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INDIAN TAX REFORMS AND ISSUES OF DIRECT TAX CODE

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Abstract

Different countries have made several changes in their tax system. These changes were either due to their development strategy or different economics policies . In developing economies the tax system is generally changed to increase the revenue to meet the increasing fiscal deficit . It has been said that fiscal crisis has been mother of tax revenues (Bird 1993).

In recent times it has been observed that globalization is also one of the reasons of change in tax system. Now such tax system is required which is broad base ,simple and transparent as well as which fulfils the international needs. In India there is transition from licensed industrial regime to open market system. The market system indicated that there should be change in the recent tax system to adjust with the needs of a market economy to ensure international competitiveness.

The systematic reform in India's tax system is seen after 1990's . Many changes have been seen in Indirect tax like VAT as well as in Direct tax . The objective of this paper is to critically evaluate the Direct Tax Code. Thus an attempt has been made in this paper to analyze the tax structure of India with reference to Direct tax Code. In Section I analysis of philosophy of tax reforms in India . Section II brings out the salient features of Direct tax code and Section III deals with the impact of Direct tax code on different sectors.

Section I

PHILOSOPY OF TAX REFORM

The philosophy of tax reforms has undergone change with the change in economic policies . The objectives of economic planning are moving from social perspective to market oriented policies. Therefore ,the reforms in tax system lead to reduction in tax rate both direct and indirect taxes. This approach lays emphasis on minimizing tax distortions to keep economy competitiveness. The tax base has been broaden and emphasis has been shifted from vertical equity to horizontal equity. This has led to broad based, simple and transparent tax. Equity, in general, is taken to man improving the living conditions of the poor . This has to be achieved mainly through expenditure policy and human resource development rather than reducing the incomes of rich as it has done in 1950's and 1960's (Govind Rao 2000) Thus , three different models of reforms have been evolved to bring changes in the tax system.

The optimal tax OT model (Ahmed and Stern 1991) theoretically sounds very good but it is very difficult to implement . It has taken into consideration tradeoff between efficiency and equity. It needs too much information as well as administrative costs.

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The Harberger tax model (HT) is like OT model but it has more practical approach which will minimize the tax distortions as well as politically acceptable . The basic HT reform package for

developing countries that are price takers in the international market consists of uniform tariffs and a broad based VAT.

The third model is supply sides tax model. It reduces the role of state. Public expenditure should be reduced by reducing direct tax rate. If direct tax rates are reduced than it will give incentive to work , save and Investment .

The recent reform in Indian tax system are based on the combination of all the above given models of reforms . The thrust of these reforms is to enhance the revenue and minimize the relative price distortions . With this view a big reform has been put forward in Direct tax.

Section II

Analysis of Direct Tax code

Direct tax has a major impact on economic policies, creation of savings and investment. But before 1991 the impact of it on the economy was very less as it contributed relatively small share in the total tax revenue. Now the share is nearly 10.94 percent to GDP in 2009-2010 .Which was 11.0 percent in 1970-71 ,14.6 percent in 1980-81 and 16.4 percent in 1990-91. Now as the share has gone down it is expected that it will give incentive to work save and investment. Jenkins (1989) and Marsden (1990) argue that lower taxes stimulate growth by increasing the incentive to save and invest.

India's direct taxes consist mainly of a personal income tax, a corporate income tax, a wealth tax, and a gift tax. Income tax is levied on individuals, firms, and corporations and includes tax on

capital gains. Residents are taxed on worldwide income, while non-residents are taxed only on income received in India or which accrues or is deemed to accrue in India. Non-residents pay withholding tax on dividends, interests, royalties and fees for technical services. Like many other developing countries, India makes wide use of tax policies to alter investment decisions. It has used tax incentives, such as a significant cut in corporate and personal income tax rates, tax holidays, rapid depreciation and other means to promote investment (Kerr & Monsingh 1998b).

With this aim the finance minister presented Direct Bill in 2009 . Acc. To him Tax structure should not be seen as mere revenue generation exercise but it is an important pillar of financial infrastructure. Thus Direct Tax Bill is a bold attempt to simplify and rationalize the tax structure. There is clear shift from the exemption based tax regime to scientific progressive taxation based on international taxation practices.

The salient features of this Direct tax code are declared on 30^{th} August 2010 which will be implemented now on 1st April 2012 instead of 1^{st} April 2011

The new bill includes following features

General provision

The concept of previous year has been replaced by a period of 12 months commencing from 1^{st} day of April.

