Legislative Brief

The Draft Direct Taxes Code Bill, 2009

The draft Bill was released for public discussion on August 12th, 2009 by the Finance Minister Shri Pranab Mukherjee.

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Highlights of the Bill

- The Bill replaces the Income Tax Act, 1961.
- The Bill widens income tax slabs for individuals. Income between Rs 1.6 lakh to Rs 10 lakh will be taxed at 10%, between Rs 10 lakh and Rs 25 lakh at 20%, and that over Rs 25 lakh at 30%.
- The Bill removes several tax deductions currently allowed such as those on investments in life insurance or provident funds. Interest paid on housing loans shall no longer be tax deductible.
- Companies will be taxed at 25% of business income. The Bill also imposes a minimum alternate tax of 2% on the assets of companies and a dividend distribution tax of 15% on domestic companies. Foreign companies shall pay an additional branch profits tax of 15%.
- Unincorporated bodies are taxed at 30% of income while non profit organisations are taxed at 15% of any surplus of income over expenditure.
- The Bill raises the wealth tax exemption limit from Rs 15 lakh to Rs 50 crore and widens the ambit of wealth tax to include financial assets.

Key Issues and Analysis

- It is not possible to assess the net impact on government revenues of the new tax proposals in the Code. While the government claims that the tax changes proposed by the Code will have no net effect on tax revenues, it has not released adequate data to support this claim.
- The Bill lowers the tax rate for those who earn between Rs 3 lakh and Rs 25 lakh, as compared with the Act. However, those who earn less than Rs 3 lakh will pay the same tax rate as before while having a narrower range of tax deductible investment options to choose from.
- Under the Bill, companies will be charged a minimum alternate tax on their assets, rather than profits as is currently the case. This implies that even sick and loss making companies may have to pay taxes.
- The Bill removes a range of tax incentives allowed to companies under the Act, such as those for investments in backward areas and exports, as these could distort investment decisions. However, the removal of such incentives may adversely affect the profitability of units which had already made investments based on such promises.

PART A: HIGHLIGHTS OF THE BILL[1]

Context

The direct taxation of the income of individuals, companies and other entities is governed by the Income Tax Act, 1961. The Act specifies the entities to be taxed, the kinds of incomes subject to tax (or exempt from tax), and the tax rates to be imposed on them. It lays out a system by which taxes are to be assessed and collected and specifies a procedure by which disputes with tax authorities are to be addressed. Changes to income and wealth tax (including tax rates) are introduced in Parliament in the form of an annual Finance Bill which amends the Income Tax Act and the Wealth Tax Act, 1957. Table 1 indicates the revenues raised by the government through the different types of direct taxes.

Table 1: Tax Revenues (2008-09)

	Rs Crore	% of Total Tax Revenue	% of GDP
Total Tax Revenue	627,949	100%	11.8%
o/w Direct Taxes	345,000	55%	6.5%
- Corporate Tax	222,000	35%	4.2%
- Income Tax	122,600	20%	2.3%
- Wealth Tax	400	0.06%	0%

Source: Receipts Budget 2009-10, PRS

The discussion paper released along with the draft Bill by Government of India has said that the complex structure of the existing Act, the numerous amendments to it over the years, and the judgements passed by courts have made it increasingly difficult to understand and interpret.[2] The Direct Taxes Code Bill therefore seeks to consolidate and amend the law relating to all direct taxes and will replace the Income Tax Act, 1961. While tax rates have been gradually reduced, the paper says that any further reduction in rates may not be possible without a corresponding increase in the tax base, for which it proposes a three-fold strategy (a) the minimising of tax exemptions (b) the removal of loopholes and ambiguities in the law which allow taxpayers to reduce the amount of tax they must pay and (c) preventing tax evasion. Accordingly, the Bill removes tax exemptions, and lowers effective tax rates.

