Finance Bill 2012

An Analysis of Important Income-tax Amendments

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Note

This is an analysis of only the main Income-tax provisions of the Finance Bill 2012. Particularly, procedural amendments are not included. To that extent, this is not an exhaustive listing of amendments proposed by the Finance Bill, 2012.

It provides an academic guidance to the proposals and is for general information. This analysis is not an opinion. This note does not substitute the need to refer to the original bill.

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INTRODUCTION

The Finance Bill was presented in the Parliament on 16th March 2012. There are amendments with far reaching consequences. We are presenting here our analysis of some important Income-tax amendments.

A trend may be observed which was also highlighted at one of the conferences in Mumbai on International Taxation. There has been an economic crisis in the USA from 2008. This has spread to the developed world and is also affecting the emerging countries. This is affecting the tax revenues. Countries want to protect their tax revenues. Several steps are being taken including – removal of secrecy, extensive reporting requirements, etc. **Several situations which were accepted as all right are being challenged by the revenue in many countries.**

Developed countries have the tax laws more suited to their requirements. The emerging countries have understood their means and are no longer willing to agree to the developed countries' views. **This can result in a tug of war between developed and emerging countries - creating difficult situations for the tax payer.**

On one side there is aggressive tax planning resulting in harsher laws; on the other side we have more acquisition of power in the hands of the revenue. We hope better sense of balance prevails soon.

This year, two of the most important amendments have been – reversing Vodafone decision of the Honourable Supreme Court, and General Anti-Avoidance Rules. These have serious implications. Please do have a look.

While news reports have provided a lot of information quickly, we have preferred to provide you an **analysed document** rather than a quick document. We hope you will find this useful. Your observations are most welcome.

Yours sincerely,
Rashmin Sanghvi and Associates
14th April 2012

List of Abbreviations used

ALP	–	Arm's Length Price
AMT	–	Alternate Minimum Tax
APA	–	Advance Pricing Agreement
CBDT	–	Central Board of Direct Taxes
DDT	–	Dividend Distribution Tax
DTAA	–	Double Taxation Avoidance Agreement
ECB	–	External Commercial Borrowings
FEMA	–	Foreign Exchange Management Act
FII(s)	–	Foreign Institutional Investor(s)
GAAR	–	General Anti Avoidance Rules
HUF	–	Hindu Undivided Family
IAA	–	Impermissible Avoidance Agreement
IDF	–	Infrastructure Debt Fund
MAT	–	Minimum Alternate Tax
NOR	–	Not Ordinarily Resident
RBI	–	Reserve Bank of India
SAAR	–	Specific Anti–Avoidance Rules
SC	–	Supreme Court
SEBI	–	Securities Exchange Board of India
SEZ	–	Special Economic Zone
SME	–	Small & Medium Enterprises
TAN	–	Tax Deduction Account Number
TDS	–	Tax Deducted at Source
VCC	–	Venture Capital Company
VCF	–	Venture Capital Fund
VCU	–	Venture Capital Undertaking

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(The proposed amendments are generally effective from financial year 1st April 2012. Wherever the effective dates are different, it has been mentioned. By the time the finance bill is passed, there could be some changes. We will update you with the same.)

I. STEPS TO CURB TAX EVASION:

The budget has introduced various steps to curb tax evasion. The most comprehensive is General Anti Avoidance Rules. There are several other specific steps also which have been proposed. These are discussed below.

1. General Anti Avoidance Rules [Chapter X-A: Section 95 to Section 102]:

1.1 General Anti Avoidance Rules (GAAR) refer to **Anti-Tax planning rules**. People arrange their matters to avoid tax. It is called "Tax Avoidance". Government amends law to prevent tax avoidance. With growing economies, the sophistication of tax planning increases tremendously. Outside India, sophisticated tax planning has been in existence for several years. Initially countries would plug specific tax planning. However tax planners would come out with more sophisticated planning. Hence Governments would come out with more rules. These specific rules are knows as Specific Anti-Avoidance Rules (SAAR). A targeted anti avoidance provision like section 64 (clubbing provision for gifts) or section 68 (explanation regarding source of funds) is called SAAR. The specific rules result in a large law, too complex to be understood.

