, cigarettes, paper and steel	Manufacturers	G	0.10 to 0.45[4]	C[5]
4. On sale of petroleum products by PARTAMINA[6] to its distributors	PARTAMINA		S[7]	F[7]
C. Article 23: Investment/ business income and services supplied to the government				
1. Dividend (other than inter-corporate)	Companies	G	15	C
2. Interest (including guarantee fees, but excluding interest from banks outside Indonesia)	Companies/ Financial institutions	G	15	C[8]
3. Royalties	Payers	G	15	C
4. Rewards and prizes	Payers	G	15	C Contd...

[3] Prior to 1994 reforms, services were also covered under Article 22, which are now covered under Article 23.

[4] The rates are determined by the Director General of Tax depending on profit margins of distributors, through negotiations with the manufacturers and distributors of the commodities under consideration.

[5] Except on cigarettes, which is 0.1 per cent and final because of large small distributors.

[6] A big government oil company.

[7] The rates are specific and final.

[8] Withholding tax on interest paid to members of co-operative societies is final.

Box II.1 (Contd.)
Structure of Tax Withholding at Source in Indonesia

Source of income/type of transaction		Withholders	Tax base (Gross/ Net)	Tax rate (%)	Creditable (c)/ Final (f)
5.	Rental income from lease of assets such as cars and real estate	Payers companies/ institutions/ assigned individuals such as professionals	N[9]	15	C
6.	Fees for services rendered by domestic companies (such as civil contracts, management and technical services, architecture, interior and landscape design, cleaning, book keeping and accounting, pest control and timber cutting).[10]	Payers companies/ institutions	N[11]	15	C
D.	**Article 26: Income of non-residents/ foreigners**				
1.	Payments such as dividend, interest, royalty, fees for services rendered regardless of where the activities are performed[12]	Resident taxpayers	G	20[13]	F
2.	Rewards and prizes, pensions and annuities	Payers	G	20[13]	F
3.	Rental income from lease of assets such as cars and real estate	Payers	G	20[13]	F
					Contd...

9 Net income is taken as 80% of gross payment to individuals and 40% of gross payment to companies.

10 Prior to 1994 reforms, only civil contracts and management and technical services were covered.

11 Net income is computed as 10% of gross payment to the contractors and 40% of gross payments for other services.

12 Prior to the 1994 reforms, withholding tax applied to services performed only in Indonesia.

13 Subject to a lower rate based on tax treaties. As of date, Indonesia has tax treaties with 30 countries.

II.4 Audit Process in Indonesia

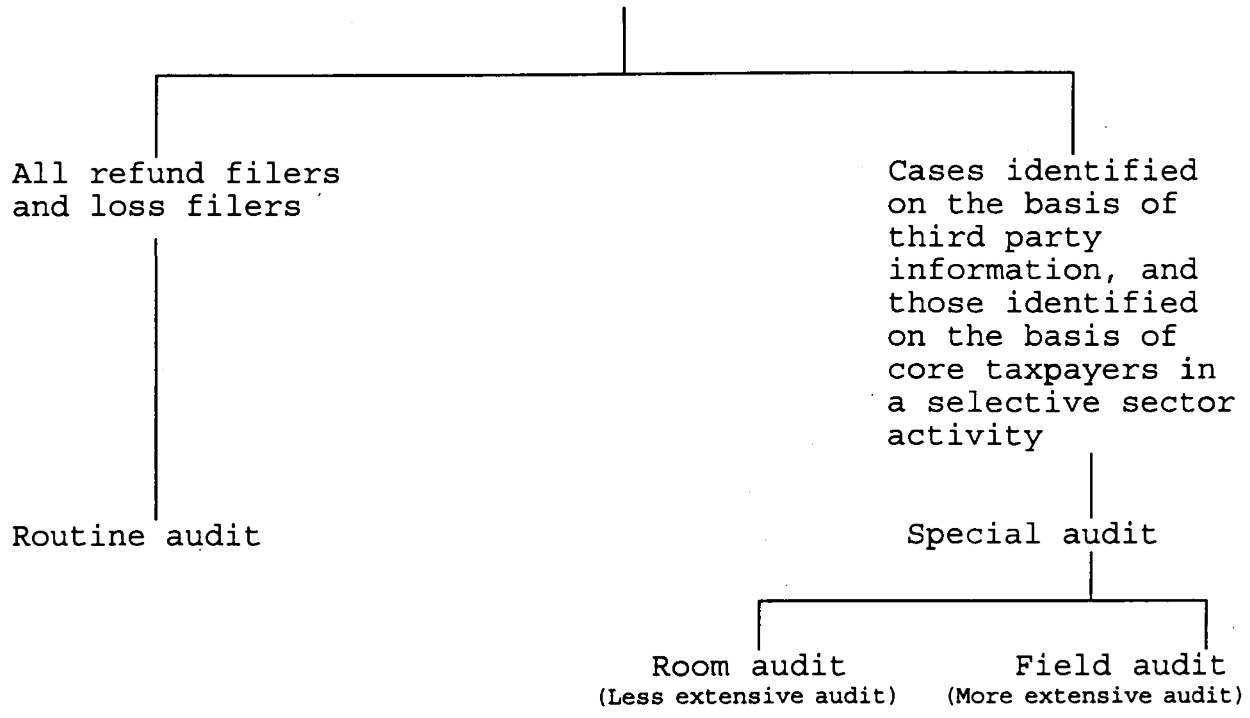
Until 1989, cases for audit were selected at the head office by using a Discriminatory Information Function (DIF) that assigns discriminatory scores to the taxpayers based on their characteristics such as income, turnover and capital investment. In 1988, in the process of simplification of tax return forms, the information requirement was substantially curtailed. Consequently, available information was not sufficient to use the DIF. Therefore, use of DIF was discontinued with effect from 1989.

With effect from 1989, the process of selection of audit cases has been decentralised. The head office provides general guidelines which may be followed by the district centres. Categories of audit and the current system of selection of cases for audit are described below.

Chart II.1 gives a brief description of the audit process in Indonesia. There are two broad categories of audit, namely, routine audit and special audit. The latter is of two types: room audit (less extensive) and field audit (more extensive). All refund cases and loss filers are subject to routine audit. Cases identified on the basis of third party information and those identified from a specific sector/activity (in general a booming activity) each year are subject to special audit. Selection of a sector/activity is made by the head office and this information is kept a top secret. Within the chosen sector/activity, core taxpayers (say top 10 taxpayers in terms of each income, turnover and capital) and branch taxpayers (say 4 biggest suppliers and 4 largest purchasers of each core taxpayer) are identified and included in the sample for special audit. For a corporate (individual) core taxpayer, branch taxpayers may include individuals (companies). The decision regarding room audit or field audit is generally based on income, turnover and capital investment of the taxpayer. The higher the income or turnover or capital investment of a taxpayer greater is the possibility of the taxpayer being subject to field audit.

Chart II.1

Audit Process in Indonesia



Four largest suppliers of a core taxpayers — Branch taxpayers — Core taxpayers — Branch taxpayers — Four largest buyers of a core taxpayers

II.5 Information System in the Department of Inland Revenue

Department of Inland Revenue uses all the three channels of obtaining information on taxpayers, i.e., (i) information supplied by the taxpayers, (ii) information obtained from third parties and (iii) information generated by the Department. Information supplied by the taxpayers comprises returns filed by taxpayers and accompanying documents. Third party information comprises returns filed by tax withholders, information sent in by the government institutions (such as on registration of vehicles and real estate, allotment of electricity connections with power load greater than specified limit and allotment of new telephone connections), and information sent by treaty partner countries on the activity of residents of Indonesia in their countries (such as the nature of activity, volume of transactions, assets, income, and income tax withheld). Information generated by the Department includes new registration numbers issued to taxpayers either on the basis of their applications or on the basis of field surveys undertaken by the Department. A description of this information system is given in Chart II.2.

All the information contained in return forms filed by taxpayers and tax withholders is computerised. Indonesia follows three tier architecture of computerisation: centre (head office), regions and districts. There are 15 regional centres and 140 district centres. The regional centres are still not functional. These are expected to be made functional within the next two years. At present, a district deals directly with the head office and other districts. The information from one regional office to the other is sent on floppies/tapes/hard disks as these are not linked through global network of computers. All the offices are equipped with fax facilities for expeditious transmission of limited vital information.

Information from various sources/areas flows to the head office where it is stored, processed and made ready for use by districts. Flow of information is shown in Chart II.3.

