



DIRECT TAX CODE

A step towards tax reforms in India

In his recent Budget speech, finance minister Pranab Mukherjee said, "Tax reform, like all reforms, is a process and not an event." As a step towards such reform, the finance minister fulfilled his promise of releasing the draft direct tax code, which provides a blueprint for the future of the Indian direct tax regime. One positive aspect of the new tax code is the relative simplicity of the language used. On the structural side, the elimination of numerous provisos and explanations is a welcome step.


PricewaterhouseCoopers analyses the impact of key provisions proposed under the direct tax code vis-à-vis the current position under the Income-tax Act, 1961.


Particulars	Existing provisions	Proposals	Impact	
 <h3>Individual taxation</h3>				
Tax rates	Old income slab (in Rs)	New income slab (in Rs)	The tax slabs are sought to be significantly liberalized. This should reduce the tax burden and increase the disposable income in the hands of individuals.	
	Up to 1,60,000*	Up to 1,60,000*		Nil
	1,60,001 – 3,00,000	1,60,001 – 10,00,000		10%
	3,00,001 – 5,00,000	10,00,001 – 25,00,000		20%
	Above 5,00,000	Above 25,00,000		30%
<small>*Basic exemption for resident women to be Rs1,90,000 and Rs2,40,000 for resident senior citizens. # No provision for levy of surcharge and cess under the code</small>				
Residency rules	Two categories of resident: i) Resident ii) Resident but not ordinarily resident (RNOR). RNOR is exempt from income accruing outside India unless it is derived from business controlled in or profession set up in India.	The separate category of RNOR to be done away with. However, a resident individual would enjoy exemption in respect of income from sources outside India for two consecutive financial years—in the financial year in which the individual becomes a resident and in the immediately succeeding financial year, if such individual was a non-resident for nine years immediately preceding the financial year in which he becomes a resident.	The removal of the category of RNORs coupled with the changes proposed are likely to increase the number of assesseees who are liable to tax in India on their worldwide incomes.	
Savings / investments	Exempt-exempt-exempt method of taxation for personal savings such as provident fund, equity-linked savings schemes and so on.	The code proposes to introduce the exempt-exempt-tax method of taxation for savings, including for provident fund.	Earlier, no tax was levied on withdrawals from savings plans such as provident funds. Now, any withdrawals of the contribution and accretions would be subject to tax. However, no tax would be payable in respect of withdrawals of accumulations up to 31 March 2011 in an approved provident fund.	
House rent allowance (HRA)	Currently, HRA received by employees is exempt from tax subject to specified conditions.	There is no specific exemption under the code for HRA.	The amount of taxable salary in the hands of employees would increase.	
Interest on housing loans for self-occupied property	Allowance of interest on housing loans for individuals up to Rs1.5 lakh. This incentive encouraged home-ownership.	No such allowance. The withdrawal of this allowance is in line with the intent to grant minimal exemptions.	The withdrawal of this allowance will increase taxable income of individuals who were availing such benefit earlier.	
Deductions	Deduction available in respect of interest on loans for higher education, investment in equity-linked savings schemes, repayment of housing loan, investment in pension plans, etc. Maximum deduction available is Rs1 lakh.	An aggregate deduction of Rs3 lakh for savings maintained with permitted savings intermediaries for children's education. Also, there is a deduction available in respect of interest on loans for higher education, payment of health insurance premiums, medical treatment of prescribed diseases or ailments of specified persons and maintenance of disabled dependants.	Increase in the limit of deduction for specified investments to Rs3 lakh would reduce the taxable income. However, the repayment of housing loans is not considered in the new provision.	
Wealth tax	<ul style="list-style-type: none"> Current threshold exemption limit is Rs30 lakh. Wealth tax levied at 1% of net wealth. 	<ul style="list-style-type: none"> The threshold limit to be significantly increased to Rs50 crore. Wealth tax to be levied at 0.25% of net wealth. Definition of assets to include all assets excluding specified exempted assets. 	Currently, only non-productive assets (jewellery, urban land and so on) come within the ambit of wealth tax. The proposed change would cover all assets, for example, shares and securities, which were earlier not liable for wealth tax. No specific exemption is available under the code for a self-occupied house (which is currently available) except for houses constructed or acquired before 1 April 2000. However, the increase in threshold limit from Rs30 lakh to Rs50 crore will mitigate the additional tax burden.	


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 <h3>Corporate tax</h3>				
Tax rates	Existing effective rates*	Proposed rates	The effective tax rate for a domestic company (including DDT) is reduced to 34.78%. Similarly, the effective tax rate for foreign companies is reduced from the existing 42.23% to 34.78% (including the branch profit tax). This will reduce the tax cost for domestic as well as foreign companies.	
	Domestic company	33.99%		25%
	Foreign company	42.23%		25%
<small>*Surcharge is applicable if total income is in excess of Rs1 crore. The prevailing dividend distribution tax (DDT) at 15% is sought to be continued in respect of dividends distributed by domestic companies. A new branch profit tax at 15% is sought to be levied on the branch profits of foreign companies.</small>				
Business income	Business income computation is based on the "business profits with specified adjustments".	The code proposes a change in the basis of computation of business income to an "income expense model" prevalent in certain developed and Asean countries. In the new scheme, even capital receipts from business shall be taxable as normal business profits; for example, profits from sale of business capital assets or gains derived from slump sale would be taxable as business profits. Income from each business is to be computed separately.	The discussion paper on the code provides that the proposed change of the computation mechanism would reduce the frequent disputes about taxability of receipts and deduction for expenses. Further, the computation of income for each business separately would require a more detailed exercise by taxpayers.	
Loss on depreciable assets	Loss on depreciable assets treated as short-term capital loss.	Loss on sale of business capital assets (where no assets remain in a particular block of assets) will be treated as an intangible asset eligible for depreciation resulting in a set-off of only a fraction of the loss every year.	As per the discussion paper, this will act as a disincentive for asset stripping and loss manipulation.	