There have been many cycles of: Tax Consultants finding loopholes; Government plugging loopholes; consultants finding new loopholes resulting in new and more complex provisions and so on. For example, HUFs & multiple HUFs; Trusts – discretionary & oral; etc. Now Government is acquiring sweeping powers: "Whatever tax planning you do, we will hit it with one common stick – GAAR." A detailed discussion on this issue is available at – http://www.rashminsanghvi.com/Vodafone_Case_Consequences.htm#III_Consequences

Governments have come out with GAAR, which give the Governments powers to examine whether the transaction involves tax avoidance or not. These are wide spectrum, general provisions targeting

all unknown, unexpected methods of tax avoidance measures. India too has now introduced GAAR with this budget which will be effective from 1st April 2012. We understand that the Indian revenue has studied the GAAR of a few countries and then framed the rules as relevant for India. A lot of provisions appear to have been adopted from the South African GAAR.

GAAR also gives tremendous powers in the hands of Government. These can be misused. Therefore the rules provide for some checks.

A country needs GAAR provisions to curb sophisticated tax planning. However these are required to be used sparingly and for high value transactions. Only time will say as to how these are being used in India.

The detailed issues are discussed below. (The rules contain a lot of legal language. In this note, the legal jargon has been removed considerably. Hence the note is not exhaustive. However the crux of the proposed provisions is adequately captured.)

1.2 Key issue:

The key issue which is examined under GAAR is – Whether the transaction (or transactions) undertaken is such which would **normally be undertaken** and whether it has **substance**? If yes, GAAR will not apply. If the transactions are such which are not normally undertaken **and** they give a tax benefit, GAAR will apply.

If GAAR applies, the consequence is that the form of the transaction/s will be ignored. The intent and substance of the transaction/s will be considered for tax. Tax benefit will be denied for the form of the transaction. It is the principle of "**Substance over form".**

This is easy to understand but difficult to apply. Hence GAAR has detailed guidelines.

Illustration: A three level illustration is given below:

Level I - A company is in the business of export of software. It has software units in India. It sets up a new unit in Special Economic Zone (SEZ). The profits are exempt from tax for a few years. This is in line with the policy of India where India wants

to give relief for exports. This is a transaction where there will be a tax benefit. However the setting up of SEZ unit will have commercial substance. There will be a software unit in SEZ with computers and people. Hence GAAR will not apply. Tax benefit should be given.

Level II - Consider further. The income-tax rules require that it should be a new unit. It should not happen that an old unit is closed and the business is transferred to SEZ unit. If the company closes its old unit and sets up a unit in SEZ, it will be considered as reorganisation of an existing business. SEZ relief will not apply. GAAR is not even required. The SEZ rules will themselves deny the relief.

Level III - Assume in the same illustration, that the company has set up the SEZ unit. It continues its old unit. However slowly in 2-3 years, it reduces exports from the old unit and increases exports from SEZ unit. This will result in more profits in SEZ unit and less profit in old unit. After 3 years, it closes the old unit. Will GAAR apply? This is a case where application of SEZ rules may be difficult to apply. However GAAR can apply. It will be examined whether the two acts – opening of SEZ unit and closing of old unit – were pre-ordained, pre-planned, etc. If yes, under GAAR relief will not be available. Thus the entire gamut of facts, and the circumstances in which acts were undertaken, will have to be examined.

Let us see the detailed rules.

1.3 Impermissible Avoidance Arrangement:

If any transaction or arrangement is undertaken which is declared as "Impermissible Avoidance Arrangement", GAAR will apply. Impermissible Avoidance Arrangement has been defined widely. For a transaction to be considered as Impermissible Avoidance Arrangement, two basic conditions should be satisfied.

i) The main or one of the main purposes is to obtain a **tax benefit**.

and

ii) It lacks **commercial substance**; or creates rights or obligations which are not normal; results in abuse of Income-tax Act; or carried out in a manner which is not normally done.

