

REVISED DISCUSSION PAPER

ON

THE DIRECT TAXES CODE

JUNE 2010

**Central Board of Direct Taxes
Department of Revenue
Ministry of Finance**

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INTRODUCTION

1. The draft Direct Taxes Code (DTC) along with a Discussion Paper was released in August, 2009 for public comments. Since then, a number of valuable inputs on the proposals outlined in these documents have been received from a large number of organisations and individuals. These inputs have been examined and the major issues on which various stakeholders have given their views have been identified. This Revised Discussion Paper addresses these major issues. There are a number of other issues which have been raised in the public feedback, which, though not part of this Discussion Paper, will be considered while finalising the Bill for introduction in Parliament. The issues which this Revised Discussion Paper addresses are:

- i. Minimum Alternate Tax (MAT) - Gross assets vis-a-vis book profit.
- ii. Tax treatment of savings - Exempt Exempt Tax (EET) vis-a-vis Exempt Exempt Exempt (EEE) basis.
- iii. Taxation of income from employment - Retirement benefits and perquisites.
- iv. Taxation of income from house property.
- v. Taxation of capital gains
- vi. Taxation of non-profit organisations
- vii. Special Economic Zones – Taxation of existing units
- viii. Concept of Residence in the case of a company incorporated outside India.
- ix. Double Taxation Avoidance Agreement (DTAA) vis-a-vis domestic law.
- x. Wealth Tax.
- xi. General Anti Avoidance Rule (GAAR).

Paragraph 1 in each Chapter describes the proposals in the DTC and Discussion Paper, paragraph 2 highlights the issues and concerns raised and paragraph 3 details the revised proposals in response to these concerns.

2. It had been stated in the first Discussion Paper that the Government would consider calibrating the rates of tax in the light of the response and comments received on the scope of the tax base discussed in the Discussion Paper.

The proposals in this Revised Discussion Paper would lead to a reduction in the tax base proposed in the DTC. The indicative tax slabs and tax rates and monetary limits for exemptions and deductions proposed in the DTC will, therefore, be calibrated accordingly while finalising the legislation.

3. This Revised Discussion Paper is available on the following websites:

finmin.nic.in and incometaxindia.gov.in

Responses to the Revised Discussion Paper should be sent online through the link provided at these websites or at the following e-mail address: directtaxescode-rev@nic.in. Responses are solicited upto 30th June, 2010.

CHAPTER I

MINIMUM ALTERNATE TAX – GROSS ASSETS VIS-À-VIS BOOK PROFIT

1. Chapter XIII of the Discussion Paper on the DTC deals with Minimum Alternate Tax (MAT). As stated in the Discussion Paper, a company would ordinarily be liable to tax in respect of its total income. However, owing to tax incentives, the liability on total income, in many cases, has been found to be extremely low or even zero. Internationally, a variety of economic bases and methods are used to calculate presumptive income so as to overcome the problem of excessive tax incentives. These presumptions could be based on net wealth, value of assets used in business or gross receipts of the enterprise.

1.1 The DTC has proposed a Minimum Alternate Tax (MAT) on companies calculated with reference to the "value of gross assets". The economic rationale for the assets tax is that investors can expect ex-ante to earn a specified average rate of return on their assets, hence it provides an incentive for efficiency.

1.2 It has been proposed in the DTC that the "value of gross assets" will be the aggregate of the value of gross block of fixed assets of the company, the value of capital works in progress of the company, the book value of all other assets of the company, as on the last day of the relevant financial year, as reduced by the accumulated depreciation on the value of the gross block of the fixed assets and the debit balance of the profit and loss account if included in the book value of other assets. The rate of MAT will be 0.25 per cent of the value of gross assets in the case of banking companies and 2 per cent of the value of gross assets in the case of all other companies. The MAT will be a final tax. Hence, it will not be allowed to be carried forward for claiming tax credit in subsequent years.

2. The following major issues have been raised regarding the proposed MAT on gross assets :

- (i) Computation of MAT with reference to gross value of assets will require all companies to pay tax even if they are loss making companies or operating in a cyclical downturn. An asset based MAT does not have a proximate linkage with a particular year's income or turnover. An asset based MAT on loss making companies would result in significant hardship since they would not have the resources to pay the tax. While one 'incentive for efficiency' argument could be that such companies could shut down or restructure their businesses, such an argument would not be valid for businesses where losses may be inherent over long periods of the business cycle. Income tax should be on real income and any method for presuming income should also be reasonable enough to come closer to the real income.
- (ii) The return on assets is one of the indicators for evaluating the performance of companies. However, it is not reasonable to apply this for newly set up infrastructure companies which have long gestation periods. Since the proposed MAT regime does not provide any exemption for gestation period, investment costs in new businesses will be higher on account of the MAT when compared to old businesses which already have a depreciated asset base. Similarly, for companies undergoing major expansion resulting in the value of assets being much higher, the MAT may be much greater than the income tax liability.
- (iii) In the case of corporates under liquidation, a levy of a presumptive asset tax till the time the company is dissolved is not reasonable.
- (iv) Assuming the same net income as a percentage of gross assets for all taxpayers is not practical as this would vary depending on the industry concerned, the degree of integration of the particular enterprise, and the type of product or service provided.
- (v) The inclusion of 'capital works in progress' which is not used in the business and does not contribute in revenue generation would distort the asset based tax. Taxation should be based on net worth and not on gross assets.

- (vi) The asset based MAT does not cover situations where there are multiple tiers of subsidiaries for handling separate businesses or investments. There would be a cascading effect of the asset based MAT in such cases.
- (vii) The proposed MAT does not allow for any carry forward which would result in a corporate paying more overall tax in a low profit year without there being any relief against above average profits earned in a subsequent year.
- (viii) The DTC proposes 'investment linked' incentives to specified sectors for investment. The application of asset based MAT on companies operating in such sectors contradicts this policy.

