Legislative Brief

The Direct Taxes Code Bill, 2010

The Direct Taxes Code Bill, 2010 was introduced in the Lok Sabha by the Minister for Finance on August 31, 2010. The Bill has been referred to the Standing Committee on Finance (Chairman Shri Yashwant Sinha) on September 9, 2010. The Committee was due to submit its report in three months.

Recent Brief:

The Judicial Standards and Accountability Bill, 2010
March 18, 2011

The Public Interest Disclosure Bill, 2010
January 24, 2011

Anirudh Burman
anirudh@prsindia.org

Sana Gangwani
sana@prsindia.org

April 21, 2011

Highlights of the Bill

- The Bill replaces the Income Tax Act, 1961 and the Wealth Tax Act, 1957.
- The Bill widens income tax slabs for individuals. Income between Rs 2 lakh to Rs 5 lakh will be taxed at 10%, between Rs 5 lakh and Rs 10 lakh at 20%, and that over Rs 10 lakh at 30%.
- Companies will be taxed at 30% of business income. Foreign companies shall pay an additional branch profits tax of 15%. Non profit organisations are taxed at 15%.
- The Bill removes several tax deductions currently allowed for companies, but retains most deductions currently available to individuals.
- The Bill removes the distinction between short term and long term capital gains for all assets except securities listed on stock exchanges.
- The wealth tax exemption limit is increased from Rs 15 lakh to Rs 1 crore.
- The Bill introduces General Anti Avoidance Rules to allow tax authorities to classify any arrangement as one entered into for evading taxes.

Key Issues and Analysis

- A Draft Direct Taxes Code, 2009 that was published for public feedback had the intent of simplifying tax legislation and widening the tax base. The Bill reverses some of the provisions of that Draft Code.
- Tax exemptions for individuals have been retained while most exemptions for corporates removed. The tax rates for individuals have been lowered. The taxes paid by corporates will form a greater part of the government's revenue than earlier.
- The Bill may increase the burden of compliance in two ways. There are no guidelines to indicate in what situations the General Anti Avoidance Rules will be implemented. Additionally, the Bill requires income from different units of the same business to compute their tax liability separately.
- The Bill retains the Dividend Distribution Tax and the Security Transaction Tax. These taxes are levied at a uniform rate irrespective of the amount of income or profit, and go against the principle of progressive taxation of individuals.
- The Bill seeks to tax foreign companies if their place of 'effective management' is in India at any time of the year. It is unclear as to what would constitute effective management of a foreign company in India.

PART A: HIGHLIGHTS OF THE BILL[1]

Context

The 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. The process of taxing the wealth of individuals and other entities is governed by the Wealth Tax Act, 1957. 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. Table 1 indicates the revenues raised by the government through the different types of direct taxes.

Table 1: Estimated Tax Revenues (2010-11)

	Rs Crore	% of Total Tax Revenue	% of GDP
Total Tax Revenue	7,86,888	100%	10%
Of which, Direct Taxes	4,46,000	56.7%	5.7%
- Corporate Tax	2,96,377	37.7%	3.8%
- Income Tax	1,49,066	18.9%	1.9%
- Wealth Tax	557	0.1%	0%

Source: Receipts Budget 2011-12; Economic Survey of India, 2010-11; PRS.

A draft Direct Taxes Code, 2009 ("Draft Code") along with a Discussion Paper was released in August, 2009[2] for public comments. Pursuant to feedback received, a revised discussion paper[3] was released in June 2010, and the Direct Taxes Code Bill, 2010 was introduced in Parliament in August 2010. This Bill seeks to consolidate and simplify the language and structure of the direct tax laws. The Bill will replace the Income Tax Act, 1961 and the Wealth Tax Act, 1957.

Key Features

The Bill makes a number of broad changes to the way income is taxed under the Income Tax Act, 1961. These include:

- **Personal income** – Widening of income tax slabs and the removal of some exemptions;
- **Business and corporate income** – Removal or grandfathering (phasing out) of most exemptions;
- **Tax administration –** Wider powers to prevent tax evasion, and an increase in certain penalties.

The main changes proposed by the Bill are summarised in Table 2 on page 3.

Tax on Individuals

- The Bill retains the rates of income tax at 10%, 20% and 30%. It widens the slabs: income up to Rs 2 lakh will be tax exempt; income between Rs 2 lakh and Rs 5 lakh will be taxed at 10% and income between Rs 5 lakh and Rs 10 lakh will be taxed at 20% and income above Rs 10 lakh will be taxed at 30%. Senior citizens will be exempt from tax for income up to Rs 2.5 lakh. Most existing exemptions and deductions for individuals have been retained.
- The Bill specifically taxes any income from a "controlled foreign company" set up by Indian residents in a foreign country with the purpose of paying lower taxes.