Both are **cumulative conditions**. A mere tax benefit does not mean GAAR will apply. A tax benefit has to be coupled with lack of commercial substance for GAAR to apply. Similarly if there is no tax benefit, GAAR cannot apply.

1.3.1 Main purpose:

The first condition mentioned above, namely, that an arrangement must have tax benefit as its **main or one of the main purposes** seems to widen unreasonably the applicability of the GAAR provisions.

For example, the South African GAAR provisions, which seem to have heavily influenced the Indian GAAR provisions, provide for a more stringent condition:

> "An avoidance arrangement is an impermissible avoidance arrangement if its **sole or main purpose** was to obtain a tax benefit…"

In our view, restricting the applicability of GAAR only to arrangements whose 'main' purpose is to obtain a tax benefit would be reasonable. This view is strengthened on account of the reason mentioned below:

A separate provision presumes **all** arrangements resulting in **any tax benefit** to have been entered in to for the **main** purpose to obtain a tax benefit unless proved otherwise by the tax payer! The onus to prove that an arrangement does not result in to a tax benefit is on the tax payer.

Further, the provisions define a tax benefit as any reduction, avoidance or deferral of tax whether or not it is because of a tax treaty. It also includes any reduction of total income or increase in loss.

A sum total of all the above provisions would, in our view, make the first condition for qualifying a transaction as an Impermissible Avoidance Arrangement as hardly relevant as far as applicability of GAAR is concerned.

1.3.2 Commercial substance:

This is one of the main tests. If there is no commercial substance, the transaction can be considered as an Impermissible Avoidance Arrangement. An arrangement is considered as lacking Commercial substance if **any one** of the following conditions apply:

i) **Effect** of the arrangement as a whole, is different from the **form.**

Illustration:

Hutch sold one share of Cayman Island company, to Vodafone. The effect was that its holding in Indian business was sold. The form was the sale of foreign share. (See details in note no. 8). There is a clear difference between effect and form.

ii) The arrangement involves **Round trip finance**; or an accommodating party; or **offsetting or cancelling transactions**; or a transaction conducted through one or more persons and **disguises** the value, location, source, ownership or control of funds (any one of the above sub-tests is sufficient). For example, cross gifts to avoid section 64; Treaty shopping, etc.

iii) The **location** of an asset or of a transaction or of the place of **residence** of any party is located at a place which would normally not be so located for any substantial commercial purpose. It is located for obtaining a tax benefit. For example, Treaty shopping. It should be noted that there is a special emphasis on curbing tax avoidance by using Double Taxation Avoidance Agreement (DTAA) with tax havens.

Illustration:

An Indian company enters into a transaction to purchase goods from China, and sell the same in Europe. The company has a subsidiary in Dubai. The director of the Indian company goes to Dubai, and signs the contract. The transactions are recorded in the Dubai company. The goods move from China directly to Europe. Profits are recorded in Dubai. This is an illustration of disguising the transaction as Dubai based transaction. The location of the transaction is being changed from India to Dubai, mainly for obtaining tax benefit. GAAR can apply.

The rules specifically provide that the following factors will **not be relevant** to determine whether there is commercial substance in the arrangement or not:

- the **period** for which the arrangement exists.
- payment of **taxes** under the arrangement.
- provision of an **exit route**.

These observations were made by the Honourable Supreme Court in the case of Vodafone (see details in note 8.1.2.D). The court had said that existence of the above factors means that there was commercial substance. GAAR has negated these observations.

Thus even if a person has a Dubai company for the past several years, GAAR can apply from 1st April 2012.

1.3.3 Round trip financing:

Round trip finance has been explained as an arrangement in which funds are transferred amongst parties to the arrangement. The transactions do not have any substantial commercial purpose other than obtaining a tax benefit. In simple words, it may be referred to as "**circular movement of funds**". The movement of funds begins at a source, makes a round trip, and comes back to the source (or near the source).

