IMPACT OF DIRECT TAX CODE ON INDIVIDUAL INVESTMENT CHOICES

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The cabinet had recently approved the Direct Tax Code (DTC) bill that is going to replace the Income Tax Act, 1961 and the Wealth Tax Act, 1957. As the individuals make their investment choices today, they have to keep in mind that income tax scenario is set for substantial change in April 2012, if the new DTC bill is passed by Parliament. The new DTC will have an impact on most investment avenues, such as insurance, house property, provident fund, public provident fund, mutual funds and equity. Many of the tax exemptions in existence today will cease to be valid once the new code becomes the law. There have been significant changes in capital gains tax, investments that qualify for tax exemptions currently under section 80C, investments in life insurance products etc. An investor needs to be watchful about these changes, so as to take the right investment decisions. Now, the final Direct Tax Code (DTC) bill has been approved by the cabinet which means that the proposals contained in this bill are more or less final, unless changes are made in the parliament during discussions on the bill. This article is a modest attempt to analyse the impact of proposed changes in DTC on individual's investment choices.

Key Words: *Direct tax code, Income tax, Investor, Individual.*

INTRODUCTION

Income tax in India is governed by the Income Tax Act, 1961. This act has become very old. It has been modified many times since 1961. This has made the old act complicated and difficult to interpret, leading to many disputes and court cases. The government, wished to have a modern tax code in step with the needs of an economy. The Direct Tax Code (DTC) bill, when passed will replace the Income Tax Act, 1961 and the Wealth Tax Act, 1957.

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The new tax code is expected to widen the tax base, end unnecessary exemptions, moderate tax rates and add to the government's coffers. Government feels that the new code will help improve the tax to GDP ratio significantly from around the current 11 percent. It also aims at simplifying the laws, smoothening the entire process of tax collection and better overall compliance. As and when the DTC comes into effect, the government would not like to tinker with tax rates every year, so as to provide a greater degree of tax certainty to corporates, investors and individuals. With the introduction of the new DTC, the tax rates will not be part of the annual budget.

The first draft of the Direct Tax Code came up for public discussion in Aug 2009. It proposed some significant changes, like removal of most tax exemptions, putting most of retirement products like PF, PPF and New Pension System (NPS) in Exempt-Exempt-Tax category and a substantial widening of the income tax slabs applicable to individuals. Based on the public reaction to the first draft, the government presented the second draft of the Direct Tax Code in June 2010. Based on public reaction, even this was modified to some extent and now the final revised DTC 2010 Bill is introduced in parliament in August 2010. This revised bill has taken care of most negative proposals in the first draft but seems to have abandoned the spirit of the originally proposed DTC.

Direct Tax Code (DTC) is likely to be effective from April 1, 2012 onwards. This is going to bring several changes in the investment people make across various asset classes. There is a need for every individual to be well informed about these changes so that all their future investments are DTC complaint. Individuals need to readjust their investment portfolio in a manner that is both tax efficient and allow them to successfully achieve their life time financial goals. The important provisions of the bill that are going to affect the individual investment choices are as under:

Impact on Investments Enjoying Tax Exemptions (Under Section 80C):

In our country most of the individual investments are guided by their tax status. Most of the savings and investments by individuals are done just before the close of the financial year, based on the criterion of taking full advantage of income tax incentives. The information on income tax exemptions and categories of investments that qualify for exemption is critical input to investment decisions of most individuals.

The first draft of DTC had proposed the EET method of taxation for savings, where the contributions made by an individual, along with accumulations/accretions thereto, would be exempt only till one remained invested. However, withdrawals at any time would be subject to taxation at the marginal rate. This would result in the amount withdrawn or amount received under whatever circumstances being brought into the computation of total income of the assessee, and then being taxed at the marginal rate, according to the applicable tax slab. Further based on the EET principle, the original code had provided for a deduction in respect of aggregate contributions upto a limit of Rs 3,00,000 (both by the employee and the employer) to any account, maintained with any permitted savings intermediary during the financial year. The list of the permitted savings intermediaries included:

