STABILIZING THE INDIAN ECONOMY THROUGH NEW DIRECT TAX CODE

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Abstract

New Direct Tax Code can be altered to stabilize the Indian economy in the face of fluctuations. The current system of tax is fraught with complexities owing to many amendments over the years. New Direct tax code has done a good job of removing unnecessary complications in the tax laws. The definitions and provisions have been modified, thereby keeping pace with the times. The New Direct Tax Code would not have any long term impact on individuals.

The New Direct Tax Code will probably not have any long term impact on individuals. The corporate income tax rates have been slashed down, but keeping deductions in mind, the effective tax rate is unlikely to be affected drastically. The calculation of the Minimum Alternative Tax based on Assets needs to be re-looking at, especially for those companies which are working on projects with long gestation periods.

While the reduction of corporate income tax rates for foreign companies operating in India bodes well, it is also necessary to consider the provisions pertaining to double taxation and the agreements which India has with other countries on the same, before making any conclusions on whether India offers good scope for investment to a particular foreign company. This paper explaining in details of New Direct Tax Code, what will the effect on an Individual and the Industry? The paper also summarizes the Roadmap to NDTC.

Key words: *new direct tax code, revenue, redistribution, taxation is reprising, representation, tax rates.*

Introduction

The Four "R"s (The Purpose of Tax)

Taxation has four main purposes: Revenue, Redistribution, Repricing, and Representation. The first is revenue: taxes raise money to spend on roads, schools and hospitals, and on more indirect government functions like good regulation or justice systems. This is the most widely known function.

The second aspect is redistribution. Normally, this means transferring wealth from the richest sections of society to poorer sections, and this function is widely accepted in most democracies, although the extent to which this should happen is always controversial.

A third purpose of taxation is reprising. Taxes are levied to address externalities: tobacco is taxed, for example, to discourage smoking, and many people advocate policies such as implementing a carbon tax as a way of tackling global warming.
A fourth purpose of taxation is Representation (politics). Several studies have shown that direct taxation (such as income taxes) generates the greatest degree of accountability and better governance, while indirect taxation tends to have smaller effects. This last "R" is one of the most fundamental beneficial effects of taxation, but it is often forgotten.

THE SALIENT FEATURES OF NEW DIRECT TAX CODE

Following are the salient features pertaining to the new Direct Tax Code proposed by the government, for which a draft and a discussion paper were released by Finance Minister Pranab Mukherjee:

What does it seek: The New Direct Tax Code will replace the existing Income Tax Act that was enacted in 1961, which had replaced an earlier legislation of 1922 enacted prior to the country's independence.

When will it be introduced: The government intends to present the relevant bill during the winter session of parliament, after considering and incorporating, if seen fit, the opinions on its provisions from the public. The government hopes it will become law in 2011.
The main purpose: The new code will completely overhaul and simplify the existing tax proposals for not only individual tax payers, but also corporate houses and foreign residents.
How will it help: The idea is to keep the provisions simple so that even an average taxpayer can understand the language, than having to go to chartered accountants and income tax practitioners. It will also introduce the concept of tax calculators.
Administrative reforms: The new code will also recast the powers of the Central Board of Direct Taxes, induce more transparency in decision-making and tune it to tax boards of countries like the US, Canada and Britain.

How new tax code affects individuals

The draft of the Direct Taxes Code bill 2009 and the Discussion paper have been made public recently. In the words of the finance minister "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".
A very valuable input from the finance minister has been "It will specially meet the aspirations of our young and professionally mobile population. So what exactly is all the excitement about and will it really "change" things as they are?

What does it say about income tax rates?

The most remarkable point which would be a great cheer for all individuals is the revision in the income tax rates. The change is not only in terms of the slabs but also the simplicity in calculations. The Code proposes to create 4 slabs for the sake of income tax calculations.

For Men

Slab 1: Total income is lesser than Rs 160,000
The income tax for the above slab is proposed to be nil. This is what currently exists and hence does not in any way change anything for individuals earning below 160,000.