It is not necessary that the funds involved can be **traced to any funds** transferred to, or received by any party. (i.e. There need not be any specific trace to the original source from where funds started moving).

The **time** or sequence is also not relevant.

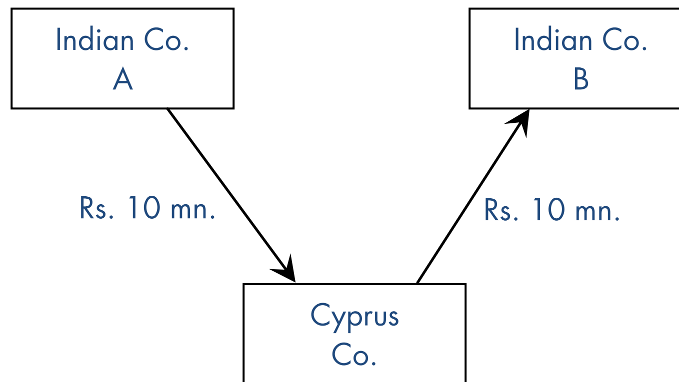
The **means**, manner or mode through which funds are transferred is also not relevant.

A few illustrations will help in understanding.

Illustration:

i) An Indian company A sets up a Wholly Owned subsidiary in Cyprus and invests Rs. 10 mn. The Cyprus company invests the funds in another company B in India owned by the promoter of the first Indian company. This is a simple illustration of round tripping. Now when Cyprus company sells the investment in company B, it will claim exemption from capital gains because of India-Cyprus treaty.

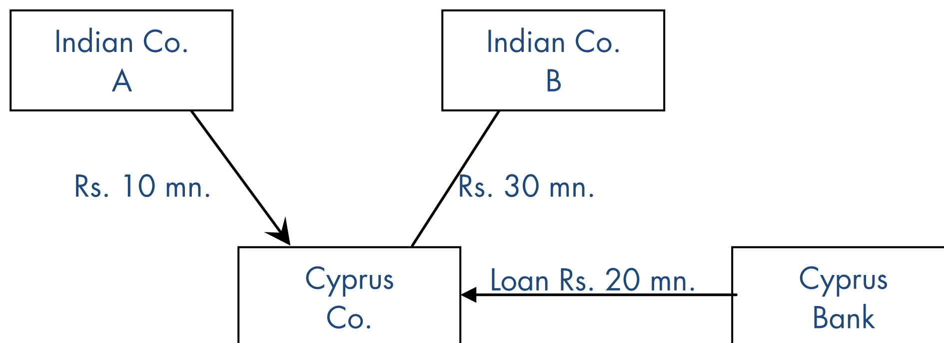
If A invests directly in B, it does not get benefit of treaty between India and Cyprus. It has to pay capital gains tax on sale. By arranging Round Tripping, the group can claim treaty benefit. Large corporations have resorted to round tripping of different forms for different advantages.



It is not relevant whether the funds come in as equity or loan or any other manner (mode or manner is irrelevant).

It is also not relevant whether the funds come in immediately or after a few years (time is not relevant).

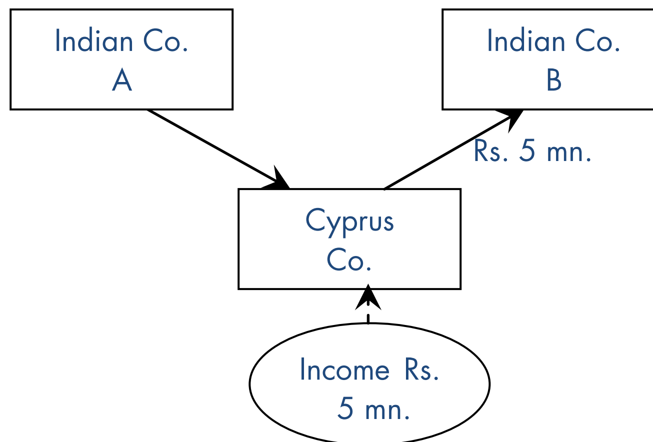
ii) In the above example, say the Cyprus company borrows funds of Rs. 20 mn. from a Cyprus bank. It then invests Rs. 30 mn. in the Indian company B of the promoter.



