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Centre For Legal Policy

BETTER LAWS. BETTER GOVERNANCE

RESEARCH REPORT ON QUERIES RAISED BY THE FOURTEENTH FINANCE COMMISSION

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1. ON WIDENING THE TAXING POWERS OF THE STATE

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Introduction

Two queries have been raised by the Fourteenth Finance Commission for our consideration:

1. Scope for levy of a surcharge on Income Tax by State Governments.
2. Scope and approach to amend the constitutional provision to levy professional tax by States in terms of enhancing the rates prescribed. Secondly, will it be in the spirit and design of the constitutional framework to make the amount of professional tax to be open-ended to the extent that the amount can be prescribed from time to time by the Central Government through a simple notification, say at an interval of three years, without resorting to a constitutional amendment every time the enhancement has to take place.

In this note, our observations and recommendations with regard to the above mentioned queries are along the following lines:

1. States do not have the power to impose a surcharge on income tax collected by the Centre.
2. An amendment to the Constitution permitting the State to impose such surcharge on income tax would not be feasible without consensus between the Centre and the States on the basis of charge, collection mechanism, and tax revenue distribution.
3. The limit of Rupees Two Thousand Five Hundred may be increased by Parliament by amending the Constitution along the lines suggested below to allow for the limits on amount of professional tax payable by a person to be imposed by law made by Parliament, subject to certain procedural safeguards to ensure that the amendment does not change the federal character of the Constitution.

Section 1 of this Note deals with the feasibility of imposing a surcharge on income tax. Section 2 deals with the feasibility of amending the Constitution to increase the limit of professional tax that can be imposed. Lastly, Section 3 summarises and concludes this note.

1. Feasibility of imposing a surcharge on income tax

During its deliberations with the various State Governments in the course of preparing its report, we have been informed that the Fourteenth Finance Commission (“the Commission”) received requests from certain States seeking the power to impose a uniform surcharge on income tax payable under the Income Tax Act, 1961. This section of the Note is thus divided into two sub-sections; one dealing with the legality of this proposal under the present constitutional scheme; the second dealing with the feasibility of any proposal to amend the Constitution for this purpose.

1.1. Constitutional position on income tax

The power to impose taxes on income is vested in the Union Parliament under clause (1) of Article 246 read with Entry 82 of List I of the Seventh Schedule of the Constitution of India. As such, being an entry in List I, i.e. the "Union List", the State Legislature will have no power to legislate on this subject matter, and therefore, State Legislatures cannot impose a tax on income.

However, State Legislatures are empowered under clause (3) of Article 246 read with Entry 46 of List II of the Seventh Schedule of the Constitution of India, to impose taxes on agricultural income. Therefore, the power of the State Legislature to impose a tax on income is limited exclusively to the agricultural income of persons, whereas the Union Parliament has the power to tax income from all other sources except agricultural income. In this context as well, it is relevant to note that clause (1) of Article 366 vests Union Parliament with the power to determine what is "agricultural income" in the income tax law.

In tax law, a "surcharge" means an additional imposition which results in enhancement of the tax and the nature of the additional imposition is the same as the tax on which it is imposed.[1] Therefore, the power to impose a surcharge is concomitant with the power to impose the tax itself in the first place. Absent the power to impose the tax, there is no power to levy a surcharge on such tax.

In the specific context of taxation of income, this principle was clarified by the Supreme Court of India in *CIT* v. *K. Srinivasa,*[2] where it was held that:

> "**9.** As mentioned before the legislative Entry 82 in List I relates to taxes on income other than agricultural income tax, super tax and surcharge would all fall under this entry. It is in exercise of the legislative power conferred by that entry that the Union Parliament enacts the provision in the Finance Act each year relating to them."[3]

Therefore, absent the legislative power to levy income tax, there is no legislative power to impose a surcharge on such income tax. State Legislatures therefore do not have the power under the Constitution to impose a surcharge on income tax levied by the Union Parliament.

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[1] *Bisra Stone Lime Co* v *OSEB* (1976) 2 SCC 167, 170 para 11, followed in *Sarojini Tea Co (P) Ltd* v *Collector of Dibrugarh (1992) 2 SCC 156, 164 para 16.*

[2] (1972) 4 SCC 526

[3] *Ibid* at page 530 para 9.

1.2. Feasibility of proposal to allow State Legislatures to impose a surcharge on income tax

In light of the above legal position, this section will try to answer the question of whether it would be feasible to amend the Constitution appropriately to permit State Legislatures to impose a surcharge on tax on income. Such a proposal would theoretically involve the insertion of a separate entry into List II of the Seventh Schedule allowing the States to impose a surcharge on income tax.

