Opinion | Revised tax surcharge doesn't only have wealthy individuals in its ambit

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Capital gains, in particular LTCG, should have been excluded from high surcharge

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In the recent budget, finance minister Nirmala Sitharaman substantially hiked the rate of surcharge in the highest tax slab of 30% for persons with taxable income of between Rs.2 crore and Rs.5 crore (from 15% to 25%) and for persons with taxable income of more than Rs.5 crore (from 15% to 37%). Effectively, the tax rate went up from 35.88% to 39% for persons with taxable income between Rs.2 crore and Rs.5 crore and from 35.88% to 42.74% for persons with taxable income above Rs.5 crore, a hefty hike indeed!

The ostensible reason given by the finance minister is that in view of rising income levels, those in the highest income tax brackets need to contribute more to the nation's development. But is this large hike in tax rates restricted only to those wealthy individuals in the highest income tax brackets?

One needs to keep in mind that these slab rates apply not only to an individual but also to a Hindu Undivided Family (HUF), Body of Individuals (BoI), Association of Persons (AoP) and Artificial Juridical Person. There is also a concept of the maximum marginal rate, which applies to certain entities under certain situations. The maximum marginal rate is defined as the rate of income tax applicable in relation to the highest slab of income in the case of an individual, AoP or BoI. Therefore, the rate of 42.74% would now be the maximum marginal rate.

A family trust would be taxed as an individual, assuming that all the beneficiaries are individuals. If it is a discretionary trust (as is the case for most family trusts), where the share of each of the beneficiaries in either the income or the capital of the trust is not definite, then the income of such a trust would be taxable at the maximum marginal rate, which is now 42.74%. Similarly, a charitable trust which loses tax exemption for having made an investment not permitted under the law or which has provided a benefit to a specified person, such as a trustee or a substantial contributor, is taxable at such maximum marginal rate on such income.

Many entities, including alternative investment funds (AIFs) and various foreign institutional investors (FIIs) investing in the Indian stock markets, are structured as trusts. Category III AIFs and such trust FIIs are, typically, taxable at the trust level, and not at the investor level. Such trusts are, typically, taxed at the rate applicable to AoPs. Their business income will be taxable at 42.74%, while if their income exceeds Rs.2 or Rs.5 crore, their capital gains will now be subject to tax with the higher surcharge. FIIs, instead of paying long-term capital gains (LTCG) tax of 11.96% on stock market gains, will end up paying such tax at 14.25%. Their short-term capital gains on market transactions will be taxed at 21.37%, instead of 17.94%. With the withdrawal of the Mauritius and Singapore treaty exemptions, such capital gains will no longer be exempt and, therefore, they would invariably have to bear the additional tax burden. An AIF would end up paying 28.50% capital gains tax on its transactions in unlisted shares, up from 23.92%. The worst part is that such rates are applicable from April 2019, and not from 5 July (the date of the budget). If the sale proceeds of shares have already been distributed to investors, funds need to be found to pay the additional tax.

The worst part is that these rates apply in any year in which you have taxable income exceeding these limits, though your normal income may be less than Rs.50 lakh. Such taxable income would include your LTCG on sale of property or shares. So if you have substantial LTCG in one year on account of which your income exceeds these limits of Rs.2 or Rs.5 crore, the revised surcharge would apply, though on the capital gains tax rate of 10% (for shares on the stock exchange) or 20% (for other property or assets). So, you may end up paying 28.50% of your LTCG as taxes. Further, the phasing out of the exemptions, such as limiting the investment in capital gains bonds to Rs.50 lakh and that too only for sale of immovable property, and removal of the stock market LTCG exemption, ensures that you have little scope to reduce your income below the limit beyond which the increased surcharge applies.

This is extremely unfair. For computing the limit of Rs.2 crore or Rs.5 crore and deciding the surcharge, capital gains, in particular LTCG, which is not in the nature of recurring or regular income, should have been excluded. Otherwise, it would amount to punishing a person who has nurtured his property or investments for a long period, compared to someone who has booked small gains frequently from time to time. The revised surcharge, therefore, has a far larger number of taxpayers within its ambit, and not just wealthy individuals. In particular, salaried employees really do not have much scope but to pay and suffer this high rate of tax.

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