In this situation, Rs. 10 million will be considered as round tripping funds. However Rs. 20 million should not be considered as round tripping. There is no circular movement of funds. This is however not clear. The rules provide for the test of round tripping based on movement of funds amongst parties to the arrangement. They do not provide that if the Control and Management of the companies involved is under same management, it will be round tripping. The rules however do provide that

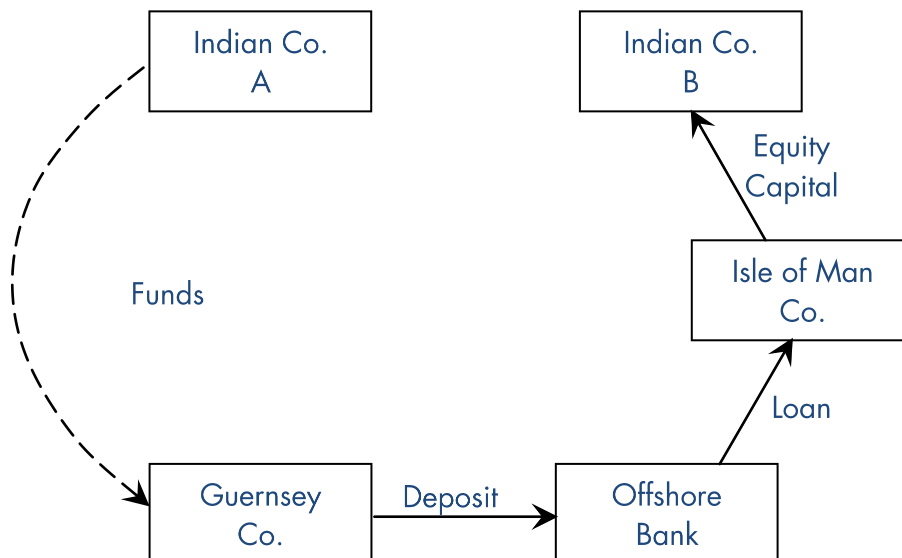
tracing the funds to the original source is not necessary. Hence the revenue can allege that the above arrangement is also round tripping.

iii) Let us further assume that the Cyprus company earns income of Rs. 5 mn. It then invests those Rs. 5 mn. in the Indian company B.



In this situation, there is no round tripping of funds as far as Rs. 5 mn. is concerned. This is because those funds never went from India. They were earned outside India and then brought into India. (However this transaction may be caught by other rules. That is not discussed here.)

iv) Let us consider a more complex round tripping illustration. An Indian resident sends funds abroad through hawala. The funds are then invested in a Guernsey company (an offshore centre). The Guernsey company keeps the money in the offshore bank. The bank gives loan to an Isle of Man company (another offshore centre). The Isle of Man company then invests the money in India as equity capital.



This is also a clear case of round tripping. The number of transactions carried out is not relevant. The offshore companies, the foreign bank, Indian persons are all parties to the arrangement. They will be considered as accommodating parties.

In this transaction, proving that it is round tripping funds may be difficult for the department. Round trip means funds begin at the source, make a round trip and come back to the source. If one finds a link between Guernsey company, foreign bank, Isle of Man Company and the Indian resident, it may be possible to allege round tripping. To take care of such difficulty, at least under the law it has been provided that trace to original source and manner of round tripping are not relevant.

