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Theme 218

TAX REFORMS IN INDIA – DIRECT TAXES CODE (DTC) Part-I

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SIB STUDENTS' ECONOMIC FORUM

JANUARY 2010

Theme No. 218 : TAX REFORMS IN INDIA – DIRECT TAXES CODE (DTC) Part - I

The government unveiled the draft of a new Direct Taxes Code, which will replace the Income-Tax Act. It is aimed to improve the efficiency and equity of our tax system by eliminating distortions in the tax structure. It is also intended to introduce moderate levels of taxation and also to expand the tax base.

The **new direct taxes code** will become a law only by 2011. The government proposes to pursue structural changes in **direct taxes** by releasing the new **Direct Taxes Code.** The Direct Taxes Code, along with a Discussion Paper, was released to the public for debate. Based on the inputs received, the govt. will finalize the Direct Taxes Code Bill for introduction in Parliament.

What is the need for a new Direct Taxes Code?

The Income Tax Act was passed in 1961 and has been amended every year through the Finance Acts. The Act deals with income tax. Dividend Distribution Tax was included in the Act with effect from June 1, 1997. Fringe Benefit Tax was included in the Act with effect from April 1, 2006. Wealth Tax is administered through the Wealth Tax Act, 1957. Tax administrators, chartered accountants and tax payers have raised concerns about the complex structure of the Income Tax Act. In particular, the numerous amendments have rendered the Act incomprehensible to the average tax payer. Besides, there have been frequent policy changes due to changing economic environment, complexity in the market, increasing sophistication of commerce, development of information technology and attempts to minimize tax avoidance. The problem has been further compounded by a multitude of judgements, very often, conflicting, rendered by the courts at different levels. Any complex tax legislation increases the cost of compliance as well as administration. Given that the cost of compliance is essentially regressive in nature, this undermines the equity of the tax system. Similarly, high cost of administration is wasteful.

How is it proposed to broaden the tax base?

Over the last twenty five years, the tax rates have been steadily lowered and the rate structure rationalized to reflect the best international practices. Any further rationalization of the tax rates may not be feasible without corresponding increase in the tax base. Broadening of the base is important to enhance revenue productivity of the tax system and to improve its horizontal equity. The strategy for broadening the base essentially comprises of three elements. The first is to minimize exemptions. For many decades, the tax base has been eroded through a steadily escalating range of exemptions. The removal of these exemptions will have three consequences: (i) it will result in a higher tax-GDP ratio; (ii) it will enhance GDP growth, since tax exemptions and deductions distort allocative efficiency; and (iii) it will improve equity, reduce compliance costs, lower administrative burdens, and discourage corruption. The second element of the strategy relates to the problem of ambiguity in the law which facilitates tax avoidance. Therefore, it is necessary to undertake a periodic exercise of rewriting the Tax Code in the light of new trends in interpretation by the judiciary, aggressive tax planning by taxpayers, and new opportunities for reducing compliance cost through massive induction of technology and public private partnership. The third element of the strategy relates to checking of erosion of the tax base through tax evasion. The Direct Taxes Code is designed to reflect this strategy.

What are the taxes that are covered under Direct Taxes Code?

The draft Direct Taxes Code will have coverage on income taxes – personal taxation and corporate taxation, capital gains taxation, wealth tax and international taxes including DTAA – Double Taxation Avoidance Agreement.

What are the provisions proposed in personal taxation?

In the matter of personal taxation, moderation of tax rates and increases in tax slabs are proposed. This will reduce the tax burden of the individuals. No income tax is payable for income up to Rs. 160,000- The tax rate of 10 percent is payable on income exceeding Rs. 1.60 lakh- and up to Rs. 10 lakh. For annual income exceeding Rs. 10 lakh and up to Rs 25 lakh, the tax rate will be 20 percent. The peak rate of 30 percent is proposed to be applicable on income exceeding Rs. 25 lakh. Only two categories of individual tax payers are proposed – Residents and Nonresidents. 'Not ordinarily resident' category will be abolished.

