# PRE-BUDGET MEMORANDUM - 2008

## DIRECT TAXES

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

# NEW DELHI

CONTENTS

# INTRODUCTION

1.1 The Council of the Institute of Chartered Accountants of India considers it a privilege to submit this Pre-Budget Memorandum to the Government. The memorandum contains suggestions for the consideration of the Government while formulating the tax proposals for the year 2008-2009.

1.2 The Indian economy recorded an impressive performance during the first quarter of 2007-08. The real GDP growth in the first quarter of 2007-08 decelerated slightly to 9.3% from 9.6% in the corresponding period of the preceding year. Industrial production remained buoyant during the first five months of 2007-08. During April-August, 2007, index of industrial production rose by 9.8% as against 11% in the same period of 2006-07. The manufacturing sector with a growth of 10.3% (12.2% a year ago) continued to be the main driver of the industrial activity. Real GDP growth originating from the 'agriculture and allied activities', at 3.8% in the first quarter of the year 2007-08 was much better than 2.8% growth achieved during the corresponding period of 2006-07. Strong improvement in Rabi output in 2006-07, above average and reasonably well-distributed rains and reasonably high level of reservoir have improved the outlook for agriculture for the year 2007-08. The positive prospects augur well for the economy in terms of both aggregate supply conditions and food prices which, until early 2007, were the main drivers of inflation.

The services sector with double digit growth (10.6% in April – June, 2007 on top of 11.6% in April – June, 2006) remained the leading sector of the Indian economy. Service now accounts for nearly 60% of GDP. India's BOP position has remained comfortable during 2007-08 so far. While merchandise trade deficit has widened, sustained buoyancy in invisibles and sizeable net capital inflows have more than made for increasing trade deficit. India's merchandise exports during April – June, 2007 increased by 17.8% in U.S. dollar terms as compared with 23.7% in the corresponding period of the previous year.

Merchandise imports payment rose by 21.3% as against an increase of 22.9% in the corresponding period last year. Net capital inflows also remained buoyant. Reflecting the movements in current and capital accounts of the BPO, the accretion of foreign exchange reserves amounted to US $ 11.2 billions during April – June, 2007 as against US $ 6.4 billions a year ago.

1.3 While there is a pick-up in the momentum of growth which also appears to be spreading across all constituent sectors, there are several factors that pose risks to the outlook of growth. These include, infrastructural bottlenecks, high inflation rate of assets especially housing prices, continuous and volatile increase in crude oil prices in the international market, widening trade deficits turbulent global financial market, increasing value of rupee having its impact on exporters and unfolding of the US sub prime mortgage crises. All these factors warrant close monitoring for sustaining the growth process with a tolerable level of inflation.

1.4 There has been improvement in Central Government finances, benefiting from higher tax collections and expenditure management through control over non-plan expenditure. During April-August 2007, revenue receipts of the Union Government as proportion of the budget estimates improved to 26.7% from 26.4%. Total expenditure at 36.8% of the B.E. was higher than 35.5% of the B.E. in April-August, 2006.

1.5 So far the revenue deficit and the fiscal deficit are concerned, as proportion to the Budget estimate they increased respectively to 122.9% and 67.6% in April – August, 2007 as compared to 93.7% and 61% in the corresponding period last year. However, the government hopes to make good the situation by the end of the financial year.

1.6 In this macro-economic scenario, the Institute submits its Pre-Budget Memorandum for the kind consideration of the Government before finalizing the Budget Proposals for the year 2008-09. Separate memoranda are being submitted in respect of Direct Taxes and Indirect Taxes.

1.7 Suggestions in the Pre-Budget Memorandum – 2008 on direct taxes have been given under the following heads:

I. Suggestions for widening the tax base and increasing the tax revenue.

II. Suggestions to check tax avoidance.

III. Suggestions for rationalization of the provisions of direct tax laws.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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EXECUTIVE SUMMARY

I. SUGGESTIONS FOR WIDENING THE TAX BASE AND INCREASING THE TAX REVENUE

1. Widening the scope of section 44AF

The scope of section 44AF may be widened to cover all businesses including small scale manufacturing, job workers, dabas, tailors, small restaurants, home delivery out-lets, auto spare servicing, software ancillary units and other small businesses whose sales, turnover or gross receipts are less than Rs.40 lakhs.

2. Persons paying VAT or service tax should file return of income

Dealers who are liable to pay VAT under various State legislations may be required to furnish returns of income wherein full details of the turnover disclosed under State VAT Legislations should also be furnished.

3. Encouraging voluntary compliance – Filing of income-tax return

A provision may be introduced to allow the specified persons to file return of income and pay tax along with interest and such further penal interest as may be thought fit. This will encourage voluntary compliance and at the same time there will be no immunity to these persons from the provisions of law.

4. Utilisation of PAN and Bank Account Data

PAN and bank account data may be cross verified as contained in the detailed suggestion.

II. SUGGESTIONS TO CHECK TAX AVOIDANCE

1. Information to be furnished in the Annual Information Return

Section 285BA may appropriately be amended to require information regarding the following financial transactions:

(a) Listed companies receiving share application monies (including preferential allotments) exceeding Rs.1 lakh.

(b) Unlisted companies receiving share application monies (including preferential allotments)exceeding Rs.50,000.

(c) Payment received by tour operators exceeding Rs.1 lakh.

(d) Information regarding Government tenders where the value exceeds Rs.10 akhs. This information may be provided by the concerned Government Department.

(e) Sales and purchases of shares exceeding Rs.5 crores respectively in the case of day traders. This information can be filed by the concerned brokers who are dealing with the day traders.

(f) Receipt of donations by trusts or Institutions exceeding Rs.1 lakh. Such information may be filed by the concerned trusts or institutions.

(g) Educational fees paid in excess of Rs.1 lakh per annum. The concerned educational institution should furnish the relevant information to the Department.

(h) Time deposits with banks exceeding Rs.5 lakhs. The concerned banks should furnish the information.

2. Real estate transactions – Uniformity and reduction in stamp duty rates

In the matter of Stamp Duty rates also the Central Government can take the initiative and bring about a consensus among the State Governments for prescribing uniform stamp duty rates in accordance with a general agreement between the State Governments and the Central Government. This will go a long way in simplifying capital gains taxation and would also encourage disclosure of the correct consideration received from the transfer of capital assets.

3. Mechanism when the assessee surrenders income

Since the Settlement Commission is not having jurisdiction over the past years after the search is conducted by the Department, there should be a suitable mechanism to be drawn for those who have agreed, during the search, to surrender their income to avoid complicated verification under section 142(2A).

III. SUGGESTIONS FOR RATIONALISATION OF THE PROVISIONS OF DIRECT-TAX LAWS

INCOME-TAX

Definitions

Income deemed to accrue or arise in India

1. Section 9(1)(i) Explanation (b)

An Explanation should be provided to define the activity of "operations which are confined to the purchase of goods in India for the purpose of export" i.e. whether it would include the activity of purchase of customized goods made as per the specification and with the supervision of buyer.

2. Taxability of software payments made to non-residents

An amendment may be made to provide that licence payments made for use of software for the payer's own operations (as against duplication for onward sale/licence) being payments for use of a copy-righted article are outside the ambit of the definition of "royalty" as provided in section 9(1)(vi).

Exclusions from total income

3. "Annual receipts" under section 10(23C)

It is suggested that "annual receipts" may be clearly defined as income of the hospitals/ educational institutions arising every year but excluding value of donation received in kind by way of shares, other movable assets, land, hospitals/educational equipment, sale consideration received on disposal of land, shares or other movable property etc.

Further, it may be specifically provided that donations received towards corpus by way of land, shares or other movable assets are excluded from computation of "annual receipts" as prescribed under Rule 2BC of Income-tax Rules.

The present limit of Rs.1 crore may also be increased to Rs.5 crores

4. Defining "Services" in section 10AA

   (i) Section 10AA should be amended to define the intended scope of "any services" referred in section 10AA.

   (ii) Computer Software (as defined in section 10A), ITES (on the lines covered by the notification), film software and television software (as defined in section 80-HHF) may be defined as being included in "services"

5. First proviso to section 10AA

   The first, second and third provisos to section 10AA fall after its sub-section (3). The first proviso refers to "deduction referred to in this sub-section". However, sub-section (3) does not refer to any "deduction".

   The reference should be: "deduction referred to in this section"

6. Concessional tax treatment to foreign sourced dividend income

   A concessional tax treatment may be accorded to foreign sourced dividend income by subjecting it to tax in India at the same rate as the dividend distribution tax levied on Indian companies paying dividends to their shareholders.

<u>Income from salaries</u>

7. Proviso to section 17(2)(iii) and FBT on ESOPs

   It may be clarified that ESOPs would not be taxable as perquisite in all cases.

8. Clause (v) of proviso to section 17(2)(vi) of the Income-tax Act, 1961

   In view of increased cost of medical facilities the exemption limit needs to be increased suitably.

Profits and gains of business or profession

9. Depreciation – Section 32

Keeping in view the huge investments planned, it is essential that the rates of depreciation are revised back to 25% from the existing depreciation rates of 15%. This will help in financing the part of the cost of the project.

10. Depreciation – Air pollution equipments

As the capital investment in new technology and equipments for controlling damage to environment is increasing, a reduction in depreciation rate would prevent the corporates from embracing new and more effective technology. Hence, the depreciation allowance of 100% for these selected equipments may be reinstated.

11. Section 32 – Computer peripherals

Computer peripherals being integral part of the computer devices should specifically be included in the definition of computer.

12. Section 32 - Depreciation in case of slump sale

Whether depreciation can be claimed on the basis of proportionate number of days by the transferor and the transferee company in case of slump sale considering the proviso to section 32 read with section 170 may be appropriately clarified.

13. Investment allowance

The investment allowance may be re-introduced as an incentive so as to facilitate faster growth

14. Section 35D

The expenses on raising additional capital may be allowed over a reasonable time period, say 3 to 5 years, even in cases not covered by section 35D. Alternatively, section 35D may be amended to allow deduction of expenses on raising additional capital in all cases.

15. Section 36(1) (viia)

    There is differentiation in the tax treatment for Indian and foreign banks resulting in lack of level playing field. The law should be amended to provide for deduction to foreign banks up to 7.5 % of the total income.

16. Section 36(1) (viii)

    Asset reconstruction companies should be eligible for deduction under section 36 (1) (viii).

17. Section 40a(ia)

    (i) The proviso below section 40(a)(ia) may be deleted and a new sub-section may be introduced in section 155 allowing rectification in that very year to which the expenditure pertains to, on the assessee producing evidence of payment of the tax deducted or evidence that the deductee has included the income received by him from the deductor in his return of income and has paid tax on the income declared by him.

    (ii) Alternatively, the expenditure on interest, commission, brokerage, fee for professional services, fee for technical services payable to a resident or amount payable to a contractor or sub-contractor may be allowed as a deduction provided the relevant tax deductible at source has been deducted and paid before the date of filing of the return of income.

18. Section 40(a)(iii)

    A proviso similar to the one appearing in sections 40(a)(i) / (ia) of the Act should be inserted in clause (iii) so that a deduction for salary payment is allowed at a later date, when the tax on such salary has been paid or deducted therefrom.

19. Remuneration to working partners - Section 40(b)

    The restrictive provisions on remuneration payable to partners of a firm should be deleted and the limits prescribed in the partnership deed should be allowed to prevail. Even if this suggestion is not acceptable for all firms, at least in the case of professional firms, the limits may be removed, as every partner in a professional firm is a working partner.

20. Section 40A(3) - Direct cash deposits in banks due to contractual obligations

There is an urgent need to exempt direct payments into bank account of the payee arising out of genuine contractual obligations from the scope of section 40A(3). The categories of the payees in respect of whose transactions such exemption shall apply may also be stated to avoid any abuse of this relaxation.

21. Section 40A(3)/Rule 6DD

Insertion of a clause on the lines of erstwhile clause (j) is suggested in section 40A(3) itself.

The following payments may also be prescribed as exempt under Rule 6DD:

a) Payment of octroi at octroi posts;

b) Payments to small transport operators, or drivers, towards freight;

c) Payments at public auctions;

d) Other payments where the nature of the transaction is such that it is to be ordinarily paid only in legal tender.

22. Section 42

As a result of the requirement of surrender of the area prior to the beginning of commercial production, the assessee may not be able to avail deduction from the taxable income of expenses on account of abortive exploration in the year of incurring of expenditure. Hence, the words "in respect of any area surrendered" may be deleted from section 42(1)(a).

23. Section 43B – Slump sale

The section specifically does not provide for the time of claiming deduction in case of slump sale. The following issues usually arise at the time of slump sale for claiming deduction under section 43B of the Act:

- Whether the transferor company should claim deduction at the time of slump sale considering it as actual payment?

  or

- Whether the transferee company should claim deduction under section 43B when it actually discharges the obligation in respect of liabilities taken over?

The section may be amended to clarify the legal position.

24. Section 44BB – Project-wise computation

Suitable amendments may be made in the section to specifically provide for such contract / project wise computation.

<u>Capital gains</u>

25. Section 47 – Expansion of scope

Taking into account the increased globalization of the Indian economy, and consequent holding of Indian assets by many foreign companies, the following transactions in respect of Indian assets should also not be regarded as transfer for the purposes of capital gains under section 47:

(a) amalgamation of a foreign subsidiary with foreign parent company;

(b) transfer by a foreign parent company to a wholly owned foreign subsidiary;

(c) transfer by a wholly owned foreign subsidiary to its foreign parent company;

provided that such transfer does not attract tax on gains in the country in which the transferor company is incorporated.

26. Capital gains not to be charged on investments in certain bonds - Section 54EC

Placing limit of Rs.50 lakhs per investor per year is a restrictive step, more so when the funds collected shall be available for infrastructure needs of our country. It is, therefore, suggested that the proposed amendment may be withdrawn.

Carry forward of losses

27. Carry forward of business loss on amalgamation - Section 72A

The benefit of set-off under section 72A should be available to the amalgamated company in all amalgamations, and not merely to those specified companies.

28. Additional conditions under section 72A

Both the conditions in section 72A(2)(a) for the amalgamating companies are unworkable, and in fact, they are also capable of manifold interpretations. In fact, these conditions may not serve the purpose for which section 72A is introduced. Therefore, these conditions under section 72A(2)(a) should be deleted w.e.f. 1-4-2004.

29. Condition regarding holding fixed assets

The condition should not be applied, if fixed assets of the amalgamated company are destroyed due to flood, fire or action by an enemy or any other natural calamity.

30. Amendment to section 72A - Carry forward and set-off of losses in amalgamation

The benefit of continuation of allowability of brought forward business losses may be allowed to amalgamation of all types of banks.

The scope of section 72A may be expanded to cover all companies in the service sector.

31. Section 73 – Explanation

Explanation to section 73 may be omitted.

Chapter VI-A Deductions

32. Income tax - Section 80-IA

A good amount of investment on power projects (generation & distribution) is under planning /execution stage. The completion time limit needs to be increased from 31.3.2010 to 31.3.2015 so as to facilitate sizable investment in this sector.

33. Section 80-IA(4)(iii)/ 80-IAB (second proviso)

1) Even if the operation and maintenance is transferred, it may be clarified that the benefit shall be available to the developer for income arising from development activity.

2) The developer should get the benefit in respect of its rental income from the lease, irrespective of whether the income is assessed as income from house property or as profits of business of the developer.

34. 80-IA benefits to cross country natural gas distribution network

The benefit under this section may be extended to cover distribution networks in case of all energy fuels.

35. Section 80-IA

Oil and Gas Exploration and Production industry may be given 'Infrastructure' status and the benefits of Section 80-IA may be extended accordingly.

36. Section 80IA(4)(iv)(c) - Substantial expansion by the undertaking

The Explanation to section 80-IA(4)(iv) (c) may be suitably modified with retrospective effect from 01.04.2005 to clarify that substantial renovation and modernization shall mean the relevant capitalization.

37. Sub – section (12A) of section 80-IA

For the reasons explained in the detailed suggestion sub-section (12A) may be omitted;

Further, the scope of sub-section (12) may be expanded in the following manner:

- By including all forms of corporate restructuring, in line with the spirit of Board Circular Letter F. No. 15/5/63-IT (AI), dt. 13-12-1963 ; and
- By specifically providing that in the year of such corporate restructuring, the benefit shall be available to transferor entity up to the date of transfer.
- To address the concern of possible misuse, a proviso may be added to sub-section (5) to provide that the word "assessee" as used therein shall include successors in business also.

38. Section 80-IA(13)

The correct reference is “clause (iii) of sub-section (4)”. The provision may be accordingly amended.

39. Section 80-IB (10)

The absolute limit of 2000 sq. ft. may be deleted. This amendment may be made effective 1.4.2005.

40. Section 80-IB – Hydrocarbon sector

Undertakings engaged in exploration, extraction, production or refining of mineral oil should also be given the option of claiming tax holiday in respect of 100% of its profits for 10 consecutive years at any time during the first 15 years after the commencement of commercial production.

41. Section 80-IB (11A)

For the words “processing, preservation and packaging” the words “‘processing and packaging’ or ‘preservation and packaging’” may be substituted.

These amendments may be made effective 1.4.2005.

42. Special provisions in respect of industrial undertakings in certain special category States - Section 80-IC

The law may suitably be amended to bring out clearly that for the purposes of the grant of the benefit the initial year will be the year in which the production is commenced as a result of such substantial expansion.

43. Section 80C

Section 80C may be amended to increase the limit of deduction available from Rs.1 lakh to Rs.2 lakhs with a condition that an amount of Rs.1 lakh should be invested in shares of companies belonging to infrastructure sector.

<u>Double taxation avoidance</u>

44. Entitlement to avail DTA benefit - Section 90

The term “liable to tax” should be defined in Act (in section 90 and 91) to say that there should be tax laws in force in the other State, which provide for taxation of such person (i.e. being a “taxable subject” in that country), irrespective that such tax laws fully or partly exempt such person from charge of tax on any income in any manner.

45. Foreign tax credit to permanent establishments of foreign branches Section 91

The Act should contain enabling provisions allowing credit to a foreign company / its PE for taxes paid in other countries on incomes received by it from a third country and taxable in India. This provision can be beneficially used in the absence of such treaty or such provision in the Treaty.

46. Procedure for granting tax credit available under DTA - Section 91

Suitable amendment may be made in the Act requiring that rules in this regard may be prescribed. CBDT may, in its turn, formulate appropriate rules to provide the necessary documentation in connection with the claim and grant of credit for foreign tax paid by Indian companies.

<u>Transfer pricing</u>

47. Section 92B(1) - Transactions between an Indian entity and a Permanent Establishment (PE) of a Foreign associated enterprise

Such transactions should be excluded from the transfer pricing regulation.

48. Section 92C(1) - Absence of a residuary transfer pricing method

The law should permit the application of any other pricing method [including those specified by the OECD Guidelines], the results of which are in accordance with the arm’s length principle. Transfer pricing rules of most countries (like US, UK, etc) contain a similar residuary clause under which non-specified transfer pricing methods are permitted to be used by the taxpayer.

49. Proviso to section 92C(2) - Application of [+/-] 5% range

It has been the practical experience in the past five years of transfer pricing operation in India that there always remain un-adjustable/unquantifiable material differences between finally selected comparables and the assessee. This is true in case of comparables adopted by assesses in their transfer pricing documentation as well as final comparables applied by Transfer Pricing Officers (TPOs) during audits. Accordingly, it is recommended that the arm's length price and 5% range should be replaced by the arm's length inter-quartile range.

Further, in case a single representative point within the range is sought to be identified from the various points in the range (for audit adjustment purposes), it is suggested that the "mean" should be replaced by the "median", since the median is a better statistical representative of a sample.

Alternatively and without prejudice to the above suggestion, if the current provisions of arm's length price with a 5% range are retained without any change, it is recommended that instead of the "mean", the "median" should be used to determine the arm's length price in the proviso to Section 92C(2) of the Act.

50. Second proviso to section 92C(4)

The second proviso to section 92C(4) may result in tax loss to the foreign associated enterprise to the extent of withholding tax charged by India on the transfer pricing adjustment amount. This goes against the basic intent of avoidance of double taxation as set out in the corresponding adjustment clause of the respective DTAA.

51. Section 92CA - Time limit for issuing notice under section 92CA(2)

A time limit for issuing a notice under section 92CA(2) may be introduced, so that there is sufficient time for completion of transfer pricing assessments.

52. Applicability of transfer pricing documentation/ compliance requirements (sections 92D, 92E) in cases where the charging provision is not triggered

The law may clarify that if the charging section is not attracted, compliance sections would also not be applicable.

53. Section 92C - Data for comparability analysis

Relevant clarifications may be incorporated in the rules that clearly allow the taxpayer the flexibility to use past years' data for margin analysis, based on the business and industry situation applicable to it taking into account business/ economic factors discussed in the suggestion. Similarly, taxpayers' average results (including past 2/3 year results) may be compared with the results of comparables, for a more robust analysis.

A clarification may be provided in the rules with respect to the number of years of data which could be used by taxpayers for economic analysis [Rule 10(1)] vis-à-vis number of years data to be considered purely for the purposes of comparability analysis/selecting comparables [Rule 10B(4)].