- Approved provident funds
- Approved superannuation funds
- Life insurer
- New Pension System Trust

But under the revised DTC bill, all the above permitted savings have been put back under the Exempt-Exempt-Exempt (EEE) regime of taxation. In the revised DTC, income tax exemptions for the above savings would be available only up to Rs.1,50,000. This is up from the current Rs. 1,00,000 for investments under section 80C plus Rs.20,000 for investment in infrastructure bonds u/s 80CCF. However, the new limit of Rs. 1,50,000 under revised DTC would have 2 sub-limits:

- Rs.1,00,000 for approved long term savings, which are geared towards retirement like the new pension scheme (NPS), provident fund (PF) and PPF.
- Rs. 50,000 for some other investments, like pure life insurance, health insurance premiums, and children's tuition fees.

Under the revised DTC bill, most of current tax saving investment will not be eligible for tax deduction. There will be loss of tax immunity on the popular Equity Linked Savings Scheme (ELSS), National Savings Certificate, 5-year tax saving bank fixed deposits and investment in ULIPs.

Impact on Insurance:

Many individuals in our country prefer to buy life insurance policies merely to save tax. Therefore it is important for them to know about tax breaks pertaining to life and health insurance policies under DTC. The reason, they need to understand DTC provisions on insurance is because it will have retrospective effect. This means policies that you may buy this year and even those that you bought in the past, might see different tax treatment in future. The revised second DTC bill will have significant impact on insurance.

Under the revised DTC bill, to be eligible for tax deduction, a policy should provide a life cover of at least 20 times the amount of annual premium. That is, if your policy offers a cover of Rs.10 lakh, then your annual premium cannot be more than Rs 50,000. If this condition is not met, an individual will not get any tax deduction on the amount of annual premium paid on life policy. Not only this, even the income from the policy will be taxable. At present, any income received from life insurance policies is tax free. In times to come, if you are looking for tax deduction on any life insurance plan, make sure you buy a policy in which the life cover is 20 times or more than the amount of annual premium. This is possible only if you take a pure term plan of long duration.

Under the current laws, an individual can claim deduction on premium of up to Rs 1 lakh per annum paid for life insurance. Life insurance is among the many tax-saving avenues under section 80C of the Income-Tax Act. The section also offers tax breaks on investments in provident fund, pension fund, and equity-linked saving schemes, besides home loan principal repayment and children's tuition fees. If revised DTC bill becomes effective, the total savings-related deduction will be Rs 1.5 lakh. However, out of this, an aggregate deduction on life as well as health insurance premium and children tuition fees will be restricted to Rs 50,000. What's more, you will not be entitled to deduction on life insurance premium if it exceeds 5% of the policy's sum assured. This apart, the maturity proceeds will be exempt from tax only if they are received upon the death of the insured or completion of the original period of contract of the insurance. Another change is that both forms of insurance - life and health - are clubbed together for calculating deductions unlike now, where health insurance-related concessions for premiums up to Rs 35,000 fall under section 80D.

The intention of these changes in DTC appears to be, to give encouragement to pure term insurance products of long tenure and to discourage combination products like ULIPS and endowment policies. Most combination products neither provide sufficient life cover nor provide good returns over the term of insurance. Most such products provide a cover of less than 20 times the amount of annual premium. Therefore they will lose the tax advantage and favour of the investing community. The objective of this change in DTC appears to encourage individuals to look upon life insurance as a product that only provides a financial cover to the family in case of loss of life of the insured. This should also motivate individuals to take a long term view on this investment.

Most current Ulips will lose their tax advantage when the Direct Tax Code comes into effect. This is because most existing Ulips have a life cover of less than 20 times the amount af annual premium. This makes ULIPs far less attractive once DTC comes into effect.

