



Direct Taxes Code

Back to the past

Dilution of the reforms suggested in the original version defies the purpose behind their introduction

The final version of the Direct Taxes Code (DTC) 2010 bill that aims to replace the existing Income Tax (IT) Act, 1961, neither represents a clean break from the past nor a culmination of a well thought-out process to unshackle assesseees and increase tax compliance. Instead, it looks like a hotchpotch effort to take a stab at reforms but succumbing to doubts and second thoughts. Even the date of implementation has been deferred by one year to 1 April 2011. The bill, presented in parliament on 30 August 2010, has been referred to the standing committee on finance, which will submit its report within two months. Once approved by both the houses of parliament it will be enacted as law.

The government had gave no justification when the concept of higher exemption limit was introduced for women. Again, the finance ministry has not bothered to give any reasoning for scrapping the higher ba-

sic exemption limit for women in DTC 2010. After the DTC becomes effective from 1 April 2012, both men and women will enjoy the same basic exemption limit of Rs 2 lakh as against the present basic exemption limit of Rs 1.6 lakh for men and Rs 1.9 lakh for women.

For senior citizens above 65 years of age, the exemption limit has been raised to Rs 2.5 lakh from the present Rs 2.4 lakh. For all those earning up to Rs 8 lakh per annum, the tax relief will be a minuscule Rs 4000 per annum for men and Rs 1000 per annum for both woman and senior citizens. Thus, hopes of getting substantial tax relief, when the DTC was unveiled in August 2009, stands completely shattered.

The IT Act, 1961, provides to individuals annual deduction of Rs 1 lakh from total income under Section 80C that can be availed through a mix of investment in various tax saving schemes such as Public

Provident Fund (PPF) (up to a cap of Rs 70000), statutory PF, new pension scheme (NPS), equity-linked saving schemes (ELSS) of mutual funds, premium paid for life insurance policies or unit-linked insurance plans (Ulipis), repayment of principal amount of home loan, National Savings Certificate, fixed deposits with banks with maturity period of five years, payment of tuition fees for full-time education of up to two children.

In the current financial year (1 April 2010 to 31 March 2011), an assessee can avail additional deduction of Rs 20000 from total income under Section 80CCF of the IT Act by investing in certain notified infrastructure bonds such as the IDFC bonds issue that closed for subscription on 18 October 2010. Section 80D of the IT Act further allows deduction of Rs 15000 towards premium paid for medical insurance policies for self and family members and a further Rs 20000 on medical insurance of dependent parents who are senior citizens. Thus, through judicious tax planning, an assessee can reduce his total taxable income by Rs 1.35 lakh to Rs 1.55 lakh.

Under the DTC bill, some of these deductions have been changed. The present deduction of Rs 1 lakh under Section 80C will be available only on investment in retiral accounts such as PPF, PF, NPS and in savings schemes notified by the government. All these investments will enjoy exempt-exempt-exempt benefits, meaning the tax payer will enjoy tax exemption at the time of investment (subject to a maximum of Rs 1 lakh per annum), interest accrued or accumulated during the tenure of the scheme will be exempt, and the withdrawal on maturity will also be exempt from tax. Additionally, an aggregate deduction of Rs 50000 will be available on account of premium paid for pure life insurance and health insurance policies and tuition fees of up to two children. Consequently, total deduction available will increase from the present Rs 1.35 lakh to Rs 1.5 lakh.

A matter of grave concern is that after the bill is enacted, ELSS shall not be eligible for tax exemption. No doubt these schemes have lock-in period of three years. Still they are quite popular among investors as they provide better return compared with PPF and NSCs and the redemption amount is also 100% tax-free. Equity mutual funds and Ulipis will also attract dividend distribution tax of 5%. Accordingly, the dividend option

of mutual fund schemes will be less tax efficient as compared with the growth option. All these proposals may reduce the assets under management of mutual funds as they will have to eventually phase out their open-ended tax saving schemes.

