TAX

Revised discussion paper on the Direct Taxes Code

June 2010

KPMG IN INDIA

AUDIT ▪ TAX ▪ ADVISORY

FOREWORD

The Government released the keenly- awaited Revised Discussion Paper on the Draft Direct Taxes Code Bill 2009 (DTC). This Paper covers nine issues identified by the Honorable Finance Minister from various representations which were received earlier and two additional issues, viz. Special Economic Zone (SEZ) and Wealth-tax.

While the Government has been sensitive to the representations made, it seems determined to balance the needs of revenue by fine tuning proposals to raise additional taxes and introducing additional anti-avoidance measures.

It is heartening to note that Minimum Alternate Tax (MAT) on book profits is restored as against the draconian levy of MAT based on gross assets, pursuant to strong representations made in this regard.

Allaying fears of a blanket treaty override, it has been clarified that as between the domestic law and the relevant tax treaty, the one which is more beneficial to the taxpayer shall apply. Whilst the international investing community heaves a sigh of relief at this clarification, one needs to be cognizant that treaty override will still prevail in specific situations such as invocation of General Anti Avoidance Rule (GAAR) and Controlled Foreign Corporation (CFC) provisions or when Branch Profits tax is levied.

The wide sweep of the GAAR provisions is sought to be circumscribed by providing threshold limits and administrative guidelines. However, it remains to be seen whether the Dispute Resolution Panel serves as an appropriate forum for adjudicating GAAR disputes.

As regards determination of residential status of foreign companies, in line with international practice, it is now proposed that the residential status of foreign companies will depend on their place of effective management. The DTC had proposed to treat foreign companies as residents even if a part of their management and control was situated in India, which had created considerable uncertainty.

Raising the complexity in Indian tax law, CFC regulations are now proposed to be introduced as an anti-avoidance measure. Indian taxpayers will now have to face the rigors of CFC regulations and ensure that they do not fall foul of these provisions. India Inc.'s fledgling outbound foray will thus grapple with one more tax hurdle.

Indian Capital markets are unlikely to cheer the substitution of a complete exemption of capital gains tax on listed securities with a concessional tax regime coupled with Securities Transaction Tax (STT).

The Government has also reinstated most of the favorable tax treatments currently available under the Exempt-Exempt- Exempt (EEE) regime to individuals on their long term savings.

The omission of profit linked incentives for SEZ units under the DTC was seen as a retrograde step, adversely impacting SEZ development in contrast to the promises held out in the SEZ Act. Partly redressing this, existing SEZ units would continue to enjoy profit-linked tax benefits for the unexpired period.

Overall, the Government, while accepting many of the representations made, has also cautioned in the Discussion Paper that due to the concomitant reduction in tax base originally proposed in the DTC, the indicative generous tax slabs, rates and other monetary limits for deductions will be reconsidered.

The following paragraphs provide an analysis of the proposals in the revised discussion paper.

The revised discussion paper invites responses upto 30th June 30, 2010 and we would be delighted to receive your inputs and suggestions to make these responses more relevant and useful.

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MAT -TAX ON GROSS ASSETS

Under the Income-tax Act, 1961 (the Act), a company is required to pay MAT at the rate of 18 percent[1] of book profits, if the tax payable under the provisions of the Act is lower than the MAT. MAT Credit is allowed to be carried forward for 10 years for set off against normal tax liability.

Under the DTC, it was proposed that a company shall pay tax on its gross assets at the rate of 2 percent (0.25 percent in case of Banking companies) if the tax liability under provisions of the DTC is less than the tax on gross assets. The DTC did not provide for credit of such tax paid on gross assets.

REVISED DISCUSSION PAPER

- Tax on gross assets is done away with and MAT on book profits is reinstated.

1. Excluding Surcharge and Education Cess

OUR COMMENTS

Reinstating the MAT on book profits is a welcome change. However, the discussion paper is silent on the following aspects:

- Rate of MAT
- Computation of book profits
- Computation/ carry forward/ transfer of MAT credit

The above aspects should be covered in the revised DTC.

Wealth-tax made applicable to companies on specified 'unproductive assets' may partially offset the impact of changes in the MAT provisions.

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TEST OF RESIDENCY

Under the Act, a company is resident in India in any previous year, if the control and management of its affairs is situated 'wholly' in India.

Under the DTC, a company shall be resident in India, if the place of control and management, at any time during the financial year, is situated 'wholly or partly' in India.

REVISED DISCUSSION PAPER

- A company incorporated outside India will be resident in India, if its 'place of effective management' is situated in India
- Place of effective management of the company means –
  - Place where the board of directors or its executive directors make their decisions or
  - In cases where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

OUR COMMENTS

- The concept of place of effective management for determining residential status of companies is in line with the international practice.

