Code And After

Direct taxes debate throws up some unresolved issues

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In a remarkable act of consultative policy-making not often seen in India, Pranab Mukherjee released the draft of a proposed new direct taxes code on August 12 for public discussion. Repeated amendments of the 1961 Income Tax Act through the annual finance Acts and judicial interpretations of various aspects of the Act, or related Acts like the 1957 Wealth Tax Act, have resulted in a direct tax system that is complex, cumbersome and ambiguous. It has spawned a flourishing industry of tax accountants and lawyers, but for the public at large the system has been a nightmare. Hence, the decision to issue a fresh tax code has been widely welcomed. However, views are divided on whether the new code will achieve its goal of establishing a direct tax system that is simple, economically efficient, effective and equitable.

Some key proposals in the draft code are quite puzzling. In personal income taxes, for instance, the ceiling of the lowest non-zero bracket for taxation at 10 per cent has been extended from Rs 3 lakh taxable income to Rs 10 lakh. The ceiling for 20 per cent tax rate has been extended from Rs 5 lakh to Rs 25 lakh, and the 30 per cent rate will now be applicable only to annual income of over Rs 25 lakh as compared to over Rs 5 lakh earlier. In short, most income taxpayers will pay at rates about a third lower than at present. A similar drastic adjustment of the wealth tax is also proposed. While financial assets are being brought within its purview, a long overdue reform, the threshold is being raised from Rs 15 lakh to Rs 50 crore!

This lowering of rates has naturally been welcomed by the public. However, there are limits to how far we can go here without losing revenue and hurting the provision of sound infrastructure and essential public goods such as public health care, basic education, law and order, security and defence. The draft code mentions that income tax rates in India are already among the world's lowest, hence it is inexplicable why it has proposed a further drastic lowering of these rates. The claim of equity is also challenged in setting the marginal rate at 30 per cent only for taxable incomes above Rs 25 lakh in a country where nearly 70 per cent of the population lives on less than Rs 36,000 per year (about $2 per day).

The code points out that widening of the base, with most current exemptions such as interest on housing loans, medical benefits, travel benefits etc, being withdrawn, will help offset the revenue loss. However, there are no computations to show how much revenue the elimination of these exemptions will generate. On the other hand, one estimate indicates that lowering of the effective personal income tax rates and corporate tax and abolition of the securities transactions tax will together lead to a total revenue loss of as much as Rs 55,000 crore.

A bird's eye view of tax rationalisation

On the corporate tax side, the code proposes that companies are to be taxed at a flat rate of 25 per cent compared to the highest marginal income tax rate of 30 per cent. Global best practice is to equate these two rates as at present. Hence, the purpose of lowering the corporate tax rate is a mystery. On the other hand, the code has proposed a Minimum Alternative Tax (MAT) of 2 per cent of the gross value of assets, much higher than the usual MAT rates of 0.5 per cent to 0.75 per cent of assets seen elsewhere. This particular proposal has been heavily criticised and is unlikely to be retained in the final draft of the code. Dividends will be taxed at 15 per cent at the company stage, with no further taxation as income of the recipient. While avoiding double taxation of dividends, this in effect retains an iniquitous income tax concession since two individuals subject to different marginal rates of income tax will bear the same rate of tax on their dividend income.

There is a major change in the treatment of capital gains. The distinction between short- and long-term capital gains is abolished and capital gains will be taxed at the same rate as income. This is conceptually appropriate since a capital gain is indeed income. However, a capital gain is also the reward for bearing risk. In treating it the same way as other income, the code is significantly dampening the incentive to invest in risk capital. Is this the desired outcome or an unintended consequence?

Some of these issues will hopefully be addressed in the revised code. One neglected issue is the tax system's stability and predictability. Entrepreneurs often say they can adjust to any reasonable system of taxation provided rates and provisions are stable. It is the tax regime's unpredictability and year-to-year changes that they find difficult to handle. The new code does refer to stability as one objective. However, it is not clear how it will be achieved if there is still room for year-to-year changes in tax rates. Hopefully, the code's final version will address this issue.

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