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Tax
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Direct Tax Alert

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Direct Tax Code Bill, 2009 and Discussion Paper released for public debate

Background

The Finance Minister during his speech in the Parliament on 6 July 2009 had promised to bring about structural changes in direct taxes by releasing the new Direct Tax Code ('Code'). Keeping with his promise, the Finance Minister has released the draft Code alongwith a discussion paper on 12 August 2009 inviting the public to share their views and suggestions. The final version of the Code would then be presented before the Parliament in the Winter Session, 2009 for enactment.

The Discussion Paper states that the thrust of the Code is to improve the efficiency and equity of the Indian tax system by eliminating distortions in the tax structure, introducing moderate levels of taxation and expanding the tax base. The attempt is to simplify the language, remove ambiguity, provide stability and adopt best international practices.

Key Highlights

This Alert provides key highlights of the Code as summarized in the Discussion Paper.

Base for taxation and scope of total income

Base for taxation

- Comprehensive definition of the term 'income' provided to include all accruals and receipts of revenue and capital nature unless otherwise specified.
- Agricultural income to be excluded from the scope of the Code.

Residence

- Residential status of an individual to be determined on the basis of his stay in India.
- Indian company to be treated as resident in India.
- Foreign company and every other person to be treated as resident in India, if the control and management of its affairs are situated wholly or partly in India at any time in the financial year.

Scope of total income

- Residence based taxation to be applied for residents and accordingly world-

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wide income liable to be taxed.

- Source based taxation to be applied for non-residents and accordingly accruals and receipts in India (including deemed accruals and receipts) liable to be taxed.

Rules for computation of total income

Classification of sources of income

- The Code specifies that income from all sources will be classified either as Income from Special Sources or Income from Ordinary Sources.
- Income from Special Sources include interest, dividends on which distribution tax has not been paid, capital gains, any other investment income, royalty, fees for technical services, amongst others.
- Income from Ordinary Sources is classified under the following heads of income
 - (i) Income from employment
 - (ii) Income from house property
 - (iii) Income from business
 - (iv) Capital gains
 - (v) Income from residuary sources

General Rules

- Total income of the tax payer to be the aggregate of Income from Ordinary Sources and Income from Special sources.
- Loss under the head 'Capital gains' and loss from speculative business will not be allowed to be set off against income under other heads.
- Losses to be allowed to be carried forward indefinitely for set-off in the subsequent financial years.
- Provisions for avoiding double taxation / double deduction laid down.
- Certain expenses such as expenditure attributable to tax free income, expenditure incurred for any purpose prohibited by law, provision for unascertained liability, etc. not to be allowed as deduction in computing the total income.
- Payments in respect of which tax has not been deducted at source to be disallowed; however, deduction to be allowed in the year of payment, subject to certain exceptions. Where the payment is made after two years from the end of the financial year in which the tax was deductible at source, no deduction to be allowed.

Rules for computation of heads of income falling within income from ordinary sources

Income from employment

- Gross salary, including the value of perquisites and profits in lieu of salary, to be taxed on due or receipt basis, whichever is earlier and to be reduced by permissible deductions.
- Permissible deductions to include professional tax, transport allowance, prescribed special allowance, compensation under voluntary retirement scheme, gratuity, commutation of pension, amongst others.

Income from house property

- Income from house property to be the gross rent less specified deductions.
- Gross rent to be higher of contractual rent or presumptive rent calculated at 6% per annum of the rateable value fixed by the local authority / 6% of cost of construction or acquisition of the property (in the absence of rateable value).
- Advance rent to be taxed in the financial year to which it relates to.

Income from business

- Every business to constitute a separate source for the purpose of computation of income provided there is no interdependence between the two businesses.
- Key features of the provisions relating to computation of business income are:
 - All assets to be classified into business and investment assets, wherein business assets to be further classified into business trading assets and business capital assets.
 - Only income from transactions in business assets to form part of business income.
 - Profit on sale of business capital assets, profit on sale of an undertaking under a slump sale, transfer of any self generated business asset, etc. to be treated as business income.
- Business expenditure to be classified into (i) operating expenditure (ii) permitted financial charges and (iii) capital allowances as defined.
- Loss on sale of business capital assets (which was hitherto treated as a capital loss) to be treated as an intangible asset on which depreciation to be allowed. Effectively, a taxpayer will be allowed to set-off only a fraction of loss every year.
- Presumptive basis of taxation to apply for certain businesses.
- Separate income determination regimes provided for certain specified businesses such as business of insurance, operating a qualifying ship, mineral oil or natural gas, generation, transmission or distribution of power, developing a special economic zone, etc.

