

Deciphering the Direct Tax Code

Ernst & Young's pan-India panel dialogues on the new Direct Tax Code

August – September 2009

- | | |
|-------------|-----------|
| Ahmedabad | Hyderabad |
| Bengaluru | Kochi |
| Bhubaneswar | Kolkata |
| Chennai | Mumbai |
| Delhi | Pune |



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Introduction

On 12 August 2009, the Finance Minister, Mr. Pranab Mukherjee tabled the new Direct Tax Code in front of the denizens of the country, to contribute and share their thoughts to what is being viewed as the most awaited change in the Indian taxation system. The proposed Direct Tax Code (DTC) would replace the existing direct tax legislations constituted by the Income Tax Act, 1961 and the Wealth Tax Act, 1957.

The Government will consider these inputs and suggestions before tabling this legislation in the Parliament and transcending them into a law.

In order to channelize the thoughts of India Inc, Ernst & Young conducted a series of seminars across ten key cities of India, including the four major metros. Eight of these sessions were conducted in partnership with the Confederation of Indian Industries (CII).

These sessions were part of our initiative to provide a platform to India Inc to understand and analyze the impact of the Direct Tax Code bill, while also engage them in a constructive way to share their thought to the Government of India. The technical sessions were lead by a senior panel of experts from Ernst & Young's Tax and Regulatory Services practice. The discussions served as an opportunity for India Inc to closely examine implications of these announcements on the economy, industry and individual and get experts' opinion on issues affecting the corporate sector. The session was witnessed by over 1,000 members from India Inc, from across the country.

We at Ernst & Young feel that the underlying philosophy of the new direct tax code recognises the complexity of language and interpretation that has crept into the present direct tax laws over the last nearly 50 years through, innumerable amendments and piecemeal introduction of new provisions. The new Code aims to simplify the language, remove uncertainty in interpretation and mitigate undue litigation. Whilst, most of the provisions in the new Code measure up to these objectives there are some provisions like levy of Minimum Alternate Tax, increase in capital gain tax rates, General Anti-Avoidance Rules, residency of a company and so on, which could have unfavourable impact over businesses and tax cash flow generation.

The outcome of our pan-India deliberations will help provide concrete and constructive suggestions to the Government of India. This document provides the material that was presented by our panels at the various seminars and also provides details of our panelists and information about our practice.



Presentation on the new Direct Tax Code

Outline

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Development of the Direct Tax Code (DTC)

- ▶ Substantial amendments to Income-tax Act, 1961 (Act) by various Finance Acts and amending statutes
- ▶ Concerns raised by taxpayers and tax administrators on the complex structure of tax laws
 - ▶ Numerous amendments have rendered the Act incomprehensible
 - ▶ Has resulted in increased cost of compliance and administration
 - ▶ Difference in interpretation on a number of issues has led to litigation
 - ▶ Conflicting judgments rendered by Courts at various levels has compounded the problem further
- ▶ Several attempts to reform the tax laws since the 1990s
- ▶ 2005-06 Budget: Intention to undertake major tax reforms
 - ▶ To improve Tax-GDP ratio, expand taxpayer base, increase tax compliance and make tax administration efficient
 - ▶ Proposal to introduce simplified Income Tax Bill
- ▶ 2007-08 Budget: Proposal to release DTC for public discussion
- ▶ 12 August 2009: DTC Bill, 2009 and Discussion Paper released
 - ▶ 285 sections, 18 schedules, power to make rules on several aspects
 - ▶ 318 terms defined in “Definition Section”!
- ▶ DTC to replace the Act and come into force on 1 April 2011

The shifting world of tax

- ▶ US international tax reform proposals: Limit companies ability to defer tax on foreign earnings until repatriated
- ▶ UK & Japan tax reforms: Participation exemption for foreign source income
- ▶ German Tax Reforms: Tightening of thin capitalization/earnings stripping rules
- ▶ Dutch Government's Consultation Paper on Tax Reforms issued in June 2009
- ▶ China: New income tax legislation
- ▶ Mexico: Tax Reforms in 2008
- ▶ Rapid legislative change in a number of other countries
 - ▶ Economic stimulus in response to crisis
 - ▶ Improving competitiveness
 - ▶ General trend of corporate tax reductions



Key messages of the DTC

- ▶ Thrust of the DTC
 - ▶ Improve efficiency of tax system by eliminating distortions in the tax structure
 - ▶ Simplify the complex structure of the Act, that is incomprehensible to average taxpayer
 - ▶ Introduce moderate levels of taxation and expand the tax base
 - ▶ Simplify the language to enable better comprehension
 - ▶ Remove ambiguity to foster voluntary compliance
 - ▶ Provide stability in the tax regime based on well accepted principles of taxation and best international practices



Salient features of the DTC

- ▶ Single code for all direct taxes
- ▶ Use of simple language and consolidation of provisions to enable better understanding and facilitate voluntary compliance
- ▶ Extensive use of tables & formulae, elimination of provisos & explanations
- ▶ Attempt made to avoid ambiguity in the provisions that give rise to contrary interpretations
- ▶ Powers delegated to Central Government/Board to avoid protracted litigation on procedural issues
- ▶ Flexible structure capable of accommodating changes of dynamic economy without resorting to frequent amendments

Tax rates – Corporates

Particulars	Current Tax Rates*	Tax rates under DTC
Domestic Company	30%	25%
Foreign Company	40%	25%
Branch Profit Tax	Not Applicable	15% (New tax)
DDT	15%	15%
MAT	15% of the adjusted book profits	0.25% of the value of gross assets for banking companies and 2% in other cases

* Exclusive of surcharge and cess

Computation of income

- ▶ Concept of 'previous year' and 'assessment year' replaced by a uniform concept of 'financial year' (FY)
- ▶ Classification of income as either 'special source' or 'ordinary source'
 - ▶ Separate computation of ordinary source and special source income
 - ▶ Special source income specified in Schedule
 - ▶ Interest, capital gains, investment income, royalty/FTS of non-residents
 - ▶ Ordinary source income classified under five heads
 - ▶ Employment income, house property, business income, capital gains, residuary income
- ▶ Total income determined by aggregating 'gross total income from ordinary sources less permissible deductions' and 'total income from special sources'

Computation of income – Ordinary sources

- ▶ Step 1 – Compute income in respect of each source of income separately
- ▶ Step 2 – Aggregate income from all the sources falling within a head to arrive at the figure of income assessable under that particular head
- ▶ Step 3 – Aggregate income under all the heads to arrive at ‘Current income from ordinary sources’
- ▶ Step 4 – Aggregate current income with unabsorbed loss at the end of the immediate preceding FY, if any, to arrive at ‘gross total income from ordinary sources’
- ▶ Step 5 – Gross total income from ordinary sources to be reduced by specified incentives to arrive at ‘total income from ordinary sources’