3. Some of the issues raised by stakeholders (such as MAT credit) can be addressed by making appropriate changes in the proposed scheme of the asset based MAT. However, there may be practical difficulties and unintended consequences, particularly in the case of loss making companies and companies having a long gestation period. It is, therefore, proposed to compute MAT with reference to book profit.

CHAPTER II

TAX TREATMENT OF SAVINGS – EXEMPT EXEMPT TAX (EET) VIS-À-VIS EXEMPT EXEMPT EXEMPT (EEE) BASIS

1. Chapter-XII of the Discussion Paper on the Direct Taxes Code (DTC) deals with tax incentives for savings. It proposes the 'Exempt-Exempt-Taxation' (EET) method of taxation for savings. Under this method, the contributions towards certain savings are deductible from income (this represents the first 'E' under the EET method), the accumulation/accretions are exempt (free from any tax incidence) till such time as they remain invested (this represents the second 'E' under the EET method) and all withdrawals at any time are subject to tax at the applicable marginal rate of tax (this represents the 'T' under the EET method).

1.1 Based on the EET principle, the Code provides for deduction in respect of aggregate contributions upto a limit of three hundred thousand rupees (both by the employee and the employer) to any account maintained with any permitted savings intermediary, during the financial year. This account will have to be maintained with any permitted savings intermediary in accordance with the scheme framed and prescribed by the Central Government. The permitted savings intermediaries will be approved provident funds, approved superannuation funds, life insurer and New Pension System Trust. The accretions to the deposits will remain untaxed till such time as they are allowed to accumulate in the account. Any withdrawal made, or amount received, under whatever circumstances, from this account will be included in the income of the assessee under the head 'income from residuary sources', in the year of such withdrawal or receipt. It will accordingly be subject to tax at the applicable personal marginal rate of tax.

1.2 Taxation on EET basis is proposed to be prospective. The DTC provides that the withdrawal of any amount of accumulated balance as on the 31st day of March, 2011 in the account of the individual in a Government Provident Fund (GPF), Public Provident Fund (PPF), Recognised Provident Funds (RPFs) and the Employees Provident Fund (EPF) will not be subject to tax. Therefore, only new contributions as well as accretions on or after the commencement of the DTC, will be subject to the EET method of taxation.

1.3 The permitted savings intermediaries would be approved by the Pension Fund Regulatory and Development Authority (PFRDA). These intermediaries will, in turn, invest the amounts deposited with them in government securities, term deposits of banks, unit-linked insurance plans, annuity plans, bonds and securities of public sector companies, banks and financial institutions, bonds of other companies enjoying prescribed investment grade rating, equity linked schemes of mutual funds, debt oriented mutual funds, equity and debt instruments. The choice of instruments will, in some schemes, be with the investor and in some others with the trustees of the schemes. The pattern of investment by the latter will be as prescribed. The rollover of any amount received, or withdrawn, from one account with the permitted savings intermediary to any other account with the same or any other permitted savings intermediary will not be treated as withdrawal and, accordingly, will not be subject to tax.

2. A large number of representations have been made with regard to the proposed EET system. It has been stated that most countries that follow the EET method of taxation of savings also have a social security system in place for all their citizens. The EET savings accounts which operate for individuals in these countries are over and above the mandatory social service payments received by them. It has been represented that in India, in the absence of a universal social security system, the proposed EET method of taxation of permitted savings would be harsh. Tax payers require some flexibility in making withdrawals in lump sum without being subjected to tax. People may need lump sum funds on retirement for various family obligations. Requests have therefore been made for continuation of Exempt Exempt Exempt (EEE) method of tax treatment of investments. Alternatively, the application of EET should be restricted to new savings instruments after the date from which the DTC comes into effect, and it should not apply to existing saving instruments.

3. Universal social security benefits for tax payers may not be feasible in the near future. Also, switching over to a complete EET method of taxation for all savings instruments would entail many administrative, logistical and technological challenges. It would require a vast network of permitted savings intermediaries, a central record keeping authority and a central agency to service around more than

three crore accounts and deduct tax at the time of withdrawals. The segregation of taxable and non-taxable amounts at the time of withdrawal and rollover from one account to another would introduce complexities and create practical difficulties.

3.1 Therefore, as of now, it is proposed to provide the EEE method of taxation for Government Provident Fund (GPF), Public Provident Fund (PPF) and Recognised Provident Funds (RPFs) and the pension scheme administered by Pension Fund Regulatory and Development Authority. Approved pure life insurance products and annuity schemes will also be subject to EEE method of tax treatment. In order to achieve the objective of long term savings, the rules for contribution as well as withdrawal will be harmonised and made uniform so that such savings are actually made and utilised by the taxpayer for the long term. Investments made, before the date of commencement of the DTC, in instruments which enjoy EEE method of taxation under the current law, would continue to be eligible for EEE method of tax treatment for the full duration of the financial instrument.

CHAPTER III

TAXATION OF INCOME FROM EMPLOYMENT – RETIREMENT BENEFITS AND PERQUISITES

1. Chapter VII of the Discussion Paper on the Direct Taxes Code (DTC) deals with computation of income taxable under the head 'Income from employment'. It provides that "Income from employment" will be gross salary as reduced by the aggregate amount of permissible deductions.

1.1 The term 'salary' is defined to include the value of perquisites, profits in lieu of salary, amount received on voluntary retirement or termination, leave salary, gratuity and any annuity, pension or any commutation thereof. Contributions made by the employer to an approved superannuation fund, provident fund, life insurer and New Pension System Trust is considered as salary.

