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DIRECT TAXES CODE V2.0
Unscramble the Code with BMR Advisors in association with Mint

Direct Taxes Code V2.0 – Analysis by BMR Advisors

The Government has released the Revised Discussion Paper on the Direct Taxes Code ("DTC") on June 15. While retaining the basic philosophy and object of the DTC, the Revised Discussion Paper seeks to address 11 key issues that were raised by the stakeholders following the original draft released in August 2009. In some aspects the original proposals have been diluted whereas on other issues, the Government has held its ground. The key proposals in the original draft DTC on Gross Assets Taxation, Treaty Override provisions, Capital gains taxation, Tax holiday for SEZ units, EET scheme of taxation for tax savings instruments, General Anti-Avoidance Rule provisions have been considerably relaxed. Public comments have been invited on the revised paper till June 30. The detailed DTC is expected to be tabled before the Parliament in the monsoon session. The Government is committed to introduce the new DTC with effect from April, 2011.

Double Taxation Avoidance Agreements vis-à-vis Domestic law

The original draft DTC had proposed a policy shift on the option currently available to non-resident taxpayers to be governed by *more beneficial* provisions of the Income tax Act, 1961 ("Act") or the Agreement for Avoidance of Double taxation ("DTAA") by providing that provisions of the DTAA or the DTC, whichever is *later in time* will prevail. This proposal in the DTC had received significant criticism from international investors, who labeled the sweeping treaty override provisions in the DTC as a retrograde move.

It was also felt that such a proposal in the new legislation would be against the spirit of the Vienna Convention. Whilst in subsequent interactions with the stakeholders, the Working Committee for DTC clarified that post commencement of DTC, the Government may consider re-notifying the existing DTAA to bear "later in time" effect, it was believed that such unilateral notification by one treaty state (ie India) may be difficult to implement.

Upcoming Events

- Direct Taxes Code V2.0 – Unscramble the Code with BMR Advisors, June 18, 2010, New Delhi, India
- Fourth residential refresher conference on international taxation – Current & emerging issues, June 18-20, 2010, Pune, India

Awards & Recognitions

- BMR ranked Tier 1 Tax Planning and Tax Transactional Firm in India, International Tax Review's online poll 2010
- BMR Advisors ranked second most active transaction advisor (Private Equity) in 2009, Venture Intelligence League Table
- BMR is Transfer Pricing Firm of the Year and wins India Case of the Year award, International Tax Review Asia Awards, 2009

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The Revised Discussion Paper recognizes the limitation of sweeping treaty override provisions, and proposes to revert to the position under the Act with some exceptions. Accordingly, the DTC is expected to restore the taxpayer's option to be governed by more beneficial provisions of DTC or DTAA, except in the following circumstances:

- where the General Anti Avoidance Rule is invoked; or
- when the Controlled Foreign Corporation provision is invoked; or
- when branch profits tax is levied.

Tax holiday for SEZ units

The original draft DTC and the accompanying discussion paper proposed to protect the profit linked tax holiday available to the developers of notified Special Economic Zones ("SEZs") for the unexpired period, while there was no such proposal to protect the existing tax holiday for units operating within the notified SEZs. Absence of grandfathering provisions for SEZ units invited considerable debate and industry's criticism appealing the Government to reconsider its views.

As per the Revised Discussion Paper, the units already operating in SEZs will now be able to enjoy the tax holiday for the unexpired period.

It is not clear whether the extension of tax holiday for the unexpired period would be available for SEZ units existing as on March 31, 2010 (as in the case of SEZ developers) or for all SEZ units existing as on March 31, 2011 (the date before the DTC comes into effect).

Under the DTC, there is a proposal to shift from profit linked incentives to investment linked incentives. Accordingly, all the new tax holidays will be linked to the investments made. While the Revised Discussion Paper states that the tax holiday for SEZ developers and SEZ units will be protected for unexpired period, it is not entirely clear whether tax holiday for the unexpired period will be profit linked or investment linked.

