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Tax Alert

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REVISED DISCUSSION ON PAPER ON DIRECT TAX CODE- PART II

TAX TREATMENT OF SAVINGS:

Indians are well known for their habit of saving a large part of their income for future use. There are many investment avenues that Indians generally use for parking their savings. Presently, many of these investments also fetch tax benefits to the investor. In many cases, the initial investment itself fetches tax benefits. Thereafter, the income from the investment is also exempt from tax in many cases. Finally, when the investment matures and the principal (plus accrued income) is received back, once again, the investor does not pay tax thereon. Thus, for example, under the existing provisions of the Income-tax Act (Act), contributions to Provident Fund, Pension Funds, etc. follow the Exempt–Exempt–Exempt ('EEE') scheme of taxation, which operates as under:

E – Contributions towards certain savings are deductible from Income.

E – Accumulations/Accretions are exempt.

E – Withdrawal is exempt from tax, subject to certain conditions and monetary limits

Under the Direct Tax Code (DTC), it was proposed to introduce an Exempt-Exempt-Tax ('EET') scheme of taxation.

E – Contributions towards certain savings are deductible from Income.

E – Accumulations/Accretions are exempt.

T – Withdrawal at any time is taxable.

There was considerable anxiety amongst tax payers regarding the fate of investments already made in the provident fund and similar accounts. The original DTC had clarified that all the existing investments would continue to be governed by the EEE scheme of taxation.

A large number of representations were made to the Government regarding the application of EET scheme of taxation. It was argued that EET scheme of taxation is operational in countries which have a robust social security system in place for their citizens. In India, in the absence of a universal social security system, the EET method proposed would be harsh on tax payers as flexibility for withdrawals is desirable and people may need lump sum funds for retirement/family obligations. The Revised Discussion Paper (RDP) now seeks to partially restore the EEE scheme of taxation.

Summary of changes proposed:

The salient features of tax treatment of savings under the proposed DTC are as under:

Existing provisions of the Act	Proposed provisions in original DTC	Revised Proposals as per RDP
Investments in Provident Funds, Pension Funds etc. and accrued income thereon are governed by the EEE scheme of taxation. Withdrawals from these schemes are also tax free.	Investments in Provident Funds, Pension Funds etc. will be governed by the EET scheme of taxation. Withdrawals from these schemes would be liable to tax.	As of now, the EEE method of taxation will continue to apply for Government Provident Fund ('GPF'), Public Provident Fund ('PPF') and Recognised Provident Fund ('RPF) and the Pension Scheme administered by Pension Fund Regulatory and Development Authority. Investments made before the commencement of the DTC in instruments which enjoy exemption under the current law will be eligible for the same tax treatment for the full duration of the financial instrument.

The RDP has accepted that switching over to a complete EET system of taxation for all savings instruments would entail many administrative, logistical and technological challenges. The requisite infrastructure to implement the EET scheme is not in place. Hence, the RDP lays down that *"as of now, it is proposed to provide the EEE method of taxation for Government Provident Fund ('GPF'), Public Provident Fund ('PPF') and Recognised Provident Fund ('RPF) and the Pension Scheme administered by Pension Fund Regulatory and Development Authority".*

SKP's comments:

The relaxation provided by the RDP comes as a big relief to a large number of salaried and other tax payers. However, it can be observed that the EEE scheme of taxation has been restored on the grounds of administrative, logistical and technological deficiencies to implement the same. The RDP is, however, silent on the merits of the EET scheme of taxation and its applicability in absence of a social security system in India. Moreover, the restoration of EEE scheme of taxation has been made ***'as of now'***. Hence, the relief provided could only be an interim measure. It is possible that once the required infrastructure is in place, the Government may re-consider the implementation of EET scheme of taxation. Hence, notwithstanding the social and political ramifications that the EET scheme may have, the Government could still be considering the implementation of the EET scheme of taxation. However, it is too early to come to a conclusion on this issue.

INCOME FROM EMPLOYMENT

Wherever an employer-employee relationship exists between two persons, the remuneration that the employee receives or is entitled to in respect of such employment is considered as salary income at present. This position would continue even under the DTC.

Principally, under the DTC, the taxable salary would be computed in a manner as below -

Gross Salary
Less: Exemptions provided for under section 9
Less: Deductions provided for under section 22

Thus, to begin with, all items of income received from an employer would be treated as part of gross income and thereafter the exemptions and

deductions would be reduced.

There are several changes proposed in the DTC in the computation of salary income (which will now be known as "income from employment")

Summary of changes proposed:

Existing provisions of the Act	Proposed provisions in original DTC	Revised Proposals as per RDP
Basis of taxation		
Salary is taxable on accrual or receipt basis whichever is earlier and in respect of salary from employer or former employer	The same system continues – no change in the basis of taxation	There is no specific mention about this in the RDP
Definition of Salary		
The definition is an inclusive one and lists down several items which are included in "salary"	There is no clear definition of salary given. It appears that everything received by an employee from his employer would be considered as income from employment subject to specified deductions.	There is no specific mention about this in the RDP
Deductions available		
At present, the only real deduction that is available from salary income is in respect of Profession Tax paid by the employee. Apart from this, Govt. employees are also entitled to a deduction of the entertainment allowance subject to an upper limit.	In contrast, under the DTC, most of the exemptions that are presently available under section 10 (such as gratuity, VRS settlement, conveyance allowance, commutation of pension, etc.) are proposed to be allowed as deductions from salary instead of as exemptions.	There is no specific mention about this in the RDP.
At present, there are no conditions for claiming the deductions (since there is only one deduction available for most categories of employees)	The deduction in respect of gratuity, commutation of pension and the VRS settlement will be available only if the amount received is deposited by the employee in a "**Retirement Benefits Account**" to be opened with a "permitted savings intermediary" which, in turn, is defined to mean an approved PF or an approved superannuation fund or a life insurer or New Pension System Trust. The Central Govt. will notify a scheme for this purpose.	It has been proposed not to introduce the Retirement Benefit Account scheme. Further, it is proposed that these retirement benefits would be exempt subject to specified limits for all employees.
At present, the employees are entitled to claim exemption in respect of amount received by way of Leave Travel Concession, Leave Encashment, House Rent Allowance, Medical Reimbursements, free/concessional medical treatment, etc.	The existing exemptions in respect of LTA, HRA and medical reimbursements have neither been provided for under section 9 nor have they been provided by way of deductions under section 22.	The value of medical facilities/ reimbursement provided by an employer to its employees would be valued as at present but with raise in the monetary limits. Thus, subject to an upper limit that will be prescribed, reimbursement of medical expenses will continue to be exempt in the hands of an employee.
Valuation of perquisites		
Valuation of perquisites is presently done as per Rule 3 of the Income-tax Rules.	The methodology for valuation of taxable perquisites is yet to be prescribed. However, it was apprehended that value of accommodation provided to Govt. Employees would be done as per market values and that would adversely affect such employees.	In respect of valuation of rent free accommodation it has been clarified that the DTC does not propose to compute said perquisite value based on market value. Other than this, there is no clarification or preview of what would be the perquisite valuation rules.

SKP's comments:

The originally proposed RBA Scheme has been scrapped in the revised proposal to provide a major relief to the middle class as now the retirement benefits would not be required to be once again blocked up in any scheme as proposed earlier.

To the extent of allowances other than reimbursement of medical expenses, the taxable salary as per the new rules would be higher than the amount as per existing provisions. Only after the new rules for valuation of perquisites are prescribed can there be a greater clarity and further analysis about the taxability of Salary Income.

TAXATION OF INCOME FROM HOUSE PROPERTY

Under the existing scheme of the Act, income from house property is computed with reference to the actual rent realised or the annual lettable value (i.e. fair rent), whichever is higher. The original DTC proposed certain changes in the manner in which the income from house property would be computed. It also laid down that the gross rent of a house property shall be the higher of contractual rent for the year and presumptive rent calculated at the rate of 6% of rateable value fixed by the municipal authority. Where no rateable value is fixed, the gross rent would be 6% of the cost of acquisition or construction of the property.

Representations were made to the Government that the method of determination of notional rent on presumptive basis is inequitable as it discriminates against recent purchasers of properties as cost is a function of inflation. Hence, the gross rent would be higher for newly acquired properties in comparison to the old properties. Also, the original DTC did not provide for deduction for interest on housing loan on self-occupied properties.

Summary of changes made:

Based on the representations received, the changes proposed by the original DTC and the RDP are summarised hereunder:

Existing provisions	Original DTC	Revised Discussion Paper
Calculation of Gross Rent for house property that has been let out		
Higher of Contractual rent, Fair Rent and Municipal Value	Higher of: i. Contractual rent for the financial year; and ii. The presumptive rent calculated at 6% p.a. of the rateable value fixed by the local authority. If no rateable value has been fixed, 6% shall be calculated with reference to the cost of construction or acquisition of the property. The presumptive rent shall be calculated on a proportionate basis for a property acquired during the financial year.	Gross rent will be the amount of rent received or receivable for the financial year. Gross rent will not be computed at presumptive rate of 6% of the rateable value or cost of construction / acquisition. It appears that as per the RDP, if a property is not actually let out, there will be no deemed or notional income that would be taxed in the hands of the owner. This is a welcome change.
Standard Deduction		
(Gross rent less municipal taxes actually paid) x 30%	Gross rent x 20%	There is no specific mention about this in the RDP. Therefore, the proposal in the DTC remains intact.

Existing provisions	Original DTC	Revised Discussion Paper
Deduction for Interest on borrowed capital for self-occupied house property		
Rs. 1.5 lacs, subject to certain conditions	No deduction	Rs. 1.5 lacs, subject to certain conditions
Inseparable letting of building and furniture – Whether taxable as income from property or income from other sources?		
There is considerable controversy as to whether income from inseparable property should be treated as income from house property or as income from other sources	Income from inseparable letting to be considered as income from house property	There is no specific mention about this in the RDP. Therefore, the proposal in the DTC remains intact.

SKP's comments:

The revised Discussion Paper has provided due relief to individual and HUF tax payers by reinstating the deduction for interest on housing loan for one self-occupied house property. No change has been made to the standard deduction which was reduced to 20% by the original DTC.

Gross rent is now based on the rent received or receivable during the year. On a literal reading, it appears that income from house property would be computed with reference to contractual rent and the requirement of considering the fair rent and municipal value of the property let out is not required to be considered. However, such an interpretation does not seem to be as per the intention of law. The fine print of the revised DTC will have to be examined to understand how the computation mechanism would actually operate .

These changes pertaining to the computation of income, however, comprise only a fraction of the many changes proposed in the new Direct Tax Code. To know more about other significant aspects of the proposed overhaul in the Indian taxation system, watch out for our forthcoming tax alerts in this special series on the DTC.

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