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TREATY OVERRIDE

Under the Act, the provisions of the domestic law prevail over tax treaties to the extent they are more beneficial to the taxpayer.

The DTC provided that neither the tax treaty nor the Code shall have preferential status and the provisions which come into effect at a later point in time shall prevail.

REVISED DISCUSSION PAPER

- Beneficial position under the Act to continue. Tax Treaty not to have preferential status-
  - where the GAAR is invoked or
  - when CFC provisions are invoked or
  - when Branch Profits Tax is levied.

OUR COMMENTS

- Restoring the beneficial position under the Act is welcome
- However, the impact of GAAR and CFC provisions would need careful examination, especially for investments using favorable tax treaty jurisdictions
- Indiscriminate invocation of these anti-abuse provisions could lead to significant dilution of tax treaty benefits.

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GENERAL ANTI AVOIDANCE RULE

Under the Act, there are limited anti-abuse provisions.

The DTC proposed a GAAR. Under GAAR, Revenue Authorities had sweeping powers to, inter alia, disregard, combine or re-characterize any part or whole of a transaction / arrangement if the transaction / arrangement was considered to be an 'impermissible avoidance arrangement'.

For the above purpose, 'impermissible avoidance arrangement' means an arrangement, the main purpose of which is to obtain tax benefit and, inter alia, which lacks commercial substance or which results in the abuse of the provisions of the DTC.

REVISED DISCUSSION PAPER

- Every arrangement for tax mitigation would not be classified as an 'impermissible avoidance arrangement'. Further, an arrangement would also have to satisfy any one of the following conditions to qualify as an 'impermissible avoidance arrangement':
  - It is not at arm's length
  - It represents misuse or abuse of the provisions of the DTC
  - It lacks commercial substance
  - It is carried out in a manner not normally employed for bona fide business purposes.

Safeguards provided are:

- The Central Board of Direct Taxes (CBDT) will issue guidelines to provide for the circumstances under which GAAR may be invoked
- A threshold limit of the tax avoided would be provided for invoking GAAR
- The forum of Dispute Resolution Panel (DRP) would be available where GAAR provisions are invoked.

OUR COMMENTS

- Guidelines to be issued by CBDT would need careful examination to assess the scope and impact of these provisions
- Further, whether reference to the DRP against GAAR invocation is an appropriate remedy, remains to be seen
- It is also an open question whether GAAR can be invoked for transactions undertaken prior to the enactment of DTC.

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CFC PROVISIONS

Under the Act as well as the DTC, there are no CFC provisions.

REVISED DISCUSSION PAPER

- CFC provisions brought in as an anti-avoidance measure.
  - Passive income earned by a foreign company controlled directly or indirectly by a resident in India, and where such income is not distributed to the shareholders, resulting in deferral of taxes shall be deemed to have been distributed
  - Consequently, such deemed distribution shall be taxable in the hands of resident shareholders as the dividend received from the foreign company.

OUR COMMENTS

- CFC provisions will bring in additional complexity in the tax legislation
- CFC provisions would need careful examination to evaluate their impact on outbound investment structures.

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TAXATION OF CAPITAL GAINS

The DTC has made a distinction between 'investment assets' and 'business assets'. It provided that gains arising from the transfer of 'investment assets' were taxable under the head 'capital gains'.

The DTC eliminated the distinction between short-term capital gains and long-term capital gains, especially with respect to the rates at which such gains would be taxed. In case of non-residents, capital gains was considered as "special source" income and taxed at the rate of 30 percent. In respect of residents, capital gains were subjected to tax at applicable rates.

REVISED DISCUSSION PAPER

- Capital gains to be treated as income from 'ordinary sources' for all taxpayers, including non-residents and taxed at applicable rates
- **Gains from transfer of listed equity shares / units held for more than one year**

  Deduction will be allowed at a specified percentage of the gains, in respect of gains on transfer of listed equity shares / units of equity oriented fund held for more than one year from the end of the financial year in which these were acquired. However, no indexation benefit will be allowed. The adjusted capital gains after such deduction will be taxed at applicable rates.

  Similarly, capital losses will be scaled down by the specified percentage.

  The specified percentage of deduction will be finalized in the context of the overall tax rates.
- **Gains from transfer of other investment assets held for more than one year**

  In respect of other investment assets held for more than one year from the end of the financial year in which these were acquired, the indexation benefit would be available with reference to the base date of April 1, 2000. However, deduction at specified percentage will not be allowed
- **Gains from transfer of assets held for less than one year**

  In respect of assets held for less than one year from the end of the financial year in which these were acquired, capital gains will be computed without the benefit of either a specified deduction or indexation.

