Direct Tax Code 2.0

New proposals neutral to negative for the market

New discussion paper on Direct Tax Code: The government today came up with a new Revised Discussion Paper on the Direct Tax Code (DTC). Many (but not all) of the issues raised in an earlier draft (August 2009) have been addressed, and we believe this is a key step forward on reforms. That said, these proposals might see further revisions before becoming laws.

Progressive on reforms, but implementation is the key: Revision of the direct (with the Direct Tax Code) and indirect tax structure (with the Goods and Sales Tax) in the country has been one of the cornerstones of the reform agenda of the government. After the success of the recent 3G and BWA auctions, the focus is back on these reforms, first proposed last year. The ostensible dates of implementation of both have been set for FY12. However, the legal (on some provisions like the DTAAs) and legislative (both the bills have to be passed by the parliament, likely in the monsoon session) aspects would remain overhangs in meeting the implementation guidelines. We believe the proposals may see further revisions before each of the two stages.

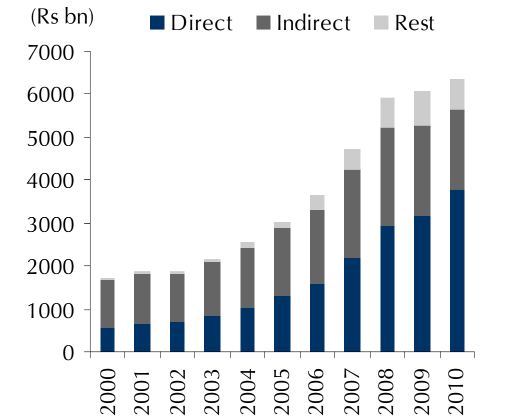
Revisiting major changes in the first discussion paper: Among the many changes proposed in the first version of the DTC were: 1. Revised tax treatment of capital gains—concessions on long-term capital gains to be abolished (pure-life insurance to be spared); 2. Rescinding of double taxation treaties—the DTC would have equal precedence with all bilateral tax agreement signed by India. 3. Reduced tax burden—Revision of direct tax slabs—Tax slabs are significantly revised upwards--while keeping tax rates low; 4. MAT to be levied on assets rather than profits, and 5. Revision in area-based tax exemptions (SEZs).

What's clearer: Major changes proposed in the revised discussion paper: The discussion paper addresses many concerns raised on the first draft, and also ties up many loose ends. 1. MAT computation would remain on booked profits, and not assets (+ve for asset-heavy companies viz. Reliance); 2. Potential conflicts between the DTC and various bilateral tax agreements have been resolved with the final tax regime being the one most favourable to the tax payer; 3. Trading income from foreign institutional investors would now be considered under capital gains (and hence taxed), to avoid the potential loophole (and tax avoidance) of classification as 'business income'. Further, the code also makes its recognition of a foreign investor clearer, using the internationally known categorization of the 'place of effective management'.

What's not, the STT: Ambiguity remains on the securities transaction tax (STT). While the paper stresses on the abolition of the STT (in its current form?), it also contends that the tax per se is on 'specified transactions', and not on income, and that its taxation would be akin to that of capital gains. The STT is then proposed to be 'calibrated based on the revised taxation for capital gains and flow of funds to the capital markets'. We believe this uncertainty could weigh on the markets in the near term, in other words, a 'sentiment-negative', though the overall impact would be minimal.

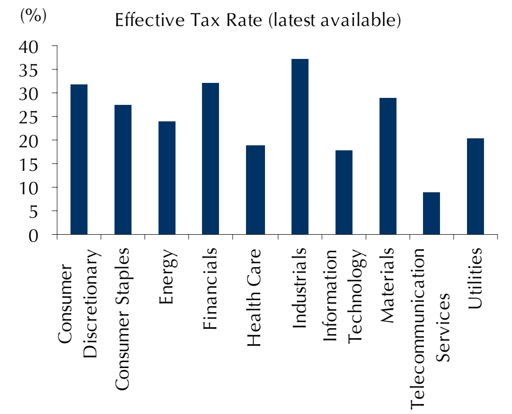
Neutral to negative for the markets: While the revised calculation of MAT (on profits, not assets), and the reduced tax burden, on both individuals and corporates--leading to higher disposable incomes and improved margins--ought to be positive for the market, the STT ambiguity, taxation of foreign investors and of long-term capital gains would remain overhangs.

Govt. tax collections



Source: CMIE, RCML research

Effective tax rate in BSE 500



Source: CBDT, RCML research

In the interest of timeliness this report has not been edited.

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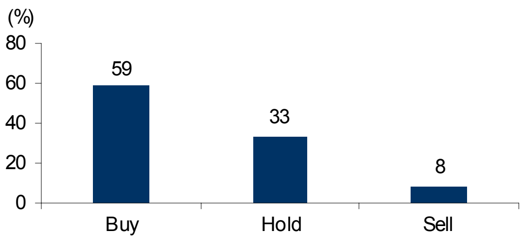
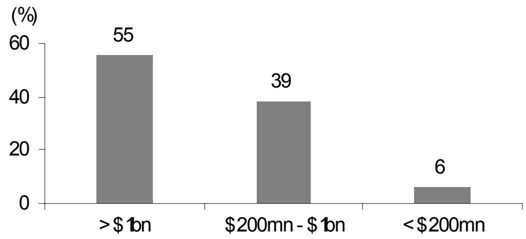
Coverage Profile

By recommendation	By market cap (US$)
	

Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

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