CBDT releases Discussion Paper on the revised Direct Taxes Code

Executive Summary

In August, 2009 with the object of replacing the existing Income Tax Act, 1961 with new taxes code, the draft Direct Taxes Code (DTC) along with discussion paper was released for public comments. The DTC was criticized heavily in respect of certain vital changes proposed in tax regime such as asset based MAT, EET basis of taxation of savings instruments, capital gains taxation, etc.

The Ministry of Finance responded to the suggestions from the tax paying community, the professional bodies and other stake holders by agreeing to address the concerns raised. Recently, the finance minister had announced that the Revised Direct Taxes Code (RDTC) bill will be introduced in the monsoon session of the parliament preceded by a discussion paper for the public comments. Accordingly, the discussion paper (DP) has been released on 15th June, 2010. The DP deals with only those proposals of the DTC which were highly resisted in the public response and it suggests the proposed revision in the RDTC.

- ➢ The major concerns over the MAT, EET, taxation of house property income, the treaty override and continuity of tax exemption of income in case of units in SEZs have been addressed.
- ➢ While the proposed capital gains tax regime under RDTC is an improvisation over the one that was proposed in the DTC, it is certainly less liberal than the current tax regime.
  - In the RDTC the period of holding in respect of all capital assets, whether shares and securities, or otherwise, has been uniformly fixed as a period of over one year from the end of the financial year in which it is acquired, for the asset to qualify as long term capital asset.
  - In respect of assets being shares of listed companies and units of equity oriented mutual funds, the long term capital gain will be scaled down by a prescribed percentage of deduction, regardless of the period of holding. However, no indexation benefit would be available.
  - In case of other capital assets, the benefit of indexation will be available in the same manner as the current provisions; however, the benefit of scale down as discussed above will not be available.

- In deviation from the proposal in the DTC to tax the capital gains income in the case of non residents (including FIIs) @ 30%, the RDTC provides uniform regime for taxation of capital gains regardless of the residential status of the Tax payer.
- In the case of FIIs it has been provided that its income from the transaction in securities will be taxed as capital gains only, as against the position taken by some FIIs currently that their income is business profits and in the absence of its permanent establishment in India it is not chargeable to tax.

➢ The existing units in SEZs will be entitled to deduction of profits in respect of unexpired period in the RDTC regime. However, new units that will commence its operations in SEZs post the date of coming into force (proposed 01 April 2011) of the RDTC, will not be eligible for the income tax incentive.

➢ Significant changes are proposed for determination of residential status of foreign company.

➢ In the case of Controlled Foreign Corporations (CFCs) – the RDTC proposes that passive income earned by such company if not distributed to the shareholders in India, it shall be deemed to be the dividend income liable to tax in India.

➢ The General Anti Avoidance Rules proposed in the DTC have been retained, albeit, with some rationalization. The treaty override provisions of DTC have been significantly modified to restrict its applications only to the cases of tax avoidance, the provisions of Controlled Foreign Corporations, etc.

1. The salient features of the proposed changes over of the DTC

Proposals	DTC	RDTC
Minimum Alternate Tax (MAT)	➢ Asset based tax	➢ The book profit based tax
Taxation of saving instruments like PF, PPF, Pension fund, etc and Gratuity	➢ Exempt Exempt Tax (EET) basis	Exempt Exempt Exempt (EEE) basis
Employment Income	➢ Perquisites like medical facilities / reimbursements leave travel concession wholly taxable.	➢ Exemption of leave travel concession to continue. ➢ The exemption limit for medical facilities /