OUR COMMENTS

- The distinction between 'ordinary source' and 'special source' income in so far as capital gains in the hands of non-resident is done away with. All capital gains are now proposed to be treated as 'ordinary source' income in the hands of both the resident and non-resident taxpayers
- Several representations were made for restoring the current exemption from long term capital gains on sale of listed securities etc. Whilst no exemption has been provided, the proposed deduction should provide some relief, as it will reduce the effective rate of taxation of such capital gains. As per an illustration in the Paper, based on a specified deduction rate between 50 percent and 70 percent, the effective tax rate would be between 5 percent and 15 percent depending on the marginal rate applicable to the taxpayer.

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TAXATION OF CAPITAL GAINS

REVISED DISCUSSION PAPER

- **Capital gains in the hands of FIIs**

  Income arising on purchase and sale of securities by an FII shall be deemed to be income chargeable under the head 'capital gains'. Further, such gains arising to FIIs shall not be subject to TDS and FIIs would be required to pay advance tax on such gains

- The DTC proposed to eliminate STT. However, in the light of the revised regime providing for specified deduction from capital gains on listed equity shares / units in an equity-oriented fund, STT will be calibrated instead of being eliminated

- Capital Gains Savings Scheme not being introduced as proposed in the DTC.

OUR COMMENTS

- To end litigation on whether income from sale of securities in the hands of FIIs will be treated as 'capital gains' or 'business income', it has been provided that such income will be deemed to be 'capital gains'. The elimination of TDS on capital gains earned by FIIs is a positive measure

- Under the DTC, capital losses were ring-fenced and could not be set off against other income. There were representations that since capital gains were being taxed at the same rate as other income, such set-off should be allowed. The Paper does not address this issue.

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TAXATION OF EXISTING UNITS IN SEZ

Under the Act, units operating in SEZ enjoy profit-linked deductions.

Profit-linked deductions were done away with in the DTC. However, DTC provided for grandfathering of profit-linked deduction for SEZ developers and not for SEZ units.

REVISED DISCUSSION PAPER

- Profit-linked deduction extended to existing SEZ units for the unexpired period.

OUR COMMENTS

- This relieves concerns of existing SEZ units. However, absence of profit-linked deductions for new units could significantly impact development of SEZs.

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TAXATION OF 'INCOME FROM HOUSE PROPERTY'

Under the Act:

(a) House property is classified either as self occupied, let out or deemed to be let out

(b) The annual value of a House property deemed to be let out is determined with reference to the 'fair rent' of the property

(c) In case of properties let out / deemed to be let out, a deduction of 30 percent of the annual value for repairs and maintenance is allowed. Additionally, interest on housing loan is allowed as a deduction

(d) In case of one self occupied property, the annual value is Nil and an interest deduction up to INR 1.5 lacs is allowed.

Under the DTC:

(a) The gross rent from house property was proposed to be determined at higher of contractual rent or presumptive rent. The presumptive rent was to be determined at the rate of 6 percent of the value fixed by the local authority or the cost of construction / acquisition of house property, where no such value was fixed by the local authority

(b) Deduction for repairs and maintenance was restricted to 20 percent of the gross rent of the property

(c) No deduction was provided for interest on loan for a self-occupied house property.

REVISED DISCUSSION PAPER

- The concept of presumptive rent has been eliminated. Further, the value of house property not let out for any part of the year will be considered as NIL. However, no deduction for taxes or interest will be allowed for such house property
- The deduction of INR 1.5 lacs in respect of the loan taken for acquisition / construction of self occupied house property has been retained.

OUR COMMENTS

- The removal of taxation based on presumptive rent is in line with the international practice of taxing real / actual income instead of notional income
- Continuation of deduction of INR 1.5 lacs interest for self-occupied property is a welcome step.

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EET vs. EEE REGIME FOR SAVINGS SCHEMES

Under the Act, the long-term savings schemes like Government Provident Fund (GPF), Recognized Provident Fund (RPF), Public Provident Fund (PPF), Life Insurance, etc. are covered under the EEE method, wherein the contributions, accumulations / accretions thereto and the withdrawals are exempt from tax.

The DTC proposed to introduce Exempt-Exempt-Taxation (EET) method of taxation on all such schemes, wherein the contributions and accretions were exempt from tax, while the withdrawals were proposed to be taxable. It was, however, proposed that only withdrawals of accumulated balances on March 31, 2011 in specified Provident Funds would not be subject to tax.

