

Direct Tax Alert

Revised Discussion Paper on The Direct Taxes Code



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Background

The draft Direct Taxes Code (DTC) along with a Discussion Paper was released on 12 August 2009 for public comments with the intention to simplify direct tax legislation in India. Subsequently, comments were solicited from the public and examined by the Government. A Revised Discussion Paper which is meant to respond to the major concerns and comments of stakeholders has now been released on 15 June 2010.

In view of the changes proposed and concessions given, it is expected that the proposals would lead to a reduction in the original tax base proposed in the DTC. The indicative tax slabs, tax rates, monetary limits for exemptions and deductions proposed in the DTC will, therefore, be calibrated accordingly while finalizing the legislation.

Key Highlights

While the text of changes to the statute are awaited, it has been indicated that the Revised Discussion Paper does not address all changes and there will possibly be more changes when the final DTC Bill makes its way to Parliament. This alert provides key highlights of the Revised Discussion Paper:

Minimum Alternate Tax (MAT) – Gross assets vis-a-vis Book profit

Original proposals under the DTC

- MAT was to be computed on the “value of gross assets”¹.
- Tax rate under MAT to be 0.25% on value of gross assets in case of banking companies and 2% for other companies.

¹ “Value of gross assets” defined to mean the aggregate of the value of the gross block of fixed assets, capital work in progress, the book value of all other assets, as on the last day of the relevant financial year, as reduced by the accumulated depreciation on the value of the gross block of fixed assets and the debit balance of profit and loss account, if included in the book value of other assets

- MAT to be the final tax liability and carry-forward credit not allowed.

Issues and concerns raised

- Significant hardship to loss making companies or companies operating in a cyclical downturn. Also, inequitable to newly set up infrastructure companies and companies undergoing major expansion as compared to the old businesses.
- Not reasonable to levy a presumptive asset tax on companies under liquidation.
- “Capital works in progress” does not contribute in revenue generation and thus distorts the asset based tax.
- Cascading tax effect in a situation where there are multiple tiers of subsidiaries.
- Carry forward of MAT to a subsequent year not allowed resulting in higher tax payout.
- “Investment linked” incentives proposed in DTC in certain specified sectors, whereas the application of an asset based MAT on these companies contradicts this policy.

Revised Proposal

- MAT to be computed with reference to book profit.

Tax treatment of savings – Exempt-Exempt-Tax (EET) vis-a-vis Exempt-Exempt-Exempt (EEE) basis

Original proposals under the DTC

- The EET method of taxation for savings allowed a deduction for individuals up to INR 300,000 in a financial year on contributions made to permitted savings intermediary. Accumulation/accretions from such savings were to be exempt from tax till such time as they remained invested. All withdrawals were subject to tax at the applicable rate in the year of withdrawal under the head ‘income from residuary sources’.
- The EET based taxation proposal was to be prospective and withdrawals from accumulated balances as on 31 March 2011 from Government Provident Fund (GPF), Public Provident Fund (PPF), Recognized Provident Funds (RPFs) and Employees Provident Fund (EPF) were not taxable. Only new contributions as well as accretions on or after the commencement of the DTC were subject to the EET method of taxation.

Issues and concerns raised

- The EET method of taxation on savings is generally followed in countries having a social security system, which is absent in India and making the change would be harsh on people that need a lump sum fund on retirement for family obligations.
- The application of the EET method should be restricted to new savings instruments after the date from which the DTC comes into effect.

Revised Proposals

- The EEE method of taxation to be followed for GPF, PPF, RPFs and pension scheme administered by Pension Fund Regulatory and Development Authority, approved pure life insurance products and annuity schemes.

- Investments made, before commencement of the DTC in instruments currently enjoying the EEE method of taxation would continue to be so eligible for the full duration of the instrument.

