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Two trends to watch for in Indian personal taxation

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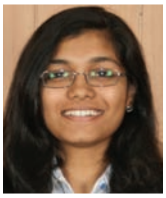
Following the recession, some countries have taken the lead in imposing taxes specifically targeting high net worth individuals. India appears to be following suit. Of the various tax measures the Government was considering, the 2013 Budget, which was presented on February 28, 2013, has chosen to enact a more progressive rate of tax on persons beyond the income threshold of Re10m. While India does not have an estate tax currently, there has been talk of reintroducing it at some point in the near future. This article looks at two trends in Indian personal taxation: increased progressivity and heightened transparency.



On August 14, 2011, Warren Buffett, the philanthropist chairman of Berkshire Hathaway, published an oped in the New York Times calling for US tax policy makers to stop coddling the super-rich. Therefore, when the Indian business magnate Azim Premji (Wipro chairman, third richest Indian and 41st richest man in the world) made statements at the 2013 World Economic Forum in Davos about higher taxes on the super-rich being a politically correct move, it was inevitable that comparisons would be drawn between the two.

India is no stranger to discussions on sharp progressivity. India's maximum marginal tax rate was, at one point in time, as high as 97% at the highest slab. However, over the last two decades post liberalisation, there has been a coordinated move to reduce tax rates and expand the tax base in an attempt to provide an atmosphere conducive to compliance and to encourage the free flow of funds through the economy. In the recent past, the economic downturn has formed part of the context against which the discussions on progressivity have achieved new relevance, and these discussions have made their presence felt in India as well. This piece attempts to examine two key trends in the personal tax space in India today.

A higher tax burden on the super-rich

Proponents for a higher rate of tax on the Indian super-rich argue that extreme income inequality in India is enough justification for the introduction of greater progressivity in the system. Liberalisation has had benefits for all but India's poorest. Along with reports of a doubling of economic inequality in India,[1] there are also reports of an increase in the number of High Networth Individuals (HNIs) in India[2] (a recent study has projected that the number of HNIs and ultra-HNIs will triple in the next five years to 219,000 by 2015-16, accounting for about Re235 lakh crore in wealth).[3] This has brought the super-rich under the Government's spotlight as a significant tax base.[4]

The discussion in India also appears to be influenced by the approach that other countries have taken towards more progressive taxation. In the US where the recession originated, the extension of the Bush-era tax cuts into 2012 (beyond the sunset clause of 2010) was much maligned for its role in prolonging the impact of the recession. Recently, legislation was passed to revert to a top income tax rate of 39.6% for single individuals in the top slab bracket.[5] The UK had imposed a 50% top rate on incomes above the threshold limit of £150,000, which has been revised to 45% from 2013-14 onwards.[6] France had sought to impose an ambitious top rate of 75% with the hope of reducing €85bn of deficit by bringing in €300m.[7] The French Finance Bill 2013 contained a provision to impose 75% tax (applicable for one year) on individuals with income above €1m. This measure was struck down as unconstitutional by the Constitutional Council because it created inequality by being calculated on individuals rather than households.[8]

There has also been discussion about the manner in which differential taxation of capital gains and ordinary income has favoured the higher income bracket of individuals who may have more investment income. In the US, one measure that was singled out for being a tax shelter for the high income earners was the ability of investment managers to get "carried interest" treated as capital gains and taxed at the lower rate of 15% (as opposed to the marginal rate of 35%, which would have applied had this been treated as salary income).[9]

Similarly in the UK, capital gains are taxed at 28% for high income earners. India taxes capital gains at a rate of 0-40% depending on the holding period of the asset, the nature of asset and the nature of sale. However, the proposed Direct Taxes Code bill (a bill to revamp and "modernise" the Indian Income Tax Act in place since 1961 (ITA) contains provisions to do away with the capital gains rate differential to an extent.[10]

A recent public statement by India's Finance Minister (made in the run-up to the Union Budget), indicated the Government's inclination towards introducing tax measures targeting HNIs, in the context of which Azim Premji made the statement discussed above. In a televised interview, the Finance Minister, P. Chidambaram expressed his view that: "*The tax rates that are announced in 1997 have remained and have survived four governments and four finance ministers. I believe in stable tax rates. However I must concede that there is an argument, underline the word argument, that when the economy requires, government requires more resources, the very rich willingly should pay a little more*".[11] The Chairman of the Prime Minister's Economic Advisory Council (PMEAC), C Rangarajan, gave more definite shape to such thoughts of the Government by proposing that it should increase tax revenue to bridge the fiscal deficit by either introducing a higher tax slab on income or a surcharge[12] (essentially a tax on a tax) on income above a specified threshold.

