Business Standard
Thursday, Aug 13, 2009

Govt proposes radical changes in direct taxes

BS Reporter / New Delhi August 13, 2009, 1:10 IST

The government today initiated radical tax reforms through a draft code that aims to reduce the tax burden and streamline the over four-decade-old Income Tax Act.

Releasing the code today, Finance Minister Pranab Mukherjee said if reasonable level of discussion takes place on the code, a Bill could be placed in the winter session of Parliament.

For individuals, the code proposes to treble the tax deduction on savings to Rs 3 lakh. In addition, the tax slabs have been reworked in a way that 10 per cent tax would be levied on income up to Rs 10 lakh as against an income of Rs 1.6 lakh to Rs 3 lakh at present. The highest tax rate of 30 per cent will be paid by those earning over Rs 25 lakh as against Rs 5 lakh now.

The corporation tax rate is proposed to be lowered to 25 per cent from 30 per cent now, a move that would bring India's tax rate in line with that of China.

However, companies paying minimum alternate tax (MAT) would see a higher burden as the government intends to calculate the tax on the basis of the gross value of assets at the end of the financial year against the present system of the levy being linked to book profits. For non-banking companies, MAT will be 2 per cent of the gross value of assets.

Mukesh Butani, partner, BMR Advisors, said, "If you look at countries that levy MAT as a percentage of the value of gross assets, the rate is anywhere between 0.5 and 0.75 per cent. Two per cent is a very high rate. So, if you look at a company that is capital-intensive, it's making investments, it's building assets — 2 per cent is a very regressive rate of tax."

In the biggest change to tax laws since 1961, Finance Minister Pranab Mukherjee also proposed to abolish the Securities Transaction Tax. However, investors will have to pay a capital gains tax on profits earned by them on investments irrespective of the tenure of investments. In other words, there is no distinction between short-term and long-term, though the gains realised after one year will be eligible for indexation benefits. "The rate of capital gains tax at 30 per cent is rather high," Uday Ved, head, taxation, KPMG, said.

It also proposes rationalisation of tax provisions for amalgamations and demergers so that tax remains neutral when businesses reorganise. Also, the draft code proposes to allow business losses to be carried forward indefinitely as against the present ceiling of eight years. This will allow companies to set off the losses against future business profits and help reduce the tax burden.

The other bad news is the proposed withdrawal of exemptions for individuals as well as companies. While a handful of companies in sectors such as infrastructure, oil and gas exploration and production and special economic zones would be eligible for tax breaks, the formula has also been changed to investment-linked incentives instead of the practice of profit-linked sops used at present.

Under the new regime, companies would be eligible to recover all capital and revenue expenditure, barring those related to land, goodwill and financial instruments, before its profits are subjected to tax. "The period consumed in recovering all capital and revenue expenditure will be the period tax holiday," the 254-page document released for public comment today said.

The other tax benefits, including the area-specific ones, will be allowed to lapse.

In case of individuals, the code seeks to bring provident fund and life insurance accumulation under the tax net at the time of withdrawal. In a big setback to home buyers, the interest component on home loans for self-occupied properties can no longer be used to claim tax deductions. The underlying principle is that a self-occupied property does not generate any income for a tax payer.

Tax experts said that a lower tax burden was expected to rein in widespread tax evasion that leaves the government reliant on only 27 million people who pay taxes out of a population of 1.2 billion. The carrot however comes with a stick, too. The government proposes to term those who do not file returns on time as wilful defaulters. Those under-reporting incomes now face higher penalties and stepped-up prosecution procedures.

The code also suggests introduction of a general anti-avoidance rule to combat tax avoidance to check instances of round-tripping, dividend-stripping and accommodating "party transactions". Nishith Desai, Founder, Nishith Desai Associates, said this was a "draconian provision which contradicted the settled positions of tax jurisprudence established over more than half a century ago. Under the present law, the tax treaties override the Income Tax Act, if more beneficial. Now it is proposed that changes in the Tax Code can override the treaty. This means the benefits of the treaties can be totally negated. Even the constitutionality of many of these provisions could be challenged. At this juncture when the Indian tax regime is perceived highly adversarial, a question arises whether we really need to add more complications".

Releasing the code, the finance minister said "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".

Home Minister P Chidambaram, who initiated work on the code during his tenure as finance minister, said the attempt was to simplify the language to enable better comprehension and remove ambiguity to foster voluntary compliance.

Chidambaram added that the present IT Act had virtually become a happy hunting ground for lawyers. The code would probably become law by 2011, which will be the golden jubilee of the Income Tax Act.

In his Budget speech on July 6, Mukherjee had promised to bring the draft code within 45 days for the public comment. However, the code was released over a week ahead of schedule.

Tax evaders may face prison terms up to seven years and fines to ensure compliance.