COVER STORY

Crack The Code

The big reforms are missing, but the little changes could leave you poorer than before

S. HAMSINI AMRITHA

"Oh, no, he will come back. We all come back Kate. These private revolutions always die. The compromise is always made."

Jim Bayliss to Kate Keller in Arthur Miller's "All My Sons" (1947)

What promised to be a public revolution for the Indian taxpayer is now clearly headed to meet the fate of most private revolutions: compromise. On 30 August 2010, the Union finance minister Pranab Mukherjee tabled in Parliament the Direct Tax Code (DTC) that is to come into effect on 1 April 2012 and replace the existing tax law, Income Tax Act, 1961. Of course, the implementation will follow after the proposals are examined by a Parliamentary Standing Committee and passed by Parliament.

The contents of the DTC tabled in Parliament are a far cry from the revolutionary draft, unveiled more than 13 months ago, that promised to make taxation far less complicated with broader tax slabs and near-extermination of tax leakages via numerous exemptions

. Such attributes in the taxation system in different countries have benefitted taxpayers as well as governments. But blame it on the feedback that the government received to the two DTC drafts that, among other things, made shrill pitches for maintaining existing tax exemptions. The DTC provisions show the government has gone quite some way in trying to have something for everyone, in short, making the perfect coffin for tax reforms. For instance, while deduction of interest on home loans remains with its annual limit of `1.5 lakh, the `1-lakh limit of principal payment has been jettisoned

"I expect some tinkering in the Direct Taxes Code rules, since there is no substantial enhancement in the basic (tax) slab rate."

"There's emphasis on pension and superannuation funds, life insurance and provident funds. Government is looking to encourage long-term savings."

. In cases of many investments, such as in the Public Provident Fund (PPF), there is no taxation at the stages of contribution, returns and maturity making it exempt-exempt-exempt (EEE). To balance the give-outs, the government had to make only modest changes in the tax slabs, to `2 lakh-5 lakh, `5 lakh-10 lakh and `10 lakh and above at tax rates of 10 per cent, 20 per cent and 30 per cent, respectively. Of course, this will provide relief of `40,000 for men below age 65 and `10,000 to women and senior citizens. But with the existing high inflation and income growth, by 1 April 2012, the net result will be no different from proposals that could have been made in a regular Union Budget. Why have a DTC? DTC provisions do have a few things good for the taxpayer, but, in sum, you will likely pay the government more than you will get from it. A closer look at important provisions.

Weighing The New Tax Code

How some new tax provisions will make a major impact on your finances

WHILE ONE HAND GIVES......

PROVISIONS	IMPACT
Higher tax slabs of ₹2 lakh-5 lakh, ₹5 lakh-10 lakh and above ₹10 lakh per annum	Gain of ₹10,000 for women and senior citizens; ₹40,000 for others
Hike in annual medical reimbursement from ₹15,000 to ₹50,000	Should help you bear rapidly rising medical costs
No tax on notional rent on residential properties that are not self-occupied	Will prevent tax outgo for property that is not self-occupied, but from which there is no income either
Long-term capital gain on assets, such as gold and property available after one year of acquisition	Makes exit from these assets more tax-efficient; greater harmonisation in capital gains tax among different asset classes

....THE OTHER TAKES AWAY MORE

PROVISIONS	IMPACT
Leave travel allowance (LTA) and leave travel concession (LTC), both will be fully taxable	Yet another important pay component becomes fully taxable
Standard deduction for income from house property down to 20 per cent from 30 per cent	Huge dent on rental income; seeking investment income from residential property becomes practically meaningless
Though tax deduction limit under Section 80C raised to ₹1.5 lakh; ₹50,000 sub-limit for tuition fees, insurance and health insurance	Killer provision that will increase your tax payout. Requirement of premium not exceeding 5 per cent of sum assured for life insurance policies means, only plans such as term plans will qualify for tax-breaks; say goodbye to tax deductions from unit-linked insurance plans (Ulips); The limit for claiming deduction for kids' tuition fees is down to ₹50,000 from ₹1 lakh before; if you claim tax deduction for life insurance and tuition, you can banish the thought of claiming deduction for health covers of up to ₹15,000 and ₹20,000 under Section 80D currently for non-senior citizens and senior citizens respectively
Tax-saving options to avail of annual deduction limit of ₹1lakh gets severely restricted to approved provident pension, superannuation, gratuity funds and other approved funds	Tax-saving will now have to be linked to long-term goals such as retirement. Say goodbye to saving taxes through 5-year notified FDs, National Savings Certificate (NSC), Senior Citizens Savings Scheme, Equity-linked Savings Schemes (ELSS)
No tax deduction for home loan principal repayment, previously with an annual limit of ₹1 lakh under Section 80C	Actual home acquisition costs will now go up significantly