Taxation of income from employment – Retirement Benefits and Perquisites

Original proposals under the DTC

- Contributions made by the employer to an approved superannuation fund, provident fund, life insurer and New Pension System Trust to be considered as salary. Deductions from gross salary to be allowed for compensation received under a voluntary retirement scheme, gratuity received on retirement or death and amount received on commutation of pension to the extent such amounts are deposited in a Retirement Benefits Account (RBA). The accretion to and withdrawal from deposits was to follow EET system of taxation.
- Salary was to include the following:
 - (a) value of rent free or concessional accommodation provided by the employer;
 - (b) value of any leave travel concession;
 - (c) encashment of unavailed earned leave on retirement or otherwise;
 - (d) medical reimbursement; and
 - (e) value of free or concessional medical treatment paid for, or provided by the employer.
- Value of rent-free accommodation for all employees (including Government employees) to be determined in the same manner as currently determined in case of private sector employees.

Issues and concerns raised

- In the absence of adequate social security benefits, retirement benefit amount is used for savings and social expenditure. Taxation of withdrawals from RBA would be harsh.
- Value of accommodation in the case of Government employees, if taken at market rent, would create high tax burden.
- Perquisites in the nature of medical benefits should be exempt as under the current law.

Revised Proposals

- The RBA Scheme is not to be introduced in view of the complicated logistics involved in managing a large number of accounts and tracking the taxes on withdrawal.
- Gratuity, voluntary retirement scheme, commuted pension linked to gratuity and leave encashment receipts at the time of superannuation to be exempt for all employees, subject to specified limits.
- Perquisites in relation to medical facilities/reimbursement provided to employees to be valued as per the existing law with appropriate enhancement of monetary limits.
- Perquisite value of rent-free accommodation not to be computed based on market value.
- Method of valuation of perquisites to be appropriately provided in the rules.

Taxation of income from house property

Original proposals under the DTC

- Income from house property to be computed at gross rent less specified deductions. Gross rent to be the higher of contractual rent or the presumptive rent which is calculated at 6% per annum of the rateable value fixed by the local authority or in the absence of rateable value, of the cost of construction or acquisition of the property.
- Gross Rent of a single self occupied property to be deemed to be nil, and deduction for taxes or interest not to be allowed.

Issues and concerns raised

- Determination of notional rent on presumptive basis at the rate of 6% with reference to the cost of construction/acquisition is inequitable as it discriminates against recent owners, cost being a function of inflation.
- To incentivize investment in housing, the deduction for interest on capital borrowed for acquisition or construction of a self occupied house property, upto a ceiling of INR 150,000 should be retained.

Revised Proposals

- Gross rent not to be computed at a presumptive rate of 6% of the rateable value or cost of construction/acquisition.
- For a house property that is let out, gross rent will be the amount of rent received or receivable.
- For a house property that is not let out, the gross rent will be nil. As the gross rent is taken as nil, no deduction for taxes or interest, etc. will be allowed.
- An individual or HUF will be eligible to deduct upto INR 150,000 on account of interest on capital borrowed for acquisition or construction of any one self-occupied house property from gross total income. The overall limit of deduction for savings is to be calibrated accordingly.

Taxation of capital gain

Original proposals under the DTC

- Income from all investment assets to be computed under the head 'Capital gains'.
- Capital gains to be subject to tax at 30% in case of non-residents and at the applicable marginal rate in the case of residents.
- Distinction between short-term investment asset and long-term investment asset on the basis of the length of holding of the asset to be eliminated.
- Capital gain to be reckoned as equal to full consideration minus cost of acquisition, cost of improvement and incidental expenses.

- If capital asset transferred after one year from the end of the financial year in which acquired; the cost of acquisition and cost of improvement to be indexed.
- The base date for determining cost of acquisition to be shifted from 1.4.1981 to 1.4.2000.
- Securities Transaction Tax ('STT') to be abolished.
- Proposal to introduce the Capital Gains Saving Scheme for rollover of gains.

Issues and concerns raised

- Withdrawal of the existing tax regime will significantly raise tax liability and possibly affect the capital markets.
- A capital gains tax rate of 30% in the case of non-residents was very high
- Foreign Institutional Investors (FIIs) should not be liable to withholding tax on capital gains, instead the payment of advance tax should be continued as under the existing provisions.