		reimbursements to be enhanced from the current level.
House Property income	➢ Presumptive rent value basis of taxation ➢ No deduction of interest on self occupied house	➢ Fair rent value basis of taxation ➢ Self occupied house eligible for interest upto Rs 1.50 lacs.
Capital gains	➢ Both Long term and short term capital gains treated at par except that LTCG eligible for indexation benefit. ➢ No separate categorization for equity shares of listed companies or units of equity oriented mutual funds. ➢ In case of residents, all capital gains whether long term or otherwise taxable as part of total income liable to tax at the applicable rate of taxation. ➢ Incase of non-residents (including FIIs) all capital gains whether long term or otherwise to be taxed at flat rate of 30%.	➢ For all tax payers, whether resident or not, capital gains to be included in the total income and liable to tax at the rate applicable to that tax payer. ➢ All capital assets whether financial instruments or otherwise will be long term if held for more than one year from the end of the financial year in which the asset is acquired. ➢ <u>Listed equity shares or units of equity oriented mutual funds</u> No indexation. However, capital gains amount to be scaled down by a prescribed percentage deduction (percentage not suggested yet) ➢ <u>All other capital assets</u> - indexation benefit available. ➢ Securities Transaction Tax (STT) may continue. However, the rate will be reviewed. ➢ FIIs income from transaction in capital market to be characterized as capital gain – not permitted to treat as business income.
Units in SEZ	➢ No deduction of profits to the existing units or new units.	➢ The deductions currently available to the existing units to continue for the unexpired period of the tax holiday. ➢ New units will not be eligible to any deduction.
Residential status of foreign companies	➢ A foreign company to be resident of India even if part of the control situated in India.	➢ A foreign company to be resident of India if its place of effective management is situated in India.
Treaty override	➢ Neither DTAA nor Domestic Tax Law shall have a preferential status over the other. Incase of conflict between the two, the one that is later in	➢ DTAA or the Domestic law which ever is more beneficial to the tax payer shall apply. ➢ However, the domestic law shall prevail if the following provisions are invoked:

	point of time shall prevail.	▪ General Anti Avoidance Rule ▪ Controlled foreign corporation ▪ Branch profit tax levied
General Anti Avoidance Rule	➢ Wide power with the assessing officer to declare any arrangement as tax avoidance method if it results into tax benefits with also the power to redefine the transactions.	➢ Arrangement for tax mitigation would not be classified as impermissible tax avoidance unless, besides obtaining tax benefit for the tax payer, the arrangement attracts one of the following conditions - Transaction is not at the arms length ▪ It represents misuse or abuse of the RDTC ▪ There is a lack of commercial substance ▪ It is not bonafide ➢ Further, CBDT to issue guidelines to provide for circumstances under which provision may be invoked. ➢ The provision will be invoked subject to specified threshold limit. ➢ Also, the forum of Dispute Resolution Panel (DRP) would be available when such provisions are invoked.
Wealth Tax	➢ Incase of individual, HuF and private discretionary trust, wealth tax to be charged on net wealth exceeding INR 50 crores. ➢ Barring a few exemptions such as one residential house, stock in trade, etc all assets whether or not related to business to be included in the net wealth.	➢ The Wealth Tax provisions to be brought in line with current provisions of the Wealth Tax Act, i.e the assets which are unproductive would be included in the net wealth. ➢ However, the scope is now extended to all tax payers except the non profit organizations.
Taxation for Non Profit Organization (NPO)	➢ Fresh registration required with income tax department even for existing NPOs ➢ No provision for accumulation of income for charitable purpose. ➢ Unless entire receipts spent during the financial year, the surplus liable to tax @ 15%. ➢ Surplus to be ascertained on cash system of accounting.	➢ Fresh registration not required in the case of existing NPOs. However, additional information to be provided. ➢ Religious Trust will be compulsorily required to be registered under RDTC and shall fulfill various other conditions prescribed. ➢ Donations to such Trusts not eligible for deduction in the hands of the donor. ➢ Specific provisions made incase of Trusts which are

	➢ Religious Trusts exempt from tax only if registered under religious endowment Acts of central or state government. ➢ Donations not eligible for deductions in the hands of the donor.	partly religious and partly charitable. ➢ Surplus to be computed as per cash system of accounting.
Controlled Foreign Corporations (CFCs)		➢ CFC is defined as a foreign company controlled by a resident in India. ➢ As an Anti Avoidance measure, it is provided that passive income earned by such companies, if not distributed, shall be deemed to be the dividend income of the resident shareholder in India.

2. The RDTC, unlike the DTC, has not indicated the proposed tax rates. It may be recalled that the DTC had proposed very liberal tax rates. The DP has clarified that in view of major changes proposed in the RDTC, the rates of taxation will have to be calibrated appropriately to factor the reduction in revenue. The actual rates of taxation will be known only when the RTDC Bill is placed in the Parliament. Similarly, the security transaction tax will be calibrated with the new tax regime of capital gains and the inflow of foreign funds.