Impact on Equity Investment:

The first draft of DTC had suggested that the Securities Transaction Tax (STT) that is currently levied on transactions in equities would be abolished. Instead of the STT, the long term capital gain (LTCG) tax would be reinstated. The revised DTC bill placed before the Parliament on August 30, 2010, had the following provisions related to equity investment:

- Securities Transaction Tax (STT) that is currently levied on transactions in equities is to be continued.
- The long term capital gains from sale of shares and units of equity mutual funds would remain completely tax free. This means there would be no tax on gains from sale of shares/equity oriented mutual fund units held for more than a year. This is positive news as the earlier proposal in the first draft to tax the LTCG, would have badly hurt the capital market.
- In case of gain on sale of equity shares and units of equity mutual funds held for less than 12 months, deduction of 50% of gains will be allowed and the balance will be added to the income of individual and taxed as per his income tax slab. Effectively, for short term capital gains, the tax rate would come to be 5%, 10% or 15% depending on the tax bracket of investor. This is a positive measure and should boost the stock market. In case of short term capital losses (STCL), under the revised DTC bill, it is possible to set off 50% of STCL against STCG. Currently it could be completely set- off.
- Also, equity-linked mutual funds and ULIPs will attract 5% tax on the dividend declared. Currently this is nil. For the investor in equity mutual fund, it is better to go for growth option, if you have a long term horizon.
- Individuals will not be entitled to any tax exemption on money invested in mutual fund's Equity Linked Saving Schemes (ELSS). These will be treated at par with other

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- Individuals will not be entitled to any tax exemption on money invested in mutual fund's Equity Linked Saving Schemes (ELSS). These will be treated at par with other

schemes in market with no tax exemption. Individuals who are planning for investment in mutual fund schemes for tax exemption should consider this factor while investing. However EEE tax status will continue for all ELSS investments made in the past.

Impact on Investment in Retirement Security Products like PF, PPF and Pension Funds:

The first draft of DTC had proposed taxation on EET basis on retirement savings products like Provident Fund (PF), Public Provident Fund (PPF), and Pension Funds. This was to be done only prospectively. This would have led to only new contributions and accretions, commencing on or after the initiation of DTC, being taxed as per the EET regime of taxation. To a great relief of all investors, under the revised second DTC Bill , Exempt-Exempt-Exempt (EEE) regime of taxation has been retained on above mentioned retirement savings products.

The government seems to have realised that EET method of taxation can be adopted only in those countries which have a strong social security system in place for all their citizens. It must have been felt, that in the absence of a universal social security system, the proposed EET method of taxation of permitted savings would be harsh. People in general, need lump sum funds on retirement to meet various family obligations. The individuals, therefore need some flexibility, in the form of withdrawals in lump sums without being subjected to tax. Moreover, switching to the EET method of taxation completely, for all saving instruments now would entail many administrative and technological challenges. The revised second DTC bill has therefore proposed to provide EEE tax status to money invested in Government Provident Fund, Public Provident Fund (PPF), Recognised Provident Funds, Approved pure life insurance products and Annuity schemes. The revised DTC bill also includes pensions administered by interim Pension Fund Regulatory and Development Authority (PFRDA), including pensions of government employees who are recruited since January 2004, under the EEE tax regime.

This means a huge benefit for an individual. Implementation of the original proposal of EET would have meant a big loss to an individual in the form of substantial income tax at the time of withdrawal. Putting these retirement savings avenues back under the current EEE regime means a triple tax benefit for an individual. He/she would get tax exemption for making the investment, the interest would be tax free, and the withdrawal funds, will be taxed at normal rates subject to indexation benefits, where applicable. Presently, such units are taxed at the rate of 20 percent (with indexation benefits) and 10 percent (without indexation benefits) for holding periods of more than one year. Indexation takes into account inflation during the holding period and allows the investor to adjust his buying price. However, to claim indexation benefits, the holding period has to be computed from the end of the financial year in which the units are purchased. This is a significant change and will impact the way investors invest in fixed debt funds. One issue, however, is that it puts investors investing early, at a disadvantage when compared with investors investing just before the end of the financial year. This is a significant change and will impact the way investors in debt funds use this.

Conclusions and Suggestions:

The revised DTC bill has more or less brought the original DTC back towards the present Income Tax Act, 1961 & the Wealth Tax Act, 1957. Most of the recommendations, which find a place in the revised bill, are in tandem with the present provisions of the Income Tax Act, 1961 and Wealth Tax Act, 1957.