Revised Proposals

- Capital gains to be considered as income from ordinary sources in case of all taxpayers including non-residents and to be taxed at rates applicable to that taxpayer.
- *Capital asset held for a period of more than one year from the end of financial year in which asset is acquired*
 - (A) Listed equity shares or units of an equity oriented fund
 - Capital gains to be adjusted after allowing a deduction at a specified percentage without any indexation. Loss arising on transfer of such asset to be scaled down in a similar manner. Rate of deduction to be finalized in the context of overall tax rates.
 - Adjusted capital gain/loss to be included in the total income of the taxpayer and taxed at the applicable rate.
 - Transition provisions from the current scheme, under which such assets are taxed at a nil rate to be provided.
 - (B) Other assets
 - The base date for determining the cost of acquisition to be shifted from 1.04.1981 to 1.04.2000. Consequently, all unrealized capital gains on assets between 1.4.1981 and 31.3.2000 not to be liable to tax.
 - Capital gains to be computed after allowing indexation, to be included in the total income of the taxpayer and to be taxed at the applicable rate.
- The proposal to introduce the Capital Gains Savings Scheme for rollover is to be dropped.
- *Capital gains on assets held for less than one year from the end of financial year in which asset is acquired*
 - Capital gain to be computed without any specified deduction or indexation.
 - Capital gain to be included in the total income and to be charged to tax at the rate applicable to taxpayer.

- *Income of FIIs*
 - Income arising on purchase and sale of securities by FIIs to be deemed to be income chargeable under the head 'capital gains'.
 - Capital gains arising to FIIs not to be subjected to withholding tax. FIIs to pay tax by way of advance tax on such gains as per the existing practice.
- STT not to be abolished but the rate will be calibrated based on the revised taxation regime for capital gains and flow of funds to the capital market.

Taxation of non-profit organisations

Original proposals under the DTC

Non-profit organisations (NPOs)

- Every NPO to obtain fresh mandatory registration with the income tax authorities.
- Phrase 'permitted welfare activity' has been used instead of 'charitable purpose'.
- No provision for a basic exemption limit.
- No provision for carry forward of unutilized surplus for use in subsequent years.

Religious institutions

- Any association, authority, body, institution or trust registered under any law of the Central, State or Provincial Government for the regulation of religious endowments to be exempt from tax; no income-tax deduction allowed in the hands of the donor.

Issues and concerns raised

- Fresh registration of existing NPOs after introduction of DTC will lead to increase in the compliance cost for NPOs.
- Phrase 'charitable purpose' should be used as this will minimize litigation.
- The taxation of the surplus of income over expenditure will be harsh in cases where grants are received at the end of the financial year or funds are not deployed due to reasons beyond their control. The window for carry forward of surplus for use in the subsequent years is therefore necessary.
- No clarification for religious institutions located in States having no special legislation dealing with religious endowments.
- Status of partly religious and partly charitable institutions not clear.

Revised Proposals

- Fresh registration not to be required for NPO's having existing income tax registration; however, some prescribed additional information may need to be provided to the tax authorities.
- Phrase 'permitted welfare activity' to be replaced by the phrase 'charitable purpose'
- Basic exemption limit to be provided.
- 15% of the surplus or 10% of gross receipts, whichever is higher, to be carried forward for use within three subsequent years; donations from accumulated surplus to other NPOs not to be considered as application for charitable purpose.
- Religious institutions, including institutions in States not having registration laws, to be entitled for exemption, subject to fulfillment of all the prescribed conditions; no income-tax deduction to be allowed in the hands of the donor.
- Institutions engaged in charitable as well as religious activities to be exempt to the extent of income from religious activities and taxed in the manner of NPOs in relation to income from charitable activities, subject to fulfillment of all the prescribed conditions; no income tax deduction to be allowed in the hands of the donor.

Special Economic Zones (SEZ) – Taxation of existing units

Original proposal under the DTC

- Profit linked deduction to existing units operating in SEZs, not grandfathered.

Issues and concerns raised

- Profit linked deduction available to developers in SEZ grandfathered but no grandfathering of deduction to existing units operating in SEZs.

Revised Proposal

- Existing units in SEZs to be eligible for the profit linked incentive for the unexpired period.

Concept of residence in the case of a company incorporated outside India

Original proposals under the DTC

- Foreign company to be treated as resident in India if, at any time in the financial year, the control and management of its affairs is situated 'wholly or partly' in India.
- Control and management not defined.