Computation of income – Special sources

- ▶ Step 1 – Compute income in respect of each of the special sources to arrive at ‘current income from the special source’
 - ▶ No deductions allowed for “special source” income other than for Capital Gains
- ▶ Step 2 – Aggregate the ‘current income from the special source’ with the unabsorbed loss from that special source at the end of the immediately preceding FY, if any
- ▶ Step 3 – Result of the aggregation under Step 3 to be ‘gross total income from the special source’. The ‘gross total income from special source’ to be computed with respect to each of the special sources
- ▶ Step 4 – Aggregate the gross total income from all such special sources to arrive at the ‘total income from special sources’

Income from ordinary sources

Particulars	Amount
(a) Income from employment	xxx
(b) Income from house property	xxx
(c) Income from business*	xxx
(d) Capital gains	xxx
(e) Income from residuary sources	xxx
Current income from ordinary sources <i>[total of (a) to (e) above]</i>	xxx
Less: Unabsorbed loss at the end of the preceding FY	(xxx)
Gross total income from ordinary sources	xxx
Less: Incentives under sub-chapter I of Chapter III	(xxx)
Total Income from ordinary sources	xxx

* Income from separate businesses to be computed separately

Income from special sources

Particulars	Amount
Current Income from special source (Category I)	xxx
Less: Unabsorbed loss from the special source (Category I)	(xxx)
Gross Total Income from the special source (Category I) (a)	xxx
Current Income from special source (Category II)	xxx
Less: Unabsorbed loss from the special source (Category II)	(xxx)
Gross Total Income from the special source (Category II) (b)	xxx
Total Income from special sources <i>[total to (a) and (b) above]</i>	xxx

Business income

- ▶ Every business to constitute a separate source and income from each to be computed separately
- ▶ Businesses to be treated as separate and distinct if no interlacing, interdependence or unity
- ▶ Following deemed to be separate businesses
 - ▶ Units are located physically apart from each other
 - ▶ Units using different raw material or manufacturing process
 - ▶ Separate books are maintained or capable of being maintained
 - ▶ It is a “specified business”
 - ▶ Speculative business

Presumptive basis of taxation

- ▶ Presumptive basis of taxation for foreign company/non-resident engagement in following businesses:
 - ▶ Civil construction in connection with a turnkey power project
 - ▶ Erection of plant or machinery or testing or commissioning thereof, in connection with a turnkey power project
 - ▶ Providing services or facilities in connection with prospecting for, or extraction or production of mineral oil
 - ▶ Supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils
 - ▶ Operation of ships/aircrafts (including an arrangement such as slot charter, space charter or joint charter)

Computation of business income

- ▶ Profits of other businesses to be gross earnings less business expenditure
- ▶ Gross earnings to be aggregate of all business receipts including
 - ▶ Profit on sale of business capital assets including self-generated assets
 - ▶ Profit on sale of an undertaking under a slump sale
 - ▶ Reduction or remission of any loan, deposit or advance
 - ▶ Reimbursement of expenditure
- ▶ Business expenditure classified into three broad categories
 - ▶ Operating expenditure
 - ▶ Permitted financial charges
 - ▶ Capital allowances

Business expenditure

- ▶ Detailed listing of qualifying operating expenditure
- ▶ Residuary clause to cover amount of any other expenditure
- ▶ Expenditure not to be allowed
 - ▶ Expenditure attributable to income which does not form part of total income
 - ▶ Provision for “unascertained liability”
 - ▶ Where tax is not deducted at source
 - ▶ Exception: where tax is deducted in last quarter and paid before filing tax return or paid within a period of two FYs



Business expenditure

- ▶ Capital allowances (depreciation, initial depreciation, terminal allowance)
- ▶ Applicable when business asset is owned by taxpayer and used for purpose of business
- ▶ Lessee deemed to be owner of asset under a financial lease
- ▶ New category of assets eligible for depreciation allowance
 - ▶ Prescribed preliminary expenses (25%)
 - ▶ Deferred revenue expenditure including non-compete fees, lease premium, business reorganization expenses, VRS expenses (25%)
- ▶ Allowance of depreciation even where all assets under a particular “block of assets” are demolished, destroyed or transferred if adjusted WDV is > zero
- ▶ Concept of “block of assets”, actual cost, written down value and depreciation rates broadly similar to that under current law

Business expenditure

- ▶ Scientific research & development expenses
 - ▶ Expenditure relating to business treated as “operating expenditure”
 - ▶ All “scientific research assets” eligible for 100% depreciation
- ▶ In-house Scientific research & development facility
 - ▶ Weighted deduction at 150% for expenditure incurred in creating, maintaining facility and carrying out research
 - ▶ All businesses eligible for weighted deduction
 - ▶ Prescribed conditions to be satisfied



Minimum Alternate Tax (MAT)

- ▶ Company liable to pay MAT or tax as per “normal provisions”, whichever is higher
- ▶ Basis for levy of MAT shifted from book profits to gross assets
- ▶ Rate of tax - 2% of the value of ‘gross assets’ (0.25% in case of banking companies)
- ▶ Value of ‘gross assets’ aggregate of
 - ▶ Gross block of assets less accumulated depreciation
 - ▶ Capital work-in-progress
 - ▶ Book value of other assets (excluding debit balance of P&L account, if any)
- ▶ Balance sheet for computing ‘gross assets’ to be in accordance with the provisions of Part I of Schedule VI to the Companies Act, 1956
- ▶ MAT to be final tax and no tax credit available in respect of MAT tax in subsequent years

Computation of MAT – Comparative illustration

Balance Sheet and Profit & Loss Account (P&L) of Company A

in millions (INR)

Particulars	Amount
Share Capital	300
Reserves and Surplus (P&L Balance)	70*
Secured Loan	330
Total	700
Fixed Assets	
Gross Block	600
Less: Accumulated Depreciation	(150)
Net Block	450
Capital work in progress	150
Inventories	50
Sundry Debtors	75
Cash and Bank Balances	45
Less: Current liabilities and provisions	
Liabilities	(40)
Provisions	(30)
Net Current Assets	100
Total	700

Particulars	Amount
Income:	
Sales of goods	235
Other Income	15
Total Income	250
Expenditure:	
Cost of goods sold	115
Depreciation	45
Interest and Other expenses	35
Total expenditure	195
Profit for the year	55
Less: Provision for taxation	(15)
Profit after taxation	40
Profit b/f from previous year	30
Profit carried to Balance Sheet*	70

MAT under the current provisions

Computation of Book profits

in millions (INR)

Particulars	Amount
Net profit as per P&L Account	40
Add - Amount debited to P&L	
Amount of income tax paid/payable	15
Amount of depreciation	45
Less - Amount credited to P&L	
Amount of depreciation debited to P&L (excluding the depreciation on account of revaluation of assets)	(45)
Book Profits as per Section 115 JB	55

MAT liability = 15% on Book profits (55) = 8.25 million (INR)

MAT under DTC

Computation of value of gross assets

in millions (INR)