Another option being considered was that of increasing the effective tax rate on dividends received by the super-rich to 30%, the existing maximum marginal income tax rate. The intent is to tax dividend income beyond a certain threshold, such as Re20 lakh, in the hands of the receiver also, at the same rate it is taxed at the giver's end.[13] Under the current provisions of the ITA, companies pay 15% dividend distribution tax (DDT)[14] but the dividend is not taxed in the receiver's hands. There were also indications that the estate duty regime (discussed further below), which was in place from 1953-85, might be brought back.

Of these options, the Government has chosen to implement the surcharge. The 2013 Budget announced the imposition of a surcharge at the rate of 10% on persons whose total income exceeds Re1crore but will be applicable only for one year. Currently, India has three income slabs: 10%, 20% and 30% which have been in place since 1997 (and left untouched by the 2013 Budget). Therefore, the maximum tax rate for individuals has now gone up to 33.99%.

The real difficulty with introducing sharply progressive rates is India's past experience with the enforcement of such rates. It was seen that a higher tax rate only served to increase non-compliance and divert income into the black market or siphon away income with the use of complicated tax shelters (a consequence which the UK experienced in the recent past after it introduced the 50% top rate in 2010-11).[15] India tried to induce voluntary disclosure by offering ad hoc tax amnesty schemes but such measures had limited success.[16]

Enforcement difficulties also colour the debate surrounding the re-introduction of an estate tax in India. As mentioned above, estate duty was introduced in India in 1953 and removed in 1985. Then, the rate of duty ranged from a minimum of 7.5% to a maximum of 40%[17] for estates valued at more than Re20 lakh (and was payable by the executor of the estate of the deceased).

Estate duty collection also faced the problem of being too costly to administer in comparison to the amount of revenue that was being collected. Citing the reasons for its removal, the then Finance Minister stated that: "*... estate duty has not achieved the twin objectives with which it was introduced, namely, to reduce unequal distribution of wealth and assist the states in financing their development schemes*".[18]

During pre-Budget discussions in 2012, apprehensions were again voiced that the re-introduction of estate duty would lead to the flight of wealth to offshore jurisdictions rather than to greater intergenerational equity. Although the 2013 Budget did not revive the estate duty regime, India continues to have wealth tax (at the rate of 1% of the amount by which net wealth exceeds Re30 lakh)[19] and a quasi-gift tax (certain gifts[20] above the value of Re50,000 are taxed as income under the ITA).

Transparency, disclosure and information exchange

If India has had enforcement difficulties with high progressive rates in the past, globalisation has created fresh concerns by enabling easy movement of capital and individuals across borders.

The 2012 Budget had introduced a provision making it mandatory for Indian residents to report their overseas assets including interests in foreign entities, financial interests or signing authority in any offshore account. This is regardless of whether the resident has earned any income in a financial year. HNIs such as fund managers, who may have carried interest and foreign co-investment structures, are therefore required to disclose these to the tax authorities irrespective of any returns being derived.

The 2012 Budget also introduced changes with respect to the ability of tax authorities to reopen assessments for past years, both under the income tax and wealth tax regimes. The time limit for an issue of notice for reopening an assessment was increased from six to 16 years if the income in relation to any offshore asset (including financial interest in any entity) is chargeable to tax and has escaped assessment. This increase in time limit can result in significant amount of distress for taxpayers since there will be an additional compliance burden for maintenance of records and issues relating to information gathering consequently may arise.

India has taken active steps to expand its information collection system, including participating in intergovernmental initiatives such as the OECD's Agreement on Exchange of Information on Tax Matters or bilateral tax information exchange agreements. The Indian Government has also been taking steps to address concerns with money laundering and non-disclosure of offshore assets by entering into exchange of information agreements with a number of offshore tax jurisdictions.

The 2013 Budget has announced measures to tighten tax administration and compliance mechanisms. A Tax Administration Reform Commission has been proposed whose mandate will be to review and submit periodic reports on ways to strengthen the tax system.

