

**Suggestions on the
Revised Discussion Paper (RDP)
on Direct Taxes Code (DTC)**



**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF INDIA**

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Suggestions of the ICAI on the Revised Discussion Paper on the Direct Taxes Code

A Revised Discussion Paper (RDP) on Direct Taxes Code (DTC) has been released by the CBDT on 15th June, 2010, taking into consideration the vital and critical issues raised by the various stakeholders on the DTC. It is extremely satisfying to note that six of the eleven significant issues identified in the RDP are as per the specific suggestions of the Direct Taxes Committee of the ICAI. In regard to the other issues, we are pleased to submit some suggestions for your consideration. Even in regard to areas where our suggestions have been broadly accepted, we are placing on record certain follow-through suggestions on a broader plane which may be useful in giving effect to the concepts that have been agreed upon.

It is also suggested that as a general rule based on the concept of promissory estoppel, suitable transitional provisions may be introduced in the Code for carry forward of unavailed benefits as on the date of implementation of the Code for the unexpired period and utilization/set-off of the same under the provisions of the Code.

Accordingly, we proceed to submit our specific observations and suggestions in regard to the issues dealt with in the RDP -

Chapter I

[Minimum Alternate Tax (MAT) - Gross assets vis-à-vis Book profit]

(A) Proposal in the RDP

MAT on book profits is proposed to be restored instead of MAT on the “value of gross assets” as proposed in the DTC. This is a welcome measure.

(B) Suggestions

The following are our suggestions relating to credit for MAT and rate of MAT.

- (1) The Code should provide for carry forward of credit for MAT paid on book profits for a period of ten years for set-off in the years in which the company is liable to tax under the normal provisions of the Code.
- (2) Further, the Code should also provide for carry forward of unavailed MAT credit under the Income-tax Act as on the date of implementation of the Code, for the unexpired period under the new Code and set-off of the same in the years in which the company is chargeable to tax under the normal provisions of the Code.
- (3) The prevailing rate of tax on companies is 30%, against which the effective rate of MAT on book profits is 19.93%. The rate of MAT on book profits under the Code should be suitably harmonised¹ with the revised corporate tax rate under the Code.

¹ Since rates of tax, whether for MAT or capital gains, are matters of consequential policy, we have refrained from making any specific suggestion of a particular rate of tax.

Chapter II

[Tax Treatment of Savings – EET vs. EEE]

(A) Proposal in the RDP

EEE is proposed to be restored on specified savings instruments keeping in mind the difficulties that could arise on account of implementation of EET (in the absence of a social security system in place). This is a good relief measure. Further, it is proposed to continue EEE for the full period of the investments in all eligible savings instruments made before the date of implementation of the Code.

(B) Suggestions

- (1) Investment in Senior Citizens Savings Scheme may also be brought within the scope of EEE, since this scheme is for the benefit of the senior citizens, who are eligible for deduction in respect of investment in this scheme as per the present provisions of the Income-tax Act, 1961. The inclusion of this scheme under EEE would also be in line with the overall objective of the Government to promote welfare schemes for senior citizens (like Reverse Mortgage Scheme, higher basic exemption limit, higher rate of interest on deposits etc.).
- (2) The Government has given a special additional deduction of up to Rs.20,000 for investment in infrastructure bonds during the F.Y.2010-11, as a measure for promoting infrastructure development. Therefore, to achieve this objective, the Government may consider inclusion of infrastructure bonds under the instruments qualifying for EEE.

Chapter III

[Taxation of Income from Employment]

(A) Proposal in the RDP

The exemption for terminal benefits, namely, gratuity, leave encashment, VRS compensation and commuted pension, have been restored in the RDP. However, no exemption has been proposed in respect of leave travel concession.

(B) Suggestions

- (1) An exemption may be introduced in respect of leave travel concession as well in line with the provisions of the Income-tax Act, 1961. This is necessary since a large number of people move from their native towns and villages to big cities for earning a living. Their regular income would be sufficient for their re-settlement (housing), and other day to day expenditure and savings. Therefore, in order to satisfy the social need of people to meet their family at least one a year, an exemption may be introduced for reimbursement of travel expenditure to home town.

An exemption for leave travel concession in general would also, inter alia, serve to promote the tourism industry.