1.2 Deductions from gross salary are allowed for compensation received under voluntary retirement scheme, amount of 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. The employee will have to maintain a Retirement Benefit Account with any permitted savings intermediary in accordance with the scheme framed and prescribed by the Central Government. The permitted savings intermediaries will be approved provident funds, approved superannuation funds, life insurer and New Pension System Trust. The accretions to the deposits will remain untaxed till such time as they are allowed to accumulate in the account. Any withdrawal made, or amount received, under whatever circumstances, from this account will be included in the income of the assessee for the year in which the withdrawal is made or the amount is received. Thus, retirement benefits will be exempt only if deposited in Retirement Benefits Account and will be subject to tax on withdrawal from such account.

1.3 Under the DTC, salary will include, inter-alia, the following:-

- (a) the value of rent free or concessional, accommodation provided by the employer irrespective of whether the employer is a Government or any other person;
- (b) the value of any leave travel concession;
- (c) the amount received on encashment of unavailed earned leave on retirement or otherwise;
- (d) medical reimbursement; and
- (e) the value of free or concessional medical treatment paid for, or provided by, the employer.

The Discussion Paper states that the value of rent-free accommodation will be determined for all employees including Government employees in the same manner as is presently determined in the case of employees in the private sector.

2. Representations have been received from stakeholders that in the absence of adequate social security benefits, the social and economic norm is to use retirement benefit amounts for savings as well as for social expenditure. Hence, taxation of withdrawals from a Retirement Benefit Account would be harsh.

2.1 Though valuation on the basis of market value has not been prescribed in the DTC or the Discussion Paper, apprehensions have also been expressed that if the value of accommodation in the case of government employees will be taken at market rent, it would create a high tax burden. Concerns have also been expressed regarding non-availability of exemption for perquisites in the nature of medical benefits which are available in the current law.

3. Maintaining individual Retirement Benefits Account by permitted savings intermediaries on behalf of all employees would require a centralised nationwide authority to regulate and manage crores of retirement benefits accounts of employees and to deduct tax on withdrawal which entails creation of a separate institutional mechanism, complex logistics and substantial costs. The complexity of maintaining permitted savings accounts has been discussed in the context of the

EET method of taxation. For the same reasons, it is proposed not to introduce the Retirement Benefits Account scheme.

3.1 An employer's contribution to an approved provident fund, superannuation fund and New Pension Scheme within the limits prescribed shall not be considered as salary in the hands of the employee. Also, retirement benefits received by an employee will be exempt subject to specified monetary limits. Thus, the amount of gratuity received, the amount received under a voluntary retirement scheme, the amount received on commutation of pension linked to gratuity received and the amount received on account of encashment of leave at the time of superannuation are proposed to be exempt, subject to specified limits, for all employees.

3.2 The method of valuation of perquisites will be appropriately provided in the rules. It is proposed that perquisites in relation to medical facilities/reimbursement provided by an employer to its employees shall be valued as per the existing law with appropriate enhancement of monetary limits. It is clarified that the DTC does not propose to compute perquisite value of rent free accommodation based on market value.

CHAPTER IV

TAXATION OF INCOME FROM HOUSE PROPERTY

1. Chapter VIII of the Discussion Paper on the draft Direct Taxes Code (DTC) deals with the computation of income from house property. "Income from house property" is one of the five heads under which accruals or receipts relating to ordinary sources of income are to be classified. The Discussion Paper states that income from house property, which is not occupied for the purpose of any business or profession by its owner, is to be taxed under this head. The Discussion Paper proposes a new scheme for computation of income from house property in the draft DTC, the salient features of which are:

- (a) Income from house property shall be the gross rent less specified deductions.
- (b) Gross rent will be higher of (i) the amount of contractual rent for the financial year; and (ii) the presumptive rent calculated at six per cent per annum of the ratable value fixed by the local authority. However, in a case where no ratable value has been fixed, six per cent shall be calculated with reference to the cost of construction or acquisition of the property. If the property is acquired during the financial year, the presumptive rent shall be calculated for the proportionate period of that financial year.
- (c) The advance rent will be taxed only in the financial year to which it relates.
- (d) The gross rent of one self-occupied property will be deemed to be nil, as at present. In addition, the gross rent of any one palace in the occupation of a ruler will also be deemed to be nil, as at present.
- (e) The following deductions will be admissible against the gross rent:-
 - (i) Amount of taxes levied by a local authority and tax on services, if actually paid.
 - (ii) Twenty per cent of the gross rent towards repairs and maintenance as against thirty per cent at present.

- (iii) Amount of any interest payable on capital borrowed for the purposes of acquiring, constructing, repairing, renewing or re-constructing the property.
- (f) In the case of a self-occupied property where the gross rent is deemed to be nil, no deduction for taxes or interest will be allowed.
- (g) The income from property shall include income from the letting of any buildings along with any machinery, plant, furniture or any other facility if the letting of such building is inseparable from the letting of the machinery, plant, furniture or facility.

2. The most frequent feedback on computation of income from house property has been the determination of notional rent on presumptive basis (at the rate of 6%) with reference to the cost of construction/ acquisition. The input is that this is inequitable as it discriminates against recent owners as such cost is a function of inflation. The other major issue which has been raised is that, in order to incentivize investment in housing, the deduction for interest on capital borrowed for acquisition or construction of a self occupied house property, up to a ceiling of Rs. 1.5 lakhs, as available in the existing provisions of the Income-tax Act, 1961 should be retained.

3. The determination of notional rent for computing income from house property has been a cause for much litigation. Internationally also, in most jurisdictions, income from house property is taxed on the basis of rent from letting out of property.

