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A NEW DIRECT TAX CODE FROM 2012

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The Income Tax Act, 1961 (IT Act) imposes tax on income of individuals and corporations under the different heads, viz. 'income from salaries', 'income from house property', 'income from business and profession', 'income in the form of capital gains' and 'income from other sources'. The Act is perceived as 'lawyers/accountants' delight being far too complex and full of ambiguous sections, with varied piecemeal amendments carried out over the years. The Act has also been perceived as economically inefficient, incompatible and also inequitable for all tax payers. Although it has undergone numerous changes to keep pace with the changing requirements of a liberalized, emerging world economic power but a holistic overhaul has so far been elusive.

Realizing that the basic approach of amendments through annual Finance Acts does not allow for comprehensive structural changes in the Act, attempts have been made from time to time for its review and various Working Groups / Task Forces have made suggestions in this area. The latest such exercise resulted in a draft code being put in public domain for discussion titled " Direct Tax Code (DTC)", which is the subject matter of this paper.

The draft code is intended to replace the IT Act while also consolidating the laws on relating to taxation of both income and wealth under a single statute. The draft code covers Income Tax, Wealth Tax, Tax Deducted at Source, Dividend Distribution Tax, and Fringe Benefit Tax with an objective of simplification of the language and complexity of tax laws. On the basis of representations, certain amendments were incorporated in the DTC and Direct Taxes Code Bill, 2010 was approved by the Cabinet and introduced in Parliament in August, 2010. After consideration of the recommendations of the Parliamentary Standing Committee on finance, the Bill is likely to be passed in the Winter Session of the Parliament and expected to be effected from the financial year commencing April, 2012.

The objectives of direct tax reform include enhancing the tax revenue by widening and deepening the tax net, bringing equity and efficiency of the tax administration, elimination of the plethora of tax exemptions, subsidies and varied distortions as well as keeping moderate tax rates, ensuring better taxpayer service, tax collection and compliance

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by effectively deploying the information technology. Collection from Direct taxes has increased from 2.97 percent to GDP in the financial year 1999-2000 to 6.45 percent to GDP in the financial year 2009-2010.

Structural changes

The DTC integrates the Income Tax Act, 1961 and the Wealth Tax Act, 1957 into a single legislation. The language of the tax code is direct, active speech, expressing only a single point through one sub-section, re-arranging various provisions into a rational structure, incorporating tax rates in Schedules to the Code instead of proposing through annual Finance Acts, as is being done so far.

The concept of assessment year and previous year is abolished and only ‘Financial Year’ terminology is used to avert confusing interpretations. Only status of ‘Non-Resident’ and ‘Resident of India’ exist and ‘resident but not ordinarily resident’ goes away. Tax incentives are rationalized, and profit linked tax incentives replaced by investment linked incentives. The new draft legislation permits loss allowed to be carried forward indefinitely as against the existing cap of 8 years. Provisions regarding General Anti-Avoidance Rule (GAAR) are geared to curb aggressive tax avoidance in a moderate tax regime. It revamps provisions relating to international taxation.

Instead of the existing practice of mentioning tax rates in the Finance Act and TDS rates and provisions spreading over the Schedules and 43 sections of the Finance Act, in the DTC, all tax rates are consolidated into 4 Schedules in a tabular format with TDS provisions in 8 clauses and 2 of the Schedules.

Instead of spreading over exemption provisions under the present Act (Section 10), these provisions are contained in two Schedules of the DTC. The Sixth Schedule lists the income which is exempt and the Seventh Schedule lists the persons whose income is exempt. The DTC requires Rental Income to be computed on actual and not on notional basis.

In case of international taxation, DTC aligns the concept of residence (of a company) with India's tax treaties by introduction of concept of "place of effective management" instead of "wholly controlled" in India and bases Advance Pricing Agreements for International Transactions for bringing certainty in transfer pricing issues. It brings an anti-deferral mechanism to assist in taxation of passive profits accumulated in companies incorporated in low tax jurisdictions which are controlled by resident shareholders and introduces Branch Profit Tax on foreign companies in lieu of higher rate of taxation.

