India releases revised Direct Taxes Code 2013

Executive summary

The Direct Taxes Code (DTC) is an attempt by the Government of India (GOI), for many years, to revise, consolidate and simplify the language and structure of direct tax laws in India into a single legislation. DTC 2010 was introduced in the Indian Parliament in August 2010 and since then there have been recommendations from various stakeholders, as well as the Standing Committee on Finance (SCF) specifically formed for the purpose. As a follow-up on this initiative and as stated by the Finance Minister (FM) in his Interim Budget Speech in February 2014, after taking into account the recommendations of the SCF, a “revised” version of DTC 2013 has been released.

Broadly, the revised version of DTC 2013 largely aligns with the provisions of the Indian Tax Laws (ITL), in a sense that many of the proposals contained in the earlier version of DTC 2010 have already been introduced in the ITL as part of Finance Act (FA) 2011, FA 2012 and FA 2013 provisions. Prominent among these are the introduction of a broad-based General Anti-avoidance Rule (GAAR), provisions for taxation of the indirect transfer of Indian assets and an expanded source rule in the case of taxation of royalty and fees for technical services (FTS).

This Tax Alert outlines some of the key proposals of DTC 2013 relevant to multinational enterprises.

Detailed discussion

Computation of total income

In contrast to the ITL, in DTC 2013, income is broadly classified into two categories viz., “special sources” (specified in a separate schedule) and “ordinary sources.” Income classified as “special sources” include items such as investment income, royalties, and FTS. Income falling under this heading is taxable on a “gross” basis at specified rates without any deduction for expenditures incurred in earning such income.¹
The total income of the taxpayer for a financial year (FY) is the aggregate of “total income from ordinary sources” and “total income from special sources.”

**Determination of residence for corporate entities**

The present provisions of the ITL treat a company incorporated outside India as an Indian tax resident only if the place of control and management of its affairs is situated “wholly” in India during a tax year.

DTC 2013 amends and widens this by including a place of effective management (POEM) rule to determine residency for corporate entities. Under this POEM rule, a company incorporated outside India is treated as a resident in India if its POEM, at any time during a tax year, is situated in India.

DTC 2013 defines POEM to mean the place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made. Accordingly, if the POEM is situated “at any time” during a tax year in India, the foreign corporate entity would be determined to be a resident in India.

As a consequence, this entity would be subject to taxation of its global income in India. Additionally, profit distributions by the entity would be subject to a dividend distribution tax (DDT) levy in India.

**Taxation of indirect transfer provisions**

FA 2012 had amended the ITL retroactively from 1 April 1962 to bring the indirect transfer of certain Indian assets within the Indian tax net. As per the amended law, any asset/capital asset, being any share or interest in a company/entity incorporated outside India, is deemed to be situated in India if the share or interest derives its value, either directly or indirectly, substantially from assets located in India. The ITL, however, does not define what constitutes “substantially.”

DTC 2013 also contains a comparable provision. The threshold of “substantially” is stated at 20% of the Fair Market Value (FMV) of all the assets owned by the company. Furthermore, there is also a threshold of a monetary amount which may be prescribed. Exceptions have been carved out in the case of transfers by a small shareholder whose holding does not exceed 5% of the voting power or share capital or interest provided certain other conditions are satisfied.

Income from the transfer is computed as a proportion to the FMV of Indian assets vis-à-vis FMV of all the assets owned by the concerned company whose shares are transferred. Furthermore, this FMV is computed without reducing any liability which may have been incurred in respect of such assets.

“Specified date” is defined to mean the date on which accounting period of the company/entity whose share/interest is transferred ends and which immediately precedes the date of transfer of the asset share/interest in the entity.

In formulating the revised provisions, DTC 2013 has considered some recommendations of the SCF, such as exempting small shareholdings and criteria for computing the FMV of assets made with reference to a particular date. However, certain other suggestions, like exempting transactions in the course of overseas intra-group restructuring, have not been favorably considered. Therefore, an anomaly persists as the direct transfer of shares of Indian company upon merger or demerger of foreign companies may be tax-protected, whereas the overseas corporate reorganization, involving indirect transfer of shares in India, is not protected and may still trigger indirect transfer tax.

**Expanding of source rules**

FTS is defined in the ITL to mean consideration for rendering any managerial, technical or consultancy services and includes provision of services of technical or other personnel. An expanded form of this definition is adopted in DTC 2013 to also include a payment made, directly or indirectly, for the development and transfer of a design, drawing, plan or software or any other service of similar nature.