Particulars	Amount
Gross block of fixed assets	600
Add: Value of capital work in progress	150
Add: Book Value of all other assets	170
Less: Accumulated depreciation of fixed assets	(150)
Less: Debit balance of P&L Account (if included in book value of other assets)	Nil
Value of Gross Assets	770

MAT liability = 2% of the value of gross assets (770) = 15.4 million (INR)

Tax incentives

- ▶ Profit based tax holiday incentives replaced with investment based incentives
- ▶ New approach for granting tax incentives
 - ▶ Available only to certain specified kinds of businesses
 - ▶ Taxpayer first allowed to recover all capital expenditure (other than land, goodwill and financial instrument) and revenue expenditure and would be liable to income-tax on profits made thereafter
 - ▶ Period consumed in recovering such expenditure regarded as period of tax holiday
 - ▶ Tax holiday benefits linked to additional new investments made
 - ▶ Entitlement to claim tax benefits as long as there are new investments without inclusion of any kind of 'sunset' clause



Tax incentives

- ▶ New scheme of tax incentives applicable to businesses include (“Specified Business”)
 - ▶ Exploration and production of mineral oil and natural gas
 - ▶ Developing a SEZ
 - ▶ Generation/transmission or distribution of power
 - ▶ Developing/operating/maintaining any infrastructure facility
 - ▶ Operating and maintaining a hospital in specified areas
 - ▶ Setting up and operating a cold chain facility
 - ▶ Laying and operating a cross country natural gas or crude oil pipeline network

- ▶ Export oriented businesses including those in the IT/ITES sectors not covered in the list of specified businesses entitled for tax holiday

- ▶ Grandfathering of existing profit-linked incentives, area based exemptions

Adjustment of losses

- ▶ Loss from ordinary source from “specified business” cannot be set off in year of loss
- ▶ Indefinite carried forward and set off against same source
- ▶ Loss from ordinary source from “non-specified business” can be set off in the same year against any other ordinary source
- ▶ Unabsorbed loss can be carried forward indefinitely and set off against income from ordinary sources in the subsequent years
- ▶ Loss under the head ‘Capital gains’ and from speculative business ring fenced, not allowed to be set off against income under other heads

Adjustment of unabsorbed losses – Illustration

Description	Case 1	Case 2	Case 3	Case 4	Case 5
Current Income from ordinary sources	1000	1000	1000	(1000)	(1000)
Unabsorbed preceding years loss from ordinary sources	Nil	(500)	(1500)	Nil	(1500)
Gross Total Income from ordinary sources	1000	500	Nil	Nil	Nil
Unabsorbed current loss from ordinary sources*	Nil	Nil	(500)	(1000)	(2500)

**Unabsorbed current loss from ordinary sources is allowed to be carried forward to the subsequent year for the purposes of set off*

Issues/discussion points

- ▶ Entry into force
 - ▶ Section 1: Effective from 1 April 2011
 - ▶ Section 2(7): Law prevailing on first day of succeeding FY to apply to apply for any FY
 - ▶ Applicable for FY 2010-11 or FY 2011-12?
- ▶ Same business v separate & distinct business
 - ▶ Appropriateness of criteria used
 - ▶ Some of the deeming criteria could be inconsistent with the general principle of inter-dependency and interlacing
 - ▶ Whether separate books are capable of being maintained could be subjective



Issues/discussion points

▶ MAT

- ▶ Inconsistent with original intent of MAT
- ▶ Applies even if no “book profits” – would be the “minimum” tax a company would pay literally, irrespective of its financial condition
- ▶ 2% rate applicable to even NBFCs
- ▶ Computed on gross assets, irrespective of debt, net worth of a company
- ▶ Introducing investment-linked incentives and levying MAT on assets created by the investment – is it fair?
- ▶ Application to foreign companies, even if no presence by way of Branch?

▶ Tax incentives

- ▶ Discussion paper states that existing profit-linked incentives would be “grandfathered”
- ▶ Tax incentive under Section 10AA of Act not covered in transitional provisions of DTC for grandfathering
- ▶ Tax incentive under 10A/10B extended for 2010-11 by Finance Act, 2009
- ▶ No transitional provision if DTC is effective FY 2010-11

Capital gains

- ▶ Income from transactions in investment assets taxed as 'Capital gains'
- ▶ Investment assets exclude "business trading asset" and "business capital asset"
- ▶ Distinction between short term capital gain and long term capital gain eliminated
- ▶ Indexation benefit available where investment asset is transferred at any time after one year from the end of the FY in which the asset is acquired
- ▶ Shift in base date from 1 April 1981 to 1 April 2000 for computing cost of acquisition
 - ▶ Appreciation in value of the asset till 1 April 2000 not liable for tax

Capital gains: significant deviations from current law

- ▶ Taxation of listed securities
 - ▶ Abolition of securities transaction tax
 - ▶ Capital gains tax exemption on long-term gains abolished
- ▶ Tax rates
 - ▶ Concessional rates for long-term gains, listed securities, Foreign Institutional Investors (FIIs)/NRIs removed
 - ▶ Capital gains of non-residents taxed at 30%
- ▶ Cost of acquisition deemed to be nil for all “self-generated” assets or if cost cannot be determined or ascertained
- ▶ Capital losses allowed to be carried forward for indefinite period to be set off against income from ‘capital gains’

Capital gains: significant deviations from current law

- ▶ Exemption for holding-subsiary and subsidiary-holding transfer retained, but conditions for exemption modified
 - ▶ Eight year holding period criteria removed
 - ▶ Exempted gains taxed whenever any condition is violated at any point in time without limitation
 - ▶ Taxable in the year of violation
- ▶ Right given to CBDT to prescribe cost of acquisition, method of determination etc.
- ▶ Buy-back of shares specifically covered within definition of “transfer”
 - ▶ No condition that it should be buy back pursuant to Indian company law

Taxation of Unincorporated Bodies (UBs)

- ▶ UBs to consist of partnership firms, Limited Liability Partnerships (LLPs), Association of Persons (AOPs), Body of Individuals (BOIs)
- ▶ Members of UBs regarded as 'participants'
- ▶ UBs taxed as a separate entity at the basic tax rate of 30% and share of participant's profits exempt from tax
- ▶ Salary, commission and interest to participants allowable as a deduction, taxable in the hands of the recipients
- ▶ Carry forward and set off of losses allowed
 - ▶ In case of death/retirement of any participant, loss attributable to such participant not permitted to be carried forward

Taxation of Financial Intermediaries (FIs)

- ▶ Discussion Paper: “Financial Intermediaries (FI)” such as VC to be accorded “pass through” tax treatment
- ▶ “Pass-thru entity” defined to include mutual fund (MF)
 - ▶ MF in-turn defined to include Venture Capital Fund/Venture Capital Company (VCF/VCC)
- ▶ VCF/VCC not liable to tax on income: Covered within scope of persons exempt from tax
 - ▶ No requirement that investment should be in specified sector
- ▶ Company paying dividend to “pass-thru” entity exempt from DDT
- ▶ Income from units of MF exempt from tax
- ▶ Withholding tax exemption on payment of interest to MF

Taxation of FIs

- ▶ Issues/discussion points
 - ▶ Taxation of investors/beneficiaries
 - ▶ No specific provision to provide for taxing investor in VCC/VCF on same basis as underlying income
 - ▶ VCC subject to DDT on distribution
 - ▶ Distinction between Mutual Fund registered under SEBI regulations v Venture Capital Fund?