Slab 2: Income is between 160,001 and Rs 10,00,000
This is the most drastic change proposed. The tax for the above slab is proposed to be 10 percent of the amount by which the total income exceeds 1, 60,000. Meaning, if your income is 572,000/- then, the income tax would be 10% of (Rs 572,000-Rs 160,000). Although for individuals who were earlier earning between Rs 160,000 and Rs 300,000 this does not bring about any change, it brings great cheer for individuals earning between Rs 300,000 and Rs 500,000 as they straight away save 10% of any income that exceeds Rs 300,000, but is lesser than Rs 500,000. Today they have to pay 20% on this amount!
For individuals who are today earning above Rs 500,000, this would bring even more cheer as they save a flat Rs 20,000,plus 20% of any amount above Rs 500,000 and lesser than Rs 1,000,000!
Example: Mr. 'X' income today is Rs 7 00,000
Income tax as per present rates = Rs 118,450 (excluding surcharges and any cess)
Income if new code comes into effect = Rs 54,000, a saving of Rs 61000

Slab 3: Income is between Rs 10,00,001 and Rs 25,00,000
The code proposes the income tax for this slab to be Rs 84,000 (10% of 840,000) plus 20% of any amount above Rs 10,00,001 but lesser than Rs 25,00,000. This would also bring about happy tidings for people who are currently earning above Rs 1,000,000 as they save around Rs 100,000 plus 10 per cent of any income which exceeds 10,00, 000.

Slab 4: Income exceeds Rs 25,00,000
The code proposes the income tax for this slab to be Rs 384,000 plus 30% of any amount exceeding Rs 25,00,000. People currently earning above 25,00,000 would expect savings of over 40% of their current tax liabilities.
Away with 'assessment and previous year'
The new code has proposed to do away with the concept of using 'previous year' to denote the year in which you earned the money and 'assessment year' the year in which you pay the self assessment tax and file your return.
The new proposal is to use the simpler terminology of Financial Year (FY). For example if you earned income in FY09-10 then, your pay advance tax in FY09-10 and any balance tax and returns in FY10-11.

Source of income defined:

The income is proposed to be bifurcated into 'special sources' and ordinary sources. The special sources include items like lotteries, games and non residents etc which will be charged on the basis of a rate schedule.
Thus while calculating the total income we will have to add total income from ordinary sources and total income from special sources.

Source based versus Residence based taxation:

Source based taxation is a process in which the income tax is calculated on the basis of the source of income whereas residence based taxation calculates income on the basis that individuals are taxable in the country or tax jurisdiction in which they are residing.
The debate has been for long on which methodology to use. The new code proposes to use residence based taxation for residents and source based taxation for non-residents.
It states 'a resident in India will be liable to tax on his worldwide income and a non-resident will be liable to tax in India only in respect of receipts in India'.
What this means is that if you have been out of India for more than 183 days you would be treated as a non-resident and you need not pay tax on income which has already been taxed in the country where you get the income from and also if it's not taxed there.
But, in case of residents the income which has not been taxed in another country will be taxed in India upon repatriation.

Capital gains

The new code proposes two important ideas.
The concept of long term and short-term defined by the period of holding of a capital asset will be removed.
Instead, for any capital asset which is transferred, to get a gain, anytime after one year from the end of the financial year in which it was acquired, the cost of acquisition and cost of improvement wil be adjusted on the basis of cost inflation index to reduce the inflationary gains?
The base date for calculation of cost of acquisition of a capital asset has been proposed to be shifted from 01-01-1981 to 01-04-2000. This would be a big disadvantage to people who had brought the assets very long ago.
The reason is that you would have brought it for very low prices but the capital gains will be calculated based on the price of the asset on 01-04-2000.

Indian poised to embrace anti-avoidance tax regulation

The 2008 version of OECD Model Convention commentary also specifically acknowledges that the purpose of tax conventions, inter alia, is to prevent tax avoidance and evasion.
Section 112 of the proposed Direct Tax Code provides extensive powers to Commissioner of Income Tax to disregard any arrangement because of its improper tax benefit availing characteristics.
The measures that may be adopted by the Commissioner to tackle such an arrangement are:

- Disregarding, re characterizing any part or if required the whole of the arrangement
- Treat the arrangement as if it had not been entered into at all; or
- Disregarding any accommodating party and the party in question as the same;
- Any other manner which the Commissioner shall deem appropriate