Key Features

Personal Income Tax and Capital Gains Tax

- Indian residents must pay tax on all income (both Indian and overseas), while non-residents pay tax only on income earned in India. The Bill redefines criteria by which tax payers are to be treated as resident or non-resident.
- The Bill classifies income under five heads depending on the source: salaries, house property, business, capital gains and others. It widens existing tax slabs and specifies three rates of income tax (see Table 2). It removes tax deductions available on certain investments, taxing them at the time of withdrawal. Other expenditures, such as the interest paid on home loans, are no longer tax deductible.
- **Capital Gains / Tax on Securities Transactions**: Under the Act, profits from the sale of assets (capital gains) are taxed depending on how long such assets were held. The Bill no longer makes this distinction. Profits on sales of certain assets, such as plant and equipment will no longer be treated as capital gains, but as business income. The Securities Transaction Tax (STT) on the sale or purchase of shares or mutual fund units has been done away with.

Table 2: Comparison between the Income Tax Act, 1961 and the Bill with respect to Personal Income Tax

Topic	Income Tax Act, 1961	The Bill
Types of Taxpayers (residency status)	Three types of taxpayers – Resident/ Non Resident / Resident but not ordinarily resident (RNOR). Residency status is defined by the total days spent in India over the previous few years. RNORs are taxed on parts of overseas income and all Indian income.	The Bill does away with the category of RNOR. Those who become residents after being non-residents in the previous nine years, will receive exemptions on parts of overseas income for the previous and the current year.
Computation of Income	Salaries: Deductions allowed for medical expenses, education loans, home loans etc and for certain investments up to a maximum of Rs 1 lakh. Such investments are tax-free at all times. House Property: Taxable rent is higher of actual rent or 'reasonable' rent set by municipality(less specified deductions). Rent is nil for one self-occupied property. Business: Taxable income is business profits with specified adjustments. Losses cannot be carried forward for more than 8 years. Capital Gains: Different rates specified for long term / short term gains	Salaries: Permitted deductions reduced. Investments in permitted savings intermediaries allowed up to Rs 3 lakh but taxed as they are withdrawn. House Property: Taxable rent is higher of actual rent or 6% of cost /value set by municipality (less specified deductions). Rent is nil for one self-occupied property. Business: Taxable income is gross income less deductions. Losses can be carried forward indefinitely. Capital Gains: Taxed at the applicable income tax rate.
Tax Rates	Income Tax: Up to 1.6 lakh – 0%; 1.6 to 3 lakh – 10%; 3 lakh to 5 lakh – 20%; above Rs 5 lakh – 30%. Women and senior citizens have a higher exemption limit. Education cess of 3% is applied on all taxes. Capital Gains: Short/Long term- 30%/20%.	Income Tax: up to 1.6 lakh – 0%; 1.6 to 10 lakh – 10%; 10 lakh to 25 lakh – 20%; above Rs 25 lakh – 30%. Women and senior citizens have a higher exemption limit. No cess. Capital Gains: The applicable income tax rate

Sources: The Income Tax Act, 1961; The Direct Taxes Code Bill; PRS

Corporate Tax

- The Bill reduces the tax rate on corporate profits. Companies shall now pay tax calculated as a share of profits or as a percentage of their total assets (minimum alternate tax or MAT), whichever is higher (see table 3).
- Most tax deductions, such as those offered on export profits, will be removed and offered only on investments in certain sectors. In some cases, existing units can continue to avail of incentives currently offered for the period that was originally specified. New units however, will be offered only incentives available in the Code.