We understand why the rules provide that tracing the funds is not necessary. However, there are complications. Any tax payer taking an External Commercial Borrowing (ECB) may be alleged to have resorted to round tripping. And then the burden of proof (as per the Finance Bill 2012 proposal) to prove that the ECB is not out of his own funds is with the tax payer! How can anyone prove that he has not made any hawala? Very essence of Round Tripping is that funds originated from India go abroad & again come back to India. If the law provides that investments coming in to India can be alleged to be Round Tripping transaction even if the same cannot be traced, then how is it Round Tripping?

The above kind of transaction of course involves several violations of Foreign Exchange Management Act (FEMA), etc. But that is a different matter.

1.4 Consequences of Impermissible Avoidance Arrangement:

If any arrangement is considered as Impermissible Avoidance Arrangement, then the tax shall be determined as considered appropriate by the assessing officer. The treatment can include any of the following:

- The transaction can be disregarded, recharacterised, or combined;

- Any step in the transaction can be ignored;

- Any accommodating party can be disregarded, or parties can treated as one and the same;

- Income can reallocated, and recharacterised;

- Residential status and location of the transaction can be considered at a different place;

- Equity can be considered as debt and vice versa.

Illustration:

A real estate developer invites foreign investor to participate in his real estate project. The developer gives an assurance that he will repurchase the foreigner investor's equity after 5 years at an agreed price which will give the investor a return of 10% p.a. Normally assured return means a loan transaction. However the parties have given the form of equity investment. Hence on sale of equity they will claim capital gains and not interest income. Capital gain can be taxed only at 20%.

Under GAAR, this transaction may be recharacterised as debt. The appreciation which the investor will earn may be considered as interest and taxable at 40%. (This transaction is a violation of FEMA also. But that is a different matter.)

1.5 Applicability of other provisions:

It is clarified that GAAR will apply in **addition** to other provisions. Thus specific provisions for disallowances, etc. will continue to apply. GAAR can apply additionally.

Normally one would assume that if there is a specific provision to consider a transaction, general provision cannot apply. However under GAAR, it is specifically provided that GAAR is in addition to the specific provisions. Thus even if one passes through the tests of a specific provision, GAAR can still apply. This will become quite onerous to comply with.

Illustration:

Assume that there are two related companies. Company A is a profit making company. Company B is a loss making company. Company A makes a payment for purchase of goods from Company B. Under various provisions of the Income-tax law, if any payment of expenditure is made to related or associated person, then the same has to be made at market price. Assume that the payment made by Company A is at market price. Still GAAR can apply. This is because

Company A can transfer profits from itself to Company B. Company A will pay lower tax. Company B will not pay any tax as it is making losses. Unless commercial reasons can be given for purchase of goods by Company A from Company B, GAAR can apply.

1.6 Drama:

An interesting drama is unfolding. Government wants to plug treaty shopping through tax havens. (See note to paragraph 1.3.1) This would directly hit Foreign Institutional Investors (FIIs) coming from Mauritius and Participating Notes (PNs) using FIIs. However, Government has since many years declared its decision to protect Mauritius, FIIs and PNs from all anti-avoidance provisions. Since the case of Azadi Bachao Andolan & Central Board of Direct Taxes' (CBDT) Circular No. 789 (this strategy is clear. After the presentation of the Finance Bill 2012, when FIIs got worried, Finance Ministry has issued clarifications as per media reports that they do not want to tax the PN holders. However in case of FIIs, if they have substance in Mauritius, they will not be taxed. Without substance, GAAR may apply to FIIs. What kind of special provisions will be brought in, is to be seen.

1.7 Manner of invoking GAAR:

To provide some checks and balances, it is proposed to invoke and apply GAAR in the following manner.

If the **Income-tax officer** considers during an assessment that the arrangement is an Impermissible Avoidance Arrangement, he will have to make a reference to the **Commissioner**.

If the Commissioner considers that GAAR is applicable, he will give an opportunity to the tax payer. If the Commissioner does not consider that GAAR is applicable, he will communicate to the Assessing officer that GAAR cannot be invoked.

If the tax payer does not object, the Commissioner may consider the arrangement as Impermissible Avoidance Arrangement. If he objects, then the Commissioner will refer the matter to **Approving Panel**. The Approving Panel shall comprise of a minimum of 3 Commissioners.