We do not feel that such a proposal is, at present, feasible within the existing constitutional structure for the following reasons:

First, there is no instance of any tax which can be imposed both by the Centre and by the State Governments. List III of the Seventh Schedule i.e. the "Concurrent List", which gives concurrent legislative powers to the Parliament and State Legislative Assemblies, does not contain any entry on taxation. It is well-established law that in the absence of a separate entry permitting taxation, the mere power to make law on that subject matter does not imply the power to impose a tax on that subject matter.[4] Consequently, there is no area where both the State and the Centre have the power to impose a tax.

Second, even if there were to be a provision permitting the Centre and the States to levy a tax on the same subject matter (as is being attempted to be done in the context of the Goods and Services Tax regime), the same cannot be introduced in the absence of consensus between all the States and the Centre on a number of key issues, namely the basis for taxation, allocation of tax revenues between Centre and States, and a collection mechanism for the tax, as discussed below:

1.2.1. Basis for Taxation

There are two bases for income taxation in India: source and residence. All persons, whether individuals or companies, resident in India according to the tests laid down in Section 6 of the Income Tax Act, 1961 will be taxed on their incomes accruing and arising anywhere. For those persons who are non-residents, only their incomes which accrue or arise in India are brought to tax.

At present, there is no concept of sub-national residency within the Income Tax Act. Residency of an individual for instance is determined under Section 6 of the Income Tax Act on the basis of the following criteria:

1. Whether they have been in India for at least one hundred and eighty two days in the "previous year" or

[4] *MPV Sundararamaier v State of Andhra Pradesh* AIR 1958 SC 468 and *State of West Bengal v Kesoram Industries* (2004) 10 SCC 201, 312-3, paras 108-110.

2. Whether they have, within the four years preceding the “previous year”, been in India for an overall period of at least three hundred and sixty-five days, and at least sixty days in the “previous year”.

Likewise, for source-based taxation of income accruing or arising in India to non-residents, there is no further basis to classify sub-nationally where such income arises from.

The issue of residency and source become crucial in the context of income taxation since a State cannot, by definition, extend its laws beyond the boundaries of the State. There is no material yet to suggest any concrete definition of “residence” or “source” which can be applied to surcharges on income tax imposed by a State. Absent a common and coherent definition of “residence” and “source”, a surcharge on income tax by States will only lead to confusion and difficulty for taxpayers.

1.2.2. Collection of Income Tax Revenues

At present, income taxes are collected by the Centre and apportioned between the Centre and the States, in accordance with the provisions of clause (1) of Article 270, on the basis of the Finance Commission’s recommendation. State Governments do not have a mechanism to collect such a surcharge on income tax, let alone provisions to collect tax deducted at source or advance tax. There is every likelihood that without consensus on how such taxes are to be collected, there will be a repeat of the difficulties caused when all States sought to impose sales tax on inter-state and international sales.[5] It was for this reason also that the Constitution had to be amended to make it clear that the Centre was the only entity which had the power to impose sales tax on inter-state sales.[6]

Even in those federal systems where the power to tax income is given to both Federal and State Governments, we find that there are vastly different mechanisms at the Federal and State level for levy and collection of taxes. Two examples that of the United States of America and Canada, are discussed here briefly to highlight the differences in tax administration.

In Canada, the constitutional authority for the Federal income tax is found in Section 91 paragraph 3 of the Constitution Act, 1867, which assigns to the Federal Parliament power over "The raising of Money by any Mode or System of Taxation". The constitutional authority for the various provincial income taxes is found in Section 92 paragraph 2 of the Constitution Act, 1867, which assigns to the Legislature of each

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[5] The Constituent Assembly, in inserting Article 286, was also aware of these difficulties. *See* Constituent Assembly Debates, Volume 10, speech by Dr Ambedkar, 16th October, 1949, available at <http://164.100.47.132/LssNew/constituent/vol10p9.html> accessed on 26 September, 2014. Also *see Bengal Immunity Co v State of Bihar* (1955) 2 SCR 603, para 39 where the Court observes that such chaos continued post-Constitution as well.

[6] *See MPV Sundararamaier v State of Andhra Pradesh*, *supra* note 4.