Income has been classified into two broad groups

1. Income from Ordinary sources , it includes
   a. Income from employment
   b. Income from house property
   c. Income from business
   d. Capital Gains
   e. Income from Residuary Sources

2 Income from Special Sources

Income from Special Sources to include specified income of non residents , winning from lotteries horse races etc.

The tax trends

For Individual (Men, Women & HUF)

The big change is that the same tax slabs will apply to men and women. Now both are eligible for Rs 2 lakhs tax free exemption, whereas previously it used to be up to Rs 1.6 lakhs for men and up to Rs 1.9 lakhs for women.

Tax Rate	**DTC Parliamentary Bill (Aug 2010)**	**Current Slab under Income Tax Act**	**Original DTC**
Nil	Upto Rs 2,00,000	Upto Rs 1,60,000	Upto Rs. 1,60,000
10%	From Rs 2,00,001 to Rs 5,00,000	From Rs 1,60,001 to Rs 5,00,000	From Rs 1,60,001 to Rs 10,00,000
20%	From Rs 5,00,001 to Rs 10,00,000	From Rs 5,00,001 to Rs 8,00,000	From Rs 10,00,001 to Rs 25,00,000
30%	Above Rs 10,00,000	Above Rs 8,00,000	Above Rs 25,00,000

For Senior Citizens

For those above 65 years of age, the tax exemption limit has been raised to Rs 2.5 lakhs from Rs 2.4 lakhs, for a net new saving of Rs 1,000 per annum.

Tax Rate	**DTC Parliamentary Bill (Aug 2010)**	**Current Slab under Income Tax Act**	**Original DTC**
Nil	Upto Rs 2,50,000	Upto Rs 2,40,000	Upto Rs. 2,40,000
10%	From Rs 2,50,001 to Rs 5,00,000	From Rs 2,40,001 to Rs 5,00,000	From Rs 2,40,001 to Rs 10,00,000
20%	From Rs 5,00,001 to Rs 10,00,000	From Rs 5,00,001 to Rs 8,00,000	From Rs 10,00,001 to Rs 25,00,000
30%	Above Rs 10,00,000	Above Rs 8,00,000	Above Rs 25,00,000

The above given data shows that the new direct tax law proposes sweeping taxation changes to promote long savings and retirement benefits. Save more money and save more tax, that seems to be the principle guiding the government's new direct tax code that allows higher tax exemptions for long term savings and retirement benefits.

Exempt Exempt and Exempt Region

The new tax code has proposed to continue the current tax treatment for provident fund investments. So provident fund investments would continue to be treated under exempt exempt and exempt (EEE) regime which means that the investments would be tax exempt at the investment stage, earnings stage (when interests are earned) and withdrawal stage. The pure insurance products have also been treated on EEE basis. But the revenue secretary said that fewer saving products would fall under the EEE basis. In the drafted bill it was in the net of EET.

The new draft has proposed EEE method of taxation for Government Provident Fund (GPF), Public Provident Fund (PPF) and Recognised Provident Funds (RPFs) and the pension scheme administered by Pension Fund Regulatory and Development Authority. Approved pure life insurance products and annuity schemes will also be subject to EEE method of tax treatment.

Investments made, before the date of commencement of the DTC, in instruments which enjoy EEE method of taxation under the current law, would continue to be eligible for EEE method of tax treatment for the full duration of the financial instrument.

In a major change, under the new code, the current distinction between short-term investment asset and long-term investment asset on the basis of the length of holding of the asset will be eliminated. Income under the head Capital Gains will be considered as income from ordinary sources in case of all taxpayers including non-residents. It will be taxed at the rate applicable to that taxpayer.

Currently, short-term capital gains arising on transfer of listed equity shares or units of equity oriented funds are being taxed at 15 per cent and long term capital gain arising on transfer of such assets is exempt from tax. The withdrawal of this regime will raise the tax liability and may cause fluctuations in the capital market. The developing countries need more saving and capital formation than developed countries. The wealth tax changes are also brought forward i.e. net wealth in excess of RS 50 crore will be charged at 0.25percent as wealth tax..

Section III

Impact of Direct tax Code on Sectors of Indian economy

In this section an attempt is to find out the impact of direct tax on different sector of the economy.

The impact on agricultural sector is neutral . whereas on industrial sector it will help to bring investment as the corporate tax has been reduced from 33 percent to 30 percent. In case if one has any existing investment , which enjoyed EEE method of taxation it will be treated the same way for their full tenure.