On eligible savings which are tax exempt, the methodology of exemption will be on the basis of 'Exempt-Exempt-Tax' instead of the present form of 'Exempt-Exempt-Exempt'. The 'EET' means that the savings will be exempt from taxation in the year of investment and accretion of income on the investment also will be exempt from tax, but withdrawal of investment cum interest will be subject to tax in the year of withdrawal.

What are the new code provisions as regards corporate taxation?

Corporate income tax is proposed to be reduced from the present 30 percent to 25 percent of the taxable income. The Minimum Alternative Tax (MAT) is presently charged on the book profits of the company at the rate 15 percent, if the taxes payable on income normally are found less than the tax as per MAT basis. According to the new Code, taxes will be applicable on the total assets of the company at the rate of 2 percent of the gross assets in case of companies other than banking and 0.25 percent of the assets in case of banking companies. Thus in the case of companies, its liability to pay income tax is to be the higher of the two – the amount of income tax liability on its total income calculated at specific rates or the amount of income tax liability calculated at the prescribed rates on gross assets. Dividend Distribution Tax will continue to be at 15 percent as at present. The provisions of transfer pricing regulations of associated enterprises have been expanded and made more stringent.

What are the changes proposed in the capital gains taxation in the DTC?

The definition of capital asset has been modified and replaced with the term 'investment asset'. All gains from sale of investment assets would be considered as capital gains for taxation without the distinction of short term assets and long term assets. Further, indexation facility would be available to all investment assets held for more than one year to account for inflationary impact. The indexation base date is proposed to be changed from 1 April 1981 to 1 April 2000. Securities Transaction Tax –STT- will be abolished.

What are the new provisions as regards wealth tax?

Individuals, HUFs and private discretionary trusts are liable to wealth tax. Wealth is to be taxed at 0.25 percent of the net wealth. The basic exemption limit has been enhanced to Rs. 50 crore. The new concept of wealth includes all assets. The key exclusions from net wealth are assets located outside India of foreign citizens, non-resident individuals / HUF and any one house or part of a house or plot of land belonging to an individual or a HUF which is acquired or constructed before 1 April 2000.

What are the provisions as regards international taxation in the DTC?

Foreign companies will be taxed at 25 percent of the income as against the present rate of 40 percent. For branches of foreign companies in India, an additional branch profits tax is also payable resulting in effective tax rate of 36.25 percent. Double Taxation Avoidance Agreement provides for tax credits as relief from double taxation of income from foreign and domestic sources and exchange of information for prevention of evasion or avoidance of income tax.

What are the proposed provisions as regards taxation of non-profit organizations?

The tax liability of a non-profit organization shall be 15 percent of the aggregate of the amount of surplus generated from the permitted welfare activities and the amount of capital gains arising on transfer of investment asset.

Tax reform is a process, not an event, as stated by the Finance Minister Pranab Mukherjee. “The Code is not an attempt to amend the Income Tax Act, 1961; nor is it an attempt to “improve” upon the present Act. In drafting the Code, the Central Board of Direct Taxes has, to the extent possible, started on a clean drafting slate. The best practices in the world have been studied and incorporated. Tax policies that would promote growth with equity have been reflected in the new provisions”. (Discussion Paper, Direct Taxes Code)

Direct Taxes Code (DTC) - The Draft

Corporate Tax

Category	Existing Tax Rate	As per DTC
Corporate Income-tax	30 percent	25 percent
Minimum Alternative Tax	Levied at 15 percent of the adjusted book profits in the case of those companies where income-tax payable on the taxable income according to the normal provisions of the act is lesser than the same.	Tax on gross assets Introduced as under: - 0.25 percent of gross assets for Banking companies - 2 percent of gross assets for other companies
Dividend Distribution Tax	15 percent	15 percent

International Tax

Category	Existing Rate	As per DTC
Foreign Company	40 percent	- 25 percent - For branches of foreign companies in India, an additional branch profits tax of 15 percent (on after tax total income) is also payable resulting in Effective Tax Rate of 36.25 percent