Issues and concerns raised

- The word 'partly' sets a very low threshold for regarding a foreign company as a resident in India.

Revised Proposals

- A company incorporated outside India to be treated as resident in India if its 'place of effective management' situated in India.
- 'Place of effective management' defined to mean:
 - 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.
- Controlled Foreign Corporation (CFC) Provisions
 - A provision introducing the taxation of CFC income is proposed for the first time. Passive income earned by a foreign company controlled directly or indirectly by a resident in India, if such income is not distributed to shareholders results in a deferral of taxes. Such income will now be deemed to have been distributed and will be taxable in India in the hands of resident shareholders as dividend received from the foreign company.

Double Tax Avoidance Agreement (DTAA) vis-à-vis domestic laws

Original proposal under the DTC

- Neither a DTAA nor the DTC to have any preferential status by reason of its being a treaty or law. In the case of a conflict between the treaty and the DTC, the one later in point of time to prevail.

Issues and concerns raised

- A general treaty override rule would render existing DTAAs redundant and is against the spirit of the Vienna Convention.
- Bilateral agreements cannot be re-notified unilaterally so it may not be possible to restore the preferential status of DTAA's over domestic law for all existing DTAA's
- The proposal would result in higher rates of taxation on royalty, fees for technical services and interest income etc. currently taxed in the source country at a concessional rate as per the provisions of the DTAA.
- The proposal could affect the inflow of foreign direct investment.

Revised Proposals

- The domestic law or the relevant DTAA, whichever is more beneficial to the taxpayer, to be applied.
- DTAA to have a preferential status over domestic law except in the following circumstances (limited treaty override):
 - when General Anti-Avoidance Rules (GAAR) invoked, or
 - when CFC provisions invoked, or
 - when Branch Profits Tax levied.

Wealth tax

Original proposals under the DTC

- Only Individuals, HUF's and Private Discretionary Trusts to be liable to wealth tax.
- Scope of assets chargeable to wealth tax widened to include financial assets.
- Threshold limit to be enhanced from existing INR 3 million to INR 500 million.
- Rate of wealth tax to be reduced from 1% to 0.25%.

Issues and concerns raised

- Productive assets should be exempted from wealth tax as is currently the case.
- Threshold limit of INR 500 million for levy of wealth tax too high.
- Harsh to tax the financial assets as they are currently exempt.

Revised Proposals

- Wealth Tax to be levied broadly on the same lines as provided in the Wealth Tax Act, 1957. Accordingly, specified “unproductive assets” to be subject to the wealth tax.
- Wealth tax to be payable by all taxpayers except NPOs.
- Threshold limit and rate of tax to be suitably calibrated in the context of overall tax rates.

General Anti-Avoidance Rules

Original proposal under the DTC

- GAAR to be introduced to deal with specific instances where a taxpayer enters into an arrangement, the main purpose of which is to obtain a tax benefit and such arrangement is entered or carried on in a manner not normally employed for bona-fide business purposes or is not at arm's length or abuses the provisions of the DTC or lacks economic substance.

Issues and concerns raised

- GAAR provisions are sweeping in nature and may be invoked by the tax authorities in a routine manner.
- No distinction between tax mitigation and tax avoidance as any arrangement to obtain a tax benefit may be considered as an impermissible avoidance arrangement.
- To avoid arbitrary application of the provisions:
 - legislative and administrative safeguards should be provided for invoking GAAR; and
 - suitable threshold limits should be provided for invoking GAAR.

Revised Proposals

- GAAR proposed to be retained in its existing form.
- It is clarified that every arrangement for tax mitigation is not to be classified as an impermissible avoidance agreement.
- Safeguards proposed to be introduced for invoking GAAR provisions:
 - Central Board of Direct Taxes to issue guidelines to provide for the circumstances under which GAAR may be invoked.
 - threshold limits to be prescribed for initiating GAAR provisions.
 - the forum of Dispute Resolution Panel to be made available where GAAR provisions are invoked.

Source: Revised Discussion paper on The Direct Taxes Code released on 15 June 2010.

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