Compliance under Direct Tax Laws

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Compliances under Direct Tax Laws have assumed great importance due to large monetary implications. Tax compliances also carry significant reputation risk for corporates, board members, tax advisors as well as corporate professionals. Some practical aspects of the compliances have been spelt out here.

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Corporate compliance management is drawing increased attention worldwide, and possibly the reputation risk associated with bad press is the biggest driver of this attention. Compliances under direct tax laws are often inter-mingled with large impact issues on tax cost. If tax planning is very aggressive and designed to avoid tax liabilities by superficial design, it could border at poor compliance management either at ethics or spirit of law level. Tax compliances carry a significant reputation risk for the corporates, Board members, tax Advisors and the company personnel involved in compliance. Non- compliance also attracts high level of penalties and interest costs. The objective of this article is to share experiences and thoughts on approach to compliance under direct tax laws and highlight some best practices. The objective is not to dwell into specific tax provisions, and deal with details and operational challenges of any specific tax provisions. To that extent, readers will not find references to sections of any of the direct tax laws in this article or to any associated case laws.

The compliances under direct tax laws, can be looked at from following different perspectives -

(a) strategic tax planning related

(b) operational and transactions related

(c) cross border related

STRATEGIC TAX PLANNING

The strategic tax planning related compliances can be very important to a Corporate from the point of view of huge tax implications to the balance sheet and business model of a Corporate. Some e.g. can be :

Tax Holiday

If a software company or an off-shoring MNC chooses to avail section 10 A tax holiday benefits, it is a choice it is exercising which comes with a few very important compliances to ensure that tax holiday is not lost. For instance proper registration with STPI authorities and maintaining continued status as an STPI unit is an important pre-requisite to continued tax holiday. The export sales should constitute a ratio prescribed by the section, to continue to be treated as an eligible unit. Hence, it becomes very important to monitor the ratio of exports to domestic sales. These are very important elements to business model of the Corporate, and the business model is very intricately linked to the tax holiday. Compliances like these require constant interaction with business and educating them on compliances which have direct linkages to business and revenue model of the company.

Mergers & Acquisitions

Merger transactions which meet laid down conditions are often eligible for continued tax benefits or deduction of carry forward losses of the merging company, etc… Proper execution of the merger transaction and adequate documentation of meeting of all conditions will be very important to demonstrate eligibility for tax benefits. At the time of planning of these transactions, it is important to understand whether the transaction completely meets the conditions both in letter and spirit, or is there an element of doubt associated with same. The tax advisors should be fully engaged in evaluation of compliance conditions, any risk associated with meeting compliances, and monitoring mechanism to ensure compliance.

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OPERATIONAL & TRANSACTIONAL RELATED

Operational related could be related to Sales/Income, business expenses, employees' salary compensation, tax withholding obligations, tax filing obligations, etc.

Sales/Income Related

Compliance related to sales or Income related would begin with proper customer order/ contracts related to income leading up to sales invoicing by the Company. These documents should clearly identify as to what is the nature of income and any break-up of income. For e.g. reimbursement of expenses by a client need to be so clearly identified to avoid the same being classified as income. Another example could be clear identification of indirect taxes like sales tax, service tax to enable proper accounting for them, and thereby proper accounting for income.

Also, some elements of income could be eligible for special tax treatment, e.g., sales to a export processing zone is considered as export sales and hence needs to be separately tracked and compliances associated with same ensured.

Business Expenses Related

Expenses are deductible for income computation as per detailed provisions in tax laws. Often specific expenses are identified as non-deductible if they do not meet certain conditions. For instance, unless payments have been made for expenses by account payee cheque, they could be disallowed, and tax auditors would identify them in their report. Similarly, if tax should have been deducted at source while paying for expenses, and if the same is inadvertently also missed, the expense may become non-deductible apart from liability for taxes not deducted. Hence, it becomes very important that due care has been taken while recording any business expenses.

Salary Compensation

Every organization wants to offer salary which is competitive and tax efficient in the hands of the employees. Employees also expect that their tax outgo in a compensation package should be minimal. Aggressive tax planning in this respect creates tax exposures for the employers, if there are any tax demands post assessments. Also, if there are too many compensation elements which require satisfactory documentation from employee, and if the documentation that is submitted is not complete and reliable, it creates tax exposures for employers.

