Direct Taxes Code

Revised but not better

Changing the holding period to 'one year from the end of fiscal year' to attract long-term capital gain tax will affect stock churning

The Direct Taxes Code (DTC), unveiled for public comments last year, was a rude shock for investors as it not only sought to levy tax on long-term capital gain but also proposed to tax short-term capital gain at the personal marginal tax rate instead of the flat 15% tax applicable right now. After a lot of hue and cry by various stakeholders, the government came out with a revised discussion paper (RDP) on 15 June 2010 to respond to the major concerns and comments of the stakeholders.

Under the current law, taxation of capital gain is a function of the nature of the capital asset, the duration for which the capital asset has been held and whether it has been sold on a recognised stock exchange or otherwise if it is a listed security.

The duration of holding determines whether a capital asset is classified as a short-term capital asset or long-term capital asset. Gain arising from the disposal of a long-term capital asset is taxed at lower rates (or not taxed at all as is the case with equity shares and units of equity-oriented mutual funds). Gain arising from disposal of a short-term capital asset is treated as regular income and taxed at the rate applicable to the concerned tax payer.

For unlisted shares, the long-term capital gain is taxed at a concessional rate of 20% plus education cess, while the short-term capital gain is taxed at the applicable rate, i.e., as per the slab rate applicable to the tax payer.

The DTC had proposed to remove the distinction between long- and short-term capital gain. Any gain arising from the sale of investment assets was proposed to be taxed as capital gain at 30% for non-residents and at the applicable marginal tax rate for residents. DTC had shocked investors by proposing just indexation benefit for equity shares and mutual fund units held for more than one year from the end of the financial year of their acquisition. RDP has proposed some changes to give relief to investors. But whether such relief is adequate is a million-dollar question.

RDP proposes to maintain the distinction between long- and short-term capital gain. The minimum holding period required to classify an asset as a long-term capital asset will be one year from the end of the financial year in which the asset was acquired. The existing taxation system recognises holding period of one year for equity shares and equity-oriented mutual fund units and three years for other assets.

RDP provides that long-term capital gain on shares and equity-oriented mutual funds will be added to the total income of the tax payer after allowing a certain prescribed percentage of capital gain as notional deduction. The specified rate of deduction has not yet been notified. But a rate of 50% to 70% of capital gain has been indicated in RDP. Thus, the effective rate for a tax payer in the highest slab (whose applicable marginal tax rate is 30%) could be anywhere between 9% to 15%, depending on the rate of notional deduction to be notified. This is very high compared with the nil income-tax currently applicable if shares are sold after one year from the date of acquisition.

DTC had proposed to abolish the securities transaction tax (STT). However, RDP provides that STT will continue. Since the long-term capital gain for listed equity shares and units of equity-oriented mutual funds is proposed to be taxed, the rate of STT is likely to be reduced. Still, investors will have to bear the brunt of STT as well as tax on long-term capital gain, which is very unfair.

Another concern for investors is the change in the definition of 'holding period'. On plain reading of the provisions of DTC, it seems holding period will continue to be one year for listed securities. But it is not so. Under DTC, long-term capital gain has been defined as an investment held for more than one year from the end of the financial year in which the asset was acquired. Thus, if an investor buys shares, say, on 1 May 2011, he will have to hold on to them at least till 1 April 2013, i.e., at least for a period of one year, 11 months and one day, to be eligible to claim the benefit of notional deduction proposed for long-term capital gain. This is in sharp contrast to the existing tax provisions, where long-term capital gain is exempt from tax.

The holding period for long-term capital gain on shares will vary between 12 months and one day if an investor buys shares on the last day of the financial year, i.e., 31 March to 24 months and one day if an investor buys shares on the very first day of the financial year, i.e., April 1. If this proposal becomes part of the Income Tax (IT) Act, 1961, investors buying shares on 1 April will have to wait for complete two years to enjoy the reduced tax rate applicable to long-term capital gain.