- (2) The difficulties that would be faced on account of valuing the perquisite of rent-free or concessional accommodation at market value has been taken care of in the RDP. However, the Code does not provide for any relief in respect of rental outflow of salaried persons. In order to provide parity in treatment of provision of rent free/concessional accommodation and allowance for house rent, a suitable exemption may be provided in respect of house rent allowance.

Chapter IV

[Taxation of income from house property]

(A) Proposal in the RDP

The provisions for taxation of notional rent on house property are proposed to be removed. This measure is appreciated since the charge of tax on income from house property would now be based on an individual's "ability to pay". The best and most simple tax law is the one which is based on real income rather than on notional income.

(B) Suggestions

(1) In case of let out house property, gross rent will be the amount of rent received or receivable for the financial year. However, it is necessary to exclude unrealized rent while computing income from house property, since it represents a sum which the assessee does not actually receive. This deduction is allowed under the present provisions of the Income-tax Act, 1961, subject to the fulfillment of conditions specified in Rule 4, namely –

- (a) the tenancy is bonafide;
- (b) the defaulting tenant has vacated, or steps have been taken to compel him to vacate the property;
- (c) the defaulting tenant is not in occupation of any other property of the assessee;
- (d) the assessee has taken all reasonable steps to institute legal proceedings for the recovery of unpaid rent or satisfies the Assessing Officer that legal proceedings would be useless.

These conditions may be introduced in the Code as well for excluding unrealized rent from computation of income from house property.

- (2) If the unrealized rent is recovered in any subsequent year, it can be brought to tax in that year, after providing for the statutory deduction at the prescribed percentage.
- (3) A clarification may be given as to the year of taxability of arrears of rent, and deduction permissible against such rent.
- (4) Interest for the pre-construction period should also be allowed as deduction. The manner of allowing such deduction may be considered and provided for in the Code.

Chapter V

[Taxation of capital gains]

(A) Proposal in the RDP

The RDP proposes a differential tax treatment for capital gains on sale of equity shares and units of equity oriented funds and other assets held for more than one year from the end of the financial year in which the assets are purchased. In respect of capital gains on sale of equity shares and units of equity oriented funds, the benefit of deduction at a specified percentage of capital gains is proposed, whereas in respect of other assets held for more than one year, the benefit of indexation (with base date as 1.4.2000) would be available.

(B) Suggestions

- (1) Capital gains on sale of equity shares and units of equity oriented fund (purchased before the date of implementation of Code) on which securities transaction tax has been paid, should be exempt from tax if held for more than one year and should be subject to tax @15%, if held for less than one year, in line with the principle of promissory estoppel. Appropriate transition regime providing for the same should be incorporated in the Code.
- (2) The benefit of availing exemption of capital gains by investing in Capital Gains Savings Schemes would not be available under the Code. Therefore, rationalisation of indexation is necessary, since, in respect of capital gains on sale of assets held for more than one year from the end of the financial year of purchase, this is the only benefit available. The cost inflation index takes into consideration only 75% of average rise in consumer price index (CPI) for urban non-manual employees for the immediately preceding year. It should take into account 100% of average rise in consumer price index, since the indexation benefit is the only benefit available in respect of capital gains under the Code.
- (3) Securities transaction tax paid should be allowed as a deduction while computing capital gains since it is considered as part of the cost of acquisition of the capital asset as per the proposed provisions.
- (4) Capital losses arising out of sale of unlisted shares which remain unabsorbed as on the date of implementation of the Code should be permitted to be set-off also against capital gains on sale of listed shares and units of equity oriented fund after the implementation of the Code, since such gains would become taxable under the Code.

Chapter VI

[Taxation of Non-profit organizations]

(A) Proposals in the RDP

The RDP of the DTC proposes the following tax regime for non-profit organizations –

- (1) A trust or institution established wholly for charitable purposes would be taxable@15% in respect of surplus generated from charitable activities and capital gains arising on transfer of an investment asset, being a financial asset.

Such trusts are, therefore, required to apply their income for charitable purposes during the year to claim the benefit of exemption. However, they are allowed to accumulate up to 15% of the surplus or 10% of gross receipts, whichever is higher, to be used within three years from the end of the relevant financial year.

The donations made to such trusts and institutions will be eligible for deduction in the hands of the donor at the appropriate rates.