Income from Employment

'Income from salary' will be rechristened 'income from employment' in the DTC. Leave travel allowance (LTA) and leave travel concession (LTC) will become fully taxable. Earlier, while LTA was fully taxable, LTC was fully taxable every alternate year in a block of four years and, every alternate year, it was reimbursed to the extent of expenses. Also, the annual medical reimbursement limit has been enhanced from `15,000 to `50,000. But for people to take advantage of this provision, the employers will have to provide this in the pay structure. DTC provisions are rather supportive of pension accumulations. One of the provisions deals with employer's contribution to superannuation funds. Homi Mistry, tax partner, Deloitte, Haskins & Sells, says: "Currently, employer's contribution to superannuation funds in excess of `1 lakh is taxed. DTC has removed this clause. This is could be a tool for employee tax planning." In the lead up to the DTC, almost all perquisites have been covered under the tax net and DTC has done little to change that position. "There is limited avenue for perquisites planning and to save taxes on what is left for the salaried class in the DTC," says Pranay Bhatia, partner, Economic Laws Practice, a Mumbai-based law firm. Nikhil Bhatia, executive director, direct tax, PricewaterhouseCoopers India, agrees: "I expect some tinkering in the rules since there is no substantial enhancement in the basic slab rate."

Tax Liability

Income tax rates and how much you will need to pay the taxman

INCOME SLABS (₹ LAKH)	INCOME TAX FOR PERSONS UNDER 65 YRS	INCOME TAX FOR SENIOR CITIZENS*	INCOME SLABS (₹ LAKH)
Up to 2.00	NIL	NIL	Upto 2.50
2.00-5.00	10% of total income exceeding ₹2 lakh	10% of total income exceeding ₹ 2.50 lakh	2.50-5.00
5.00-10.00	₹30,000 + 20% of total income exceeding ₹ 5 lakh	₹25,000 + 20% of total income exceeding ₹ 5 lakh	5.00-10.00
Above 10.00	₹1,30,000 + 30% of total income exceeding ₹10 lakh	₹1,25,000 + 30% of total income exceeding ₹10 lakh	Above 10.00

* Over 65 years; The DTC has done away with gender inequalities. Unlike the old system, there is no difference in taxing income of men and women. Both are taxed at the same rate; new tax slabs will take effect from Assessment Year 2013-14.

Tax Savings

Tax Savings under the Direct Tax Code regime

TAXABLE INCOME (₹LAKH)	MEN LESS THAN 65 YEARS		WOMEN LESS THAN 65 YEARS		SENIOR CITIZENS (OVER 65 YEARS)	
	POST-DTC LIABILITY (₹)	SAVINGS (₹)	POST-DTC LIABILITY (₹)	SAVINGS (₹)	POST-DTC LIABILITY (₹)	SAVINGS (₹)
1.60	Nil	Nil	Nil	Nil	Nil	Nil
1.90	Nil	3,090	Nil	Nil	Nil	Nil
2.00	Nil	4,120	Nil	1,030	Nil	Nil
2.40	4,000	4,240	4,000	1,150	Nil	Nil
2.50	5,000	4,270	5,000	1,180	Nil	1,030
4.00	20,000	4,720	20,000	1,630	15,000	1,480
5.00	30,000	5,020	30,000	1,930	25,000	1,780
8.00	90,000	6,820	90,000	3,730	85,000	3,580
8.50	1,00,000	12,270	1,00,000	9,180	95,000	9,030
10.00	1,30,000	28,620	1,30,000	25,530	1,25,000	25,380
12.50	2,05,000	30,870	2,05,000	27,780	2,00,000	27,630

1. This calculation is without taking into account deductions that can be availed under respective laws. 2. 2% education cess and 1% higher education cess will not be levied under DTC

Income from house property

DTC has done away with the concept of notional rent on properties that have not been let out. So, if a taxpayer has many house properties, but has not let out the ones that aren't self-occupied, there will be no tax payouts on the basis of notional rent. "But, to that extent, it is a loss to the taxpayer who is availing the benefit of interest deduction," warns Bhatia. Current tax laws provide for deduction from income of the entire amount paid as interest on loan on property that is not self-occupied only if is let out. "When the vacant property is not subject to tax, (it) cannot avail exemption on this interest," says Divya Baweja, partner, Tax and Regulatory Services, Grant Thornton. If this provision is helpful, the provision of reducing the standard deduction to 20 per cent from 30 per cent is a big blow. Much of it is due to the fact that given the rental yield, typically 4-6 per cent (pre-tax) of the market value of the residential property, a 20 per cent deduction will barely—and in some cases not—cover maintenance and insurance costs. This will make investing in residential property somewhat less attractive (see Income From Property).