On receipt of the reference from the Commissioner, the Approving Panel will hear the tax payer and the Income-tax officer. Within a period of 6 months, the Approving Panel is required to give directions for the application of GAAR. The order of the Approving Panel is binding on the Assessing officer.

Compared to the draft of the Direct Taxes Code Bill where the revenue has wide powers, these provisions are slightly better. The main issue here is that the Approving Panel will comprise of the Commissioners of the department itself. To what extent they can give independent orders, remains to be seen. The Government will come out with rules. The rules will clarify the threshold limits, whether there will be independent people on the panel, etc.

1.8 Will treaty relief be available?

As per current provisions of the Income-tax Act (Section 90(2) & 90A(2)), the provisions of the treaty or the domestic act, whichever are more beneficial to the tax payer will apply. This gives precedence to the agreement entered in to by India with another country over its own laws. This is a widely accepted interpretation in international taxation.

However, as per the above provision, actions taken under GAAR can be contested by taking benefit of the provisions of a DTAA. An amendment has been proposed which provides for 'treaty override by domestic law' in case of GAAR. This amendment in line with similar provisions made by other countries which have brought in GAAR in their domestic tax law. Without inclusion of this provision, GAAR would be rendered ineffective in every case of treaty-shopping.

1.9 On invoking of GAAR, will normal provisions apply?

Illustration:

A US company invests in India through a Mauritian company to claim the benefit of India-Mauritius treaty. This is treaty shopping. Under GAAR, the Mauritius company may be ignored due to lack of substance. It means that it will be considered that US company is the real owner. Under GAAR, will the US company be able to apply India-US DTAA?

Normally it should be possible. However that is not clear.

As mentioned above, DTAA relief will not be available if GAAR is applied. One can appreciate that GAAR can be invoked against Mauritian company. DTAA relief will not be given to that company. However GAAR cannot be invoked against US company as it has substance. Hence DTAA relief should apply.

A clarification in this matter by the CBDT will help.

It is a basic principle of fairness. For one offence, a person can be penalised only once. On application of GAAR, the person will have to pay tax, interest and penalty. That should be the end of it. Not to give DTAA relief which is applicable is like **additional penalty**. It will be unfair if the India-US DTAA is not given in the above illustration.

1.10 Consequential effects:

Due to application of GAAR, there could be consequential effects.

Illustration:

Consider the illustration shown in 1.5, where Company A (profit making company) pays for purchase of goods from Company B (loss making company). GAAR is invoked and the profit which is transferred to Company B, is taxed in the hands of Company A. The consequential effect should be in the hands of Company B, the loss should be increased.

The basic principle of fairness should apply here too. For one offence, there can be only one penal consequence. The South African provisions contain provisions for consequential effects.

1.11 Old structures:

When the Direct Taxes Codewas proposed, it was a point of debate as to whether GAAR would apply to new arrangements, or will it apply even to old structures created before GAAR would come into effect. At that the time, the response of the Government was that they will consider and clarify.

Now in the budget it is provided that GAAR will apply to all arrangements – whether the same are already in place when GAAR comes into effect, or whether the arrangements are made after GAAR comes into effect. Thus all existing structures through offshore centres will have difficulties. One may have to seriously consider the implications.

1.12 Suo-moto action by the tax payer:

We assume that GAAR provisions will be passed by the Parliament. The tax payers will become aware of the same. Can the tax payers suo-moto pay tax by considering the substance of the transaction?

Illustration:

A US investor has invested in India through a Mauritius company. On his own, the investor ignores the Mauritian company and pays tax as per India-US DTAA. Will this be accepted?

Logically and in fairness, in our view, this should be possible.

Can the revenue deny the India-US DTAA relief on some pretext? For example, can the revenue argue that if the investor would have unwound the transaction by winding up the Mauritian company, there would be some tax in India. Let that tax be paid on winding up the Mauritian company. Let the US company become the owner. After that normal provisions may be applied.