Recently the government increased the rate of interest on -Public Provident Fund (PPF) accounts from the current 8.00% to 8.60% per year. This is the equivalent of a very attractive pre-tax interest rate of 12.28% (considering a 30% tax bracket). The maximum permissible investment in PPF accounts has also been increased to Rs.1 lakh from the current Rs. 70,000. If you do not have provident fund or pension, PPF account make an excellent avenue to create the core of your retirement corpus. With PPF scheme enjoying the EEE status under the revised DTC, we expect the investment in this financial product to increase substantially in coming years.

Providing tax incentives, is a key driver to promote long-term saving habits in our country. Withdrawing tax incentives for schemes like ELSS and ULIPs may have an adverse impact on the sales of these financial products. In our opinion the tax incentives for these saving instruments should continue as they help in transfer of funds to the infrastructure sector.

The first draft of DTC had suggested very liberal individual tax slabs along with EET regime of taxation. The loss of tax revenue due to substantial widening of tax slabs would have been made good by increase in tax collection due to the suggested regime of EET in the original draft. Now as per the revised DTC bill, the EEE regime is being continued along with many other tax benefits, like deduction for home loan interest. With continuation of EEE tax regime on most long term savings products, the government couldn't possibly afford to have the same liberal tax slabs as were proposed in the first draft. It would have lead to significant loss of revenues for the government.

The new Bill continues with the dividend distribution tax of 15 per cent. A novelty is the levy of 5 per cent tax on incomes earned by mutual funds. Mutual funds have become popular in the last deçade. The new levy will certainly hit them.

It is not clear as to why the taxpayers' choice should be restricted to 4 or 5 approved funds, when presently the choice extends to 19 investments for tax incentives. This move is likely to curb incentive for investment as taxpayers want to invest in areas where there are no hassles, in instruments like NSCs, fixed deposits, etc., which are under their control. There has to be a rationale for withdrawing the incentives which investors have been enjoying for a long time.

In view of the increased cost of construction, the proposed reduction in deduction from gross rent for repairs and renewals, from 30% to 20% is prima facie unwarranted and of an arbitrary and ad hoc nature. This is likely to reduce rental income on property investment due to higher taxation.

Due to blind reliance on agents' advice and low financial awareness, it is not rare to hear of policyholders being stuck with multiple policies like Ulips, endowment plans, money back and pension plans and yet being low on cover. The total premium payout may run into lakhs of rupees a year, but the amount that the policyholder's dependants may get in his/her absence may not be enough to fulfil their needs. Therefore, the first step while buying a new insurance product is to find out if the current policies add up to your ideal protection requirement. Ideally, it is best to address the objectives of insurance, investment and tax-saving separately. However, if you have decided to choose insurance this year to reduce your tax outgo, it would be wise to keep an eye on the annual premium payable. Ensure that the premium does not exceed 5% of the sum assured.

The DTC doesn't talk about deduction of up to Rs. 20,000 under section 80CCF available on investment in infrastructure bonds. Our country needs very heavy investment in infrastructure in the years to come. In the 12th five year plan, the projected investment in the infrastructure sector is to the tune of Rupees four lakh crores. To achieve this kind of target, the deduction for investment in infrastructure bonds should be retained at least till the end of 12th five year plan.

Under the DTC any interest paid on education loan would be exempt from income tax. However, the DTC doesn't talk about the amount upto which this exemption would be available.

There was a golden opportunity before the Government to align the slabs and rates to inflation. We already have the cost inflation index for computing capital gains. The same index could have been taken for fixing the slabs. The present system leaves the slabs and rates to the whims and fancies of the Government of the day. About 90 per cent of the taxpayers in our country fall in the lowest tax bracket. They deserved much more relief than what the Government has provided them. The exemption limit should have been raised much higher to help small taxpayers fight inflation.

Looking at proposals in the final DTC bill, it appears that the government has yielded to pressures from vested interests and retained most of the provisions of income tax act 1961. It was a very good opportunity, coming after almost 50 years to make some genuinely progressive tax reforms. But that has not happened.

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