3.1 Taking the above factors into account, the following modifications are proposed:

- (a) In case of let out house property, gross rent will be the amount of rent received or receivable for the financial year.
- (b) Gross rent will not be computed at a presumptive rate of six per cent of the rateable value or cost of construction/acquisition.
- (c) In case of house property which is not let out, the gross rent will be nil. As the gross rent will be taken as nil, no deduction for taxes or interest etc., will be allowed. However, in case of any one house property,

which has not been let out, an individual or HUF will be eligible for deduction on account of interest on capital borrowed for acquisition or construction of such house property (subject to a ceiling of Rs. 1.5 lakh) from the gross total income. The overall limit of deduction for savings will be calibrated accordingly.

CHAPTER V

TAXATION OF CAPITAL GAINS

1.1 Chapter X of the Discussion Paper on the Direct Taxes Code (DTC) provides that income from transactions in all investment assets will be computed under the head "Capital gains". The DTC provides that gains (losses) arising from the transfer of investment assets will be treated as capital gains (losses). These gains (losses) will be included in the total income of the financial year in which the investment asset is transferred. The capital gains will be subjected to tax at the rate of 30% in the case of non-residents and in the case of residents at the applicable marginal rate.

1.2 Under the Code, the current distinction between short-term investment asset and long-term investment asset on the basis of the length of holding of the asset will be eliminated.

1.3 In general, the capital gains will be equal to the full consideration from the transfer of the investment asset minus the cost of acquisition of the asset, cost of improvement thereof and transfer-related incidental expenses. However, in the case of a capital asset which is transferred anytime after one year from the end of the financial year in which it is acquired, the cost of acquisition and cost of improvement will be indexed to reduce the inflationary gains.

1.4 The capital gains from all investment assets will be aggregated to arrive at the total amount of current income from capital gains. This will, then, be aggregated with unabsorbed capital loss at the end of the immediate preceding financial year (unabsorbed preceding year capital loss) to arrive at the total amount of income under the head 'Capital gains'. If the result of the aggregation is a loss, the total amount of capital gains will be treated as 'nil' and the loss will be treated as unabsorbed current capital loss at the end of the financial year.

1.5 The DTC proposes to abolish Securities Transaction Tax. Therefore, all capital gains (loss) arising from the transfer of equity shares in a company or units of an equity oriented fund will form part of the computation process described above.

1.6 The cost of acquisition is generally with reference to the value of the asset on the base date or, if the asset is acquired after such date, the cost at which the asset is acquired. The base date will now be shifted from 1.4.1981 to 1.4.2000. As a result, all unrealized capital gains due to appreciation during the period from 1.4.1981 to 31.3.2000 will not be liable to tax as the assessee will have an option to take the cost of acquisition for these assets at the price prevailing as on 1.4.2000.

1.7 The DTC also proposes that a new Capital Gains Savings Scheme will be framed by the Central Government. Capital Gains deposited under this scheme will not be subject to tax till the withdrawal from such scheme.

2. The following major issues and concerns have been raised regarding the taxation of capital gains:

- (i) Currently, short-term capital gains arising on transfer of listed equity shares or units of equity oriented funds are being taxed at 15% and long term capital gain arising on transfer of such assets is exempt from tax. The withdrawal of this regime will raise the tax liability and may cause fluctuations in the capital market.
- (ii) The rate of 30 % for taxation of capital gains in the hands of non-residents is very high as in the case of listed equity shares they are currently being taxed at nil rate if held for more than one year.
 - (iii) Foreign Institutional Investors (FIIs) play a significant role in the Indian capital market. Various countries, including emerging markets, offer non-residents a special tax regime to attract investments and promote depth of capital markets.
- (iv) FII should not be liable to TDS on capital gains as this may cause undue hardship to them. The current provisions relating to payment of the liability as advance tax should be continued.

3. After considering the inputs received the following regime is proposed.

3.1 Income under the head 'Capital Gains' will be considered as income from ordinary sources in case of all taxpayers including non-residents. It will be taxed at the rate applicable to that taxpayer.

3.2 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 arising from transfer of an investment asset, being equity shares of a company listed on a recognized stock exchange or units of an equity oriented fund, which are held for more than one year, shall be computed after allowing a deduction at a specified percentage of capital gains without any indexation. This adjusted capital gain will be included in the total income of the taxpayer and will be taxed at the applicable rate. The loss arising on transfer of such asset held for more than one year will be scaled down in a similar manner.

Therefore if the "capital gains" before the deduction at the specified rate comes to Rs.100, it would stand reduced to Rs.50 (if the specified deduction rate is 50 percent). This capital gains would then be included in the taxpayer's total income and taxed at the applicable rate. In this example, for a taxpayer in the tax bracket of 10%, such gain will bear an effective tax at the rate of 5% and for taxpayers in tax bracket of 20% or 30%, the effective tax rate would be 10% or 15% respectively.

The Table below gives examples of the effective rate of taxation for different taxpayers at different specified rates of deduction:

<i>Examples of specified percentage deduction for computing adjusted Capital Gain</i>	<i>Effective tax rate for taxpayer whose applicable marginal tax rate is 10 percent</i>	<i>Effective tax rate for taxpayer whose applicable marginal tax rate is 20 percent</i>	<i>Effective tax rate for taxpayer whose applicable marginal tax rate is 30 percent</i>
50	5%	10%	15%
60	4%	8%	12%
70	3%	6%	9%

The proposed scheme is therefore specially beneficial to low and middle income category of taxpayers as they are to be taxed at their applicable marginal rate of 10 percent or 20 percent after the specified deduction for computing adjusted capital gains. The specific rate of deduction for computing adjusted capital gain will be finalized in the context of overall tax rates.

As there will be a shift from nil rate of tax on listed equity shares and units equity oriented funds held for more than one year, an appropriate transition regime will be provided, if required.

