India’s Direct Tax System

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Ram Iyer provides a roundup of the direct tax landscape to complement the overview of the indirect tax update.

Introduction

Gross direct and indirect tax collections form roughly 12% of India’s GDP (compared with the OECD 2016 average of approximately 35%), with each contributing about half therein. Overall, gross tax collections currently fund roughly 90% of India’s annual budget expenditure.

In my previous article in January 2018, I had outlined the new GST system, India's most fundamental tax reform in the seven decades since independence. Apart from basic customs duties, some state (regional) taxes like entertainment tax and the separate taxation of electricity, real estate and petroleum, GST is now the only indirect tax system in the country. This article summarizes the direct tax system.

How the direct tax system is structured

The legislative framework includes the Income Tax Act, 1961, amended through annual Finance Acts and is supported by rules, circulars, notifications and legal judgements. For instance, Chapter XVII-B of the Act deals with deduction of tax at source (withholding tax). A corresponding rule 31A explains compliance requirements like return periodicity, the fields in the return form like the nature of payments, the amount of tax deductible, tax actually deducted, etc. In addition, the government issues an updated circular every year, incorporating the latest withholding rates, reliefs, remittance mechanism, penalties for non-compliance, numerical examples, etc. A related notification provides operational clarity on payment dates and online payments.

The CBDT (Central Board of Direct Taxes), under the Finance Ministry, headed by officers from the IRS (Indian Revenue Service), administers India's direct tax system via the IT (Income Tax) Department.

The IT Department, with more than fifty thousand employees (similar to that of HMRC), including various levels of commissioners and officers, operates through a network of regions, ranges, circles and wards located throughout the country. An example would be the Mumbai region headed by a Principal Chief Commissioner of Income Tax supported by a team segmented by ranges (groups of postal codes) and circles and wards (sub-groups of postal codes).

Assessments follow the 1 April to 31 March cycle, notwithstanding the fact that businesses could have different accounting year-ends. This results in two financial statements and audits for some companies, especially foreign-origin MNC's that typically have non-March year-ends. Almost all Indian-origin companies have a March accounting year-end.

Unlike several other countries that use the term "corporation tax" to encompass the taxation of corporate bodies and those with similar characteristics, the phrase “income tax” in India includes the taxation of individuals, non-corporate entities and companies, although the government does administer these differently. Further, “income tax” also covers capital gains, with specific rates and reliefs, albeit under the umbrella of the Income Tax Act.

The main heads of tax are income from salaries, house property (i.e. rental income from immovable property), business or profession, capital gains and the residual head of other sources.

Some indicative rates and exemptions

The highest marginal rate in India is 30% (40% for foreign companies), with some additional levies, explained after the table below.

The table gives an indication of the key income tax rates and exemptions (using approximate exchange rates of 1 USD = 65 INR, 1 GBP = 90 INR). The data is for the Assessment Year 2019/20 (i.e. for the Financial Year ending 31 March 2019, known for tax purposes as the “Previous Year”).

Some examples	Rates	Key Exemptions/Allowances
Income Tax		
Individuals (below 60 years of age), earning salaries, income from house property, business profits, professional income, other sources	5%-30% based on the income slabs (bands)	The first USD 3,850 (GBP 2,780) is exempt; there are various allowances and reliefs, to encourage savings and investment

Some examples	Rates	Key Exemptions/Allowances
Companies	25% for companies with turnover of up to USD 38 million (GBP 27 million); 30% for other companies	Business losses (excluding unabsorbed tax depreciation) can be carried forward for eight years; unabsorbed tax depreciation can be carried forward indefinitely Dividend pay-outs are taxed at 20% in the hands of the company declaring the dividend, with certain reliefs for dividends paid to parent holding companies. For example, a company declaring a dividend of 100 would pay 20 as tax and the balance 80 as dividend to the shareholder.
Capital Gains Tax	Gains from listed securities and equity mutual fund units are taxed at 15% if held for 12 months or less, and at 10% if held beyond 12 months. In general, the gain would be proceeds less brokerage less un-indexed acquisition cost. Other assets are taxed at varying rates of income or capital gains tax, depending on the asset and on the period of holding, generally, 24 months or 36 months.	

On top of the slab-based tax rates, there are additional levies like the Health and Education Cess of 4% on individual income tax, the surcharge of 10% and 15% for individuals earning an income above USD 77,000 (GBP 55,000) and USD 154,000 (GBP 110,000), respectively, and separate surcharge slabs for company profits. These levies are applied on the computed tax, not on the income.

Select features of the law

A tax audit is required for businesses and professions with revenues exceeding pre-defined thresholds, even if they are un-incorporated entities. For instance, a professional with revenues of USD 77,000 (GBP 55,000) and a trader with a turnover of USD 154,000 (GBP 110,000) are required to undergo a tax audit, i.e. a detailed testing of transactions to report compliance with the tax laws.

To ease the compliance burden of small professional practices and businesses, presumptive taxable income is an option. For example, a practicing lawyer or accountant can choose a presumptive taxable income of 50% if their gross annual receipts are below USD 77,000 (GBP 55,000).

In general, a 10% tax is required to be deducted at source when making payments to service providers.

Advance tax is due every quarter, based on the estimated annual income, at 15%, 45%, 75% and 100% of the full year’s tax, on a cumulative catch-up basis. For example, a salaried individual would have tax deducted at source by his employer at the applicable rates depending on his allowances and slabs / rate bands. In addition, if he generates investment income, then he would estimate his annual tax and pay a cumulative 15% in Q1, 45% in Q2 and so on.

There is a separate ICDS (Income Computation and Disclosure Standards), that prescribes accounting rules from a tax perspective. While this is not comprehensive, it does result in further differences between the accounting profit and tax profit. For instance, the ICDS requires income to be assessed on a percentage-of-completion basis even if the accounting income is recorded on a completed-contract basis.

Businesses are subject to a minimum tax of 18.5% of book profit (accounting profit) under a MAT (Minimum Alternate Tax) rule, introduced many years ago to curb excessive tax planning. The additional tax, as a result of applying the MAT rule, can be offset against future taxable profits, subject to a time limit. For example, the book profit is 100 and the tax profit is 50 (i.e. after applying tax rules, allowances and reliefs). 18.5% of the book profit is 18.5 and 30% of the tax profit is 15, leading to a MAT tax liability of the higher amount, i.e.18.5. The excess of 3.5 (i.e. 18.5 minus 15) is available for future offset.

Group companies are not subject to consolidated assessments, nor is there a concept of group relief.

India does not currently tax inheritances.

India is aligned with the OECD transfer pricing principles and has a rigorous compliance regime of annual audits (in contrast to the global norm of once in three years) and detailed local documentation requirements.

Some challenges and transformations

The law and its administration have historically been complex and cumbersome. However, there have been significant initiatives to use technology effectively and to reduce the administrative burden on taxpayers. For example, tax computation utilities, online payment of taxes, return e-filing, friendlier communication language in letters, online submission of appeals, pre-defined objective criteria for selecting “scrutiny” cases and investigations with reduced personal interactions have been some good steps.

One of the challenges governments have faced is to improve the compliance rate. The demonetisation of the 500 and 1,000-rupee notes in November 2016, the introduction of the GST law in July 2017, continuous press advertisements about important deadlines and mobile phone alerts have significantly improved both the ability of the government to track transactions and the overall compliance rate.

More recently, the government has started a formal consultation with stakeholders on how to overhaul the law and make it modern, simpler and efficient. The coming months should witness good progress with this initiative.