Income From Employment

Here's a bird's eye view of what's going to change once the DTC takes effect from 1 April, 2012

PROVISIONS	UNDER CURRENT LAWS	UNDER DTC
Gratuity	Fully exempt for government employees, for others exempt up to ₹10 lakh	Exempt for both categories, subject to prescribed limits
Voluntary retirement compensation	Exempt up to ₹5 lakh, subject to conditions	Exempt subject to conditions
House rent allowance	Exempt subject to conditions	Exempt subject to conditions
Entertainment allowance	Exempt for government employees, taxable for others	Taxable for all categories
Special Allowance	Taxable	Taxable
Accommodation	Preferential treatment to government employees for arriving at the value	No difference between government and other employees for determining the value
Employer contribution to approved superannuation fund	Exempt up to ₹1 lakh	Fully exempt
Leave travel concession	Exempt	Taxable
Medical reimbursement	Exempt up to ₹15,000	Exempt up to ₹50,000
Employer's contribution to New Pension Scheme (NPS)	Not taxed up to 10% of salary	Not taxed up to 10% of salary
Employee contribution to NPS	Not taxed up to 10% of salary	Exempt up to ₹1 lakh
Withdrawal from NPS	Taxable	Exempt

Capital Gains

The base date for indexation has been upped from 1 April 1981 to 1 April 2000. Also, any investment asset, other than equity or equity-related products such as gold and real estate, if held for a period of 12 months or more from the end of the financial year in which it was purchased, shall qualify for indexation benefits. In other words, such assets will be treated as long-term assets for the purpose of indexation. Current laws prescribe a holding period of 36 months from the date of purchase of the asset. This will make the exit from such asset classes more tax-efficient. Another significant aspect is that DTC treats gains from long-term and short-term capital assets as equals. This is a major departure from the present regime, where long-term capital gains are taxed at a lower rate compared to short-term capital gains. Such assets will be taxed at the normal slab rates applicable to the assessee. Contrary to fears, DTC has stuck with the current provisions relating to taxation of long-term capital gains arising from sale of equity or equity-oriented products. Long-term gains arising from these assets, held for more than a year, will continue to be exempt from tax.

The present law slaps a flat 15 per cent tax on short-term gains arising from sale of equity or equity-oriented assets; the new code plans to exempt a portion of such gains. The rest shall be taxed as per normal slab rates. "People who fall in the 10 per cent and 20 per cent tax slab rate stand to benefit the most," says Mayur Shah, associate director, Tax & Regulatory Services, Ernst & Young India. Laws relating to exemptions from capital gains have also been simplified, though not enough. The numerous options currently available to claim exemption have been reduced to just two now. Subject to certain conditions, capital gains from any investment asset, if reinvested in a residential house property, shall be eligible for exemption. Similar exemption exists for reinvesting capital gains from sale of an agricultural land into another agricultural land. Many DTC provisions with regard to set-off and carry-forward of losses have been made taxpayer-friendly. For example, a long-term capital loss can be set off against short-term capital gain also. However, while setting off short-term capital loss arising on account of equity transaction, one can consider only a part of such a loss for this purpose.

Tax Savings Made Difficult

Saving on taxes through tax-savings investments and expenses will become much more difficult. While total annual deductions though tax savings have been enhanced to `1.5 lakh, there are two sub-limits of `1 lakh and `50,000. The list of tax-saving investments has been reduced to approved provident, gratuity and superannuation funds, besides other funds approved from time to time. So unless you link your long-term goals to tax-saving investments, you will come to grief. Baweja says:"There's a lot of emphasis on approved pension funds, superannuation funds, life insurance, provident funds, and so on. The government is looking at encouraging savings."