Chart II.2

Information System of Indonesia

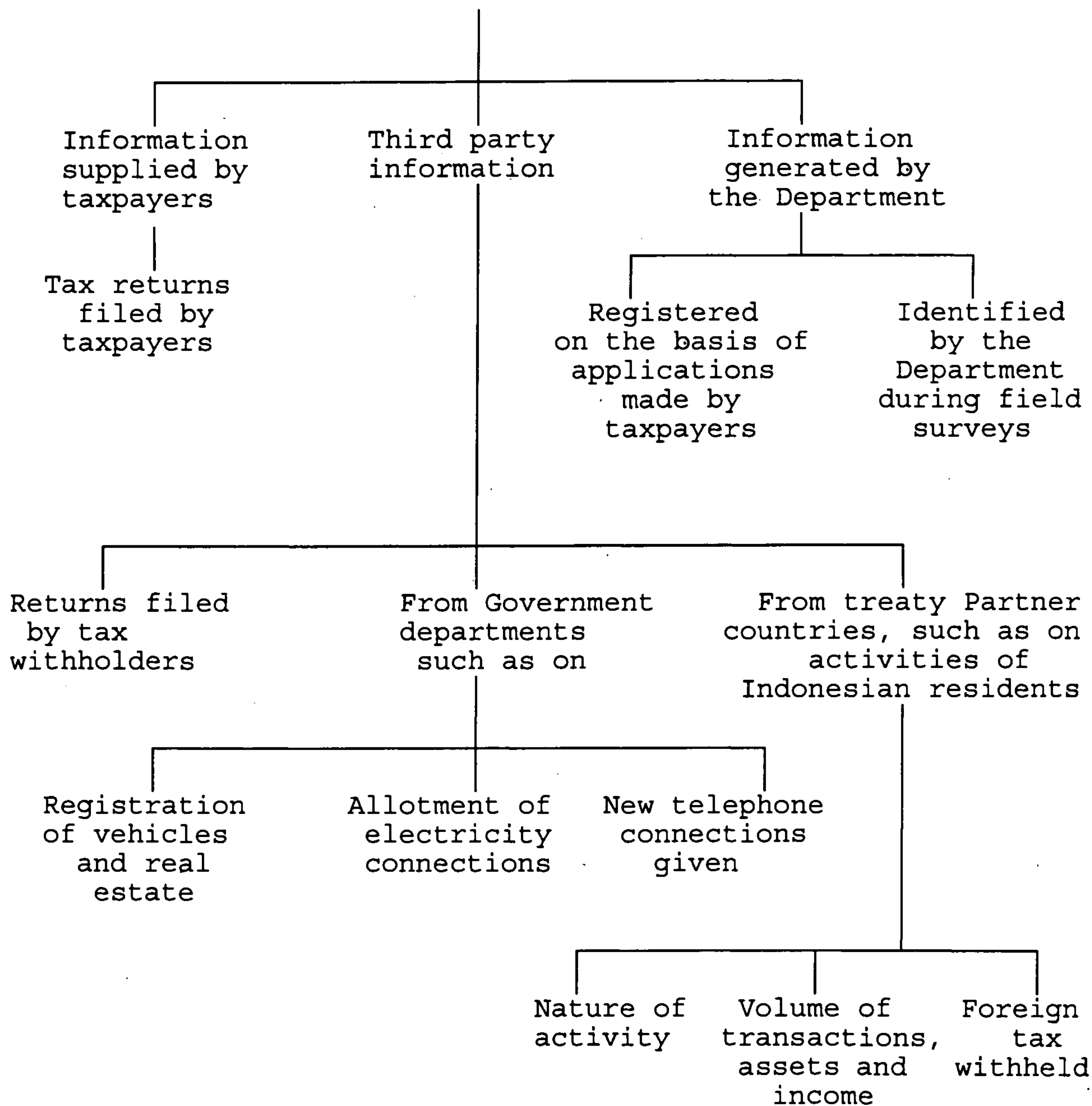
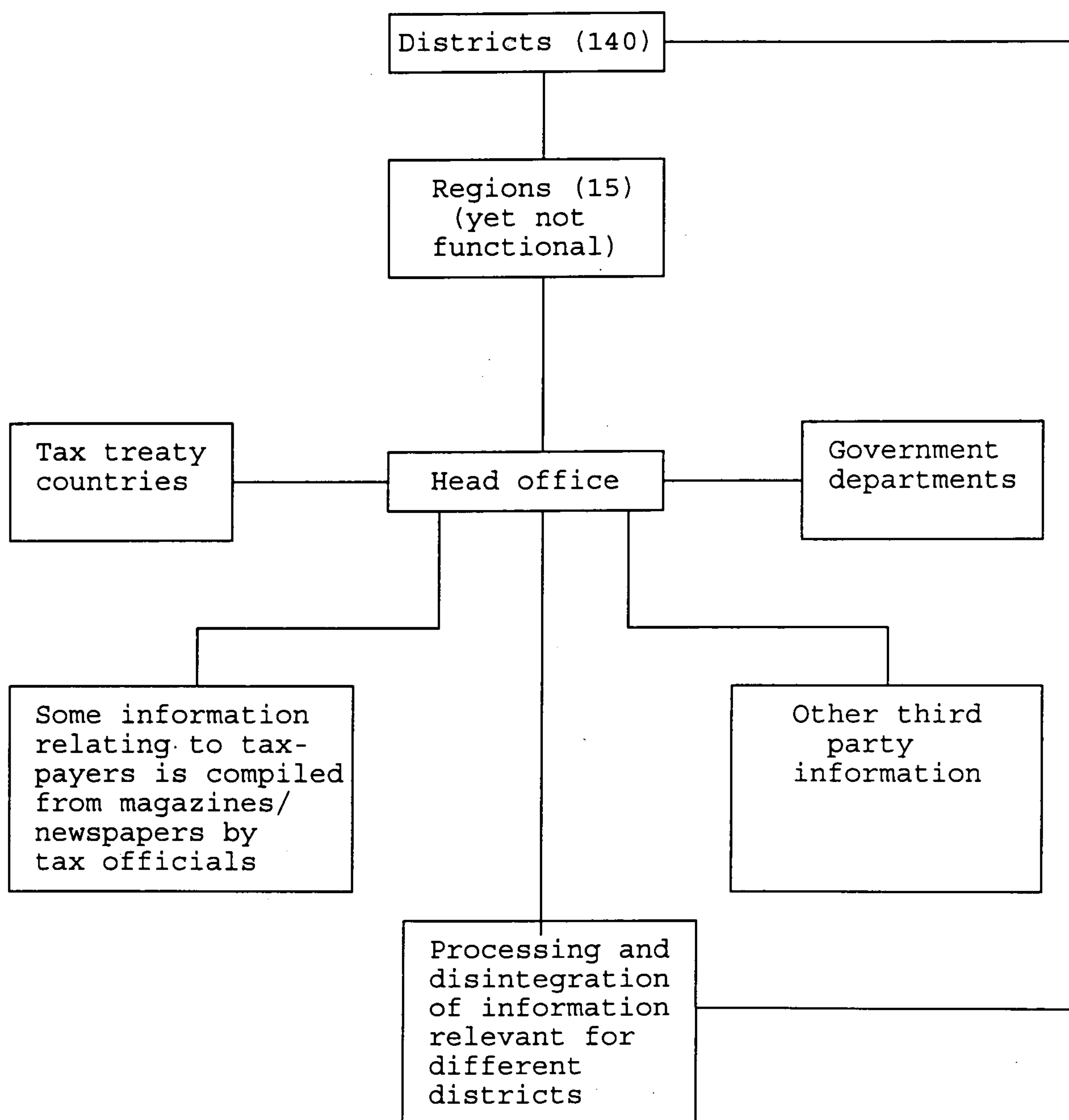


Chart II.3

Flow of Information



Annual tax returns relating to an assessment year (January to December) are filed during April to June. These are received at the district centres where all the information contained therein is entered into computers and verified, by the end of October. Then it is sent to the head office (at Jakarta), as the regional centres are yet not functional. The head office receives information also from government departments and treaty partner countries (on floppies in certain cases). Also the income tax officers extract information relating to the taxpayers from magazines and newspapers, that is maintained at the head office and made available to the relevant income tax offices. The third party information is processed at the head office. About 40 per cent of the third party information is also stored on the computer. The information relevant to different district centres is sent to them for their perusal. All the offices are equipped with fax facilities for expeditious transmission of limited information. A district centre can obtain information from other districts or the head office that may be required for verification during audit.

For keying in the data from tax return forms, into computers, no private personnel is involved. During the peak period, the staff in the Department of Inland Revenue (at the district centres) is re-allocated on part or full time basis for keying in the data. About four thousand persons are deployed for keying in the data. They account for about 16 per cent of total personnel in the Department.

The Department maintains the following data bases which have been found useful for internal management and implementing income tax enforcement strategies.

a. Information from the tax returns of taxpayers.
b. Information from the tax returns of tax withholders.
c. Information on collection of tax from taxpayers and tax withholders, along with their registration numbers.
d. Information received from government departments/public sector undertakings (such as on telephone connections given, allotment of electricity connections with load exceeding 5000 watt, registration of vehicles (car, etc.) and real estate, and distribution of petroleum products by the only big oil company (PARTIMINA) to its distributors), and information provided by mining companies.

e. Internal information relating to management of the Department.

There are inbuilt checks for security of data bases and these can be modified or updated by only selected authorised officials. Application of these data bases in identifying non-filers and in cross verification of information is discussed below.

II.5.1 Identification of non-filers

Information from the tax returns filed by tax withholders is used in preparing the list of potential taxpayers (though it may not be exhaustive as some tax withholders might have failed in filing the returns or in reporting the registration numbers of some of the taxpayers for whom tax has been withheld). Non-filers are identified by comparing this list with the list of those taxpayers who filed tax returns. A non-filer is sent a notice for explaining his/her failure in filing the tax return. Many of these cases report their incomes below the exemption limit. Some of these cases are audited and this does result in recovery of some amount of tax.

II.5.2 Cross verification of information

The computer facilities in Indonesia do not permit extensive matching of information across large files relating to five million taxpayers. Therefore, only a limited matching has been possible that too semi-manually. Cross verification is limited largely to audit cases. In such cases, selected information required for cross verification is obtained from different district offices and/or the head office. In addition, in selected cases, routine semi-manual verification is done with regard to tax withheld (reported by tax withholders) and tax credits claimed by the taxpayers. This does bring to light some tax defaulters. Also, limited use is made of third party information (other than tax withheld) in identifying tax defaulters.

II.6 Concluding Remarks

Indonesia has only two types of tax entities: individuals and companies. Both types of entities are subject to the same progressive rate schedule comprising three rates (10, 15 and 30 per cent). It follows classical system of income taxation with exemption of inter-corporate

dividends.

Among the tax enforcement strategies adopted in Indonesia, the prominent one is its scheme of withholding tax at source. In the international perspective, it perhaps, has the widest scope in terms of its coverage. It is applicable to various sources of income and a variety of transactions. Included in its ambit are wages and salaries, interest, dividend, royalties, rewards and prizes, rental income, fees for services rendered, fees or commissions of independent salesmen, all imports, supply of goods and services to the government, receipts on account of sale of shares, and receipts on account of transfer of land and/or buildings. On some of the transactions tax is withheld on gross basis and on others on net basis. In certain cases tax withheld is final and in other cases it is creditable.

Final withholding of tax applies also to some receipts of the residents that is not consistent with the progressive rate structure. These include receipts on account of fees or commissions, sale of shares in the stock exchange market and sale of land or buildings.

Tax withholders are required to deposit the tax withheld with the government within 15 days. In case of failure in depositing the tax within the specified period, an interest at the rate of 2 per cent per month is charged for the period of delay. In case of short-payment of tax withheld, 100 per cent of the amount of tax short-paid is charged as penalty.