During audit proceedings, TPOs should be permitted to use only data as available with the taxpayers at the time of setting their prices/ preparing the documentation.

If the TPOs use current year data of comparables to determine the arm's length price, it is suggested that TPOs/ taxpayers must then do a comprehensive, structured fresh search for functionally comparable companies using data as is available during the audit proceedings instead of a mere updation of numbers for companies selected using past year data or simply adding/ deleting companies to/ from such comparables set. This would at least lead to a complete industry representative set being used for analysis.

54. Conducting a fresh search/economic analysis during assessment proceedings

Conducting a fresh search/economic analysis based on information currently available but not available at the time of determining the arm's length price is not the intent of the Regulations and is practically impossible.

Therefore the TPOs should also use the same data as was available to the assessee at the time of preparing the documentation. This should be clearly laid out in the Rules.

55. Rule 10B - Application of Cost Plus method

The 'direct and indirect cost of production' may be replaced by direct cost of production which could be defined to mean costs incurred on account of raw material price, related taxes and change in stocks in case of manufacturing companies and manpower cost in case of service companies. Such costs can be easily identified from audited financial statements of comparable companies.

56. Application of Profit Split Method (PSM)

Appropriate flexible criteria for determining the relative contribution of each entity may be provided in the Rules. For example, the US transfer pricing rules allow the use of cost of developing the intangibles and all related updates and improvements or actual expenditure/ cost incurred by each entity to determine relative contribution and split profits. Some element of guidance in the Rules permitting alternative criteria (including internal contribution analysis undertaken by taxpayers) that reflect arm's length dealings would assist in the practical application of this method.

57. Tested party concept

The "tested part" concept may be explicitly included in the regulations in line with global practices in this regard. This would result in more clarity on selecting the party whose profits and prices from an international transaction must be tested and would also accord support to the use of foreign databases in case of an overseas tested party.

58. Attribution of profits to Indian Permanent Establishments (PE)

In view of the fact that the law allows the application of transfer pricing principles for determining the profits attributable to an Indian PE of a non-resident, it is suggested that in all cases involving the attribution of profits to the business activities carried out in India by a non-resident, transfer pricing principles should be applied.

59. Penalty

Appropriate clarifications may be issued providing circumstances in which the assessing officer should invoke penalty proceedings under Section 271(1)(c) on the basis of a transfer pricing adjustment.

As the transfer pricing law and its application is subjective and open to various judgmental issues, it is suggested that the penalties for transfer pricing adjustments should be lower. For example, the US transfer pricing regulations prescribe a 20%-40% penalty for transfer pricing related defaults. The transfer pricing law and its application entails subjectivity and in view of this, a reasonable rate of penalty along with the some degree of flexibility in its application (as provided in the US Laws) should be introduced.

Further, it is suggested that there should be only one penalty for failure to keep and maintain information and documents in respect of international transactions. Further, some guidance should be issued relating to the circumstances in which such penalty may be levied.

60. Applicability of transfer pricing regulations in respect of transactions like loans/ royalties/ technical collaborations entailing less than arm's length consideration

Where any services/goods/property are provided at concessional or NIL value by a foreign company to the Indian company, it should be provided that the foreign company would not be taxed (if the foreign company is taxable in India in respect of the transaction) on the basis of arm's length price. It is also suggested that such transactions should be specifically excluded from the ambit of the legislation.

61. Use of confidential competitor information

There should be appropriate amendments in law requiring that confidential competitor information not available in the public domain should not be used for the purpose of computing arm's length price of the international transactions of the taxpayer with associated enterprises.

Further and without prejudice to the above suggestion, if any information sought under section 133(6) is sought to be used by the TPOs, the TPOs must be instructed to conduct a complete functional, asset and risk analysis in respect of the transactions in order to ensure appropriate comparability and proper analysis

62. Absence of Advance Pricing Agreement (APA) mechanism

Comprehensive procedures should be incorporated in the Act, under which taxpayer may obtain APAs from the Indian tax authorities. Adequate effective mechanisms should also be in place for negotiating bilateral and multilateral APAs.

63. Concept of intentional set-off

The transfer pricing rules should contain guidance on the issue of intentional set-off and also provide considerations (including documentation) to be fulfilled by taxpayers for claiming such set-offs.

64. Taxation of Income of Non-residents – Sections 115A, 115AB, 115AC, 115ACA and 115AD

The above said provisions may be consolidated and a uniform tax rate may be provided in respect of all types of income earned by all the non-residents.

MAT

65. Deduction of depreciation or loss

The explanation that depreciation does not include loss should be deleted and brought forward loss as per books should be allowed to be deducted.

66. Oil exploration and production

Oil exploration and production companies should be exempted from MAT to promote this sector.

67. Section 44AB / 115JB

It may be clarified that provisions relating to

(i) tax audit report under section 44AB;

(ii) MAT under section 115JB;

(iii) Transfer Pricing

shall apply only to the payer and not to the recipient of presumptive income under section 115A/DTAs except that they shall be subject to such provisions where the assessee is taxable on net-basis.

68. Scope of exemption from MAT

It may be clarified that the exemption from MAT to a "developer" is available in respect of income arising from an undertaking or enterprise engaged in

(a) developing a SEZ,

(b) developing and operating a SEZ and

(c) developing, operating and maintaining a SEZ.

69. Section 115JB(6)

It may be clarified that the relevant income of entrepreneur or developer mentioned in section 115JB(6) shall be excluded while computing book profit under explanation to section 115JB(2).

70. Long term capital gains

It may be provided that MAT paying corporate aseessees who are hit by the amendment in section 115JB would be entitled to the credit of STT as tax paid.

71. Section 115JB – Deferred tax (MAT)

There is a doubt whether debit to profit and loss account of deferred tax is liable to be added back, whether as part of "income –tax paid or payable and the provision therefor" or "as amount or amounts set aside to provisions made for meeting liabilities other than ascertained liabilities".

This issue may be suitably clarified.

<u>Corporate dividend tax and deemed dividend under section 2(22)(e)</u>

72. Bringing tax on deemed dividend under section 2(22)(e) on par with the corporate dividend tax

In order to bring parity between the various items of deemed dividend mentioned in section 2(22) it is suggested that dividend chargeable in the hands of the beneficial shareholders under section 2(22)(e) should also be charged at the rate of 12.5%.

73. Section 115-O(6) - Dividend Distribution Tax

Section 115-O(6) may be amended to provide the mechanism for computation of dividend which will be exempt from dividend distribution tax.

74. Credit of dividend distribution tax in case of inter-corporate dividends – Section 115-O

On the lines of the erstwhile section 80M, credit may be made available to the holding parent company, of the proportionate dividend distribution tax paid by subsidiary companies, against their own dividend distribution tax liability at the time of payments of dividends to shareholders. This will prevent economic double taxation of the same income, once in the hands of the subsidiary company and again in the hands of the parent company, and will promote a holding company regime facilitating downstream investments by them in India.

75. Section 115-O

The payment of dividend by a wholly owned subsidiary to its holding company both being tax residents of India is akin to a pass through transaction and logically dividend distribution tax should only be levied when the holding company declares dividend to its shareholders.

Fringe Benefit Tax – General principles

76. Chapter XII-H

Option to prove lesser fringe benefits

It is suggested that the provisions of FBT may be suitably modified and an option may be provided on the lines given under section 44AD, 44AE, 44AF to the effect that in the case of those employers who claim that the fringe benefits extended by them to the employees are less than what is computed under the deeming provision the employer should maintain the accounts for such expenditure and get the same audited.

Threshold limit

Presently, this provision applies to all persons other than individual and HUF falling within the definition of the term “employer” and there is no threshold limit. This tax is payable by small firms and companies. Though such firms and companies may have employees where none of the employee's income may be more than the amount not chargeable to tax. Further, there may be many employers whose liability will be very minimal and it may not be cost effective to collect FBT from such persons. It is suggested that a threshold limit should be prescribed.

Average rate of tax

Further, the rate of tax of 30% may not be justified as income of all the employees may not fall in the tax bracket of 30%. As clarified in the circular dated 29th August, 2005, FBT is a surrogate tax being the tax of the employees to be borne by the employers and, if that be so, the tax rate applicable to the employee is an important consideration. Under the deeming fiction created under the existing provision, no distinction has been drawn in respect of the employees who are neither liable to pay tax or liable to pay tax at a lower rate or at the maximum rate of 30%. Further, with every employer it may be a normal presumption that out of the total number of employees a very few employees may be falling in the highest tax bracket and as such to tax the value of the fringe benefits at the highest tax rate may not be appropriate. To avoid this hardship and at the same time for the sake of simplicity, it is suggested that the FBT should be levied at the average tax rate of 20 per cent.

Concessional rate for professionals

As per the provisions of section 115WC(2), the value of fringe benefit in respect of expenditure incurred on conveyance, tours and travels, use of hotel, boarding and lodging is to be taken at 5% for employers like pharmaceuticals, computer software etc. The reason for giving this concession was that a large amount of expenditure is being incurred under these heads a substantial portion of which is not for employees. No concessional rate has been provided in the case of professionals. It is an admitted fact that in the case of professionals a large amount of expenditure is incurred on conveyance, tour and travel and hotel, boarding and lodging etc in discharge of their professional duties which has nothing to do with the fringe benefits provided to the employees. Accordingly, the concessional rate of 5% in respect of the specified expenditure should be extended to the professionals on the line on which the concession has been given to the pharmaceuticals and computer software industry.

<u>Exemption to those covered by presumptive taxation</u>

There are certain classes of employers who are covered by presumptive method of taxation and such employers are not required to maintain books of accounts particularly those engaged in retail trade having a turnover of Rs.40 lakhs, contractors and transporters etc. engaged in one business of plyin,g hiring or leasing goods carriage. The existing provision is applicable to all employers covered by the definition of Section 115W(a). In the absence of books of account it may not be possible to compute the value of fringe benefits liable for FBT. As such, there is a need either to exempt this class of employers or to prescribe a mechanism for the value of fringe benefits in such cases.

<u>Adjustment of income-tax against FBT and vice-versa</u>

As per the provisions of section 115WA, FBT is a tax in addition to income tax and as such this amount should be paid along with the income tax and accordingly adjustment for any excess tax paid should be allowed against FBT and vice versa. This will not only reduce the administrative work but also avoid the hardship which otherwise will be caused, as an employer may be required to pay interest in respect of liability on account of FBT and, on the other hand, there may be refund of tax under the regular income tax.

<u>Penalty for delay in filing the return</u>

As per provisions of section 271FB, a penalty of Rs.5,000 has been prescribed in case the return is filed beyond the due date of filing the return. This provision is inconsistent with section 271F of the Act, whereby a penalty for delay in filing the return is leviable only when the return is filed after the end of the relevant assessment year. It may be recalled that by the Income-tax (Amendment) Act, 1987 the provision for the levy of penalty for delay in filing the return was rationalised. Section 271(1)(a) under which a penalty was computed on the basis of each month of delay was in operation and the same was substituted by section 234A of the Act. This section continues to be there as on date as well as section 115WK which is exactly on the lines of section 234A. As such, there is already a penal provision for delay in filing the return. Thus, firstly there is no need to have a separate provision for the levy of penalty in case of delay in filing the return. Secondly, even if it is required, a penalty should be leviable only if there is a delay beyond the end of the assessment year and not before. Further, it is suggested that the penalty even in such cases should not exceed the amount of the tax involved.

Need for audit provision

The fringe benefits tax is an independent tax governed by the provisions of Chapter XII-H. There are separate provisions providing for the administrative procedures in connection therewith. Form No.3CD was amended by Notification No.8/2006 dated 10th August, 2006 whereby Annexure II was inserted to Form No.3CD containing the details to be furnished for the purpose of valuing the fringe benefits. However, it is felt that a separate provision providing for audit of fringe benefits is necessary in the Income-tax Act. Appropriate changes may also be effected in the form of audit report in Form No.3CA/3CB. The ICAI can provide relevant inputs in this regard.

77. Free Offers

The terms ‘sales promotion including publicity’ is not defined anywhere in the Act. The same may be defined.

78. Maintenance of any Accommodation in the nature of Guest House other than Accommodation used for Training Purposes

As explained in the suggestion there is a case of double taxation. Employees occupying guest houses are taxed on one hand and again the company (organisation) is also taxed under FBT. This needs to be rectified.

79. Section 115WKA – Recovery of fringe benefit tax by the employer from the employee

An amendment may be made in section 115WKA or a separate section may be introduced to specifically provide for non taxability of the recovery of such FBT by adjusting such recovery against the employer's FBT liability.

80. FBT provisions vis-à-vis provisions of section 17(2)(iii)

The provisions of clause (iii) of section 17(2) should be amended to the effect that the benefits which are chargeable to FBT will be excluded from the scope of personal taxation.

81. Scholarship

Scholarships are given to the children who excel in their education for pursuing higher education. This is also in line with the national policy of encouraging education. Misuse of exemption of scholarship could be easily avoided by providing a ceiling under section 10(16). Alternatively any sum paid beyond a ceiling per student may be brought under FBT. This is essential to ensure that genuine students do not suffer and only abnormal scholarships given with the objective of tax avoidance get covered under FBT.

82. Admissibility of FBT as deduction

Since FBT is also (indirectly) a tax on the income of the employee (benefits enjoyed by the employee) but borne by the employer, deduction of such FBT should be allowed in the hands of the employer. This would require removal of sub-clause (ic) to section 40(a) and a corresponding clarificatory amendment to sub-clause (ii) to section 40(a).

83. Levy of FBT on overnight stay for flight crew and in-flight services to passengers and crew

Overnight stay for flight crew and in-flight services to passengers and crew should not be liable for FBT.

84. Amendment by Finance Act, 2006

The term “a person of repute” may be suitably defined.

Issues arising out of circular No.208 of 2005

85. Question No. 50: FBT on expenditure on in-house training in training centre

Since the expenditure on food or beverages during training of employees is in the normal course of business and cannot be treated as expenditure on hospitality, it should be excluded from FBT. For the purpose, it may be clarified that the requirement that the training center should be an “exclusive” training center is not necessary. Further, it may be clarified that the training may be either “owned” or “hired” (whether taken on temporary basis or otherwise).

86. Question No. 51: FBT on expenditure on in-house training

It is suggested to clarify that expenditure on food and beverages during in-house training is not included in the expression ‘conference’ and accordingly, such expenditure would be excluded from the scope of FBT.

87. Question No. 56: FBT on expenditure on conference vis-à-vis business convention

It may be provided that expenditure on conference intended for publicity or sales promotion would be covered under clause (D) of section 115WB(2) and shall not be liable to FBT.

The terms “conference” and “business convention” may be defined to bring in more clarity.

88. Question No. 82, 83, 84 : FBT on perquisite by way of motor car

The implication of financial lease and operating lease may be taken into account as explained in the suggestion.

89. Depreciation on motor cars

Depreciation for purposes of FBT should be the depreciation on the individual assets subject to FBT and computed as per accounting standards.

90. Question No. 87: FBT on salary to driver for motor car or pilot for aircraft

Distinction should be made between "salary" paid to an employee who serves as a driver or pilot vis-à-vis amount paid for the services of a driver or pilot. The former should not be treated as part of expenditure on motor car or aircraft, as the case may be.

91. Question No. 90: FBT on telephone installed in office

Expenditure for use of telephone installed in office should not be subject to FBT.

Search and seizure - Section 132

92. Assessee's explanation of seized and requisitioned assets

Where the assessee files a statement explaining the source of seized and requisitioned assets the Assessing Officer should issue an order accepting or denying assessee's statement. Such an order should be appealable under section 246A

Assessment procedures

93. Hardship arising out of the Apex Court's decision in Goetze (India) Ltd. v. CIT (2006) 284 ITR 323 (SC)

Appropriate amendments may be made to enable the assessee to get relief during the assessment proceedings by methods otherwise than by way of filing a revised return.

94. Re-alignment of due dates for filing returns

The due dates of filing the return may be revised as under :

| Assessee | Proposed due date |
|---|---|
| Non-corporate non-audit cases including salaried class | 30th June |
| Non-corporate audit cases | 31st August |
| Corporate assessees | 30th September |

95. Method of accounting and accounting standards

The Accounting Standards of ICAI may be notified under section 145(2) to be complied by the assessees.

96. The need for withdrawing section 145A in view of Accounting Standard 2 (Revised) - Valuation of Inventories becoming mandatory

The complicated computation required for complying with the provisions of section 145A will not generate any extra revenue as the impact of section 145A is revenue neutral. Hence section 145A needs to be deleted.

97. E-filing v. Explanation to section 139(9)

Provisions of the Act and the rules need amendment in view of the objectives of e-filing, particularly the ones referring to the defective return in Explanation to section 139(9).

98. Section 147 and 148

Definite procedural steps may be legislated in section 147/148 to make the procedure mandatory. This would also enable review by appellate authorities [CIT(A)/ ITAT] of the speaking order to be passed by the Assessing Officer in examining the validity of proceedings under section 148/ 147. This will have concomitant benefits on the entire assessment process.

99. Section 154

It may be clarified in section 154 itself (not withstanding Board Circular to the effect) that as long as the assessee had made the application within the time of 4 years, restriction of time limit would not apply and amendments under the section can be made even after the period of 4 years.

Also, an option may be provided to the assessee to appeal against the failure of the Assessing Officer.

100. Section 154

Suitable mechanism may be put in place in the law to facilitate filing of appeal for the reasons explained in the suggestion in the context of section 154(8).

101. Non-speaking orders

The Act may contain a procedure requiring the Assessing Officer:

(i) to state all the facts as brought on record by the assessee;

(ii) to give notice to the assessee of specific additions intended to be made and to allow reasonable time to meet his case.

(iii) to list all the case laws cited by the assessee in support of his case and giving reason(s) for not following it;

(iv) to state reason(s) for allowing lesser time to gather facts where such an application by the assessee is rejected.

This will save avoidable burden on appellate authorities.

102. Section 153C - Assessment of income of any other person

Section 153C could be amended as follows:

153C(1) Notwithstanding anything contained in section 139, section 147, section 148, section 149, section 151 and section 153, where the Assessing Officer is satisfied that any money, bullion, jewellery or other valuable article or thing or books of account or documents or assets seized or requisitioned belongs or belongs to a person other than the person referred in section 153A represents either wholly or partly income or property which has not been, or would not be disclosed for the purposes of the Income Tax Act, 1922(11 of 1922) or this Act , then the books of account or documents or assets seized or requisitioned shall be handed over to the Assessing Officer having jurisdiction over such other person and that Assessing Officer shall proceed against each such other person and issue such other person notice and assess or reassess income of such other person in accordance with the provision of section 153A.

103. Section 153C

The provisions of section 153C may be amended in such a manner that the Assessing Officer must record the reasons for his belief on the basis of the material found before initiating proceedings under section 153C.

Deduction of tax at source

104. Section 192

Section 192 may be amended to specifically provide that credit for foreign taxes on the salary is allowable to be set-off for computing the TDS obligation thereunder. As a safe guard, the certificate of accountant may be required in all such cases.

105. Section 192 read with section 80G

Section 192 was amended to allow the employer to net off, loss from house property to avoid the paper work relating to refund claims on account of interest on housing loans. Considering the above, similar amendment should be made to specifically allow the employer to consider all donations eligible for deductions under section 80G.

106. Section 194-I v. section 194J on payment for equipment hire

The scope of tax deductible under respective sections may be clarified so far as they relate to payment for use of equipment.

107. Withholding on long term lease

It may be clarified that lump sum payments for long term lease would not be covered within the ambit of section 194-I.

108. Sections 10(13A), 80GG read with section 194-I

The deduction under section 80GG has been specifically provided for furnished accommodation also. Also, tax under section 194-I is to be deducted (by specified persons) from any amount paid for use of any furniture and fittings.

Benefit under section 10(13A) should be specifically extended to include any payment made for the use of any furniture or fittings by the assessee.

109. Credit for tax deducted – Section 199

The payee should be given credit for the entire tax deducted at source by the payer irrespective of the fact whether he accounts for the entire income or a portion of the income in his books of account depending on the method of accounting followed by him.

Section 199 may be appropriately amended to take care of the situation explained in the suggestion.

110. Time limit and finality of TDS verification

A time limit for initiation/completion of TDS verification and its intimation to the assessee should be provided for in the Act.

111. Credit for TDS

Full TDS credit may be allowed to the deductee in the year in which the same is deducted and paid to the Central Government.

112. Default by deductee

While assessing the TDS return a time limit may be prescribed within which all the relevant information should be furnished either by deductor or the deductee. If the relevant information is not provided by the deductee then an appropriate penalty may be levied on the deductee.

113. Incentive to the tax deductor

The tax deductor may be given a credit of 5% of the tax deducted and remitted by him to the credit of the Central Government.

<u>Appeals</u>

114. Power to stay demand to be given to CIT (Appeals)

A specific provision may be enacted in the Income-tax Act to give power to stay demand of tax to the Commissioner (Appeals).

<u>Promoting India as a favorable 'Holding Company' destination</u>

115. Underlying tax credit

A mechanism, known as the allowance of underlying tax credit for the stream of dividend income may be adopted. In this scheme, credit is given by the country where the parent company is a resident, not only for the tax withheld at source on the dividend payout by the overseas subsidiary but also in respect of the tax suffered on distributable profits.