Income from capital gains

- Income from transactions in all investment assets to be taxed under the head 'capital gains'.
- Gains and losses to be included in the total income of the financial year in which the investment asset is transferred irrespective of the year of receipt of consideration, except in the case of compulsory acquisition of an asset.
- Distinction between short-term investment asset and long-term investment asset to be eliminated.
- Capital gains arising from transfer of personal effects and agricultural land excluded from the ambit of taxation.
- Base date for determining cost of acquisition for the purpose of computing capital gains shifted from 1 April 1981 to 1 April 2000.
- Securities Transaction Tax to be abolished.
- Benefit of indexation available in computing capital gains on transfer of capital assets held for more than one year.
- In case cost of acquisition and cost of improvement of an investment asset cannot be determined, the same shall be deemed to be Nil for the purposes of

computation of capital gains.

Income from residuary source

- Residuary income to comprise any income which does not form part of any other head of income.
- The scope of gross residuary income widened to include income having incidental nexus with some other head of income.
- Any amount exceeding Rs. 20,000, taken or accepted or repaid as loan or deposit otherwise than by account payee cheque or draft to be taxed as income from residuary sources.

Taxation of companies

Dividend Distribution Tax (DDT)

- Resident company to be liable to DDT at the rate of 15% of the amount declared by way of dividends.
- Dividend which has suffered DDT will be exempt from tax in the hands of the recipient.

Minimum alternate tax (MAT)

- The rate of MAT will be 0.25 % of the value of gross assets in the case of banking companies and 2% for other companies.
- "Value of gross assets" to be the aggregate of the value of 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 a final tax and will not be allowed to be carried forward.

Business re-organisation

- Reorganisation of business to be tax neutral, subject to certain conditions.
- "Business reorganisation" means reorganisation of business of two or more residents, involving –
 - (a) an amalgamation;
 - (b) a merger under a scheme sanctioned and brought into force by the Central Government under the Banking Regulation Act, 1949; or
 - (c) a demerger.
- Benefits of amalgamation available to all companies and co-operative societies, irrespective of the nature of their business.
- Accumulated losses of the predecessor in business reorganisation deemed to be loss of the successor if the successor satisfies the test of continuity of business.

Tax Incentives

Tax exemptions rationalised:

- Source specific exemptions provided.
- Entity related exemptions provided.

- Exemptions related to specific heads of income provided.
- Non-profit organisations, etc., to be allowed concessional tax treatment.

Some key incentives are listed hereunder:

- Incentive for savings (Exempt-Exempt-Taxation method of taxation on savings to be introduced).
- Incentive for medical treatment.
- Deduction in respect of donations.
- Tax holiday for certain specified businesses such as exploration and production of mineral oil or natural gas, generation, transmission or distribution of power, developing a special economic zone, etc.

International Taxation

Relief from Double taxation

- Power given to the Central Government to enter into an agreement with the Government of any country in order to provide relief on double taxation and also for the purpose of exchanging information for prevention of evasion or avoidance of income tax.
- In the case of a conflict between the provisions of a tax treaty and the provisions of the Code, the one that is later in time to prevail.

Transfer Pricing

- In line with the Finance Bill 2009, the determination of arm's length price will be subject to safe harbour rules as may be framed by the Board.
- Introduction to the concept of Advance Pricing Agreement ("APA").
 - Board with the approval of the Central Government will enter into an agreement with any taxpayer for determining the arm's length price of an international transaction.
 - Board is empowered to make further adjustments to the price determined as it may deem necessary.
 - Validity of the APA is limited to 5 consecutive financial years.
 - APA in relation to the international transactions for which it is being sought is binding on the taxpayer and the Income-tax authorities.
- Definition of Associated Enterprise(s) modified
 - No definitions of AE based on direct or indirect participation in management, control or capital.
 - Direct or indirect shareholding / voting power is 10%.
 - Threshold for loan advanced is 26% of the book value of total assets.
 - Power to appoint board of directors is one-third of the governing board.
 - Raw materials and consumables purchase threshold is two-thirds of total supplies.
- Reference to Dispute Resolution Mechanism ("DRM") made to reduce the scope of disputes and minimize litigation.
 - Provisions of DRM from a transfer pricing perspective are broadly similar to that introduced in Finance Bill 2009. However, the DRM provisions are applicable only where the proposed variation in the income / loss returned

is greater than Rs 25 lakhs.