Table 3: Comparison between the Income Tax Act, 1961 and the Bill with respect to Corporate Tax

Topic	Income Tax Act, 1961	The Bill
Types of Taxpayers (residency status)	Indian companies are always treated as residents. Others are resident if control or management is wholly in India.	Non-Indian companies are treated as residents if control or management is wholly or partly in India. 'Partly' is not defined.
Taxes imposed	Domestic companies / Foreign companies pay a tax on corporate profits of 30%-40%. MAT of 15% imposed on book profits. Credit available for future years. Domestic companies pay a tax of 15% on the dividends they distribute to shareholders.	The Bill reduces corporate tax to 25%. It shifts the basis of MAT from book profits to gross assets and imposes it at the rate of 2% (0.25% for banks). MAT credit is not available for future years. Domestic companies (residents) pay a tax of 15% on the dividends they distribute to shareholders. Foreign companies pay an additional tax of 15% on branch profits.
Tax incentives and deductions	Tax deductions on profits on exports, for investments in backward areas, SEZ units. Tax benefits also available for specific sectors such as power, telecom and for scientific research.	The Bill does away with a number of tax incentives and introduces investment linked incentives for sectors such as SEZ development, power, oil /natural gas exploration and cold chains.

Sources: The Income Tax Act, 1961; The Direct Taxes Code Bill; PRS

Unincorporated Bodies and Non profit Organisations

- Unincorporated bodies (such as partnerships) are taxed at 30% of income, unchanged from the Act. Investments in intermediaries such as mutual funds, life insurers and pension funds are taxed in the hands of the investor.
- Non-profit institutions will be taxed at a rate of 15% of the unspent income at the end of the year. Under the Act, non-profits are taxed (at 15% of surplus) only if their expenditure is less than 85% of income. Under the bill, the surplus is to be calculated on the basis of what is actually earned and paid out by the non-profit over the year (cash accounting), rather than what it earns or owes (accrual accounting).

Tax Administration and Appellate Authorities

- Under the Bill the apex authority for tax administration is the Central Board of Direct Taxes (CBDT) consisting of a chairperson and board members. Compared with the Act, the Bill removes the power of the CBDT to relax norms on tax relief in some cases. It provides for a separation of the institutions of the CBDT and the income tax authorities.
- Under the Act, tax authorities were given 4-6 years to re assess the tax to be paid in case the tax payer had not filed returns or had underestimated his tax. Assessments can now be reopened within 7 years. Assessments can now also be reopened to take account of orders passed by the CBDT or the courts, or observations made by the CAG.
- The Act provides for penalties for up to Rs 1 lakh or the tax not paid, for various defaults. Under the Bill, the maximum penalty for certain defaults has been raised to twice the tax not paid. Penalty for offences ranges from 1-7 years of imprisonment (as under the Act), and a fine.

Others

- **Wealth Tax**: The Bill raises the exemption limit to Rs 50 crore from the current Rs 15 lakh. The scope of taxable wealth has been widened to include financial assets. Tax will be charged at a rate of 0.25% (currently 1%).
- The Bill introduces a general anti-avoidance rule (GAAR), which aims to minimise the loopholes in the law which help tax payers reduce their tax payable. The Commissioner of Income Tax can declare any arrangement by a taxpayer as 'impermissible', if in his judgement, its main purpose was to have obtained a tax benefit.
- The Bill allows the government to enter into an agreement with another country to provide relief on double taxation. Such double taxation avoidance agreements (DTAAs) provide for taxpayers to claim an exemption if tax has already been paid on that income in the other country. Currently, in case of a conflict between the provisions of the Act and the DTAA, the provisions which are more beneficial to a taxpayer shall apply. In case of such a conflict under the Bill, the one that is later in time shall prevail. Thus, existing agreements would become void when the new Code comes into force.

PART B: KEY ISSUES AND ANALYSIS

We analyze the main features of this Bill under three broad themes:

Effect on Revenues: The government claims that the substantial changes in the Bill will not affect revenues. However, the government has not released the assumptions on the basis of which such a claim has been made.

Personal Taxation: Taxpayers in higher income brackets will benefit more from the tax provisions in the Bill than those in lower income groups. This raises issues about the progressivity of the new tax structure as compared with the old one.

Corporate Taxation: The imposition of a minimum alternate tax (MAT) on assets of companies, could force sick and loss making companies to pay tax as well. The removal of tax incentives could adversely affect companies who made investments based on expectations that such incentives would be available for a stated period of time. Finally, the Bill leaves unclear the residency status of companies not incorporated in India.