Underlying tax credit = Gross Dividend / Distributable Profits x Actual Tax

Paid on those profits.

The underlying tax credit may be computed, in the case of an Indian parent company receiving dividend from more than one tax jurisdiction, by aggregating the gross dividend, distributable profits and actual taxes suffered on those profits in all such jurisdiction.

This would give an incentive for the flow of funds to the parent Indian company and it would also make them more competitive. Larger availability of funds may generate increased investments by these Indian companies and a source of more taxes for the country.

It can be provided that the underlying tax credit would be granted on dividends paid by a company provided at least 10% of its shares are held by an Indian company.

116. Redressal mechanisms – MAP and AAR (Administrative reforms)

It is suggested as follows: -

a. The administrative guidelines in respect of MAP (including stay on tax demands during their pendency) should be formulated in a clearer manner and communicated to the taxpayers.

b. Efforts should be made to reduce the time in resolving disputes in consultation with the other treaty partner countries.

The Authority for Advance Rulings has only one bench stationed at Delhi. More benches of AAR may be constituted at any other place where the volume of work so justifies.

117. Net of tax arrangements – Section 248

The net effect of the amendment in section 248 is that in ‘subject to tax’ contracts, once the tax is deducted by the person making the payment, he shall not be eligible to file appeal against the said deduction, even though he does not agree with the Department’s order for deducting tax at source. In such cases, the only option left will be for the recipient to file the return of income and claim refund. This may be addressed.

# I. SUGGESTIONS FOR WIDENING THE TAX BASE AND INCREASING THE TAX REVENUE

Over the years the Government has made serious and sincere efforts to widen the tax base. Such efforts have indeed given results. There has been considerable increase in the direct and indirect tax revenues of the Government. There has also been increase in the proportion of the tax revenues as a percentage of GDP. However, we have to go a long way. The globalisation and the growth of the economy has resulted in a wider distribution of wealth over a large segment of the population. Therefore, efforts are necessary to bring in as many additional tax payers as possible. The following suggestions are intended to widen the tax base and increase the tax revenue.

1. Widening the scope of section 44AF

Section 44AF prescribes a method of presumptive taxation for retail trade. However, the term "retail trade" has not been defined in the section. The term "retail trader" is being understood in the common parlance as a person who is doing business other than whole trading or manufacturing or job work.

The scope of the above section should be widened to cover all businesses including small scale manufacturing, job workers, dabas, tailors, small restaurants, home delivery out-lets, auto spare servicing, software ancillary units and other small business whose sales, turnover or gross receipts are less than Rs.40 lakhs.

2. Persons paying VAT or service tax should file return of income

Several State Governments have passed VAT legislations. Many such legislations contain basic exemption limit. Generally, traders are not liable to VAT if their turnover does not exceed Rs.5 lakhs. Further, composition schemes have been devised by various States in respect of traders.

It is suggested that dealers who are liable to pay VAT under various

State legislations may be required to furnish returns of income wherein full details of the turnover disclosed under State VAT Legislations should also be furnished.

3. Encouraging voluntary compliance – Filing of income-tax return

Presently under the Income-tax Act there are many restrictive provisions which do not encourage voluntary compliance even at a later date. A person is required to file return of income within a period of one year from the relevant assessment year. As per the existing provisions he cannot file the return after the above-said period. The only course available in this case is to file a return where the revenue issues a notice and that too within a period of six years from the end of the relevant assessment year. It has been an accepted fact that the Revenue is not in a position to identify these persons and to identify income which has escaped assessment in this manner. There will always be cases where a person for one reason or the other has failed to file the return.

It is suggested that a provision may be introduced to allow such persons to file return of income and pay tax along with interest and such further penal interest as may be thought fit. This will encourage voluntary compliance and at the same time there will be no immunity to these persons from the provisions of law.

4. Utilisation of PAN and Bank Account Data

There is an urgent need to utilise the existing data with the Income-tax Department scientifically and to identify persons who are not within the tax net. This needs a very focussed strategy and can be initially started as a pilot project in metropolitan cities like Mumbai, Delhi, Chennai, Kolkata etc. For this purpose, a comprehensive analysis is required of PAN data, voter list and the list of bank accounts. This information should not be difficult for the banks to dig out because of the computerisation. The information obtained in respect of those accounts where PAN is available can easily be consolidated and ready information will be available about all bank accounts being maintained in the city by one PAN holder. This information can later be collated with the income tax return filed by such person. To ensure self-compliance, a column can be inserted in the return where a person is required to declare all his bank accounts with name and account number.

## II. SUGGESTIONS TO CHECK TAX AVOIDANCE

1. Information to be furnished in the Annual Information Return

Section 285BA may appropriately be amended to require information regarding the following financial transactions:

(a) Listed companies receiving share application monies exceeding Rs.1 lakh.

(b) Unlisted companies receiving share application monies exceeding Rs.50,000.

(c) Payment received by tour operators exceeding Rs.1 lakh.

(d) Information regarding Government tenders where the value exceeds Rs.10 lakhs. This information may be provided by the concerned Government Department.

(e) Sales and purchases of shares exceeding Rs.5 crores respectively in the case of day traders. This information can be filed by the concerned brokers who are dealing with the day traders.

(f) Receipt of donations by trusts or Institutions exceeding Rs.1 lakh. Such information may be filed by the concerned trusts or institutions.

(g) Educational fees paid in excess of Rs.1 lakh per annum. The concerned educational institution should furnish the relevant information to the Department.

(h) Time deposits with banks exceeding Rs.5 lakhs. The concerned banks should furnish the information.

2. Real estate transactions – Uniformity and reduction in stamp duty rates

Real estate business is an area where streamlining the tax laws would yield a large amount of revenue to the Government. It is common knowledge that much unaccounted money is involved in real estate transactions. One of the reasons for understatement of sale consideration is the high stamp duty rates levied by the various State Governments. There are wide variations in the rates of stamp duty levied by various States.

In this context, it worthy of note that the Central Government took a major initiative in the matter of implementation of State-Level VAT in India. An Empowered Committee of State Finance Ministers was formed and consensus was obtained from the State Governments for the introduction of a uniform State VAT legislation. Accordingly, a While Paper was brought by the Central Government and the various State Governments introduced VAT legislations in their respective States which conformed with the principles of State VAT enunciated in the White Paper.

In the matter of Stamp Duty rates also the Central Government can take the initiative and bring about a consensus among the State Governments for prescribing uniform stamp duty rates in accordance with a general agreement between the State Governments and the Central Government. This will go a long way in simplifying capital gains taxation and would also encourage disclosure of the correct consideration received from the transfer of capital assets.

3. Mechanism when the assessee surrenders income

Since the Settlement Commission is not having jurisdiction over the past years after the search is conducted by the Department, there should be a suitable mechanism to be drawn for those who have agreed, during the search, to surrender their income to avoid complicated verification under section 142(2A).

# III. SUGGESTIONS FOR RATIONALISATION OF THE PROVISIONS OF DIRECT-TAX LAWS

INCOME-TAX

Definitions

Income deemed to accrue or arise in India

1. Section 9(1)(i) Explanation (b)

The section provides that when the operations of non-residents are restricted to purchase of goods from India for export, no income shall be deemed to have accrued or arisen in India. The meaning of the expression "operations which are confined to the purchase of goods in India for the purpose of export" is subject to varying interpretations. There is a conflict of view in cases where the customized goods are purchased from Indian vendors and the process of customization is supervised by the buyer. In such cases disputes have been raised whether such activities of customization and supervision thereof would be covered by the expression "operations which are confined to the purchase of goods in India for the purpose of export",

An Explanation should be provided to define the activity of "operations which are confined to the purchase of goods in India for the purpose of export" i.e. whether it would include the activity of purchase of customized goods made as per the specification and with the supervision of buyer.

2. Taxability of software payments made to non-residents

The taxability of payments made for software exports is the subject matter of litigation. No definitive provision exists with respect to taxability of software exports. The definition of "royalty" in the domestic law tax treaties is being interpreted to include within its ambit licence payments for use of software even when the licence is for the use in the payers' operations and not for further duplication and sale/licence. It is fair that the interpretation of the provisions is in consonance with the OECD guidelines and international interpretations, thus eliminating prolonged litigation on this aspect. Further, Indian software exports are increasingly being marketed as proprietary software. The law needs clarification; otherwise the revenue authorities in the other countries may also treat such exports as being liable to tax.

It is suggested that an amendment may be made to provide that licence payments made for use of software for the payer's own operations (as against duplication for onward sale/licence) being payments for use of a copy-righted article are outside the ambit of the definition of "royalty" as provided in section 9(1)(vi).

Exclusions from total income

3. "Annual receipts" under section 10(23C)

Under section 10(23C)(iiiad) and (iiiae) of Income-tax Act, it is provided that the income of University/Educational institutions/hospitals/ other institutions specified therein will be exempt provided they comply with the conditions stipulated therein. Also it is provided that "aggregate annual receipts" of such institutions shall not exceed the amount of annual receipts as may be prescribed. Though annual receipts have been prescribed as Rs.1 crore vide Rule 2BC of Income-tax Rules, the word "annual receipts" have not been defined in the Income-tax Act.

It is not clear as to whether:

(a) for computing "annual receipts" only the receipts of such institutions from educational/hospital activities alone are to be considered each year.

(b) Certain receipts of such institutions that are not received on annual basis e.g. receipts from sale of property, equity shares and other proceeds on divestment are to be excluded from the computation of "annual receipts"

(c) In certain cases where such charitable institutions receive donations in the form of land, equity shares, bonds, donations in kind etc. whether "annual receipts" would exclude such receipts since they are not received annually.

It is suggested that "annual receipts" be clearly defined as income of the hospitals/ educational institutions arising regularly/every year but excluding value of donation received in kind by way of shares, other movable assets, land, hospitals/educational equipment, sale consideration received on disposal of land, shares or other movable property, hospital/educational equipment etc.

Further, it may be specifically provided that donations received towards corpus by way of land, shares or other movable assets are excluded from computation of “Annual Receipts” as prescribed under Rule 2BC of Income-tax Rules.

The present limit of Rs.1 crore may also be increased to Rs.5 crores

4. Defining “services” in section 10AA

Section 10AA grants deduction in respect of profits and gains derived, inter alia, from services provided from units in SEZ. Section 10AA does not define the word “services”. However, there is specific reference to “computer software” as forming part of definition of “services” in the provisions relating to computation of deduction under section 10AA [viz. in sub-section (7) and in definition of “export turnover” given in Explanation 1].

Deduction in respect of computer software is presently available under section 10A. The extended definition of “computer software” read with the notification SO 890(E) of Sep. 26, 2000 includes Information Technology Enabled Services [ITES] such as back-office operation, call centers, content development and animation, data processing, engineering and design, geographic information system services, human resource services, insurance claim processing, legal database, medical transcription, payroll, remote maintenance, revenue accounting, support centers and web-site services. Further, deduction in respect of film software and television software as defined in section 80-HHF was allowed upto A.Y. 2004-05.

The scope of “services” intended to be covered for purposes of conferring benefit under section 10AA has not been specified. The word “services” has a specific meaning assigned in clause (z) of section 2 of the SEZ Act to mean such tradable services which are notified by the Central Government and which earn foreign exchange. The said definition cannot be used for purposes of section 10AA of the

Act unless there is mandate to that effect in the section. By implication, an entrepreneur is entitled to deduction of income earned from providing all such services which a unit in SEZ can possibly carry-out in an SEZ.

Section 10AA should be amended to define the intended scope of “any services” referred in section 10AA.

Computer Software (as defined in section 10A), ITES (on the lines covered by the notification), film software and television software (as defined in section 80-HHF) may be defined as being included in “services”

5. First proviso to section 10AA

The first, second and third provisos to section 10AA fall after its sub-section (3). The first proviso refers to “deduction referred to in this sub-section”. However, sub-section (3) does not refer to any “deduction”.

The reference should be: “deduction referred to in this section”

6. Concessional tax treatment to foreign sourced dividend income

Whereas dividends earned by Indian residents from Indian companies is tax-exempt under section 10(34), the same income when earned from foreign companies is subject to the full tax rate of 30% (plus applicable surcharge and education cess) in the hands of Indian corporations. This acts as a big barrier to India becoming a favorable holding company tax regime.

In order to correct the situation, it is suggested that a concessional tax treatment be accorded to foreign sourced dividend income by subjecting it to tax in India at the same rate as the dividend distribution tax levied on Indian companies paying dividends to their shareholders.

Income from salaries

7. Proviso to section 17(2)(iii) and FBT on ESOPs

Section 17(2) (iii) stipulates that “perquisite" includes the value of any benefit or amenity granted or provided free of cost or at concessional rate by an employer.

However, proviso to sub-clause (iii), excludes therefrom the value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under any Employees' Stock Option plan or Scheme of the company, offered to such employees in accordance with the guidelines issued in this behalf by the Central Government. This proviso has been omitted w.e.f. April 1, 2008.

Simultaneous with the above, clause (d) has been inserted in sub-section (1) of section 115WB to subject ESOPs to FBT. ESOPs granted under Schemes which are not compliant with the Central Government Guidelines are taxed as perquisites. There is no clear policy statement to the effect that ESOPs henceforth shall not be subjected to tax as perquisite in the hands of the employees.

It appears that one may take inference of legislative intent of subjecting ESOPs to FBT and not tax the same as perquisite, but the issue remains regarding ESOPs which are not covered by section 115WB(1)(d).

It is suggested that it may be clarified that ESOPs would not be taxable as perquisite in all cases.

8. Clause (v) of proviso 17(2)(vi) of the Income-tax Act, 1961

The sum paid for the benefit of employees or any member of his family in respect of expenditure actually incurred by the employee on medical treatment (other than that mentioned in clause (i) and (ii) of the proviso in which cases no perquisites arises) is not a perquisite up to a limit of Rs.15,000/-. This limit was increased from Rs.10,000 from the AY 1998-99. Almost nineteen years have passed since the limit was last increased.

In view of increased cost of medical facilities the limit needs to be increased suitably.

Profits and gains of business or profession

9. Depreciation – section 32

The depreciation on plant and machinery was allowable @ 25% under the Income-tax Act upto the A.Y. 2005-06. The depreciation on plant and machinery in the earlier years was used to be @ 33%. However, during the A.Y. 2006-07 the rates of depreciation have been reduced to 15% from the level of 25%.

Keeping in view the huge investments planned, it is essential that the rates of depreciation are revised back to 25% from the existing depreciation rates of 15%. This will help in financing the part of the cost of the project.

10. Depreciation – Air pollution equipments

Refineries have to invest in air and water pollution equipment and energy conservation equipment to meet various statutory requirements and social obligations. These items were eligible for a depreciation of 100% which has been reduced to rates ranging between 40% and 80% as per notification dated 27.9.2002.

As the capital investment in new technology and equipments for controlling damage to environment is increasing, a reduction in depreciation rate would prevent the corporates from embracing new and more effective technology. It is suggested that the depreciation allowance of 100% for these selected equipments may be reinstated.

11. Section 32 – Computer peripherals

The term computer for the purpose of claiming tax depreciation has not been defined. Accordingly there is a dispute on claim of tax depreciation on computer peripherals which cannot work without being attached to the computer.

Computer peripherals being an integral part of the computer devices should specifically be included in the definition of computer.

12. Section 32 - Depreciation in case of slump sale

The proviso to section 32 provides that the aggregate deduction, in respect of depreciation of buildings, machinery, plant or furniture, being tangible assets or know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature, being intangible assets allowable to the predecessor and the successor in the case of succession referred to in clause (xiii) and clause (xiv) of section 47 or section 170 or to the amalgamating company and the amalgamated company in the case of amalgamation, or to the de-merged company and the resulting company in the case of de-merger, as the case may be, shall not exceed in any previous year the deduction calculated at the prescribed rates as if the succession or the amalgamation or the de-merger, as the case may be, had not taken place, and such deduction shall be apportioned between the predecessor and the successor, or the amalgamating company and the amalgamated company, or the de-merged company and the resulting company, as the case may be, in the ratio of the number of days for which the assets were used by them.

An issue arises whether depreciation can be claimed on the basis of proportionate number of days by the transferor and the transferee company in case of slump sale considering the proviso to section 32 read with section 170 of the Act.

Section 32 may be amended to clarify the legal position.

13. Investment allowance

The investment allowance was allowed to the assessee @ 25% of the value of plant and machinery installed upto 31.3.1988. Thereafter, the provision of investment allowance was withdrawn. The Indian economy is growing at a very fast rate. To keep pace, it needs huge investment in infrastructure.

It is suggested that the investment allowance may be re-introduced as an incentive so as to facilitate faster growth.

14. Section 35D

As per the law pronounced by the courts on the subject, the expenses incurred for raising additional capital do not qualify for deduction (being held as capital expenditure) in computing business profits except under section 35D, which allows a staggered deduction over five years in very limited circumstances where the expenses are incurred before the commencement of assessee's business or in connection with expansion of his industrial undertaking.

The purpose of raising additional capital, being the broadening of capital base for increasing investment requirements of the business, is the same even where it does not fall within the conditions prescribed under section 35D. Further, a company that raises money by a large initial public issue is in a more advantageous position than the one which phases its public issues over a period of time.

The expenses on raising additional capital may be allowed over a reasonable time period, say 3 to 5 years, even in cases not covered by section 35D. Alternatively, section 35D may be amended to allow deduction of expenses on raising additional capital in all cases.

15. Section 36(1) (viia)

Provision for NPA is allowed to foreign banks as a deduction subject to a ceiling of 5% of total income. On the other hand Indian banks are eligible for deduction in respect of provision not exceeding 7.5% of income and an amount not exceeding 10% of the aggregate average advance made by its rural branches.

There is differentiation in the tax treatment for Indian and foreign banks resulting in lack of level playing field. The law should be amended to provide for deduction to foreign banks upto 7.5 % of the total income.

16. Section 36(1) (viii)

Section 36(1)(viii) provides for deduction (upto certain prescribed limits) in respect of any special reserve created and maintained by:

- financial corporation which is engaged in providing long-term finance for industrial or agricultural development or development of infrastructure facility in India, or
- public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes.

  It is suggested that asset reconstruction companies (ARC) should be eligible for deduction under section 36 (1)(viii).

17. Section 40a(ia)

Section 40a(ia) was inserted by the Finance (No. 2) Act, 2004 to provide that the expenditure on interest, commission, brokerage, fee for professional services, fee for technical services payable to a resident or amount payable to a contractor or sub-contractor shall not be eligible for deduction while computing profits and gains of business or profession in case tax was deductible at source and the same has not been deducted or after deduction has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under sub-section (1) of section 200. The above amendment was introduced to ensure compliance with tax deduction at source provisions. The above amendment has caused a lot of hardship to the taxpayer. The objective of enforcing compliance with TDS provisions can still be achieved if the proviso below section 40(a)(ia) allowing deduction in the year in which payment is made is modified by providing rectification in that very assessment year to which the expenditure pertains instead of the year in which TDS is paid. It may be pointed out that the present proviso allowing deduction in the subsequent year in which TDS is paid has not taken into consideration the situation where the deductee has filed return of income and has paid tax thereon. No deduction of tax at source can be made by the deductor and the deductor is not liable in such an eventuality to deposit the amount of the TDS. In such a situation there will be a permanent disallowance which is not the intention of the section 40(a)(ia). The above fact gets further supported by section 191 which provides that

"Where income tax has not been deducted in accordance with the provisions of this Chapter, income tax shall be payable by the assessee direct".

Further explanation below section 191 also makes it clear that recovery of tax under section 201(1) in case of failure to deduct tax at source can be made only when such tax has not been paid by the assessee direct.

In view of the above provisions of the Act, it is suggested that the proviso below section 40(a)(ia) may be deleted and a new sub-section may be introduced in section 155 allowing rectification in that very year to which the expenditure pertains to, on the assessee producing evidence of payment of the tax deducted or evidence that the deductee has included the income received by him from the deductor in his return of income and has paid tax on the income declared by him.

The above rectification will ensure compliance and at the same time will remove the hardship of income getting assessed at a very high figure in one year and getting reduced at a very low figure in the subsequent year. Further, the income assessed will always be close to the actual income and will also avoid complications of cross references to the records of earlier assessment years. This will also meet inherent contradictions as explained above in the present proviso and Section 191 of the Act.

Alternatively, the expenditure on interest, commission, brokerage, fee for professional services, fee for technical services payable to a resident or amount payable to a contractor or sub-contractor may be allowed as a deduction provided the relevant tax deductible at source has been deducted and paid before the date of filing of the return of income.

18. Section 40(a)(iii)

Any payment, which is chargeable under the head 'Salaries', if payable (a) outside India or (b) to a non-resident, is not an admissible deduction if the tax has not been paid thereon or deducted therefrom under Chapter XVII-B. Accordingly, if tax has neither been deducted nor paid thereon, the employer is subject to disallowance of such expenditure (salary). Due to the absence of the proviso on the lines as appearing in clauses (i) and (ia), the assessee may not be entitled to a deduction of such salary payment, even if tax has been deducted and paid at a later date. Deduction for such salary payment should be allowed at a later date, when the tax on such salary has been paid or deducted therefrom.