Tax on Businesses

- Most tax deductions, such as those offered on export profits, will be removed. In some cases, existing units can continue to avail of incentives currently offered for the period that was originally specified (i.e. grandfathered). New units however, will be offered only incentives available in the Code.
- The Bill does away with a number of tax incentives in the Act and introduces investment linked incentives for sectors such as SEZ development, power, oil and natural gas exploration and cold chains. That is, cumulative profits up to the amount of capital investment will be eligible for exemption. Certain incentives existing under the Act will be grandfathered.
- The Bill states that income from separate businesses shall be computed differently. A business shall be distinct if there is no connection or interdependence between the businesses, or if they are at different locations.
- The Act also prevented business losses to be carried forward for more than eight years. The Bill allows losses to be carried forward indefinitely.
- In the Act, Indian companies are treated as residents. Non-Indian companies are resident if control or management is wholly in India. According to the Bill any non-Indian company is treated as residents if its place of effective management is in India.

Table 2: Some broad changes proposed by the Bill

Issue	Income Tax Act, 1961	Direct Taxes Code Bill, 2010
Residency	Status divided into (a) resident, (b) non-resident, and (c) resident but not ordinarily resident (RNOR).	Concept of RNOR removed.
Tax rates (slabs in Rupees)	Up to 1.8 lakh – 0%; 1.8 to 3 lakh – 10%; 3 to 5 lakh - 20%; 5 lakh and above- 30%; 3% education cess. Higher exemption limits for women and senior citizens, and senior citizens above 80 years of age.	Up to 2 lakh – 0%; 2 to 5 lakh – 10%; 5 lakh to 10 lakh – 20%; above Rs 10 lakh – 30%. No cess. Exemption for women removed. Exemption for senior citizens retained.
Personal benefits	Certain personal savings are tax deductible.	No change.
Income from House Property	Taxable rent is higher of (a) actual rent or (b) 'reasonable' rent set by the municipality (less specified deductions).	Taxable rent is the amount of rent received or receivable for the property (less specified deductions).
Home loans	Interest is tax deductible.	No change.
Capital Gains (Capital gains are gains from the transfer of property.)	Capital gains where Securities Transaction Tax (STT) is payable (such as listed equity shares): Long term (assets held for one year) - tax free; Short-term - 15%. Other cases (where STT is not payable): Long-term (assets held for 3 years) : 20% with indexation benefits; Short-term: to be charged at marginal tax rate.	Capital gains where STT is payable: Long term – remains tax free; Short term – allowed a 50% deduction, and taxed at marginal rates. Other cases: No difference between long-term and short-term capital gains. All capital gains taxed at marginal rates. Indexation benefits available for transfer of assets held for more than a year.
Taxes payable by companies	Domestic companies and foreign companies pay a tax on corporate profits of 30% and 40% respectively. Minimum Alternate Tax (MAT) of 18.5% imposed on book profits.	Corporate tax rate is 30%. Foreign companies shall also have to pay a 15% tax on the branch profits attributable to its permanent establishments or immovable property. MAT increased to 20% of book profits.
Non-profit Organisations	Applies to organizations set up for 'charitable purposes'. Taxed (at 15% of surplus) only if expenditure is less than 85% of income.	Income from charitable activities is taxable at 15% of amount exceeding 1 lakh rupees. Up to 15% of total income or 10% of gross receipts can be carried forward for 3 years.
Wealth Tax	Charged at 1% of net wealth above Rs 15 lakh.	Charged at 1% of the net wealth above Rs 1 crore.

Sources: Income Tax Act, 1961; Finance Bill, 2011; Direct Taxes Code Bill, 2010; PRS

Tax Administration and Appellate Authorities

- Under the Act, the apex authority for tax administration is the Central Board of Direct Taxes (CBDT). The Bill removes some of the powers available to the CBDT to provide tax relief in individual cases.
- Under the Act, tax authorities were given four to six years to re-assess the tax payable. Assessments can now be reopened within seven 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 unpaid tax amount, for various defaults. Under the Bill, the maximum penalty for certain defaults has been increased to an amount up to twice the amount of tax not paid. Penalty for offences continue to range from three months to seven years of imprisonment and a fine.
- Any person who has not disclosed full income or wealth in earlier financial years is permitted to apply for a settlement by paying the unpaid tax with interest.
- The Bill introduces a general anti-avoidance rule (GAAR), which aims to plug loopholes in the law which help tax payers reduce their tax liability. 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.