Business reorganization

- ▶ Business Reorganization with different types of combinations to be tax neutral
- ▶ Business Reorganization defined to mean amalgamation or demerger between two or more residents
- ▶ Amalgamation defined to provide for amalgamation of companies, co-operative societies, UBs and proprietary concerns
- ▶ No incidence of capital gains tax on exchange of shares and transfer of investment assets, subject to conditions similar to that presently applicable
- ▶ Scientific R&D - Approval of research facility by prescribed authority obtained by predecessor, deemed to have been granted to the successor
- ▶ Carry forward and set off losses
 - ▶ Successor can claim benefits of losses of the predecessor on satisfaction of 'continuity of business' test
 - ▶ Nature of business carried out by successor/predecessor immaterial
 - ▶ Benefits not restricted to industrial undertakings or banking companies alone
 - ▶ Losses of closely-held companies not to lapse if 51% voting power remains unchanged
- ▶ Depreciation allowance
 - ▶ Proportionate depreciation allowed in hands of successor if reorganisation takes place during the FY
 - ▶ Adjusted value of block of assets to be computed ignoring business reorganization

Withholding tax

- ▶ Applicable to “any person”
- ▶ On “specified payments” at the time of payment or credit
- ▶ Withholding at “appropriate rates”
- ▶ “Specified payments” and “appropriate rates” defined in Schedule to DTC
 - ▶ Separate listing for residents and non-resident recipients
- ▶ “Appropriate rate” would be higher of prescribed rate or 20% if recipient does not have PAN
- ▶ Specified payments:
 - ▶ Residents
 - ▶ Rent, professional & technical services, royalty, contractors etc
 - ▶ Any other income – 10 per cent
 - ▶ Non-residents:
 - ▶ Interest – 20 per cent
 - ▶ Capital gains – 30 per cent
 - ▶ Other investment income – 20 per cent
 - ▶ Royalty/FTS – 20 per cent
 - ▶ “Whole of other income” – 35 per cent
- ▶ Provision for obtaining certificate for no deduction of tax

Withholding tax

▶ Issues/discussion points

- ▶ Wide coverage on payments to residents – “any person” making any payment that would be income –transactions for goods/services, capital gains?
- ▶ Literal reading: any person making “specified payment” anywhere in the world would need to comply!
- ▶ Person making payment cannot determine net income
- ▶ No requirement that payment should be chargeable to tax in India
- ▶ No provision for certificate for lower withholding tax
- ▶ No provision to apply treaty rates
- ▶ Withholding tax on the gross receipts at 35 per cent on business income of PE/PO

Tax return filing

- ▶ A consolidated return for filing return of income, net wealth and dividends distributed
- ▶ Due date for filing returns advanced
 - ▶ 30 June for non-business and non-corporate taxpayers
 - ▶ 31 August for all other taxpayers
- ▶ Belated/revised return can be filed within 21 months from the end of the FY as stipulated

Assessment procedure

▶ Intimation

- ▶ Intimation on processing of return specifying tax liability and sum payable/refundable
- ▶ Intimation for sum payable/demand notice to be within 12 months from end of month in which return is furnished

▶ Scrutiny assessment

- ▶ Selection of scrutiny cases to be made as per risk management strategy
- ▶ Notice for assessment to be issued within four months from the end of the FY in which return is furnished
- ▶ Assessment to be completed within 21 months from end of FY in which return was filed, subject to exceptions
- ▶ In cases involving TP assessment, 21 months or 3 months after receipt of TPOs order, whichever is later



Dispute Resolution & Appeals

- ▶ Dispute Resolution Panel (DRP)
 - ▶ Alternative dispute resolution mechanism on similar lines as that introduced by Finance Act, 2009
 - ▶ Scope of coverage extended to cover all taxpayers where variation proposed exceeds INR 2,500,000
- ▶ Appellate Structure
 - ▶ Commissioner (Appeals)
 - ▶ Appellate Tribunal
 - ▶ National Tax Tribunal
 - ▶ Supreme Court
 - ▶ No procedure for appeal to High Court in case of delay in NTT notification



Penalties

- ▶ Seeks to elaborate, define and explain circumstances in which penalties can be levied
- ▶ Presumption of willful under-reporting of tax base
 - ▶ failure to file tax return by the due date
 - ▶ assessment of the tax base at an amount higher than the amount disclosed in the tax return
- ▶ Penalty leviable upto a maximum of 200% of tax payable
- ▶ No provisions for seeking waiver
- ▶ Penal provisions not to be imposed in the following situations
 - ▶ On the taxpayer providing bonafide explanation and supporting
 - ▶ Genuine differences between the taxpayer and tax authority
 - ▶ Variance covered by prepaid taxes will not attract penalty
- ▶ Penalty with respect to default in compliances retained, subject to minor variations

Transition provisions

- ▶ 1961 Act stands repealed on enactment of the DTC
- ▶ Where return of income is filed before enactment of DTC, proceedings to be governed by erstwhile provisions
- ▶ Appeals pending before enactment of DTC to be governed by erstwhile provisions
- ▶ Tax treaties entered under 1961 Act deemed to be entered into under DTC
- ▶ Certain tax incentives of 1961 Act to be allowed under DTC if taxpayer is eligible for the same on 1 April 2010



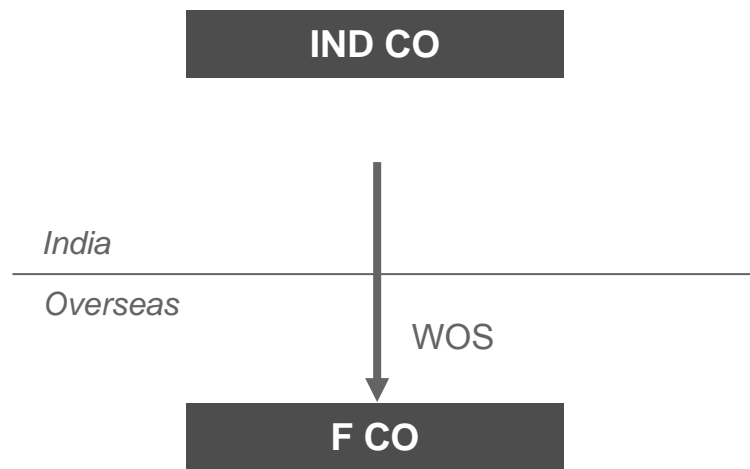
Test of residence

- ▶ Residence test for companies

- ▶ A foreign company to be resident even if partial control & management (C&M) is in India
- ▶ Current law requires C&M to be wholly situated in India
- ▶ Judicial precedents have held that C&M is situated at the place where “the head and brain and directing power” of the company’s affairs is situated
- ▶ Generally, the place where important business decisions substantially affecting the company are taken