A proviso similar to one appearing in sections 40(a)(i) / (ia) of the Act should be inserted in clause (iii) so that a deduction for salary payment is allowed at a later date, when the tax on such salary has been paid or deducted therefrom.

19. Remuneration to working partners - Section 40(b)

The present slabs of 90% of first Rs.75,000/- (Rs.1,00,000/- in the case of professional firms) 60% of next Rs.75,000/- and 40% of balance book profit were fixed in the year 1992 (with effect from 1.4.1993). The firms are now being taxed as separate entities at a flat rate of 30%, which is also the maximum marginal rate applicable to an individual. The limits on allowance of salary to partners create an artificial restriction. Further, there has been inflation as well as growth in the economy over the past decade. These artificial limits on salaries to partners are acting as a disincentive for the expansion of the firms. The revenue will not lose because the remuneration paid to the partners will be taxed in their hands as business income. Moreover, a professional is subjected to the law governing the profession whereby a professional cannot form a company and has to necessarily carry on the profession in the form of a proprietary concern or a partnership firm. Further, placing restrictions on the salary paid to a working partner has been found to be one of the impediments in the growth of bigger firms of professionals which will ultimately contribute significantly to the revenue as is the case with the big business corporates.

It is suggested that the restrictive provisions on remuneration payable to partners of a firm should be deleted and the limits prescribed in the partnership deed should be allowed to prevail. Even if this suggestion is not acceptable for all firms, at least in the case of professional firms, the limits may be removed, as every partner in a professional firm is a working partner.

20. Section 40A(3) - Direct cash deposits in banks due to contractual obligations

Under section 40A(3), 20% of any expenditure in excess of Rs.20,000, if paid otherwise than by way of an account payee cheque/draft would be disallowed. In certain cases however, payments have to be made directly into bank account of the payee - for example purchase of liquor from the State agencies by the licence holders. The authorities are taking a view that such direct payments exceeding Rs.20,000 would be hit by the provisions of section 40A(3). This is causing great practical difficulties and hardship. Such situations were earlier redressed by the Assessing Officer under Rule 6DD(j). However, the same has been omitted.

There is an urgent need to exempt such direct payments into bank account of the payee arising out of genuine contractual obligations from the scope of section 40A(3). The categories of the payees in respect of whose transactions such exemption shall apply may also be stated to avoid any abuse of this relaxation.

21. Section 40A(3)/Rule 6DD

With the deletion of the erstwhile rule 6DD(j) [which provided for non-disallowance if the assessee satisfied the Assessing Officer regarding commercial exigency attending the payment in cash], even genuine and bonafide transactions are subject to disallowance. It would be useful to recall that the constitutionality of the provision was upheld by the SC in the case of Attar Singh Gurmukh Singh v. ITO (1991) 191 ITR 667 (SC) only because of the saving provision incorporated per the said rule, which now stands deleted.

Alternatively, insertion of a clause on the lines of erstwhile clause (j) is suggested in section 40A(3) itself.

The following payments may be also prescribed as exempt under Rule 6DD:

c) payment of octroi at octroi posts;

d) payments to small transport operators, or drivers, towards freight;

c) payments at public auctions;

d) other payments where the nature of the transaction is such that it is to be ordinarily paid only in legal tender.

22. Section 42

Under section 42 of the Act, the deduction for infructuous or abortive exploration expenses is not allowed till the surrender of the area though the same is generally charged off in the books of account. As a result of requirement of surrender of the area prior to the beginning of commercial production, the assessee may not able to avail deduction from taxable income, of expenses on account of abortive exploration in the year of incurring of expenditure.

It is suggested that the words "in respect of any area surrendered" may be deleted from section 42(1)(a).

23. Section 43B – Slump sale

Section 43B provides that notwithstanding anything contained in any other provision of the Act, a deduction otherwise allowable under the Act in respect of items specified in clause (a) to (f) shall be allowed in the year in which the sum is actually paid irrespective of the previous year in which the liability to pay such sum was incurred by the assessee according to the method of accounting regularly employed by him.

The section specifically does not provide for the time of claiming deduction in case of slump sale. The following issues usually arise at the time of slump sale for claiming deduction under section 43B of the Act:

- Whether the transferor company should claim deduction at the time of slump sale considering it as actual payment?

  or

- Whether the transferee company should claim deduction under section 43B when it actually discharges the obligation in respect of liabilities taken over?

The section may be amended to clarify the legal position.

24. Section 44BB – Project-wise computation

Section 44BB provides an option to the assessee to be taxed

- either on presumptive basis i.e. on a sum equal to 10% of amount specified in sub-section (2); or
- where the assessee claims his business profits to be less than such sum, on net basis subject to certain conditions [sub-section (3)].

The computation of presumptive income as a sum equal to 10% of the amount specified in sub-section (2) rules out the categorization of income based on individual projects. Article 7(2) of the OECD Model treaty gives an indication that profits are to be computed on per project basis. It is not clear from the provisions of the section whether computation as per the Article referred above is permissible. In view of the independent nature of contracts in Oil and Gas Industry and with a view to encourage the industry, the taxation on the OECD model is desirable.

Suitable amendments may be made in the section to specifically provide for such contract / project wise computation.

Capital gains

25. Section 47 - Expansion of scope

Since Indian companies may have commercial compulsions to set up overseas subsidiaries and joint ventures, many Indian companies are now investing in shares of foreign companies. Often, these foreign companies either merge with other foreign companies or demerge a division into a separate company.

Though such transactions are generally not taxable in the foreign country, in the absence of a specific provision in section 47, exchange of shares arising from such merger or demerger by the Indian parent may be regarded as a transfer liable to tax under the Indian tax laws, which govern the Indian shareholder.

Section 47 needs to be expanded to cover transfer of shares in a foreign company by a resident or domestic company pursuant to a merger or demerger abroad, provided that such merger or demerger is exempt from tax under the domestic tax laws of the foreign country in which such merger or demerger takes place.

Further, taking into account the increased globalization of the Indian economy, and consequent holding of Indian assets by many foreign companies, the following transactions in respect of Indian assets should also not be regarded as transfer for the purposes of capital gains under section 47:

(a) amalgamation of a foreign subsidiary with foreign parent company;

(b) transfer by a foreign parent company to a wholly owned foreign subsidiary;

(c) transfer by a wholly owned foreign subsidiary to its foreign parent company;

provided that such transfer does not attract tax on gains in the country in which the transferor company is incorporated.

26. Capital Gains not to be charged on Investments in certain bonds - Section 54EC

Capital Gains arising from transfer of long-term capital assets are presently exempt if such gains are invested (within a period of six months from the date of transfer) in specified bonds namely notified bonds issued by National Highway Authority of India and by Rural Electrification Corporation. The Finance Act 2007 has restricted reinvestment of gains arising from transfer of long term capital assets in specified bonds available under section 54EC to Rs.50 lakhs per investor per year.

Placing limit of Rs.50 lakhs per investor per year is a restrictive step, more so when the funds collected shall be available for infrastructure needs of our country. It is, therefore, suggested that the proposed amendment may be withdrawn.

<u>Carry forward of losses</u>

27. Carry forward of business loss on amalgamation - Section 72A

Section 72A had been restricted only to a case where the amalgamating company is a company owning an industrial undertaking. The Finance Act, 2003 has extended the benefit also to an amalgamating company which owns a ship or a hotel or is a banking company. There is no reason to deny the benefit of set-off of losses to an amalgamated company, merely because the amalgamating company does not own an industrial undertaking or is not a hotel or a banking company.

It is, therefore, suggested that the benefit of set-off under section 72A should be available to the amalgamated company in all amalgamations, and not merely to those specified companies.

28. Additional conditions under section 72A

Two additional conditions have been inserted by the Finance Act, 2003 in section 72A(2)(a) which need to be fulfilled by the amalgamating company to enable the amalgamated company to set off or carry forward the loss of amalgamating company.

Both the conditions for the amalgamating companies are unworkable, and in fact, they are also capable of manifold interpretations. In fact, these conditions may not serve the purpose for which section 72A is introduced. Therefore, these conditions under section 72A(2)(a) should be deleted w.e.f. 1-4-2004.

29. Condition regarding holding fixed assets

A further requirement is of having to hold ¾th in the book value of fixed assets of the amalgamating company by the amalgamated company for a period of five years. It may happen that fixed assets may cease to be held by the amalgamated company for no fault of the company, on account of destruction by fire, theft, etc., which would result in loss of benefit under section 72A.

It is, therefore, suggested that this condition should not be applied, if fixed assets of the amalgamated company are destroyed due to flood, fire or action by an enemy or any other natural calamity.

30. Amendment to section 72A - Carry forward and set-off of losses in amalgamation

Section 72A of the Act provides for continuation of allowability of brought forward business losses to a banking company amalgamating with a specified bank being a public sector bank. The amendment discriminates against the co-operative banks and the foreign banks and such other banks which are not public sector banks. The benefit of the section should be made available to all the banks and in effect should be extended to all amalgamations including the service sector.

It is suggested that the benefit of continuation of allowability of brought forward business losses be allowed to amalgamation of all types of banks.

It is also suggested that the scope of section 72A be expanded to cover all companies in the service sector.

31. Section 73 – Explanation

As per Explanation to section 73, in the case of companies, profit/loss arising from the business of purchase and sale of shares is deemed to be a speculation loss except in the case of finance and banking companies. As such all companies engaged in the business of share broking and doing trading of shares are deemed to be carrying on speculation business. This section was introduced to curb the practice of setting off profit from manufacturing/trading activities against share loss. But, to the corporate sector doing business as share brokers, these provisions are causing genuine hardship. Further, this goes against the intention of the Government to encourage corporatisation of the members of the recognized stock exchanges. It is also significant that the Finance Act, 2005 has recognized the principle that trading in derivatives is not speculative in nature. Against this backdrop, there is a necessity to withdraw the restrictive provisions of Explanation to section 73.

It is suggested that Explanation to section 73 may be omitted.

<u>Chapter VI-A Deductions</u>

32. Income tax - Section 80-IA

Under section 80-IA(4)(iv) the benefit is available only when an undertaking , which is set up in any part of India for the generation or generation and distribution of power if it begins to generate power at any time during the period beginning on the 1st day of April, 1993 and ending on the 31st day of March, 2010;

A good amount of investment on power projects (generation and distribution) is under planning /execution stage. The completion time limit needs to be increased from 31.3.2010 to 31.3.2015 so as to facilitate sizable investment in this sector.

33. Section 80-IA(4)(iii)/ 80-IAB (second proviso)

Initially section 80-IA was intended to grant benefit to enterprises engaged in development of infrastructure facility. Thereafter the benefits were extended to various other sectors like developers of industrial park, SEZ, etc. Under section 80-IA(4)(iii) the benefit is made available to any undertaking which develops, develops and operates or maintains and operates an industrial park or SEZ.

However, where the developer of an industrial park / SEZ transfers the operations and maintenance of the industrial park/ SEZ to another, then it appears that the benefit u/s. 80-IA is made available to the transferee undertaking and it is not clear as to whether the benefits would be available to the developer also, from income arising from development, who makes substantial investment for development of SEZ.

Generally, any development of real estate results in sale or lease transactions. However, in case of such park/SEZ, the only revenue source is lease as the sale per se is not allowed. Hence, the lease rentals should be considered as income from business in respect of such properties.

1) Even if the operation and maintenance is transferred, it may be clarified that the benefit shall be available to the developer for income arising from development activity.
2) The developer should get benefit in respect of its rental income from the lease, irrespective of whether the income is assessed as income from house property or as Profits of business of the developer.

34. 80-IA benefit to cross country natural gas distribution network

The Finance Act 2007 has extended the 10 year tax holiday to any undertaking carrying on the business of laying and operating a cross–country natural gas distribution network, including pipelines and storage facilities being an integral part of such network, subject to certain conditions.

Similar benefits are desirable for distribution networks of other energy fuels as well.

It is suggested that similar benefit may be extended to cover distribution networks in case of all energy fuels.

35. Section 80-IA – Oil and gas exploration and production

Even though partial benefits on taxes are allowed under section 80-IB(9) to the industrial undertakings engaged in the business of commercial production or refining of mineral oils, infrastructure benefits need to be extended to oil exploration and production ("E&P") activities which are of importance in terms of national economy and involve very high costs.

It is suggested that the oil and gas exploration and production industry be given 'Infrastructure' status and the benefits of section 80-IA may be extended accordingly.

36. Section 80IA(4)(iv)(c) - Substantial expansion by the undertaking

The section provides for deduction to an electricity undertaking which undertakes substantial renovation and modernization of the existing network of transmission or distribution lines. Substantial renovation and modernization has been defined to mean an increase in plant and machinery in the network of transmission or distribution lines of by 50% of the book value of such plant and machinery as on 01.04.04

In the case of electricity companies capitalization of plant and machinery require time which may span from a month to a year.

Achievement of substantial expansion can thus have various interpretations i.e. achievement of increase in plant and machinery in the network by 50% of the book value of plant and machinery as on 01.04.04 by:

Alternate I - Considering the capitalization of plant and machinery, construction of which has started after 01.04. 04. i.e. Assets capitalized out of opening CWIP will not be considered.

Alternate II- Considering the capitalization of plant and machinery done after 01.04.04 irrespective of start date of construction of the same i.e. it would include assets capitalized out of opening CWIP.

Alternate III -Considering the capitalization of plant and machinery construction of which has started after 01.04. 04 and addition made to CWIP as on 01.04.04. This would exclude the opening CWIP out of the total capitalization.

The Explanation to section 80-IA(4)(iv) (c) may be suitably modified with retrospective effect from 01.04.2005 to clarify that substantial renovation and modernization shall mean the relevant capitalization.

37. Sub – section (12A) of section 80-IA

Section 80-IA provides for deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development etc.

Sub-section (12) of section 80-IA provides that where any undertaking of an Indian company which is entitled to deduction under the said section is transferred before the expiry of the period specified therein, to another Indian Company in a scheme of amalgamation or demerger, the deductions to the extent and in the manner specified shall be available to the amalgamated or the resulting company.

It is further provided that, no deduction shall be admissible under the said section to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place.

The Finance Act 2007 inserted sub-section (12A) in section 80-IA to provide that nothing contained in sub-section (12) shall apply to any undertaking or enterprise which is transferred in a scheme of amalgamation or demerger on or after April 1, 2007.

Sub-section (12) of section 80-IA, while incorporating Board Circular Letter F. No. 15/5/63-IT (AI), dt. 13-12-1963 (which had the effect of providing that the benefit of section 84 of 1922 Act attaches to the undertaking and not to the owner thereof, and the successor will be entitled to the benefit for the unexpired period provided the undertaking is taken over as a running business) had gone a step further in diluting the benefit to the amalgamating or demerged company.

As such clause (a) of sub-section (12) is a set-back in the tax neutrality of corporate restructurings in as much as the amalgamating company or demerged company is deprived of the benefit for the year in which the amalgamation or demerger takes place.

One may note that the assets vest in amalgamated company or resulting company with effect from the Appointed Date, and the amalgamated company or demerged company is liable to pay taxes for the period from 1st day of April of the year (in which Appointed Date falls) to the Appointed Date with reference to the undertaking transferred. As such, in the year of amalgamation or demerger, the deduction for such period is not available to either of the companies. The proposed amendment, instead of addressing the grievance in the matter of tax neutrality, has withdrawn the benefit altogether.

As the benefit of deduction under section. 80-IA attaches to the “undertaking”, prima facie there does not appear to be any possibility of any misuse, more so, because of sub-section (5) thereof. Sub-section (5) provides that for the purpose of determining the quantum of deduction, the profits and gains of the eligible business shall be computed ‘as if such eligible business were the only source of income of the assessee’.

However, if it is felt that since an assessee has the option of choosing the 10 year period out of first 15 or 20 years, he may get undue advantage of set-off of losses incurred during the period till he does not choose 10 year period (by transferring the undertaking in a scheme of amalgamation or demerger to other entity - had he continued the undertaking in the old entity, the deduction would have been reduced by set-off of losses, which may not be the case after amalgamation or demerger), it would be better to plug such possible loophole only instead of withdrawing the provision altogether.

This amendment may prove to be a major set-back for merger and amalgamation activities pertaining to infrastructure sector. Merger and amalgamation, it is submitted, is a healthy trend for the consolidation and growth of Industry, and the Government should not take any retrograde step by impinging on the tax neutrality of corporate restructuring.

It is, therefore, suggested that sub-section (12A) be omitted;

Further, the scope of sub-section (12) may be expanded in the following manner:

- By including all forms of corporate restructuring, in line with the spirit of Board Circular Letter F. No. 15/5/63-IT (AI), dt. 13-12-1963 ; and
- By specifically providing that in the year of such corporate restructuring, the benefit shall be available to the transferor entity upto the date of transfer.

  To address the concern of possible misuse, a proviso may be added to sub-section (5) to provide that the word "assessee" as used therein shall include successors in business also.

38. Section 80-IA(13)

Sub-section (13) of section 80-IA refers to denial of exemption under section 80-IA in respect of SEZ notified on or after 1.4.2005 "in accordance with the scheme referred to in sub-clause (iii) of clause (c) of sub-section (4)".

The correct reference is "clause (iii) of sub-section (4)"

The provision may be accordingly amended.

39. Section 80-IB (10)

The section provides incentive for development of housing projects. One of the prescribed condition, is that the built up area of the shop and other commercial establishments included in the housing projects shall not exceed 5% of the aggregate built up area of the housing project or 2000 sq ft, whichever is less.

In large housing projects, 2000 sq. ft. may not be adequate, particularly in view of high density as may arise from restriction of maximum built up area of 1000/ 1500 sq. ft. per residential unit.

The absolute limit of 2000 sq. ft. may be deleted and this amendment may be made effective from 1.4.2005.

40. Section 80-IB – Hydrocarbon sector

The hydrocarbon sector is the backbone of the Indian economy, since the growth of the industry as a whole largely depends on the easy availability at reasonable prices of petroleum products.

Undertakings engaged in the business of exploration, extraction, production or refining of mineral oil are highly capital intensive in nature and have long gestation period and therefore, are not in a position to effectively utilize the incentives provided in the Income-tax Act in the initial years of operation.

Under the existing provision of section 80-IA, all units engaged in the infrastructure sector, namely power, telecommunication services, road, rail, bridges, ports, airports, highway projects, water supply projects, etc. have been given an option of claiming the benefit of tax holiday in a period of any 10 consecutive years out of 15 years and in some cases 20 years beginning from the year in which the undertaking starts commercial operation.

However, the tax holiday to undertakings engaged in the exploration, extraction, production or refining of mineral oil, which are also equally important for the nation's economy, has been restricted to first seven years after the undertaking commences commercial production, there being no flexibility to choose the period in which to claim the benefit.

During the initial seven year period of tax holiday, companies have large expenditure to set-off and hence actual benefit of tax holiday does not flow to them.

It is submitted that undertakings engaged in exploration, extraction, production or refining of mineral oil should also be given the option of claiming tax holiday in respect of 100% of its profits for 10 consecutive years at any time during the first 15 years after the commencement of commercial production.

41. Section 80-IB (11A)

The Finance (No.2) Act, 2004 has extended the benefit of tax holiday to an undertaking deriving profits from the business of processing, preservation and packaging of fruits or vegetables.

Notwithstanding the fact that the words 'integrated' is not used a doubt arises as to whether the conditions of "processing, preservation and packaging" are cumulative. Given the intent of promoting agro based industry, the benefit should be extended to undertakings deriving profits from the business of either 'processing and packaging' or 'preservation and packaging'.

For the words "processing, preservation and packaging" the words "'processing and packaging' or 'preservation and packaging'" may be substituted.

These amendments may be made effective 1.4.2005.

42. Special provisions in respect of industrial undertakings in certain Special Category States - Section 80-IC

Section 80IC of the Act provides for the grant of specified deduction from the profits and gains of business of an industry set up in specified areas of the country. Clauses (a) and (b) of sub-section (2) of the said section provides that the section applies to any undertaking or enterprise which has begun or begins to manufacture or produce any article or thing not being an article or thing specified in Thirteenth Schedule or Fourteenth Schedule, as the case may be, and undertakes substantial expansion beginning on the dates specified in the aforesaid clauses. The clauses as aforesaid also provide for the date upto which such activity can be taken up so as to avail the benefit.

The words "undertakes substantial expansion" is being interpreted by the department to mean that the substantial expansion should be completed within the year in which such expansion is undertaken. It would be appreciated that a substantial expansion cannot normally be completed within the same year. Such an interpretation would thus make the section inoperative for substantial expansions which take more than one year. This cannot be the intention of law.

It is therefore suggested that the law may suitably be amended that for the purposes of the grant of the benefit the initial year will be the year in which the production is commenced as a result of such substantial expansion.

43. Section 80C

Section 80C providing for deduction in respect of life insurance premium, deferred annuity, contributions to provident fund, subscription to certain equity shares was inserted by the Finance Act, 2005 w.e.f. 1.4.2006. Since then the economy has registered considerable growth. However, infrastructure is a critical constraint for the future growth. It is necessary to chanalise funds to the infrastructure sector.

It is suggested that section 80C may be amended to increase the limit of deduction available from Rs.1 lakh to Rs.2 lakhs with a condition that an amount of Rs.1 lakh should be invested in shares of companies belonging to infrastructure sector.