As a corollary, the holding period for short-term capital gain has increased. Suppose, if an investor buys shares on 1

Out of reach

FIIs will now have to show income from equity transactions as capital gain instead of business income. Still they will remain tax-free because of double taxation avoidance agreements

Taxation is like a tug-of war, with the income tax department trying to extract the maximum amount from the pocket of the tax payer and the tax payer trying to pay the minimum by organising his business affairs in a manner that the incidence of tax is the least. In this regard, the practice adopted by foreign institutional investors (FIIs) is noteworthy. Some FIIs are characterising their income from investment in equity shares and derivative transactions as 'business income' instead of 'capital gain'. Consequently, they claim complete exemption from tax on the ground that they do not have any permanent establishment in India. This leads to avoidable litigation. The revised discussion paper (RDP), therefore, proposes that the income earned by FIIs is to be deemed to be income chargeable under the head, 'Capital gain'.

This is not the end of the story. Most FIIs show their income from investment in shares as capital gain. However, their income also escapes from the clutches of the income tax department as they take shelter under the umbrella of double taxation avoidance agreements (DTAAs), which India has entered into

Escaping the net

with various countries. The Direct Taxes Code (DTC) had threatened to bring all FIIs under the tax net by overruling the DTAAs. However, RDP has recognised the fact that unilaterally overriding bilateral tax treaties is not feasible. RDP has proposed that the law, which is more beneficial to the tax payer — between domestic law and DTAA — shall prevail.

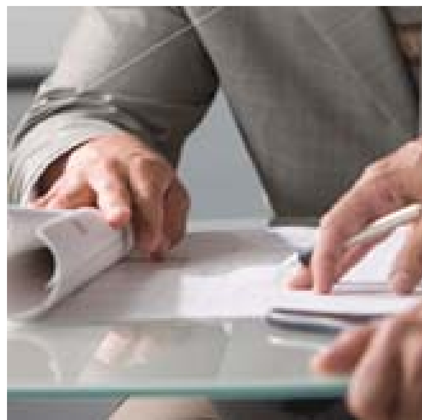
FIIs utilising the DTAAs to avoid paying capital gains tax in India will continue to enjoy the benefit. They will neither have to pay short- nor long-term capital gain tax under the revised proposal as the tax rate on capital gain in India due to DTAAs is nil. The only hope is the government will some day snap its DTAAs with countries like Mauritius and Cyprus, thereby giving a level-playing field to all investors. However, till the time it happens, FIIs will continue to laugh all their way to bank.

The only saving grace for the exchequer is that tax authorities have the power to invoke the General Anti-Avoidance Rule (GAAR) when they think that the DTAA provisions are being misused to avoid tax. For instance, GAAR can be invoked on shell companies formed in tax heavens to route funds into the Indian stock markets. Such companies will have to prove that they had commercial substance. RDP states that, when GAAR is invoked, domestic laws will prevail over DTAA and the concerned FII or foreign company can be made liable to pay tax that it was avoiding.

May 2011 and sells them on any date before 1 April 2013, the resulting capital gain will be treated as short-term capital gain. The amount of such gain will be added to the total income of the tax payer in that year and taxed at the personal marginal tax rate.

As very few investors prefer to hold on to their investments for long duration due to uncertain market conditions, most of the stock market transactions will fall in the category of short-term capital gain. Thus, the tax payers in the highest slab of 30% will have to bear short-term capital gain tax of 30% plus education cess for major part of their stock market transactions compared with the existing tax rate of 15%. This move is also bound to hurt speculators, who trade in the short term.

Under the DTC, there is no distinction between financial assets and other assets. Accordingly, the holding period will become uniform for all kinds of assets, whether the asset is an immovable property or gold or equity shares or mutual fund units. The existing provision of the IT Act, 1961, provides that assets



EEE relief to pre-DTC investors

like immovable property or gold, must have been held as investment for at least three years from the date of their acquisition to qualify as long-term capital asset. Thus, the proposed change will benefit real estate investors as the holding period to enjoy the benefit of long-term capital gain will reduce considerably.