Test of residence – possible implication



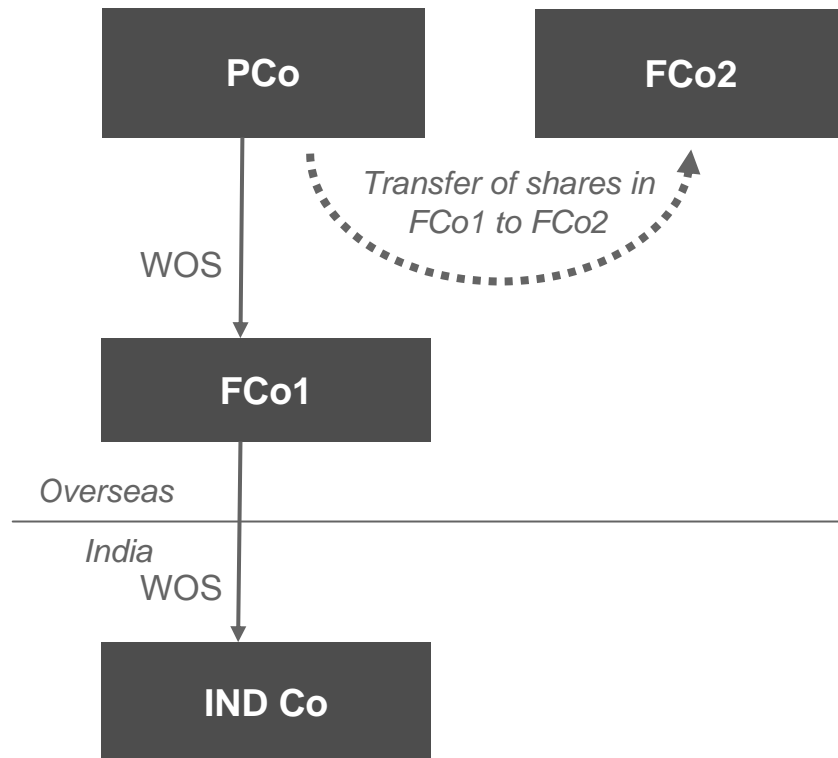
- ▶ Risk of FCo being regarded as “resident” if Ind Co exercises even partial control & management over FCo from India
- ▶ Implications
 - ▶ FCo taxed on worldwide income and dividends subject to DDT
 - ▶ Inter-play with tax treaty would need to be considered

Source rules

- ▶ Income deemed to accrue or arise in India defined to cover
 - ▶ Income from direct or indirect transfer of a capital asset situated in India
 - ▶ Services rendered outside India
 - ▶ Transportation charges for carriage by aircraft or ship
 - ▶ Accrued from non-resident if charges are in respect of carriage to or from a place in India
 - ▶ Accrued from resident except where charges are in respect of carriage between places outside India
 - ▶ Interest in respect of any debt for purpose of earning any income sourced in India

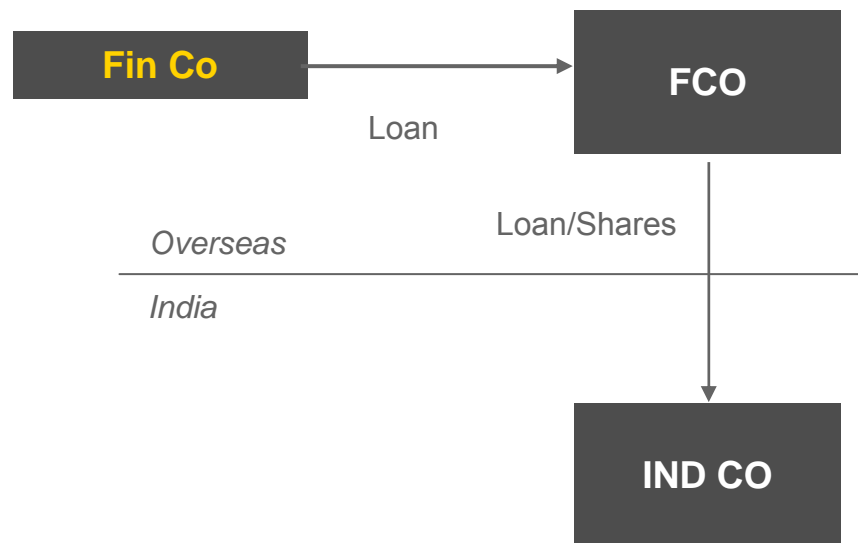


Indirect transfer of capital asset



- ▶ Current law - Income accruing directly or indirectly through the transfer of capital asset situated in India is taxable
- ▶ Controversy on whether the term 'indirect' qualifies 'income' or 'asset'?
- ▶ DTC proposes to address this controversy
- ▶ Implications
 - ▶ Transfer of indirect controlling interest in Ind Co
 - ▶ What if FCo1 has other assets?
 - ▶ Would proportionate value of "capital asset" situated in India be taxed?

Cross-border financing



- ▶ FCo acquires debt fund for investing in Ind Co/ granting loan to Ind Co
- ▶ Under the Act, Interest taxable in India if debt used for purpose of business carried on in India
- ▶ Source rule expanded under DTC to include interest on debt used for earning income from any source in India
- ▶ Taxability of interest in India on account of funds used by F Co for acquiring ICo shares or granting loan to ICo
- ▶ Cascading WHT impact in case of back-to-back loans

Taxation of royalty/FTS

- ▶ Enlarged definition of royalty/FTS
 - ▶ FTS to cover development and transfer of a design, drawing, plan or software, or any other service of a similar nature
 - ▶ Royalty to cover payment for use/right to use of transmission by satellite, cable, optic fibre or similar technology, transfer of all or any rights in respect of cinematograph films & live coverage of events
- ▶ Royalty & FTS of non-resident taxed on gross basis at 20%
- ▶ Net basis of taxation if effectively connected to a Permanent Establishment (PE) abolished

Branch Profit Tax

- ▶ Foreign Companies liable to pay branch profit tax (BPT) on total income reduced by corporate tax

Particulars	Amount
Total Income for the FY	100
(Less) Corporate Tax	(25)
Taxable amount for BPT (A)	75
BPT @15% on (A)	11.25

- ▶ Effective tax rate for Foreign companies is 36.25%

BPT – Issues/discussion points

- ▶ Liability not dependent on remittance of profits to head office
- ▶ “Branch” not defined
- ▶ Does it cover all foreign companies, even if no “branch” presence?
- ▶ Does it override non-discrimination principles of tax treaty