Minimum Alternate Tax – Gross assets vis-à-vis book profit

One of the most criticized proposals under the DTC was to impose Minimum Alternate Tax ("MAT") on companies on gross assets as against book profits under the Act. MAT was proposed at the rate of 2 percent of the value of gross assets (0.25 percent in case of banking companies). Value of gross assets was defined to consist of gross fixed assets, capital work-in-progress and book value of all other assets less depreciation on fixed assets and debit balance of profit and loss account. No credit for MAT was allowable in subsequent years.

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The Revised Discussion Paper considers lacuna of proposal to levy MAT on gross asset basis and proposes to roll back to the current MAT regime under the Act, ie impose MAT on the book profits.

Some of the justifications provided in the Revised Discussion Paper for not computing MAT on the basis of value of assets are as follows:

- An asset based MAT does not have a proximate linkage with a particular year's income or turnover.
- If gross asset basis is allowed, MAT liability would arise even where book loss is incurred. This may result in undue hardship since such taxpayers may end up borrowing funds to meet tax obligations.
- Income tax should be on real income and any method for presuming income should also be reasonable enough to come closer to the real income.
- In the case of corporates under liquidation, a levy of a presumptive asset tax till the time the company is dissolved is not reasonable.

The proposal to realign MAT to the book profits as under the Act is a welcome move. There is, however, no clarity on the rate at which MAT will be levied, eligibility of MAT credit, mechanism for computing book profits etc.

Taxation of capital gains

Originally, the DTC proposed to tax capital gains earned by non-residents at 30 percent, treating it as income from special sources. The Revised Discussion Paper proposes to consider all capital gains, including those arising to a non-resident, as income from ordinary sources, which would be taxed at the normal rates. This would provide marginal relief to companies, as the DTC had indicated a tax rate of 25 percent for all companies.

The DTC proposed to remove the distinction between long term and short term capital assets. However, it provided for benefit of cost indexation in computing capital gains on transfer of investment assets held for more than one year from the end of the financial year in which they were acquired. The base date for computing the cost indexation was proposed to be shifted from April 1, 1981 to April 1, 2000.

Under the Act, long term capital gains arising on the transfer of listed equity shares or units of equity oriented funds is exempt from tax whereas short term capital gains are taxed at 15 percent. The Revised Discussion Paper proposes a graded basis of taxation in place of the cost indexation scheme for long term gains arising from sale of listed equity shares/ units of equity oriented funds. Capital gains or loss on the listed equity shares/ units of equity oriented funds will now be computed after allowing deduction at specified percentages, which are to be finalised in the context of the overall tax rates. As an example, if 50 percent deduction is provided, an investor in the tax bracket of 30 percent will pay tax on long term gains at the effective tax rate of 15 percent. Long term gains arising from other assets will be taxed at ordinary rates after cost indexation. Short term gains will be taxed at the ordinary rates without any specified deduction.

The Revised Discussion Paper states that if required, an appropriate transition regime will be provided to shift from the present position of exemption to the proposed scheme of levying tax on the transfer of listed equity shares/ units equity oriented funds. The proposal to abolish Securities Transaction Tax ("STT") has been withdrawn. Instead, STT will be calibrated based on the revised taxation regime for capital gains and flow of funds to the capital market. Also, the proposal to introduce the Capital Gains Saving Scheme has been withdrawn, considering the logistic challenges in administering the scheme.

Taxation of FIIs

In the context of income earned by Foreign Institutional Investors ("FIIs") from the purchase and sale of securities, the Revised Discussion Paper proposes to deem such income to be capital gains. The paper seeks to prevent FIIs from treating such income as business profits and claim exemption under the Tax Treaty, which could be available in the absence of a Permanent Establishment ("PE") in India. The paper is silent on classification of income from derivatives. It is also proposed to continue with the present scheme where the capital gains arising to FIIs are not subject to tax withholding and the FIIs are required to pay advance tax as applicable.

Taxation of non-profit organisations

The Revised Discussion Paper takes cognizance of practical difficulties in requiring Non-profit Organisations **("**NPOs") currently registered under the Act to re-register on commencement of DTC. Therefore, the revised paper proposes to withdraw mandatory re-registration provisions for existing NPOs and provides that such organizations would need to only submit additional information/ documents to facilitate administration under the new regime.