RDP provides that investments made before the date of commencement of the DTC in instruments enjoying exempt-exempt-exempt (EEE) method of taxation under the current law will continue to be eligible for the EEE method of tax treatment for the full duration of the financial instrument. This is a big relief for investors who have put in their hard earned money in equity-linked savings schemes (ELSS) of mutual funds. For example, if an investor had invested Rs 50000 in ELSS in September 2008 to claim

Then and now

Key highllights of the revised discussion paper on the Direct Taxes Code

ORIGINAL PROPOSAL UNDER DTC	ISSUES / CONCERNS RAISED	REVISED PROPOSAL
Tax treatment of savings: exempt-exempt-tax (EET) compared with exempt-exempt-exempt (EEE) basis		
● Accumulation / accretion to savings was to be exempt from tax till it remained invested. All withdrawals were subject to tax at the applicable rate in the year of withdrawal under the head, 'Income from residuary sources'. ● The EET-based taxation proposal was to be prospective and withdrawals from accumulated balances as on 31 March 2011 from GPF, PPF, RPFs and Employees' Provident Fund (EPF) were not taxable.	● The EET method of taxation on savings is generally followed in countries with a social security system, which is absent in India. Introducing this method will be harsh on people that need a lump-sum fund on retirement to meet family needs. ● The application of the EET method should be restricted to new saving instruments after the date from which the DTC comes into effect.	● EEE method of taxation to be followed for Government Provident Fund (GPF), Public Provident Fund (PPF), Recognised Provident Funds (RPFs) and pension scheme administered by the Pension Fund Regulatory and Development Authority, approved pure life insurance products and annuity schemes. ● Investments made before commencement of the DTC in instruments and currently enjoying the EEE method of taxation will continue to be so eligible for the full duration of the instrument.
Taxation of income from salary: Retirement benefits and perquisites		
● Contributions made by the employer to an approved superannuation fund, provident fund, life insurer and the New Pension System Trust to be considered as salary. ●Deductions from gross salary to be allowed for compensation received under a voluntary retirement scheme, gratuity received on retirement or death and amount received on commutation of pension to the extent such amount is deposited in a Retirement Benefits Account (RBA). The accretion to and withdrawal from deposits was to follow EET system of taxation. ● Salary was to include the following: (a) Value of rent-free or concessional accommodation provided by the employer. (b) Value of any leave travel concession. (c) Encashment of unavailed earned leave on retirement or otherwise. (d) Medical reimbursement. (e) Value of free or concessional medical treatment paid for, or provided by the employer.	● In the absence of adequate social security benefits, retirement benefit is used for savings and social expenditure. Taxation of withdrawals from RBA is harsh. ● Value of accommodation in for government employees, if taken at market rent, will create high tax burden. ●Perquisites in the nature of medical benefits should be exempt as under the current law.	● The RBA scheme will not to be introduced in view of the complexity involved in managing a large number of accounts and tracking the taxes on withdrawal. ● Gratuity, voluntary retirement scheme, commuted pension linked to gratuity and leave encashment receipts at the time of superannuation to be exempt for all employees, subject to specified limits. ● Perquisites such as medical facilities/reimbursement provided to employees to be valued as per the existing law, with appropriate enhancement in monetary limits. ● Perquisite value of rent-free accommodation not to be computed based on market value.
Taxation of income from house property		
● Income from house property to be computed at gross rent less specified deductions. Gross rent to be the higher of contractual rent or the presumptive rent, calculated at 6% per annum of the rateable value fixed by the local authority or, in the absence of rateable value, of the cost of construction or acquisition of the property. ●Gross rent of a single self-occupied property to be deemed to be nil, and deduction for taxes or interest not to be allowed.	●Determination of notional rent on presumptive basis at the rate of 6% with reference to the cost of construction acquisition is inequitable as it discriminates against recent owners, because cost is a function of inflation. ● To incentivise investment in housing, deduction for interest on capital borrowed for acquisition or construction of a self-occupied house property, up to a ceiling of Rs 1.5 lakh should be retained.	● Gross rent not to be computed at a presumptive rate of 6% of the rateable value or cost of construction/acquisition. ● For a house property that is let out, gross rent will be the amount of rent received or receivable. ●For a house property that is not let out, the gross rent will be nil. As the gross rent is taken as nil, no deduction for taxes or interest will be allowed. ● An individual or HUF will be eligible to deduct upto Rs. 1.5 lakh on account of interest on capital borrowed for acquisition or construction of any one self-occupied house property from gross total income.
Minimum Alternate Tax (MAT)		
● MAT was to be computed on the 'value of gross assets'. ● Tax rate under MAT to be 0.25% of value of gross assets for banking companies and 2% for other companies. ● MAT to be the final tax liability and carry-forward credit not allowed.	● Significant hardship to loss making companies or companies operating in a cyclical downturn. Also, inequitable to newly set-up infrastructure companies and companies undergoing major expansion as compared with old businesses. ●Unreasonable to levy a presumptive asset tax on companies under liquidation. ● 'Capital works in progress' does not contribute to revenue and, hence, tax based on assets is not justified.	● MAT to be computed with reference to book profit.