Transfer pricing

- ▶ Amendment to definition of 'Associated Enterprise' (AE) to enlarge scope
 - ▶ Threshold for AE relationship in case of companies reduced from 26% to 10%
- ▶ Determination of arm's length price (ALP) similar to that existing under the current rules
- ▶ Safe Harbour rules to be framed by the Board for determination of ALP



Transfer pricing

- ▶ Transfer Pricing assessment
 - ▶ TP Accountants Report to be filed with TPO within due date
 - ▶ TPO to select cases for assessment based on risk management strategy
 - ▶ Notice for assessment to be served within 2 months from end of FY in which Report is filed with TPO
 - ▶ TPO can use “material in his possession”, but need to give opportunity of being heard
 - ▶ TP assessment to be completed within 42 months from the end of FY in which the transaction is entered into
- ▶ Board empowered to enter into APAs in respect of determination of ALP
- ▶ Determination of ALP for APA to be based on transfer pricing rules
- ▶ Flexibility given to make adjustments as may be necessary or expedient to do so
- ▶ APA can be valid for a period not exceeding five consecutive FYs

Tax treaty

- ▶ Power given to Government to enter into Tax Treaties
- ▶ Relationship between Treaty law and domestic tax law
 - ▶ Status under current law
 - ▶ Preferential treatment for Treaty law over domestic tax law
 - ▶ In case of conflict between Treaty law and domestic tax law, taxpayer can chose the more beneficial provision
 - ▶ Status under DTC
 - ▶ Neither Treaty nor DTC shall have preferential status
 - ▶ Provision that is later in point of time shall prevail
 - ▶ Possible “Treaty Override” if subsequent domestic law is inconsistent with treaty
- ▶ Treaty benefits not available until a tax residency certificate is furnished



Tax treaty

- ▶ Concept of Treaty Override
 - ▶ The enactment of domestic legislation intended by the Legislature to have effects in clear contradistinction to international treaty obligations
- ▶ Vienna Convention on the Law of Treaties (VCLT)
 - ▶ Article 26 – every treaty in force is binding upon the parties to it and must be performed by them in good faith
 - ▶ Article 27 - internal law cannot serve as justification for non-compliance with treaty obligation
- ▶ OECD Treaty Override Report (1989)
 - ▶ Treaty overrides violate international law, although they may still be binding as a matter of domestic law
- ▶ Constitution of India
 - ▶ Article 51(c): India shall endeavor to foster respect for international law and treaty obligations

Tax override – international practice

- ▶ In most countries, tax treaties have a status superior to that of ordinary domestic laws (e.g. France, Germany, the Netherlands)
 - ▶ “lex posterior generalis non derogate legi priori speciali” (a subsequent general law does not override a prior special law)
- ▶ In some countries (primarily the US, but also to some extent the UK and Australia) treaties can be changed by subsequent domestic legislation
 - ▶ “lex posterior derogate legi priori (a subsequent law overrides a prior law)
- ▶ IRC Sec. 7852(d): “for purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law” - Identical language used in DTC!
 - ▶ Senate Report: “A treaty will not be deemed to have been abrogated or modified by a later statute **unless such purpose on the part of Congress has been clearly expressed**”

Possible implications of Treaty override

- ▶ As DTC comes into force after 1 April 2011 does DTC override all tax treaties entered into before that date?
 - ▶ Narrower definition/lower WHT under Treaty v Broader definition in DTC (e.g. royalty/FTS)
 - ▶ Exclusive taxation right to residence state in Treaty v taxing rights with India under DTC (e.g. capital gains in some Treaties, International Transportation income)
- ▶ Does DTC and existing tax treaties become “effective” on same day by virtue of “transitional provisions”?
 - ▶ Any subsequent amendment in DTC to override all prior tax treaties?
- ▶ Can DTC provision override existing treaty only if Legislature specifically intends?
 - ▶ Application of anti-abuse rules and BPT to even prior tax treaties
 - ▶ What if existing tax treaty has narrower anti-abuse provision?

General approach to tax avoidance

- ▶ Application of anti-avoidance principles emerging from judicial decisions
- ▶ General Anti-avoidance Rules (GAAR)
 - ▶ A broad rule that has the effect of invalidating an arrangement that has been entered into by a taxpayer for the purpose of obtaining a tax advantage
- ▶ Specific Anti-avoidance Rules (SAAR), such as:
 - ▶ Transfer Pricing
 - ▶ Anti-treaty shopping provisions
 - ▶ Anti-deferral/CFC Rules
 - ▶ Thin Capitalization

Anti-avoidance principles

▶ Business Purpose Rule

- ▶ A transaction must have a main or predominant business purpose other than tax avoidance

▶ Substance over Form Rule

- ▶ Lack of economic substance - Legal form used for a transaction by a taxpayer who has real economic power over the taxable income without tax liability
- ▶ Sham transaction - Hides the economic reality of a transaction that exists in form only

▶ Step Transaction Doctrine

- ▶ Series of connected transactions regarded as single transaction
- ▶ Intermediate steps in a chain of pre-ordained transactions may be disregarded

- ▶ Key UK Judicial decisions: WT Ramsay [1982] AC 300, Furniss v Dawson [1984] AC 474, *Burmah Oil Co Ltd* [1981] 54 TC 200

International scenario

- ▶ Countries that have introduced GAAR
 - ▶ Australia, Canada, New Zealand, South Africa, Germany, France
- ▶ UK
 - ▶ Consultative Paper released by HMRC in 1998
 - ▶ Conclusion against codification of GAAR
 - ▶ Reliance on judicial principles
- ▶ US
 - ▶ Reliance on Judicial decisions on anti-abuse principles
 - ▶ Legislative provisions to deal with specific situations: Conduit Financing, Earnings Stripping etc
 - ▶ Proposal to codify economic substance doctrine in Obama's tax reform proposals
- ▶ OECD Commentary on Article 1 (2003 Update)
 - ▶ Improper Use of Convention

- ▶ Codification of anti-abuse rules in DTC which permit declaration of an arrangement as an “**impermissible avoidance arrangement**”
 - ▶ Impermissible avoidance arrangement:
 - ▶ Main purpose of the arrangement should be to obtain a **tax benefit** and it
 - ▶ Is not for bona fide business purpose
 - ▶ Creates rights and obligations which would not normally be created between persons dealing at ALP
 - ▶ Results, directly or indirectly, in the misuse or abuse of the provisions of DTC
 - ▶ Lacks commercial substance in whole or in part

- ▶ “Tax benefit” means:
 - ▶ A reduction, avoidance or deferral of tax
 - ▶ Increase in refund of tax
 - ▶ Reduction, avoidance or deferral of tax that would be payable under the DTC but for a tax treaty
 - ▶ An increase in refund of tax under the DTC as a result of a tax treaty

GAAR

- ▶ Tax consequences if GAAR is invoked:
 - ▶ Disregard, combine, recharacterize steps or parts of the arrangement
 - ▶ Disregard any accommodating party
 - ▶ Deem persons who are connected to be one and the same person
 - ▶ Recharacterize or re-allocate income
 - ▶ Recharacterize multi-party financing transaction
 - ▶ Recharacterize debt financing as equity