Double Taxation Avoidance

44. Entitlement to avail DTA benefit - Section 90

Presently, under certain treaties, a person is entitled to claim tax credit if he is 'liable to tax' in the other Contracting State.

There is lack of clarity whether the words 'liable to tax' means 'liable to pay tax' or 'liable to tax, notwithstanding exemption or concession under any incentive provisions' as per the laws governing taxation in the other contracting State. In other words, the scope of liability to tax is not defined.

The term "liable to tax" should be defined in Act (in section 90 and 91) to say that there should be tax laws in force in the other State, which provide for taxation of such person (i.e. being a "taxable subject" in that country), irrespective of the fact that such tax laws fully or partly exempt such person from charge of tax on any income in any manner.

45. Foreign tax credit to PEs of foreign branches – Section 91

Section 91 contains enabling provisions for claiming tax credit by residents for taxes paid in foreign country. The section does not contain any enabling provision by which a foreign company/its PE can claim credit for taxes paid by it (as withholding tax or otherwise) in a third country on incomes derived therefrom. In the circumstances, such foreign company / its PE is worse off than an Indian tax resident as it is denied the tax credit which a resident would be entitled to. The only recourse available to the foreign company / its PE is the non-discrimination clause contained in the treaty between India and the country of residency of such foreign company.

The Act should contain enabling provisions allowing credit to such foreign company / its PE for taxes paid in other countries on incomes received by it from such third country and taxable in India. This provision can be beneficially used in the absence of such treaty or such provision in the Treaty.

46. Procedure for granting tax credit available under DTA - Section 91

Indian companies are extending their businesses across the border and their income is subject to tax at source in other countries. Credit for such taxes paid abroad is allowed against its Indian tax liability on such foreign sourced income under section 91 or under Tax Treaties.

There are no prescribed guidelines/rules as regards the documentation required for claiming credit for such foreign tax.

Suitable amendment may be made in the Act requiring that rules in this regard may be prescribed. CBDT may, in its turn, formulate appropriate Rules to provide the necessary documentation in connection with claim and grant of credit for foreign tax paid by Indian companies.

<u>Transfer Pricing</u>

47. Section 92B(1) - Transactions between an Indian entity and a Permanent Establishment (PE) of a Foreign associated enterprise

The TP regulations include transactions between an Indian associated enterprise of a foreign company and an Indian PE of the group within the ambit of the TP code.

As Indian PEs are subject to taxation on “net-profit” basis and such transactions are actually “domestic transactions” they would not result in any cross-border transfer of profits.

Accordingly, it is suggested that such transactions should be excluded from the TP regulation.

48. Section 92C(1) - Absence of a residuary transfer pricing method

Section 92C(1) requires selection of the most appropriate method out of the prescribed five methods or any other method as may be notified by the Board.

The five methods may not be suitable in certain cases like transfer of intangibles (where it may be necessary to apply other internationally recognized methods like the discounted cash flow method, economic return method, capital asset pricing method, etc).

Further, section 92B(1) defines international transactions to include cost contribution agreements and section 92(3) requires cost apportionment/ allocation under such arrangements to be undertaken on an arm's length basis. However, none of the methods prescribed by section 92C(1) may be applicable for such arrangements.

Accordingly, it is recommended that the law should permit the application of any other pricing method [including those specified by the OECD Guidelines], the results of which are in accordance with the arm's length principle. TP rules of most countries (like US, UK, etc) contain a similar residuary clause under which non-specified TP methods are permitted to be used by the taxpayer.

49. Proviso to Section 92C(2) - Application of [+/-] 5% range

Section 92C(2) requires the determination of a single arm's length price. Where multiple comparable prices exist, the proviso to section 92C(2) requires the single arm's length price to be determined as the arithmetic mean of the prices of comparable uncontrolled transactions. Further, the proviso gives the assessee an option to adopt an arm's length price that could vary by (+/-)5% from the arithmetic mean of comparable uncontrolled prices.

The Transfer Pricing Officers (TPOs) have interpreted that the 5% flexibility as envisaged in the proviso is to accommodate cases where the value of transaction(s) falls within the stated range of the arithmetic mean.

The above interpretation implies that if the actual value of transaction falls within the tolerance band, no adjustment is required and the book value of transactions is to be considered at arm's length. Once it breaches the 5% range, the benefit of 5% is not to be allowed.

It is recommended that the concept of arm's length (mean) price and the 5% range contained in section 92C(2) should be replaced by the concept of arm's length range. The limited 5% range extended by the proviso to section 92C(2) is without any statistical force. It should be prescribed in the law that the arm's length range of margins (as contained in the OECD Guidelines as well as the UK and Australian rules) is an acceptable range of outcomes for evaluating the assessee's compliance with the arm's length standard. Alternatively, recognizing the practical reality that very close comparables may be difficult to obtain in most circumstances, it may be provided that to increase the reliability of the analysis, the inter-quartile range should be prescribed as the appropriate arm's length range (similar to the US regulation).

It has been the practical experience in the past five years of Transfer Pricing operation in India that there always remain unadjustable/ unquantifiable material differences between finally selected comparables and the assessee/ tested party. This is true in case of comparables adopted by assessees in their TP documentation as well as final comparables applied by Transfer Pricing Officers (TPOs) during audits. Accordingly, it is recommended that the arm's length price and 5% range should be replaced by the arm's length inter-quartile range.

Further, in case a single representative point within the range is sought to be identified from the various points in the range (for audit adjustment purposes), it is suggested that the "mean" should be replaced by the "median", since the median is a better statistical representative of a sample.

Alternatively and without prejudice to the above suggestion, if the current provisions of arm's length price with a 5% range are retained without any change, it is recommended that instead of the “mean”, the “median” should be used to determine the arm’s length price in the proviso to section 92C(2.)

Further, section 92C(2) read with the proviso to the section, clearly provides that at the option of the assessee, a price chosen by the assessee on the continuum of (+) 5% to (-) 5% of the mean of uncontrolled prices shall be an Arm’s Length Price (ALP) for the purposes of section 92.

Based on a plain reading of the section 92C(2) and the proviso to the section, it is clear that the option can be exercised by the assessee, and this is not subject to any conditions.

In no event does the proviso suggest that the option to use a (+/-) 5% range on arithmetic mean of uncontrolled prices would only be available when the actual transaction value falls within the tolerance band of 5%.

It is suggested that appropriate clarification should be provided on this matter, and the 5% range should be made available in all circumstances.

Further, in case the concept of a single arm’s length price with a 5% range is retained, it is recommended that the Rules provide appropriate guidance on the application of (+/-] 5% range in case of assessees/ tested parties having multiple transactions with associated enterprises, where profit-based methods are used. One scientific and practical solution for this problem could be to calculate the arm’s length prices of purchases and sales in the ratio of their book values and then compute the 5% range for all transactions with associated enterprises. Such guidance would provide more clarity on this issue.

The computation of a single arm’s length price poses many difficulties, since Transfer Pricing (TP), like all pricing matters, is not a mathematical, scientific calculation but a subjective commercial issue. Even in the real world, no two companies or transactions are exactly alike. Inspite of the best analysis, there would be unique and unquantifiable differences between the assessee/tested party and the finally selected comparables. Even a company that carries out exactly the same functions and assumes exactly the same risk as the assessee/ tested party may still earn a different price/ profit on account of unique business characteristics and differences in commercial conditions. Thus, a range of results is inevitable even where companies are comparable. The concept of a single arm's length price (with a limited/ narrow 5% range) should take into account this commercial reality.

It is on account of the above reason that the TP rules of many countries (including US, UK and Australia) provide for an acceptable arm's length range of prices. The concept of arm's length range is also recognized in the transfer pricing guidelines for Multinational Enterprises and Tax Administrators issued by the Organization for Economic Co-operation and Development (OECD Guidelines).

The OECD Guidelines recognize that on many occasions a range of equally reliable comparable figures may be produced and if the assessee's controlled transaction is within such range, its Transfer Prices should be accepted. The Transfer Pricing legislations of UK and Australia contain similar provisions. Further, the OECD Guidelines specifically mention that the use of a range may be particularly appropriate where the transactional net margin method is applied. The US Transfer Pricing code also accepts the concept of arm's length range. Further, the US rules also recognize the practical reality that in many cases it may not be possible to obtain sufficiently complete information relating to comparables, thus leading to a situation that all material differences between the tested party and uncontrolled comparables cannot be identified or quantified to make an appropriate adjustment. In such circumstances, the US TP code prescribes the use of statistical tools to increase the reliability of the analysis. The inter quartile range is an acceptable statistical tool to be ordinarily used for such purposes under the US TP code.

50. Second proviso to section 92C(4)

Second proviso to section 92C(4) states that where the total income of an associated enterprise is computed under this subsection on determination of the arm's length price paid to another associated enterprise from which tax has been deducted under the provision of Chapter XVIIB, the income of the other associated enterprises shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise. This proviso would lead to double taxation of group profits and is against the principles of natural justice.

It is suggested that this Proviso should be deleted.

Without prejudice to the above, the proviso may contain an exception for the case, where India has entered into a Double Taxation Avoidance Agreement (DTAA) with a country, which has a clause for corresponding adjustment to the profits of the Associated Enterprise for avoidance of double taxation [e.g. Article 9(2) of the India-US DTAA]. A corresponding adjustment clause in the DTAA signed by India reflects the commitment of both the countries to avoid double taxation in case of a transfer pricing adjustment.

The second proviso to section 92C(4) may result in tax loss to the foreign associated enterprise to the extent of withholding tax charged by India on the TP adjustment amount. This goes against the basic intent of avoidance of double taxation as set out in the corresponding adjustment clause of the respective DTAA.

51. Section 92CA - Time limit for issuing notice under section 92CA(2)

Presently, for issuing notice for scrutiny assessment under section 143(2), there is a time limit. Also, for passing an order under section 143(3), there is a time limit under section 153. However, no time limit is prescribed for referring a case for transfer pricing assessment by the Assessing officer to the Transfer Pricing Officer.

In many instances, the notice under section 92CA(2) is issued by the TPO when the time limit of completing the assessment (as per section 153) is about to expire. In such cases the transfer pricing assessment proceedings are conducted in a manner and time that cannot do justice to a complex issue like transfer pricing.

A time limit for issuing a notice under section 92CA(2) should be introduced, so that there is sufficient time for completion of transfer pricing assessments.

52. Applicability of transfer pricing documentation/ compliance requirements (sections 92D, 92E) in cases where the charging provision is not triggered

There are various instances where the taxpayer does not have any income chargeable to India tax. (e.g. taxpayers in pre-commencement stage of operations, etc).

In such cases, the charging section 92 is not triggered. However, the way sections 92D (TP Documentation) and 92E (Accountants' certificate) are worded, existence of an 'international transaction' with an associated enterprise results in compliance requirements, without reference to the charging section.

The law should clarify that if the charging section is not attracted, compliance sections would also not be applicable.

53. Section 92C - Data for comparability analysis

Rule 10D(4) requires the taxpayer to maintain contemporaneous transfer pricing documentation. Such documentation inter-alia comprises the comparability analysis.

Rule 10B(4) requires the comparability analysis (or choice of appropriate comparables) to be based on comparable data pertaining to the year in which the taxpayer undertakes the international transactions with associated enterprises ("current year" data). Further, the use of past two year data is permitted where such past data reveals facts which could influence the determination of transfer prices of the current year. It is worthwhile to note that the taxpayers need to have their transfer pricing analysis in place latest by the due date of filing the income tax return (in case of companies – October 31 following the close of relevant tax year).

In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle. Such an analysis may be particularly useful where as a last resort a transactional profit method is applied.

Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be used as a comparable.

Rule 10B(1) prescribes various methods and the manner of application of each method for determination of arm’s length price. However, this Rule is silent on the number of years of data to be used for applying any method to determine the arm’s length nature of international transactions. This results in subjective interpretation on the numbers of years’ data to be used for the purposes of benchmarking/ economic analysis. Presently, the TPOs apply the criteria as set out in Rule 10B(4) (for comparability analysis) for the purpose of economic analysis as well. However, this interpretation is completely against the scheme of OECD Guidelines and TP rules of other jurisdictions (like UK, Australia etc.), which allow use of multiple year data (without any specific restriction on the number of years of data) based on business, economic and industry situations applicable to the taxpayer.

During the transfer pricing audits, the TPOs have generally tested the taxpayer’s result with the use of current year data of comparable companies. The practice of using current (single) year data is based on the above interpretation of the regulations. It is worthwhile to note that where a profit based analysis is being undertaken using external databases, such databases do not contain reliable/ audited data of the current financial year, as the current year audited accounts of comparables are not filed and updated on the databases on a contemporaneous basis. The use of such data (which is not available to the taxpayer at the time of determining its transfer prices/preparing its documentation) instead of average data of the past two years, is a critical issue which has resulted in taxpayers facing significant hardships, even though they may have undertaken a thorough, contemporaneous transfer pricing analysis. The acceptability of use of data which is reasonably available to the taxpayer at the time its transfer prices are established also finds support in the OECD Guidelines.

Further, the use of current (single) year data instead of an average of past few year data (of comparables as well as the taxpayer) does not even-out product and business life cycles or specific economic conditions that may impact some companies. Generally, the Transfer Pricing Rules of most countries permit the use of multiple year data for the purpose of comparability analysis. The concept of multiple year data also finds support in the OECD Guidelines.

Further, the data to be used for comparability analysis assumes more significance in view of the rule that extends to taxpayers the limited flexibility of a 5% range around the “mean” of comparable prices.

It is recommended that relevant clarifications are incorporated in the rules that clearly allow the taxpayer the flexibility to use past years data for margin analysis, based on the business and industry situation applicable to it taking into account business/ economic factors discussed above. Similarly, taxpayers’ average results (including past 2/3 year results) may be compared with the results of comparables, for a more robust analysis.

Thus, it is recommended that clarity be provided in the rules with respect to the number of years data which could be used by taxpayers for economic analysis [Rule 10(1)] vis-à-vis number of years data to be considered purely for the purposes of comparability analysis/selecting comparables [Rule 10B(4)].

In any case during audit proceedings, TPOs should be permitted to use only data as available with the taxpayers at the time of setting their prices/ preparing the documentation.

Without prejudice to the above suggestion, if the TPOs use current year data of comparables to determine the arm's length price, it is suggested that TPOs/ taxpayers must then do a comprehensive, structured fresh search for functionally comparable companies using data as is available during the audit proceedings instead of a mere updation of numbers for companies selected using past year data or simply adding/ deleting companies to/ from such comparables set. This would at least lead to a complete industry representative set being used for analysis.

54. Conducting a fresh search/economic analysis during assessment proceedings

For the purpose of applying the margin based transfer pricing methods, it is required to compute margins of functionally comparable companies from publicly available data/ databases. These databases are updated regularly. However, the assessee can compute the margins of the comparables only from the latest available information in such databases.

The Law also recognizes the practical difficulty in using the data of the same financial year for which arm's length margins are being computed. Hence Rule 10C(1) read with sub-clause (2)(c) states that in selecting the most appropriate method, factors such as the availability of data necessary for application of the method shall be taken into account.

Further, sub-rule (4) of Rule 10D provides that "The information and documents specified under sub-rules (1) and (2), should, as far as possible, be contemporaneous and should exist latest by the specified date referred to in clause (iv) of section 92F."

From a harmonious reading of the above, data relating to financial year in which international transaction(s) has been entered into should mean data available in the financial year when the international transaction was entered into.

The above also finds support in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators issued by the OECD.

While conducting assessments, TPOs are performing fresh searches for financial information of comparable companies, as available at the time of assessment. There would be fresh updated data available in the databases, which was not available to the assessee at the time of computing the arm's length margins/prices.

One of the vital aspects of the information and documents prescribed under the legislation is that it should be 'contemporaneous'. The term, as defined in the Oxford English dictionary means something existing at or occurring in the same period of time or happening or being at the same time. It is therefore submitted that contemporaneous data should be data as available at the time when the international transaction(s) was entered into.

Conducting a fresh search/economic analysis based on information currently available but not available at the time of determining the arm's length price is not the intent of the Regulations and is practically impossible.

Therefore the TPOs should also use the same data as was available to the assessee at the time of preparing the documentation. This should be clearly laid out in the Rules.

55. Rule 10B - Application of Cost Plus Method

Rule 10B deals with the various TP methods and their manner of application. The cost plus method tests the arm's length nature of the transfer price of a controlled transaction by reference to the gross profit mark-up on direct and indirect costs of production recognized in a comparable uncontrolled transaction.

In view of the disclosure requirements in audited accounts and the absence of consistency of classification of costs by companies, it is not possible to break down costs into indirect and direct costs of production e.g. wages and salaries are not segregated as those for employees engaged in production and other employees. Therefore, the cost plus method, as it is currently defined, is practically difficult to be applied in any case.

It is recommended that 'direct and indirect cost of production' be replaced by direct cost of production which could be defined to mean costs incurred on account of raw material price, related taxes and change in stocks in case of manufacturing companies and manpower cost in case of service companies. Such costs can be easily identified from audited financial statements of comparable companies.

56. Application of Profit Split Method (PSM)

Rule 10B(1)(d) deals with profit split method and its manner of application. Under this method the combined profit arising from international transaction is split among various participating entities in the ratio of their relative contribution to such profits. The relative contribution of each party is required to be determined on the basis of functions performed, assets employed and risks assumed by each enterprise and on the basis of reliable market data which indicates how such contribution would be evaluated by unrelated enterprises.

It is worthwhile to note that the profit split method is mainly applicable for international transactions involving unique intangibles or in interrelated multiple transactions which cannot be evaluated separately.

Given the unique, intangible nature of transactions in which the PSM is applied in the first place, reliable market data for such transactions/ contributions by entities is generally/ practically not available. Therefore, it needs to be clarified or guidance needs to be given to taxpayers as to how such contributions may be measured in the profit split method.

It is recommended that appropriate flexible criteria for determining the relative contribution of each entity may be provided in the Rules. For example, the US TP rules provide/allow the use of cost of developing the intangibles and all related updates and improvements or actual expenditure/ cost incurred by each entity to determine relative contribution and split profits. Some element of guidance in the Rules permitting alternative criteria (including internal contribution analysis undertaken by taxpayers) that reflect arm’s length dealings would assist in the practical application of this method.

57. Tested party concept

Rule 10B deals with determination of arm's length price under section 92C of the Act. Sub rule (2) and (3) of Rule 10B provide the considerations for comparability of an international transaction with an uncontrolled transaction/ comparable transaction. Further, comparability requires the identification of material differences between the transaction and uncontrolled comparables and undertaking reasonably accurate adjustments to eliminate the material effects of such differences.

The tested party concept is fundamental in any transfer pricing analysis and is recognized by the OECD Guidelines and the transfer pricing rules of US. As per the US regulations, the tested party is the participant in the controlled transaction whose profit attributable to the controlled transaction can be verified using the most reliable data and requiring the fewest and most reliable adjustments. Consequently, in most cases the tested party is the least complex entity amongst transacting entities and the party which does not own valuable intangible property or unique assets that distinguishes it from potential uncontrolled comparables.

Therefore, any of the transacting party can be considered for comparison of its results with the results of uncontrolled comparables.

The transfer pricing rules however do not explicitly recognize the concept of "tested party". This results in ambiguity in (i) selecting a party for transfer pricing analysis in order to test the results in relation to unrelated enterprises, (ii) acceptance of the overseas entity as the tested party and (iii) the economic analysis conducted for such overseas tested party using foreign/overseas database.

It is recommended that the "tested party" concept be explicitly included in the transfer pricing rules in line with global practices in this regard. This would result in more clarity/ guidance on selecting the party whose profits/prices from an international transaction must be tested and would also accord strength/ support to the use of foreign databases in case of an overseas tested party.

58. Attribution of profits to Indian Permanent Establishments (PE)

A Permanent Establishment (PE) is treated as an "enterprise". Accordingly, a PE and its Head Office (HO)/ other group entities qualify as Associated Enterprises, thereby adopting the "functionally separate entity" approach for attributing profits to Indian PEs. Further, like in case of all enterprises, a PE is also required to adopt transfer pricing principles to justify the arm's length character of the profits attributed to the Indian PE.

However, Rule 10(ii) of the Income-tax Rules continues to apply other procedures for determining profits of a non-resident to be taxed in India. Such alternative procedures do not apply Transfer Pricing principles for attributing profits of non-residents liable to India tax.

Accordingly, the domestic tax law currently has two provisions that deal with the determination of profits of non-residents liable to India tax. In view of the inconsistency between these two provisions, it is possible that revenue officials may continue to apply the non-Transfer Pricing provisions (like a global formulary apportionment basis) for determining the profits liable to India tax of non-residents undertaking business in India.

In view of the fact that the tax code allows the application of transfer pricing principles for determining the profits attributable to an Indian PE of a non-resident, it is suggested that in all cases involving the attribution of profits to the business activities carried out in India by a non-resident, transfer pricing principles should be applied.

59. Penalty

Many taxpayers faced with transfer pricing adjustments have been served notices under section 271(1) (c) initiating penalty proceedings.

Given the developing nature of transfer pricing law in India, it is necessary that taxpayers following due diligence and undertaking detailed documentation/ TP studies in accordance with the relevant provisions should be considered as acting in good faith. No penalty proceedings should thus be initiated for such taxpayers.

