Inspira-Journal of Commerce, Economics & Computer Science (JCECS)
ISSN : 2395-7069 General Impact Factor : 2.0546, Volume 03, No. 04, Oct.-Dec., 2017, pp. 351-354

DEMONETIZATION : TAX SCENARIO AND CHALLENGES

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ABSTRACT

Stronger the ills, stronger the pills! It was in line with this thought that on November 8, 2016 the Prime Minister gave a call for demonetization of high value Indian currency. It was a major decision and it impacts all the citizens of the country. So this paper proposes to deal with the emerging tax scenario in the wake of this demonetization, in particular the tax implications of deposit of those illegal tenders in banks. It is also pertinent to note that in view of the emergence of law keeping in tune with the present times the case law relating to the previous demonetizations have become redundant and may not be much use. For this purpose researcher used secondary sources and accessing website.

KEYWORDS*: Demonetization, Economy, Emerging Tax Scenario, Tax Implications.*

Introduction

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency: The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes, a country completely replaces the old currency with new currency.

First Demonetization: January 12, 1946

The idea seems to have come from the colonial master Britain where 10 Pound notes were called back:

Soon after the war, while Government were giving attention to ways and means of averting the expected slump, thought was also given to check black market operations and tax evasion, which were known to have occurred on a considerable scale. Following the action in several foreign countries, including France, Belgium and the U.K., the Government of India decided on demonetization of high denomination notes, in January 1946. It is interesting that as early as April 7, 1945, in an editorial on the tasks before the new Finance Member, Sir Archibald Rowlands, the Indian Finance referred to the action of the Bank of England in calling in notes of ₤ 10 and higher denominations and suggestedsimilar action in India as ‘one more concrete example for the Indian Government to follow in its fight against black market money and tax evasions which have now assumed enormous proportions’.

Second Demonetization: January 16, 1978

The Finance Minister H.M. Patel in his budget speech on 28 Feb 1978 remarked:

The demonetization of high denomination bank notes was a step primarily aimed at controlling illegal transactions. It is a part of a series of measures which Government has taken and is determined to take against anti-social elements. As the FM did not say anything about the success of the exercise, one can almost guess that it did not create much impact like in 1946.

The Ordinance provided that all banks and government treasuries would be closed on 17 January 1978 for transaction of ‘all business except the preparation and presentation or the receipt of returns’ that were needed to be completed in the context of demonetization. For purposes of the Negotiable Instruments Act, 1881, 17 January 1978 was deemed to be a public holiday notified under the Act. This time public was given even lesser time of 3 days to exchange Rs 1000, Rs 5000 and Rs 10000 notes.

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Third Demonetization: November 8, 2016

In 2016, the Indian government decided to demonetize the 500- and 1000- rupee notes, the two biggest demonetizations in its currency system; these notes accounted for 86% of the country's circulating cash. With little warning, India's Prime Minister Narendra Modi announced to the citizenry on Nov. 8 that the notes of Rs 500 and Rs 1000 "will not be legal tender from midnight tonight" and these will be "just worthless pieces of paper. PM also urged people to 'join this mahayajna against the ills of corruption.

Reasons

As per the Notification No. S.O.3707(E), dated 8th November 2016, by the Department of Economic Affairs of Ministry of Finance, the reasons for demonetization are:

- Difficulty in identifying fake currency notes and the use of fake currency notes causing adverse effect to the economy of the country.
- Fake currency being used for financing subversive activities such as drug trafficking and terrorism, causing damage to the economy and security of the country and
- High denomination notes are used for storage of unaccounted wealth as has been evident from the large cash recoveries made by law enforcement agencies.

Review of Literature

Some studies related to demonetization were reviewed and their important insights are being highlighted here:

Mali (2016) explained that demonetization though it has created some positive and some negative imparts on different sectors but in long run it definitely will have positive impact in controlling black money and fake money.

Kaur (2016) explained this move would be positive for sectors like banking and infrastructure in the medium to long term.

Objectives of the Study

This study has the following objectives:

- Emerging tax scenario
- Other advantages and disadvantages.

Research Methodology

The paper is based on the secondary data. The secondary data was collected from various published sources like reports, magazines, journals, newspapers and the like etc.

Provisions of Income Tax Act, 1961 Regarding Demonetization

There were suggestions that the unaccounted SBN can be declared as income of the financial year 16-17 for the tax purposes and tax paid @30% under Section 115BBE. It was also suggested that in such cases, no penalty can be levied under the existing tax laws. The Government noted the concerns that the some of the provisions of the Income-tax Act, 1961 could be used for conversion of black money. The Government therefore quickly proposed necessary amendments to the Income-tax Act, 1961 through the Taxation Laws (Second Amendment), so as to ensure that the defaulting assesses are subjected to tax at a higher rate and stringent penalty provision.

Enhanced Tax and Penalty in Sections 68 TO 69 D

The incomes of the nature as above are at present charged to tax at a flat rate of 30% as per Section 115 BBE, without allowing any deductions, expenditure or set off of loss against such Incomes.

The Bill proposes to insert a new sub-section (1) containing two clauses in Section 115BBE effective from the Assessment Year 2017-18 that is

- Where the total income of the includes any income referred to in Section 68 to 69D and reflected in the return of income furnished under Section 139;
- Where the total income of an assessee determined by the Assessing Officer includes any income referred to in Section 68 to 69D, if such income is not covered under clause (a).

It is proposed that in both the above cases the rate of tax will be 60%. Further the rate of tax will be subject to surcharge of 25% of the tax making the total tax and surcharge at 75%. The total tax liability including education cess will be 77.25%.