- (2) The income of any trust or institution recognized/registered under the religious endowment Acts of the Central Government or the State Governments would be fully exempt from tax. However, donations to such trusts or institutions will not enjoy any deduction in the hands of the donor.
- (3) The income of public religious institutions will be exempt subject to fulfillment of the prescribed conditions. Such trusts should apply their income wholly for public religious purposes only. Donations to these institutions will not be eligible for deduction in the hands of the donor.
- (4) Partly religious and partly charitable institutions will also be treated as NPOs if they are registered under the Code. They are required to comply with all the conditions applicable for wholly religious institutions for claiming exemption of their income from religious activities. Further, their trust deed/memorandum should contain a clause specifying the pre-determined ratio for application of gross receipts between charitable and religious activities. Also, they are required to maintain separate books of account and separate financial statements in respect of religious and charitable activities.

It may be inferred that if the conditions are complied with, the income from religious activities would be completely exempt. Income from charitable activities would be taxable@15% in respect of surplus generated from charitable activities and capital gains arising on transfer of an investment asset, being a financial asset. Therefore, income from charitable activities are required to be applied for charitable purposes during the year to claim the benefit of exemption. However, accumulation up to 15% of the surplus or 10% of gross receipts, whichever is higher, to be used within three years from the end of the relevant financial year, is permissible in respect of income from charitable activities.

Donations to these institutions will not be eligible for deduction in the hands of the donor.

This is the tax treatment for NPOs and religious trusts apparent from a plain reading of the relevant provisions of the DTC along with the RDP. In case the legislative intent is different from our understanding of the provisions, the same may be clarified.

(B) Suggestions

- (1) The permissible period of accumulation may be increased from three to five years.
- (2) The additional two conditions required to be complied with by partly religious and partly charitable institutions should be relaxed, since it is not practically possible to pre-determine the ratio for application of gross receipts between charitable and religious purposes. Further, the requirement of maintaining separate books of accounts and separate financial statements in respect of religious and charitable activities would increase the administrative cost considerably.

In the alternative, these institutions may be required to file a declaration every year specifying the percentage of application of gross receipts between charitable and religious purposes. A deviation of say, 10%, from the percentage may be permitted.

- (3) If a trust/institution established for partly charitable and partly religious purposes applies its income for any of the following purposes, such income should be exempt –
 - (i) wholly religious purposes (to the extent of income from religious activities); or
 - (ii) education; or
 - (iii) medical facilities; or
 - (iv) relief of poor.

However, if it applies its income for the object of general public utility, the same may not be treated as application of income and may be subject to tax@15%.

Further, anonymous donations received by such trusts/institutions should be fully taxable.

- (4) The trust/institution should be given an option to apply the income received during the last quarter of the financial year in the immediately following financial year. Such application should be deemed to be application in the same financial year. The option should be exercised by the trust/institution in writing within a time limit that may be prescribed.
- (5) In case application during a particular year by a charitable trust exceeds its income, such excess should be permitted to be carried forward and treated as the application in the subsequent year.

- (6) The Companies Act, 1956 requires the companies registered under section 25 of the said Act to follow mercantile system of accounting. The proposed requirement for all NPOs to mandatorily follow cash system would be contrary to the requirement under the Companies Act, 1956, in cases where such NPO is a company registered under section 25. This conflict may be resolved.
- (7) It has been clarified that donations by an NPO out of its accumulated surplus to another NPO will not be considered as application for charitable purpose. This condition should be relaxed in case of dissolution of trust/institution and consequent takeover by, or transfer to, another trust/institution. Similar provision was introduced in the present Act after operational difficulties were noted in this regard.

Chapter VII

[Special Economic Zones – Taxation of Existing Units]

(A) Proposal in the RDP

Although as a policy, it has been decided not to extend the scope or the period of profit linked deductions under the Code, since they have the effect of transferring profits from a taxable entity to a non-taxable entity, however, specific provisions for protecting such deduction for the unexpired period have been provided in the DTC in the case of SEZ developers. The RDP clarifies that a similar provision to protect profit-linked deductions of units already operating in SEZs for the unexpired period will also be incorporated.

(B) Suggestions

- (1) As per the provisions of the Code, as revised by the RDP, the benefit under the Code would be available only in respect of units which become operational before the date of implementation of the Code. The benefit is not proposed to be made available to units which commence operation after the date of implementation of the Code. However, there would be many developers who would have already invested in the development of SEZs, who would not be able to claim benefit of exemption under the Code if they are not able to commence operation before the date of implementation of the Code. Therefore, the benefit should be available under the Code even if the units become operational after the date of implementation of the Code, if steps have been taken for setting up the unit (say, like, the plans have been approved by the prescribed authority) before such date. A suitable time period may be provided within which such units should become operational after the implementation of the Code.
- (2) At present, the MAT provisions under section 115JB are not applicable to the income accrued or arising from any business carried on, or services rendered, by an entrepreneur or a Developer, in a Unit or SEZ, as the case may be. It is suggested that such exemption may be continued in the Code as well.