- ▶ As per Discussion Paper GAAR can be applied by disregarding benefit under a tax treaty



GAAR

- ▶ Presumption of purpose
 - ▶ Burden of proof on taxpayer to establish that tax benefit was not the main purpose
- ▶ Powers to invoke GAAR bestowed only upon the Commissioner
 - ▶ Time limit for passing order - 12 months from date of issue of notice
- ▶ SAAR also introduced to supplement GAAR and deal with
 - ▶ Payment to associated persons in respect of expenditure
 - ▶ International transactions not at ALP
 - ▶ Transactions resulting in transfer of income to non-residents
 - ▶ Avoidance of tax in certain transactions in securities

GAAR

- ▶ Issues/discussion points
 - ▶ Several terms used in GAAR capable of alternative interpretations
 - ▶ Terms such as “commercial substance” and “business purpose” not defined in an exhaustive manner
 - ▶ Application could be subjective/arbitrary
 - ▶ Can GAAR be applied for arrangements that existing prior to 1 April 2011 but results in “tax benefit” after coming into force of DTC?
 - ▶ Need for grandfathering



Concluding thoughts



Key observations

- ▶ Simple and easy to comprehend
- ▶ Reduction in tax rates expected to be welcome; in line with global trend
 - ▶ But does come with broadening of the tax base
- ▶ Proposal to introduce APAs meets long standing demand of Multi-national Enterprises
- ▶ New approach to MAT likely to be a concern
- ▶ Practical challenges associated with withholding tax provisions
- ▶ Emphasis on greater “source country tax” continues
- ▶ New “residence” test for companies would require careful consideration Indian multi-national companies
- ▶ GAAR likely to cause uncertainty for business with scope for litigation
- ▶ Re-defining relationship between Treaty Law and Domestic Law could impact stability and certainty provided by tax treaties



Concluding thoughts

- ▶ The DTC proposes significant changes to the current tax system
- ▶ Taxpayers would need to assess impact of some of the proposals on their current structures and business models
- ▶ Stringent anti-avoidance measures could impact bona fide business structures
- ▶ Need to integrate tax into business decision process and vice versa more important than ever
- ▶ Government expected to consider public comments before tabling legislation in Parliament
- ▶ Proposed to come into force from 1 April 2011
- ▶ Business community needs to watch developments and actively engage with Government for presenting business point of view

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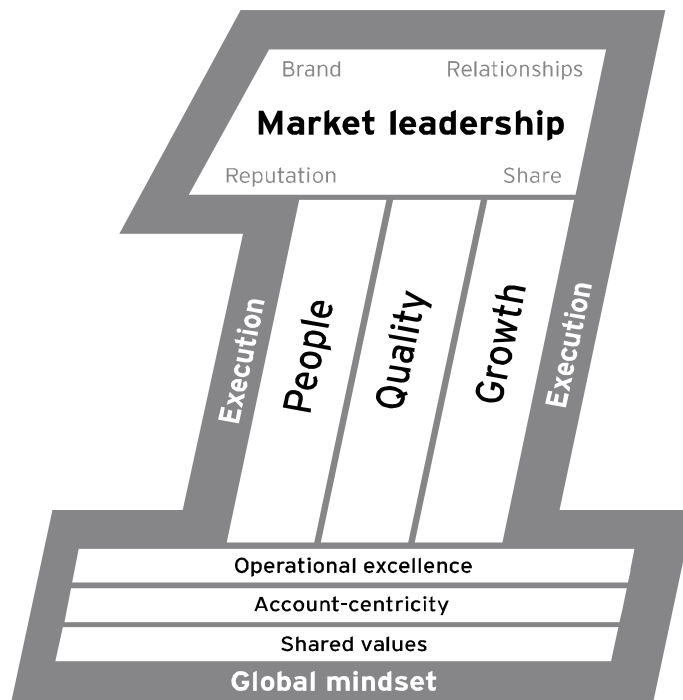
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EY-CII session @ Ahmedabad



Dhinal Shah
Partner
Tax & Regulatory Services
Dhinal.Shah@in.ey.com



Geeta Jani
Partner
Tax Knowledge & Solutions Group
Geeta.Jani@in.ey.com



MP Lohia
Executive Director
Tax Litigation Advisory Group
MP.Lohia@in.ey.com

EY session @ Bengaluru



KT Chandy
Partner
Tax & Regulatory Services
KT.Chandy@in.ey.com



Rajendra Nayak
Partner
Tax Knowledge & Solutions Group
Rajendra.Nayak@in.ey.com



MP Lohia
Executive Director
Tax Litigation Advisory Group
MP.Lohia@in.ey.com

EY-CII session @ Bhubaneswar



Dinesh Agarwal
Partner
Tax & Regulatory Services
Dinesh.Agarwal@in.ey.com



Preeti Bhatnagar
Manager, Tax & Regulatory Services
Preeti.Bhatnagar@in.ey.com

EY-CII session @ Chennai



V. Ranganathan
Partner
Tax & Regulatory Services
V.Ranganathan@in.ey.com



R. Anand
Partner
Tax & Regulatory Services
R.Anand@in.ey.com



N. Madhan
Partner
Tax & Regulatory Services
N.Madhan@in.ey.com



AJ Majumdar
Advisor
Tax Policy Advisory Group
AJ.Majumdar@in.ey.com



Vidya Nagarajan
Associate Director
Tax & Regulatory Services
Vidya.Nagarajan@in.ey.com

Our panels on the new Direct Tax Code (2/3)

EY session @ Delhi



Ganesh Raj
Partner
Tax & Regulatory Services
Ganesh.Raj@in.ey.com



Vijay Iyer
Partner
Tax & Regulatory Services
Vijay.Iyer@in.ey.com



AJ Majumdar
Advisor
Tax Policy Advisory Group
AJ.Majumdar@in.ey.com



Sharat Chandra
Senior Advisor
Tax Policy Advisory Group
Sharat.Chandra@in.ey.com

EY-CII session @ Hyderabad



Jayesh Sanghvi
Partner
Tax & Regulatory Services
Jayesh.Sanghvi@in.ey.com



Sharat Chandra
Senior Advisor
Tax Policy Advisory Group
Sharat.Chandra@in.ey.com



N Madhan
Partner
Tax & Regulatory Services
N.Madhan@in.ey.com

EY-CII session @ Kochi



KT Chandy
Partner
Tax & Regulatory Services
KT.Chandy@in.ey.com



Riad Joseph
Senior Manager
Tax & Regulatory Services
Riad.Joseph@in.ey.com

Our panels on the new Direct Tax Code (3/3)