(B) Capital gains on other assets held for more than one year

For taxation of capital gains arising from transfer of investment assets held for more than one year (other than listed equity shares or units of equity oriented funds), the base date for determining the cost of acquisition will now be shifted from 1.4.1981 to 1.4.2000. As a result, all unrealized capital gains on such assets between 1.4.1981 and 31.3.2000 will not be liable to tax. The capital gains will be computed after allowing indexation on this raised base. The capital gains on such assets will be included in the total income of the taxpayer and will be taxed at the applicable rate.

3.3 The complexity of maintaining a permitted savings account and retirement benefits account scheme has been discussed in detail in context of EET method of taxation and taxation of Income from Employment. For the same reasons it is proposed not to introduce the Capital Gains Savings Scheme.

3.4 Capital gains on assets held for less than one year from the end of Financial Year in which asset is acquired.

The capital gain arising from transfer of any investment asset held for less than one year from the end of the financial year in which it is acquired will be computed without any specified deduction or indexation. It will be included in the total income and will be charged to tax at the rate applicable to taxpayer.

3.5 Characterization of income of Foreign Institutional Investors (FIIs)

A major area of dispute is whether the income from transactions in the capital market should be characterized as business income or as capital gains. This has ramifications for taxation in the case of FIIs. A foreign company is not allowed to invest in securities in India except under a special regime provided for Foreign Institutional Investors (FIIs). This regime is regulated by the Securities Exchange Board of India (SEBI) under the SEBI Regulations for FIIs. The regulations provide that an FII can make investment in specified securities in India. The majority of FIIs are reporting their income from such investments as capital gains. However, some of them are characterizing such income as “business income” and consequently claiming total exemption from taxation in the absence of a Permanent Establishment in India. This leads to avoidable litigation. It is therefore, proposed that the income arising on purchase and sale of securities by an FII shall be deemed to be income chargeable under the head ‘capital gains’. This would simplify the system of taxation, bring certainty, eliminate litigation and is easy to administer.

3.6 The capital gains arising to FIIs shall not be subjected to TDS and they will be required to pay tax by way of advance tax on such gains as is the existing practice.

3.7 Securities Transaction Tax

The Securities Transaction Tax (STT) is a tax on specified transactions and not on income. Accordingly, STT is proposed to be calibrated based on the revised taxation regime for capital gains and flow of funds to the capital market.

CHAPTER VI

TAXATION OF NON-PROFIT ORGANISATIONS

1. Chapter XV of the Discussion Paper on the Direct Taxes Code (DTC) deals with taxation of non-profit organizations. The Code uses the phrase 'permitted welfare activities' instead of the phrase "charitable purpose" used in the current legislation to define the activities to be pursued by these organisations. Permitted welfare activities has been defined to mean any activity involving relief of the poor, advancement of education, provision of medical relief, preservation of environment, preservation of monuments or places or objects of artistic or historic interest and the advancement of any other object of general public utility. Advancement of any other object of general public utility will not include any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a fee or for any other consideration, irrespective of the nature of use, application or retention of the income from such activity.

1.1 The Discussion Paper mentions that while trusts and institutions established for charitable purposes have generally enjoyed tax exemptions, the following shortcomings have been observed in the exemption regime:-

- (a) The exemption regime is complex, overlapping and dissimilar since it varies across institutions based on their activities.
- (b) The provisions fail to meet the test of efficiency as they provide different conditions for institutions carrying on similar activities.
- (c) The provisions also do not meet the test of equity as the compliance cost for an institution varies depending upon the provision of law under which the exemption is granted.
- (d) The concept of income of such an institution has been the subject matter of litigation. Should gross receipts of the institution or the net income of the institution be reckoned as the income? This question has been the subject matter of extensive debate.

- (e) A vexed issue is whether the institution should be allowed to accumulate income not applied or utilized for charitable purposes and how the accumulation should be treated.
- (f) There is unending dispute whether a business is incidental to attainment of the objectives of the institution or not, since the income from incidental business is exempt from tax.

1.2 The DTC proposes a new tax regime for all trusts and institutions carrying on charitable activities. The salient features of the new regime are as under:-

- (a) An organization shall be treated as a non-profit organization if,-
 - (i) it is established for the benefit of the general public;
 - (ii) it is established for carrying on permitted welfare activities;
 - (iii) it is not established for the benefit of any particular caste;
 - (iv) it is not established for the benefit of any of its members;
 - (v) it actually carries on the permitted welfare activities during the financial year and the beneficiaries of the activities are the general public;
 - (vi) it does not intend to apply its surplus or other income or use its assets or incur expenditure, directly or indirectly, for the benefit of any interested person;
 - (vii) any expenditure by the organisation does not enure, directly or indirectly, for the benefit of any interested person;
 - (viii) the funds or assets of the organisation are not used or applied, or deemed to have been used or applied, directly or indirectly, for the benefit of any interested person;

- (ix) the surplus, if any, accruing from its permitted activities does not enure, directly or indirectly, for the benefit of any interested person;
 - (x) the funds or the assets of the non-profit organisation are not invested or held in any associate concern or in any prescribed form or mode;
 - (xi) it maintains such books of account and in such manner, as may be prescribed;
 - (xii) it obtains a report of audit in the prescribed form from an accountant before the due date of filing of the return in respect of the accounts of the business, if any, carried on by it; and the accounts relating to the permitted welfare activities and
 - (xiii) it is registered with the Income-tax Department under the Code.
- (b) The tax liability of a non-profit organisation shall be 15 per cent. of the aggregate of the following:-
- (I) the amount of **surplus** generated from the permitted welfare activities; and
 - (II) the amount of capital gains arising on transfer of an investment asset, being a financial asset;

Surplus generated from permitted welfare activities;

The amount of surplus generated from the permitted welfare activities shall be the **gross receipts** as reduced by the **outgoings**.