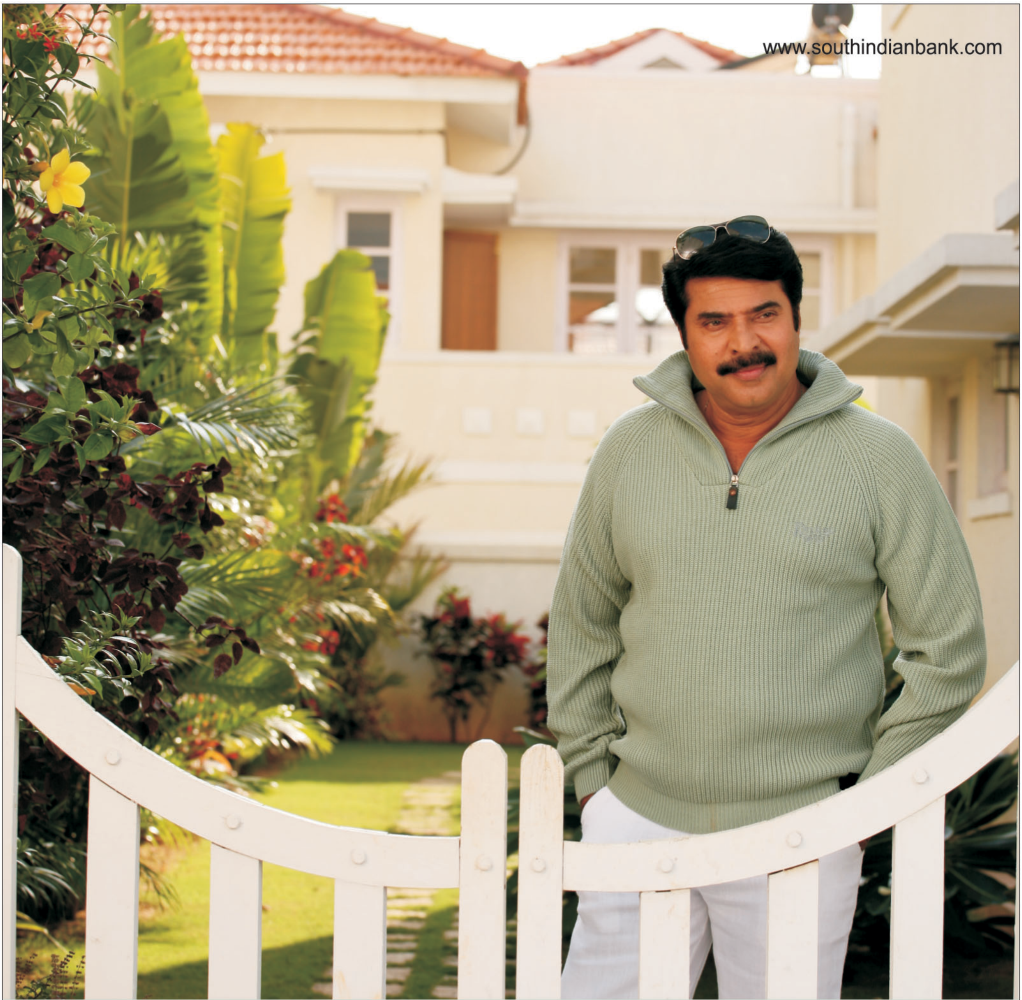
Rates of income-tax (for individual, other than women and senior citizens)

where the total income does not exceed Rs. **1,60,000**	***Nil***
where the total income exceeds Rs.1,60,000 but does not exceed Rs. **10,00,000**	10 per cent of the amount by which the total income exceeds Rs. 1,60,000
where the total income exceeds Rs.10,00,000 but does not exceed Rs. **25,00,000**	Rs.84,000 *plus* 20 per cent of the amount by which the total income exceeds Rs. 10,00,000
where the total income exceeds Rs. **25,00,000**	Rs.3,84,000 *plus* 30 per cent of the amount by which the total income exceeds Rs. 25,00,000

Exempt-Exempt-Tax (EET) regime for savings scheme

- All long-term retiral savings schemes are proposed to be moved to the EET regime.
- Contributions (both by employee and employer) of up to Rs. 3 lakh to any account with permitted savings intermediaries is proposed to be deductible.
- Accretion of income till withdrawal is exempt.
- Any withdrawal made under any circumstances is taxable. Withdrawals pertaining to approved employee provident fund accumulated balance as on 31 March 2011 and accretions thereon not taxable.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in



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