Time is the key

The New Pension Scheme will emerger as an attractive investment alternative in the revised DTC era

The New Pension Scheme (NPS) comprises defined contribution pension, and is open to any Indian citizen in the age group of 18 to 55 years. An individual can invest a certain amount in the NPS till he retires. At retirement, he can either withdraw the money accumulated or buy an immediate annuity from an insurance company to generate regular income, or do both.

Hitherto, pension schemes were dominated by employer-sponsored plans, with contribution from the employee to a certain extent. Conventional retirement options like the Employees' Provident Fund and the Employees Pension Scheme give fixed or defined benefits that may not be adequate to meet expenses after retirement. Therefore, the NPS is not only a good option to substantially enhance monthly income after retirement but also good for those working in the unorganised sector, where the employer does not provide any pension.

The fund manager can invest up to 50% of the corpus of the NPS in equity shares. Therefore, returns generated through contributions to the NPS are likely to be much more than from the Public Provident Fund (PPF), which guarantees a fixed return of 8% per annum as the PF trustees invest in pure debt instruments. Under the Income Tax (IT) Act, 1961, the maturity proceeds of the NPS are taxed. In other words, the exempt-exempt-tax (EET) method is followed. This has put the scheme at a disadvantage compared with other savings instruments like PPF, mutual funds and unit-linked insurance plans (Ulips), where the exempt-exempt-exempt (EEE) method is followed.

Countdown to a new era

The revised discussion paper on the Direct Taxes Code (DTC) has proposed to bring the NPS under the EEE method of taxation. As such, accruals as well as withdrawals from the NPS will be fully exempt from tax. Thus, it will be able to score over Ulips and mutual funds because both these investment options will be taxed as per the EET method under the DTC. Moreover, at present, investment up to Rs 1 lakh in the NPS is tax deductible under Section 80C of the IT Act, and will continue to be so even after the DTC comes into effect. There will be no such exemption for investment in mutual funds and Ulips.

The NPS will not only have an edge over PPF on expected returns, but will also score over mutual funds and Ulips on tax benefits on investment as well as maturity. Therefore, investors can set apart certain amount every year for contributing towards the NPS.

the tax rebate under Section 80C of the IT Act, the mandatory three-year lock-in period will be complete only in September 2011, if DTC becomes effective by that time, the entire amount of capital gain at the time of redemption would have been taxable in the hands of the tax payer. However, now RDP has assured that such investments will be spared from tax at the time of redemption.

As there will be a shift from nil rate of tax on listed equity shares and units of equity-oriented mutual funds held for more than one year, an appropriate transition regime will be provided. This has been done to calm down the apprehensions that DTC will lead to lot of volatility in the stock market in the last quarter of this financial year as various investors are sitting on huge amount of notional gains over the past several years will contemplate booking profit on their shares and mutual fund units to avoid payment of tax on long-term capital gains after the DTC becomes effective. Thus, this is a welcome move.

For long-term capital gain on unlisted shares, the base rate for determining the cost of acquisition is proposed to be shifted from 1 April 1981 to 1 April 2000. Capital gain will be computed after allowing indexation on this raised base. Capital gain on such assets will be included in the total income of the tax payer and will be taxed at the applicable rate.

Addressing concerns of volatility

The government has been a proponent of equity cult in the country. It has also taken effective measures like offering 5% discount to retail investors on the cut-off price in public issues of public sector undertakings. Tax rebate under Section 80C of the IT Act for investment in ELSS of mutual funds is another incentive to channel the savings of a large number of tax payers into the stock market. So why has the government taken a U-turn in its policy by proposing withdrawal of tax rebate under DTC for investment in ELSS coupled with levy of tax on long-term capital gain (although at a lower rate) and enhancement of tax rate on short-term capital gain? The Centre should review its proposal, which might obstruct rather than encourage participation of retail investors in the capital markets.

—Rajesh Relan