Income From Property

The DTC intends to do away with some quirks while reducing standard deduction

PROVISIONS	UNDER CURRENT LAWS	UNDER DTC
Self-occupied or vacant house property	Income from self occupied house or vacant property was taxed at on a notional basis	Only income from a let-out property will be taxed. No notional income will be arrived at for self-occupied and vacant properties for the purpose of taxing them
Standard deduction	Allowed at 30 per cent	Reduced to 20 per cent

Far-Reaching Effects

Self-Occupied Property

- **Present:** Home loan principal repayment up to `1 lakh can be deducted from taxable income under section 80c
- **Impact:** Tax savings of `30,000 (in highest tax slab)
- **Post-DTC:** No deduction of home loan principal repayment
- **Impact:** Even if you are repaying a home loan, to save `30,000 in taxes, you need to invest another `1 lakh, or a total cash fl ow of `2 lakh

Residential property not self-occupied

Approximate rental return on market value of residential property=3.5% p.a. say, value of property=`1 crore approximate annual rent=`3.50 lakh

- **Present:** Standard deduction=30 per cent of rent=`1.05 lakh
- **Impact:** Tax savings=`31,500
- **Post-DTC:** standard deduction=20 per cent of rent=`70,000
- **Impact:** tax savings=`21,000, or increase in tax payout=`10,500, house-owners expected to maintain property for 0.7 per cent of the property value. this does not appear justified.

Capital Gains

The method of calculation gets simpler and tax burden goes down

PROVISIONS	UNDER CURRENT LAWS	UNDER DTC
Asset Classification	Assets other than equity held for 36 months or more is recognised as long-term capital assets for the purpose indexation	Assets other than equity held for 12 months or more from the financial year in which the asset was acquired will be recognised as long-term capital asset for the purpose of indexation
Taxation of gains on assets other than equity or equity linked	Gains from long-term capital assets and short-term capital assets are taxed at different rates	Gains from long-term and short-term capital assets will be treated at the same rate. Income tax slabs will be applicable for both
Taxation of gains on equity or equity-linked assets.	Long-term capital gains exempt from tax if the transaction suffers STT. Short-term capital gains taxed at 15 per cent.	No change in long-term capital gains. Short-term capital gains to enjoy a part exemption. The rest will be taxed at the applicable slab rate.
Base date for indexation	1 April 1981	1 April 2000

The second sub-limit provides the knockout punch. This is the maximum deduction available for insurance plans, down from the current `1 lakh under Section 80C. This, too, is available for plans with annual premium below 5 per cent of the sum assured or 20 times annual premium as the sum assured. It is now 20 per cent or 5 times the cover and for plans with terms of at least 20 years. Maturity benefits of life cover are tax-free for existing policyholders under DTC only if the sum assured is 20 times of the premium paid. For covers less than that, says Ernst & Young tax partner Anish Thacker, life insurers will have to withhold tax from maturity benefits at 10 per cent for individuals and 20 per cent for companies. DTC says that all life insurers shall be liable to pay tax on any amount distributed to the policyholders of an approved equity-oriented life insurance scheme at 5 per cent. This will mean lower returns for the most popular insurance products, unit-linked insurance plans (Ulips). DTC has withdrawn the product's major selling proposition: tax deductions. The `50,000 sub-limit is bad news for those enjoying annual tax deductions under Section 80D of `15,000 and `20,000 for senior citizens. Now, this entitlement has been boxed with tax deductions for life insurance. That's not all; tuition fees of children, which currently enjoy an upper limit of Rs 1 lakh, are also boxed in the sub-limit. Given the fact that educational and health expenses have been growing much faster than the general inflation, this provision can be considered quite regressive. "Insurance companies will have to tweak their products to remain lucrative," foresees Vijay Ravi, tax partner, Kochhar & Co., a Delhi-based law firm.

One important provision of the DTC deals with a 5 per cent dividend distribution tax (DDT) on equity-oriented mutual funds and equity-linked saving schemes (ELSS). The latter will no longer get tax deductions. "Dividend options will become less tax-efficient compared to capital growth options. Systematic withdrawal plans and growth options would become more tax-efficient," says R. Raja, head of products, UTI Mutual Fund.

What we have provided so far in this article is our preliminary analysis of the DTC. As we uncover more important aspects, we will bring them to your notice. However, what is clear from the provisions is that the gravitational pull of short-term interest and the present has prevented India from soaring to reach a brighter future as far as tax reforms are concerned.

If you have any queries regarding the Direct Taxes Code, write in to us at letters AT outlookmoney.com

By S. Hamsini Amritha With inputs from Teena Jain

hamsini AT outlookindia.com