Experience of Indonesia in the operation of the scheme of withholding tax at source is encouraging. It demonstrates that the scheme of withholding tax at source can be operated successfully even with limited infrastructure such as limited computer capabilities as is the case in most developing countries. However, care should be taken not to fall in the trap of final withholding on the pretext of simplicity.

The process of computerisation of the Department of Inland Revenue has been slow. The head office, regional centres and district centres are yet not connected through global net work of computers though Indonesia embarked upon computerisation, in 1985. Information from one centre to the other is sent on floppies/tapes/hard disks and cross verification of large files is not feasible. Also, the regional centres are yet to start their operations.

Experience of Indonesia also indicates that tax returns of even a large number of taxpayers can be computerised within a reasonable period by re-allocation of Departmental personnel for a short period. In the absence of global net working of computers, information can be transmitted on floppies/tapes/hard disks, processed centrally and relevant information sent to the respective regional/district offices. Such computerised information can be used meaningfully semi-manually for selective cross verification, identifying defaulters and improving tax compliance.

Appendix III

Income Tax System of Malaysia With Special Reference to Tax Withholding at Source

III.1 Introduction

Malaysia has a population of approximately 25 millions and there are about 2.5 million income tax payers implying that about 10 per cent of the population pays income tax. It follows classical system of income taxation with imputation of dividend income to shareholders. Corporate income tax on distributed profits is treated as tax withheld on behalf of shareholders. Accordingly, it is creditable against the tax liability of shareholders. A partnership is not subject to tax as it is not treated as an independent tax entity. The income of a partnership is taxed in the hands of partners in proportion to their shares in the partnership. For convenience, the principle of 'pay as you earn' is observed.

Income tax rate for companies and non-resident individuals is 34 per cent. Resident individuals are subject to a progressive rate schedule with rates varying from 2 to 34 per cent and the personal circumstances of a resident individual such as his marital status, status of his spouse (working or non-working) and number of children influence his tax liability. The income tax rate schedule for individuals is given in Box III.1.

Malaysia has followed an integrated system of pro-active tax service and re-active enforcement strategies for improving tax compliance and mitigating taxpayer's resistance. Recently, Malaysia had adopted certain tax enforcement strategies for facilitating maximum tax compliance with minimum cost. The strategies are believed to have yielded expected results. The enforcement strategies adopted for improving compliance with the tax laws included:(i) Computerisation of the Income Tax Department, (ii) aggressive publicity about the obligations of taxpayers and tax withholders towards the tax laws through public lectures, media and distribution of booklets, (iii) opening taxpayer assistance counters for helping them in filling tax returns and clearing their doubts, (iv) compilation and meaningful use of third party information in identifying defaulters, (v) street visits by the tax officials, and (vi)

improvement in tax administration. Malaysia, with better enforcement of the scheme of withholding tax at source has managed to collect about the same percentage of its total income tax receipts as Indonesia (above 60 per cent) even with relatively narrow coverage.

A careful study of the operation enforcement strategies implemented in Malaysia can be useful in deriving policy implications for improving compliance with the tax laws in other developing countries. Also, the experience of Malaysia perhaps, would show that even limited and selective application of computers can be useful in mitigating non-compliance.

The main objective of this study is to briefly describe the structure and operation of the scheme of tax withholding at source in Malaysia.

Box III.1
Income Tax Rate Schedules for Individuals: Malaysia

Income bracket (RM)	Tax rate in the year	
	1991 (per cent)	1992 (per cent)
A. Resident Individuals		
0 - 2,500	4	2
2,501 - 5,000	7	5
5,001 - 10,000	10	8
10,001 - 20,000	12	10
20,001 - 35,000	17	15
35,001 - 50,000	22	21
50,001 - 70,000	27	26
70,001 - 100,000	32	31
over 100,000	35	34
B. Non-Resident Individuals		
All income	35	34

III.2 Tax withholding at source in Malaysia

Tax withholding system of Malaysia has a limited coverage. It is applicable to a variety of payments to non-residents, namely, royalty, interest, payments for specified services (such as services of public entertainers), payments for use of assets of non-residents (leased assets) and services component of contracts awarded to non-residents. Whereas in the case of residents, only interest and wage income is subject to tax withholding. Box III.2 gives the structure of tax withholding system of Malaysia. On some of the transactions tax is withheld on gross basis while on others it is withheld on net basis. In certain cases tax withheld is final and in other cases it is creditable.

In the case of residents, the scheme of tax withholding at source is applicable to only remunerations and interest income. Tax is withheld on net basis from the former and on gross basis from the latter. Tax from remunerations is withheld as per tax deduction tables and from interest it is withheld at the rate of 5 per cent. The tax so withheld is creditable against final tax liability of taxpayers. In the case of non-residents a variety of payments, as described above, are subject to tax withholding at source. Tax is withheld on gross basis. The tax withhold at source is final except when it is withheld from payments relating to contracts. The non-resident contractors are required to file annual returns giving details on their income from the contracts undertaken in Malaysia. They are eligible for tax credit for the tax withheld at source, against their final tax liability in Malaysia. Tax withheld from payments to contractors is made creditable to avoid excessive taxation of those with low profit margins. Tax from payments to non-resident taxpayers is withheld at the rate of 15 per cent except when it is a payment of interest in which case the rate is 20 per cent.

It may be noted that there is only a little dependence (in terms of both coverage and rate) on the strategy of tax withholding at source for enforcing compliance by resident taxpayers. Tax from payment of interest to resident taxpayers is withheld at the rate of 5 per cent whereas it is withheld at the rate of 20 per cent from payments to non-resident taxpayers.

Box III.2

Structure of Tax Withholding at Source in Malaysia

Source of income/ type of transaction	Withholders	Tax base (Gross (G)/ Net (N))	Tax rate (%)	Creditable (C)/ Final (F)
A. From Residents				
1. Income of individuals from employee-employer relationship such as salary, wages, commission, tips, director's fees, allowances and bonus	Employers	N	As per tax deduction table	C
2. Interest from[1] savings/fixed deposits	Financial institutions	G	5	C
B. From Non-Residents				
1. Interest[2]	Financial institutions	G	20	F
2. Royalties	Payers	G	15	F
3. Payment relating to service portion of a contract	Payers	G	15	C
4. Public entertainers	Resident agents	G	15	F
5. Lease or rental value of movable properties	Payer	G	15	F

Notes:

1. Interest earned by an individual from corporate non-convertible (into equity shares) bonds is exempt.

2. Interest earned by a non-resident individual from corporate non-convertible bonds is not subject to withholding tax with effect from October 30, 1992.

All employers are required to withhold tax from remunerations of their employees on monthly basis by using a tax deduction schedule supplied by the Department which predetermines the amount of tax to be withheld.

The tax withheld from the current remuneration of an employee who was in employment before 1.1.95 relates to his income received in the preceding year and not to his income received in the current year. Employees who commence employment on or after 1.1.95 pay tax as they earn. Accordingly, in the case of such an employee, tax withheld from the current remuneration relates to his income received in the current year.

III.2.1 Withholding tax from payments to non-resident contractors

Malaysia has an extensive system of withholding tax from payments made to non-resident contractors. Withholding provisions are applicable to only service component of the contract. Thereby, implying that supply of materials by a non-resident does not result in income taxable in Malaysia. The tax rate for withholding tax from service component of a contract is 20 per cent that comprises two components: 15 per cent and 5 per cent. The first component, is on account of tax on income of the contractor and the second component, is on account of tax on income of his employees. The former is creditable against the final tax liability of the contractor and the latter is refundable to the contractor on satisfying certain conditions such as giving details of employees and their salaries and in- kind benefits, to the Income Tax Department.

Service component of a contract is determined by the payer. For the purposes of tax withholding at source, service component of a contractor includes lease value of machinery leased-in from another non-resident. This provision does not appear to be neutral between purchase and lease of machinery. The former does not result in any income taxable in Malaysia.

Professional services of a non-resident contractor such as advisory, consultancy and technical are subject to tax withholding at source at the rate of 15 per cent. Income of non-resident partners from a partnership firm is subject to tax withholding at source at the rate of

20 per cent[1]. However, joint ventures through a resident company or payments to non-resident banks are not in the ambit of tax withholding at source.

III.2.2 Tax withholders and their responsibilities

All those persons who make payments to non-residents or pay interest to residents are required to withhold tax at source. Similarly, all employers are required to withhold tax from remunerations of their employees. All such persons or employers are referred to as tax withholders. They are required to apply and obtain registration as tax withholders.

The employers (tax withholders) are required to withhold tax from remunerations of their employees on monthly basis. The amount withheld is to be deposited into the government account by the 10th of the following month. At the end of each calender year, employers are required to give to each employee a certificate showing the total remuneration paid in the year and the amount of tax withheld at source.

The other payers (tax withholders) such as those awarding contracts or paying interest are required to withhold tax at the time of giving credit or making payment whichever is earlier and deposit it with the government within 30 days. At the end of each contract or calender year, whichever is earlier, the payer is required to give to each payee a certificate showing the total amount paid in the year or for the contract and the amount of tax withheld at source.

The amount of tax that a tax deductor is required to withhold has to be paid to the government whether or not it has actually been withheld. Also, the tax withholders are required to file monthly returns with details of tax withheld at source and registration numbers of taxpayers for whom tax has been withheld.

As soon as an employee commences employment, the employer is required to collect the following information from the employee:

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[1] In Malaysia partnership is not a legal entity. Partners are taxed separately as individuals.

(i) Full name (as it appears in identity card or passport)

(ii) New identify card No. and old identity card No. (date of birth, passport No. and country in the case of foreigners)

(iii) Full residential address (post box address not acceptable)

(iv) Income tax reference No.

(v) Marital status

(vi) If married, full name of the spouse

(vii) Names of children and

(viii) Dates of birth of children.

This information serves not only as identification of the employee but is also necessary for determining the amount of tax to be withheld from remuneration of the employee as it is influenced by his/her personal circumstances such as marital status and number of children.