Further, it is worthwhile to note that the quantum of penalty as per the current provisions of 100% to 300% of the tax on the adjustment amount is exorbitant.

The transfer pricing law also provides stringent and two distinct penalties of 2% of the value of international transactions, each for failure to keep and maintain information and document in respect of international transactions (Section 271AA) and for failure to furnish information or document (section 271G).

It is suggested that appropriate clarifications may be issued providing circumstances in which the assessing officer should invoke penalty proceedings under Section 271(1) (c) on the basis of a TP adjustment.

As the transfer pricing law and its application is subjective and open to various judgmental issues, it is suggested that the penalties for Transfer Pricing adjustments should be lower.

Further, it is suggested that there should be only one penalty for failure to keep and maintain information and documents in respect of international transactions. Further, some guidance should be issued relating to the circumstances in which such penalty may be levied.

60. Applicability of transfer pricing regulations in respect of transactions like loans/ royalties/ technical collaborations entailing nil/ less than arm's length consideration

The transfer pricing law applies to both transacting group companies (Indian as well as the foreign group entity). A less than arm's length/ nil consideration charged by the foreign company to an Indian entity has the effect of increasing the income chargeable to tax of the Indian company.

The imputation/ increase of consideration for such "soft" transactions (from an India tax perspective) in the hands of the foreign company would force the Indian associated enterprise to readjust/ increase the value of soft transactions, and accordingly claim corresponding allowance of expense in their tax assessment. This would result lesser revenue collection. This may not be the intent of the transfer pricing legislation since it would lead to erosion of tax base.

Such adjustments would not only require revision of many old agreements in force, but may also raise exchange control issues.

Accordingly, where any services / goods/ property are provided at concessional or NIL value by a foreign company to the Indian company, it should be provided that the foreign company would not be taxed (if the foreign company is taxable in India in respect of the transaction) on the basis of arm's length price. It is also suggested that such "soft" transactions should be specifically excluded from the ambit of the legislation.

61. Use of confidential competitor information

In certain assessments, TPOs have sought to use information provided to them by competitors of the assessee, for the purpose of computing arm's length price for the asessee's transactions. This information was provided by competitors of the assessee by way of notice issued to those competitors under section 133(6) of the Act. The information sought to be used by TPOs do not form part of the public domain and therefore, but for their enquiries made under section 133(6) would not have been known to them or to the assessee. Since such information is not publicly available information, the assessee does not have this information at the time of determining the arm's length price of the international transactions with its associated enterprises.

Sub-rule (3) of Rule 10D states that the information and documents required to be maintained under sub-rule (1) shall be supported by authentic documents and provides a list of such documents. From the very nature of the type of documents listed, it can be concluded that the comparable data (if external) should be published data and available in public domain.

The OECD Guidelines provide guidance on documentation rules and state that every taxpayer should endeavour to determine transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time of determination.

It is suggested that there should be appropriate amendments in law requiring that confidential competitor information not available in the public domain should not be used for the purpose of computing arm's length price of the international transactions of the taxpayer with associated enterprises.

Further and without prejudice to the above suggestion, if any information sought under section 133(6) is sought to be used by the TPOs, the TPOs must be required to conduct a complete functional, asset and risk analysis in respect of the transactions in order to ensure appropriate comparability and proper analysis

62. Absence of Advance Pricing Agreement (APA) mechanism

The APA process is intended to provide a framework agreement between the taxpayer and the tax administration in advance and so avoid (or reduce) the debate at the time of audit, i.e. it is in the nature of a ruling from an authority of advance rulings for transfer pricing. Almost all developed countries (including US, UK, France, and Germany etc) and many other countries (like China, Taiwan and Poland) have comprehensive set of procedures for obtaining binding "Advance (transfer) Pricing Agreements (APA)" from the tax authorities. APAs reduce uncertainty and reduce expensive litigation.

Transfer pricing regulations provide an extensive framework and lay down principles for determination of arms-length price to ensure appropriate allocation of profits in transactions between related entities. However, 'arms-length' is a very abstract concept.

It is suggested that comprehensive procedures should be incorporated in the Act, under which taxpayer may obtain APAs from the Indian tax authorities. Adequate effective mechanisms should also be in place for negotiating bilateral and multilateral APAs.

63. Concept of Intentional Setoff

OECD Guidelines on international set-offs provides that an intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions. It occurs when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced to some degree by different benefits received from that enterprise in return. These enterprises may claim that the benefit each has received should be set off against the benefit each has provided as full or part payment for those benefits so that only the net gain or loss (if any) on the transactions needs to be considered for purpose of assessing tax liabilities. The OECD Guidelines _recognize that intentional set-offs are not inconsistent with the arm's length principle and encourage taxpayers to disclose the existence of intentional set-offs to show that the results of the transactions as reported on their tax return are consistent with the arm's length principle after taking intentional set-offs into account. The concept of intention set-off is not explicitly recognized in Act/Rules.

The principle of intentional set-off contained in the OECD Guidelines is a reflection of the commercial realities based on which current businesses are undertaken.

It is suggested that the transfer pricing rules should contain guidance on the issue and also provide considerations (including documentation) to be fulfilled by taxpayers for claiming such set-offs.

64. Taxation of Income of Non-residents – Sections 115A, 115AB, 115AC, 115ACA and 115AD

Sections 115A, 115AB, 115AC, 115ACA and 115AD provide for taxation at varying rates depending upon the nature of income sought to be taxed. Examples of such income include income from royalties, fees for technical services, income from GDRs, dividends, interests, etc.

The provisions have become more complex and need to be simplified (in line with the legislature's move towards simplification of tax laws over the past few years).

All the said provisions should be consolidated and a uniform tax rate may be provided in respect of all types of income earned by all the non-residents.

MAT

65. Deduction of depreciation or loss

Provisions of Minimum Alternate Tax (MAT) have been introduced to levy tax on those companies which are having sufficient profit and are not paying any tax because of the benefits, allowances and deductions available under the provisions of the Act. The liability to pay MAT is on the book profit of the company computed in accordance with the provisions of the Companies Act, 1956. Since the objective is to tax those companies which have sufficient profit, deduction is allowed in the current year book profit of the carry forward depreciation or loss. However, in clause (iii) of Explanation below Section 115JB(2) it has been stated that loss shall not include depreciation. Further, it has been provided that the benefit of carry forward loss or unabsorbed depreciation shall not be available if either the amount of loss or unabsorbed depreciation is nil. This clause has created an unequal situation in respect of various entities which are liable to pay MAT. This explanation visualises that depreciation and loss are parallel to each other and have gone more on the principle of Section 32 whereby depreciation is considered a separate charge and for that purpose it does not form part of the loss. The reason for the same is that sub-section (2) of Section 32 stipulates that in case full effect cannot be given to any depreciation allowance under sub-section (1) in any previous year owing to there being no profit or gain chargeable for that period to the extent of the allowance to which effect has not been given, such allowance is deemed to be the allowance for the succeeding year. As per this stipulation there cannot be any loss in case of unabsorbed depreciation because unabsorbed depreciation shall become depreciation of subsequent year. In the subsequent year the unabsorbed depreciation having become the depreciation of such subsequent year, there cannot be any profit till such time such unabsorbed depreciation gets fully adjusted. As such, under the provisions of the Income-tax Act, there cannot be any profit in any year till such time there is unabsorbed depreciation as the same becomes depreciation of the current year which goes to reduce the profit of the current year. However, while computing book profit under the Companies Act, no distinction is made between the loss and the depreciation. Book loss is always computed after charge of depreciation which is invariably made by all companies. If that be so, then the loss has to include depreciation as it stands already included in the loss and is not considered as unabsorbed depreciation which can go to reduce the current year book profit. This is an important distinction which has not been considered while inserting the explanation that "the loss shall not include depreciation". Similarly, there is a reference in sub-clause (iii) in the Explanation below Section 115JB of unabsorbed depreciation. As explained above, there is no such unabsorbed depreciation under the Act.

In view of the above facts, the rationale of allowing deduction of carry forward loss or unabsorbed depreciation whichever is less is not correct on the principle that a company despite earning profit, but still because of the various allowances and rebates is not paying tax though it has capacity to pay tax. A company which has unabsorbed depreciation and carry forward loss and which has not been able to set off the same against the current year profit cannot be considered as having capacity to pay tax. The MAT provision as it stands makes the company liable to pay tax despite having huge carry forward losses as can be seen from the example below:

| BOX-1 | | | |
|---|---|---|---|
| | Company 'A' Rupees | Company 'B' Rupees | Company 'C' Rupees |
| 1st Year (i) Net Profit/Loss before depreciation as per Companies Act | | | |

| | | | |
|---|---|---|---|
| (ii) Depreciation charged in Profit and Loss A/c | (-) 1,00,000 | (-)2,50,000 | + 1,00,000 |
| (iii) Net Profit/Loss Carried | (-) 4,00,000 | 2,50,000 | (-)6,00,000 |
| 2nd Year | (-) 5,00,000 | (-)5,00,000 | (-)5,00,000 |
| (iv) Net Profit/Loss for the year before depreciation | | | |
| (v) Depreciation for the year (vi) | + 6,00,000 | (+)4,50,000 | (+)8,00,000 |
| Profit for the year (iv-v) Net | (-) 4,00,000 | (-) 2,50,000 | (-)6,00,000 |
| Profit/Loss to be | + 2,00,000 | (+)2,00,000 | +2,00,000 |
| Carried forward (iii-iv) | | | |
| Book Profit for the purpose of MAT | (-) 3,00,000 | (-)3,00,000 | (-)3,00,000 |
| | + 1,00,000 | (-) 50,000 | + 2,00,000 |

As such Company 'C' will have to pay MAT on Rs. 2,00,000 whereas Company 'A' will have to pay MAT on Rs.1,00,000 and Company 'B' will not be liable for MAT though in all the three cases net profit/loss as per Companies Act is identical. MAT should be applicable when there is actual profit as per Profit and Loss Account after adjusting carry forward loss and unabsorbed depreciation. As such both unabsorbed depreciation and carry forward loss as per book of account should be first deducted for computing book profit. Otherwise, the companies where depreciation element is low by nature of their activities such as service companies, finance companies, but making consistent losses on account of trading activities, overheads etc. will have to pay MAT in the year in which they make profit despite heavy carry forward losses as can be seen from Box 2.

Despite there being aggregate cash loss of the Rs.40,00,000, the company will be liable for MAT on Book Profit of Rs. 3,00,000.

Likewise, companies that are making nominal profit or loss before depreciation but depreciation charge being very heavy will be liable for MAT in the year in which there is net profit after depreciation irrespective of the fact of heavy unabsorbed depreciation.

The objective-levying MAT is not to charge tax from these companies that have earned profit during the year despite having carry forward losses or unabsorbed depreciation. The liability to MAT should be worked out on basis of net profit as per Profit and Loss account after adjustment of both carry forward loss and unabsorbed depreciation, not the lower of the two, so that the provisions of MAT become more equitable and simple, without making complicated adjustments of carry forward and unabsorbed depreciation.

It is suggested that the explanation that depreciation does not include loss should be deleted and brought forward loss as per books should be allowed to be deducted.

66. Oil exploration and production

Every company is required to pay minimum tax on book profits, even if it does not have any taxable profit.

For oil exploration and production companies being in high risk high capital business, the profile of profits could be erratic. Due to MAT, it ends up paying taxes in the year of profit but gets no advantage in the year of loss.

It is suggested that oil exploration and production companies should be exempted from MAT to promote mineral oil exploration and production sector.

67. Section 44AB and 115JB

There is lack of clarity whether non-residents not having a PE in India but subject to tax on presumptive or gross basis under section 115A / DTAs are subject to provisions relating to

(i) tax audit report under section 44AB and

(ii) MAT under section 115JB.

Further, the non-residents not having a PE in India but subject to tax in India on presumptive or gross basis under section 115A / DTAs are also subject to transfer pricing regulation requiring documentation and furnishing transfer pricing report.

A strict view of the matter i.e. filing of tax audit report or certificate of MAT, etc. may lead to practical difficulties (such as in getting accounts audited, engaging professionals for certification, etc. ) without any corresponding tax benefit.

It may be clarified that provisions relating to

(iv) tax audit report under section 44AB;

(v) MAT under section 115JB;

(vi) Transfer Pricing

shall apply only to the payer and not to the recipient of such income except that they shall be subject to such provisions where the assessee is taxable on net-basis.

68. Scope of exemption from MAT

Sub-section (6) of section 115JB provides for exemption from MAT to an “entrepreneur” or “developer” in respect of income accruing or arising from any business carried on, or services rendered, in a “Unit” or “SEZ”, as the case may be.

The plain reading of the provision indicates that exemption from MAT is available to a developer in respect of income accruing or arising from any business carried on, or services rendered, in a SEZ. This may be construed as not referring to income accruing or arising from any business of developing a SEZ since there can be no business carried on, or services rendered, in a SEZ prior to its development. This does not appear to be so intended.

It may be clarified that the exemption from MAT to a “developer” is available in respect of income arising from an undertaking or enterprise engaged in

(a) developing a SEZ,

(b) developing & operating a SEZ and

(c) developing, operating and maintaining a SEZ.

69. Section 115JB(6)

Sub-section (6) of section 115JB provides that provisions of section 115JB shall not apply to income accrued or accruing on or after 01-04-2005 from any business carried on or services rendered by an entrepreneur or a developer, in a unit or a SEZ, as the case may be.

It is not clear as to whether the provisions of section 115JB shall apply in the case of an assessee who also carries on any business not covered by section 10AA/80-IAB.

It may be clarified that the relevant income of such entrepreneur or developer shall be excluded while computing book profits under explanation to section 115JB(2).

70. Long term capital gains

While on one hand, by virtue of amendments made by the Finance Act 2006, tax payable on book profits has been increased from 7.5% to 10%, on the other hand profits on sale of equity shares or units of equity oriented funds (held for a period exceeding 12 months) which are exempt under section 10(38) of the Act would no longer be excluded while computing book profits under section 115JB.

The net effect of these amendments is that certain category of corporate assessees (i.e. those paying MAT on their books profits) are back to pre STT regime of 10% tax on long term capital gains arising for listed securities, STT being an additional hit.

When STT was introduced it was considered as a major shift in the regime of taxation of capital gains. The effect of the amendment is that there is virtually a roll back of benefits in case of one category of assessees, namely MAT paying corporate assessees, whereas the other assessees (corporate assessees paying tax under the regular provisions of the Act and non corporate assessees) continue to enjoy the benefits of the STT regime.

As it would be unfair to single out one category of assessees and deny them the benefit of STT regime, it is suggested that the amendment made by Finance Act 2006, be withdrawn with retrospective effect.

Without prejudice to the above, in case the said amendment has to be retained it should be provided that such corporate aseessees who are hit by the amendment would be entitled to the credit of STT as tax paid.

71. Section 115JB – Deferred tax (MAT)

Section 115JB provides for levy of minimum alternate tax on the basis of book profits of a company. Clause (a) of the Explanation to the same provides for increasing the book profits by income-tax paid or payable and the provision there for.

There is a doubt whether debit to the profit and loss account of deferred tax is liable to be added back, whether as part of "income –tax paid or payable and the provision therefor" or "as amount or amounts set aside to provisions made for meeting liabilities other than ascertained liabilities".

This issue may be suitably clarified.

<u>Corporate dividend tax and deemed dividend under section 2(22)(e)</u>

72. Bringing tax on deemed dividend under section 2(22)(e) on par with the corporate dividend tax

The Finance Act, 1997, withdrew the tax on dividend income. This was done on the ground that taxation of dividend income is double taxation. Simultaneously, Chapter XII-D was inserted by the Finance Act, 1997 w.e.f. 1.6.1997 to provide for tax on distributed profits of domestic companies. This was done to discourage companies from distributing whole of the income. Accordingly domestic companies have to pay tax @ 12.5% on any amount declared, distributed or paid by such companies by way of dividends. Explanation under section 115Q provides that for the purposes of Chapter XII-D the expression "dividends" shall have the same meaning as is given to "dividend" in clause (22) of section 2, but shall not include sub-clause (e) thereof. Section 10(33) exempts such dividend in the hands of the shareholders. Consequently, dividend coming within the scope of section 2(22)(e) is still chargeable in the hands of the shareholders but at the normal rates of tax.

In order to bring parity between the various items of deemed dividend mentioned in section 2(22) it is suggested that dividend chargeable in the hands of the beneficial shareholders under section 2(22)(e) should also be charged at the rate of 12.5%.

73. Section 115-O(6) - Dividend Distribution Tax

Sub-section (6) of in section 115-O provides that no dividend distribution tax shall be levied on the total income of an undertaking or enterprise engaged in developing or developing and operating or developing, operating and maintaining a SEZ on any amount declared, distributed or paid by way of dividend out of its current income, either in the hands of the enterprise or the person receiving such dividend.

There is no clarity as to how the exemption would be available in respect of an enterprise engaged in the SEZ activity and any other business activity.

It is suggested that section 115-O(6) may be amended to provide the mechanism for computation of dividend which will be exempt from dividend distribution tax.

74. Credit of Dividend distribution tax in case of inter-corporate dividends – Section 115-O

There is multiple incidence of dividend distribution tax on up flow of dividends from subsidiary companies to parent / holding companies. The cascading effect of such multiple incidence of dividend distribution tax acts as a barrier to the creation of a holding company regime in India and hinders downstream investments by holding companies in India.

To correct the situation, it is suggested that on the lines of the erstwhile section 80M, credit may be made available to the holding parent company, of the proportionate dividend distribution tax paid by subsidiary companies, against their own dividend distribution tax liability at the time of payments of dividends to shareholders. This will prevent economic double taxation of the same income, once in the hands of the subsidiary company and again in the hands of the parent company, and will promote a holding company regime facilitating downstream investments by them in India.

75. Section 115-O – Holding company

Section 115-O provides for levy of dividend distribution tax on dividend declared / distributed / paid by a domestic company. Dividends distributed by wholly owned subsidiary of a domestic company to its holding company are also subject to such a tax. There should be no levy of dividend distribution tax where dividends are distributed by a wholly owned subsidiary to its holding company which is also a domestic company.

The payment of dividend by a wholly owned subsidiary to its holding company both being tax residents of India is akin to a pass through transaction and logically dividend distribution tax should only be levied when the holding company declares dividend to its shareholders.

<u>Fringe Benefit Tax</u>

76. Chapter XII-H - General principles

Chapter XIIH was introduced by the Finance Act, 2005 levying tax on the fringe benefits provided or deemed to have been provided by the employer to his employees. As per the scheme, this tax is payable on deemed fringe benefits by applying the presumptive method of computing the value of the benefits. This tax is payable by all entities other than an individual and HUF, entities registered under section 12AA, and those eligible for exemption under section 10(23C) of the Act. The objective of this tax is to capture those fringe benefits which are enjoyed in common by the employees and cannot easily be identified or computed to be taxed in the hands of the employees. However, the implications of these provisions have resulted in taxing even those expenditure which may not have any direct and indirect nexus with the employees. The main reason for the same is treating all expenditure in the course of business under specified heads as fringe benefits and giving no option to the assessee to compute the fringe benefits on an actual basis. As has been stated in the objective, this tax is a tax on the fringe benefits to the employees. To avoid resentment and in some cases undue hardship to the employers who are incurring genuine expenditure in the course of business and where the expenditure has nothing to do with any fringe benefits being extended to the employees, an option should be given to the employer to compute the value of fringe benefits actually provided to the employees only. The disallowance of the expenditure if any incurred for personal purposes other than the employees can still be resorted to under section 37(1) of the Act. As regards any expenditure incurred by the employer in the course of business which results into any benefit or perquisite to a person other than an employee, the same can still be taxed under the existing clause (iv) of section 28 in the hands of the recipient rather than requiring the person who has incurred such expenditure in the course of business to pay tax thereon.

Option to prove lesser fringe benefits

It is suggested that the provisions of FBT may be suitably modified and an option may be provided on the lines given under section 44AD, 44AE, 44AF to the effect that in the case of those employers who claim that the fringe benefits extended by them to the employees are less than what is computed under the deeming provision the employer should maintain the accounts for such expenditure and get the same audited.

Threshold limit

Presently, this provision applies to all persons other than individual and HUF falling within the definition of the term "employer" and there is no threshold limit. This tax is payable by small firms and companies. Though such firms and companies may have employees where none of the employee's income may be more than the amount not chargeable to tax. Further, there may be many employers whose liability will be very minimal and it may not be cost effective to collect FBT from such persons. It is suggested that a threshold limit should be prescribed.

Average rate of tax

Further, the rate of tax of 30% may not be justified as income of all the employees may not fall in the tax bracket of 30%. As clarified in the circular dated 29th August, 2005, FBT is a surrogate tax being the tax of the employees to be borne by the employers and, if that be so, the tax rate applicable to the employee is an important consideration. Under the deeming fiction created under the existing provision, no distinction has been drawn in respect of the employees who are neither liable to pay tax or liable to pay tax at a lower rate or at the maximum rate of 30%. Further, with every employer it may be a normal presumption that out of the total number of employees a very few employees may be falling in the highest tax bracket and as such to tax the value of the fringe benefits at the highest tax rate may not be appropriate. To avoid this hardship and at the same time for the sake of simplicity, it is suggested that the FBT should be levied at the average tax rate of 20 per cent.