REVISED DISCUSSION PAPER

- EEE method of taxation to continue for specified Provident Funds and for the Pension scheme administered by Pension Fund Regulatory and Development Authority
- Approved pure life insurance products and annuity schemes will also be covered under the EEE method
- Investments made before the commencement of the DTC in instruments which enjoy EEE method under the existing Act, would continue to enjoy EEE method for the full duration of the financial instruments.

OUR COMMENTS

- In the absence of a universal social security system in India, the continuation of EEE regime is a welcome step as it will provide a tax free lumpsum amount to individuals to meet their post-retirement financial requirements.

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TAXATION OF RETIREMENT BENEFITS

Under the Act, the amount received by an employee on account of gratuity, commutation of pension, leave encashment, voluntary retirement at the time of retirement / termination is not taxable, subject to specified limits.

The DTC provided that amount received by an employee towards gratuity, commuted pension and voluntary retirement will not be taxable only if the same is deposited in a Retirement Benefit Account (RBA) maintained with the permitted saving intermediary prescribed by the Central Government. However, leave encashment is taxable on receipt basis. Further, any withdrawals from RBA were subjected to tax in the year of withdrawal.

REVISED DISCUSSION PAPER

- Current tax regime to continue and amounts received by an employee towards gratuity, commuted pension, voluntary retirement and leave encashment will continue to be exempt, subject to specified limits.

OUR COMMENTS

- Tax exemption for retirement benefits is a welcome step and will mitigate undue hardship to employees.

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WEALTH-TAX

The Wealth-tax Act, 1957 provides for wealth tax at the rate of 1 percent on specified assets exceeding INR 3 million. Wealth-tax is levied on Individuals, Hindu Undivided Family (HUF) and Company.

The DTC proposed to levy of Wealth-tax on Individual, HUF and Private Discretionary Trust at the rate of 0.25 percent on the net wealth exceeding INR 500 million. It was proposed to include all assets including financial assets (with certain exceptions) within the definition of net wealth.

REVISED DISCUSSION PAPER

- Wealth-tax made applicable to all taxpayers except Non-profit Organizations. Wealth-tax to be levied in line with the existing provisions on specified 'unproductive assets'. Threshold limit and rate of tax to be suitably calibrated in the context of overall tax rates.

OUR COMMENTS

- Levy of tax only on specified 'unproductive assets' is a welcome step.

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TAXATION OF NON-PROFIT ORGANIZATIONS

Under the Act, charitable organizations generally enjoy exemption from tax subject to specified conditions.

Under the DTC, Non-Profit Organizations (NPOs) are subject to tax at 15 percent on the aggregate of the surplus (Gross receipts less outgoings) generated from permitted welfare activities and capital gains arising from transfer of financial assets.

REVISED DISCUSSION PAPER

- Upto 15 percent of the surplus or 10 percent of gross receipts, whichever is higher, will be allowed to be carried forward to be used within three years from the end of the relevant financial year
- Only surplus in excess of basic exemption limit will be subject to tax
- The term 'permitted welfare activity' has been substituted with the term 'charitable purpose'
- The income of public religious institutions will be exempt subject to fulfillment of certain conditions only if these institutions are registered under the applicable state law.

  No deductions will be allowed in the hands of the donor in respect of donations to these institutions
- Income from public religious activity of partly religious and partly charitable institutions will be exempt subject to fulfillment of certain conditions.

  No deductions will be allowed in the hands of the donor in respect of donations to these institutions
- NPOs already registered under the Act and holding valid registration would not be required to apply for fresh registration under DTC and they would be required to provide only some additional information to facilitate administration
- Cash system of accounting is retained.

OUR COMMENTS

- Many NPOs receive donations in the last days of the financial year which cannot be immediately utilized, and consequently would have suffered tax under the DTC. Mindful of this, the proposed allowance for carry forward of 'surplus' for use in the subsequent years is a welcome step
- The provision of basic exemption limit will benefit trusts which carry on an activity of public utility and which only have a small proportion of income from sources other than permitted welfare activities. The basic exemption limit is yet to be provided
- The discussion paper now provides much needed clarity on the taxability of partly religious and partly charitable institutions
- NPOs already registered would be spared the rigmarole of registering under the DTC all over again
- The representations made to permit mercantile system of accounting, in line with generally accepted accounting norms has not been acceded to
- Under the DTC, in case an NPO ceases to be an NPO, it will be liable to tax at 30 percent of its net worth. This was extremely harsh and unjustified. However, the Paper does not take cognizance of the various representations made to reconsider this.

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