Business Standard

Direct tax code-II: Negative equity effects, complexity must be eliminated

In a country like India, a tax on wealth is imperative for equity

Parthasarathi Shome **March 21, 2018** Last Updated at 05:58 IST

I continue with a comparison of direct tax code (DTC) 09 and DTC10 (while desisting from the virtual DTC14) in the context of the currently ongoing exercise that is revisiting the DTC yet another time. Today, I also go beyond DTC09 and DTC10 and bring to attention selected remaining challenges that were inadequately addressed in both of them, nevertheless needing urgent attention.

Wealth tax: DTC09 proposed charging wealth tax on all assets, including financial assets. The law was structured to be simple and implementable. A high threshold of Rs 0.5 billion and a low tax rate of 0.25 per cent were proposed. DTC10 provisions were aligned to the existing Wealth Tax Act, with a few additions of some financial assets located outside India. Wealth tax was subsequently abolished.

In a country like India — where 0.001 per cent of the top wealth cohorts are enjoying the most rapid increase in wealth concentration in the entire world — a tax on wealth is imperative for equity. If appropriately conceptualised and implemented, it should also generate revenue. Net wealth definition of DTC09 should be reinstated, ensuring that all assets — real and financial — are included, keeping the tax rate at 0.25 per cent between Rs 0.5 billion and 1 billion, and 0.5 per cent above Rs 1 billion. The tax rate should be kept very low so that the wealth tax is successful in terms of both compliance and revenue collection.

Taxation of house property income — presumption and exemption — and interest deduction: DTC09 proposed taking gross rent as the higher of contractual rent or presumptive rent (calculated at 6 per cent per annum of the rateable value fixed by the local authority or the cost of construction of the property). In DTC10, gross rent was the actual rent received or receivable and not taken on presumptive basis. Income Tax Act (ITA) uses the concept of notional rent.

The ITA (i) exempts one owner occupied residence from income tax; (ii) taxes second and higher numbers of owned residences; and (iii) allows deduction of interest in case of the first, exempt self-occupied property up to Rs 200,000. This results in an obvious double deduction. It also implies an inequitable structure of income and wealth taxation of real property ownership. Exempting one self-occupied house irrespective of value subsidises extremely high-income and high-wealth owners, while taxing middle income owners who may acquire additional properties later in the earning cycle. Further, aspect (iii) unjustifiably allows deduction of interest on a large residence though not on a second small residence.

Hence it is suggested to introduce a monetary threshold above which a self-occupied residence would be subject to (presumptive) income tax. This should be appropriately high, say Rs 50 million. Second, interest paid on the exempted portion of self-occupied property should not be deductible to avoid the mentioned double deduction. Even if not self-occupied, interest deduction should be allowed up to Rs 200,000, with inflation adjustment over time.

Wealth tax (which has presently been abolished) should separately exclude Rs 50 million from calculation of the wealth tax base to ensure consistency between income tax and wealth tax.

Change in the income tax rate

Illustration by Binay Sinha

structure: International indexes are revealing that there is a wider dispersion in the distribution of income today. Therefore the prevailing rate structure implies that effective progressivity in income tax has declined. Increase in the share of consumption tax with the introduction of a widely based goods and services tax (GST) would reduce effective progressivity even more. Therefore, any new DTC should introduce new rates of 35 per cent and 40 per cent for brackets of Rs 10-30 million and above Rs 30 million respectively. Presently, even a rate of 45 per cent above Rs 60 million is justified. This will not be internationally incomparable.

First, that there would be flight of professionals appears to be invalid since comparable countries have higher rates than India. And, second, any reaction from those who would be at rates of 35 per cent, 40 per cent and 45 per cent of unfair burden should be addressed through enhanced tax administration efforts to improve tax compliance and expand tax payer number — especially the self-employed — while eschewing a strategy of search and seizure. Only then the handful of individuals who declare taxable income of Rs 10 million could be increased.

Separating employees from the self-employed: In order to bring in the self-employed more successfully into the tax net, the self-employed could be separated out from the salaried. Currently in India, both the salaried and the self-employed are subjected to the same rate structure. Offering a preferable rate structure to the self-employed such as individual proprietors may be considered in light of the higher risks involved in earning income from business compared to salary income.

A counter argument could be that the self-employed are already preferred since they are taxed on net profit while employees are taxed on gross salary; but note that standard deduction has just been restored. Note further that many self-employed have recently come under the GST regime as services are now being additionally taxed at the level of states. And even though the tax is designed to be passed on to final consumers, the self-employed often do not perceive it the way tax experts do. Further, in the GST introductory stage, their compliance costs have been significant.

Minimise compliance costs: In both the GST and the income tax, perception persists of an increase in compliance costs, for example, recent requirements to submit balance sheet information by relatively small income earners. There is an overriding consideration regarding right to privacy. Without specifically attributing their actions to the European Convention on Human Rights, European tax administrations operate in accordance with it, possibly under the presumption that any disclosure of information could comprise prima facie breach of that right. In India, even if the disclosure demand is retained, disclosure should be demonstrated to be necessary and not routine or disproportionate, in particular for smaller economic agents.

To conclude, there are many other innovation aspects in DTC09 such as those pertaining to the financial sector that should be retained. And the bank cash transactions tax (BCTT) should be reinstated reflecting the hard landing of demonetisation.