Business Standard

Direct tax code should revert to 2009 while simplifying further

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The direct tax code or DTC has undergone several incarnations. During all of 2007, I had the opportunity to work on the initial 2009 (DTC09) version. Upon my return from Her Majesty's Revenue and Customs, the UK, it was clear to me that the 2010 version (DTC10) that had emerged after stakeholder and tax administration inputs, was a parried-down version, resembling the Income Tax Act (ITA) itself rather than DTC09. Nevertheless, DTC10 had gone to the Parliamentary Finance Committee (PFC), and received major suggestions, rightfully so. By end-2012, I was obliged to return to government to consider, among other matters, the PFC recommendations and imbue meaningfulness into DTC10. The task was completed over 2013-14. Thus the work on DTC had stretched over 2007-14. The final draft — say DTC14 — had cleared all ministries but was not taken to Cabinet.

The new government first indicated unwillingness to reconsider the DTC, a decision I lamented. The government is now revisiting the DTC. Thus there is some usefulness in listing selected recommendations of DTC09 and DTC10 and comparing the two, so that the direction of the newest version comprises meaningful reform. I will desist from DTC14 since, (1) it technically did not appear for stakeholder discussion (though it must be available on file); (2) the currently ongoing exercise should possess the possibility to reconsider DTC09 that DTC14 did not have the luxury of doing; and (3) analysing three earlier DTC versions would be unnecessary.

Tax treatment of retirement savings: DTC10 was similar to the ITA except for marginal differences. Provident Fund was treated as EpEE, that is, with partial exemption (Ep) in the investment/contribution stage, then the interest earned would be exempt (E), followed by retirement income which was also exempt (E). However, Provident Fund was EpEEp in that some forms/parts of the withdrawal were taxed. Thus DTC10 reverted to differentiate across savings instruments, which any structural tax reform should obviate.

In DTC09, all savings including provident fund were subject to EpET. The contribution to retirement was exempt (Ep) only if deposited in a Retirement Benefits Account with an intermediary, exempt (E) during accrual, and taxed on withdrawal (T)to compensate for exemption during the previous two phases of the participant's life cycle. Treatment of retirement benefits in DTC10, however, was similar to that in the ITA where retirement benefits were exempt up to prescribed limits.

Ideally, DTC09 should be reverted to if a balanced treatment of taxation of savings is contemplated in the reformed DTC.

Taxation of capital gains as ordinary income: DTC09 included capital gains in total income and applied the marginal income tax rate. For capital assets held for more than a year, cost of acquisition/improvement would be indexed. Any capital loss would be carried forward to subsequent years for set off against capital gains.

DTC09 would abolish the securities transactions tax (STT). Capital gains from transfer of equity would become a part of ordinary income. DTC10 retained the STT and proposed a special scheme for capital gains computation for STT-charged transactions. Different calculations were then provided for listed equity shares held for more/less than one year on the basis of a scaling down formula. Variations were stipulated for non-STT paid capital gains. Again, it was similar to the ITA structure.

Clearly DTC09 was superior and should be reverted to. Further, it would be better not to distort markets with even low STT rates — such as 0.001/0.01.

Capital gains savings scheme (CGSS): DTC09 proposed CGSS, deposits into which would be tax free until withdrawn. DTC10 withdrew this “rollover” scheme, while maintaining two other rollover schemes in agricultural land and residential house that were available in the ITA and DTC09.

The CGSS should be reinstated, as it appeared in DTC09 reflecting its structural reform characteristic of encouraging savings.

Minimum alternate tax (MAT): DTC09 had proposed the MAT with reference to the value of gross assets. DTC10 reverted to the MAT on the basis of book profits as in the ITA, increased the rate from 18.5 per cent to 20 per cent, and extended the carry forward period from 10 to 15 years. It was termed the book profits tax.

The DTC09 gross assets-based MAT should be reconsidered while removing hurdles such as cascading in work in progress (WIP), which is not a productive asset, carving out pass-through entities, the parent-subsidiary structure, and ensuring compatibility with double taxation avoidance agreements (DTAAs). The rate should be worked out carefully, based on a presumed return to capital and the corporate income tax rate, and be capped at 1.5 per cent of gross assets.

Taxation of non-profit organisations (NPOs): In DTC09, the tax liability of an NPO was 15 per cent of the “surplus plus capital gains on transfer of any investment/financial asset”. There was no scope of setting apart any sum for future use. DTC10 reverted to comparability with the ITA in several respects, including exemption for investment or deposits in specified modes for up to three years.

In DTC10, an exemption of Rs 100,000 was provided; income above that would be subject to 15 per cent tax. These were close to the ITA in the sense that NPOs under the ITA set apart 15 per cent for an indefinite period (the remaining 85 per cent also allowed to set apart for five years on the basis of an application to the assessing officer or AO concerned). DTC09 had mitigated the concern with the AO examining assessment records of five to six years. This advantage was removed in DTC10.

Thus taxation of NPOs should reflect DTC09, however, with a new provision that an NPO may deposit 15 per cent for future use, reflecting the need to differentiate needs for ongoing current, from clustered capital, expenditure. It must be recognised that NPOs continue to play a crucial role in the development of India, in

areas where governments have been unable to provide adequate socio-economic services. Challenging NPOs with heavy-handed taxation or putting up non-tax barriers against them comprise mistaken policy. Rather, the good must be treated with care while the bad identified, examined, and action taken as needed. A cookie cutter approach should be avoided for it is certain to lead to the disappearance of NPO-provided essential services directed to the needy and vulnerable.

To be continued…