Revised Discussion Paper on DTC – An Analysis

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THE Government has finally released the revised Discussion Paper on the Direct Tax Code. As we know, the original Discussion Paper which had been issued in August 2009 had contained a lot of controversial provisions, many of which have been dealt with, in this revised discussion paper.

My take on some of the important amendments proposed by the revised discussion paper….

MAT on book profits

Minimum Alternate Tax ('MAT') would continue to be levied on the basis of Book profits and not on the basis of the value of gross assets, as had been originally proposed. This is a huge relief for the capital intensive sector including the manufacturing and infrastructure sectors. More importantly, it would remove the anomaly between the services sector and the manufacturing sector, as the services sector tends to use much lesser assets, as contrasted to the manufacturing and infrastructure sectors. Levy of MAT on book profits would also help loss making companies. This is highly welcome amendment.

DTAA will now override DTC

In a major relief to Foreign Companies in general and Foreign Institutional Investors ('FIIs') in particular, the revised Discussion Paper clarifies that the assessee would be free to opt for either for the provisions of the Double Taxation Avoidance Agreement ('DTAA') or the Indian Income tax Act, whichever is more beneficial. This is a major relief to the Foreign Companies given the fact that, in the original version, the DTC had stated that its provisions would override the provisions of the DTAA, which are generally more beneficial, including, in respect of the tax rates. As we know, many FIIs get themselves registered in tax havens outside of India, to take advantage of the beneficial provisions in the DTAAs in respect of capital gains. Of course, India has entered into with these respective countries/tax havens including Mauritius, Isle of Man, etc. It is also expected that a lot of unnecessary litigation could be avoided as many FIIs were trying to take the view that their income is to be treated as 'business income', in order to claim exemption from the levy of income tax in India, in the absence of a permanent establishment in India.

Long term capital gains on listed shares and equity mutual funds would still get taxes

The revised discussion paper's proposal on treatment of long term capital gains on sale of listed shares and units held in equity oriented mutual funds however, falls short of expectations. Currently, as we know, the long term capital gains related to shares and investment in mutual funds are completely exempt from tax and this has been one of the significant reasons for the heightened activity in the stock markets. The original discussion paper had provided that gains and losses arising from the transfer of investment assets will be treated as capital gains or losses and that these gains or losses will be included in the total income of the financial year in which the investment asset is transferred. The original discussion paper had also provided that 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 and that, 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.

Of course, these proposals had created a lot of concerns and many had predicted that the stock markets would see much less activity, post the DTC, with the proposed elimination of the tax exemption for long term capital gains for listed shares. The revised paper states that the 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. The 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. The example given in the revised paper seems complex.

This move to tax long term capital gains on listed shares and equity mutual funds might not enthuse the markets, for sure. The Government should try and retain the exemption that is available for long term capital gains available for listed shares and equity linked funds.

SEZ Units set up before the DTC would get tax holiday for the unexpired portion

It was widely expected that the Government would do a re-think on its earlier proposal to discontinue tax holiday for new SEZs set up, under the DTC. The reiteration of this stated position that SEZs set up after the coming into force of the DTC, is a major dampener for the very SEZ scheme, as this scheme would collapse without income tax holiday.

It is also now very clear that there would be no tax holiday for STP Units beyond March 31, 2011. The revised paper does talk of tax holiday for SEZ Units, to be continued for the unexpired portion, under the Direct Tax Code. This would mean that the tax holiday under the DTC would be available for units which are set up prior to the coming into force of the DTC, which in all probability, should be April 1, 2011. The tax holiday under the SEZ scheme is too big an incentive, to be ignored, especially, by the medium to large IT exporters. Units in SEZs are entitled to get 100 per cent income tax exemption on export income for the first five years, 50 per cent for the next five years. They also get exemption on 50 per cent of the ploughed back export profit for the next five years after the first 10 years. More importantly, unlike the STP Units, SEZ Units are also exempted from MAT. Viewed from any angle, the SEZ scheme is a far superior scheme, as compared to the STPI scheme and units currently operating as STP units would do well to act fast and ensure that they don't miss the tax holiday bus under the SEZ scheme.

Following the release of draft DTC last year, scores of SEZ units and developers had raised concerns that the zones were attractive due to the tax sops and their withdrawal would drive away future investors. The Government has now assured that it would protect the tax holiday for SEZ Units, in respect of the unexpired portion, under the DTC. This is some good news for the STP Units, which should now immediately work towards moving into SEZs, prior to March 31, 2011.

