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DIRECT TAXES CODE

DIRECT TAXES CODE - AN OVERVIEW

RAJESH RELAN

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he Government has on August 12, 2009 unveiled the draft of a new direct tax law that would replace the Income-tax Act, 1961. The new code will completely overhaul and simplify the existing law not only for individual taxpayers but also for the corporates and the foreign residents. The code proposes to align the Indian tax laws with internationally accepted taxation principles and best practices and also seeks to make far reaching changes in all areas of taxation. If everything goes in the right direction, one can hope to have a new Income-tax Act with effect from April 1, 2011. This article presents an overview of the Direct Taxes Code.

Introduction

1. The Government has on August 12, 2009 unveiled the draft of a new direct tax law that would replace the Income-tax Act, 1961. The new code will completely overhaul and simplify the existing tax law not only for individual taxpayers but also for the corporates and the foreign residents. In the words of the Finance Minister, 'the thrust of the code is to improve the efficiency and equity of our tax system by eliminating distortions in the tax structure, introducing moderate levels of taxation and expanding the tax base'. The Finance Minister has indicated that the Code has been drafted from scratch and does not attempt to modify the existing tax law. The Code proposes to align the Indian tax laws with internationally accepted taxation principles and best practices. The Code seeks to make far reaching changes in all the areas of taxation. The Government intends to present the relevant Bill during the winter session of the Parliament, after considering and incorporating therein the suggestions received from the chambers of commerce, professional bodies and tax experts. If everything goes in the right direction, one can hope to have a new Income-tax Act with effect from April 1, 2011.

Personal taxation

2. The Code proposes substantial rationalisation in income-tax slab rates. It proposes to tax income from Rs. 1.60 lakhs to Rs. 10 lakhs at the rate of 10 per cent; between Rs. 10 lakhs and Rs. 25 lakhs at the rate of 20 per cent and the income in excess of Rs. 25 lakhs at the rate of 30 per cent. Thus, the proposed tax slabs are decent enough to take care of the increased income levels as well as the rising cost of living. The deduction presently

allowed under section 80C for investments in specified instruments is proposed to be increased from Rs. 1 lakh to Rs. 3 lakhs, which would induce people to save more for their future requirements. After taking into account the investments made up to the maximum limit in the specified instruments, an individual with gross taxable income of Rs. 10 lakhs will pay tax of Rs. 54,000 as per the code instead of Rs. 1,74,000 as per the slab rates under the Finance (No. 2) Bill, 2009, which means saving of Rs. 10,000 per month.

Till here the picture looks rosy but the problem in case of salaried employees is that the Government seems to be determined to make everything taxable in their hands. The benefit of standard deduction has already been withdrawn few years back and now the Code proposes that all the perquisites like House Rent Allowance, medical reimbursement, leave travel allowance, etc., shall also be fully taxable. Thus, the employees who are living in rented accommodation will stand to lose the benefit of HRA exemption, which is quite significant for the employees living in metro cities. There is a bad news for house owners as well, who have purchased the house through loan from bank, as the provision for deduction of Rs. 1.5 lakhs allowed on interest paid on home loans is proposed to be scrapped. Thus, the persons who have recently taken home loans of 15 to 25 year/s duration would stand to lose the benefit of exemption on interest paid that is available under the present system. Everyone aspires to have a house and the present system provides great support and motivation in this direction, but the aforesaid proposal could spill water on the dreams of many individuals to have their own house. Moreover, it would also hurt the real estate sector as the demand for housing would decline.

Despite the treatment of the aforesaid perquisites as taxable perquisites, the tax burden of employees shall reduce considerably due to reshuffling of the tax slabs. However, the actual impact of the proposed provisions shall differ from person to person depending upon the nature of perquisites in the salary package as well as the home loan taken, if any. Every coin has two sides. If the Code has got some positive points, it has no dearth of negative points also. Some of the negative points of the Code from the point of view of personal taxation are as follows :—

- ◆ At present, section 80C of the Income-tax Act, 1961 provides that contributions/deposits/investments made in Employees Statutory Provident Fund, PPF (Public Provident Fund), NSC (National Saving Certificates), Life Insurance Policies, Pension Plans, ULIPs (Unit Linked Insurance Plans), ELSS (Equity Linked Savings Schemes of Mutual Funds), Infrastructure Bonds, FDs (Fixed Deposits of banks of at least 5 years tenure) up to maximum limit of Rs. 1 lakh are to be deducted from gross income for the purpose of computation of income-tax. Besides these investments, the principal amount of home loan repaid and the school fees of children are also eligible for

deduction under section 80C. However, the Code makes significant departure from the present system by providing that only four investments shall be eligible for deduction from gross income. These are contributions to approved provident funds, superannuation funds, life insurance policies and new pension system trust. This does not seem to be fair and reasonable since all these options are long-term in nature and are meant for use at the time of retirement of a person, although there is no restriction on using them during the working life.