The bill has more or less retained the existing framework for taxation of capital gain. While long-term capital gain on transactions through stock exchange will continue to be exempt from tax, transactions outside the stock exchanges, not subject to the securities transaction tax (STT), will be taxed at the rate of 30% as against 10% or 20% under the existing regime. However, indexation benefit will be available on such capital gain. Short-term capital gain will be taxed at the personal marginal tax rate, with a 50% deduction. For a person earning an income of Rs 9 lakh per annum, the applicable tax slab will be 20%. Correspondingly, any short-term capital gain made by him will be taxable at 10%. This appears more benign on investors' pocket as the current short-term capital gain tax is 15%. It has now been proposed that only 50% of the short-term capital losses be permitted to be set off and carried forward.

Income from equity-oriented mutual fund units will continue to be exempt from



tax. For capital gain arising on transfer/ redemption of units of an equity-oriented mutual fund on which STT has been paid, deduction will be allowed to the extent of 100% if the unit has been held for more than one year and to the extent of 50% if the unit has been held for one year or less.

The base date for determining the cost of acquisition of a capital asset will be

shifted from 1 April 1981 to 1 April 2000. Accordingly, all the unrealised capital gain on assets acquired between 1 April 1981 and 31 March 2000 will not be liable to tax. Cost of acquisition will be nil, if it cannot be determined or ascertained due to any reason.

Another noteworthy feature is the change in the definition of 'holding period'. On a plain reading of the provisions of the DTC 2010 bill, it seems that the holding period will continue to be one year for listed securities. But it is not so. DTC has defined long-term capital gain 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 on 1 May 2012, he will have to hold on to his investment till 1 April 2014 i.e., at least for one year, 11 months and one day to be eligible to claim the benefit of long-term capital gain fully exempt from tax. In other words, the holding period for long-term capital gain on shares will vary between 12 months 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., 1 April).

As a corollary to this provision, the holding period for short-term capital gain has been

Taking it personally

Key changes in personal taxation incorporated in the DTC 2010 bill

- Changes in income tax slabs proposed in the Direct Taxes Code (DTC) 2010 bill will result in incremental savings in tax. The concept of 'not ordinarily resident' is removed.
- A person who is not entitled to house rent allowance (HRA) from his employer will be allowed deduction of rent paid up to 10% of gross total income or Rs 2000 per month, whichever is less, subject to the conditions as may be prescribed by the government on the area or place in which the accommodation is situated.
- Exemption for medical expenses increased to Rs 50000 per annum from the existing Rs. 15000 per annum.
- Contribution to approved superannuation fund by the employer will be deductible to the extent of maximum of Rs 1 lakh for each employee. Although contribution exceeding Rs 1 lakh will

not be taxable in the hands of the concerned employee, it will not be

Under the Income Tax Act, 1961, applicable to men at present	
Slab	Tax rate
Up to Rs 160000	Nil
From Rs 160001 to Rs 500000	10%
From Rs 500001 to Rs 800000	20%
Above Rs 800000	30%
Original DTC in August 2009 proposed the following slabs	
Up to Rs 160,000	Nil
From Rs 160001 to Rs. 1000000	10%
From Rs 1000001 to Rs. 2500000	20%
Above Rs 2500000	30%
Proposed slabs under DTC bill August 2010 for both men and women	
Up to Rs 200000	Nil
From Rs 200001 to Rs. 500000	10%
From Rs 500001 to Rs 1000000	20%
Above Rs 1000000	30%

treated as a deductible expenditure while computing the business income of the employer. Thus, the DTC proposes to reintroduce the fringe benefits tax through the disallowance route.

- Deduction for leave travel allowance has not been specifically mentioned in the bill.
- The deduction on account of interest paid on home loans will continue with the existing annual limit of Rs 1.5 lakh. However, the Rs 1-lakh limit on principal amount of home loan repaid during the year is proposed to be withdrawn. This will impact the lower middle class, who may not have enough funds to invest in tax-saving schemes after paying their equated monthly instalments for home loans.
- Absence of any provision for furnishing Form 15G or Form 15H for non-deduction of tax at source from interest on non-taxable income will not only hit hard senior citizens but also overburden the departmental machinery.
- Wealth tax is to be levied at 1% for wealth in excess of Rs. 10 million.