III.2.3 Penalties on defaulters

The withholders which fail to comply with the provisions of the scheme of tax withholding at source are subject to harsh penalties. In case of failure in withholding tax where it was due, expense deduction to the payer is disallowed, and the tax that should have been withheld is treated as loan to the withholder. Failure in depositing the tax withheld, with the government, within 30 days attracts a penalty of 10 per cent and failure in depositing the same within next 60 days attracts an additional penalty of 5 per cent. Also, a defaulter is prevented from leaving the country until he/she clears his/her dues. Interestingly, these rules are strictly applied to common men as well as VIPs.

III.3 Tax Compliance Measures Practised in Malaysia

As discussed earlier, Malaysia has followed an integrated system of pro-active tax services and re-active enforcement strategies for improving tax compliance and mitigating taxpayer's resistance. Recently, the Income Tax Department embarked upon various programmes for facilitating maximum tax compliance with minimum cost. This has resulted in economic growth particularly in the private sector which had exceptional ability and

potential to become more profitable. The Department seems to have benefited from the planned specific and concrete programmes aimed at increasing tax compliance. These programmes seem to have resulted in an increase in tax revenue. The specific programmes were aimed at providing better services to the taxpayers, increasing taxpayers' awareness about their obligations towards the tax and strengthening enforcement of the tax law. These included: taxpayer's service week, external counter services, taxpayer guidelines and special task force unit. These programmes are briefly discussed below.

III.3.1 Taxpayer's service week (MPPC)

This one week programme, scheduled to run annually, was initiated in 1991. It was given wide publicity through public media. The basic objective of the programme has been to educate taxpayers about their tax obligations, filling tax return forms, penalties for non-compliance with the tax laws and other related issues. The programme has received warm response from taxpayers and general public alike. Since 1991, the number of visitors to the service counters has increased three-fold within a period of three years. The number of visitors has increased from about 38820 in 1991 to 103117 in 1993 and the number of new taxpayers registered on such counters has increased from about 3669 in 1991 to about 11318 in 1993. Thus, this programme not only served the purpose of providing assistance to the taxpayers but also helped in registering new taxpayers. The ratio of new taxpayers to total taxpayers has been about 10 per cent. Following the success of this programme, duration of the programme was extended from six days in 1992 to seven days in 1993. The success of this programme is considered to be attributable, at least partly, to the dedication shown by the tax officials in building a good rapport with the taxpayers.

III.3.2 External counter services

Following the success of taxpayer's service week programme, and requests from employers, external counters were set up in the vicinity of business premises to respond to taxpayer's enquiries, help them in filling tax returns correctly and register new taxpayers. This programme also has proved to be a success. The number of requests for setting up external counters increased over time. Accordingly, the number of counters set up by the

Department increased from about 1761 in 1992 to about 2060 in 1993. It is interesting to note that the growth in registration of new taxpayers was greater than that in the number of counters. While the latter increased at the rate of 40 per cent, the former increased at the rate of 69 per cent.

III.3.3 Guidelines for the taxpayers

In an effort to improve compliance, the Department has stepped up the process of disseminating information on the tax laws via free distribution of booklets, pamphlets and leaflets containing guidelines for the taxpayers. These publications are aimed at not only to provide information regarding tax laws but also to reiterate the utility of taxes paid. These publications are made available at all counters in the Department and also distributed to the general public during special occasions like taxpayer's service week.

III.3.4 Special task force unit

A special task force unit was set up in 1988 for identifying potential taxpayers who might have failed in complying with their tax obligations. It focuses mainly on small entrepreneurs and self-employed individuals. It has been found successful in identifying many potential taxpayers in default since its introduction. The unit has succeeded in identifying 1,45,779 such potential taxpayers in 1993. The total number of such potential taxpayers identified by the unit upto the end of 1993 was 9,22,665.

III.4 Information System in the Income Tax Department

All the three channels of information (taxpayers, third party and the Department) are utilised for enforcing the tax laws. Information supplied by the taxpayers comprises returns filed by taxpayers and accompanying documents. Third party information comprises returns filed by tax withholders, information sent in by the government or other institutions. Information relating to selected activities in a year is specifically requested from the relevant institutions such as on sale of specified brand of cars from the car dealers. The Department generates useful information through street visits and field surveys, and by reading

newspapers/magazines. It has been observed that some of the information that is not disclosed correctly to the tax authorities becomes available from the interviews/articles published in newspapers/magazines as the business entities happen to disclose correct information at such occasions to boost their image. Information generated by the Department also includes new registration numbers issued to taxpayers either on the basis of their applications or on the basis of street visits or field surveys undertaken by the Department.

In Malaysia, tax collection function is centralised. All taxpayers from all over the country are required to pay tax at the head office at Kuala Lumpur. Thus, all the information relating to tax collection becomes available at the head office.

All the information relating to collection of tax and that contained in return forms filed by taxpayers and tax withholders is computerised. Indonesia follows two tier architecture of computerisation: centre (head office) and regions. There are 27 regional centres spread over 13 States. The information contained in the return forms is stored on the computers at the regional centres, in a specified format. This data base is used for computing tax liability of taxpayers by using a computer programme. All the information relating to tax collection is stored on computers at the head office. Tax collection information is on line and is accessible by all assessing officers at all the regional assessment centres which are linked to the head office at Kuala Lumpur through global net work of computers.

Third party information is processed at the head office and the relevant information is made available to the respective regional centres. Most of the third party information is scrutinised semi-manually. This information is extensively used in identifying under-reporting or non-reporting of income. The department has been able to use gainfully about 70 per cent of the third party information.

For storing the data on the computers, no private personnel is involved. During the peak period, the staff in the Department is re-allocated on part or full time basis for keying in the data into computers.

There are inbuilt checks for security of data bases and these can be modified or updated

by only selected authorised officials. Application of these data bases in completing assessments, identifying non-filers and in cross verification of information is discussed below.

It is interesting to note that, in Malaysia, enforcement activity is largely carried out semi-manually, though successfully, even after a decade of initiating the process of computerisation.

III.4.1 Completion of assessments

All the assessment work is done at the regional centres. An assessing officer, at the time of making an assessment generally verifies the tax claims made by a taxpayer with the tax collection information available on the computer. The data base relating to assessment returns is used for computing tax liabilities of the taxpayers by using a computer programme, and demand notices are sent to them. Computation of tax liability of all the taxpayers is necessary as Malaysia does not follow self assessment system. An assessing officer, generally verifies the claims of taxpayers regarding tax withheld at source by matching these semi-manually with tax collection information available on the computer with the head office which is online with the regional centres. This operation of verifying claims of tax withheld at source has successfully avoided the possibility of making false claims of tax withheld.

III.4.2 Identification of non-filers

Most of the information in possession of the Department has been found useful in checking under-reporting and identifying new taxpayers. The data base relating to tax returns filed by tax withholders is used in preparing the list of potential taxpayers. Non-filers are identified by comparing this list with the list of those taxpayers who filed tax returns. Some of the non-filer potential taxpayers are also identified on the basis of street visits and field surveys undertaken by the Department. A non-filer is sent a notice for explaining his/her failure in filing the tax return, and further action is initiated depending on taxpayer's response.

III.4.3 Cross verification of information

The computer facilities in Malaysia do not permit extensive matching of information from various sources across large files relating to 2.5 million taxpayers. Only a limited matching has been possible that too semi-manually. Verification of information is limited to

the process of assessment or audit of tax returns. Also, a limited use is made of third party information (other than tax withheld) in identifying tax defaulters. Most of this information is scrutinised semi-manually. Cross verification of information from different sources has been confined largely to audit cases. Claims of tax withheld are verified at the time of completing assessments.

III.5 Concluding Remarks

Malaysia follows classical system of income taxation with imputation of dividends to the shareholders. Corporate tax on distributed profits is treated as tax withheld at source on behalf of shareholders. A partnership is not a legal tax entity in Malaysia. Income of a partnership is taxed in the hands of partners in proportion to their shares in the partnership. Companies and non-resident individuals are taxed at a flat rate of 34 per cent. Resident individuals are subject to a progressive rate schedule with rates varying from 2 to 34 per cent, and the personal circumstances such as marital status of the individual influence his/her tax liability.

Among the tax enforcement strategies adopted in Malaysia are its scheme of tax withholding at source, taxpayer's service week, external counter services, special task force unit, taxpayer guidelines, assessment process and audit process. Enforcement is believed to be helped to a significant extent by the dedication shown by the tax officials. Tax withheld at source accounts for about 60 per cent of total collection of income tax although, in an international perspective, coverage of the withholding scheme of Malaysia is narrow.

Tax withholding system of Malaysia is applicable to a variety of payments to non-residents, namely, royalty, interest, payments for specified services (such as services of public entertainers), payments for use of assets of non-residents (leased assets) and services component of contracts awarded to non-residents. Whereas in the case of residents, there is only a little dependence (in terms of both coverage and rate) on the strategy of tax withholding at source. In their case, only interest and wage income is subject to tax withholding. Also, tax from payment of interest to resident taxpayers is withheld at the rate of 5 per cent whereas it is withheld at the rate of 20 per cent from payments to non-resident taxpayers. On some of the transactions tax is withheld on gross basis while on others it is withheld on net basis. In certain cases tax withheld is final and in other cases it is creditable.

The employers are required to deposit the tax withheld with the government by the 10th

of the following month and other withholders are required to do so within 30 days. In case of failure in depositing the tax within the specified period, a penalty of 10 per cent is levied and failure in depositing the same within next 60 days attracts an additional penalty of 5 per cent. Also, a defaulter is prevented from leaving the country until he/she clears his/her dues. Interestingly, these rules are strictly applied to common men as well as VIPs.

Experience of Malaysia demonstrates that enforcement strategies can be successfully implemented even with limited infrastructure facilities. It is not necessary to have all the information on computers for cross verification. Cross verification exercise can be carried out semi-manually even with selected information on the computers. A significant share of total income tax collection can be withheld at source, even with a narrow coverage of the scheme of tax withholding at source, with better enforcement of the tax law.

Experience of Malaysia also indicates that tax returns of even a large number of taxpayers can be computerised within a reasonable period by re-allocation of Departmental personnel for a short period.

Service component of a contract, that is subject to tax withholding at source, is determined by the payer. For the purposes of tax withholding at source, service component of a contractor includes lease value of machinery leased-in from another non-resident. This provision does not appear to be neutral between purchase and lease of machinery.

