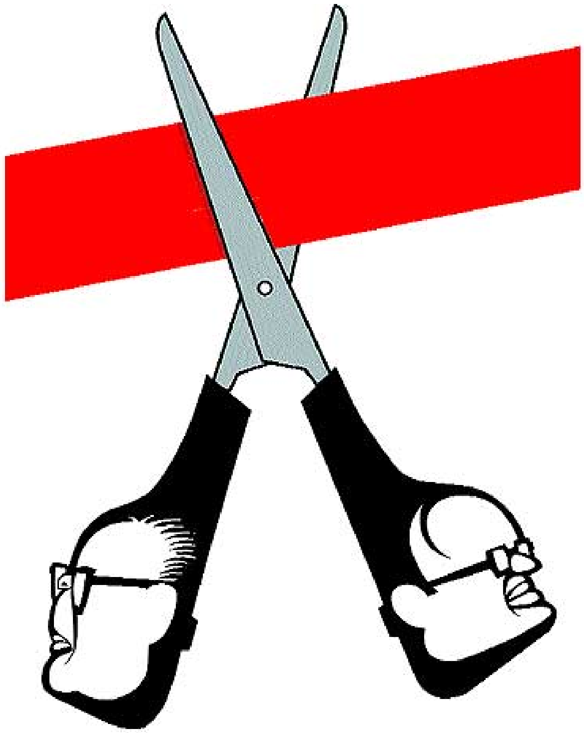

BUSINESS: DIRECT TAX CODE

It’s Still Taxing

A new tax code is replete with goodies, but still falls short of its original vision

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The New Code

Implications

Silent on IT slabs, which were very generous in the first draft

Final slabs, when announced, not likely to be as liberal as in the old draft. Expect no tax bonanza.

The popular savings—EPF, PPF, PF etc—will not be taxed at any stage

Expect premature withdrawals from savings to continue, leaving people poor in retirement

Rs 1.5-lakh exemption on housing loans to stay

Clear relief for the armies of people bent on owning a home. One of the politically savvy moves.

Minimum Alternate Tax on book profits, not gross assets

Big relief for India Inc, especially those firms incurring losses. The taxman fails to widen his net.

Indian law to over-ride international treaties in some cases

But a company can choose whether to be taxed as per DTC, or the international treaty

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The taxman’s job, never enviable, has become distinctly less attractive after the government released its final draft of the new direct tax code (DTC) in mid-June. The array of reversals—reverting to full tax exemption on popular saving schemes, or the assurance that taxes due from firms will be figured out on the basis of their profits rather than gross assets, as earlier proposed—will, no doubt, have everyone painting happy faces on their IT returns.

Nevertheless, there’s more than a shadow of doubt that some gains will be short-lived. Some fear that the fine print of the new tax law, which is to be based on the latest draft code, may reverse the jubilation. Others, enthused by the reversals, are hoping for further breaks. And, a few sections benefiting from the latest proposals are in shock— ‘can it be true’, they ask? So, is the new draft significantly different from existing laws, worth the years of preparation and public debate that preceded these announcements?

“In the new code, the government has given in partially to public demand,” says Hemal Zobalia, ED, tax and regulatory services, KPMG. He says that the fresh proposals are significant, though they don’t go as far as the original draft (which had P. Chidambaram’s stamp). He points out that the full tax break on personal savings has been restored only in select options such as PF, PPF, government-regulated pension funds, pure life insurance and annuity schemes—not the entire gamut of investments, leaving out options such as ULIPs. “Also, right now, if an individual buys stocks he holds for a year, he isn’t taxed. Under the new code there’ll be a tax, though the rate isn’t specified,” Zobalia says.

But others admit they are surprised by the extent of the “relaxations”. Gautam Bhardwaj, who runs Invest India Economic Foundation, says he expected the government to relax its stance from the earlier draft and “not use taxation as a means to encourage or discourage investments”. What he did not expect, he says, was that in the process of equalising all savings and investment routes, the government would give everyone a tax break, instead of taking it away from all.

On the personal income tax front, the earlier code proposed a tax rate of 30 per cent on people making Rs 25 lakh or more a year, as opposed to a 30 per cent tax on those making above Rs 8 lakh today—a huge relaxation. Now, this l beralised tax slab will be watered down (though we’ll have to wait for a legislative decision to know exactly how much). Ditto for the proposed corporate tax rate of 25 per cent (a significant relaxation from today’s 34 per cent).

Privately, a few taxation experts and government officials admit that with the new tax code, the exemptions that let some individuals and companies escape taxation will continue—so everybody else will pay a higher tax. Plus, compliance cost will rise. “The new DTC amounts to a tax on the non-taxpayer at the advantage of the high income individual,” one executive says. Another feels that the DTC will “somewhat equalise” the burden of taxation on different sections—but it will not achieve the paradigm shift that the code was expected to deliver, despite at least two years of discussion.

“The government has to bet very much on the buoyancy in tax revenues that will come by way of growth,” explains Mukesh Butani of BMR and Advisors, referring to the rise in taxpayer numbers as the economy has grown. He argues that breaks in the new code are directed at individuals, not corporates, though he admits, “it will be a challenge for authorities to determine how much they have given away, and for how much gain.”

This may be something even the government isn’t sure of. While the tax-GDP ratio has been slipping (tax revenues aren’t keeping pace with economic growth), the corporate sector says this is due to systemic errors—money is locked up in litigation, not enough is done to encourage voluntary compliance, and the cacophony of deductions and assessment procedures coupled with lack of data lead to lacklustre compliance. “Now, the tax rates will be lowered and exemptions will also stay. How will tax revenues increase is anyone’s guess,” says a government official on condition of anonymity.

Clearly, one reason for the changes in the draft is the huge representations the government received once it was released for discussion. Ketan Dalal, executive director, PwC India, points out that in the case of MAT (Minimum Alternate Tax), the first draft’s perspective was based on how efficiently assets are used—the draft had suggested taxation based on assets, not profits. “However, the concept was perhaps flawed—income tax should be on the income, not on assets,” Dalal says.

By going back to the profit-based calculation, the government casts a much smaller net on potential taxpayers. Nevertheless, there are demands for further breaks—for instance, on the capital gains tax front, which is being found too harsh for domestic and international investors.

B jal Ajinkya, head, international tax practice, Nishith Desai Associates, says that the DTC actually creates a fresh set of issues: including taxation of fii income as capital gains and controlled foreign corporation (CFC) rules. Under the latter rule, “passive income” earned for foreign companies by domestic residents will be taxed here. “India is still a developing and capital importing country. Fiscal measures of this nature may negatively impact both inbound and outbound investments,” she says.

There is a chance that the government is not running away with a false vision of steadily rising tax compliance and revenues no matter what the numbers show. It may be that all its cards are not on the table yet. One indication is that though exemptions are back, they are not back in the full. At times, the code does not reveal the full rates of taxation. At others, such as with respect to the override of domestic law over treaty, while reverting to status quo, the new code emphasises that from time to time the taxman may take it upon himself to revoke treaty override.

Clearly, the original purpose of the DTC—to simplify the Tax Act—has been lost to adding complexities. The agreed way to increase revenues was widening the tax base—getting more people to pay taxes, lowering tax rates to encourage compliance, and removing exemptions that allowed some people to not pay any taxes at all. This has come to a naught. The real question is not whether there will be a tax revolution or not—the more relevant question is whether this revolution is going to lead to anything useful.

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