Effect on Revenues

The Bill lowers income, corporate, and wealth tax rates, widens tax slabs and raises the exemption limit for wealth tax by 200 times. The Bill also removes personal and corporate tax exemptions, and widens the wealth tax base.

The Government claims that the tax changes proposed in the Bill would not affect the total tax revenue.[3] However the government has not released any detailed data, or explained the assumptions, which might back up its claim. A recent paper argues that if the reduction in personal income tax rates were implemented, the revenue loss to the government would be around half a percent of GDP.[4] Table 4 indicates the changes in the tax code which can potentially add to the revenue of the government or result in a reduction in revenues. However, in most cases, the revenue gain or loss is not possible to estimate due to a lack of publicly available data.

Table 4: Main Sources of Revenue Loss/Gain in the Direct Taxes Code

Topic	Sources of Revenue Loss	Sources of Revenue Gain
Personal Income Tax	Reduction in tax rates and widening of tax slabs. Exemption limit on investments in pension/provident funds and other investments raised to Rs 3 lakh from Rs 1 lakh.	Taxation of investments which are currently tax free such as pension / provident fund investments. The Code proposes to tax such investments at the time they are withdrawn by the investor.
Corporate Tax	Reduction in tax rate to 25% from 30%.	Removal of corporate tax exemptions. Total tax foregone due to exemptions in 2008-09 was Rs 68,914 crore, of which, a part would now be collected. MAT now charged on assets rather than profits.
Others	Wealth tax exemption limit raised 333 times (to Rs 50 crore) and wealth tax rate reduced to 0.25% from 1%.	Wealth tax base widened to cover financial assets. Distinction between long term and short term capital gains tax removed and capital gains taxed at the applicable rate. Provisions of double tax avoidance treaties will prevail only to extent that they are brought into force after the Code. Currently such provisions prevail to the extent that they are more beneficial to the taxpayer.

Sources: The Direct Taxes Code Bill; PRS

Personal Taxation

First Schedule

Tax Rate on Lower Income Groups

There is a greater reduction in tax rates for those in the Rs 5 lakh to Rs 10 lakh income group than those at lower incomes. This goes against the principle that those earning higher incomes should pay a higher tax rate. Over 99% of taxpayers in 2007-08 earned less than Rs 10 lakh; under the new Code, all of them would pay tax at the same rate.[5]

Table 5 : Actual Tax Rates for various levels of income

Monthly Income	Current(%)	DTC(%)	Change
15,000	1.1%	1.1%	0%
25,000	4.7%	4.7%	0%
50,000	14%	7.3%	-6.7%
75,000	19.3%	8.2%	-11.1%
1 lakh	22%	10.3%	-11.7%
3 lakh	27.3%	19.8%	-7.5%

Source: Income Tax Act, 1961, The Direct Taxes Code Bill, 2009, PRS

Those who earn between Rs 1.6 lakhs to Rs 3 lakhs will see no change in the actual tax rate they must pay (Table 5). At the same time, these taxpayers will have a more limited range of tax deductible investments to choose from, since, under the Bill, many investments currently offering tax benefits will be taxed at the time of withdrawal under the Code. Further, they will not be able to benefit from deductions currently offered on interest on housing loans. This would affect a significant number of taxpayers. While data on the number of taxpayers earning less than Rs 3 lakh is not available, those earning less than Rs 2 lakh were around 87% of non-corporate tax payers, in 2007-08 (Table 6).

Tax on Rental Income

Clauses 24, 25

Under the Bill, the income from house property shall be the higher of actual rent or 6% of cost or value set by municipality (less specified deductions). Under the Act, this income is higher of actual rent or 'reasonable' rent set by municipality. Income from one self-occupied property is exempted under the Bill and the Act.

Local rent control laws (as well as prevailing market rates) may require the landlord to set a rent lower than 6% of property value. However, he would be required to pay tax on 6% of property value, rather than the actual rent.