An important relaxation has been granted in the context of application and taxation of surplus accumulated by NPOs. Firstly, the Revised Discussion Paper proposes a basic exemption limit only beyond which surplus available with NPOs would be subject to tax. Secondly, NPOs may carry forward up to 15 percent of their surplus or 10 percent of their gross receipts, whichever is higher, for use within 3 years from the relevant financial year. NPOs that are unable to apply their funds due to circumstances beyond their control within the relevant financial year will now not be subject to tax.

The original draft of the DTC did not provide tax exemption for public religious trusts and religious-cum-charitable trusts. The Revised Discussion Paper provides that tax exemption will now be available to these trusts, subject to the conditions laid down.

Concept of Residence in the case of a company incorporated outside India

Under the existing provisions of the Act, a company incorporated outside India is considered a tax resident of India, if during the financial year ‘control and management’ of its affairs is situated “wholly in India”. The DTC had proposed that a foreign company will be treated as Indian resident, if at any time during the financial year, the control and management of its affairs is situated “wholly or partly” in India.

Based on the representations received pointing out the high degree of uncertainty and undue hardship the proposed provisions would afflict on MNCs doing business in India, the Revised Discussion paper seeks to determine the residence status of a foreign company by applying the “place of effective management” test.

The term “place of effective management” is defined to mean the following:

- The place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
- In a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

CFC regime introduced

As an anti-avoidance measure, the Revised Discussion Paper proposes to introduce Controlled Foreign Corporation (“CFC”) provisions in the DTC. These provisions would aim to tax the passive income of a foreign company which is controlled directly or indirectly by an Indian resident, where such income is not distributed resulting in tax deferral. In such a scenario, the proposed provisions would deem that the dividend has been distributed and thus, would be taxable in the hands of the resident shareholder.

This is a surprise move as the original draft of the DTC did not contain CFC provisions. While most mature economies have CFC provisions in their tax framework, in order to effectively implement the same, CFC provisions will need to be accompanied by appropriate foreign tax credit mechanism.

General Anti Avoidance Rule

The DTC had proposed to introduce General Anti Avoidance Rule (“GAAR”) to treat a transaction as tax avoidance transaction, if it is undertaken with the main purpose of obtaining a ‘tax benefit’ and is entered into or carried on in a manner not normally employed for bonafide business purposes or is not at arm’s length or abuses the provisions of the DTC or lacks economic substance. The revenue officers (Commissioner) were given powers to disregard or combine such transaction with any other step in the transaction or re-characterize the income, or the parties to the transaction could be disregarded as separate persons and treated as one person. The provisions were drafted to permit lifting of corporate veil or apply substance over form test. The onus to prove that the transaction is not a tax avoidance transaction was cast on the tax payer.

Wide spread apprehensions were expressed against the sweeping nature of this provision. It was recommended that such provisions be either dropped or a robust mechanism should be provided to administer implementation of GAAR and ensure such provisions were not routinely invoked.

The Revised Discussion Paper proposes to retain GAAR as the Government perceives it to be an effective tool against tax avoidance. However, following safeguards have been proposed:

- The CBDT would issue guidelines on the circumstances in which GAAR may be invoked.
- A threshold limit (possibly a monetary limit) would be prescribed for invoking GAAR.
- The taxpayers, in whose cases GAAR is invoked, could approach Dispute Resolution Panel ("DRP"). DRP is a collegium of three Commissioners, which was recently introduced for non-residents or those taxpayers in whose cases transfer pricing adjustments are proposed to resolve their tax dispute on a fast track basis. Now, the scope of DRP is proposed to be expanded to include cases where GAAR is invoked.

Specific rules for applicability of GAAR would make these anti-avoidance provisions easier to implement. However, the efficacy of the DRP is still to be tested and adjudication powers with a higher level authority may have been preferable to avoid harassment of the bonafide taxpayers. Further, while the Government is optimistic about curbing treaty shopping by invoking GAAR, the final outcome will be known only when the taxpayers challenge this position before the courts.

Taxation of income from employment

Retirement benefits and perquisites

The DTC had proposed to tax employer's contribution to approved superannuation funds, provident fund, etc as 'income from employment'. The 'specified deductions' were limited to amounts received under a Voluntary Retirement Scheme ("VRS"), retirement-cum-death gratuity and commuted value of pension. However, condition was prescribed that these amounts had to be deposited in a Retirement Benefits Account with a Permitted Savings Intermediary. Accordingly, avenues for investment such as Post Office schemes, fixed deposits, mutual funds, etc were not eligible for deduction. Also, any withdrawal from the Retirement Benefits Account was proposed to be taxed as per the 'Exempt-Exempt-Taxation' ("EET") method of taxation.