EY-CII session @ Kolkata



Ajit Krishna
Partner
Tax & Regulatory Services
Ajit.Krishnan@in.ey.com



Dinesh Agarwal
Partner
Tax & Regulatory Services
Dinesh.Agarwal@in.ey.com



AJ Majumdar
Advisor
Tax Policy Advisory Group
AJ.Majumdar@in.ey.com

EY-CII session @ Mumbai



Pranav Sayta
Partner
Tax & Regulatory Services
Pranav.Sayta@in.ey.com



Pinakin Desai
Partner
Tax Knowledge & Solutions Group
Pinakin.Desai@in.ey.com



Rajan Vora
Partner
Tax Litigation Advisory Group
Rajan.Vora@in.ey.com



MP Lohia
Executive Director
Tax Litigation Advisory Group
MP.Lohia@in.ey.com

EY session @ Pune



Sunil Kapadia
Partner
Tax & Regulatory Services
Sunil.Kapadia@in.ey.com



Vinesh Kriplani
Partner
Tax & Regulatory Services
Vinesh.Kriplani@in.ey.com



Chetan Rajput
Partner
Tax & Regulatory Services
Chetan.Rajput@in.ey.com

Our Tax Knowledge & Solutions Group

The “Deciphering the Direct Tax Code” presentation was prepared by our Tax Knowledge & Solutions Group

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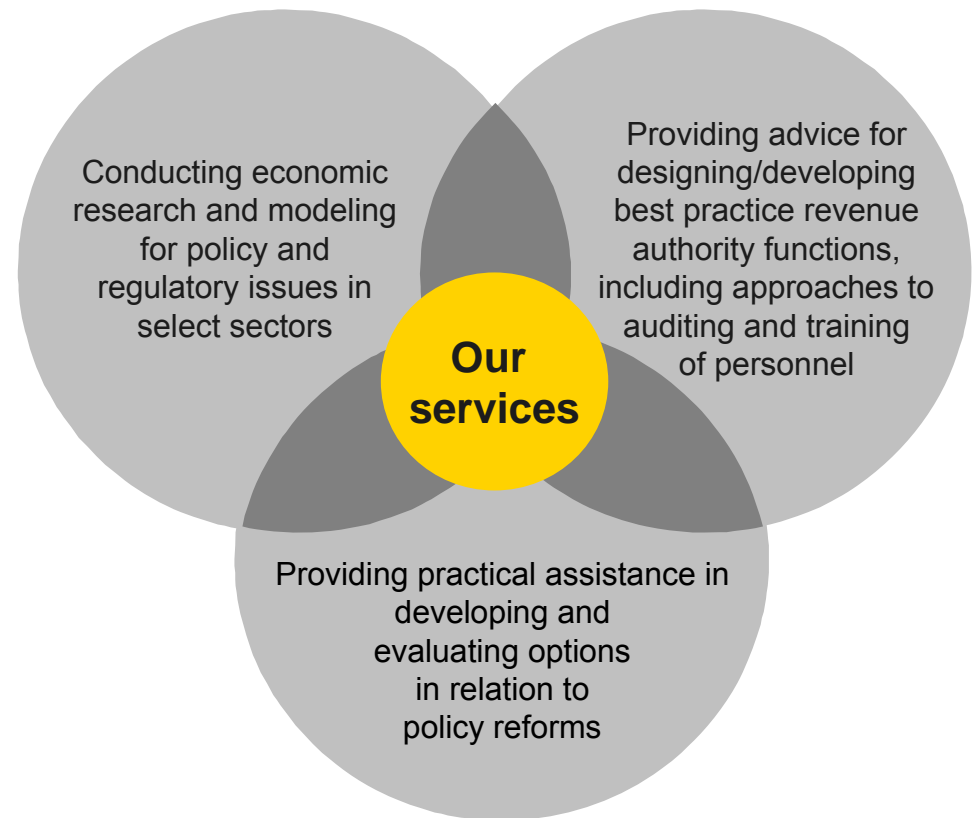
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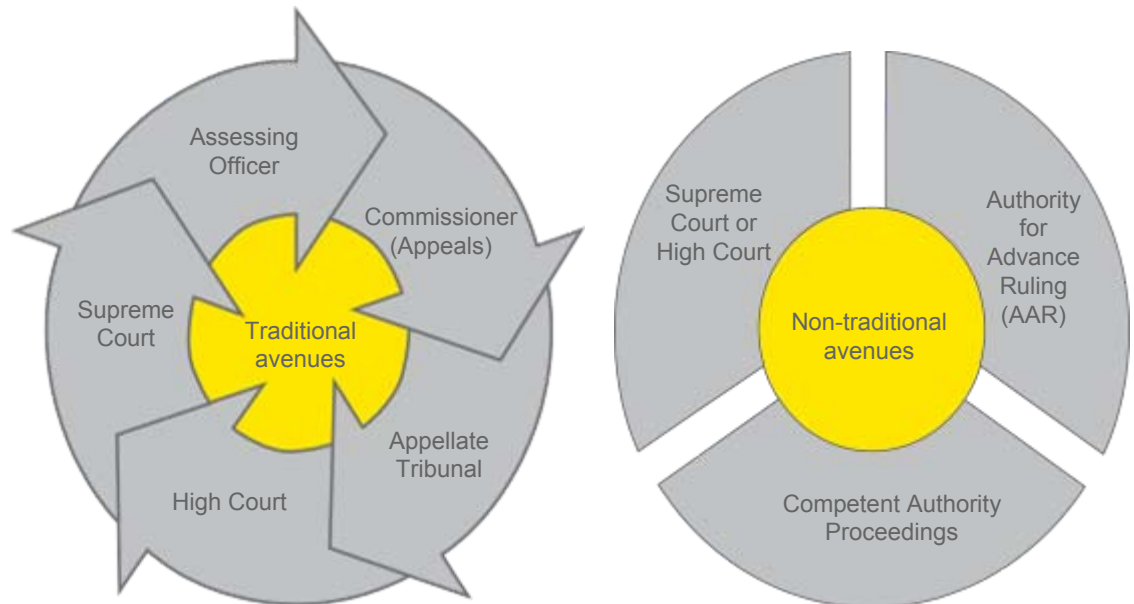


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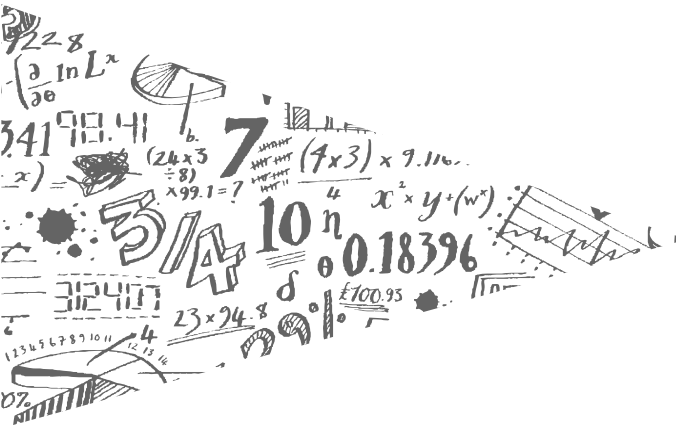


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