Non Profit Organizations

The DTC seeks to tax surplus of non-profit organizations set up for charitable purposes at the rate of 15 percent, after allowing:

(i) all receipts of the month of March of the financial year to be carried forward to be spent by end of next March
(ii) a deduction of 15 percent of the surplus or 10 percent of the gross receipts, whichever is higher and
(iii) a basic exemption limit of Rs. 1 lakh

The DTC may compel the corporates to rethink their existing structures and mode of conducting business. It proposes to tax transfer of shares of a foreign company, on the basis that there is a transfer of a capital asset situated in India, if the Fair Value of the assets situated in India constitutes at least 50 percent of the assets directly or indirectly held by the foreign company. Further, an overseas company with a place of effective management in India will now be treated as a tax resident in India and would be consequently liable to tax in India on its global income. Introduction of Controlled Foreign Company (CFC) rules would result in taxing income of certain overseas subsidiaries in the hands of their Indian owners, even before such income is distributed.

Another key provision deals with the contribution of tax holidays to units in SEZs. The Bill provides that units in SEZs that commence operations on or before 31 March 2014 are to be entitled to a grandfathering of profit linked tax deductions. However, units in SEZs will not be exempt from Minimum Alternate Tax (MAT). The long term capital gains on sale of listed shares continue to be tax exempt and short term capital gains on the sale of such shares will be taxed at half the applicable rates. Gains on sale of other assets including unlisted shares are to be taxed fully, subject to indexation benefits.

The DTC is aiming at a modern, stable and simple tax regime, which depends on the quality of tax administration's implementation.

General Provisions

The concept of previous year (PE) is replaced with a new concept of financial year which inter-alia means a period of 12 months commencing from the 1st day of April. Every person is liable to pay income –tax in respect of his total income for the financial year at the rates/conditions specified in the Schedules to the DTC after allowing credit for pre-paid taxes (including foreign tax credits)

Income has been proposed to be classified into two broad groups: ‘income from Ordinary Sources’, and ‘Income from Special Sources’.

Income from Ordinary Sources refers to 'income from employment', 'income from house property', 'income from business', 'capital gains', and 'income from residuary sources'. 'Income from special sources' includes specified income of non-residents, winning from lotteries, horse races, etc. however, if such income is attributable to the PE of the non- resident it would not be considered as special source income, accordingly, such income would be liable to tax on net income basis. Losses arising from ordinary sources would be eligible for set off or carry forward and set-off against income only from ordinary sources without any time limit. Similar treatment would apply for set off and carry forward of losses from special sources, loss arising from speculative business, losses under the head capital gains, and losses from the activity of owning and maintaining horse race to be set off only against such income in the same or succeeding financial years.

In case of delayed filing of return of income for any particular year, only losses pertaining to that year would not be allowed to be carried forward for set off in future years.

Income tax rates

The basic tax exemption limit for an individual male and female has been raised and brought at par from Rs 1,60,000 and Rs 1,90,000 to Rs 2,00,000 per annum, though senior citizens of both the sexes will enjoy tax exemption on income to Rs 2,50,000. There will be 3 slabs, tax rate of 10 percent applies on income above Rs. 2,00,000 to Rs 5,00,000; rate of 20 percent to Rs 5,00,000 to Rs 10,00,000; and rate of 30 percent above Rs 10,00,001, enhancing the levels of the existing slabs of above Rs 1.6 lakh, Rs 3 lakh and Rs 5 lakh.

Savings Limit

Savings in the form of provident funds whether public provident fund, government provident fund, or employees provident fund, in the DTC, savings limit allowed for deduction from taxable income has been increased from Rs 1,20,000 to Rs 1,50,000 including Rs 100,000 for investment in provident funds, pension funds, and other approved securities like gratuity, and Rs 50,000 for child's tuition fees, life insurance and health insurance premium and if invested in infrastructural funds, deduction of additional Rs 20,000 also can be claimed.