3. Comments:

- The DP has addressed to all the major concerns expressed after release of the DTC.
- The withdrawal of asset based MAT will give relief to companies in infrastructure segments, startup companies, capital intensive industries, loss making companies. It will also give relief to the companies structured in the holding and subsidiary company format or in the format of chain of step down subsidiaries.
- The DP is silent on the availability of MAT credit.
- While explaining the EEE basis of taxation for various saving instruments, it is mentioned that only the pure insurance products duly approved will be entitled to the above benefit of EEE. Therefore, ULIPs will not be governed by the above regime. It appears that the money back insurance policies too may not be governed by the above regime. However, it has been clarified that the saving instruments / insurance policies issued prior to RDTC coming into force shall continue to be governed by current EEE basis of taxation, till maturity.
- Post release of DTC, serious concerns were expressed over the withdrawal of

income tax exemption to units in SEZ. In partial amend, the DP addresses the issue insofar as it provides for continuity of the exemption of the profits of the existing units in respect of the unexpired period of tax holiday. However, if the computation of the profits would be as proposed in the DTC vide Schedule XII / XIII, the benefit of deduction would be limited in the case of the units which incurs capital expenditure, for, the said Schedules provide for computation method in which the profits are ascertained after deduction of capital expenditure.

- The denial of benefit to the new units in SEZs would be perceived by the tax payers as instability of the fiscal policy of the Government. One may find anxiety of the tax payers in commencing business in SEZs before the cut-off date of the RDTC coming in to force.
- In a significant departure from the current provisions of the Income Tax Act, it is proposed that for a capital asset to be long term, the period of its holding should be more than one year from the end of the financial year in which such asset is acquired. The difference in the holding periods prescribed for shares and securities as a class of assets and other capital assets has been blurred. However, it may be noted that the one year period commences from the end of the financial year in which such asset is acquired. Therefore, if an asset is acquired say on 01 April 2011, it will become long term asset on 01 April 2013, thus the effective holding period would be in fact 2 years in the instant case.
- In the case of shares of a listed company or units of an equity oriented mutual fund, it is provided that in the computation of the capital gains deduction will be granted of a prescribed percentage of the gain amount. While the actual percentage will be prescribed, the DP illustrates the scenario of the effective tax rates as follows :

Specified percentage deduction	Effective tax rate for taxpayer whose applicable marginal tax rate is 10%	Effective tax rate for taxpayer whose applicable marginal tax rate is 20%	Effective tax rate for taxpayer whose applicable marginal tax rate is 30%
50	5%	10%	15%
60	4%	8%	12%
70	3%	6%	9%

- Many FIIs in India took the position that the income earned from securities transactions are 'business profits' and in the absence of permanent establishment (PE) in India, its income is not liable to tax in India. The proposition was also supported by some favourable judicial rulings. It is now proposed that by a deeming fiction, the income of FIIs earned from securities transactions will be considered as chargeable under the head 'capital gains'. Those FIIs which are tax resident of Mauritius and other jurisdictions which do not charge tax on capital gains, will not be impacted with the above proposal. However, the FIIs which are tax resident of the other jurisdictions where the capital gains is not exempt or the jurisdictions with whom India does not have a tax treaty, will be impacted.
- A foreign company will be resident in India if "the place of effective management" of the company is situated in India. The term has been defined as
  - the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
  - in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions."

  The definition is broad and subjective. The Indian companies which have foreign operations and the foreign companies having presence in India will be impacted.
- The General Anti Avoidance Rules which were proposed in the DTC have been retained with modifications. The purport of the provisions will require a close scrutiny of the actual provisions which will be drafted in the proposed Bill. These rules are likely to give substantial power to the tax department. Unless the provision is administered in a fair manner, it is likely to cause enormous litigation and hardships to the tax payers. It has been also provided that when these rules are invoked, it will have the effect of treaty override. To

that extent, the provision will curtail the treaty abuse. In fact, most treaty have inbuilt anti avoidance rules. However, the specific rule in the domestic law will strengthen the tax department's case in such cases.

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For any clarification or elucidation in respect of this alert, you may kindly connect to our Direct Tax Team .

We are reachable at:

PHD & Associates
Chartered Accountants
Radha Chambers, Level 3,
Telli Park Lane, Andheri East,
Mumbai - 400 069. India.
Tel : +91 22 26820083
Fax : +91 22 26830824