Table 6: Non-corporate tax assessees by Income Level (2007-08)

Income Level	Number (lakh)	Percentage of total
Less than Rs 2 lakh	287.9	86.8%
Rs 2 lakh to Rs 10 lakh	41.47	12.5%
Above Rs 10 lakh	2.18	0.66%

Source: Comptroller and Auditor General, "Compliance Audit- Direct Taxes, Report 21 of 2009", Table 2.6; PRS

Dividend Distribution Tax

Clause 99

As is currently the case, the Bill imposes a tax of 15% on the dividends distributed by companies to shareholders. The tax will be paid by companies themselves before dividends are paid out, rather than being taxed in the hands of shareholders, at their respective tax rates. The Bill thus applies the same tax rate to all shareholders of a company, irrespective of their individual income levels.

Corporate Taxation

Minimum Alternate Tax

Chapter V, Second Schedule

The Bill imposes a minimum alternate tax (MAT) of 2% on the assets of companies (0.25% for banks). Companies pay corporate tax (at 25% of profits), or MAT, whichever is higher. At present, MAT is imposed at 15% of profits declared to shareholders (which could be different from profits declared under the Income Tax Act).

The government claims that charging MAT on assets will force companies to use assets efficiently. [6] It will also ensure that more companies pay tax. According to a government study of over 4 lakh companies for 2007-08, 70% of total corporate tax revenue was raised from 0.19% of companies sampled (such companies earned more than Rs 100 crore in profits). The average tax rate paid by all companies was around 22%. Around 40% of companies sampled paid no tax.[7] However, this study does not indicate how many companies had any profits, or were even carrying on operations.

The provisions for MAT under the Bill raise four issues. Firstly, the MAT has been imposed on assets, not profits, effectively making it a wealth tax. Secondly, the current provision under the Act which permits credit for MAT in future years has been removed. Therefore, the overall tax rate for companies with losses in some years (such as those in cyclical sectors like cement, steel and sugar) will be higher than those with steady profits. Third, under the Code, sick companies, which may not have sufficient funds to pay other stakeholders, such as workers or creditors, would still be required to pay MAT. Further, companies in sectors such as infrastructure, which by nature make losses in the early years of operation, would also be required to pay MAT. This may affect the willingness of companies to invest in these sectors.

Tax Exemptions

Clause 282(n), Schedules 10-13

The Bill removes a number of tax incentives which are currently offered, such as those for export units and units in Special Economic Zones and backward areas. The discussion paper sees tax incentives as 'distorting' and argues that these should be confined to exceptional cases. Tax incentives will now be offered only on investments in certain sectors.

The discussion paper claims that "tax incentives contrary to the new scheme contained in the Code will be grandfathered" i.e. units currently availing incentives can continue to do so for the specified period under the Act while new units will be covered by the new provisions under the Code.[8] However, such grandfathering provisions are allowed only for certain exemptions currently available, such as those for SEZ developers, or for units in North Eastern states – other incentives have been done away with even for existing units. This may adversely affect units which had made investments based on promises of exemptions for a specified period, and who are not covered by grandfathered provisions.

Taxation of Non-resident Companies

Resident companies are taxed on worldwide income while non-resident companies are taxed on income earned in India. Under the Act, companies are residents if they are Indian companies or are controlled and managed wholly out of India.

Clause 4 (3)(b)

Under the Bill, companies are resident if their place of control and management is situated wholly or partly in India, at any time in the year. The Bill does not define 'partly', leaving unclear the conditions under which a non-Indian company will be treated as a resident for tax purposes, and taxed on its worldwide income. For instance, under the provisions of the Bill, if such a company were to hold a board meeting in India, it could be treated as a resident.

Miscellaneous

General Anti-Avoidance Rule

Clause 112

The Bill introduces rules intended to discourage tax avoidance. Under the provisions of the general anti-avoidance rule (GAAR), the Commissioner of Income Tax can declare any arrangement or transaction by a taxpayer as 'impermissible', if, in his opinion, its main purpose was to have obtained a tax benefit.