Retirement Benefit Account (RBA)

In case of retirement DTC exempts even withdrawal from Retirement Benefit Account (RBA) and employee's contribution to his pension fund that will be deducted from his taxable income has been increased to Rs 300,000 per annum. In case of medical reimbursement in case of any medical treatment or claim in case of money spent on any medical services, Rs 50,000 will be proposed to be exempt from tax. This is intended to help the salaried employees to meet the cost of some of the surgeries since the present limit was Rs 15,000 only which is inadequate and mostly used as consultation fee and cost of medicines.

Capital gains

Definition of 'capital assets' has been replaced with the term ' Investment Asset' Investment Asset does not include business assets like self-generated assets. Right to manufacture and other capital asset connected with business. Further, Investment Asset is defined to include any securities held by foreign institutional investors and any undertaking or division of a business.

Transfer of capital assets results in capital gains. A capital gains tax is the tax levied on the profit released upon the sale of a capital asset. Existing limit for long term capital gains (long term assets are held by a person for 3 years except in case of shares or mutual funds which become long term just after one year of holding.) on shares or securities or mutual funds on which Securities Transaction Tax (STT) has been paid and through recognized stock exchange, then no tax is payable and if not, tax rate is 20 percent, which has been retained by the proposed DTC. In case of capital gain on transfer of house property is fully exempted, if assesse purchases another house within 2 years after the sale of the house or construct a new house within 3 years after the sale of the house, which is the same as in the existing IT Act.

At present, short term capital gains are taxed at the rate of 15 percent and 2 percent surcharge and cess. As per DTC, around 50 percent of short term capital gains will be exempted and the rest will be taxed at the rate of 15 percent. In case of income from house property, as per the existing IT Act, the concept of notional rent would be considered, instead in the DTC income form house property is to considered only if the property is let out. If an assesse has more than one house for self-occupation, the benefit of nil gross rent will apply only for one self-occupied house at the option of the assesse. The computation of remaining houses will be made as if the properties are let out. Deductions for 'Rent and Maintenance' will be reduced to 20 percent in the DTC.

Dividend and Leave Travel Allowance (LTA)

When a corporation earns profits or surplus, it can either be reinvested in the business called retained earnings, or it can be paid to the shareholders as a dividend. The DTC proposes to decrease the dividend distribution tax from existing 16.61 percent to 15 percent. In case of Leave Travel Allowance, the present system exempts LTA completely from tax, but DTC proposes to include LTA as part of total income but it qualifies deduction.

In case of Non-Resident Indian, IT Act, 1961 imposes tax on global income if he is in India for a period more than 182 days but as per DTC, the duration is reduced to just 60 days.

Penalty

Under DTC, tax department will have more posers to impose a penalty not only for concealing for the particulars of income but also under reporting, but the penalty for tax evasion will be reduced to 200 percent from existing 300 percent.

Corporate tax

Corporate tax refers to direct taxes charged by various jurisdictions on the profits made by companies or associations and includes capital gains of the company. The corporate tax rate for Indian companies is proposed to be reduced from the existing rate of 33.33 percent to 30 percent, seeking to remove surcharge and cess on corporate tax, which should provide relief to business houses. The tax rate for foreign companies is proposed to be the same as domestic companies instead of 40 percent as per IT Act. There is no discrimination in tax rate of 15 percent in case of Dividend Distribution Tax (DDT) too.

The Code has proposed a Minimum Alternate Tax (MAT) on companies on the basis of 'value of gross assets', the rationale for imposing asset tax is that investors can expect ex-ante to earn a specified average rate of return on their assets. Instead of levying MAT at 18 percent of the adjusted book profits in case of companies where income-tax payable on taxable income according to the normal provisions of the Act is lower than the tax @ 18 percent on book profits it proposed to be levied at 20 percent on book profits. MAT is proposed to be applicable to Special Economic Zone Developers (SEZ) and SEZ units.

It is proposed in DTC to tax at 5 percent of ‘income distributed by mutual fund to unit holders of equity oriented funds’ as well as ‘income distributed by life insurance companies to policy holders of equity-oriented life insurance schemes.

DTC proposes to abolish surcharge and education cess. It also removes most of the categories of exempted income. All term deposits, ULIPS, principal payment, stamp duty, registration fees on purchase of house property will lose tax benefits.