Province the power of "Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes".[7]

The system of collection of income tax by Provinces and territories and the Federal Government is harmonised through "tax collection agreements". The Federal Government, through the Canada Revenue Agency ('CRA') collects personal income taxes on behalf of all Provinces and territories except Quebec and collects corporate income taxes on behalf of all Provinces and territories except Alberta and Quebec. Provinces and territories that have entered into tax collection agreements with the Federal Government for collection of personal/corporate income taxes must use the federal definition of "taxable income" as the basis for their taxation. This means that they are not allowed to provide or ignore federal deductions in calculating the income on which Provincial tax is based. If any refunds need to be given to taxpayers, the CRA is the source of all such refunds, whether of Federal or Provincial taxes.[8]

Conversely, in the United States, each State has its own elaborate mechanism for levy and collection of income taxes in addition to the Federal income tax. The States' power to impose income taxes however is traceable not from the United States Constitution which vests power to impose taxes on income only on Congress,[9] but from the individual States' Constitutions which vest legislative power of the State in the respective State Legislatures.[10]

While the examples of Canada and the United States are possibly the two extremes on how to implement concurrent taxing powers between Centre and States, they show that there needs to be some level of consensus on how such taxes should be collected at the State and Central level.

1.2.3. Allocation of Tax Revenues

Another aspect of this issue that needs to be highlighted here is that at present the States have a share in the income taxes levied and collected by the Centre with allocations determined by the Finance Commission. If States are also empowered to levy and collect income taxes in parallel with the Centre, in order to impose a surcharge, then the existing scheme of apportioning of tax revenues between Centre

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[7] This, the Courts in Canada have held to mean that "an income tax is the most typical form of direct taxation". *See Forbes v A.-G. Man.* [1937] A.C. 260,268

[8] Structure and Operational Framework, The Canadian Revenue Agency. Available at <http://www.cra-arc.gc.ca/gncy/bkgrd-eng.html> accessed on 26th September, 2014.

[9] Sixteenth Amendment of the United States Constitution, which reads, "Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

[10] Constituent Assembly Debates, Vol. 9 part 8b, Speech of Dr. BR Ambedkar, 9th August, 1949. Available at <http://parliamentofindia.nic.in/ls/debates/vol9p8b.htm> accessed on 7 October, 2014.

and State will have to be re-looked in its entirety, especially since an existing source of revenue for the Centre is now being carved out for the States.

The implementation of the proposal would therefore require amendment of the Constitution to allow both State and Centre concurrent power to impose income taxes and also recast the present structure of sharing of revenues between Centre and States. However, this cannot be undertaken without consensus between the Centre and the States, not just on rates, but also on the basis of taxation, whether residence or source, and the common collection mechanisms, somewhat similar to the procedure being presently adopted in the context of the Goods and Services Tax. The process through which such amendments are introduced will have to take place under proviso to clause (2) of Article 368 requiring the assent of at least half the State Legislatures in order to take effect.

To summarise the above discussion:

1. It is not permissible under the Constitution for a State Legislature to impose a surcharge on income taxes paid to the Centre.
2. Amendment of the Constitution to permit a State Legislature to impose such a surcharge can only be carried out once there is consensus between the Centre and States on the following issues:
    a. Basis of surcharge, specifically whether source or residence and how to define source and residence in the context of a State.
    b. Mechanism for the collection of surcharge by the States.
    c. Allocation of tax revenues from income taxes.

In the absence of consensus on the above three issues, vesting power in the States to impose income taxes would be premature.

2. Feasibility of increasing the limits for imposition of professional tax

This query has been divided into three separate sub-sections which are dealt with below. The sub-sections 2.1 and 2.2 deals with the feasibility of increasing the limit for the imposition of professional tax in a State; while sub-section 2.3 looks at whether such limits may be left to the Union Parliament to increase from time to time.

2.1. Raising the limits of professional tax

2.1.1. History of the power to levy professional tax

The power of the State Legislature to impose a professional tax can be traced to Entry 60 of List II of the Seventh Schedule, i.e. the “State List”, read with clause (3) of Article 246 of the Constitution of India.

Entry 60 speaks of "taxes on professions, trades, callings and employment". This is different from Entry 26 of List III which gives concurrent power to both the Central and State Legislatures to make legislation with respect to the "legal, medical and other professions" but which does not give the Centre or States any power to impose any tax on persons carrying on such professions.

Insofar as professional tax is concerned, Article 276 is also relevant. Clause (1) clarifies that a law of a State Legislature levying professional tax shall not be invalid merely because it relates to a tax on income. Clause (2) of Article 276 states that no one shall be required to pay more than Rupees Two Thousand Five Hundred by way of Professional Tax to any State or any local authority within that State. Clause (3) also clarifies that the State's power to impose a professional tax does not in any way impinge on the Centre's powers to impose an income tax on persons who are engaged in professions, trades, calling or employment.

