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