Appendix IV

Tax System of U.S.A. With Special Reference to Income Tax Withholding

IV.1 Introduction

In the United States of America (USA), personal as well as corporate income is subject to a progressive rate schedule. The marginal tax rates vary from 15 to 39.6 per cent for individuals and from 15 to 39 per cent for corporations. The marginal rate brackets depend upon marital status as well as separate or joint filing of returns by married individuals. The tax rate schedules of different categories of individuals are given in Box IV.1, and the tax rate schedule of corporations is given in Box IV.2. The bracket amounts for married taxpayers who file separate returns are half of the amounts for married taxpayers filing jointly.

The rate schedules are adjusted every year with reference to inflation. The Internal Revenue Service (IRS) adjusts the personal income tax brackets but not the tax rates, each year in order to reflect the change in the U.S. consumer price index. The thresholds relating to standard deduction, personal exemption and certain allowances are also adjusted. However, there is no inflation adjustment in the case of corporations.

In the USA, a substantial part of personal income tax is collected through withholding of tax at source. In this country, withholding tax was initiated in World War II primarily to bring tax revenue into the government sector more quickly. Withholding also worked satisfactorily as a collection device for collecting expected tax liabilities. Currently, withholding accounts for more than 80 per cent of the personal income tax.

The objective of this study is to give a brief description of the system of income tax withholding prevalent in the United States.

Box IV.1

Income Tax Rate Schedules of Individuals (1996)

Taxable income (US$)	Tax rate for bracket (%)
A. Single Individuals	
Less than 24,000	15
24,000 - 58,150	28
58,150 - 121,300	31
121,300 - 263,750	36
more than 263,750	39.6
B. Married Individuals Filing Joint Return	
Less than 40,100	15
40,100 - 96,900	28
96,900 - 147,700	31
147,700 - 263,750	36
more than 263,750	39.6
C. Married Individuals Filing Separately	
Less than 20,050	15
20,050 - 48,450	28
48,450 - 73,850	31
73,850 - 131,875	36
more than 131,875	39.6

Box IV.2

Income Tax Rate Schedule of Corporations (1996)

Taxable income (US$)	Tax rate for bracket (%)
Less than 50,000	15
50,000 - 75,000	25
75,000 - 100,000	34
100,000 - 335,000	39
335,000 - 10,000,000	34
10,000,000 - 15,000,000	35
15,000,000 - 18,333,333	38
more than 18,333,333	35

IV.2 Withholding Tax at Source

In the United States, withholding is applicable to wages and salaries (and related income paid to employees such as fringe benefits and sick pay); other types of incomes such as interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, royalties, salesmen's commissions, alimony, winnings from gambling (other than black jack, baccarat, craps, roulette, and big-6-wheel), federal agricultural subsidies, patronage dividends, state tax refunds, and various kinds of payments to non-residents. Withholding is applicable also to income attributable to foreign beneficiaries of an estate or trust. In the case of a grantor trust, withholding is applicable if settlor is a foreign person. Tax can be withheld on pensions, at the request of the taxpayer. Some of the incomes/receipts, however, are exempted from withholding tax. These include: (i) income from sale of real or personal property; (ii) income from hedging transactions; (iii) boot dividends received in corporate reorganisation; (iv) premia for the insurance of U.S. risks received by a foreign insurer; (v) the distribution in the process of liquidation of a company; (vi) the distribution from a regulated investment company; (vii) incomes exempted under tax treaties; (viii) incomes received under withholding agreements between the IRS and the non-resident taxpayers; (ix) the amount received as a annuity under a plan qualifying for exemption; and (x) generally, withholding is not required on income from U.S. obligations drawn by a foreign central bank of issue, or by the bank for international settlements.

In general, no withholding is required if it is established to the satisfaction of the

assistant commissioner (international) that withholding requirements impose an undue administrative burden and that collection of the tax will not be jeopardized by this exemption.

A domestic partnership is required to withhold tax on U.S. source income included in the distributive share of a partner that is a non-resident taxpayer, foreign fiduciary of a trust or State, foreign partnership, or foreign corporation whether or not actually distributed. If the income is not distributed by the year-end, the partnership must remit the withholding tax with the exchequer not latter than the 15th day of the third month following the close of taxable year of the partnership.

A payment to a foreign partnership is treated as a payment to its partners. Withholding is required even if the partners are U.S. citizens or residents or domestic corporations.

Residents or domestic fiduciaries of trust and States are required to withhold tax on the U.S. source income of beneficiaries that are non-resident taxpayers, foreign partnerships from foreign corporations, whether or not distributed. The payment to a grantor trust with a non-resident alien settlor is subject to withholding even if the beneficiaries are U.S. citizens or residents.

Generally, receipts/incomes exempted from withholding tax need to be reported to the IRS. Reporting requirements apply to: (i) U.S. source income; (ii) amount on which tax will be required to be withheld but for an exclusion from gross income under a treaty or exemption from withholding by ruling or procedure; and (iii) amount on which tax withheld has been released or refunded to the payee by the withholding agent.

The entire amount of income from which tax must be withheld is included as gross income in the recipient's tax return, without deduction of amount of tax withheld. The tax withheld is allowed as credit against income tax computed in taxpayer's return. Tax withheld at source on income paid to a fiduciary is deemed to have been paid by the taxpayer liable for tax on such income.

The tax that must be withheld is paid by either the recipient or the withholding agent. If the latter fails to withhold tax, it can be collected from either party, however, interest and penalties may be imposed on the party that fails to withhold.

For the purposes of withholding, payments to a U.S. person who is acting as an agent for a foreign person are treated as payments to a non-resident alien.

Imputed interest income, from U.S. source, of non-resident taxpayers has fallen in the ambit of withholding by case law[2]

Income of non-residents from the U.S. sources is subject to withholding at the rate of 30 per cent. Statutory and treaty exemptions/rate reductions are available which differ greatly depending on the type of income and the basis for exemption or rate reduction. "Portfolio interest", generally defined as interest payable to a foreign person (owing less than 10 per cent of the corporate obligor), is exempt from withholding. A reduced rate of 14 per cent is applied to amounts received by participants in certain exchange or training programmes.

Related party dividends under certain treaties are subject to a lower rate of withholding tax. Under the provisions of certain treaties, dividend from U.S. source paid to a corporation controlling 95 per cent of the voting power of the paying corporation will be subject to tax at 5 per cent if, (i) not more than 25 per cent of the paying corporation's gross income for the three year period preceding the dividend consists of interest and dividends; (ii) the relationship between paying corporation and the receiving corporation has not been arranged or maintained primarily for securing the 5 per cent rate; and (iii) at no time during the taxable year did the receiving corporation have a U.S. permanent establishment.

As soon as the existing treaties are modified or new treaties are signed, the IRS issues withholding tables to facilitate withholding of tax on certain types of income including dividends, interest, royalties and personal service income, by withholding agents.

The employees are subject to "pay as you earn (PAYE)" system. In an employer-employee relationship, the employer must withhold income and social security tax from wages paid. Employers are also liable for unemployment tax and for their share of social security tax. On the other hand, if the worker is self-employed, he is not required to withhold any tax,

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[2] As per the decision of district court withholding tax has become applicable to imputed interest deemed to have been paid to the non-resident taxpayers. In an unpublished opinion (Doroen Climaco and Fumiaki Nakamura v. Commissioner, 77 AFTR2d Para, 96-563, No. 94 (V2272)), the United States District Court for the Eastern District of New York, held that imputed interest related to interest-free loans to the taxpayers was subject to withholding tax. The imputed interest may be computed at the market rate of interest.

and is not liable for social security or unemployment tax on the compensation. There has been some controversy on the difference in tax treatment between employees and self-employed individuals (commonly referred to as independent contractors). Withholding on self-employment income was one of the many proposals put forward to deal with the issues relating to independent contractors. In 1979, it was proposed to have a 10 per cent withholding tax on payments to certain independent contractors which was opposed by various categories of taxpayers including industrial groups and independent contractors. In 1982, extension of withholding tax to business income derived by certain self-employed individuals was tried, though without much success. The withholding provisions were repealed before they took effect. With a view to encourage compliance, a system of backup withholding was enacted in 1983. Also, withholding is made applicable to certain "prescribed payments" which are not covered in the PAYE system. These systems are briefly described below.

IV.2.1 Pay as You Earn system (PAYE) for employees

An employee is eligible for standard personal allowances and special expenses that are deductible from the income tax of the payee such as mortgage interest, local taxes and extraordinary medical expenses. An employee with two jobs must claim personal allowances from only one employer.

Other non-wage income of the employee is not included in his wage income for withholding tax at source by the employer. However, the amount of estimated non-wage income such as dividend and interest reduces the number of additional allowances.

Tax is deducted by using appropriate withholding tables supplied by the IRS. These tables are derived from the income tax rate brackets. Tax from non-periodic wage income is withheld at a flat rate rather than at a progressive rate on which the withholding tables are based. At the request of the employee, however, the employer may agree to apply the withholding system to consolidated income, i.e., to apply progressive rate to total wage income (including non-periodic wage income). Also, the social security contributions in the United States, are not integrated with the system "pay as you earn (PAYE)". Nevertheless, contributions withheld are payable together with the PAYE.

Tax withheld on wages and salaries is creditable against the final tax liability of the taxpayer.

Depending on the amount of tax withheld, it is to be deposited with the Treasury each quarter, month, week, or day, using depository coupons preprinted with the employer's name, address and identification number. The employer is required to file payment summaries with the tax administration each quarter, with identification of the employees on the basis of their social security numbers. Annually, employers provide their employees a withholding statement for return filing purposes. A copy of the withholding statement is also forwarded to the tax administration.

IV.2.2 Backup withholding

Under the backup withholding system, a payer, under certain conditions, is required to withhold tax at the rate of 31 per cent on the specified payments made to individuals. Payments that can be subject to backup withholding include interest, dividends, broker and barter exchange transactions, rents, royalties, non-employee pay, and certain payments for fishing boat operators. However, real estate transactions are beyond the scope of backup withholding.