Others

- Dividends for investments in intermediaries such as mutual funds and life insurers are taxable.
- The central government may enter into a treaty with another country to grant income-tax relief to the assessee, prevent double taxation in both countries, or for the prevention of tax evasion.

PART B: KEY ISSUES AND ANALYSIS

Reasons for a new Act

The Draft Code proposed a number of changes in the way income is taxed under the Income Tax Act. The Discussion Paper released with the Draft Code states the following reasons for introducing the Draft Code:

Simplify tax legislation to make it easier to comply with;

1. Widening of the tax base by (a) removing exemptions, (b) reducing ambiguities in the law, and (c) preventing tax evasion which leads to erosion of the tax base;
2. Remove deductions and exemptions as these reduce efficiency and distort economic behaviour.

To implement these principles, a number of changes were made to the existing tax rates, available deductions and exemptions, and tax administration in the Draft Code. The Revised Discussion Paper released by the Ministry responded to a number of issues raised with respect to the Draft Code. It stated that some provisions in the Draft Code would be changed to address major issues. The Bill accordingly rolls back some provisions of the Draft Code, as discussed in the revised Discussion Paper.

Some of the important changes made, and comments on the same are given in the table below.

Table 3: Major changes proposed in the Draft Code compared with the final provisions in the Bill.

Income Tax Act, 1961	Draft Code, 2009	Bill, 2010	Comments
Tax-rates - Highest marginal tax rate for individuals was at Rs 5 lakh and above.	Highest marginal rate was Rs 25 lakh and above.	Highest marginal rate at Rs 10 lakh and above.	Slabs lower than the Draft Code to ensure there is no revenue loss.
Personal savings - Savings not taxed at the time of investment, accrual of income or withdrawal (EEE).	Taxed during withdrawal (EET).	EEE retained.	Individual retain tax benefits; Discussion paper to Draft Code stated EET is necessary to discourage early withdrawal and thus encourage savings; this objective not met.
Deductions – Tax deductions for both individuals and companies.	Removed deductions.	Some deductions for personal income retained.	Distortions in tax structure reduced from present levels.
SEZs – Deductions for both developers and units in SEZs.	Deductions for developers and units removed.	Deductions for developers and units grandfathered.	Profit-based tax benefits have been replaced with investment linked incentives.
Capital gains – STT on listed securities. Long-term and short-term capital gains taxed differently. Different classification for listed securities, property and other assets.	STT removed. No difference between long-term and short-term capital assets.	For listed securities, STT retained, and difference between short-term and long-term assets remains. For others, proposals of draft code retained.	Incentives for long-term capital gains reduced, except for securities listed on stock exchanges.
MAT – Imposed on book profits.	Imposed on gross assets.	Imposed on book profits.	Tax on assets would have added burden to capital intensive sectors.

Sources: Draft Direct Taxes Code, 2009; Direct Taxes Code Bill, 2010; Revised Discussion paper on Direct Taxes (June 2010); PRS.

Compliance burden

General Anti-Avoidance Rules (GAAR)

The Draft Code introduced a General Anti-Avoidance Rule (GAAR) to prevent tax evasion. The Discussion Paper stated that tax avoidance causes "cross-subsidisation" of the rich. The Draft Code therefore introduced GAAR provisions whereby, 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 obtain a tax benefit. The Bill retains these provisions.

- The Bill does not specify what kinds of transactions may be characterised as impermissible. As a result, (a) there are no guidelines for assessees to avoid transactions which may be declared impermissible, and (b) there are no safeguards against the misuse of such power.
- The revised discussion paper states that GAAR provisions will be invoked only in respect of an arrangement where tax avoidance is beyond a specified limit. However, the Bill does not set any specified limit beyond which GAAR provisions can be invoked.

- According to the Discussion Paper a Dispute Resolution Panel would be available if tax avoidance is beyond a specified limit. The Dispute Resolution Panel under the Bill does not have any specific powers related to GAAR.

Separate addition of income of different units of the same business

The Bill requires the income from a distinct and separate business to be computed separately. Businesses will be deemed to be distinct and separate if: (a) the physical location of two units of the same business are separate, (b) different raw materials are used, or different products are produced in different units, (c) separate books of accounts are maintained or are capable of being maintained. This may increase the compliance burden for businesses with a number of branches or manufacturing units. For example, a large bank may have to report branch-wise accounts for thousands of branches.