The **gross receipts** shall be the aggregate of the following:-

- (i) The amount of voluntary contributions received during the financial year;

- (ii) Any rent received in respect of a property consisting of any buildings or lands appurtenant thereto;
- (iii) The amount of any income derived from a business which is incidental to any of the permitted welfare activities;
- (iv) Full value of the consideration received from the transfer of any investment asset, not being a financial asset;
- (v) Full value of the consideration received from the transfer of any business capital asset of a business incidental to its permitted welfare activities;
- (vi) The amount of any income received from any investment of its funds or assets; and
- (vii) All other incomings, realizations, proceeds, donations or subscriptions received from any source.

The amount of **outgoings** shall be the aggregate of-

- (i) voluntary contributions received during the financial year by the non-profit organisation made with a specific direction that they shall form part of the corpus of the non-profit organisation;
- (ii) the amount actually paid during the financial year for any expenditure, excluding capital expenditure, incurred wholly and exclusively for earning or obtaining any "gross receipts";
- (iii) the amount actually paid during the financial year for any expenditure, excluding capital expenditure, on the permitted welfare activities;
- (iv) the amount of capital expenditure actually paid during the financial year in relation to-
 - (A) any business capital asset of a business incidental to any of the permitted welfare activities; or

- (B) any investment asset, not being a financial asset.
- (v) any amount actually paid during the financial year to any other non-profit organisation engaged in a similar permitted welfare activity;
- (vi) any amount applied outside India during the financial year if the amount is applied for an activity which tends to promote international welfare in which India is interested and the non-profit organisation is notified by the Central Government in this behalf.
- (c) The surplus generated from permitted welfare activities will be determined on the basis of **cash system of accounting**.
- (d) Capital gains arising on the transfer of an investment asset, being a financial asset, will be computed in accordance with the provisions under the head "Capital gains".
- (e) A non-profit organisation will be prohibited from investing any of its funds or holding any of its asset in any associate concern or in any prescribed form or mode.
- (f) It will be **mandatory for every non-profit organisation to register with the Income-tax Department** by making an application to the Chief Commissioner or Commissioner concerned. The registration, once granted, shall be valid from the financial year in which the application is made till it is withdrawn.
- (g) The donations made to a non-profit organisation will be eligible for deduction in the hands of the donor at the appropriate rates.
- (h) The income of any trust or institution recognised/registered under the religious endowment Acts of the Central Government or the State Governments shall be fully exempt from income-tax. However, donations to such trusts or institutions will not enjoy any deduction in the hands of the donor.

2. A number of inputs have been received regarding the proposed regime –
- (i) The Code provides for fresh registration of NPOs after introduction of DTC. This will lead to increase in the compliance cost for NPOs and also substantially increase the workload of the income-tax department.
 - (ii) The status of public religious institutions in the DTC is not clear as the DTC exempts the income of only such religious trusts which are registered under a religious endowments legislation of the Central or a State Government. However, there are many states where such legislation does not exist or even if it exists, it does not cover all religious institutions.
 - (iii) The status of partly religious and partly charitable institutions is not clear under the Code.
 - (iv) Instances have been cited where NPOs receive grants at the end of the financial year or are unable to spend due to reasons beyond their control. In the absence of any window for carry forward of surplus for use in the subsequent years, taxation of the surplus of income over expenditure will be harsh.
 - (v) The phrase ‘charitable purpose’ should be used instead of ‘permitted welfare activity’ in order to emphasize the charitable intent of the activities rather than permitting of certain specified welfare activities. This will ensure greater clarity and will minimize litigation as the phrase has been in use for long.
 - (vi) Only cash system of accounting is stipulated for NPOs, whereas under the existing provisions of the Income-tax Act, 1961 NPOs can follow either cash or mercantile system of accounting. The option of choosing one of the systems should be allowed.

3. The issues have been examined and having considered the concerns, the tax regime for NPOs is proposed to be modified to provide that-

- (a) NPOs already registered under the Income-tax Act, 1961 and holding valid registration on the date on which DTC comes into effect, would not be required to apply for fresh registration under the DTC. However, they would be required to provide additional information to facilitate the administration of the new provisions.
- (b) The income of a public religious institutions will be exempt subject to fulfillment of all the following conditions:
 - (A) it shall be registered under the Code.
 - (B) the trust/institution shall apply its income wholly for public religious purposes;
 - (C) it shall be registered under the state law, if any;
 - (D) it is established for the benefit of the general public;
 - (E) the trust / institution shall file the return of tax bases before the due date;
 - (F) it shall maintain books of account and obtain an audit report from a qualified accountant in case its gross receipts exceed a prescribed limit;
 - (G) the funds or the assets of the trust / institution shall be invested or held, at any time during the financial year, in specified permitted forms or modes; and
 - (H) the funds or the assets of the trust / institution shall not be used or applied or deemed to have been used or applied, directly or indirectly, for the benefit of interested person.

Donations to these institutions will not be eligible for any deduction in the hands of the donor.

(c) Partly religious and partly charitable institutions will also be treated as NPOs if they are registered under the Code. Their income from public religious activity will be exempt subject to the fulfillment of the following conditions-

- (i) the trust deed / memorandum of the institution shall contain a clause specifying the application of its gross receipts in a pre-determined ratio between charitable and religious activities;
- (ii) it shall maintain separate books of account and separate financial statements in respect of religious and charitable activities;
- (iii) it shall fulfil the conditions stipulated in clause (b) above.

In respect of income from charitable activities, the income of the trust / institution will be liable to tax in the manner provided for NPOs if they fulfill the conditions prescribed in the Code. Donations to such trust / institution will not be eligible for deduction in the hands of the donor.