Controlled Foreign Company (CFC)

The total income of a Resident taxpayer to include income attributable to a CFC which means a foreign company: that is a resident of a territory with lower rate of taxation (i.e. where taxes paid are less than 50 percent of taxes on such profits as computed under the DTC), whose shares are not listed on any stock exchange recognized by such Territory, individually or collectively controlled by persons resident in India (through capital, voting power, income, assets, dominant influence, decisive influence, etc.), that is not engaged in active trade or business (i.e. it is not engaged in commercial, industrial, financial undertakings through employees/personnel or less than 50 percent of its income is of the nature of dividend, interest, income from house property, capital gains, royalty, sale of goods/services to related parties income from management, holding or investment in securities/shareholdings, any other income under the head income from residuary sources, etc.) and has specified income exceeding INR 2.5 million

The income attributable will be based on the net IFRS, GAAP or Accounting Standards notified under the companies Act, 1956. The said net profit will be increased by any provision for unascertained liabilities or diminution in the value of assets, reduced by interim dividend paid and prior year losses before the application of specified attribution formula.

The resident taxpayer will have to furnish details of investments and interest in entities outside India in the prescribed form and manner. The amount received from a CFC as dividend in a subsequent year will be reduced from the total income to the extent it has been taxed as CFC income in any preceding previous year. CFC provisions are applicable to taxpayers notwithstanding the provisions of the DTAA that may be more beneficial.

Tax incentives

The DTC substitutes profit-linked incentives with investment based incentives wherein capital expenditure incurred for specified business will be allowed as a deductible expenditure. However, certain profit-linked tax incentives under the Act are grandfathered in the DTC. The investment linked incentives will apply to the businesses: generation, transmission or distribution of power, developing or operating and maintaining any infrastructure facility, operating and maintaining a hospital in a specified area, processing, preservation and packaging of fruits and vegetables, laying and operating of a cross country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of the network, setting up and operating a cold chain facility, setting up and operating a warehousing facility for the storage of agricultural produce, explorations and production of mineral or natural gas, SEZ Developers and units established in SEZ, building and operating a new hotel of two-star or above category commencing operations on or after 1 April 2010 and developing and building a housing project under slum redevelopment or rehabilitation scheme commencing operations on or after 1 April 2010.

Special Economic Zones

SEZ Developers and even units established in SEZ engaged in the business of manufacture or production of article or things or providing of services would be eligible for tax incentives. Grandfathering of profit-linked incentives under the Act to continue for SEZ developers notified on or before 31 March 2012. In case of SEZ units, grandfathering extended for units commencing operations on or before 31 March 2014. Eligible expenditure for investment based tax incentive not to include: expenditure on purchase, lease or rental of land or land rights, and negative profit for any financial year proceeding the relevant financial year.

Mineral Oil or natural gas

In computing profits from the business of mineral oil or natural gas, deduction allowed for payment towards Site Restoration Account maintained with the State Bank of India as per scheme framed by the Central Government. Expenditure incurred on acquisition of any land including long term lease, goodwill or financial instrument not allowed as business expenditure.

Business of qualifying ships

Option made available to a company engaged in the business of operating qualifying ships to compute profits by applying the Tonnage Income Scheme. Negative profit of immediately preceding financial year can be set off against business profits.

Profits derived from core shipping activities to be excluded from book profit for the purpose of MAT.

Transfer pricing provision

Provisions relating to Advance Pricing Agreement (APA) mechanism have been introduced. The CBDT with the approval of the Central Government may enter into an agreement with the tax payer, specifying the manner in which the arm's length price is to be determined in relation to an international transaction. The said agreement will be valid for a maximum period of five consecutive financial years unless there is a change in law or facts. The agreement will be binding on the tax payer and the CIT and the income tax authorities below him.

The scope of the term 'associated enterprise' has once again been brought in line with the scope as existing under the Act, and the stringent conditions proposed by the earlier draft of DTC have been removed. However, additional criteria have been introduced viz. provision of services (directly or indirectly) to another enterprise or person specified by it, if the amount payable and other terms relating thereto are influenced by such other enterprise, if any of the enterprises to the transaction are situated in any specific or distinct location which may be prescribed.