This might become an obstacle in the plans of salaried employees who save their hard earned money every year for financing some major expenditure like purchase of a house or for children's education, etc. This may be a major deterrent for investors to invest their money in mutual funds because mutual fund schemes would be out of the purview of tax saving instruments. Thus, the proposed provision is likely to impact the mutual fund houses like SBI Mutual Fund, which has a corpus of around Rs. 4,400 crores in its mega scheme, SBI Magnum Tax Gain, 1993. Needless to say, if the mutual funds are impacted, the stock market will also bear the heat. All these aspects need to be looked into by the Finance Ministry before the Tax Code is given the shape of a bill for presenting the same in the winter session of the Parliament.

A positive feature is that entire tuition fees paid for up to two children studying in India shall be eligible for full deduction from gross salary within the aforesaid maximum limit of Rs. 3 lakhs.

- ◆ Another major shock for the salaried class is that all the savings are proposed to be brought under the Exempt-Exempt-Tax (EET) regime. In other words, the savings would be exempt ('E') at the time of investment, the accumulations to it would also be exempt ('E') but the withdrawals would be taxed ('T') whenever they are made, whether at maturity or prematurely. Such withdrawals would be included in the income of the assessee under the head 'Income from residuary sources' in the year in which the withdrawal is made or the amount is received. Thus, the withdrawals from PPF as well as the amount received on redemption of mutual fund units shall become taxable after the Code becomes an Act. The only saving grace is that the amount of accumulated balance as on March 31, 2011, in the account of an individual, in the specified instruments such as provident funds, etc., shall not be liable to tax. In case, the amount received or withdrawn from one account of the permitted savings is invested in another kind of permitted savings scheme, then the same shall also not be liable to tax.
- ◆ At present, the gratuity paid by an employer to employees after completion of five years of service is fully exempt from tax, but the Code proposes that the gratuity amount shall be eligible for tax

exemption only if the amount is invested in a retirement fund. In case the employee opts not to invest the money, it would be taxed at the appropriate marginal rate of tax in the concerned year, which is not fair.

- ◆ At present, the amount paid under a Voluntary Retirement Scheme (VRS) (subject to a maximum of Rs. 5 lakhs) is exempt from tax in case the Scheme is in accordance with the Government prescribed framework, but the Code provides that such sum shall be eligible for exemption only if it is deposited in retirement benefits account.

From the above discussion, one can infer that the Direct Taxes Code is a mixed bag for individuals, particularly the salaried class.

Source based taxation versus residence based taxation

3. Source based taxation is a process in which the income-tax is calculated on the basis of the source of income, whereas residence based taxation calculates income on the basis that individuals are taxable in the country in which they are residing. The debate has been going on for long on which methodology to use. The new Code proposes to use residence based taxation for residents and source based taxation for non-residents. Accordingly, a resident in India will be liable to tax on his worldwide income, whereas a non-resident will be liable to tax in India only in respect of receipts in India. Thus, if a person was out of India for more than 183 days, he would be treated as a non-resident and need not pay tax on the income which has already been taxed in the country where the income was generated.

The concept of 'resident but not ordinarily resident' is proposed to be abolished. Further, the Code seeks to enhance the tax base by including overseas incorporated companies with partial control and management in India as 'residents'. The direct implication of this provision would be that the foreign companies could be regarded as residents under the control and management test and, hence, would be liable to be taxed in India.