The genesis of Article 276 can be traced back to Section 142-A of the Government of India Act, 1935 ("GOI Act") where the limit was initially set at Rupees Fifty per annum. Section 142-A was inserted in 1940 by Section 2 of the India and Burma (Miscellaneous Amendments) Act, 1939. Sub-sections (1) and (2) of Section 142-A are almost identical to clause (1) and (2) of Article 276 of the Constitution of India.[11] As with the Constitution of India, under the GOI Act as well, the Federal Legislature had the power to tax incomes whereas the Provincial Legislatures had the power to impose professional tax.

The rationale for the insertion of Section 142-A has been explained elaborately in the judgment of the Supreme Court of India in *Jadao Bahuji v. Municipal Committee*[12], as follows:

> "12...It was, however, felt that these taxes [professional tax] might come into clash with tax on income in the Federal List, and also if unlimited in amount, might become a second tax on income to be levied by the Provinces. It was to remove these contingencies that Section 142-A was enacted. Sub-section (1) provided that a tax on professions, etc., would not be invalid on the ground that it related to a tax on income. Sub-section (3) was a counterpart of sub-section (1), and provided that the generality of the Entry in the Federal Legislative List relating to taxes on income would not be construed as in any way limited by the power of the Provincial Legislature to levy a tax on professions, etc. The fields of the two taxes were thus demarcated. No other implication arises from these two sub-sections.
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> **13.** It was also apprehended that under the guise of taxes on professions, etc., the Provincial Legislatures might start their own scheme of a tax on income, thus

[11] *See Kamta Parsad Aggarwal v The Executive Officer*, Panchayat Samiti, Ballabgarh ILR (1968) 2 P&H 695, 700.

[12] (1962) 1 SCR 633.

> subjecting incomes from professions, etc., to an additional tax of the nature of income tax. A limit was therefore placed upon the amount, which could be collected by way of tax on professions, etc., and that limit was Rs. 50 per annum per person. The second sub-section achieved this result..."[13]

Subsequently, in the Constitution of India, this limit was raised to Rupees Two Hundred and Fifty per annum in 1950. While the Drafting Committee had initially recommended Rupees One Hundred and Fifty, this was ultimately raised to Rupees Two Hundred and Fifty.[14] It was only in 1988, subsequent to the recommendations of the Commission on Centre-State Relations ('Sarkaria Commission') that the limit was raised to the present level of Rupees Two Thousand Five Hundred per annum by the Constitution (Sixtieth Amendment) Act, 1988.

Before examining the question as to whether the limit should be raised, it is relevant to note why the limit exists in the first place. The GOI Act, as enacted in 1935, did not contain any limit on the amount of professional tax that could be levied by the Provincial Legislatures in exercise of their powers under sub-section (2) of Section 100 read with Entry 46 of List II of the Seventh Schedule. As pointed out by the Supreme Court in *Jadao Bahuji*, when doubts were raised as to whether the nature of the tax on the professions would not in fact be a tax on income, Section 142-A was introduced to clarify the position and curtail the Provinces' powers.

The existence of Article 276, like Section 142-A, is tacit acceptance that the professional tax, in effect, is a tax on income. The tax base for a professional tax is a subset of the tax base for the personal income tax. The tone and tenor of the Constituent Assembly Debates on the topic seem to suggest that the majority were not particularly keen in keeping the tax on the books. Dr. Ambedkar stated that the only reason the professional tax was being continued, despite being in conflict with the income tax, is only because certain municipalities are being funded from it at the moment and such municipalities' administration should not be affected by it.[15]

The question of raising the limits on professional tax was considered by the Sarkaria Commission in its report and it was recommended that the then limit of Rupees Two Hundred and Fifty be increased and the limits be raised from time to time.[16] The Sarkaria Commission stated that taking into account

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[13] Paras 12-13.

[14] *Supra* note 10.

[15] *Ibid*.

[16] Report of the Commission on Centre-State Relations, Chapter X, paragraphs 10.5.59-60, available at <http://interstatecouncil.nic.in/Sarkaria/CHAPTERX.pdf> accessed on 27 September, 2014.

inflation, there needs to be periodic review of the limit.[17] The Sarkaria Commission also noted that the States were unwilling or unable to garner much revenue from professional taxes as a result of the low limits set therein.[18]

2.1.2. Present position of professional tax.

At present, twenty-one States impose professional tax through various laws, all of them adhering to the limit of Rupees Two Thousand Five Hundred. As far as the scope of the professional tax is concerned, in some States such as Bihar[19] and Kerala,[20] the levy is generally applicable to all persons engaged in any employment or in any profession whereas in the others it is only for enumerated professions.[21] In some States such as Bihar[22] and Karnataka,[23] the tax is levied and collected by the State alone, but in others, such as Kerala[24] and Tamil Nadu[25], municipal bodies also levy and collect the professional tax under a State legislation.