On a reading of the proposed Code an impermissible avoidance agreement is understood to be any mala fide scheme adopted by a party to obtain a tax benefit which is not normally provided for or an action that results in the misuse or abuse of the provisions of the code.
Thus it is a form of enrichment obtained without adequate consideration. An arrangement that lack/commercial substance is also impermissible.
Lack of commercial substance suggests that the arrangement, if severed, has no significant effect on the business operation of the party.
This involves inclusion of a tax indifferent party or improper round trip financing, transactions which have the effect of canceling each other or an exchange which is made in such a manner that it disguises the purpose or source of the fund.
It is pertinent to note that this power has an overriding effect over other protective shields for instance a Double Tax Avoidance Agreement.
As a measure to counter any veiled avoidance of tax, the code specifies that, if the object of a certain scheme is for some other purpose but any part of it involves availing a tax benefit, the entire arrangement shall be considered impermissible under the GAAR.
Voraciously implemented in various nations including the United States of America and Belgium, it is regarded a necessity in India. However, what needs to be considered is the alternate line of thought that whether an act which is otherwise valid in law can be treated as wrong.
Besides, Article 51 of the Constitution provides that State must strive to foster respect for international law and treaty obligations in the dealing of organized people with one another.
The Hon'ble Finance Minister also acknowledged the fact that one of the insignia of a mature fiscal policy is stability.
However, the proposed GAAR read with Section 258(8) of The New Direct Tax Code which gives overriding effect to the domestic tax law over DTAA casts a shadow over such intention.

New tax code gets tough on willful evaders

The new Direct Tax Code has proposed some stringent penalty provisions in case of willful attempt to evade tax, but maximum penalty mooted will not be more than two times the amount of tax payable in respect of the amount of tax base underreported. Imprisonment for a term which may extend to seven years and with fine has been proposed for a person who willfully attempts in any manner to evade any liability in respect of tax, interest or penalty. However, in case of income tax raids where the disclosure of hidden wealth is made after the search operation, the evader seems to have been let off lightly as the new code proposes a penalty sum equal to 10% of the undisclosed tax base for the specified financial year. So far, the evader was taxed the highest tax rate and an equal amount in penalty.
Making a strong recommendation against entry or hawala operators, the proposed law recommends rigorous imprisonment for a term which may extend to seven years and with fine, if a person is found to be making any entry or statement which is false and which he either knows to be false or does not believe to be true in any books of account.
In what could give tax sleuths more leverage to implement rules on violators who have been imposed restrain order, it has been mooted such person shall be punishable with imprisonment for a term which may extend to two years and with fine not be less than Rs 50,000 and may extend up to Rs 5 lakh.

Capital gains may be taxed

The New Direct Tax Code has proposed to tax all the capital gains at the rate of investors' marginal tax rates (tax brackets they fall). It decided to do away with the distinction between long-term and short-term capital gains tax. At the same time, the code has proposed to discontinue the STT. This will be a major setback for investors in the stock markets. At present, all the long-term investment of more than one year in equities attracts zero tax.

However, the short term capital gains become part of the income of the investor and taxed accordingly. However, as tax slabs can go for a change, the impact on small investors will be lesser. But large investors will have to pay huge tax in case of a bullish market. The code, however, left the provision for taxing the dividend unchanged. While the dividend distribution tax, payable by the company, remained at 15%, it will remain non-taxable at the hand of recipients.

Conclusion

The New Direct Tax Code, the survey shows overwhelming support for the code, with over three-fourth of respondents saying the code is simple and easy to understand. The proposed reduction of tax rates, the end of incentives are other positives, although 72% respondents fear the new rules could lead to witch hunting, while MNC respondents are unhappy with the treaty override provision. The survey reveals several positive aspects in relation to the survey. I think more than three-fourth of the people or super-majority feel that the law is simple, easy to understand, it will avoid litigation, which I tend to slightly disagree with because there are certain aspects in the law that could lead to litigation.

Most of the aspects are positive. The other important aspect is reduction of rate of tax from 30% to 25% for corporate. This whole debate about tax incentives and continuity of tax incentives, I was pleasantly surprised to see that most people believe that the shift from profit-linked incentives into amortisation; writing of expenditure-linked incentives is a good move. I think the successive recommendations of the expert group for the last almost two decades have been adhered to in spirit so far as the new tax code is concerned. So, it is not coming out from the survey because everybody has responded to this survey. But you still have 20-25% of people who believe that there are negatives with respect to tax holidays, simplicity. The verdict is divided when it comes to capital markets' impact. So, taking away the short-term, long-term distinction and bringing capital gains to normal rate of tax is also debatable. We have an equally divided house as far as that recommendation is concerned. Then finally, with respect to multinationals, they seem to be perturbed about the general anti-avoidance and are sceptical about the manner in which the tax administration will go about implementing those rules. Another important aspect is for the first time India has taken a very bold, and in my view, an unreasonable position that the domestic law will override the double tax treaty which I think goes against the cannons of international taxation.

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