DTC Bill -Companies have little to cheer about! – Sep 2, 2010

SEPTEMBER 1, 2010

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THE Finance Minister has shown his large heart by reducing the tax rates for individuals. However, in so far as the corporates are concerned, the Direct Tax Code Bill disappoints.

The corporate tax rate has been pegged at 30%, as against the earlier expectation of a rate of 25%, as was mentioned in the first discussion paper. While this is a disappointment, the proposal to levy the Minimum Alternate Tax ('MAT') at a rather hefty 20% on book profits, as against the current rate of 18% plus surcharge, comes as a bigger disappointment, especially in a situation when most tax incentives are being withdrawn. Of course, the fact that companies can carry forward the MAT credit for 15 years is small solace, as, from a practical point of view, when MAT is continuously levied year after year, the chances for an effective adjustment of the excess tax against the tax payable under the normal provisions would be bleak.

In the case of foreign companies, the tax rate would be 30% and additionally, there would also be a branch profits tax of 15%. In the absence of clarity, it would indeed seem that the foreign companies would effective pay a much higher tax.

The bad news is actually for the SEZ Developers and the SEZ Units. Under the current tax provisions, these entitles are exempted from the payment of MAT and Dividend Distribution Tax. Though, the Bill states that SEZ Developers will continue to get the current tax breaks for all the zones notified up to end March 2010 and SEZ Units would continue to avail of the tax holiday if they commence operations before the end of March 2014, the fact that they would be required to pay MAT comes as a very big dampener.

It is clear that the tax holiday for the software exporting units, under the current STP scheme, would not be available under the Bill. The only way in which the STP units can avail of tax holiday under the DTCB, would be under the SEZ scheme. As aforesaid, the DTCB provides that SEZ Units set up till March 31, 2014 would continue to get the tax holiday (which is for a period of 15 years – 100% for the first five years, 50% for the next five years and 50% for the balance period subject to reinvestment, etc). However, the fact that SEZ Units also would be subject to MAT and DDT would greatly reduce the charm for the existing IT units to go in for SEZs. The proposal to levy MAT and DDT on SEZ Units under the Bill goes against the current income tax provisions, under which, SEZ Units are exempted from the levy of both MAT and DDT.

It might not make economic sense for most smaller and mid sized IT companies to move into SEZs, given the need to take higher space and the comparatively higher rentals in the SEZs. Moreover, IT companies cannot own space under the SEZ scheme. The current provisions contained in Section 10AA, in terms of denial of tax holiday for SEZ Units which are set up by restructuring or reconstruction of the existing units or existing business would continue to apply. The IT units proposing to shift to SEZs would need to match the tax savings arising out of the SEZ scheme against the incremental costs and the implications arising out of the applicability of MAT and DDT, before taking a call. In any case, there is enough time for STP Companies to study the impact and take a cool call on moving into SEZs as they have time till March 2014.

Interestingly, limited liability partnerships ('LLPs') are outside of the purview of MAT. Closely held IT companies could think of converting themselves as LLPs to save MAT.

Before concluding…

The Finance Ministry would seem to take away with the left hand in terms of the applicability of MAT and DDT on SEZ Developers and SEZ Units, the benefit that it would be providing with its right hand, in terms of the tax holiday.

In respect of the SEZ Developers and the SEZ Units which have already been set up and are operating, the removal of the exemption from the applicability of MAT and DDT would come as a major let down. Unlike the players who are yet to get into the SEZ scheme, these players have already invested substantial amounts in setting up huge SEZ projects and a sudden applicability of MAT and DDT would seem very unfair. As things stand now, it seems that the MAT would apply with effect from April 1, 2011 and not from April 1, 2012.

With the current Income tax Act being in force till March 2012, it remains to be seen if the Government would give a last extension of the tax holiday for the STP units and other 100% EOUs under Sections 10A and 10B, for the financial year 2011-12.

In terms of international taxation, the Bill provides that that the provisions of the DTAA would override those of the tax provisions and that, the assessee can choose between the domestic law or the treaty provisions, whichever is beneficial. (The earlier version of the DTC had proposed to take away the treaty override benefit). This is a welcome step. So is the proposal to increase the tax audit threshold limit to Rs 1 crore from the present applicable limit of Rs 60 lakhs. In respect of a foreign company, the residence definition has been substituted by the internationally accepted definition of "effective management test", instead of the loosely understood " control and management" test, which is welcome.

But, from an overall perspective, it does seems that corporates have little to cheer about, from the Direct Tax Code Bill, unlike the individual tax payers.

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