Employers need to do a very delicate balancing act right from choosing the elements of compensation package. Clear rules on documentation in support of a tax exemption or a deduction need to be made and communicated with clarity to employees. For e.g. house rent is eligible for a significant tax deduction. To ensure that there is no misuse of this benefit for amounts which have not been paid by employees as rent, at least for larger rent amounts of say Rupees ten thousand and above, employers could insist that apart from rent receipt, a copy of the lease agreement be also produced.

Fringe Benefit tax related

On employee benefits and perquisites several compliances are required. The various incentives, staff welfare expenses may attract fringe benefit tax, and appropriate accounting coding is required to ensure that all such expenses are captured for the purpose of fringe benefit tax. There are also opportunities for tax planning like employer spending on car lease and running expenses for employees, and paying fringe benefit tax on same, and with no further personal tax liability for employees.

Tax withholding obligations

Many business transactions like payments to contractors, consultants, etc… require tax deduction or withholding to be made on behalf of receiver and to be deposited directly with the Government. Failure to deduct where a deduction is required can be a significant tax risk. The awareness level of finance department employees on payments subject to tax withholding is important. System configuration in vendor master to identify vendors who are subject to tax withholding is one good way of ensuring that no payment is missed out without deduction. The master could also capture the Permanent Account Number of the vendor right at the initiation of the dealings with a vendor.

Periodic independent audit of tax withholding procedures and compliances by tax advisors is useful to have a third eye identifying gaps.

Compliance in terms of deposit of withholdings with Government and filing of periodic returns of deductions and deposits by their due date(s) is a routine but important compliance. Clear definition of responsibilities within a Corporate on individuals responsible for these activities ensures that there is both responsibility and accountability attached to these activities. Automation of tracking of these tasks, and a report generated affirmatively confirming that compliances were done in time can be a very useful tool for tracking performance.

CROSS BORDER RELATED

Cross border related could relate to either inward or outward equity/debt investments, operations in other countries, deployment or movement of people on short or long business visits/deputations to other countries, etc… Each of these business situations calls for very careful evaluation of tax liabilities, exposure for permanent establishment in other countries, personal tax liabilities for individuals.

Some of the best practices of cross border related transactions are :

(a) Firstly, the India and the other country's tax experts on international taxation should be involved in the evaluation and documentation of tax implications. They should be provided with all essential terms of the business arrangement/ operations, and given a chance to evaluate tax implications, and also be able to suggest if there are any precautions to be taken in structuring of the transactions. Often, appropriate documentation may be required to bring out the true nature of the transactions, and lack of same could mean tax liabilities.

(b) The double taxation avoidance agreement (DTAA) of India if available with the other country should be checked to see provisions that would apply to specific transactions, and should be further validated by tax opinions to ensure how in practice the provisions of DTAA are being implemented at the operating level in both Countries.

(c) Companies often adopt tax havens to avoid capital gains/ dividend tax liabilities on outward investments. These tax planning options come with lot of care required in compliances in all countries involved. Tax residency status in tax haven countries would have to be maintained for the companies set up in tax haven countries.

(d) People movement to other countries and possible tax exposures they can create is another important area to be tracked in cross border transactions. The nature of the business visit, the number of days of stay in other country, the visa status of travel could all be relevant and should be considered collectively to determine whether the individual would have personal income tax or other employment law liabilities in other country. The company personnel presence and the nature of work performed, and whether an office was maintained in another country could also create permanent establishment and hence corporate tax liability for the company. These circumstances also need to be evaluated carefully and advise sought on permanent establishment status, and whether there would be any associated tax liabilities. In many cases, technical service related tax withholding liability could be created, if not permanent establishment liability. Again, all these implications may require detailed documentation of purpose of visit, duration of stay and personnel involved, revenues earned, whether office was maintained on a regular basis or was there a project office abroad or was there no office maintained at all would all be relevant.

SUMMING UP

Compliances under direct tax laws have assumed great importance due to large monetary and reputation implications. The growing cross border transactions and setting up of operations by companies in multiple countries has also increased the scope and complexity of compliances. The fringe benefit tax introduction two years back has brought significant new dimension to taxation of employees, and has extended the scope of corporate tax to large number of business expenses, as against simplifying the same. The role of professionals in being able to plan and execute well the various transactions and documentation associated with tax laws has gone up manifold. Robust internal procedures, awareness building among various key functionaries in businesses, tracking of lot transactions and appropriate IT systems enablement all go hand in hand in ensuring compliances. ❑