The scope of definition of “royalty” in the ITL was expanded retrospectively through FA 2012 to include: (a) Transfer of all or any right for use or right to use computer software, including the granting of a license, regardless of the medium through which the right is transferred; (b) Explanation on the meaning of “process” to include payment for transmission by satellite, cable, optic fiber or any other similar technology, whether or not such process is secret; and (c) Clarification that royalty includes consideration in respect of any right, property or information,
regardless of such right, property or information being: (i) in the possession of the payer; (ii) used directly by the payer; or (iii) located in India. All of these provisions are included in DTC 2013. Additionally, DTC 2013 has expanded the scope of the definition of “royalty” to include: (a) Consideration for the use or the right to use transmission by satellite, cable, optic fiber or similar technology; (b) Use or right to use ship or aircraft; and (c) Transfer of all or any rights (including the granting of a license) in respect of: (i) “live coverage of any event” and (ii) cinematographic films or work on films, tapes or any other means of reproduction.

The secondary source rule of the ITL provides for taxation of interest payable by a nonresident (NR) to another NR if interest is paid in respect of any debt incurred and used for the purposes of a business carried on by the NR in India. The secondary source rule does not extend to interest on funds used for the purpose of earning any other income from any source in India. DTC 2013 expanded this provision to include interest payable by the NR in respect of any debt incurred and used for the purpose of earning any other income from any source in India. Thus, interest paid, though not claimed as deduction in India, would still be taxable by virtue of the extended source rule.

Presumptive taxation of NRs

Certain categories of taxpayers are eligible to be taxed on a presumptive basis, wherein their total income is estimated based on gross receipts or gross income.

Foreign companies engaged in civil construction, erection testing or commissioning plant and machinery in connection with approved turnkey projects, NRs providing services or facilities or plant and machinery on hire in connection with prospecting for or extraction or production of mineral oil or natural gas, operation of ships and aircrafts, including slot charter, space charter joint charter, are eligible for presumptive taxation under DTC 2013. Such taxpayers may declare a lower income by complying with certain conditions such as the maintenance of books, audit, production of books and accounts when called for. Where, however, such taxpayers declare a higher income in their tax return, such higher income is deemed to be income from an eligible business.

**Levy of Branch Profit Tax (BPT)**

The BPT levy is not present in the ITL. Compared with the ITL provisions, DTC 2013 reduces the corporate income tax rate for foreign companies from 40% to 30%, aligning it with the tax rate for domestic companies. However, a foreign company is additionally subject to BPT of 15% on its branch profits.

BPT is levied on income directly or indirectly attributable to the PE of a foreign company or on immovable property situated in India, as reduced by the corporate income tax. The BPT would apply even if there is no remittance of profits by the branch to its head office. Furthermore, BPT applies irrespective of Double Taxation Avoidance Agreement (treaty) provisions.

Therefore, the effective tax rate for a foreign company would be 40.5% on income attributable to its Indian PE.

**Capital gains**

The capital gains chapter applies to investment assets whereas gain accruing from the transfer of a business capital asset (such as Intellectual Property Rights or other capital assets used in business) is computed as business income. All security transactions of Foreign Institutional Investors (FIIs) are classified as investment assets. Also, in respect of assets acquired prior to 1 April 2000, appreciation in value until 1 April 2000 is excluded from the taxable net.

DTC 2013 continues to provide tax neutrality to transactions of amalgamation and demerger subject to compliance of specified conditions. DTC 2013 has modified the definition of business reorganization (BR) to accommodate BRs involving NRs as well, subject to compliance of other prescribed conditions.

Under the ITL, any asset is considered long term if it is held for more than 36 months, except in the case of shares and listed securities for which the relevant holding period is 12 months. Under DTC 2013, for all assets other than listed securities, the applicable threshold for the asset to turn long term is one year from the end of the financial year in which the asset is acquired. The asset may, therefore, turn long term if held for a period of one year one day to close to two years depending on the acquisition date of the asset.
**Withholding tax (WHT) on payments to NRs**

Under the ITL, payments to NRs which are subject to tax are also subject to WHT in India at the time of payment or credit, whichever is earlier. Under DTC 2013, any person responsible for making a “specified payment” to an NR is obligated to withhold tax at the appropriate rate. In relation to residuary category of payments, there is an explicit provision that payment is subject to WHT only if it is subject to tax. There could, therefore, be ambiguity as to whether all other specified payments to the NR are subject to WHT irrespective of whether they are taxable in India or not. This is contrary to the present provisions of ITL as well as the recommendations made by the SCF on DTC 2010.