Concessional rate for professionals

As per the provisions of section 115WC(2), the value of fringe benefit in respect of expenditure incurred on conveyance, tours and travels, use of hotel, boarding and lodging is to be taken at 5% for employers like pharmaceuticals, computer software etc. The reason for giving this concession was that a large amount of expenditure is being incurred under these heads a substantial portion of which is not for employees. No concessional rate has been provided in the case of professionals. It is an admitted fact that in the case of professionals a large amount of expenditure is incurred on conveyance, tour and travel and hotel, boarding and lodging etc in discharge of their professional duties which has nothing to do with the fringe benefits provided to the employees. Accordingly, the concessional rate of 5% in respect of the specified expenditure should be extended to the professionals on the line on which the concession has been given to the pharmaceuticals and computer software industry.

Exemption to those covered by presumptive taxation

There are certain classes of employers who are covered by presumptive method of taxation and such employers are not required to maintain books of accounts particularly those engaged in retail trade having a turnover of Rs.40 lakhs, contractors and transporters etc. engaged in one business of plying, hiring or leasing goods carriage. The existing provision is applicable to all employers covered by the definition of section 115W(a). In the absence of books of account it may not be possible to compute the value of fringe benefits liable for FBT. As such, there is a need either to exempt this class of employers or to prescribe a mechanism for the value of fringe benefits in such cases.

Adjustment of income-tax against FBT and vice-versa

As per the provisions of section 115WA, FBT is a tax in addition to income tax and as such this amount should be paid along with the income tax and accordingly adjustment for any excess tax paid should be allowed against FBT and vice versa. This will not only reduce the administrative work but also avoid the hardship which otherwise will be caused, as an employer may be required to pay interest in respect of liability on account of FBT and, on the other hand, there may be refund of tax under the regular income tax.

Penalty for delay in filing the return

As per provisions of section 271FB, a penalty of Rs.5,000 has been prescribed in case the return is filed beyond the due date of filing the return. This provision is inconsistent with section 271F of the Act, whereby a penalty for delay in filing the return is leviable only when the return is filed after the end of the relevant assessment year. It may be recalled that by the Income-tax (Amendment) Act, 1987 the provision for the levy of penalty for delay in filing the return was rationalised. Section 271(1)(a) under which a penalty was computed on the basis of each month of delay was in operation and the same was substituted by section 234A of the Act. This section continues to be there as on date as well as section 115WK which is exactly on the lines of section 234A. As such, there is already a penal provision for delay in filing the return. Thus, firstly there is no need to have a separate provision for the levy of penalty in case of delay in filing the return. Secondly, even if it is required, a penalty should be leviable only if there is a delay beyond the end of the assessment year and not before. Further, it is suggested that the penalty even in such cases should not exceed the amount of the tax involved.

Need for audit provision

The fringe benefits tax is an independent tax governed by the provisions of Chapter XII-H. There are separate provisions providing for the administrative procedures in connection therewith. Form No.3CD was amended by Notification No.8/2006 dated 10th August, 2006 whereby Annexure II was inserted to Form No.3CD containing the details to be furnished for the purpose of valuing the fringe benefits. However, it is felt that a separate provision providing for audit of fringe benefits is necessary in the Income-tax Act. Appropriate changes may also be effected in the form of audit report in Form No.3CA/3CB. The ICAI can provide relevant inputs in this regard.

77. Free Offers

Clause (D) of section 115WB(2) provides that expenditure on sales promotion including publicity is liable to FBT. The terms ‘sales promotion including publicity’ is not defined anywhere in the Act.

The term ‘sales promotion including publicity’ may be defined.

78. Maintenance of any accommodation in the nature of guest house other than accommodation used for training purposes

Twenty percent of the amount on the above is included under FBT. This is a contradictory provision. Under Rule 3, table 1, Sl. 3, where the accommodation is provided by the employer in a hotel (except where the employee is provided such accommodation for a period not exceeding in aggregate 15 days on his transfer from one place to another) is taxed as perquisite at 24% of the salary or actual charges payable to such hotel, which ever is lower. Hotel has been defined to include guest house.

As such this is a case of double taxation. Employees occupying guest houses are taxed on one hand and again the company (organisation) is also taxed under FBT. This needs to be rectified.

79. Section 115WKA – Recovery of fringe benefit tax by the employer from the employee

As per newly introduced section 115WKA, w.e.f. 1.4.2007, the employer is authorized to vary the agreement or scheme under which specified security or sweat equity shares have been allotted or transferred directly or indirectly, so as to recover from employees the FBT in relation to value of fringe benefits provided to the employees and determined under clause (ba) of sub – section (1) of section 115WC. Such recovery merely represents the recovery of tax amount paid by the employer and not a business receipt liable to tax, however, there is no specific provision for treating such recovery as non-taxable.

An amendment may be made in section 115WKA or a separate section may be introduced to specifically provide for non taxability of the recovery of such FBT by adjusting such recovery against the employer's FBT liability.

80. FBT provisions vis-à-vis provisions of section 17(2)(iii)

Rule 3 of the Rules (providing for valuation of perquisites) was amended by the Income-tax (7th Amendment) Rules, 2005 w.e.f. April 1, 2005, presumably, with the intent of excluding from the scope of personal taxation all such benefits which are chargeable to FBT. Clause (vi) of section 17(2) was also amended by the Finance Act, 2005 w.e.f. April 1, 2005 to the effect that the Board may prescribe the value of any fringe benefit or amenity but only for such fringe benefits as are not chargeable to FBT.

The provisions of clause (iii) of section 17(2) of the Act are so worded to bring within its scope many of the fringe benefits that are chargeable to FBT (e.g. car). There is no amendment to this clause [corresponding to the amendment made to clause (vi) of section 17(2)] to exclude from the scope of personal taxation the benefits which are chargeable to FBT. No doubt, section 115WB(3) provides that the perquisites which are taxable in the hands of the employees shall not be liable to FBT. However, there is no express provision in section 17(2)(iii) of the Act which prohibits taxing perquisites in the hands of the employees notwithstanding that it is liable to FBT. Notwithstanding the legislative intent to exclude from the scope of personal taxation all such benefits which are chargeable to FBT, the bare reading of section 17(2)(iii) leaves the issue open to doubt.

The provisions of clause (iii) of section 17(2) of the Act should be amended to the effect that the benefits which are chargeable to FBT will be excluded from the scope of personal taxation.

This would avoid the unintended taxation of the benefits provided by the employer to the employee and, thus, would avoid otherwise avoidable litigation when the assessing officer attempts to tax perquisite (benefits) in the hands of the employee when the employer has already paid FBT by on

81. Scholarships

Scholarships have been brought under the ambit of FBT under 50% category. Scholarships granted to meet the cost of education is exempted under section 10(16). Since it was found that huge sums are given as scholarship, they have been brought under FBT.

Scholarships are given to the children who excel in their education for further pursuing higher education. This is also in line with national policy of encouraging education. Misuse of exemption of scholarship could be easily avoided by providing a ceiling under section 10(16) say Rs.500 to Rs.1000 PM. Alternatively any sum paid beyond a ceiling per student may be brought under FBT. This is essential to ensure that genuine students do not suffer and only abnormal scholarships given with the objective of tax avoidance gets covered under FBT.

82. Admissibility of FBT as deduction

Where the employer bears the tax liability of any employee and the salary is grossed up, the entire salary (including the tax amount) is allowable as deduction in the hands of the employer.

Since FBT is also (indirectly) a tax on the income of the employee (benefits enjoyed by the employee) but borne by the employer, deduction of such FBT should be allowed in the hands of the employer. This would require removal of sub-clause (ic) to section 40(a) and a corresponding clarificatory amendment to sub-clause (ii) to section 40(a).

83. Levy of FBT on overnight stay for flight crew and in-flight services to passengers and crew

In the airline industry, it is general practice to provide overnight stay facilities to its crew. Further, in-flight services to passengers are part of the services being provided by the companies. Accordingly no FBT should be levied on it. The issue is whether such expenditure, which is integral part of the services provided, should be subjected to levy of FBT.

Overnight stay for Flight Crew and in-flight services to passengers and crew should not be liable for FBT.

84. Amendments by Finance Act, 2006

The Finance Act, 2006 has amended the scope of FBT in the following areas :

(A) expenditure in the nature of payment to ‘a person of repute’ for promoting sale of goods or services of the employer has been excluded from the purview of FBT.

(B) expenditure on free/ subsidized transport or conveyance allowance for commuting between residence and office has been clarified as being not subject to FBT.

The term “person of repute” is an ambiguous term and would be open to multiple interpretations. Hence the term may be defined.

Issue arising out of Circular No.208 of 2005

85. Question No. 50: FBT on expenditure on in-house training in training centre

Expenditure on, or payment for, food or beverages provided by the employer to his employees in office or factory is excluded from the levy of FBT by sub-clause (i) of clause (B) of section 115WB(2) of the Act.

CBDT has clarified that an employer owning an exclusive training centre used to train its employees shall be construed as an 'office or a factory' within the meaning of the exclusion provided in sub - clause (i) of clause (B) of section 115WB(2). It has thereafter been observed that the exclusive training centre hired by the employer on a temporary basis cannot be construed as an office or a factory and, therefore, any expenditure on food or beverages provided by the employer to his employees at such training centre is liable to FBT.

"Office" is defined in Oxford (Concise) Dictionary (10th Edition) as "a room or set of rooms or building used as a place of business place for non-manual work'. In-house training of employees is part of the normal course of any organization's business. The place where such training is conducted is also an "office".

The likely intent of excluding expenditure on food or beverages provided in office or factory from FBT is that

- it does not partake the character of hospitality;
- such expenditure, incurred in normal course of business and not intended to substitute salary compensation, should be excluded.

Since the expenditure on food or beverages during training of employees is in the normal course of business and cannot be treated as expenditure on hospitality, it should be excluded from FBT. For the purpose, it may be clarified that the requirement that the training center should be an "exclusive" training center is not necessary. Further, it may be clarified that the training may be either "owned" or "hired" (whether taken on temporary basis or otherwise).

86. Question No. 51: FBT on expenditure on in-house training

CBDT has observed that levy of FBT is not envisaged on the expenditure incurred for the purposes of imparting in-house training to employees. Thereafter, it is further observed that FBT would be payable on any expenditure incurred towards food and beverage, tour and travel, and lodging and boarding in connection with such in-house training of employees.

The expenditure on food and beverages is specifically exempt from FBT in sub-clause (i) of clause (B) of section 115WB(2). Reference to “food and beverages” has been erroneously included in the observation of the CBDT referred here.

It is suggested to clarify that expenditure on food and beverages during in-house training is not included in the expression ‘conference’ and accordingly, such expenditure shall be excluded from the scope of FBT.

87. Question No. 56: FBT on expenditure on conference vis-à-vis business convention

Though clause (C) of section 115WB(2) deems expenditure for purposes of conference as fringe benefits provided by employer to the employees, sub-clause (ii) of clause (D) of section 115WB(2) provides that expenditure on the holding of, or the participation in, any press conference or business convention or fair or exhibition shall not be considered as expenditure on “sales promotion including publicity” and, thus, not liable to FBT.

However, the CBDT has observed [in answer to Q.56] that the expenditure incurred for the purposes of conferences of the agents or dealers or development advisors shall be subject to FBT under the aforesaid clause (C) of section 115WB(2).

It is a well settled rule of interpretation that specific provisions should prevail over general provisions. The expenditure on conference (business convention) intended for publicity or sales promotion should be governed by the specific exclusion provided in sub-clause (ii) of clause (D) of section 115WB(2) and cannot be subject to the general provisions governing taxability of expenditure on conference under clause (C) of section 115WB(2) of the Act.

As there is a very thin line of difference between ‘conference’ and ‘business convention’, in certain situations it becomes very difficult to classify an expenditure vis-à-vis the above two terms. Circular No. 8/2005 issued by CBDT also does not clarify the meaning of these two terms.

It may be provided that expenditure on conference intended for publicity or sales promotion shall be covered under clause (D) of section 115WB(2) of the Act and shall not be liable to FBT.

The terms conference and business convention may be defined to bring in more clarity.

88. Question Nos. 82, 83, 84 : FBT on perquisite by way of motor car

The CBDT has observed that rent paid for a financial lease of a motor car is in the nature of expenditure on running or maintenance of motor car and shall attract FBT as per clause (H) [wrongly referred to as (I) in the Circular ] of section 115WB(2) of the Act [Answer to Q 82].

The CBDT has further observed that depreciation on motor cars, for the purposes of levying FBT thereon, refers to the income-tax depreciation computed as per the provisions of section 32 of the Act (and not book depreciation) [Answer to Q 83].

The CBDT has further also observed that interest on loans taken to acquire motor cars would qualify as expenditure relating to repair, running and maintenance of motor cars and the same would accordingly attract FBT [Answer to Q 84].

As per the Accounting Standard 19 of the Institute of Chartered Accountants of India, in case of financial lease, the cost of the motor car is capitalized and depreciation thereon is debited to profit and loss account. The interest cost in such financial lease is also debited to profit and loss account. In operating lease, the lease rent for the accounting period is debited to profit and loss account.

Thus, lease rent being subject to FBT in respect of expenditure on running or maintenance of motor car is conceivable in the case of operating lease, whereas depreciation and interest cost being subject to FBT is conceivable in the case of finance lease.

However, the answer to question 82 refers to rent paid or payable for a financial lease of a motor car being subject to FBT. Going by the circular, in the absence of clarification, the expenditure on financial lease may be subject to double FBT – once on the lease charges paid for financial lease (which is not reflected in the books as such though covered by Q 82) and again on the income-tax depreciation and interest cost debited to profit and loss account (covered by Q 83 & 84).

Appropriate clarification may be issued to avoid the unintended double FBT.

89. The CBDT has observed that depreciation on motor cars, for the purposes of levying FBT thereon, refers to the income-tax depreciation computed as per the provisions of section 32 of the Act (and not book depreciation). The CBDT has also observed that for purposes of depreciation on motor car, the amount of depreciation relating to the (entire) block of asset, viz. motor car, shall be considered [Answer to Q 83].

However, CBDT has clarified [in answer to Q 85] that delivery/display vans, trucks/ lorries, ambulance and tractors do not constitute motor cars and, accordingly, expenditure incurred on the running, repair and maintenance of such vehicles would not attract FBT.

Depreciation as charged to profit and loss account represents the cost of wear and tear of an asset, which depends on commercial or business realities. Section 32 requires a departure from such book depreciation by specifically referring to Rules. Provisions relating to FBT do not provide for such specific departure. Therefore, on right principles of interpretation and taxation of real profits, the book depreciation in respect of specified assets must be treated as 'depreciation' for purposes of FBT. Departure from this principle as suggested by the CBDT (as answer to Q 83) will lead to inconsistencies and difficulties in computation of value of fringe benefits. As an illustration:

- The income-tax depreciation is based on the concept of block of assets which may include assets, the depreciation on which is not subject to FBT. E.g., delivery/ display vans, trucks/ lorries, ambulance & tractors have been clarified as not constituting motor cars, which may nevertheless form part of the block of assets viz. motor car.

- The income-tax depreciation is based on written down value (WDV) of the block and may not represent the depreciation on individual asset which is subject to FBT. This is because the gains or loss made on sale of assets in the block go to reduce or increase the WDV, and correspondingly, amount of depreciation. Further more, the gain or loss made on sale of assets, the depreciation of which is not subject to FBT compounds the disparity.

It is suggested that depreciation for purposes of FBT should be the depreciation on the individual assets subject to FBT and computed as per accounting standards.

90. Question No. 87: FBT on salary to driver for motor car or pilot for aircraft

CBDT has observed that salary paid to a driver of motor car or a pilot of an aircraft is for the purposes of running and maintenance of motor car or aircraft, as the case may be, and accordingly, such payment of salary would have to be classified either in clause (H) or clause (I), as the case may be, of section 115WB(2).

This view contradicts the “proximate” principle adopted by the CBDT in interpreting “purpose” of expenditures listed in section 115WB(2) of the Act. In answering Q 11, the CBDT observed as follows:

“The word ‘purposes’ in the term ‘for the following purposes’ referred to in sub–section (2) of section 115WB refers to the proximate purpose and not the distant purpose. For example, if expenditure is incurred on travel for discussing an advertisement plan for a product, such expenditure shall be construed to have been incurred for the proximate purpose of traveling and not the ultimate purpose of advertisement and accordingly liable to FBT.”

On the same line of reasoning, salary paid to an driver or pilot should be treated as “salary” only (taxable in his hands as per normal provisions of individual taxation) and not as expenditure on motor car or aircraft.

Distinction should be made between "salary" paid to an employee who serves as a driver or pilot vis-à-vis amount paid for the services of a driver or pilot. The former should not be treated as part of expenditure on motor car or aircraft, as the case may be.

91. Question No. 90: FBT on telephone installed in office

Clause (J) of section 115WB(2) deems expenditure for use of telephone (except those on leased telephone lines) as fringe benefit provided by an employer to the employee. The CBDT has observed [in answer to Q. 90] that expenditure on use of telephones installed in the office is also liable to FBT.

The mischief sought to be addressed in this deeming provision is to tax expenditure on perquisites that go disguised as official expenditure. It was intended to cover use of telephone installed in residence or mobile phones. Telephones installed in office should have been excluded from the deeming fiction.

It is suggested that expenditure for use of telephone installed in office should not be subject to FBT.

<u>Search and seizure - Section 132</u>

92. Assessee's explanation of seized and requisitioned assets

At present there are no specific provisions enabling an assessee to explain the source of seized and requisitioned assets nor is it incumbent on the Assessing Officer to issue an order or the explanation filed by the assessee.

It is suggested that where the assessee files a statement explaining the source of seized and requisitioned assets the Assessing Officer should issue an order accepting or denying assessee's statement. Such an order should be appealable under section 246A

<u>Assessment procedures</u>

93. Hardship arising out of the Apex Court's decision in Goetze (India) Ltd. v. CIT (2006) 284 ITR 323 (SC)

In the above-mentioned case the assessee filed its return of income for the relevant assessment year without claiming a particular deduction. Later on, it sought to claim the deduction by way of a letter addressed to the Assessing Officer. The deduction was disallowed by the Assessing Officer on the ground that there was no provision under the Act to make amendment in the return of income by making an application at the assessment stage without revising the return.

The assessee had relied upon the decision of the Apex Court in National Thermal Power Company Ltd. v. CIT (1998) 229 ITR 383, to contend that it was open to the assessee to raise the points of law even before the Appellate Tribunal. In that case, it was held that the Tribunal had jurisdiction to examine a question of law (raised for the first time), which arose from the facts as found by the income-tax authorities and which have a bearing on the tax liability of the assessee.

The Supreme Court held that this decision does not in any way relate to the power of the Assessing Officer to entertain a claim for deduction otherwise than by filing a revised return. Therefore, the assessee can claim deduction only by filing a revised return.

The above-mentioned decision of the Apex Court has unsettled many a case law and has caused unintended hardship to the assessees.

It is suggested that appropriate amendments may be made to enable the assessee to get relief during the assessment proceedings by methods otherwise than by way of filing a revised return.

94. Re-alignment of due dates for filing returns

Presently there are two due dates for filing the return of income, i.e., 31st July for non-corporate non-audit cases including salaried class and 31st October for corporate and all persons liable to get their accounts audited.

It is suggested that the due dates of filing the return may be revised as under :

| Assessee | Proposed due date |
|---|---|
| Non-corporate non-audit cases including salaried class | 30th June |
| Non-corporate audit cases | 31st August |
| Corporate assessees | 30th September |

The staggering of due dates to three will reduce pressure on the Department as well as improving the compliance by the taxpayers. This will also result in all returns being received within six months from the end of the relevant previous year. Within a period of further six months starting from 1st October to 31st March, all these returns can be processed and if necessary, can be selected for scrutiny latest by 31st March. Thereafter the Assessing Officer will have a full year to carry out investigation and verification in selected cases. It may be pointed out that till 31st March 1999 before the amendments were carried out by Direct Tax Laws (Amendment) Act, 1987, all returns were supposed to be filed by 31st July, i.e., within a period of four months from the end of the relevant previous year. Though there have been large scale computerization of the accounts being maintained by the taxpayer, yet the period for filing return has been extended which can be curtailed now as suggested above. It may also be pointed out that all corporate assessees were also required to file the income tax returns by 31st July every year despite the fact that under the provisions of the Companies Act, 1956, the corporate assessees were required to lay their balance sheet at the annual general meeting by 30th September. As such, in case the corporate assessees are required to file the return by 30th September, it will not cause any undue hardship to them because in any case the balance sheet of the corporate assessee has to be circulated to the shareholders at least 21 days in advance of the last date of holding the annual general meeting i.e., 30th September.