At present, the amount collected from the levy of professional tax seems to be a negligibly small percentage of the total tax revenues collected by a State. For instance, in the State of Karnataka for the Financial Year 2013-14, out of an estimated total tax revenues of Rupees 77,519 crores collected by the State, professional tax was estimated to account for only Rupees 825 crores or about 1.06% of the tax revenues.[26] Likewise in Andhra Pradesh, for the Financial Year 2013-14, out of total tax revenue of Rupees 96,575 crores, professional tax provided only Rupees 710.95 crores or about 0.7% of tax revenues.[27] The low contribution of the professional tax to the revenues of the State could be attributed to not only poor

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[17] *Ibid* para 10.5.60.

[18] *Ibid* para 10.5.59.

[19] *See* Section 4 of the Bihar Tax on Professions, Trades, Callings and Employments Act, 2011.

[20] *See* Section 4 of the Kerala Tax on Employment Act, 1976.

[21] *See* for instance, Maharashtra State Tax on Professions, Trades, Callings and Employments Act, 1975.

[22] *See* the Bihar Tax on Professions, Trades, Callings and Employments Act, 2011

[23] *See* the Karnataka Tax on Professions, Trades, Callings and Employment Act, 1976.

[24] *See* Section 245 of the Kerala Municipality Act, 1994.

[25] *See* Section 198-B of the Tamil Nadu Panchayats Act, 1994.

[26] Source: <http://www.finance.kar.nic.in/bud2013july/bdocs13-14/002-Rev%20Receipt.pdf> accessed on 27 September, 2014.

[27] 'Budget Estimates (2014-2015): Detailed estimates of Revenue and Receipts', Vol. II, available at <http://www.apfinance.gov.in/uploads/budget-2014-15-books/Volume-II.pdf> accessed on 27 September, 2014.

collection mechanisms and enforcement at the State level, but also perhaps to the low limit up to which a State may collect professional tax as pointed out by the Sarkaria Commission.

In effect it seems that Article 276, while giving validity to the States' power to impose professional tax with one hand, by imposing a low limit on how much professional tax can be collected, substantially limits the scope for exercising such power with the other.

2.1.3. Cross jurisdictional survey of professional tax collection systems.

From a survey of federal systems across the world, we have found that either the levy or collection of income and professional tax is wholly within the purview of the municipal bodies (such as in Switzerland) or with the Federal Government (as in Mexico). As we have already pointed out in the context of the United States and Canada, in some federations both Federal and State Governments have the power to impose income taxes but that does not extend to separation of the power to impose professional taxes between Federal and State Governments. In none of these countries is the State Government's power to impose a professional tax limited by the Federal Government.

The one other federation which seems to be an exception to the above general norm is Pakistan. The provisions of the GOI Act, relating to professional tax were transposed into the Constitutions of Pakistan and continue to this day. At present, the 1973 Constitution of Pakistan contains a provision similar to Article 276 of the Constitution of India in so far as professional tax are concerned as give below:

> "Article 163. Provincial taxes in respect of professions, etc.-
>
> A Provincial Assembly may by Act impose taxes, not exceeding such limits as may from time to time be fixed by Act of Majlis-e-Shoora (Parliament), on persons engaged in professions, trades, callings or employments, and no such Act of the Assembly shall be regarded as imposing a tax on income."

The key difference between Article 163 of the Constitution of Pakistan and Article 276 of the Constitution of India is that the former permits the Parliament to set the limit on professional tax leviable on a person whereas the Constitution of India itself fixes the limit.

The limit on professional tax at present is Pakistani Rupees One Lakh per annum as provided for in Section 2 of the Professions Tax Limitation Act, 1941 ("the 1941 Act"), with effect from 1977.[28]

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[28] Section 4 of the Federal Finance Act, 2006 amended the 1941 Act to impose this limit. The 1941 Act was initially enacted in furtherance of proviso to sub-section (2) to Section 142-A of the Government of India Act, 1935 and has been repealed in India by virtue of Article 395 of the Constitution of India, which inter alia, the GOI Act and laws amending and supplementing it, shall stand repealed.

At present, Provinces in Pakistan are levying a professional tax in some form or the other up to a limit of Pakistani Rupees One lakh.

Keeping in mind the recommendation of the Sarkaria Commission and the interests of allowing fiscal space to the States to increase their sources of revenue, if there has to be an increase the limit on the professional tax payable by a person per annum to a State, it would, of necessity, require a constitutional amendment since the limits are placed by the Constitution and ordinary legislation cannot supersede the Constitution.