- (d) To address the concern that an NPO would not be able to spend the entire receipts during the financial year itself, it is proposed that upto 15% of the surplus or 10% of gross receipts, whichever is higher, will be allowed to be carried forward to be used within three years from the end of the relevant financial year.
- (e) Donations by an NPO out of its accumulated surplus to another NPO will not be considered as application for the charitable purpose.
- (f) The definition of the phrase 'permitted welfare activity' is on the same lines as what is currently used for the phrase 'charitable purpose'. Accordingly, to maintain continuity and minimise litigation, the phrase 'charitable purpose' will be retained in place of 'permitted welfare activity'.
- (g) A basic exemption limit will be provided and the surplus in excess of such limit will be subject to tax.
- (h) It is proposed to retain the cash system of accounting since it is simple to follow and easy to administer.
- (i) It is also proposed that the Central Government shall be empowered to notify any non-profit organization of public importance as an exempt entity.

CHAPTER VII

SPECIAL ECONOMIC ZONES – TAXATION OF EXISTING UNITS

1. Chapter XII of the Discussion Paper on Tax Incentives deals specifically with the grandfathering of area based exemptions. It has been stated that the case for area based exemption is based on the consideration of balanced regional development. However, such area based exemptions create economic distortion, i.e., allocate/ divert resources to areas where there is no comparative advantage. Such exemptions also lead to tax evasion and avoidance. Besides, there is a huge cost of administration. Hence, the Code does not allow area-based exemptions. Area-based exemptions that are available under the Income Tax Act, 1961 will be grandfathered.

2. It has been pointed out that while the current profit linked deductions available to developers of Special Economic Zones (SEZs) have been protected for their unexpired period in the DTC, there is no mention of grandfathering of these profit linked deductions in the case of units operating in these SEZs.

3. Profit linked deductions are distortionary in nature as they create an incentive to inflate profit as well as to transfer profits from a taxable entity to a non-taxable one. As a policy, it has, therefore, been decided not to extend the scope or the period of profit linked deductions. However, specific provisions for protecting such deduction for the unexpired period have been provided in the DTC in the case of SEZ developers. A similar provision to protect profit linked deductions of units already operating in SEZs for the unexpired period will also be incorporated.

CHAPTER VIII

CONCEPT OF RESIDENCE IN THE CASE OF A COMPANY INCORPORATED OUTSIDE INDIA

1. Chapter-IV of the Discussion Paper on the draft Direct Taxes Code (DTC) discusses the test of residence of a person for tax purposes. The tax residence of companies (that is, where companies are established or carry on business) is usually based on either place of incorporation (legal seat), location of management (real seat) or a combination of the two. The DTC provides that a company incorporated in India will always be treated as resident in India. However, a company incorporated abroad (foreign company) can either be resident or non-resident in India. It has been proposed in the DTC that a foreign company will 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 (it need not be wholly situated in India, as at present).

2. It has been pointed out that under the new test for determining residence in the DTC, a foreign company whose control and management is partly in India will be treated as a resident of India and thus liable for taxation in India on its global income. The word 'partly' used in the DTC sets a very low threshold for regarding a foreign company as a resident in India. Apprehensions have been expressed that it could lead to a foreign multi-national company being held as resident in India on the ground that some activity like a single meeting of the Board of Directors is held in India. Also, a foreign company owned by residents in India could be held to be resident in India as part of the control of such company may be in India. It has been represented that this will result in uncertainty in taxation and will impact foreign direct investment into India. Modification of the phrase 'wholly or partly' has therefore been suggested.

3.1 Generally, the test of residence for foreign companies is the 'place of effective management' or 'place of central control and management'. At the same time, it is noted that the existing definition of residence of a company in the Income Tax Act, 1961 based on the control and management of its affairs being situated wholly in India is too high a threshold.

3.2 'Place of effective management' is an internationally recognized concept for determination of residence of a company incorporated in a foreign jurisdiction. Most of our tax treaties recognize the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. It is an internationally accepted principle that the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made. In case of a company incorporated outside India, the current domestic law is too narrow compared to our tax treaties as the test of residence of a foreign company is based on "whole of control and management" lying in India. However a test of residence based on control and management of the foreign company being situated "wholly or partly" in India as proposed in the DTC is much wider.

3.3 It is therefore proposed that a company incorporated outside India will be treated as resident in India if its 'place of effective management' is situated in India. The term will have the same meaning as currently laid down in the Tenth Schedule to the Code as under:

'place of effective management of the company' means-

- (i) the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
- (ii) 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."

3.4 As an anti-avoidance measure, in line with internationally accepted practices, it is also proposed to introduce Controlled Foreign Corporation provisions so as to provide that passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferral of taxes, shall be deemed to have been distributed. Consequently, it would be taxable in India in the hands of resident shareholders as dividend received from the foreign company.

CHAPTER IX

DOUBLE TAXATION AVOIDANCE AGREEMENT (DTAA) VIS-À-VIS DOMESTIC LAW

1.0 Chapter –XXIII of the Discussion paper deals with relief from double taxation. Ordinarily, countries follow both residence-based taxation and source-based taxation. However, if two countries tax the same income, one based on the principle of residence and the other based on the principle of source, it could lead to double taxation of the same income. Hence, countries have agreed on certain principles to avoid double taxation and accordingly, entered into Double Taxation Avoidance Agreements (DTAA).

1.1 DTAA provides for certainty on how and when will income of a particular kind be taxed and by which contracting State. The taxation right of each State is defined. If one State has the right to tax a certain income, provision is made for the other State to give tax credit or exemption to that income in order to avoid double taxation.

1.2 The DTC provides that neither a DTAA nor the Code shall have a preferential status by reason of its being a treaty or law. In the case of a conflict between the provisions of a treaty and the provisions of the Code, the one that is later in point of time shall prevail.

