

Direct Tax Code

Second thoughts

Introduction of EET regime, clubbing capital gains with income slabs and applying MAT on gross assets instead of book profit will call for fresh investment strategy

The initial response of the stock market to the Direct Tax Code (DTC) was positive. The BSE Sensex rallied by 498 points on 13 August 2009 after the DTC was presented on 12 August 2009. But later the market realised there are a number of grey areas not only in personal and corporate taxation but also for the stock market. For example, the limit for availing tax exemption under Section 80C of the Income Tax Act, 1961, through investment in specified instruments is proposed to be increased from Rs 1 lakh to Rs 3 lakh. This is a welcome step.

A matter of concern, however, is that after the code becomes an Act, equity-linked saving schemes (ELSS) of mutual funds will not be eligible for tax exemption as all investments are proposed to be brought under the exempt-exempt-tax (EET) regime. Though ELSS have a lock-in period of three years, they are popular among investors as they are able to provide better returns compared with bank deposits and National Saving Certificates. The redemption amount is also tax-free. The proposed move will, thus, reduce the assets under management of mutual funds as they will have to eventually phase out their open-ended tax saving schemes. Needless to say if mutual funds start liquidating their assets, the stock market is bound to be affected.

The code, however, provides that the accumulated balance up to 31 March 2011 will be exempt from tax. Hence, the accumulations in the public provident fund (PPF) account up to 31 March 2011 will be tax-free. But what about investors who have invested in ELSS after April 2008? In their case, the lock-in period of three years will be over only after 1 April 2011. By then the DTC would have become an Act. Accordingly the redemption proceeds will be taxable in their hands. This is not at all fair and reasonable as investors have relied on the prevailing tax laws as per which the redemption proceeds were tax-free. Investors who have completed the lock-in period of three years may start applying for redemption before 31 March 2011. Cautious investors may stop putting fresh money in open-



ended ELSS to claim tax exemptions for the financial years 2009-10 and 2010-11 because this amount will be locked up to September 2012 or beyond that and, thus, the redemption proceeds will be taxable.

Another major shock for the stock market is that the DTC proposes to abolish the securities transaction tax (STT) and instead introduce tax on long-term capital gain, which is so far tax-free if an investor holds a listed share for more than a year and STT had been paid. The code also proposes to scrap the distinction between long-term and short-term capital gain. Accordingly, short-term capital gain will be taxed at the personal marginal tax rate. Not only this, equity-oriented schemes of mutual funds, which are tax-free if an investor holds the mutual fund units for at least one year, are also proposed to be brought under the tax net. This can substantially reduce the AUM of several large mutual fund houses.

Retail investors may reduce their exposure to the stock market directly as well as through mutual funds. This goes against the government's attempts of spreading the equity cult in the country. In the budget speech on 6 July 2009, the finance minister had emphasised the need for increasing the pub-

lic float in listed companies.

The Securities and Exchange Board of India (Sebi) is expected to shortly come out with new regulations mandating increase in public shareholding to at least 25% by dilution of 5% promoters' stake every year over the next five years. Thus, on one hand, the government is recognising the need for participation of retail investors in the stock market. On the other hand, it is proposing to withdraw the tax incentives for investing in the stock market.

The DTC proposes to reduce the tax rate for domestic companies from the present 30% to 25%. Prima facie, this, looks attractive. But the problem is that simultaneously the code envisages doing away with a large number of exemptions and deductions. In a few cases, however, profit-linked incentives are proposed to be replaced with a new set of incentives linked to capital investment. The reduction in the tax rates, therefore, may be more or less neutralised by the withdrawal of various exemptions and deductions.

The biggest headache for companies, however, is that the base for applying minimum alternate tax (MAT) is proposed to be shifted from book profit to gross assets. At present MAT is levied at 10% of book profit.

This will be increased to 15% by Finance (No. 2) Bill, 2009. Under DTC, MAT is proposed to be levied at 0.25 % of gross assets for banks and at 2 % of gross assets for companies. MAT will be a final tax and no tax credit for it will be available in subsequent years. The proposed MAT will impact the following kinds of companies :

- Companies setting up new projects in capital-intensive sectors such as infrastructure, cement, power, special economic zones, telecom and real estate. For example, Reliance Power came out with a mega IPO in January 2008 to finance the setting up of ultra mega power projects (UMPPs) and a number of large and medium power projects. The company will take at least five to six years to construct each UMPP. Thus, there will be no revenue stream from these UMPPs in the gestation period. Yet, the company will have to pay MAT from the financial year 2011-12 onwards. This is nothing but payment of tax to the government out of shareholders' funds.