The intention of the new clause (a) of Section 115BBE (1) is to secure that even if the income under Section 68 to 69D is offered by the assessee in the return of income, the rate of tax will be 60% plus surcharge. This effectively negates the suggestions in some quarters that the unexplained income represented by SBN can be offered as income from other sources for the Assessment Year 2017-18 and tax @ 30% paid under Section 115BBE as it exists now.

Enhancement Tax and Penalty in Search Cases

The tax and penalty payable in search cases is also proposed to be made stringent. In respect of any Search initiated after the Taxation Laws (Second Amendment) receives the assent of the President of India, the penalty under the new sub-section 271AAB(1A)(a) will be 30% of the undisclosed income, if all the following four conditions are satisfied:

- The assessee in course of the search, in a statement under Section 132(4) admits the undisclosed income and specifies the manner in which such income has been derived;
- The assessee substantiates the manner in which the undisclosed income was derived;
- The assessee pays the tax, together with interest, if any, in respect of the undisclosed income; and
- The assessee furnishes the return of income for the specified previous year declaring such undisclosed income therein.

Tax Implications of Demonetization

From a tax point of view, the specified bank notes that would be deposited into Banks can classified into the following three broad categories:

- **Accounted Money:** Accounted money held in cash for various legitimate requirements, the source of which can be clearly explained with reference to contemporaneous Books of Accounts maintained and disclosed in the tax returns filed.
- **Explainable Money:** Money held in cash for various legitimate requirements, the source of which can be reasonably explained with reference to incomes/assets/transactions disclosed in the Tax returns filed for the earlier years though Books of accounts are not maintained/are not required to be maintained by law.
- **Unaccounted Money:** Unaccounted money or Black money representing income earned or moneys received through transactions such loans, gifts, etc., which are not disclosed in Tax returns, and held in cash without depositing in Bank to avoid/evade tax.

It is possible that a Person may possess specified bank notes representing combination of any one or more of the categories (i) to (iii) above.

It may not be surprising that the Black Money as in category (iii) above could be held by different sections of the Society and not confined to business entities.

Out of the three categories identified above, those falling in the category of Accounted Money, who have maintained contemporaneous Books of Accounts and other records such as Invoices, Excise Records, VAT records, or other verifiable records and have deposited the specified bank notes held as per the Books of Accounts will obviously have no tax liability on such deposits and the proposed Section 115BBE will have no application. There is no limit on the value of such deposits as the sources in such cases are verifiable from the Books of Accounts. The above proposition, of course, cannot hold good in such cases where the Books of Account have been found to be manipulated. Such cases of manipulation will not only attract the tax and penalty of 83.25 % under Section 115BBE but would also invite Prosecution proceedings.

The specified bank notes to the extent it is not accounted for or is not explainable will attract the provisions of Section 69A and will be deemed to be the income of the financial year in which the assesse is found to be owner of such money which in this case would be the financial year 2016-17. This would trigger the enhanced tax and penalty under the proposed Section 115BBE. It is also to be noted that such specified bank notes cannot be offered as " Income from other sources" since any income referred to Section 68 to 69D is an income by deeming fiction and cannot be taken as income under specific head of income.

Advantages of Demonetization

- The biggest advantage of demonetization is that it helps the government to track people who are having large sums of unaccounted cash or cash on which no income tax has been paid because many people who earn black money keep that money as cash in their houses or in some secret place which is very difficult to find and when demonetization happens all that cash is of no value and such people have two options one is to deposit the money in bank accounts and pay taxes on such amount and second option is to let the value of that cash reduced to zero.

- Another benefit is that due to people disclosing their income by depositing money in their bank accounts government gets a good amount of tax revenue which can be used by the government towards the betterment of society by providing good infrastructure, hospitals, educational institutions, roads and many facilities for poor and needy sections of society.

Disadvantages of Demonetization

- The biggest disadvantage of demonetization is that once people in the country gets to know about it than initially for few days there is chaos and frenzy among public as everybody wants to get rid of demonetized notes which in turn sometimes can lead to law and order problem and chaotic situation especially in banks and ATMs which are the only medium to change the old currency units to new currency units.
- Another problem is that majority of times this move is targeted towards black money but if people have not kept cash as their black money and rotated or used that money in other asset classes like real estate, gold and so on then there is no guarantee that demonetization will help in catching corrupt people.

Conclusion

Demonetization is generally seen as provider of a big boost to national interests by discouraging parallel economy on one hand and giving a much needed push to the cashless economy on the other. If a significant amount of black money held as cash comes into the banking system, the government will be able to utilize the resultant trail to boost tax collections in the longer run.

But some economists point out to some short term risks, particularly including a dip in the December quarter GDP growth and corporate performance. In the first policy review post demonetization, the Reserve Bank of India has already lowered the GDP growth forecast to 7.1% from 7.6%. Moreover, if money supply declines temporarily because of the demonetization, then assuming no immediate change in velocity of circulation, we would either see some deflationary tendencies or lowering of real demand (economic activity). The demonetization could rewrite some macro parameters.

However, the demonetization is likely to have several spin-offs for Asia's third largest economy, including lowering inflations, improving tax to GDP ratio, raising public investments and could lead to healthy public finances. The sectors with large exposure to cash like real estate, transport and food could witness downward price pressures. In the long term, however, the demonetization could change the face of Indian economy, improve the government's financial position and tax compliance.

While the Government's resolve to fight black money is loud and clear, it is equipped with adequate authority to deal stringently with the black money holders. The Government agencies are fully involved in implementation of the law and achieving the objectives of the Government. All the escape routes for the tax evaders have been closed. There seems to vbe a new dawn.

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