If a transaction has been declared as 'impermissible', the burden of proof is on the taxpayer, not tax authorities, to prove that obtaining tax benefits was not the main purpose of the arrangement. This could lead to harassment and litigation.

Double Taxation Avoidance Agreements

Clause 258

The Bill allows the government to enter into an agreement with another country to provide relief on double taxation. In case of a conflict between the provisions of the Bill and the agreement, the one that is later in time shall prevail (currently, the provisions which are more beneficial to the taxpayer will apply).

Thus, existing agreements would become void when the Code comes into force. This raises questions about the government's commitment to international agreements.

Recommendations of Committees

A number of committees have suggested reforms to the Income Tax Act, 1961. These include the Advisory Group on Tax Planning and Tax Administration for the Tenth Plan which submitted its report in 2001 (Chairman: Shri Parthasarathy Shome), and the Task Force on Direct Taxes which submitted its report in 2002 (Chairman: Shri Vijay Kelkar). Table 7 compares suggestions made by these committees with corresponding provisions in the Bill and the Act.

Table 7: Recommendations by Committees compared with provisions in the Bill and the Act

	Topic	Committee Recommendation	Provisions in the Bill
Clause 4	Types of taxpayers	Delete category of 'resident but not ordinarily resident' (RNOR) (Kelkar).	Bill deletes RNOR.
Clauses 66-72	Tax incentives for individuals	Remove deductions for savings instruments like relief bonds / provident funds. Tax pension funds savings at withdrawal stage (Kelkar). Remove tax incentives for savings/ home loans. Some tax concessions (medical expenses/ education loans) to be given as tax credit (Shome).	Exemption limit for savings increased to Rs 3 lakh from Rs 1 lakh but such savings are now taxed when withdrawn. Deductions for interest on home loans removed.
Chapter III, Clause 99	Corporate Tax, Dividend Tax and Capital Gains	Tax companies at the highest personal tax rate (30%) . Exempt dividends and long term capital gains on listed equity from tax (Kelkar). Remove MAT (Kelkar). Impose MAT at 0.75% of net worth and 10% of distributed dividend.(Shome).	Corporate tax at 25% lower than highest rate of income tax (30%). Same rate for long and short term capital gains. Dividend Distribution Tax at 15% remains. MAT imposed at 2% of gross assets.
Schedules 10-13	Corporate tax incentives	Remove export incentives, sector specific incentives, and backward area deductions (Kelkar). Remove deductions for in house scientific research, shipping. (Kelkar). Remove backward area deductions (Shome).	Most incentives, such as those for exports removed. However certain specific sector incentives such as for oil and natural gas, infrastructure etc remain. Deductions for shipping, scientific research allowed.
Chapter IV	Others	Income based deductions for donations to charities and non-profits be converted to tax credit at lowest rate. Exemptions for income of charities be restricted only to nonprofits whose earn 90% of receipts through donations. (Shome).	Donations to non-profits remain deductible. Any surplus taxed at 15%.

Sources: Shome Committee Report, Kelkar Committee Report, Standing Committee on Finance 33rd report (2005-06); The Income Tax Act, 1961; The Direct Taxes Code Bill; PRS

Notes

1. This Brief has been written on the basis of the Direct Taxes Code, 2009, which was released for public discussion on 12th August, 2009 by the Finance Minister Shri Pranab Mukherjee.
2. See Discussion paper on Direct Taxes Code, Department of Revenue, August 2009, p. A-7.
3. See Discussion paper, para 16.1
4. See Rao, M. Govinda and R. Kavita Rao, "Direct Taxes Code: Need for Greater Reflection", EPW, September 12, 2009, p.36.
5. Comptroller and Auditor General, "Compliance Audit- Direct Taxes, Report 21 of 2009", Table 2.6
6. Discussion paper, p. A-40.
7. Receipts Budget 2009-10 p. 46, Table 1 See indiabudget.nic.in
8. Discussion paper, Para 12.22.

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