Chapter VIII

[Concept of residence in the case of a company incorporated outside India]

(A) Proposals in the RDP

- (1) The RDP proposes that a company incorporated outside India would be treated as a resident in India if its “place of effective management” is situated in India. “Place of effective management of the company” has been defined to mean –
 - (i) the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
 - (ii) 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.”
- (2) The RDP also proposes to introduce Controlled Foreign Corporation (CFC) provisions so as to provide that passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferral of taxes, shall be deemed to have been distributed. Consequently, it would be taxable in India in the hands of resident shareholders as dividend received from the foreign company.

(B) Suggestions

- (1) There is tremendous scope for litigation in respect of clause (ii) of the definition of “place of effective management”. It would be very incongruous to consider the place where the officers of the company perform their functions as the place of effective management of the company. Further, what would constitute “routine” approval would be a subject matter of litigation. It is possible to circumvent this provision by intentionally including certain matters for rejection by the Board of Directors. Therefore, the scope of the definition should be restricted to clause (i) of (1) above and clause (ii) should be removed.
- (2) It is noted that the words “place of effective management” of a company are presently used in section 115VC, dealing with taxation of shipping companies. However, the usage in that section is applicable only to an Indian company. The ambit of its applicability is also very limited and therefore, has not resulted in widespread difficulty till date. However, the RDP proposes to apply this concept whereby a company incorporated outside India will be treated as resident in India if its “place of effective management” is situated in India. It is apprehended that application of this concept in such a sweeping manner could cause serious practical difficulties resulting in bonafide cases being put to hardship, while leaving adequate possibility for those seeking to avoid this consequence to plan in an appropriate manner.

- (3) Further, clause (i) should be drafted in such a manner that it should not include cases where one or two meetings of the Board of Directors of a foreign company is held in India. The principle of substance rather than form should be taken into consideration while determining the “place of effective management”.
- (4) It is not clear whether the passive income refers to income earned by such CFC within or outside India. It appears that the provisions would apply to the global “passive income”. Numerous issues are likely to arise out of this provision and therefore this entire concept may be reconsidered. If the above view is not acceptable, some exceptions to recognise other business compulsions for not distributing the surplus may be provided. For example, safe harbor rules may be introduced for non-applicability of such provisions, if say, passive income is within a certain percentage of total income, or a certain percentage of passive income is distributed.
- (5) Further, the parameters for treating a company as a “Controlled Foreign Corporation”, and the specific income from such company which would be subject to tax in the hands of the Indian shareholder should be clearly spelt out in the Code. A few parameters in this regard are given hereunder -
- (i) A CFC may be defined to be a company in which more than 50% of the voting power is held by persons who are resident in India and domestic companies, directly or indirectly, on any day of the year.
 - (ii) For computing “50% voting power” in (1) above, only those shareholders who own 10% or more of the voting power in the foreign company are to be included in the “more than 50%” test.
 - (iii) The Indian shareholder has to include certain profits (to be specified) derived by CFC as deemed dividend.
 - (iv) Deemed dividend has to be limited to current year profits alone. Income previously taxed cannot be taxed again on actual distribution.
 - (v) Income which is already subject to tax at the rate of say, 25% and above, in the foreign country should not be taxed again in India.
 - (vi) These provisions should not apply in respect of companies in a country with which India already has, or proposes to enter into, a double taxation avoidance agreement.

Considering the possible issues likely to arise from such provision, a macro level cost benefit analysis of introducing such a provision and the quantum of revenue recovery arising therefrom may be considered.

Chapter XI

[General Anti-Avoidance Rule]

(A) Proposal in the RDP

The RDP proposes certain safeguards for invoking GAAR provisions. GAAR provisions are to be invoked only in respect of an arrangement where tax avoidance is beyond a specified threshold limit. The RDP proposes that the forum of DRP would be available where GAAR provisions are invoked.