95. Method of accounting and accounting standards

The objective of the Income-tax Act is to compute correct income chargeable under the Act. For computing correct income from business, application of correct accounting principles is essential. The ICAI, as the apex body in accounting, has issued several accounting standards enunciating correct principles of accounting. These accounting standards have been recognized under the Companies Act and it is the duty of the management to comply with the accounting standards of the ICAI. If the accounting standards issued by the Institute of Chartered Accountants of India are notified under the Income-tax Act there is no necessity to bring separate amendments for clarifying accounting principles from time to time. For example Explanation 8 to section 43(1) was added to clarify the position of deferred interest. Recently, amendments have been made in sections 30, 31 and 36 regarding capital nature of repairs and interest expenses. These amendments which are made in the Act from time to time will not be necessary if the accounting standards of the ICAI are notified. Correct accounting principles will automatically get enshrined in the Income-tax Act as and when these accounting standards are notified. Adoption of accounting standards of ICAI will considerably reduce litigation, bring more clarity and transparency in the computation of income and pave way for harmony between the assessee and the Department. Further, it will narrow the gap between the income computed as per the books of account and income assessed as taxable income.

It is suggested that the Accounting Standards of ICAI may be notified under section 145(2) to be complied by the assessees.

96. The need for withdrawing section 145A in view of Accounting Standard 2 (Revised) - Valuation of Inventories becoming mandatory

(i) The Institute has issued 29 definitive Accounting Standards on various subjects. These Accounting Standards have been made mandatory. AS 2 (Revised) Valuation of Inventories has been made mandatory from accounting year starting from 1.4.1999 onwards. The mandatory AS also apply in respect of financial statements audited under section 44AB of the Income-tax Act, 1961.

(ii) After the Notification of Revised AS-2 the costs of purchase consists of the purchase price including duties and taxes other than those subsequently recoverable by the enterprise from the taxing authorities. In other words, the entities have to necessarily follow the exclusive method of accounting and in case they are adopting any other method, the chartered accountant certifying the financial statements has to necessarily qualify the financial statements. The qualification has to be made in the main auditor's report stating that the auditee has not complied with the Accounting Standards notified by ICAI and even the impact of the profit has to be quantified and stated in the qualification.

(iii) The Guidance Note on Tax Audit under section 44AB of the Income-tax Act, which was prepared under the close coordination and advice of the CBDT has come to the considered conclusion that section 145A is revenue neutral. In other words, even after the adjustments specified in that section have been made, there would be no impact on profit or loss of the assessee. The said conclusion was arrived at after a long and detailed deliberation at various levels and after examining basic accounting principles. As such, all entities have to follow the Accounting Standard 2 (Revised) of the Institute. However, separate computation is necessary for the purpose of complying with the provisions of section 145A. Such separate computation has to be made outside the books of account. This computation will form part of annexures to the tax audit report and statement of computation of income. However, it should be noted that any adjustment made to any figure in the profit and loss account must be in accordance with correct accounting principles.

(iv) It may be pointed out that any adjustment made in the computation of income is fraught with the danger of an assessee manipulating and in fact reducing the total income. This is so because, there are innumerable adjustments which are required to be made in the computation of income and the impact of these adjustments if not noticed separately, would lead to revenue leakage.

(v) There are possibilities of different viewpoints being taken on the interpretation of the provisions of section 145A by the Assessing Officers, which is bound to result in protracted litigation and may affect the interests of revenue.

(vi) Now that under the excise law statutory records have been abolished, it is very essential that proper records should be maintained showing the taxes collected and remitted to the Government. Moreover, maintenance of separate records in respect of CENVAT as required by AS 2 will facilitate systematic audit under the provisions of section 14AA of the Excise Act, 1944. Accounting Standard 2 (Revised) Valuation of Inventories and the Guidance Note on CENVAT would contribute immensely in this regard. The "exclusive method" also has a merit in as much as the Modvat receivable account, which is reflected as an asset would truly represent the quantum of Modvat credit as per the Excise Law. In fact the excise authorities do check the books under the Excise Law. If the accounts are maintained on "inclusive method", this check would be impossible.

(vii) The primary reason for introduction of section 145A was to negate the judgement of the Gujarat High Court in the case of Lakhanpal National Limited v ITO 162 ITR 240 (Guj) and the order of the Special Bench of the Income-tax Appellate Tribunal in the case of ITO v Food Specialities Limited 206 ITR 119 (AT). With the notification of AS 2, the aforesaid judgement and order would not hold good.

(viii) Accounting Standard 2 (Revised) Valuation of Inventories would result in more transparency in respect of accounting for taxes and duties due to the Government.

The complicated computation required for complying with the provisions of section 145A will not generate any extra revenue as the impact of section 145A is revenue neutral. Hence section 145A needs to be deleted.

97. E-filing v. Explanation to section 139(9)

At the time of e-filing of return no attachment or document is accepted.

The provisions of the Act and the rules need amendment in view of the objectives of e-filing, particularly the ones referring to the defective return in Explanation to section 139(9).

98. Sections 147 and 148

The Hon'ble Supreme Court, in GKN Drive Shafts (India) Ltd. v. ITO (2003) 259 ITR 19 (SC), spelled out a definite procedure to be followed by the authorities before initiating re-assessment proceedings under section 147. The Supreme Court held that before initiating the assessment proceedings under section 147, the Assessing Officer was duty bound to furnish reasons within a reasonable time and, upon objections to the same being raised by the assessee, to dispose of the same by passing a speaking order. However, such procedure is not being followed by the tax authorities in all cases.

The assessees, in such a case, have no recourse but to go to the High Court which is a very expensive proposition, making it unfeasible for many, and thus, effectively, defeating the rule laid down by the Supreme Court.

It is suggested that definite procedural steps may be legislated in section 147/148 to make the procedure mandatory. This would also enable review by appellate authorities [CIT(A)/ ITAT] of the speaking order to be passed by the Assessing Officer in examining the validity of proceedings under section 148/ 147. This will have concomitant benefits on the entire assessment process.

99. Section 154

Sub-section (8) of section 154 provides that wherein an application under this section is made, the income-tax authority shall within a period of 6 months from the end of the month in which the application is received by it, make the amendment or refuse to allow the claim.

There is, however, no provision as to what would be the consequence if the income-tax authority in question does not do either.

It is suggested that suitable mechanism be put in place in the law to facilitate filing of appeal against this and adjudication by CIT(A).

100. Section 154

Sub-section (7) of section 154 provides that except as provided in section 155 or sub-section (4) of section 186, no amendment under this section shall be made after the expiry of 4 years.

In situations where the assessee has submitted an application for amendment within the 4 year period but the AO has not made amendments within the period of 4 years, AO's plead inability to pass the order under section 154

It should be clarified in section 154 itself (not withstanding Board Circular to the effect) that as long as the assessee had made the application within the time of 4 years, this restriction will not apply and amendments under the section can be made even after the period of 4 years.

Also, an option may be provided to the assessee to appeal against the failure of the Assessing Officer.

101. Non-speaking orders

Non-speaking orders of assessment, etc. are passed either without giving an opportunity to the assessee to raise an objection, or without meeting the objection, to the additions.

Such non-speaking orders, apart from having a delirious effect on the morale of both the tax payer and the tax practitioners, lead to increasing litigation. This also gives rise to tax demands, which are bound to be quashed in appeals. Forcing tax recovery of demands raised on such orders results in practical difficulties to the assessees.

The Act should contain the procedure requiring the Assessing Officer:

(v) to state all the facts as brought on record by the assessee;

(vi) to give notice to the assessee of specific additions intended to be made and to allow reasonable time to meet his case.

(vii) to list all the case laws cited by the assessee in support of his case and giving reason(s) for not following it;

(viii) to state reason(s) for allowing lesser time to gather facts where such an application by the assessee is rejected.

This will save avoidable burden on appellate authorities.

102. Section 153C - Assessment of income of any other person

The above-mentioned section deals with assessment of income of a person other than the person referred to in section 153A. Accordingly, where the Assessing Officer is satisfied that any money, bullion, jewellery or other valuable article or thing or books of account or documents seized or requisitioned belongs or belong to a person other than a person referred to in section 153A, then the books of account or documents or assets seized or requisitioned shall be handed over to the Assessing Officer having jurisdiction over such other person and that Assessing Officer shall proceed against each such other person and issue such other person notice and assess or re-assess income of such other person in accordance with the provisions of section 153A.

By virtue of the above provisions the second-mentioned Assessing Officer has no other option but to issue notice in accordance with the provisions of the Act. There is every possibility that certain books of account and documents, which have been maintained in the normal course of business, are found and there is no incrimination in the books of account in the ordinary course of business, and there may not be any requirement to reassess income of such other person under Section 153C of the Act. Thus, the assessment of the other person is to be made irrespective of the fact whether any money, bullion, jewellery or other valuable article or thing or books of account or documents or assets seized or requisitioned are properly reflected in the regular books of account and records by the other person.

Therefore, it is necessary to bring the said section in line with the earlier section 158BD wherein the condition was that the Assessing Officer must be satisfied that any undisclosed income belongs to any person other than the person with respect to whom search was made under section 132 or whose books of account or other documents or any assets were requisitioned under section 132A.

It is suggested that section 153C could be amended as follows:

153C(1) Notwithstanding anything contained in section 139, section 147, section 148, section 149, section 151 and section 153, where the Assessing Officer is satisfied that any money, bullion, jewellery or other valuable article or thing or books of account or documents or assets seized or requisitioned belongs or belongs to a person other than the person referred in section 153A represents either wholly or partly income or property which has not been, or would not be disclosed for the purposes of the Income Tax Act, 1922(11 of 1922) or this Act , then the books of account or documents or assets seized or requisitioned shall be handed over to the Assessing Officer having jurisdiction over such other person and that Assessing Officer shall proceed against each such other person and issue such other person notice and assess or reassess income of such other person in accordance with the provision of section 153A.

103. Section 153C

Section 153C does not require the Assessing Officer to record the reasons for taking action against the persons in whose case search has not taken place but certain material was found during the course of search.

In effect it prescribes for the compulsory reopening of the cases of an assessee say "C" if some books or assets etc. of "C" are seized in search and seizure operations under section 132 carried out in respect of another assessee – say "A". It is obvious that even if only regular books of account of "C" are found and seized, the Assessing Officer of "C" would be required to proceed to reopen the cases of "C". It means that even if no asset or incriminating material were found in respect of "C" the assessment of "C" would be compulsorily reopened. It is prima facie unequitable and goes to generate avoidable work. Even if a slip is found which in the opinion of Assessing Officer belongs to the other person, the Assessing Officer can open the assessment of third party without bringing any reason to believe on record.

It is suggested that the provisions of section 153C may be amended in such a manner that the Assessing Officer must record the reasons for his belief on the basis of the material found before initiating proceedings under section 153C.

Deduction of tax at source

104. Section 192

In computing the TDS obligation under section 192 on salary payments, the employer is entitled to take into account other India taxes and income of the employee. However, the section does not empower the employer to take into account the credit under section 90/91 that the employee is entitled on account of taxes paid by him in overseas jurisdictions.

Non-considering of such credit creates a cash flow issue for the employee since he is first required to pay taxes in both the jurisdictions and apply for a refund in India on account of relief under section 90/91.

The Finance Act 2006 has amended section 140A, 234A, 234B and 234C to clarify that any tax paid outside India on income earned overseas shall be taken into account while computing the amount of self assessment tax and interest payable.

It is suggested that section 192 may be also amended to specifically provide that credit for foreign taxes on the salary is allowable to be set-off for computing the TDS obligation there under. As a safe guard, certificate of accountant may be required in all such cases.

105. Section 192 read with section 80G

Section 192 makes it obligatory upon the employer to deduct tax at source from the sums paid to the employees on the amount of income "chargeable under the head salaries" after considering certain deductions prescribed under section 192 itself.

The CBDT issues a circular every year for guidance of the employers, as to what matters are to be considered for deduction of tax source by the employers under section 192.

The annual Circular issued by CBDT for guidance on deduction of tax matters for the employers, permits the employers to consider 80G deduction for donations made only to prescribed organizations. This creates problems for the employees who have to make claim of refunds for small amounts due to donations made to entities u/s 80G which are not prescribed. This results in avoidable paper work and costs, both for the employees and the Government.

Section 192 was amended to allow the employer to net off, loss from house property to avoid the paper work relating to refund claims on account of interest on housing loans. Considering the above, similar amendment should be made to specifically allow the employer to consider all donations eligible for deductions u/s. 80G.

106. Section 194-I v. section 194J on payment for equipment hire

The Taxation Laws (Amendment) Act, 2006 has widened the scope of tax withholding under section 194-I and 194J. Under section 194-I, the definition of 'rent' has been widened to include tax withholding on plant, machinery or equipment, whether such assets are rented separately or together. Simultaneously, tax withholding under section 194J has been widened to cover 'royalty' as defined in Explanation 2 to section 9(1)(vi) of the Act, which includes payment for use or right to use of equipment.

There is an overlap in respect of payments for 'equipments', which is covered in the new definition of ‘rent’ u/s 194-I and also in the definition of ‘royalty’ u/s 194J. The Board has clarified vide its Circular no. 720 dated August 30, 1995 that payment can be liable for tax withholding under one section only. The issue becomes more pertinent due to different tax withholding rates prescribed under sections 194-I and 194J.

The scope of tax withholding under respective sections may be clarified so far as they relate to payment for use of equipment.

107. Withholding on long term lease

Section 194-I provides for tax withholding on lease payments, even if they are for long term such as 99 years.

Even a lump sum payment for a long term lease such as for 99 years will get covered under section 194-I. Such an interpretation does not seem to be the intention of the withholding provisions under section 194-I.

It may be clarified that such lump sum payments for long term lease would not be covered within the ambit of section 194-I.

108. Sections 10(13A), 80GG read with section 194-I

Section 194-I makes it mandatory for a (specified) person to deduct tax at source from payments made to a resident any income by way of rent. Rent here includes payments made for the use of any land, building, land appurtenant thereto, any furniture, fittings, plant, machinery etc.

Section 10(13A) exempts from tax any special allowance specifically granted to the assessee by his employer to meet expenditure actually incurred on payment of rent in respect of residential accommodation occupied by the assessee, as per prescribed limits.

Section 80GG provides deduction to assesses [other than those having income falling u/s 10(13A)] for any expenditure incurred by them for payment of rent in respect of any furnished or unfurnished accommodation occupied by him, upto prescribed limits.

There is no clarification on whether the exemption u/s 10(13A) is also available for the amount paid by the assessee towards furniture and fittings forming part of lease arrangement for the accommodation.

It may be noted that the deduction under section 80GG has been specifically provided for furnished accommodation also. Also, tax under section 194-I is to be deducted (by specified persons) from any amount paid for use of any furniture and fittings.

Benefit under section 10(13A) should be specifically extended to include any payment made for the use of any furniture or fittings by the assessee.

109. Credit for tax deducted – Section 199

The person responsible for deducting the tax at source has to deduct the same either at the time of payment or at the time of credit of the payment to the account of the payee whichever is earlier. Accordingly, he deducts full tax at source. However, it is possible that the entire amount of payment may not be realized to the payee during the relevant previous year. If the payee follows cash method of accounting then he would take only the amount actually received as income during his previous year. Here the question arises whether he can take full credit for the tax deducted by the payer.

Further, difficulties arise where the deductor maintain the accounts on cash basis and the deductee maintains the accounts on a mercantile basis. For example in respect of a service rendered by the deductee, to the deductor, the deductor might not have made payment in cash and hence he would have neither accounted for the payment nor deducted tax at source. At the same time the deductor would have accounted for the value of services rendered as income in his books of account since he is following mercantile method of accounting. The tax deductor deducts tax only in the subsequent years. Such TDS certificates do not contain dates falling in the previous year relevant for the deductee and hence they cannot be claimed for the year in which corresponding income is accounted.

It is suggested that the payee should be given credit for the entire tax deducted at source by the payer irrespective of the fact whether he accounts for the entire income or a portion of the income in his books of account depending on the method of accounting followed by him.

It is further suggested that section 199 may be appropriate amended to take care of the situation explained in the second paragraph above.

110. Time limit and finality of TDS verification

The Act does not provide for any time limit for concluding TDS verification. It also does not provide for communicating the finality of such verification to the assessee. As a result, it is open to the department to re-initiate even completed verification over an indefinite period.

A time limit for initiation/completion of TDS verification and its intimation to the assessee should be provided for in the Act.

111. Credit for TDS

It often happens that the person responsible for making payment may not pay the full amount to the payee but at the same time deduct the tax at source in full. The tax deductee who may be following cash method of account would record his income only to the extent of receipt. However, the question arises whether the entire tax deducted at source could be claimed as credit by the deductee. In some quarters the claim on a prorate basis is being advocated.

It is suggested that full TDS credit should be allowed to the deductee in the year in which the same is deducted and paid to the Central Government.

112. Default by deductee

The deductor of TDS often finds it difficult to obtain authentic information from the deductee in respect of following:

(a) PAN No. of deductee

(b) Status of deductee

(c) Complete address of deductee

In spite of verbal all written communications from the deductor the deductees sometime do not provide the above information. This causes difficulty to TDS deductor to prepare his TDS return or file it in time. Incomplete details cause data mis-match which is at present being experienced by the Government.

While assessing the TDS return a time limit should be prescribed within which all the relevant information should be furnished either by deductor or the deductee.

If the relevant information is not provided by the deductee then an appropriate penalty may be levied on the deductee.

113. Incentive to the tax deductor

The tax deductor is rendering a service on behalf of the Government. Therefore, it is but appropriate that an appropriate incentive may be given to the person who is undertaking the function of deducting tax at source and remitting the same to the Government.

It is suggested that tax deductor may be given a credit of 5% of the tax deducted and remitted by him to the credit of the Central Government.

<u>Appeals</u>

114. Power to stay demand to be given to CIT (Appeals)

At present power to stay demand of tax is being exercised by the Income-tax Appellate Tribunal. However, to meet the ends of justice and as a principle of natural justice this power may be specifically conferred on the Commissioner (Appeals).

It is suggested that specific provision may be enacted in the Income-tax Act to give power to stay demand of tax to the Commissioner (Appeals).

<u>Promoting India as a favorable 'Holding Company' destination</u>

115. Underlying Tax Credit

Outbound investment from India is on the increase with many domestic companies setting up subsidiaries in other countries that are generating profits. This has even become necessary on account of business restructuring by Indian companies.

Normally dividends should flow back to the parent company in India as and when declared. The dividends are, however, flowing to lesser tax jurisdictions where holding companies are being set up. The income in such jurisdictions accumulates and may be remitted to India at a later date.

There is, therefore, a deferment of tax as also a lack of flow back of the funds at an early date. Steps need to be taken to

- Induce these Indian companies not to structure their affairs in the above manner but to remit the dividend funds to India
- Relieve the economic double taxation on foreign dividend income.

It is suggested that a mechanism, known as the allowance of underlying tax credit for the stream of dividend income, be adopted.

In this scheme, credit is given by the country where the parent company is a resident, not only for the tax withheld at source on the dividend payout by the overseas subsidiary but also in respect of the tax suffered on distributable profits.

Underlying tax credit = Gross Dividend / Distributable Profits x Actual Tax Paid on those profits.

The underlying tax credit may be computed, in the case of an Indian parent company receiving dividend from more than one tax jurisdiction, by aggregating the gross dividend, distributable profits and actual taxes suffered on those profits in all such jurisdiction.

This would give an incentive for the flow of funds to the parent Indian company and it would also make them more competitive. Larger availability of funds may generate increased investments by these Indian companies and a source of more taxes for the country.

It can be provided that the underlying tax credit would be granted on dividends paid by a company provided at least 10% of its shares are held by an Indian company.

116. Redressal mechanisms – MAP and AAR (Administrative reforms)

Presently the machineries for settlement of disputes are the following:

- Mutual Agreement Procedure (MAP) envisaged in the tax treaties;
- Authority for Advance Rulings;
- Income-tax Appellate Tribunal.

While tax litigation and issues of interpretation are widespread in virtually all countries, the uncertainty of tax costs involved is compounded where redressal mechanisms are not conducive to timely settlement of disputes. It is necessary to devise methods for timely settlement of tax disputes.

Though the Department has a well-established judicial process, it will be seen as greatly improved if the dispute resolution is speeded up.

It is suggested as follows: -

c. The administrative guidelines in respect of MAP (including stay on tax demands during their pendency) should be formulated in a clearer manner and communicated to the taxpayers.

d. Efforts should be made to reduce the time in resolving disputes in consultation with the other treaty partner countries.

The Authority for Advance Rulings has only one bench stationed at Delhi. More benches of AAR may be constituted at any other place where the volume of work so justifies.

117. Net of Tax Arrangements – Section 248

Until amendment by Finance Act 2007, effective 1.6.2007, section 248 provided that where any person has deducted and paid tax in accordance with the provisions of section 195 and 200, in respect of any sum chargeable under the Act, other than interest and who denies his liability to make deduction, may make an appeal to the Commissioner (Appeals) to be declared not liable to make such deductions.

Finance Act 2007 has amended the provisions to provide that where under an agreement or arrangement, the tax deductible on any income other than interest under section 195 is to be borne by the person by whom the income is payable and such person having paid such tax to the credit of Central Government, claims that no tax was required to be deducted may make an appeal to the Commissioner (Appeals) for a declaration that no tax was deductible on such income.

The net effect of the amendment is that in ‘subject to tax’ contracts, once the tax is deducted by the person making the payment, he shall not be eligible to file appeal against the said deduction, even though he does not agree with the Department’s order for deducting tax at source. In such cases, the only option left will be for the recipient to file the return of income and claim refund.  This may be addressed.