Keeping company

MNCs functioning in India through subsidiaries will be better off compared with MNCs operating directly through branches

The Direct Taxes Code (DTC) 2010 bill proposes taxing companies at the flat rate of 30%. Levy of surcharge and cess is proposed to be done away with. Although this falls short of the proposal in DTC 2009 to bring down the corporate tax rate to 25%, there will still be 3.22% saving for companies as compared with the current tax rate due to removal of surcharge and cess. The effective tax rate for most companies is in the range of 18%-20% at present on account of various exemptions. However, with fewer exemptions under DTC 2010, the effective tax rate for companies is likely to go up marginally over a period of time. A foreign company will have to pay additional branch profit tax of 15%. Consequently, MNCs operating in India through subsidiaries will be better off as compared with MNCs operating directly through branches.

Another breather has been provided to special economic zone (SEZ) units

and developers by granting an extended timeline. Units established in the SEZ under the Income Tax (IT) Act, 1961, will continue to be allowed profit-linked deduction under DTC 2010 if they begin operations on or before 31 March 2014. SEZ developers notified on or before 31 March 2012, will be eligible to claim investment-linked deductions. However, they have now been included under the minimum attractive tax (MAT) regime.

The proposal to increase the rate of MAT to 20% from the existing 18% of book profit will be a dampener. MAT will be applicable if the tax based on book profit is higher than the tax on profit arrived at as per the normal tax computation. The only saving grace is that MAT will continue to be computed based on the book profits of companies instead of 2% of gross assets as was stated in DTC 2009. This will primarily be positive for companies flagging off big projects with substantial capital outlays and long gestation periods. On the other hand, it is negative for SEZ developers and units presently not subject to MAT under the IT Act, 1961. However, they will be allowed MAT credit for 15 years as against the limit of 10

years under the existing Act.

Domestic companies will continue to pay the dividend distribution tax of 15% on dividend declared. However, they will be allowed deductions as dividend received from subsidiary companies on which the tax has already been paid by the concerned subsidiary. Companies will now be allowed to carry forward business losses for unlimited periods as against the limit of eight years under the existing IT Act. The limit for in-house weighted deduction of 150% for R&D expenses has been increased to 200%. This will benefit the companies that spend huge amount on R&D activities.

Companies will be treated as residents in India if they are Indian companies or if the place of effective management (POEM) is in India. POEM has been defined to mean the place where the board of directors or executive directors take their decisions or the place where such executive directors or officers of the company perform their functions and the board of directors routinely approves the commercial and strategic decisions taken by such executive directors or officers.

In all cases other than an individual, a company will be considered to be resident in India if the place of control and management of the affairs during any time of the year is situated, wholly or partly, in India.

CATEGORY	TAX UNDER IT ACT, 1961 (INCL SURCHARGE & CESS)	TAX PROPOSED UNDER DTC 2009	TAX PROPOSED UNDER DTC BILL 2010
Domestic Company	33.22%	25.00%	30.00%
Foreign Company	42.23%	25.00%	30.00%
Branch Profit Tax	Nil	15.00%	15.00%

increased. Suppose an investor buys shares on 1 May 2012 and sells them on any date before 1 April 2014, the resulting capital gain will be treated as short-term capital gain. 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.

Further, no distinction has been proposed between financial assets and other assets. The holding period will become uniform for all kinds of assets. Immovable property or gold or equity shares or mutual fund units. The existing provision of IT Act provides that assets like immovable property and 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. The proposed change will benefit real estate investors as the holding period to enjoy the benefit of long-term capi-



tal gain will be reduced considerably.

The DTC 2010 bill has not only lowered the deduction limit for life insurance premium to Rs 50000 but has also clubbed it with Mediciclaim premium and children's tuition fees. As the existing overall limit for deduction under Section 80C of the Income Tax Act, 1961, on amount of premium paid for life insurance policies and unit-linked insurance plan (Ulips) is Rs 1 lakh per annum, it is quite possible that many tax payers might have organised their investments in such a manner that their cash outflow towards premium for life insurance policies and Ulips is between Rs 50000 to Rs 1 lakh per annum. Such assesses will find themselves in a fix as they can neither change the premium amount nor the term of the policy. Thus,

they will have to continue to pay the premium despite the fact that premium paid in excess of Rs 50000 will not be eligible for any tax incentive. Scope for deduction has been further curtailed. Policies of less than 20-year term with premium per annum more than 5% of capital sum assured will not be eligible for any tax incentive.