The simplest course of action would be for Parliament to introduce a Constitutional Amendment to replace the phrase “Rupees Two Thousand Five Hundred” with a higher figure in clause (2) of Article 276.

However, such increases may have to be made periodically to account for inflation. Thus the question which arises is whether it would be constitutionally permissible to have this limit set by law made by Parliament and whether it would be permissible for the Constitution be amended reflect this. We already have a model for such an amendment in the 1973 Constitution of Pakistan. However whether such a provision would be lawful in the context of the Constitution of India and the law laid down by the Supreme Court of India will be examined in detail in the next section.

2.2. Leaving the Limits to the Union Parliament

Although the Constitution of India has been described variously as “quasi-federal” or having a “strong unitary bias”, it is however more federal in structure than unitary.[29] States have an independent constitutional existence and are politically sovereign in their own sphere. While the Centre may, in exceptional circumstances, override the States’ sovereignty, the fact remains that in normal circumstances, they are neither “satellites” nor “agents” of the Centre.[30] States are not therefore mere appendages to the Centre and within the sphere allotted to them, they are supreme.[31] This includes the power to makes laws levying and collecting tax. Federalism thus understood, is a basic feature of the Constitution and cannot be abrogated even through an amendment of the Constitution.[32] What this section will analyse is whether the proposal to amend the Constitution give Parliament the power to place limits on the amount of professional tax payable by a person per State would violate the basic structure of the Constitution.

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[29] *SR Bommai v Union of India* 1994 3 SCC 1, 65 para 4. Per Pandian J.

[30] *Ibid*, 115 para 99. (Per Sawant J).

[31] *Ibid*, 216, para 276 (Per Reddy and Agrawal JJ).

[32] *SR Bommai v Union of India*.

That the State Legislature's power to levy a tax is plenary is evident from Article 245 and clause (3) of Article 246 of the Constitution. Entries 45 to 63 of List II in the Seventh Schedule relate to the specific subject matters on which the State Legislature may pass a law imposing a tax thereon. The source of the State Legislature's powers are these articles and not subject to any limitations imposed by Parliament. However, there are only three provisions of the Constitution which seem to, *prima facie*, permit Parliament to limit the powers of the State Legislature to impose a tax. They are Entry 50 of List II of the Seventh Schedule, Clause (1) of Article 366 and Clause (3) of Article 286. We discuss each clause and its implications in detail below:

2.2.1. Entry 50 of List II of the Seventh Schedule

Entry 50 of List II states that the State shall have the power to impose taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development. While at first it seems that the Parliament will have power to restrict the taxing power of the State, it is not so. This provision has been clarified by the Supreme Court to mean that Entry 50 does not permit the Centre to limit the taxing power of the State but merely clarifies that the regulatory power of the Union under Entry 54 of List I cannot be encroached upon by the State in exercise of its taxing powers.[33] Parliament cannot, in exercise of it regulatory power, limit the power of the State Governments to impose a tax on mineral rights designed to augment the revenues of the State. A law made by Parliament to regulate mines and minerals in India cannot prohibit or restrict State taxation of such mineral rights. Entry 50 of List II therefore does not actually permit Parliament to place a fetter on the State's taxing power.

2.2.2. Clause (1) of Article 366

This clause defines "agricultural income" to mean whatever meaning the term has been given in the income tax laws made by Parliament. This would seem to suggest that the Centre is free to determine the scope and extent of the term "agricultural income". However, the Constitution has placed a procedural restriction on this power as well. Any amendment to the Income Tax Act, 1961 or introduction of any law imposing tax that affects the meaning of the word "agricultural income" has to be on the recommendation of the President under Article 274. Parliament's power to limit the scope of the State's taxation power therefore, in this context as well, is not unfettered.

2.2.3. Clause (3) of Article 286

Clause (3) of Article 286 mandates that a tax imposed by the State Legislature on the sale or purchase of goods will be subject to certain limitations imposed by the Parliament. Specifically, taxes on goods which are declared of "special importance" to inter-State trade and taxes on goods involved in works

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[33] *Supra* note 4, 325 para 129(9).

contracts, hire purchases and leases would be subject to limitations imposed by Parliament. *Prima facie,* this would appear to be a substantive limit on the power of the State Government's plenary taxing powers. However the history of how sub-clause (b) came to be inserted into the Constitution suggests otherwise.