- MAT will be a severe strain on resources of companies in recession when they incur losses continuously for several years.

- At present, companies with past years' accumulated losses in their books do not have to pay any tax because whatever profit they earn can be set off against accumulated losses. After the proposed MAT regime, no such set-off will be allowed. Thus, MAT can adversely impact airlines which have huge accumulated losses but will still have to pay MAT from 1 April 2011.

- Even sick companies referred to the Board or Industrial and Financial Reconstruction (BIFR) will have to bear the brunt of MAT, which will further worsen their financial condition. The government gives various kinds of concessions and reliefs to BIFR companies to revive them. Yet, such com-

A new era

Under the EET regime, even redemption of ELSS will be taxed from April 2011

Top 5 ELSS schemes by AUM

SCHEME NAME	LATEST AUM (Rs cr)
Magnum Tax Gain Scheme (G)	4466.97
Reliance Tax Saver (ELSS) Fund - (G)	2006.63
HDFC Tax Saver Fund (G)	1740.73
UTI-Master Equity Plan Unit Scheme	1163.35
Sundaram BNP Paribas Tax Saver (G)	1089.08
Birla Sun Life Tax Relief '96 (G)	896.39
ICICI Pru Tax Plan - (G)	870.70
HDFC Long Term Advantage Fund (G)	828.32

Latest corpus dated 31 July 2009



panies will have to pay MAT, which seems to be a retrograde step.

- Investment companies formed by promoters of listed companies, which hold shares as strategic investment in the promoter group, will also have to pay MAT on the basis of their gross assets. At present, such companies do not pay much tax because their primary source of income is dividend from listed/unlisted group companies, which is tax-free.

It becomes clear that the proposed MAT will hit hard valuations of listed companies within its ambit. As such, it is a negative factor from the stock market's perspective. This is not the end of the story. The DTC will also be prejudicial to the interests of foreign institutional investors (FIIs) as it proposes to do away with the concessional tax rates available to FIIs. The net capital gain of FIIs will be taxed at 30 % as against the present concessional rate of 10 % for long-term capital gain and 15% for short-term capital gain.

Under the present system, 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, the tax payer has the option either to be governed by the Act or by the concerned DTAA, whichever may be more beneficial to him. However, the code proposes a departure from this established international principle by providing that the provisions under the Act or DTAA, whichever is later in time, shall prevail. The intention behind this move seems to be to make ineffective treaties with countries like Mauritius and Cyprus, which have become tax heavens for FIIs. FIIs who are investing money in the Indian stock market through the Mauritius route will, thus, come under the tax net. DTAAs are bilateral agreements between two sovereign states. A such an attempt to unilaterally restrict their applicability is likely to be opposed by the other government. If the Indian government prevails, FIIs can, however, substantially reduce their exposure to the Indian stock market.

Last, but not the least, investors who are sitting on huge gains may start booking profit in February or March 2011 or even before that to avoid payment of capital gain tax as the shares sold / mutual fund units redeemed after 1 April 2011 will be taxed at the personal marginal tax rate. This may lead to a sharp correction in the market, which can erode the shareholders' wealth.

—Rajesh Felan

Clipping their wings

The DTC does away setting off profit against accumulated losses. Hence, even loss-making airlines will have to pay MAT

COMPANY	PRICE (Rs) 31 MAR 09	PRICE (Rs) 31 MAR 08	RETURNS (%)	Q1-NP 200906	Q1-NP 200806	VAR (%)	FY NP 2009	FY NP 2008	VAR (%)
SpiceJet	13.47	40.8	-66.99	26.34	-129.16	120.39	-333.79	-176.23	-89.41
Jagson Airlines	6.05	19.85	-69.52	-1.89	-0.89	-112.36	-7.09	-6.16	-15.10
Jet Airways	169.9	556.35	-69.46	-250.99	-695.36	63.91	-1747.9	-641.39	-172.52
KF Airlines	33.4	122.05	-72.63	-229.45	-157.87	-45.34	-1371.29	-237.57*	-477.22

Net profit in Rs crore is after excluding extraordinary items * nine months ended