Corporate taxation

4. The tax rate for both domestic and foreign companies has been reduced to 25 per cent from the present 30 per cent. In addition, foreign companies would be liable to pay the branch profits tax at the rate of 15 per cent on post-tax branch profits, irrespective of the fact whether they remit profits outside India or not. The Code envisages doing away with a large number of exemptions and deductions, though in a few cases, the profit linked incentives are proposed to be replaced with a new set of incentives linked to capital investment. The Dividend Distribution Tax ('DDT') remains unchanged at 15 per cent. Surcharge and education cess will be chargeable in accordance with the relevant provisions of the Finance Act. Current relief from the DDT, available to the Indian holding companies in respect of dividends received from a subsidiary company, is to continue,

provided the holding company is not a subsidiary of any other company. Dividends paid to following entities are to be reduced while computing the DDT liability :

- (i) New Pension System Trust
- (ii) Mutual fund (includes venture capital funds/companies)
- (iii) Approved provident fund
- (iv) Approved superannuation fund
- (v) Life Insurance Company

The base for applying Minimum Alternate Tax ('MAT') has been shifted from book profits to gross assets. Rate of MAT shall be 0.25 per cent of gross assets in case of banks and 2 per cent in case of companies. MAT will be a final tax and no tax credit will be available for it in subsequent years. The proposed MAT would hit hard the capital intensive projects like infrastructure, cement, power, SEZs, telecom, real estate, etc., since the gestation period is very long and the companies engaged in setting up these projects will have to bear MAT despite the fact that they have not generated revenue of a single rupee. MAT could become a severe strain on resources during business cycles with prolonged recession, when companies witness negative cash flows. Even the companies referred to BIFR would have to bear the brunt of MAT, which is not at all fair. Thus, the implications of the proposed MAT must be looked into before presenting the Bill in the Parliament.

Capital gains

5. Capital gain is the term used for the amount by which the sale price of a capital asset, net of any expense incurred in connection with the sale of the asset, exceeds the acquisition price of the capital asset. No distinction shall be made between the long-term and short-term capital gains, except for allowing the indexation and rollover benefits. The assets held for more than a year shall be entitled to indexation benefit. Presently, the indexation benefit is available for shares/securities if the same are held for at least a year and for other assets, the period is three years. Only net gain/loss from all investment assets collectively shall be considered for calculating the capital gains. Capital gains will be included in the total income of the financial year in which the asset is transferred and not the financial year in which the consideration is received. However, in case of compulsory acquisition of an asset, capital gains will be taxed in the year in which the compensation is actually received. Capital loss will not be allowed to be set off against any other income.

Inflation indexation of cost of acquisition/improvement shall continue under the proposed system also. The base year for calculation of capital gains is proposed to be shifted from April 1, 1981 to April 1, 2000. Consequently, all the capital gains made between April, 1981 and April, 2000 would be exempt from tax. This would substantially benefit the

persons who had purchased capital asset(s) long back. Transfer of an asset as 'gift' or 'will' would not be liable to capital gains tax. In case the amount of capital gain is invested in approved capital gains savings scheme, the same shall not be liable to tax. Reinvestment (rollover) options to claim exemption from levy of tax will be limited to the following types of capital gains :

- (i) From agricultural land to one or more pieces of agricultural land.
- (ii) From investment asset to a residential house, provided the taxpayer does not own any residential house other than the new asset on the date of transfer of original asset.
- (iii) From any investment asset to deposit in an account maintained under the capital gains savings scheme.

The withdrawals from the capital gains savings scheme shall be included under the head 'Income from residuary sources' and, accordingly, shall be subject to tax.

Last, but not the least, the Securities Transaction Tax ('STT') is proposed to be abolished. Therefore, the long-term capital gains from sale of listed securities shall be taxable at the ordinary rate of tax. However, the benefit of indexation shall be available in case the security was held for more than a year. This provision may affect the sentiment of the stock market as well as the money flow because a number of investors invest in shares not only because of expectation of superior returns, but also because the long-term capital gains from listed shares are tax-free. Under the present system, the gain on redemption of units of equity oriented mutual fund schemes after one year of purchase/subscription is exempt from tax but the proposed law would tax it as capital gain. This may lead to reduction in assets under management of mutual funds, another negative factor for the stock market.

Further, the Code proposes to do away with the concessional tax rates available to FIIs. The net capital gains of FIIs shall be taxed at the rate of 30 per cent as against the present concessional rate of 10 per cent for long-term capital gains and 15 per cent for short-term capital gains. A specific exemption is provided in connection with transfer of bonds or Global Depository Receipts (GDRs) by one non-resident to another outside India.

Income from house property

6. At present, the Income-tax Act, 1961 uses the concept of 'Fair Rent' and 'Standard Rent' for the purpose of computing the 'Gross Rent'. This concept is proposed to be substituted by the 'Contractual Rent' and 'Presumptive Rent'. Contractual Rent means rent as per a contract (written or otherwise), whereas Presumptive Rent shall be calculated at the rate of 6 per cent of the ratable value of the concerned property. In case the ratable value has not been fixed, the cost of construction or acquisition shall be considered. The deduction on account of repair and maintenance

is proposed to be reduced to 20 per cent of gross rent instead of the present permissible deduction of 30 per cent of the net annual value. Income from any house property is mandatorily required to be computed under this head notwithstanding that the letting, if any, of the property is in the nature of trade, commerce or business.