Sub-clause (b) came to be inserted as a result of a peculiar set of circumstances. The Supreme Court of India, in *State of Madras v Gannon Dunkerley*[34] held that the State had no power to impose a sales tax on goods which were purchased as part of a single indivisible contract to construct a building. This settled a cleavage of opinion between High Courts in India as to the exact scope of the power of the State to impose a sales tax on such transactions that involved an indivisible combination of goods and services.

The narrowing of the State's taxing powers in these and other judgments,[35] led to a reference being made to the Law Commission of India to determine how the powers of the State to tax sales of goods in such circumstances could be narrowed. In its 61st report, the Law Commission of India certain amendments including, *inter alia*, the insertion of clause 29-A of Article 366 and amendment of clause (3) of Article 286 along the lines as they stand now.[36]

In effect therefore, the provisions of clause 3(b) of Article 286 extend the powers of the State to levy sales tax to transactions which were held to be outside the purview of the State but subject to the limitations imposed by the Parliament. Even so, such limits do not apply to the general power to impose tax on sale of goods but only to the limited categories of goods where the Centre might also otherwise have the power to levy tax upon.

2.2.4. Federalism as the Basic Structure of the Constitution

What emerges from these three instances is that Parliament's function here is not so much to limit but to draw the boundaries between the State Legislature's and Parliament's powers of taxation or law making, as the case may be. In no case has it been given the absolute power to legislate on how and in what manner the State manner the State may exercise its taxing power.

Even when it comes to the power of amendment of the Constitution by the Parliament, important safeguards have been placed in the text of the Constitution in the interests of protecting the State's taxing powers. The first of these is found in Article 368 itself, specifically in proviso to clause (2), according to which Constitutional amendments that affect States' law making powers will not take effect

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[34] 1959 SCR 379.

[35] *See* for instance *Northern India Caterers (India) Ltd v Lt. Governor of Delhi* 1978 4 SCC 36.

[36] Law Commission of India, 61st Report on Certain Problems connected with the Powers of the State to Levy a Tax on the Sale of Goods and the Central Sales Tax Act. 1956, May 1974 available at <http://lawcommissionofindia.nic.in/51-100/Report61.pdf> accessed on 28 September, 2014.

unless they have been ratified by at least half of the State Legislatures. Similarly, Article 274 also requires that before any Bill or even Constitutional amendment that affects any tax or duty which States are interested in, it should do so only on the recommendation of the President.

Additionally, any amendment to the Constitution that damage or destroy the basic features of the Constitution such as judicial review,[37] fundamental rights,[38] or rule of law[39] would be beyond the powers of Parliament in exercise of its amending power.[40] Federalism being part of the basic structure of the Constitution, any amendment that damages or destroys the federal character of the Constitution would be struck down by the Supreme Court.

The norm therefore still remains that in a Federal Constitution, a State Legislature is as sovereign in its field of legislation as Parliament. In certain exceptional situations, the Parliament may limit the powers of the State through ordinary legislation. However this power of Parliament is itself restricted. In no case is Parliament given the power to control the core of the taxing power itself, with no procedural limits. An amendment that would empower Parliament to limit the State Legislature's power to tax in a given subject matter area, totally and with no restrictions as to procedure, would go contrary to the Constitutional scheme and the basic structure principle of federalism. An amendment giving such uncontrolled power would be struck down by the Courts as being contrary to the basic structure of the Constitution.

In our view, any measure that seeks to limit the power of the State Legislature to tax and give Parliament the power to determine what these limits are, will be against the basic structure of the Constitution. A provision allowing the Centre to restrict the State's taxing powers unilaterally and without limits is unprecedented in the context of the Constitution of India. A provision along the lines of the 1973 Pakistan Constitution giving the Centre absolute power to determine the limits of the State's power to levy professional tax would, in our view, go against the principle of federalism.

2.3. A restricted power of imposing limits on Professional Tax would be acceptable.

However, the reasons for giving the Union Parliament power to determine the limits of professional tax imposed by States are valid. That there have to be limits cannot be disputed since otherwise a professional tax would impinge on income tax imposed by the Centre. If there are limits, it is obvious that such limits have to be periodically reviewed to keep up with inflation. As we have already noted,

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[37] *See L Chandra Kumar v Union of India* (1997) 3 SCC 261.

[38] *See IR Coelho v State of Tamil Nadu* (2007) 2 SCC 1.