The WHT rates on certain payments under DTC 2013 are listed below:

<table>
<thead>
<tr>
<th>Nature of payment</th>
<th>WHT Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest (other than specified interest), Dividends not subject to distribution tax, Insurance payments including reinsurance</td>
<td>20%</td>
</tr>
<tr>
<td>Royalty/FTS</td>
<td>25%</td>
</tr>
<tr>
<td>Payment of specified interest[^5]</td>
<td>5%</td>
</tr>
<tr>
<td>Winnings from lottery, crossword puzzle, games, races</td>
<td>30%</td>
</tr>
<tr>
<td>Payment to NR sportsman/sports association/ entertainer</td>
<td>10%</td>
</tr>
<tr>
<td>Any other payment chargeable to tax</td>
<td>30%</td>
</tr>
<tr>
<td>Payment made to an FII on sale consideration of listed securities on a recognized stock exchange</td>
<td>Nil</td>
</tr>
</tbody>
</table>

If the rates prescribed under a treaty are lower, the person making payment to the NR can withhold taxes at such lower rate. Accordingly, the above rates will apply only in respect of payments where the treaty benefit is not available.

A penal rate of the higher of 20% or applicable WHT rate applies if the NR does not furnish Permanent Account Number [PAN], except in case of payment of specified interest to NR for long term infrastructure bonds. In line with recent changes in the ITL, payments to an NR situated in a Notified Jurisdictional Area (NJA) would attract WHT at the rate of 30% or the applicable rate, whichever is higher. Further, DTC 2013 also contains anti-avoidance provisions in respect of transactions with persons located in an NJA. These provisions aim at discouraging transactions with persons located in countries/territories which do not effectively exchange information with India.

The GOI also has power to notify certain category of payments to certain persons or transactions which would be exempted from WHT. Similar to the ITL provisions, DTC 2013 also provides for the obligation on the person deducting the tax to furnish information to the GOI.

**Application of treaty benefits**

The provisions under DTC 2013 in relation to treaties have been aligned on the lines of the ITL provisions. As per the general rule, beneficial provisions of a treaty would prevail over domestic law and a limited treaty override applies in all cases except where GAAR, BPT, or CFC (controlled foreign company) provisions are invoked.[^6] Additionally, DTC 2013 provides that the levy of BPT cannot be regarded as discriminatory against a foreign company in addition to an existing similar provision relating to differential tax rate.

Similar to current provisions of the ITL (i) taxpayers are required to obtain a Tax Residency Certificate (TRC) from the specified authority and also provide documents and information as may be prescribed, for applying a treaty benefit; (ii) the GOI is empowered to issue notification defining terms undefined under DTC 2013 or the treaty
and the same would be effective from the date when the concerned treaty came into force.

**GAAR**
GAAR contains a broad set of provisions which have the effect of invalidating an arrangement under certain circumstances. The Tax Authority, in such cases, is granted wide powers to adjust the taxpayer’s assessment. GAAR was proposed in the Indian tax legislation for the first time in DTC 2009.

These GAAR provisions were adopted in the existing ITL by FA 2012, which were subsequently amended by FA 2013, based on the SCF recommendations. Though GAAR provisions are present in the existing ITL, they take effect from 1 April 2015.

It is worth noting that GAAR provisions of DTC 2013 are drafted along the lines of the ITL provisions, except that the definition of “connected person” now extends to co-subsidiaries. All other procedural provisions including AAR application, reference to commissioner, approving panel etc. remain unchanged.

**Transfer pricing (TP) provisions**
TP provisions in DTC 2013 are broadly similar to those contained in the ITL. The proposed definition of “international transaction” is largely aligned with the current definition in the ITL. Under the ITL, intellectual property (IP) is defined to include, among other things, (a) human capital related IP such as trained and organized work force, employment agreements, union contracts; (b) contract related IP such as favorable supplier, non-compete agreement; (c) customer related IP such as customer relationship, purchase orders etc. Such specific listing of IP is absent in DTC 2013, though it has inclusive and generic reference to any other thing that derives its value from its intellectual content instead of its physical attributes. Further, provisions along the lines of the ITL are available for the tolerance range of arms-length price, safe harbor and advance pricing arrangements.