Taxes on Income on Investment

Dividend Distribution Tax (DDT)

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. This implies that even a shareholder, who otherwise may fall in the zero tax bracket, would effectively pay this tax.

Securities Transaction Tax (STT)

Currently, there is a tax levied on every transaction in the stock exchange. This tax is however, not a tax on income but a turnover tax (similar to sales tax). In other words, irrespective of the fact that a person makes a profit or loss on a share he/she will have to pay the tax on any transaction on the stock exchange. Also, this tax is imposed on the buyer/seller of the share irrespective of their income levels.

Capital Gains Tax

The Bill removes the differentiation between long term and short term capital gains for all assets other than securities listed on the stock exchanges. Under the Act, capital gains on property held for over three years were considered long term gains, and had a lower tax rate. Under the Bill, any asset (other than securities eligible for STT) would be eligible for indexation (adjustment for inflation) if they are held for longer than one year. These measures reduce the incentive for holding investment over a long period

Taxation of Non-resident Companies

Resident companies are currently 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 in India.

Under the Bill, companies are resident if their place of effective management is situated in India, at any time in the year. The Bill does not define ‘effective management’. This leaves unclear the conditions under which a Non-Indian company will be treated as a resident for tax purposes. For instance, under the provisions of the Bill, if a foreign multi-national company were to hold one board meeting in India, it could be treated as a resident company, and its global profits would be taxable in India.

Overall revenue impact

The Bill removes a number of deductions and exemptions which could lead to a rise in revenue. At the same time income tax slabs have been widened, which could lead to a decrease in tax collections. There is no information available in the public domain which shows the net impact on revenue of these proposals. Therefore, it is not possible to estimate whether there will be an increase or decrease in the government’s revenue collection under the Bill. The Revenue Secretary has stated that there may be a loss of Rs 53,000 crore in 2012-13 due to the implementation of the Bill.[4]

Table 4: Revenue loss due to exemptions and deductions under the Income Tax Act and status under the Bill

Revenue loss	Estimated revenue foregone from Businesses (2010-11)	Estimated revenue foregone from Individuals (2010-11)
		(Rs crore)
Total revenue loss	93,699	45,222
Exemptions retained	40,215	42,195
Exemptions grandfathered	37,373	477
Exemptions removed	16,083	2,550

Sources: Receipts Budget, 2011-12; Direct Taxes Code Bill, 2010; PRS.

The Bill does away with a number of exemptions and deductions available for businesses (companies and other unincorporated bodies such as partnerships) and also individuals, under the Income Tax Act, and grandfathers many others. If the Direct Taxes Code Bill, 2010 is adopted in its current format, the revenue earned from removal of these exemptions and deductions would be Rs 56,483 crore (over the collections in 2010-11).

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: Dr Parthasarathy Shome) and the Task Force on Direct Taxes which submitted its report in 2002 (Chairman: Dr Vijay Kelkar). Table 5 compares suggestions made by these committees with corresponding provisions in the Bill and the Act.

Table 5: Recommendations by Committees compared with provisions in the Bill and the Act

Topic	Committee Recommendation	Provisions in the Bill
Types of taxpayers	Delete category of 'resident but not ordinarily resident' (RNOR) (Kelkar).	Bill deletes RNOR.
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 for savings retained.
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 30%. Different rates of deduction for long and short term capital gains. Dividend Distribution Tax at 15% remains. MAT imposed at 20% of book profits.
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. Certain specific sector incentives such as for oil and natural gas, infrastructure etc grandfathered. Deductions for shipping, scientific research allowed.
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 which earn 90% of receipts through donations (Shome).	Donations to non-profits remain deductible. Charities to pay tax at 15% for income above Rs 1 lakh.

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, 2010; 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. Revised Discussion Paper on the Direct Taxes Code, June 2010, CBDT, Department of Revenue, Ministry of Finance (http://www.incometaxindia.gov.in/archive/BreakingNews_RevisedDiscussionPaper_06152010.pdf).

3. Available at website of Ministry of Finance at http://finmin.nic.in/Dtcode/RevisedDiscussionPaper.pdf (visited on January 3, 2011)

.4. Centre may lose Rs 53,000 cr in 2012-13 due to changes in code, Business Line, http://www.thehindubusinessline.in/2010/08/31/stories/2010083153340400.htm.

PRS LEGISLATIVE RESEARCH

CENTRE FOR POLICY RESEARCH