2. Apprehensions have been raised that the aforesaid proposal would lead to treaty override and the existing DTAAs could be rendered otiose. This would result in higher rate of taxation on royalty, fees for technical services and interest income etc , which are taxed in the source country at a concessional rate as per the provisions of the DTAA. The uncertainty regarding cost of doing business in India will also affect foreign direct investment. It has been represented that such general treaty override is against the spirit of the Vienna Convention. It may not be possible to restore the preferential status of the DTAAs over domestic law by re-notification of all the existing DTAAs as they are bilateral agreements which cannot be re-notified unilaterally.

3. The current provisions of the Income-tax Act provide that between the domestic law and relevant DTAA, the one which is more beneficial to the taxpayer will apply. However, this is subject to specific exceptions e.g., the taxation of a foreign company at a rate higher than that of a domestic company is not considered as a less favourable charge in respect of the foreign company.

3.1 Similarly it is proposed to provide that between the domestic law and relevant DTAA, the one which is more beneficial to the taxpayer shall apply. However, DTAA will not have preferential status over the domestic law in the following circumstances:-

- when the General Anti Avoidance Rule is invoked, or
- when Controlled Foreign Corporation provisions are invoked or
- when Branch Profits Tax is levied.

3.2 This limited treaty override is in accordance with the internationally accepted principles. Since anti-avoidance rules are part of the domestic legislation and they are not addressed in tax treaties, such limited treaty override will not be in conflict with the DTAAs. Further this will not deprive any taxpayer of any intended tax benefit available under the DTAAs.

CHAPTER X

WEALTH TAX

1. Chapter XVII of the Discussion Paper on the Direct Taxes Code (DTC) deals with the levy of wealth tax. Under the DTC, wealth-tax will be payable by an individual, HUF and private discretionary trusts. It will be levied on net wealth on the valuation date i.e. the last day of the financial year. Net wealth is defined as assets chargeable to wealth-tax as reduced by the debt owed in respect of such assets. Assets chargeable to wealth-tax shall mean all assets, including financial assets and deemed assets, as reduced by exempted assets. Exempted assets include stock in trade, a single residential house or a plot of land etc. The net wealth of an individual or HUF in excess of Rupees fifty crore shall be chargeable to wealth-tax at the rate of 0.25 per cent.

2. The inputs on the Wealth Tax proposals are

- (i) Productive assets should be exempted from wealth tax as is currently the case.
- (ii) The threshold limit of Rupees 50 crore for levy of wealth tax is too high.
- (iii) On the other hand it has also been argued that tax on financial assets will be harsh as they are currently exempt.

3. Wealth tax is an anti- abuse measure in the integrated tax system. It ensures reporting of significant assets held by a tax payer. It is proposed that Wealth Tax will be levied broadly on the same lines as provided in the Wealth Tax Act, 1957. Accordingly, specified “unproductive assets” will be subject to the wealth tax. However, it will be payable by all taxpayers except non-profit organizations. The threshold limit and rate of tax will be suitably calibrated in the context of overall tax rates.

CHAPTER XI

GENERAL ANTI-AVOIDANCE RULE

1. Chapter XXIV of the Discussion Paper on the Direct Taxes Code (DTC) deals with the provisions of the General Anti Avoidance Rule (GAAR). The harmful effects of tax avoidance on the tax base, on tax equity and on the compliance regime have been discussed at length. The need for general anti avoidance provisions instead of legislative amendments to deal with specific instance of tax avoidance has also been discussed. The GAAR provisions apply where a taxpayer has entered 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. The Assessing Officer in accordance with the directions of Commissioner of Income Tax may in such cases determine the tax consequences for the assessee by disregarding the arrangement. These provisions have been further elaborated in the Discussion Paper.

1.1 Under the Code, the power to invoke GAAR is bestowed upon the Commissioner of Income- tax. For this purposes the Code empowers him to call for such information as may be necessary. He is also required to follow the principles of natural justice before declaring an arrangement as an impermissible avoidance arrangement. He will determine the tax consequences of such impermissible avoidance arrangement and issue necessary directions to the Assessing Officer for making appropriate adjustments. The directions issued by him will be binding on the Assessing Officer.

2. Apprehensions have been expressed that the GAAR provision is sweeping in nature and may be invoked by the Assessing Officer in a routine manner. Apprehensions have also been raised that 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 arrangement. It has been represented that to avoid arbitrary application of the provisions, further legislative and administrative safeguards be provided. Besides suitable threshold limits for invoking GAAR should be considered.

3 GAAR legislation exists in a number of countries. Jurisdictions which do not have GAAR legislation impose significant additional information and disclosure requirements on tax practitioners regarding advance intimation and registration of tax shelters with the tax administration. These can be investigated and potentially abusive arrangements can be declared impermissible. A statutory GAAR can act as an effective deterrent and compliance tool against tax avoidance in an environment of moderate tax rates.

3.1 The proposed GAAR provisions do not envisage that every arrangement for tax mitigation would be liable to be classified as an impermissible avoidance arrangement. It is only in a case where the arrangement, besides obtaining a tax benefit for the assessee, is also covered by one of the four conditions i.e. it is not at arms length or it represents misuse or abuse of the provisions of the Code or it lacks commercial substance or it is entered or carried on in a manner not normally employed for bona-fide business purposes, the GAAR provisions would come into effect.

3.2 The following safeguards are also proposed for invoking GAAR provisions:-

- i) The Central Board of Direct Taxes will issue guidelines to provide for the circumstances under which GAAR may be invoked.
- ii) GAAR provisions will be invoked only in respect of an arrangement where tax avoidance is beyond a specified threshold limit.
- iii) The forum of Dispute Resolution Panel (DRP) would be available where GAAR provisions are invoked.