Of course, shifting of the existing business by the STP Units to the SEZs, would result in loss of the income tax holiday, as it would amount to re-structuring of an existing business. However, STP Units are entitled to plan their business operations in a legal manner, by ensuring that, a new 'business' is set up in the SEZ, so as to ensure that, the tax holiday is available. It could mean that time is running out for the current STP Units, who would need to move to SEZs, in order to be able to get the tax holiday under the DTC. It is legally permissible for STP Units to start a unit in the SEZ, in a small scale and ramp up the same, in subsequent years. This announcement from the Government could see a mad rush by the existing STP Units and new Units, to move towards SEZs, resulting in a lot of sudden increase in business for SEZ Developers.

Other proposals in the revised discussion paper

++ Tax exemption on maturity for all existing approved provident and pension schemes- this is a highly welcome step which would go a long way in encouraging personal investments.

++ The employer's contribution to provident fund and such schemes within prescribed limits shall not be considered as salary, as is the existing case.

++ Amounts received as gratuity, from voluntary retirement schemes and pension at retirement would be exempt subject to specified limits.

++ Rent on self owned house property will be the amount of rent received for the year and would not be taxed on a presumptive basis, as is the current situation. A welcome proposal.

++ Wealth tax will be levied broadly on the same lines as provided in the Wealth Tax Act, 1957. One does not understand the Government's continuing love for wealth tax when many of us have pointed out that it just does not make economic sense to levy tax on wealth. With no need to please the Communists any more, the Government would do well to abolish wealth tax altogether.

++ Capital gains for foreign funds will not be subjected to TDS.

++ A Company incorporated outside India would be treated as resident in India only if its effective management in within the country. This is a highly welcome clarification, considering the fact that in terms of the original discussion paper, a foreign company which had held its board meeting once in India, could have been required to pay tax on its global income.

Government should work towards clarifying these unaddressed issues

The Government should consciously work towards clarifying the following issues under the DTC…

++ Income arising or accruing to the Non-Resident and the need to deduct tax at source in cases when no income arises or accrues to the Non-Resident in India. This subject has been a nightmare for the consultants and the Departmental officers, alike, over the last few months, in the wake of conflicting decisions of High Courts compounded further by the issue/withdrawal of circulars by the CBDT. One hopes that the Government would provide for clear provisions under the DTC to clarify that there is no need for tax to be deducted, when no income arises or accrues to the Non-Resident, in India.

++ The Government, thro' the Finance Acts of 2009 and 2010 had amended the current Section 56 to provide for levy of tax under 'Income from other sources', in respect of the difference between the market/fair value of the shares transferred and the actual values, in the case of shares of unlisted companies. This move has brought about a lot of uncertainty in terms of private equity investments into unlisted companies. One hopes not to see provisions of this kind, in the DTC.

Before parting……

++ It is now curtains for the tax exemptions for STP Units, under the DTC. Of course, the medium and large STP Units could still try and set up new units in SEZs before the DTC comes into force.

++ The Government should do a re-think on the proposed denial of tax holiday for new SEZs getting set up after the DTC comes into effect. Developers have pumped in tens of hundreds of crores of rupees into SEZ projects and the denial of the income tax benefit coming at this stage, when the realty sector is showing some signs of recovery, could be disastrous, as Developers cannot withdraw from SEZ projects already in progress. With no new units likely to get set up after the DTC comes into force, SEZ Developers could be left with a lot of unused space. The Government should give at least two further years' extension for SEZs getting set up, to avail of tax holiday under the DTC and should also amend Section 10AA of the Income tax Act, to facilitate the shifting of the STP Units into SEZs, without losing the tax holiday due to provisions which talk of denial of tax holiday to SEZ units formed as a result of re-structuring of existing STP units/business.

The current window of about 9 months available for SEZs to get set up, to avail of tax holiday, is rather too short for any effective planning to happen. It has been reported that even the Commerce Ministry is unhappy with the provisions contained in the revised discussion paper as they relate to tax holiday for SEZs.

++ The Government, of course, needs to be complimented for listening to its stakeholders and bringing about some welcome changes in the DTC. One hopes the Government would make further amendments to the DTC, especially in respect of continuation of tax holiday for SEZ Units and Developers.

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