INDIAN DIRECT TAX CODE 2009 – AN OVERVIEW

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The Government of India had released the draft Direct Tax Code ('DTC') along with a Discussion Paper in August 2009 for public comments. Various stakeholders have provided their feedback and the Government subsequently released a Revised Discussion Paper in June 2010 addressing some of the key concerns on the DTC.

The DTC would replace the existing direct tax legislation constituted by the Income Tax Act, 1961 and the Wealth Tax Act, 1957 with effect from April 1, 2011. It aims to simplify the language with an intention to remove uncertainty in interpretation of the tax law and mitigate undue litigation. While most of the provisions in the DTC meet these objectives, there are certain provisions relating to Minimum Alternate Tax ('MAT'), General Anti-Avoidance Rules ('GAAR') and Determination of Residential Status of Foreign Corporate, which could have adverse and undesirable consequences.

This article provides an overview of the key proposals in the DTC and their impact on both domestic and international businesses in India.

CORPORATE TAXATION

Tax Rates

Under the existing provisions, the tax rate applicable to domestic companies is 30 per cent (*plus surcharge and education cess*). Additionally, domestic companies are required to pay a tax of 15 per cent in respect of dividend distributed to the shareholders. On the other hand, foreign companies are subject to a 40 per cent tax (*plus surcharge and education cess*), with no obligation to pay tax on remittance of such profits to their head office overseas.

The DTC has proposed to bring harmony in the tax structures applicable to Indian and foreign companies by introducing a unified rate of tax at 25 per cent in respect of both entities. However, Distribution tax at 15 per cent would continue in respect of domestic companies and a new levy, namely Branch Profit Tax ('BPT') is proposed on branch profits earned by foreign companies.

This proposal would bring parity in tax rates and also reduce the effective tax liability in respect of both domestic as well as foreign companies.

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Minimum Alternate Tax

Presently, companies are required to pay Minimum Alternate tax ('MAT') at 18 per cent *(plus surcharge and education cess)* of its 'book profits' (adjusted net profit). Credit of MAT can be availed during ten subsequent financial years.

The DTC had initially proposed a radical shift in the manner of computing MAT liability, by considering the value of 'gross assets' against 'book profits' and reducing tax rate to 2 per cent[1] from existing 18 per cent. However, the Revised Discussion Paper has retained the existing scheme of computing MAT i.e. with reference to 'book profits'. The manner of computing 'book profits', provisions relating to MAT credit and rate of MAT has not been specified.

Business Income

Under the existing scheme of taxation, computation of business income is based on 'business profits', which is then adjusted to arrive at the 'taxable income'.

The DTC has proposed a complete revamp of the existing 'business profits' model to an 'income expense model', which is prevalent in certain developed and ASEAN countries. Under the proposed 'income expense model', capital receipts from business shall also be taxable as normal business profits. For instance, profits from sale of business capital assets, presently considered as Capital Gains, would be taxable as business profits. Furthermore, income from each business would be computed separately.

The Discussion Paper has indicated that the proposed change in the method of computing business income would mitigate disputes arising from taxability of receipts and deduction for expenses, which are a subject matter of frequent disputes between tax-payers and authorities. Further, the computation of income for each business separately would require a more detailed exercise by taxpayers.

Loss on Depreciable Assets

Under the existing regulations, loss arising due to transfer of depreciable assets results into 'short-term capital loss' to the business. However, the DTC has proposed that loss arising on transfer of business capital assets, be treated as intangible asset, which is eligible for depreciation at applicable rates. In effect, only a fraction of such loss would be set off against business income each year in the form of depreciation.

Wealth Tax

Wealth tax is payable in cases where the net wealth (net value of specific assets) of the company is higher than the threshold exemption limit, presently at Rs 3 mn. The rate of tax is 1 per cent. The DTC has proposed to abolish wealth tax on companies.

[1] 0.25 per cent for banking companies

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CAPITAL GAINS TAX

Long Term vs Short Term Capital Gains

Under the existing provisions, capital gains are bifurcated as long term or short term, wherein long term gains are eligible for concessional rate of tax.

The DTC had initially proposed to eliminate the differential tax treatment for long term and short term capital gains. However, the Revised Discussion Paper has again provided for differential treatment of capital gains arising from transfer of assets held for more than one year and less than one year.