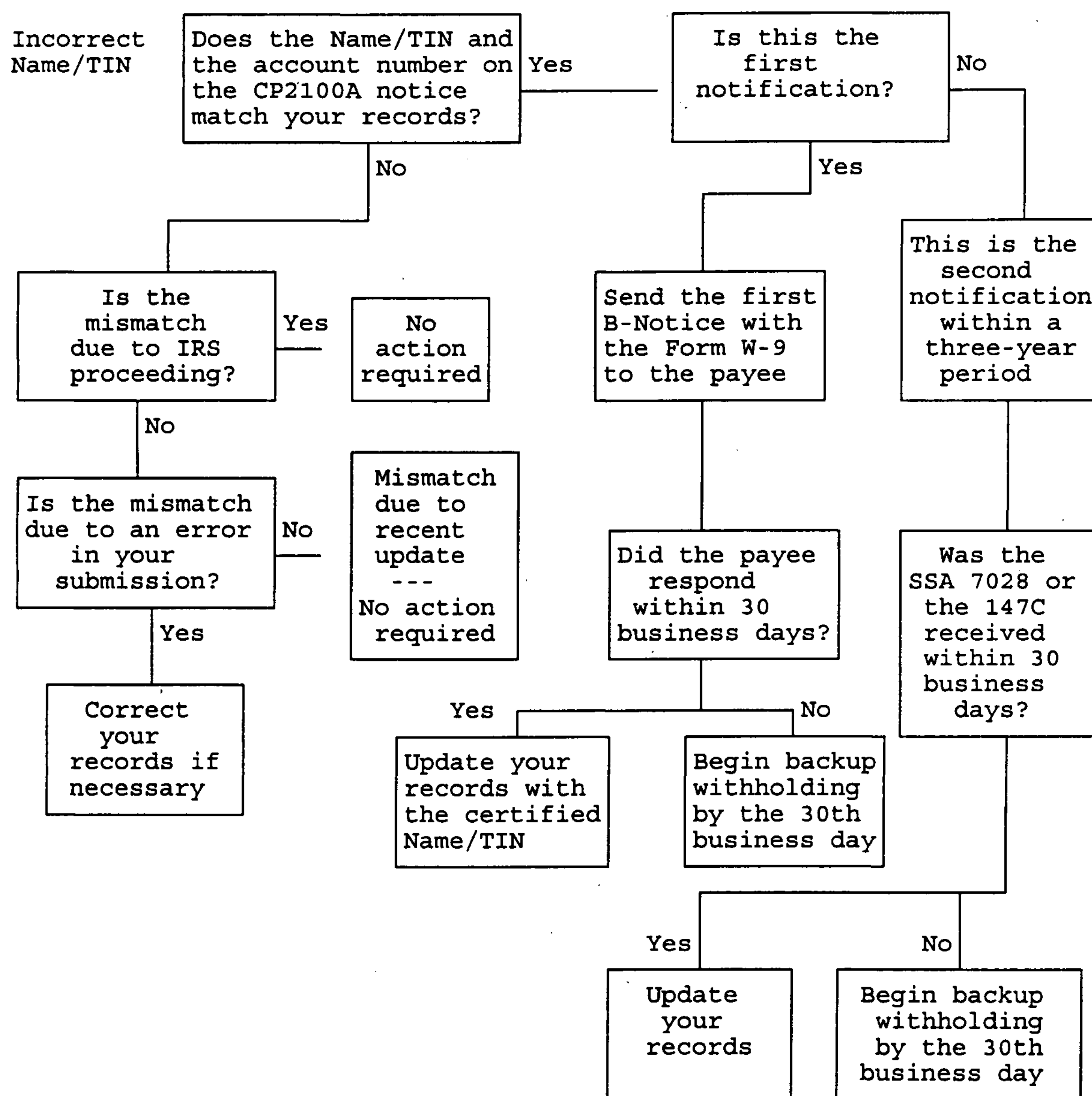
The system of backup withholding becomes applicable to a taxpayer who fails to give correct information regarding his taxpayer identification number (TIN) to the requester (payer), or if the internal revenue service (IRS) informs the requester that the reported TIN is incorrect, or if the IRS informs you that you are subject to backup withholding because of your failure to disclose correctly your interest and dividend income in your tax return, or if you fail to certify to the requester that you are not subject to backup withholding because of default in discloser of income, or if you have failed to certify your TIN.

In the event of incorrect TIN/name or missing TIN, the payer is required to send a notice to the payee for rectification of the same. If the latter fails to respond within 30 days, backup withholding becomes applicable. It is applied until correct TIN/name is obtained from the payee. The process is shown in Charts IV.1 and IV.2.

Certain payees and payments are exempt from backup withholding and information reporting. For example corporations are exempt from backup withholding for certain payments, such as interest and dividends. However, individuals (including sole proprietors) are not exempt from backup withholding.

Chart IV.1

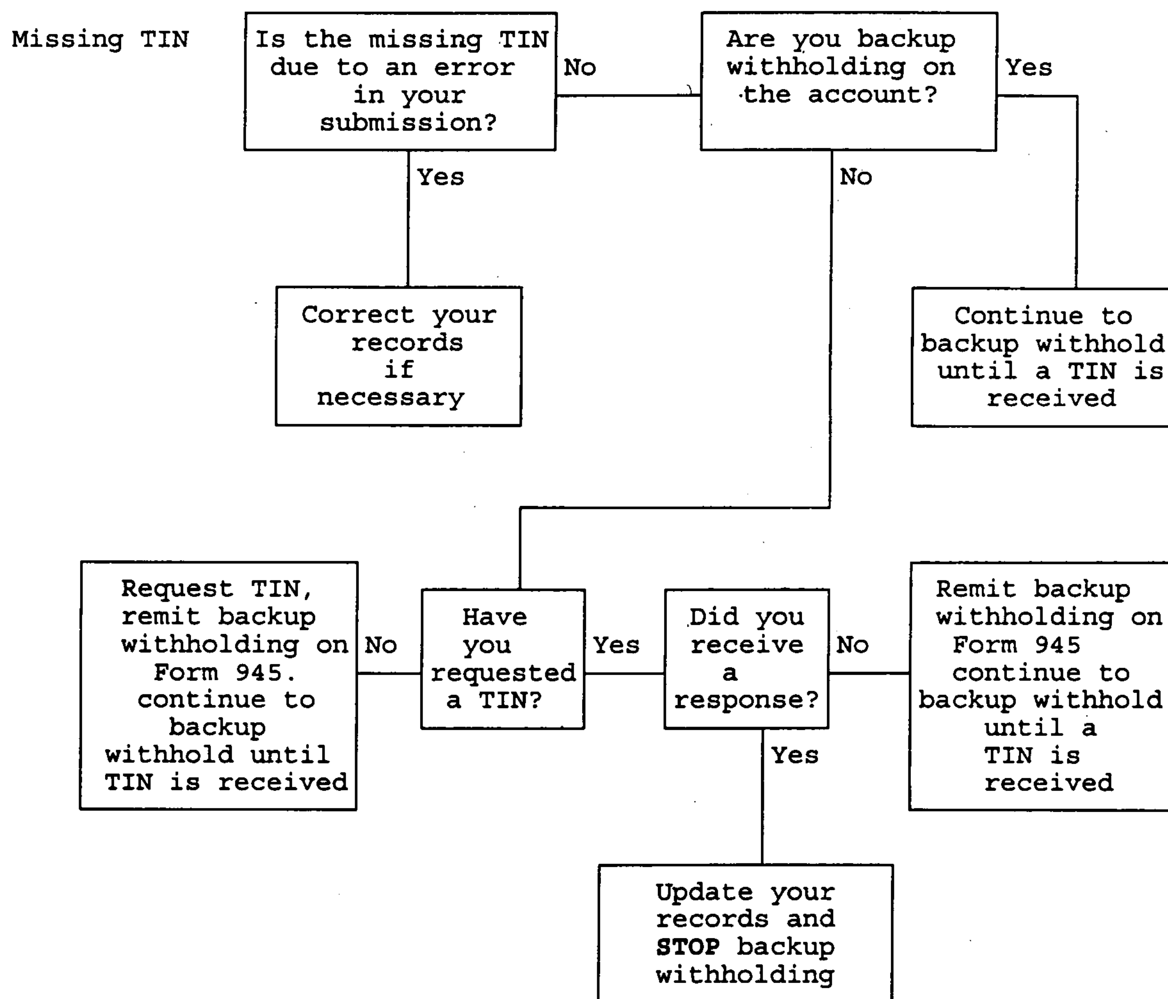
Backup Withholding for Reporting Incorrect Name/TINs



Source: A Guide to Backup Withholding, Internal Revenue Service, Washington, D.C.

Chart IV.2

Backup Withholding for Missing TINs



Source: A Guide to Backup Withholding, Internal Revenue Service, Washington, D.C.

IV.2.3 Prescribed payment system

A separate system applies for collecting tax at source from certain prescribed payments for work or services in specified industries, whereas those payments are not made under the PAYE system. This system requires the households to inform the commissioner on completion of a private contractor's project costing more than $ 10,000/-. These measures are collectively referred to as the prescribed payment system (PPS).

The PPS is quite separate from the PAYE system and it is the intension to avoid overlap between the two. The PAYE system continues to apply to payments to employees as such, and to various types of payments made to non-employees which are explicitly included in its scope. However, to the extent a payment to a non-employee falls within the PPS, that system will apply to the exclusion of the PAYE provisions. A payer who is liable, under a contract, to a prescribed payment must register with the Inland Revenue Service (IRS) by lodging a paying authority certificate within 14 days of entering into the contract. The payments to which the PPS applies are called prescribed payments. For prescribed payments the following rules must be satisfied: (i) there must be a payment; (ii) the payment must be made, or be liable to be made, under a contract for performance of work; and (iii) the work must consist of a specified type of activity carried out for "prescribed persons".

The payer must withhold tax at the rate of 20 per cent on prescribed payments. Tax will be deducted at a lower rate if the payee holds a current deduction variation certificate; and no tax at all is required to be deducted where the payee holds a deduction exemption certificate or where the payee has given an exemption number to the payer. On the other hand, tax may be deducted at a higher rate at the request of the payees. Where the payee has not furnished a "payee declaration" to the payer or the declaration is incomplete, tax must be deducted at the non declaration percentage rate of 48.25 per cent (for 1992-93).