The Revised Discussion Paper now proposes following key changes to the DTC on taxing 'income from employment':

- Owing to withdrawal of the EET method of taxation, the Retirement Benefits Account scheme is proposed to be withdrawn. Employer's contribution to approved superannuation funds, provident funds and under the New Pension

Scheme will not be considered as salary if the contributions are within the prescribed limits.

- As against the deduction method that was proposed from gross salary, the retirement benefits, viz gratuity, VRS amount, commuted value of pension, leave encashment, would be exempt subject to specified limits.
- Perquisites in relation to medical facilities and medical reimbursements shall be valued as per the Act, with appropriate enhancement of monetary limits. It has also been clarified that the rent free accommodation perquisite will not be computed with reference to market value of the accommodation.

The changes proposed in the Revised Discussion Paper are welcome as method of taxing employment income is likely to remain in line with the existing rules.

EET taxation scheme relaxed

The original Discussion Paper on the DTC had proposed the EET method of taxing savings instruments. Under the EET scheme, while initial contributions towards and accretion from specified savings (maintained by savings intermediary including approved provident funds, superannuation funds, life insurers and New Pension System Trust) were not subject to tax, withdrawals at any time were proposed to be taxed at the applicable marginal rate of tax. The existing accumulated balances as on March 31, 2011 were proposed to be grandfathered.

Recognizing the absence of a well established social security system that is required for the EET method to be just and equitable; the Revised Discussion Paper proposes to revert to the existing system of the Exempt-Exempt-Exempt ("EEE") scheme for taxation of specified savings instruments. It is now proposed that contributions, accumulations/ accruals and withdrawals towards the Government Provident Fund, Public Provident Fund and Recognised Provident Fund and Pension Scheme administered by the Pension Fund Regulatory and Development Authority, along with approved pure life insurance products and annuity schemes would continue to enjoy the EEE method of taxation.

The Revised Discussion Paper also proposes that rules for contribution as well as withdrawal shall be harmonized so that actual savings are utilized by taxpayers for the long term. Further, it is also proposed that those instruments which currently enjoy the EEE method under the Act would continue to be eligible for the EEE method for full duration of the instrument.

Taxation of house property

The DTC had proposed to compute gross rent value of let out property at higher of amount of contractual rent or presumptive rent. The presumptive rent was to be calculated at six percent per annum on the rateable value fixed by the local authority or on the cost of construction/ acquisition of the property, where rateable value is not fixed.

The Revised Discussion Paper proposes to withdraw the aforesaid proposal to compute gross rent on presumptive basis; accordingly, gross rent shall be computed on the basis of the amount of rent received or receivable on contractual basis in case of let out property.

The Revised Discussion Paper also proposes to restore deduction to individuals or HUFs on account of interest on capital borrowed for construction/ acquisition of a house property for self occupation, subject to a maximum of INR 0.15 million.

Wealth tax

The DTC proposed to withdraw wealth tax on Companies and unincorporated bodies other than Individuals, HUFs and private discretionary trusts. Wealth tax was proposed to be levied on "net wealth" exceeding INR 500 million at the rate of 0.25 percent on the valuation date (ie, last day of the financial year).

As per the Revised Discussion Paper, wealth tax shall be levied on the specified unproductive assets of all taxpayers except NPOs. It is also proposed to align provisions under the revised Bill with the existing regime under the Wealth tax Act, 1957. The threshold limit and the tax rates would be regulated based on overall tax rates.

Conclusion

In summary, the interim efforts of the Government to retain the spirit of the original draft DTC while at the same time rationalizing some of the proposals is encouraging. The approach of the Government to place the revised policy paper in public domain before drafting the legislation is also laudable.

The Revised Discussion paper is open for public comments for 15 days after which, the revised DTC Bill will be placed before the Parliament. While not much change is expected on the Government's position on these key issues, a more comprehensive analysis of the implications can only be done once the Bill is released.

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