As already discussed, deduction of interest paid on housing loan taken (subject to maximum of Rs. 1,50,000 per annum) from the gross income for the purpose of acquisition/construction of self-occupied property is proposed to be withdrawn. However, if the same or second house is given on rent, the person can still enjoy the benefit of tax exemption on interest payout and that too without any limit. Thus, the proposed system augurs well for the landlords, but not for the tenants.

Income from residuary sources

7. The scope of residuary income has been increased to include therein :

- ◆ Amount received as advance or as security deposit through long-term lease or from transfer of whole or part of, or any interest in any investment asset.
- ◆ Sum received under life insurance policy, included that any bonus on such policy shall be taxable. However, deduction shall be allowed if the premium payable of any of the years during the term of the policy does not exceed 5 per cent of the capital sum assured.
- ◆ Unexplained cash credits, investments, money and expenditure.
- ◆ The value of the net assets held by a non-profit organization on the 1st day of the financial year in which it ceases to be a non-profit organization.

Double taxation avoidance agreements

8. Under the present system, the Double Taxation Avoidance Agreements ('DTAAs') entered into by the Indian Government with the Government of a foreign Country override the Income-tax Act, 1961. Therefore, a taxpayer has the option either to be governed by the Act or by the concerned DTAA, whichever may be more beneficial to him. This principle is more or less an acceptable international convention also. However, the Code proposes a departure from the aforesaid established principle by providing that the provisions under the Act or DTAA, whichever is later in time, shall prevail.

The proposed move may make the provisions of all the existing DTAAs ineffective. The intention behind this proposal seems to be to make treaties with countries like Mauritius and Cyprus ineffective, which have become tax heavens for investors. A major implication of the proposed change shall be that FIIs who are investing money in the Indian stock market through the Mauritius route and, thus, avoiding payment of tax on their profits shall also come under the tax net. Only time would tell whether the

Government is successful in its proposed attempt or not because the DTAA's are bilateral agreements between two sovereign States and as such an attempt to unilaterally restrict their applicability is likely to be opposed by the other Government. In other words, the move to position the Code above the tax treaties is a welcome move but the same may not be digested by the treaty partners. May be the Government would have to strive to renegotiate the terms of DTAA's with the treaty partners.

Wealth-tax

9. The wealth tax has been brought under the Code itself. New wealth tax law would be applicable only to individuals, Hindu Undivided Families and Private Discretionary Trusts, thereby exempting companies and other unincorporated bodies. The wealth tax will be levied in case 'net wealth' on the valuation date exceeds Rs. 50 crores as against the limit of Rs. 30 lakhs proposed under the Finance (No. 2) Bill, 2009. The scope of definition of 'assets' has been widened to include all assets including 'net wealth'. Rate of wealth tax is proposed to be reduced to 0.25 per cent as against the present rate of 1 per cent, which is likely to improve the level of compliance.

Due date of filing of income-tax returns

10. The due date for filing of income-tax returns is proposed to be advanced by one month for individuals as well as for corporates. Thus, the due date for individuals shall be June 30, every year and for corporates it shall be August 31, every year.

Conclusion

11. The modest tax rates coupled with the 'EET' regime shall benefit the lower and middle income groups the most through reduction in their tax burden. Thus, the disposable income in their hands shall increase to some extent which is likely to boost the domestic consumption and give a fillip to the country's economy. The modest tax rates shall also improve the level of compliance and widen the tax net, which shall be a big positive for the national exchequer.

With the passage of time the Income-tax Act, 1961 had made the tax system too onerous and complex to understand for the ordinary taxpayers. The piecemeal changes every year through Union Budgets further added to the problem. For example, the Finance Act, 2005 introduced the Fringe Benefit Tax and the Finance (No. 2) Bill, 2009 has proposed to scrap the same. Thus, there have been various contradictory policy changes which need to be streamlined at one go through enactment of a new Act. The new Code is a lot leaner, simpler, logically organised and aims at reducing litigation. To conclude, one can say that the move of the Finance Minister to come out with new tax Code within the time line of 45 days as promised by him in the Union Budget on July 6, 2009 is really laudable.