This is not the end of the woes. The DTC 2010 bill further provides that sum received from the insurance company on maturity of the policy, where premium paid per annum is more than 5% of the capital sum assured, will be subject to tax. As the amount received on maturity also includes the annual premium paid by the policy holder during the tenure of the policy, it has been specifically provided in the bill that the tax will be levied only on the amount that is over and above the aggregate of the premium paid by the policy holder during the entire tenure of the scheme. This is a deviation from the original DTC 2009, which proposed to tax the entire lumpsum amount received on maturity, which would have been nothing but taxation of capital or principal amount contributed in the form of annual premiums.



The amount paid by the insurance company to the policy holder or nominee on maturity or death will be subject to 10% tax deduction at source if the tenure of the policy is less than 20 years. The proposed levy of 5% distribution tax on income distributed under Ulips will reduce the return on investment.

Capital treatment

Income earned by FIIs through stock market transactions will be treated as capital gain

Some foreign institutional investors (FIIs) characterise 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 Direct Taxes Code (DTC) 2010 bill has, therefore, proposed charging income earned by FIIs through stock market transactions as capital gain.

Even if FIIs show their income from investment in shares as capital gain, the income escapes as they take shelter under the umbrella of double taxation avoidance agreements (DTAAs), which India has entered into with various countries. It has been categorically stated that between domestic law and DTAA, the law that is more beneficial to the tax payer will prevail.

Thus, FIIs who are able to take advantage of the provisions of DTAAs

will not pay any tax on capital gain in India. It can only be hoped that the government would some day snap its DTAAs with countries like Mauritius and Cyprus, thereby giving a level-playing field to all investors. 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 for the shell companies formed in tax heavens like Mauritius and Cyprus to route the funds in to the Indian stock market. Such companies would have to prove that they had the commercial substance. DTC 2010 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 the tax that it was avoiding.

For a house property that is let out, gross rent will be the amount of rent actually received. This is substantial relief as the DTC 2009 had proposed to tax income from house property on the basis of notional or presumptive rent calculated at 6% of the cost of construction or acquisition. This proposal was inequitable as it discriminated against the recent owners cost being a function of inflation.

For a house property that is not let out, the gross rent will be nil. As the gross rent will be taken as nil, no deduction for taxes paid or interest on home loan will be allowed. Therefore, if any person has purchased a house through borrowed funds he will have to give it on rent in order to claim the deduction of interest on home loan. Not only this, the standard deduction for income from house property is also proposed to be reduced to 20% from the existing 30%.

Under the IT Act, 1961, a non-resident Indian (NRI) is liable to pay tax on his global income only if he stays in India in a particular financial year for 182 days or more. The DTC 2010 bill proposes to reduce this period from 182 days to just 60 days. The proposal, thus, will make the life of NRIs tough. Not only this, if an NRI resides in India for 365 days or more over four years prior to the assessment year, he will be liable to pay tax on his global income.

In the case of resident of a country, with which India has no double-taxation avoidance agreement, the tax burden will be much higher if he exceeds the threshold limit of stay in India, because he will have to pay tax in India on his global income as well as tax in the country of residence, as per the prevailing tax laws of that country. The DTC 2010 bill has also removed the resident-but-not-ordinarily resident category to simplify the tax laws. Although DTC is attempting to plug the loophole to prevent tax vasion through this route, it could end up as a dampener for NRIs, who visit India to meet their relatives or for business promotion.

Last year, the finance minister had unveiled the DTC with lot of fanfare, evincing hopes in the minds of millions of tax payers that our direct tax law and not only be simplified to a great extent but the tax burden will also be reduced substantially. However, after receiving the feedback from various stakeholders, the ministry has twisted the original code to such an extent that it seems to be just old wine in new bottle.

— Rajesh Relan