(B) Suggestions

- (1) The threshold limit for invoking GAAR should be relatively high so that inconsequential transactions and small assesseees are not subject to rigors of GAAR.
- (2) Where GAAR provisions are invoked, a forum which should be adequately represented by departmental officers, professionals as well as the industry, should be available. In the absence of such balanced representation, an appreciation of the commercial perspective from a businessman's point of view is often lost sight of. This could lead to increased litigation which would seek to bring in rules of equity and principles of natural justice. The RDP recognizes that *"the GAAR provisions apply only where a taxpayer has entered into an arrangement, the main purpose of which is to obtain a tax benefit and such arrangement is entered 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"*. An evaluation of such criteria is necessarily subjective. It is a well-established principle that in such circumstances the transaction has to be viewed from the perspective of a common businessman and not from the point of revenue. This objective would be best achieved if the Dispute Resolution Panel (DRP) includes requisite number of businessmen and professionals. There should therefore be adequate representation from all quarters to provide a meaningful DRP.
- (3) The onus of proving that an arrangement has been made with an intention of obtaining tax benefit should be on the revenue authorities invoking GAAR provisions. The presumption of tax avoidance should not be drawn in respect of tax benefit derived from genuine business transactions. Only in cases where the tax consideration significantly overrides commercial considerations, GAAR provisions may be invoked.
- (4) The power to invoke GAAR is bestowed upon the Commissioner of Income-tax. When the GAAR provisions are invoked, the remedy of appeal to Income-tax Appellate Tribunal should be available. Therefore, suitable provisions may be introduced in the Code to provide for such remedy.

- (5) The RDP has very rightly recognized the concerns expressed with regard to arbitrary application of the power to invoke GAAR. It has accordingly proposed certain safeguards. While appreciating this gesture, it may be appropriate to point out that a clear prescription of accountability in regard to discretionary powers exercised is the best curb on unwarranted use of such powers. The DTC has referred to similar practices in other countries. It may not be out of place to mention that the persons exercising such authority are clearly accountable for the manner in which such authority exercised. It would be in keeping with our rapidly evolving fiscal and economic environment to prescribe specific methodologies for accountability of revenue officials. There can be no better signal from the Government that while avoidance on part of taxpayers would not be condoned, an equally adverse view would be taken if those charged with responsibility of application of the law exceed certain limits. In order to project the appropriate sense of evenhandedness in dealing with taxpayers, provisions relating to accountability (including certain minimum actions/ consequences) should be incorporated in the Code, and not left to be formulated independently.

Consideration of suggestions given by the Institute relating to critical issues

The RDP addresses the major issues on which various stakeholders have given their views. Eleven significant issues have been considered and each issue is discussed in a separate chapter of the RDP. It has also been mentioned in the RDP, that there are a number of other issues which have been raised in the public feedback, which, though not part of this Discussion Paper, will be considered while finalizing the Bill for introduction in Parliament.

In this regard, we wish to bring to your notice that the Institute has submitted its suggestions on the Direct Taxes Code Bill, 2009 to the Ministry of Finance on 4th May, 2010, which contains suggestions on critical issues concerning penalty, prosecution, service of notice, revision of other orders, stay of demand by the Appellate Tribunal, opportunity of being heard in a best judgment assessment, determination of arm's length price, search and seizure, survey, branch profits tax, maintenance of accounts, method of accounting, depreciation etc., arising out of the provisions of the Code. Since it has been indicated in the introduction of the RDP that responses are sought on the 11 issues mentioned in the RDP, we have not reiterated / repeated the matters mentioned in our earlier submission. We wish to emphasize that these suggestions have been given after detailed consideration and deliberation of the proposals contained in various chapters of the Code at high level meetings of the Direct Taxes Committee of the Institute and its study groups. It is possible that the number of representations received on some of the above-mentioned subjects may be much lesser in number than those received on the subjects dealt with in the RDP. It is submitted that this is possibly due to the fact that procedural issues and those concerning onus of proof, application of rules of equity etc. are not so easily appreciated by a layman. However, taxpayers will realise the considerable impact of these provisions only when they are actually applied. It is, therefore, suggested that although these issues have not been dealt with in the RDP, a more detailed consideration of these aspects may be undertaken before formulating the Revised Direct Taxes Code. The Direct Taxes Committee of The Institute of Chartered Accountants of India will be glad to interact with the designated officials and to elaborate on the suggestions made earlier. The path breaking step of inviting public comments and engaging taxpayers and professionals in this debate would bear the full fruit when these suggestions are suitably considered before presenting the Direct Taxes Code in the Parliament.