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Particulars	Existing provisions	Proposals	Impact
Minimum alternative tax (MAT)	MAT payable at 16.995% of book profits (net profit as per profit & loss account +/- prescribed adjustments). MAT paid is available as tax credit in subsequent years.	Base for computing MAT is to be shifted from book profits to gross assets. The rate of MAT is proposed to be 2% for all companies (0.25% for banking companies). Value of gross assets will be the value of the gross block of fixed assets, value of capital work-in-progress and book value of all other assets, less accumulated depreciation on fixed assets and debit balance of profit and loss account. MAT paid will not be available as tax credit in subsequent years.	The shift of basis for levy of MAT from profits to assets is likely to result in tax liability even for loss-making companies. No provision has been made for reduction of debts owed by the company in computing the gross assets. This levy is likely to significantly affect companies that undertake capital-intensive projects and which are highly leveraged. Companies with multi-tiered holding structures will be worst hit as the tax will be levied at each level, resulting in effective multiple taxation. The non-availability of MAT credit will result in MAT being a permanent cash outflow.
Wealth tax	Companies are liable to wealth tax.	Wealth tax to be abolished for companies.	Positive for companies.

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 <h3>Capital gains tax</h3>			
Long-term vs short-term capital gains	<ul style="list-style-type: none"> Bifurcated as long-term or short-term depending on period for which the capital asset is held. Concessional tax rates in case of long-term capital gains. 	No such bifurcation is to be made. Tax would be uniformly charged at normal rates.	The advantage of a concessional tax rate for long-term capital gains has been removed, which may result in higher tax cost for investment transactions.
Benefit of indexation and fair market value	<ul style="list-style-type: none"> Indexation benefit is available only in respect of capital asset held for "long term". Fair market value of 1 April 1981 is available. 	<ul style="list-style-type: none"> The benefit of indexation is now sought to be provided in respect of all assets transferred after one year from the end of the fiscal year in which it is purchased. The indexation base and fair market value date has been moved from 1 April 1981 to 1 April 2000. 	The reduction in period for availing indexation benefit (from existing three years in certain cases) will largely be beneficial to taxpayers.
Securities transaction tax (STT)	STT is levied on purchase/sale of equity shares on stock exchanges. Consequently, long-term/ short-term capital gains arising on sale of such shares is exempted/taxed at lower rate, respectively.	STT to be abolished.	The long-term capital gains exemption and concessional tax rate for short-term capital gains in respect of listed securities no longer available.
Reverse mortgage	Currently, a transfer of a capital asset in a scheme of reverse mortgage is not considered as taxable transfer.	No such exemption is proposed under the code.	Transfer of a capital asset under a scheme of reverse mortgage may be treated as taxable transfer and hence taxable as capital gains.

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 <h3>International taxation</h3>			
Residence of foreign companies	Foreign companies to be "resident" in India only if control and management is wholly situated in India.	Foreign companies to be "resident" in India if control and management is even partly situated in India.	A resident company is taxable in India on its worldwide income. The new provisions could create significant issues for overseas subsidiaries of Indian companies or for foreign companies in case part of their control and management is said to be situated in India. Absence of legislative clarity on what constitutes "control and management" is likely to result in litigation.
Royalty	Use or right to use of transmission by satellite, cable, live coverage of any event is not specifically covered under the definition of royalty.	Specifically included under the code.	Subscription revenues of foreign telecasting companies from India likely to be taxed in India. Payments for obtaining live feed of an event likely to be taxed in India.
Tax rates for royalty and fees for technical services (FTS)	<ul style="list-style-type: none"> Royalty/FTS earned by a non-resident is taxed at the rate of 10% on gross basis subject to certain conditions. In case such payments are linked to the permanent establishment (PE) of a foreign company in India, then the same would be taxable on net income basis at the rate of 42.23%. 	The tax rate on royalties and FTS earned by non-residents is sought to be increased to 20% on gross basis, regardless of whether such non-residents have a PE in India or not.	The increase in tax rates will adversely impact non-residents earning royalty/FTS from India. Further, the removal of net basis of taxation may increase the tax cost for non-residents having a PE in India. The cost of importing technology and services into India likely to increase in case the additional tax cost is passed on to Indian customers.
Treaty override	Presently, the provisions of tax treaties overrides the provisions of domestic tax law, to the extent they are beneficial to the non-resident taxpayer.	It is proposed that the provisions of the treaty or the code, whichever is later in time, shall prevail.	No clarity on relief available to non-resident taxpayers under the existing tax treaties.

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 <h3>Transfer pricing</h3>			
Advance pricing agreement (APA)	No provision exists under the current framework of law.	The concept of APA is proposed to be introduced.	The code provides for upfront determination of the arm's length price/pricing methodology in international transactions between associated enterprises. This will reduce litigation on the issue of acceptable arm's length price.

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 <h3>Anti-abuse provisions</h3>			
General anti-avoidance rule (GAAR)	Specific anti-avoidance provisions having limited applicability.	Broad, sweeping and elaborate GAAR introduced.	Wide discretionary powers have been granted to tax authorities to, among other things, disregard or re-characterize whole or part of transactions and reallocate incomes if the transactions have been entered into with the objective of tax avoidance, if they lack commercial substance, and so on.

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