[39] *See Indira Gandhi v Raj Narain 1975 Supp SCC 1.*

[40] *Kesavananda Bharati v State of Kerala* (1973) 4 SCC 225.

giving the Union Parliament an uncontrolled power to restrict a State's taxing power is not permissible. However a specific, limited power may be granted to the Parliament in certain cases along the lines of extant provisions of the Constitution allowing for limited restrictions to be imposed by Parliament on the State's taxing power, as discussed in the previous section. In this instance, since the base for both the income tax and the professional tax are one and the same, Parliament can justifiably be given such a power subject to certain Constitutional restrictions designed to protect the State's interests as to when Parliament may invoke this power. In all the three cases discussed above, Parliament's ability to "limit" a State's taxing power is restricted either to the scope of the taxing power or comes with restrictions to ensure that States' interests are protected.

Taking a cue from the above, we suggest that the procedural restriction of Article 274, applicable in the context of defining "agricultural income" under the Income Tax Act, would be appropriate in the context of Parliament fixing the limits of professional tax since this also would have an impact on taxes on income. Article 274 states:

> "274. Prior recommendation of President required to Bills affecting taxation in which States are interested
>
> (1) No Bill or amendment which imposes or varies any tax or duty in which States are interested, or which varies the meaning of the expression agricultural income as defined for the purposes of the enactments relating to Indian income tax, or which affects the principles on which under any of the foregoing provisions of the Chapter moneys are or may be distributable to State, or which imposes any surcharge for the purposes of the Union as is mentioned in the foregoing provisions of this Chapter, shall be introduced or moved in either House of Parliament except on the recommendation of the President
>
> (2) In this article, the expression "tax or duty in which States are interested" means-
>
> (a) a tax or duty the whole or part of the net proceeds whereof are assigned to any State; or
>
> (b) a tax or duty by reference to the net proceeds whereof sums are for the time being payable out of the Consolidated Fund of India to any State"

A Bill fixing limits on the levy of professional tax by States must therefore be recommended as such by the President before being introduced as a Bill in Parliament.

Two further requirements are necessary in our view for any law imposing limits on professional tax; first there must be periodicity in the raising of limits and second, the limits must be set in a manner which balances the interests of the Centre and the State in obtaining tax revenues. Both these requirements, we believe, will be met if the limits on professional tax are set on the basis of a Finance Commission recommendation. The Finance Commission submits its reports once every five years, thus ensuring that

the question of professional taxes is likely to addressed on a sufficiently periodic basis, even if it may not necessarily recommend a change in the limits.

The Finance Commission already has the power to make recommendations to the States under sub-clauses (bb) and (c) of clause (3) of Article 280. Under sub-clauses (bb) and (c) of clause (3) of Article 280, it is also empowered to suggest how state revenues may be augmented to ensure proper funding of local self-government bodies. This, in our view, would also include suggestions as to how much professional tax should be permitted to be collected by the States.

It is also our view that the Commission itself is best placed to evaluate the claims of the States vis-à-vis the claims of the Centre and accordingly place its recommendations before the President for action.

We therefore propose that the following amendment be made to the Constitution of India.

1. *In clause (2) of Article 276, for the words "two thousand and five hundred rupees per annum" the words "such amount as Parliament may by law specify" shall be substituted.*
2. *In Article 276 of the Constitution, after clause (2) the following provisos shall be inserted:*

> *"Provided that no Bill or amendment which imposes or varies the amount shall be introduced or moved in either House of Parliament except on the recommendation of the President made in pursuance of a recommendation of the Finance Commission to this effect."*
>
> *"Provided further that nothing contained in clause (2) shall be construed to give Parliament the power to prescribe different limits on the amount payable as tax on professions, trades, callings and employment for different States."*

The provisos place certain fetters on the powers of the Parliament to limit States' power to levy professional tax. The first being the precondition of Presidential Recommendation, similar to the precondition found in clause (1) of Article 274. Since the Finance Commission makes its recommendations to the President, it would be constitutionally appropriate therefore that the recommendation to change the limit of professional tax inform the recommendation of the President to Parliament.

The second fetter is placed more by way of abundant caution than necessity. In the second proviso, it is clarified that the limit has to be uniform and applicable across the country to all States. This is to prevent the Parliament from effectively setting the State's tax policy by prescribing different rates for different States. This is also to prevent the Centre from playing favourites with any State and choosing to implement recommendations selectively.

3. Conclusion

1. States do not have the power to impose a surcharge on income tax collected by the Centre.
2. An amendment to the Constitution permitting the State to impose such surcharge on income tax would not be feasible without consensus between the Centre and the States on the basis of charge, collection mechanism, and tax revenue distribution.
3. The limit of Rupees Two Thousand Five Hundred may be increased by Parliament by amending the Constitution along the lines suggested above to allow for the limits on amount of professional tax payable by a person to be imposed by law made by Parliament, subject to certain procedural safeguards to ensure that the amendment does not change the federal character of the Constitution.