In respect of transfer of listed equity shares or units of equity oriented funds, the DTC has done away with the process of indexation of costs and instead provided that a percentage would be deducted from the amount of capital gains to arrive at the taxable gain. Income of Foreign Institutional Investors ('FIIs') would be taxed as capital gains and not business income. This has been done to ensure that FII's are subject to Indian tax even when they do not establish a PE in India.

INTERNATIONAL TAXATION

Residential Status of Foreign Companies

Under the existing scheme of law, a foreign company is considered to be a resident of India if the whole of its management and control is situated in India. Test of residency is critical to determine the scope of income chargeable to tax. A resident company is taxable in India on its worldwide income.

The DTC had proposed a drastic change to this provision by providing that foreign companies would be treated as residents in India if control and management is even partly situated in India. This had raised significant issues for overseas subsidiaries of Indian companies or for foreign companies who may have some part of their control and management situated in India.

The Revised Discussion Paper has proposed to adopt 'Place of Effective Management' as the criteria for determination of residential status of a foreign company. It refers to the place where board of directors of the company or its executive directors makes their decisions. In case where board of directors routinely approve the commercial and strategic decisions taken by the executive directors or officers of the company, the place where such executive directors or officers perform their functions.

The proposed criteria for determining the 'Effective Place of Management' is rather ambiguous and leave a lot to interpretation. Specific issues viz. meaning of expression 'strategic and commercial decisions' and what constitutes a 'routine' approval would likely invite litigation.

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Royalty and Fee for Technical Services (FTS)

Royalty and FTS earned by non-residents are presently taxed at 10 per cent (*plus surcharge and education cess*) on gross amount. Should these payments relate to a Permanent Establishment ('PE') of the foreign company in India, these are taxable on net income basis at an effective rate of 40 per cent (*plus surcharge and education cess*).

The DTC has proposed to enhance the tax rate from 10 per cent to 20 per cent tax on gross amount of royalty and FTS income earned by non-residents in India, even when a PE of such foreign company is in existence.

The increase in tax rates would adversely impact non-residents earning royalty / FTS from India. This would also lead to increase in cost of importing technology and services into India should the impact of additional tax cost is shifted to the Indian customer. Further, removal of net income basis of taxation may increase the tax cost for non-residents having a PE in India.

Treaty Override

At present, the provisions of tax treaties override domestic tax law to the extent these are beneficial to the tax-payer.

The DTC, however, had initially proposed to introduce a concept of treaty override, whereby the provisions of the treaty or the code, whichever is later in time, was to prevail. Further, there was no clarity on relief, as may be available, to non-resident tax-payers under the existing tax treaties. This invited a sharp reaction from the international investors and specific representations were made to bring clarity to table.

As a result, the Revised Discussion Paper proposed to reinstate the existing provisions with regard to treaty override. At the same time, it clarified that provisions of the DTC would still override provisions of the tax treaties under the following circumstances

- When General Anti Avoidance Rules are invoked
- When Controlled Foreign Corporation Rules are invoked
- When Branch Profit Tax is levied

Until the Indian Government comes out with clear parameters on invoking GAAR provisions, treaty overriding provisions would remain uncertain.

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TRANSFER PRICING

Advanced Pricing Agreement ('APA')

An APA is an arrangement between the tax payer and revenue authorities which is made prior to actual transaction, with a view to solve potential taxation disputes in a co-operative manner. The tax payer and the authority mutually agree on the Transfer Pricing methodology to be applied over a certain future period of time. An APA is thus a pre transaction analysis rather than a post mortem. APAs can be applied for a variety of transactions, eg; dealing in goods and services, financing arrangements, transfer of tangible/intangible goods etc.

In the present scheme of Indian tax law, there is no provision of negotiating an Advanced Pricing Agreement ('APA') with revenue authorities.

The DTC has proposed to incorporate the APA provisions in the domestic law, primarily to serve as an effective tool to mitigate TP litigation and provide certainty to international investors on taxability of their Indian subsidiaries. Such APAs can be entered for a maximum period of five years.