Capital Gains on Equity

In the new bill equity investment in shares and equity mutual funds are going to be taxed .If there is short term capital gains on equity then it will be added to income and taxed at applicable tax rates .As per this rule, for any long-term capital gains, one will get certain specified deductions which will be some percentage of profits, and then after deducting these, the rest will be added to income and then taxed at applicable rates, the indexation benefits are deleted . Still some aspects are not very clear in the new bill. The other change is in the holding period.

Reduction in corporate rate is a positive signs as it will benefit the companies across sectors but especially to FMCG and banking where the effective tax rates are close to 33 percent for most of the companies .Moreover , business losses will be allowed to carried forward **.** But tax experts say whether a company pays more tax or less will also depend on a key provision called the minimum alternate tax (MAT).MAT is applicable to those companies who do not show book profits liable to tax, as they claim a plethora of exemptions on account of being in capital intensive industries. The MAT rate has now been increased from 18% to 20% in the new code. Foreign corporate today pay a higher rate of tax. However, the new rate of taxation for foreign corporates is not yet known**.**

Corporate houses heaved a sigh of relief as the finance ministry decided to continue with the existing system of minimum alternate tax (MAT) —calculating it on book profit and not on gross asset value — though with a marginally higher rate of 20% as against 19.83% at present.

However, they are disappointed with higher corporate tax of 30% proposed in the bill as against 25% proposed in both the original and revised discussion papers of Direct Tax Code (DTC). As some comment of business men show that"If the credit is allowed against the payment of MAT, impact won't be much," Dinesh Kanabar, deputy CEO and chairman of tax division of KPMG, said. But, the decision to continue with 30% corporate tax has certainly disappointed companies as they were hoping that the government would bring it down to 25% as proposed in the original discussion paper in August 2009," he added.

R Shankar Raman, senior v-p (finance & legal), Larsen & Toubro, also expressed his disappointment as the "big bang" tax rationalization, which was proposed in the discussion paper for DTC, did not happen. "The tax structure for companies which are already in normal tax mode as compared to MAT mode is unlikely to change much," he said.

However the code does provide for some investment based incentives . In respect of revenue and capital expenditure on scientific research and development , deduction to the extent of 150 percent of the expenditure will be allowed to all the companies **.** It has negative impact on cash rich companies that have invested surplus cash in mutual funds and other financial instruments .It is discussed that some sort of relief the companies are feeling with the lower income tax rate as it may increase the disposable income but if inflation rate continues to increase then this aspect will not work. **.**

CONCLUSION

Thus it appears that new tax bill to be implemented on 1st April 2012 has some good news and some bad news.The aspects of taxation that need to be taken into consideration while framing taxation policy has been taken into consideration by lowering the personal tax rate. This will have a positive effect on the work and consumption/savings rates. costs. The tax base will increase as the tax rate are simple to understand .These rates have greater revenue potential . It seems that Implementation of tax reforms will further decrease the marginal tax burden on investment and reduce tax-induced distortions. But the cost of collection tax still remains to be examined.

It seems the reforms proposed in new direct tax code would have great positive implication for India's outlook and would make the most of tax system, as part of efforts to cancel revenue deficit and lower fiscal deficit to less than 3.0 percent of GDP . Moreover, the implementation of the proposed fiscal reforms should reduce both tax evasion and costs of compliance, and should eliminate most of the distorted behavior coming from tax avoidance. These tax reforms are largely in response to the massive reforms enacted in the UK and the US in the 1980's. Tax reforms, such as the reduction in personal and corporate income tax rates, and the determination of a minimum exemption limit (tax threshold), are generally applicable to both developed and developing economies. However, the translating of tax reforms from developed to developing economies has to be done with caution, since there are many impediments that prevent the efficient working of an under developed economy. For example, in less developed countries, tax evasion and black money, a wide disparity of incomes, and highly complex tax laws make it difficult to mobilise adequate tax revenue for development. The developing countries need more saving and capital formation than developed countries (Vasanthi Monsingh Peter, Ian A Kerr &Michael Thorpe)

. Therefore, this bill introduces a total departure from multiple tax brackets and high rates of tax prior to reforms . Simplification and rationalisastion have been emphasized with the ultimate objective of mobilizing resources for investment. Thus in market oriented economy like us it is expected that the tax structure brought forward by this bill would reduce conspicuous consumption and make it difficult for people to evade and avoid tax, and thus would promote horizontal equity. Also, a switch to a cash flow tax from the existing business tax is suggested on the grounds that it would remove the hurdles in the measurement of the corporate tax base and would eventually increase business output. These suggested tax measures are envisaged to promote growth with equity.

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