- The Transfer Pricing assessment procedure is consolidated to ensure that officers with requisite expertise on the subject address disputes.
 - Accountant’s report to be filed with the Transfer Pricing Officer (“TPO”) instead of the Assessing Officer (“AO”).
 - Selection of transfer pricing cases for scrutiny is to be based on a risk management strategy as may be framed by the Board. The strategy will not be disclosed to the taxpayer or any member of the public.
- Modification to timelines relating to filing of Accountant’s Report and assessment proceedings proposed.
 - Accountant’s report to be filed by 31st August.
 - TPO to issue notice for selection of case within 2 months from the end of the financial year in which the accountant’s report is filed.
 - TPO to issue order within 42 months from the end of the financial year in which the international transaction is entered into.
 - Where matter not referred to the Dispute Resolution Panel, the AO to pass an order within 3 months in which the order is passed by the TPO.
- Penalty provisions modified for various defaults under transfer pricing.
 - Non-filing of Accountant’s Report is Rs 50,000 to Rs 2 lakhs.
 - Non-maintenance of documentation is Rs 50,000 to Rs 2 lakhs.

General Anti Avoidance Rule

- GAAR introduced to curtail tax avoidance and to be invoked on satisfaction of prescribed conditions.

Rates of Taxes

- Tax rates for individuals:

Slabs of income (Rs.)	Rate of tax (%)
0– 160,000	Nil
160,001 – 1,000,000	10
1,000,001 – 2,500,000	20
2,500,001 and above	30

Notes:

- *In respect of women below the age of 65 years, the basic exemption limit to be Rs. 190,000.*
- *In respect of senior citizens, the basic exemptions limit to be Rs. 240,000.*
- Tax rates for domestic companies - 25%.
- Tax rates for foreign companies 25%, however, foreign companies further liable to a branch profits tax of 15% on branch profits i.e. total income as reduced by corporate tax.
- Rates of tax for all other cases also prescribed.

Others

Other amendments

- Concept of previous year and assessment year to be done away with and all rights and obligations of the tax payer and the tax administration to be with reference to the financial year.
- Partnership firms, Association of Persons and Body of Individuals to be collectively referred to as "unincorporated body" and to be taxed as a separate entity at the maximum marginal rate applicable to individuals without any threshold exemption limit.
- Financial intermediaries like the mutual fund, venture capital fund, pension funds, superannuation funds, provident funds and life insurance companies to be treated as pass-thru entities.
- New tax regime proposed for all trusts and institutions carrying on "permitted welfare activities".

Wealth Tax

- Individual, HUF and private discretionary trusts liable to wealth tax.
- Assets chargeable to wealth-tax defined.
- Net wealth in excess of Rs. 50 crores to be chargeable to wealth-tax at the rate of 0.25%.
- Threshold limit of Rs. 50 crores not to apply to a private discretionary trust.

Procedural law

- Due date for filing of tax return for non-business, non-corporate taxpayers to be 30th June following the financial year and for all other taxpayers to be 31st August following the financial year.
- Return to be processed within one year from the end of month in which the return is furnished failing which the tax payer will not be liable to pay the amount determined as payable on account of any adjustments.
- Provisions relating to the re-assessment of income to be streamlined. Case not to be re-opened after seven years from the end of relevant financial year, subject to certain exceptions.

Penalties and Prosecution

- Provisions included ensuring certainty of punishment in case of non-compliance with the tax laws.
- Amount of penalty shall not be less than, and upto twice, the amount of tax payable in respect of the amount of tax base so under-reported.
- Amount of tax payable in respect of the amount of tax base so under-reported to be calculated at the maximum marginal rate in order to arrive at the quantum of penalty.
- No income tax authority to have the power to waive the penalty imposed.
- Provisions made for compounding of an offence.

The Code is proposed to take effect from 1 April, 2011. The proposed Direct Tax Code when implemented would go a long way in streamlining the existing complex tax structure. As it includes international best practices, its adoption would ensure that the Indian tax structure is on par with global standards.

A separate Alert will be issued for elaborating on the specifics contained in the Code.

Source: Discussion paper on Direct Tax Code – August, 2009

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