**CFC**
CFC regulations basically focus on taxing the undistributed profits of a foreign company which is situated in a low tax jurisdiction but is controlled by the residents. It is developed to eliminate the artificial deferral of resident taxes on foreign source incomes. Though CFC rules are presently absent in the ITL, they were introduced for the first time in DTC 2010.

Key provisions in the CFC rules, proposed as a part of the “Second Schedule” of DTC 2013, are outlined below:

- CFC rules apply to foreign companies over which a resident taxpayer has “control.” Control can be de jure (50% or more control over voting power or capital) or de facto or a combination thereof, of substantial interest/influence or control over income or asset of the CFC.
- CFC rules exclude a foreign company which is engaged in an active trade or business and less than 25% of its income comprises passive income. An exemption is also available if the CFC is listed or if the CFC income does not exceed INR2.5 million.
- CFC rules target foreign entities which are tax resident of a “territory with a lower rate of taxation” i.e., a country/territory in which the tax paid by the foreign company is less than 50% of the tax it would have paid if it were a domestic company. DTC 2013 has specifically clarified that taxes paid by a foreign company in third countries, the credit of which is available in its country of residence shall also be considered for the purpose of above comparable tax test.
- It may be noted that the GOI has a power to notify the territories which would not be regarded as “territory with a lower rate of taxation.” In other words, once a country/territory is notified concerning the tax rates and tax exemptions prevailing therein, foreign companies which are tax residents of such county/territory, shall be presumed not to be CFCs.
- Once a foreign company qualifies as a CFC, all of the income of the CFC (including passive income) is attributed and taxed in the hands of the resident-controlling shareholder on a proportionate basis under the head “income from residuary sources.” The net profit after tax subject to certain adjustments is taken as the specified income of the CFC for the purpose of attribution. However if such specified income is negative, the same is not attributed in the hands of resident shareholders.
It may also be noted that in case of any TP adjustment in the hands of a resident assessee (e.g., disallowance of expenditure) on account of an international transaction between such resident and the CFC, no corresponding/correlative adjustment is made to the attributable income of the CFC.

Once resident shareholders are taxed by virtue of such deeming fiction, future dividend distribution of the attributed income by the CFC is deductible.

Implications

The revised provisions in DTC 2013 vis-à-vis the provisions under DTC 2010 are largely either aligned with the ITL provisions or are a response to the recommendations of the SCF.

While some of the provisions such as alignment of the POEM definition, exclusion of small shareholders from the indirect tax levy, and providing the white list jurisdictions for the non-trigger of CFC are positive provisions, other provisions such as lowering the threshold to 20% for trigger of indirect transfer, and making the active test (a condition for the trigger of CFC provisions) stringent, could cause concerns.

It is important to note that DTC 2013 is presently a draft version which can be implemented only after it is presented before the Indian Parliament and is thereafter approved after debate. This can happen only when the next Parliament session commences after the general elections scheduled in April/May 2014 conclude and a new GOI is formed. Therefore, the intent in making the DTC 2013 draft available for public comments at this stage appears to be to send out a message that the present GOI has completed the necessary work on DTC 2010. If a new GOI is formed post elections and intends to continue with the work, it has the option to resume from the present stage of DTC 2013.

While presently, the fate of the DTC 2013 is uncertain, more certainty is expected once the new GOI is formed, post elections, in June/July 2014. It provides an opportunity to assess the impact of the proposals on current structures and business models.

Endnotes

1. However, where such income is attributable to a permanent establishment of a nonresident in India, the same is not considered as income from special source.
2. DTC 2010 had contained a threshold of 50%.
3. Presumptive tax rate for income of NR from operation of ships/aircrafts has been enhanced from 7.5%/5% under ITL to 10%/7%, respectively, under DTC 2013. The tax rates in respect of other activities have not changed.
4. Definition of BR as per DTC 2010 was restricted to BR between two or more residents. This had raised doubts on tax neutrality of merger or demerger involving an NR.
5. (a) Payment of interest to a Qualified Foreign Investor or FII on rupee denominated bonds of an Indian company or a Government security (b) Payment of interest by an Indian company on foreign currency borrowings under a loan agreement or issue of long term infrastructure bonds (c) Payment to NR by an infrastructure debt fund.
6. These provisions were also proposed under DTC 2010.
7. Earlier, DTC 2010 provided the composition of active v. passive income as 50:50.
8. Passive income not only include interest, royalty, rent, capital gains, dividends but also income from active trading with related parties (commonly referred to as “base company income” in international taxation).
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