Report of international transactions certified by a Chartered accountant is to be lodged directly with the Transfer Pricing Officer instead of the AO. However, the proposal of selecting cases for scrutiny by the Transfer Pricing Officer based on risk management strategy framed by the CBDT as contained in the DTC 2009, has been done away with. Instead, the AO shall make a reference to the Transfer Pricing Officer for determination of arm's length price which is in line with the position as contained in existing provisions of the Act.

Transfer Pricing Officer will have the power to determine the arm's length price after due verification; however, such determination will not be subject to the specific conditions as contained presently in the Act. Further, the requirement of issuance of show cause notice by the transfer pricing officer before proposing variation to the arm's length price determined by the taxpayer has been done away with.

Mergers and Acquisitions

Definition of amalgamation to include amalgamation of a firm, AOP, BOI into a company and other specified form of re-organization. The consideration for demerger is to be in the form of equity shares issued by the resulting company to shareholders of demerged company. In case of amalgamation or demerger amongst foreign companies, the condition of 75 percent shareholders continuing in the amalgamated/resulting company has been introduced for availing exemption from capital gains.

Capital gains on transfer by way of slump sale of an undertaking/division would be subject to capital gains tax. Under the earlier DTC draft, the same was proposed to be treated as business income. DTC defines business reorganization; amalgamation, (Reference to the Companies Act, 1956 incorporated), demerger, successor, predecessor. The present provision of providing exemption in respect of transfer of shares through the process of amalgamation / demerger of a foreign company with another foreign company is proposed to be extended to all assets (i.e. investment assets).

Liability of the successor in business widened and all proceedings taken against the predecessor may be continued against the successor from the stage at which it stood on the date of business re-organization.

General Anti-Avoidance Rules (GAAR)

The DTC contains GAAR provisions which provide sweeping powers to the tax authorities. The same are applicable to domestic as well as international arrangements. GAAR provisions empower the CIT to declare any arrangement as "impermissible avoidance arrangement" provided the same has been entered into with the objective of obtaining tax benefit and satisfies any one of the conditions like; it is not at arm's length, it represents misuse or abuse of the provisions of the DTC, it lacks commercial substance and it is carried out in a manner not normally employed for bona fide business purposes. An arrangement would be presumed to be for obtaining tax benefit unless the tax payer demonstrates that obtaining tax benefit was not the main objective of the arrangement. CIT to determine the tax consequences on invoking GAAR by reallocating the income or disregarding the arrangement

Meaning of 'tax benefit' widened to include any reduction in the tax base including increase in loss. GAAR provisions are to be applicable as per the guidelines to be framed by the Central Government.

Serious concerns have been expressed that GAAR provisions are sweeping in nature and may be invoked by the Assessing Officer in a routine manner, as there is no distinction between tax mitigation and tax avoidance as any arrangement to obtain a tax benefit may be considered as an impermissible avoidance agreement. In order to safeguard the interests of the tax payers, the Central Board of Direct Taxes (CBDT) is expected to issue guidelines stating clearly the circumstances under which GAAR may be invoked beyond specified threshold limits. The forum of Dispute Resolution Panel (DRP) would be available where GAAR provisions are invoked.

Conclusion

In view of sustained reforms in ensuring liberalization and globalization of Indian economy, India Inc. has been advocating for a modern, stable, equitable, and simple tax laws and tax administration. The government is keen to expand the existing tax base to enhance the revenue collection and intensify the efforts to avert tax evasion and improve tax compliance. The proposed DTC seeks to effect a template change in taxation of income and wealth and remove annual uncertainty about tax rates. Once it is implemented from 1st April, 2012, it will be tested as to how far the objectives of the new tax laws are going to be realized. Quality tax administration to ensure effective implementation is equally important besides a modern tax code to determine the desired long term impact of the proposed new tax regime. The government has over more than a decade now pursued systemic improvements and innovative use of technology and psychology in its running battle with tax evaders. It is hoped that the DTC will further reduce incentives and opportunities for tax evasion.