A regime in flux

The general anti-avoidance rules (GAAR) were introduced into India's tax law last year. Initially slated for implementation on April 1, 2013, that date has been deferred by two years through this Budget. There is still ambiguity on the scope and application of the GAAR to current investment structures. Although not reflected in the 2013 Budget, the Finance Minister announced in January 2013 that investments made prior to August 30, 2010 would be grandfathered and GAAR would not apply to exits from such investments. Therefore, GAAR may retroactively apply to transactions taking place between August 30, 2010 and the date when GAAR comes into force, thereby creating issues for post 2010 deals where divestments take place subsequent to April 1, 2015.[21] Arrangements lacking commercial substance would come under the GAAR scanner. This criterion needs more clarity in a private client planning context as structures are not motivated by commercial factors.

It must be remembered that the proposals in the Budget were presented with an eye on the 2014 national elections. Whether the same Government will continue to be in power or be replaced by a new one, the debates surrounding wealth planning, progressive taxation and transparency make it clear that the HNI tax regime is in flux and likely to face more changes in the near future.

Notes:

1 http://articles.economictimes.indiatimes. com/2011-12-05/news/30477784_1_oecd-region-inequality-cent-of-global-output.

2 http://businesstoday.intoday.in/story/india-high-networth-hni-population-grows-by-20-per-cent/1/19634.html.

3 For this study, UHNI was defined as a person or household worth Re25 crore or above, study by Kotak Wealth and Crisil Research, http://business today.intoday.in/story/hni-india-high-networth-individuals-charity-philanthropy/ 1/16122.html.

4 The same study concluded that there were around 62,000 ultra HNIs or households in India in 2010-11, with a net worth of about Re45 lakh crore.

5 http://www.forbes.com/sites/moneybuilder/2013/01/05/updated-2013-federal-income-tax-brackets-and-marginal-rates/.

6 http://www.hmrc.gov.uk/rates/it.htm

7 http://www.huffingtonpost.com/2012/12/29/france-super-rich-tax_n_2380887.html

8 France - Finance Bill 2013 – 75% tax rate for high income earners removed by Constitutional Council (Dec 31, 2012), News IBFD

9 "Stop Coddling the Super-Rich", Warren E. Buffet, The New York Times, August 14, 2011, http://www.nytimes.com/2011/08/15/opinion/stop -coddling-the-super-rich.html?_r=0

10 The Direct Taxes Code is still in draft stage. It was introduced with the initial expectation of being enacted into law for the fiscal year 2010. However, lack of clarity on some new measures and political compulsions have put this draft law on hold for the past two years. There is no clear signal from the Government yet on whether this will be enacted into law anytime soon.

11 http://www.business-standard.com/results/news/chidambaram-suggests-higher-taxes-forvery-rich/203821/on

12 Before surcharge was removed through the 2009-10 budget, it used to be imposed at the rate of 10% on an annual income of Re10 lakh a year in India. The surcharge led to a collection of Re10,034 constituting 8.18% of income tax collection that year. http://www.business-standard.com/india/news/even-thosers-12-lakh-annual-income-may-find-life-more-taxing/498236/.

13 http://www.indianexpress.com/news/revenuehungry-finmin-mulls-taxing-dividends-of-superrich/1059786.

14 The Union Budget has introduced a 10% surcharge on the DDT.

15 http://www.telegraph.co.uk/news/politics/9740253/Two-thirds-of-millionaires-disappeared-from-official-statistics-to-avoid-50p-tax-rate.html

16 In his Budget speech this year, the Finance Minister stated that only 42,800 Indians had admitted to an annual taxable income exceeding Re1 crore.

17 In the US, UK and France, inheritance/estate duty rate has hovered around the 40% mark.

18 "Economists say inheritance tax preferable to super-rich tax", January 13, 2013, The Business Standard, http://www.business-standard.com/article/economy-policy/economists-say-inheritance-tax-preferable-to-super-rich-tax-113011300020_1.html

19 The Direct Taxes Code Bill, 2010 had also proposed to impose a wealth tax of 1% on a person's net wealth exceeding Re10 million (regardless of whether the asset was productive or not).

20 Certain types of gifts are excluded such as, among others, gifts between relatives and gifts under a will. Gift tax was in place from 1958 until 1998. In 2004, it was re-introduced in a limited form through an amendment to the ITA.

21 India Budget 2013: Where's the Excitement? February 28, 2013, Nishith Desai Associates, http://www.nishithdesai.com/nishithdesai.htm

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