A household who makes a prescribed payment in a domestic consumption project is not required to deduct tax from the payment. Where the value of the payment is more than $ 10,000, the household must inform the commissioner on completion of the project by lodging the householder's payment summary form that is required to be provided to the householder by the payee at the start of the project. There are no circumstances in which a householder, in that capacity, will be required to deduct tax from prescribed payments.

However, persons classified as "owner builders" are required to make deductions.

IV.2.3.1 Deduction variation certificate

Payee who wishes to have tax deducted from prescribed payments at a rate lower than the normal percentage (20 per cent) may apply to the commissioner for a deduction variation certificate. The certificate will be granted only when the commissioner is satisfied that: (i) the varied percentage is a reasonable estimate of the percentage that may apply to payees yearly receipts of prescribed payments; and (ii) the payee has satisfactorily complied with his tax obligations during the last 12 months.

A deduction variation certificate remains in force indefinitely unless it is revoked or a new certificate is granted. The commissioner may revoke a certificate at any time.

IV.2.3.2 Deduction exemption certificate

A payee is entitled to receive prescribed payments without any deduction of tax where he is a holder of deduction exemption certificate. The payee can apply to the commissioner for obtaining this certificate.

The commissioner will issue an exemption certificate where he is satisfied that the applicant has, for the previous three years, complied with a series of conditions relating to matters such as establishment of applicant's business, adequacy of records, establishment of business premises and conduct of financial transactions.

The commission has power to issue a deduction exemption certificate in special circumstances notwithstanding non-compliance with any of the conditions.

A deduction exemption certificate remains in force until it is revoked. The commissioner may revoke the certificate at any time. A person who is dissatisfied with the commissioner's decision, may lodge an objection against it.

IV.2.3.3 Reporting exemption approvals

Where a payee gives his reporting exemption number to the payer, the payer is not

required to deduct tax from prescribed payments made to the payee or report the payments to the commissioner.

To qualify for reporting exemption number, a payee is required to meet the same test as an applicant for a deduction exemption certificate. The commissioner is to notify the payee in writing, of the approval of the period for which the reporting exemption approval is in force. The period can not exceed three years.

The payee must report to the payer, in writing, the reporting exemption number and the day on which the approval ends.

IV.2.3.4 Effect on provisional tax and company tax instalments

Provisional tax continues to be payable on prescribed payments notwithstanding that tax has been deducted at source. However, in calculating the provisional tax for a particular year, based on the taxable income of the previous year, the deductions of tax which were made in that previous year will be taken into account. Similarly, a taxpayer will, under the self-assessment provisions, be able to have provisional tax recalculated to take into account the relevant income and source deductions which are made, or estimated to be made, during the current year.

A company, at the time of depositing corporate tax with the exchequer, can avail of tax credit for the tax paid at source under the PPS.

IV.2.3.5 Payment to the Exchequer

The amount of tax deducted by the payer must be deposited with the exchequer each month along with a completed remittance advice form. The payers must issue certificates of deduction of tax at source, on yearly basis, to the payees and send copies of the same to the exchequer.

IV.2.3.6 Penalties on defaulters

Both payer and payee obligations under the PPS are enforceable either by statutory penalties or court imposed penalties (imprisonment) resulting from prosecution. A person

who is dissatisfied with the commissioner's decision can lodge an objection against it.

IV.3 Information Reporting and Utilisation

In the United States, information reporting along with withholding has been effectively used in checking tax evasion. Most of the information obtained from third parties through information documents is stored on the computers. Most of the information is received on magnetic tapes. The information that is received on paper is coded, edited and transcribed to magnetic tapes. The information contained in the income tax returns filed by the taxpayers is matched with the third party information. The matching is accomplished by computers. This matching has been possible because of presence of social security numbers (SSNs) of individuals in the income tax returns as well as in the information documents supplied by the third parties. The efficacy of matching, however, depends on the accuracy of reported SSNs in all income tax returns and information documents.

The IRS has developed sophisticated computer techniques for linking the documents of husbands and wives by cross-referencing their SSNs. These techniques have been found useful in validating and correcting erroneous SSNs by comparing the payee documents.

The availability of information on computers has facilitated use of sophisticated techniques for selection of cases for audit. Their DIF system that assigns scores, in terms of probability of default in paying taxes, to different returns is known to be very successful in identifying suitable cases for audit besides its role in encouraging voluntary tax compliance.

Annexure

Operation of The Scheme of Tax Deduction at Source (TDS) in Selected States of India

1. TDS: Bangalore

The objective of our visit was to discuss the operation of the system of Income Tax deduction at source (TDS) in Karnataka. We met the Chief Commissioner (Mr. D. Lakshminarayana), Commissioner of Income Tax (Smt. Vijaya Mohanram) and other officers (Mr. Shekhar Reddy, Deputy Commissioner; Mr. Sanjay Verma, Computer In-charge; and Mr. R. Rao), and discussed operation of the system of TDS in Bangalore.

Smt. Vijaya Mohanram gave an overview of the operation of the system of TDS in Bangalore. She pointed out that TAN has been allotted to about 13,000 tax deductors and allotment of TAN is made within 24 hours of filing the application. Processing of TDS returns is done on the computer and adequate attention is paid to those defaulting in deduction of tax at source. In the year 1995-96, about 11,000 tax deductors filed the returns. To rest of the tax deductors letters were sent for calling an explanation for not filing the returns. Some of these deductors have reported to have filed the returns at other places and some have reported that they did not have any transaction warranting filing of the returns.

Some attempt is also made for identifying potential tax deductors who have not obtained TAN, on the basis of information compiled from yellow pages of the telephone directory and enquiries are made as to their failure in applying and obtaining TAN.

The computer personnel at Bangalore have developed software for processing TDS returns. For each taxpayer, tax that should have been deducted is computed in a spread sheet on the basis of selected characteristics of the taxpayer (such as income, investment eligible for tax credit under Section 88, income deductible under Section 80 L that is included in total income and rebate under Section 89(1), in the case of a salary earner) and compared with the actual tax deducted at source. The short/excess deduction cases are sorted out and complete information on them is entered into the computer in D-base. In the cases of short deduction (which are about 11 per cent of total cases) demand notices are issued for the short deduction, interest and penalty. A demand of Rs. 6.77 crore has been raised from the cases processed

during April 1995 to February 1996. TDS returns relating to both salary and non-salary cases are processed centrally. Computerization and careful processing of TDS returns has enhanced credibility of the department. Revenue Collections from TDS has increased from Rs. 200 crore in 1994-95 to Rs. 600 crore in 1995-96 and is expected to increase to RS. 1000 crore in the next year (1996-97).

We were informed that there are 15 types of return forms depending on the source of income subject to TDS. A tax deductor is required to file a separate return for each type of income subject to TDS. Certificates for receiving income without deduction of tax at source can be issued in respect of income from four sources (interest on securities, interest other than on securities, dividend, withdrawals from NSS)[3].

Challan processing is also done on the computer. Challans relating to the period upto December 1995 have been received and processed, lists of payment of tax by jurisdiction of ITOs have been prepared and sent to them. Information relating to total number of challans was not readily available, however.

In Bangalore, some innovative techniques have been adopted for expediting issuing of refunds and reducing the cost of administration of such cases. A system of batch processing of such cases has been adopted. In this system, a company having a large number of employees is contacted and its help is sought in entering the data relating to tax returns of its employees on its computer, and subsequently this information is processed and a list of refund cases is prepared. The refunds relating to employees of a company/institution are cleared through a single cheque with an instruction for crediting relevant amounts to the accounts of different employees/taxpayers. This saves substantial effort of the tax administration and the taxpayers are able to get a quick refund for the excess tax paid or deducted at source.

A simple exercise carried out by the department illustrates a high menace of filing false certificates for avoiding deduction of tax at source (forms 15, 15 G, 15 H and 15 I). An analysis of 15 H certificates filed with four companies for receiving interest without deduction of tax at source revealed that about 25 per cent of the depositors who filed these certificates had multiple deposits warranting deduction of tax at source. The number of

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3 In Bangalore, all the salary returns are processed on the computer.

persons for whom total amount of deposits exceeded Rs. 3 lakhs or interest exceeded Rs. 40,000 was 85. Information on total number of persons (not deposits) who filed 15H certificates was not readily available.

The computer centre comprises one SN 73 and fourteen PCs. The computer centre functions in two shifts. It has two Computer Programmers and a few data entry operators. We visited the Computer Centre. We were given an illustration of the software developed for processing TDS returns and preparing demand notices for short deduction of tax at source.

2. TDS: Calcutta

Meetings with Messrs. Samarpan Banerjee and K. Dehia, both Income Tax Commissioners revealed that the TDS mechanism in Calcutta was somewhat different from that of Bombay, in that salary and non-salary circles are not separated in Calcutta.

The following points emerged from the meetings:

1. The current computerised list of employers includes 85,000 tax deductors--this is expected to go up to one lakh when the list is improved.

2. The universe of taxpayers is attempted to be expanded through: (i) internal verification by assessing income tax officers (ITOs) of list of companies; and (ii) examination of the record of the registrar of companies, yellow pages, etc. Last year, for example, 65 tea companies were added to the list from the latter.

3. Per Section 203.A, companies and their branches are required to apply for TAN. When applications are received, computer generated numbers are allotted within two days. There is also suo moto application. In the absence of filing for application, there is a threat of penalty which, however, is rarely applied.

4. Assessees are required to file 14 different returns annually for different TDS Sections (i.e., different income sources) and on different dates. This not only makes extraordinary demands on tax deductors who are basically rendering a free service to government, but also makes monitoring by ITOs difficult.

5. Sections 201(1) and 201(1A) render interest withholding compulsory. On occasion, infractions are detected, for example, a recent detection of a case worth Rs 4 crore.

6. In 1994-95, the Calcutta office collected, on TDS account, Rs 567 crore on Resident Account. Approximately 100 companies plus 200 Directors, subject to the Central Excise Circle (which monitors all tax aspects of selected, special taxpayers), yielded Rs 60 crore. State TDS yielded Rs 30 crore (though the state government has the right to pay TDS by book adjustment instead of through challans). TDS submitted outside Calcutta, but belonging to Calcutta, yielded Rs 16 crore. Central government

departments--Railways, Telecommunications, other Central government agencies and departments--that are Calcutta-based pay TDS directly to the Delhi office, however.