ANTI ABUSE PROVISIONS

General Anti Avoidance Rules ('GAAR')

The DTC has introduced the concept of GAAR as an anti-avoidance measure. GAAR empowers the revenue authorities to disregard or re-characterize any transaction or arrangement, if they are satisfied that the transaction/arrangement lacks commercial substance or bona fide purpose and has primarily been entered into for the purpose of avoidance of tax. Thus, GAAR provisions empower the revenue authorities with sweeping powers to characterize any transaction for the purpose of computing the tax liability, and are expected to be applied in cases involving 'treaty shopping' and 'round tripping'. The benefits endowed by a tax treaty would not be available once the tax authorities choose to invoke GAAR provisions.

The Revised Discussion Paper has clarified that Central Board of Direct Taxes ('CBDT') would issue specific guidelines indicating specific circumstances (safe harbour rules) under which GAAR provisions may be invoked by the revenue authorities. Further, GAAR provisions would be invoked only in respect of arrangements, where tax avoidance is beyond a specific threshold limit. The newly constituted forum of Dispute Resolution Panel ('DRP') would also be available to tax-payers where GAAR provisions are invoked.

In essence, the DTC has maintained status quo in respect of GAAR provisions. Considering the gravity of the proposed GAAR provisions and the discretionary powers vested with the revenue authorities, it

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remains to be seen whether these provisions will be invoked sparingly, and whether the proposed safe harbour rules would ensure that legitimate tax mitigation arrangements are not adversely viewed by the revenue authorities.

Controlled Foreign Corporations

The Revised Discussion Paper has proposed to introduce the concept of Controlled Foreign Corporations ('CFC') as an anti-avoidance measure to ensure that passive income earned by a foreign company, controlled directly or indirectly by a resident in India, is taxed in India. The CFC provisions provide that passive income (eg dividend, interest, royalty) earned by a foreign company controlled directly or indirectly by a resident in India, which is not distributed to its shareholders, shall be deemed to have been distributed. Consequently, such income will be taxed in the hands of the Indian shareholders as dividend income. These provisions would bring to tax the income of offshore holding companies, mainly created for holding investments to earn dividend / interest income or to hold IPRs to earn royalty income in low tax jurisdictions.

The CFC rules poses a risk of double taxation of foreign income earned abroad, one by virtue of domestic tax laws in foreign jurisdiction and another by virtue of CFC rules. There is likelihood of this income being taxed again when it is distributed to India. This would remain an issue until the CFC rules provide for credit of underlying taxes paid in the foreign jurisdiction and also a credit / exemption at the time of actual distribution to the Indian company.

INDIVIDUAL TAXATION

Rules of Residency

Test of residency is critical to determine the scope of income chargeable to tax. While residents are charged to tax on their worldwide income, non-residents are only chargeable to tax on incomes received or sourced from India.

Under the existing provisions, an individual may qualify as a resident or non-resident, depending upon his stay in India. However, under specific circumstances, the individual may acquire a Resident but Not Ordinarily Resident ('RNOR') status, which exempts his overseas income.

The DTC has proposed to abolish the RNOR status and instead provided an exemption of overseas income to those who have maintained a non-resident status in the past nine consecutive years. Such exemption would be available to a resident individual for 2 consecutive years.

The removal of RNOR status would likely enhance the number of tax-payers who would be declaring their worldwide incomes in India.

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Tax Rates

The tax rates for individuals have been significantly liberalised

Old Income Slabs (INR)	New Income Slabs (INR)	Rate of Tax
Upto 160,000	Upto 160,000	Nil
160,001 – 500,000	160,000 – 1,000,000	10%
500,000 – 800,000	1,000,000 – 2,500,000	20%
Above 800,000	Above 2,500,000	30%

The reduction in tax rates would reduce the tax burden and increase the disposable income in the hands of individuals.

Savings/Investments

India presently follows an Exempt Exempt Exempt ('EEE') scheme of taxation for personal savings such as provident fund etc.

The DTC had initially proposed a radical shift from the EEE to an Exempt Exempt Tax ('EET') scheme of taxation. However, the Revised Discussion Paper has proposed to restore the EEE scheme in respect of provident funds, approved pension schemes, superannuation funds, pure life insurance products and annuity schemes.

In effect, saving schemes other than those specified above would be taxed per the EET scheme and any withdrawals of the contribution and accretions would be subject to tax.