7. TDS assessment is done on a selective basis. Errors are not detected very easily; investigation is essential for that. Of 44,000 deductors, 800-1000 are problem cases. Some certificates of TDS are defective; and a few are fraudulent, for example, recently a public sector company used the same number for different taxpayers, so that the income tax department refused to give refund for either. Interest is automatically charged in these cases; penalty is optional.

8. Refunds are a difficult area. From the data provided, of the total number of cases processed, approximately 25 per cent result in refunds. Recently, two groups of four inspectors each have been formed to improve efficiency. Also, ITOs have checked their records (DNCR) and noted the amount refundable to taxpayers. On the whole, 18,000 pending cases were detected from all ranges. Mr. Dehia made December 31, 1995 as the deadline for refunds. All cases other than about 200 were terminated. Interest was also paid with the refunds, at 15 per cent. It was felt that the Receipts Clerks should also inspect the returns as they come in, so that the amount of refund could be detected immediately in simple cases. This was not currently being done. [4]

9. Other problem areas include: (i) TDS of expatriate incomes which are usually shown as a fraction of their presumptive incomes, requiring letters from the Commissioner to multinationals; (ii) conflicting directives from the Central Board of Direct Taxes (CBDT), for example, recently in the case of warehouse businesses for which two directives had been issued, first, that TDS be applied on the basis of rental income (section 194i) which stipulates a 20 per cent TDS and, second, on the basis of contract income (section 194c), which stipulates a 2 per cent TDS; (iii) erroneous CBDT opinions, for example, application of TDS from non-refundable rental deposits but not from refundable deposits even though the latter yields interest income; and (iv) unlike in Bombay, in Calcutta deductors are not using floppies, even though the income tax department had written to 200 companies regarding this matter.

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[4] Mr. Jhunjhunwala, a Birla firm executive, who was visiting the Commissioner's office, commented that this was happening in Madras and that, while TDS operations had vastly improved in Calcutta, some emulation could be made based on the practices in Madras.

10. The Calcutta office claimed that it was the only one that prepared a projection for TDS collection by Section. The author was given a copy of the projections for 1995/96. When inquired if the actual collections were also available by Section, it was told that it was not since all challans--from different sources--were consolidated before entering the collection information.

3. TDS: Mumbai

The objective of the visit was to discuss the operation of the system of income tax deduction at source (TDS) in Maharashtra. We had four sessions of discussions, first with the Chief Commissioner Income Tax (Mr. G.S. Sidhu, Aaikar Bhawan), second with Commissioner of Income Tax-Range 11 (Mr. Damodar Agarwala, Central Building), third with the Commissioner of Income Tax- Range 12 (Mr. C.M. Betgiri, Bandra Corolla Complex) and fourth with the Commissioner of Income Tax-Computers (Mr. D.P. Panta, Bandra Kurla Complex).

Mr. Sidhu gave an overview of the operation of TDS in Mumbai. He pointed out that it has not been possible to pay adequate attention to those defaulting in deduction of tax at source. Not much progress has been made as to computerization of TDS. Processing of tax returns relating to TDS is done manually. A computer package for processing of returns relating to TDS is being developed by Mr. R.R. Singh, Director Systems, Delhi. Verification of claims regarding deduction of tax at source is based on the certificates accompanying a tax return. However, no cross-verification is attempted by crossing information with the origin of the certificates.

Regarding refund cases, most of these relate to interest or dividend. Mr. Sidhu pointed out that, by convention, there are two types of refund cases - direct refunds and indirect refunds. By convention, a refund claim by a taxpayer with income below the exemption limit is referred to as direct refund. Generally, a direct refund case does not require scrutiny and the refund orders can be issued quickly, whereas an indirect refund claim needs to be looked into more carefully. Earlier all the refund cases were being looked into by Bombay Refund Circle. From the current year the refund circle has been decentralized. The refund cases are being dealt within their respective jurisdictions. As a result, the indirect refund cases are being looked into more carefully. This seems to have resulted in a decline in the number of refund cases. [5] Settlement of appeals in arrears also results in many refund cases. No separate account is kept relating to direct and indirect refunds.

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[5] For some jurisdictions, they have been reported to be zero. The validity of this information is being looked into.

Mr. D. Agarwala, incharge of TDS salary only, made the following points. First, there are separate tax return forms relating to TDS from salary and other income, implying that a company has to deal with two commissioners - salary (TDS) and non-salary (TDS). Second, it was important to make available at an early date a computer package for processing tax returns relating to TDS even at the cost of precision. Without quick computerization, TDS would be a failure. He also informed us that processing of TDS returns is already computerized at Bangalore and is being computerized at Pune. He expressed dissatisfaction at its pace in Mumbai. Third, efforts are being made to improve compliance with the provisions of TDS. With a view to apprise the tax deductors about the enlarged scope of TDS, courses are conducted at the regional centres for private sector representatives. Two such courses have already been conducted. The requested statistics relating to TDS were not readily available. Mr. Agarwala promised to provide this information by January 8, 1996 (salary cases).

Mr. Betgiri, incharge of refunds, emphasized the need for issuing refund orders promptly. In fact,, this is the requirement of any broad- based system of TDS. Currently, tax challans from banks are processed on the computers. As on date, cash book by Commissioner's charge was ready up to September, 1995. Interestingly, simple information requested such as total number of refunds, refunds by source of income etc. were not available. Mr. Betgiri promised to give the required statistics by January 8, 1996 (non-salary cases).

Mr. Panta gave us an overview of computerization of income tax department in Mumbai. Commissioners and some Deputy Commissioners have individual PC's connected to the local network. He indicated that permanent account numbers (PAN) of the taxpayers will have to be given in the return forms relating to TDS without which cross verification of tax claims will be difficult. Regarding allotment of PAN's, about 6.25 lakh forms have been received as against 8.69 lakh returns filed. This has been possible because of various steps taken in this regard such as setting regional counters for helping the taxpayers in filling up the forms and collecting the forms at the spot, advocating that it will be useful for taxpayers to have a PAN as it will help matching challans with individual's returns and facilitate expeditious refund system, arranging meetings with business associations and personal visits by the officials to the taxpayers. The contribution of the last strategy has not been significant.

So far, about 1.2 lakh PAN forms have been processed and about 1 lakh taxpayers

have been allotted PAN's. As PAN is being allotted centrally and the computer system is not 'on line' between Delhi and Mumbai, the necessary information is transferred through physical movement of floppies. Mumbai is expected to be 'on line' with Delhi on any day. This will facilitate expeditious allotments of PAN's. Mr. Panta is hopeful of allotting 6 lakh PAN's by June, 1996. PAN cards are also being issued to the taxpayers which has been viewed as a welcome step. Though the process of issuing PAN cards is slow.

Regarding personnel for data entry, 85 persons with 10+2 qualification have been appointed in the scale of LDC (i.e., at a gross salary of about Rs. 3000/- per month). It is possible to contract out the work relating to data entry, but no estimates are available as to cost effectiveness of these alternatives. Programmers are given the scale of class A officers. For them, there was always the fear of absorption by the private sector reflecting its higher salaries. Nevertheless, some good programmers still enter government service due to its prestige, security and perhaps housing facilities.

4. TDS: New Delhi

On the basis of discussion with the income tax officials at Delhi and examination of some registers/documents, the following observations can be made:

1. Allotment of TAN is generally up to date. Only the time taken in intimation is involved. The time lag is less than one week. No control registers were maintained in the earlier years. A beginning has made in 1995 to maintain such registers on computers. Out of about 62000 tax deductors 50 per cent are covered by control registers.

2. Total number of TAN's allotted upto 30.6.95 is 28,939 and 28,606 in ranges 22 and 23. In range 22 the actual returns received till date number 20930.

3. The staff deployed consists of Additional Commissioner who is a Senior Deputy Commissioner as incharge of the Range 22 with one A.C. and 9 ITOs. Each of these 10 assessment units has on an average 2500 returns. In Range 23 position is reported to be similar.

4. The Additional Commissioner is assisted by one Steno, one Inspector, one LDC and half T.A. Each of the assessment unit consists of the Assessing Officer with one TA/UDC, one LDC, half Steno, half Notice Server and half Peon.

5. The number of returns received in Range 22 for each of the provisions relating to TDS not readily available. Shri Negi, Additional Commissioner promised to furnish details later.

6. Processing of returns as seen from the registers of one of the wards 22(6) of range 22 showed 226 cases wherein checking did not show any under payment and 70 cases where additional demand was created mostly in form of interest under Section 201(1A). *Thus only about 12 per cent of the returns have been checked so far and in about 23 per cent of those checked additional demand of Rs 288(000) has been created.*

7. The details of payments made by the tax deductors are received from CTU with a

considerable time lag. The details of aggregate collection upto June 1995 had been received. Partywise details have not been received during the year.

8. While verifying the returns credit is given on the basis of the challans submitted by the tax deductors. The returns under Section 206 provide for information on monthly payment of tax. Attempt is being made to levy interest under Section 201(1A) for deferred payments.

9. Computerisation is almost nil in so far as working of the TDS is concerned. The CIT has received software for checking calculations. This is yet to be used.

10. According to CIT/Additional CIT focus is to ensure checking of returns showing payment of Rs. 5 lakhs or above, in the first instance.

11. The budget collection in the range 22 was 9.5 crore approximately. As against this the brought forward arrear demand is Rs 16.75 crore. Rs 12 crore out of this relates to big institutions like IAC and Oil India. Taxability of certain allowances is the point of dispute. Matters are before the Committee of Secretaries.

12. Information system consists of submitting quarterly reports to the CBDT on the prescribed proforma. There is no other report submitted to any other authority. The format of quarterly report shows that the number of entries in the returns is not indicated. It is not, therefore, possible to have a precise idea of the workload as also the number of persons who should be paying income tax. Number of returns received, verification of the returns, creation of additional demand, levy of interest and penalty and recovery of demand are monitored in this quarterly statement.