In our view, if Mauritian company has to be ignored, then some other person has to be recognised. It is a basic requirement that a **"person"** and the **"income"** have to be identified. If one person is ignored under GAAR, some other person is considered as the taxable person. Once a person and the income are identified as "real", tax treatment has to apply accordingly.

This is similar to the issue of "Consequential effects". If the Mauritian company is ignored, the US company is considered as real. The consequence of treating the US company should apply. A specific provision needs to be made in this regard.

2. Domestic Transfer Pricing [Section 92BA]:

2.1 In case of transactions where non-residents are involved, there are detailed transfer pricing rules. However under the current provisions, there are limited provisions which provide that transactions between **domestic related parties** should be conducted at market prices. Following are the situations where market prices are applicable:

i) The Assessing Officer can disallow unreasonable expenditure incurred between related parties (Section 40A) (it provides for disallowance of excessive expenses, but has no provision where incomes have been earned at less than the market prices).

ii) For entities (or their business divisions) availing profit linked incentives, the entity (or the division) can undertake transactions with their related entities (or divisions) at abnormal prices so that the entity (or its division) can make higher than normal profit. In such cases, the revenue can recompute the income in respect of such entities with respect to market prices. (Section 10AA, Section 80A, Section 80-IA & similar Chapter VI-A deductions).

At present, there are no detailed rules for determining market prices.

2.2 Government is now proposing to apply the benchmark of Arms' Length Price (ALP) as presently provided in the Transfer Pricing provisions, to transactions between domestic related parties. As per the memorandum, the Government has based its decision on the **Supreme Court decision in CIT vs. Glaxo Smithkline Asia (P.) Ltd.** (2010 TII 2, [2010] 195 Taxman 35). The Honourable Supreme Court in this decision had addressed a larger issue of whether Transfer Pricing provisions should be extended to domestic transactions. It mentioned that shifting of profits in such transactions, being domestic, would ordinarily be tax neutral. However, this would not be the case where one of the companies is making a loss (resulting in tax arbitrage); or if different tax rates are applicable to the assesses concerned. The Honourable Supreme Court had recommended empowering the assessing officer to apply any of the generally accepted methods to determine ALP in determining the fair market value. Further, it recommended maintenance of books of accounts and documents in such cases; as also obtaining of an audit report from a Chartered Accountant.

2.3 Transfer Pricing provisions are presently applicable only in cases of international transactions. Following the above recommendations, the Government has extended transfer pricing provisions to the above-mentioned domestic transactions. Therefore, any income (or item impacting income) in relation to the specified domestic transactions shall be computed having regard to the ALP.

2.4 As a saving, the domestic transfer pricing provisions would apply only in cases where the aggregate of such transactions exceeds **Rs. Five crores in a year.**

2.5 Under transfer pricing rules involving non-residents, international transactions between 'associated enterprises' are covered. 'Associated enterprises' cover many types of relations. Domestic transactions do not cover transactions between 'associated enterprises'. The applicability of these provisions to domestic enterprises will therefore be restricted to fewer kinds of relations. In effect, there is no expansion in applicability of these provisions. Only now detailed rules have been provided.

2.6 Transfer Pricing provisions do not apply where the result of the Transfer Pricing provisions is a reduction of taxable income or increase in losses. The same would continue in case of specified domestic transactions too.

2.7 Further, amendments are proposed to **extend** the following provisions presently applicable only to international transactions, to specified domestic transactions:

i) Application of the methods used for computation of the ALP;
ii) Maintenance of information and documents as prescribed;
iii) Obtaining of report from a Chartered Accountant; and
iv) Reference to a Transfer Pricing Officer.

2.8 As is seen in other amendments, the Government has been over-zealous in curbing tax evasion this time. In our view, the compliance requirement for Transfer Pricing provisions are enormous. Further, there is generally no one view on ALP. This has resulted in huge compliance and legal costs in case of international transactions between associated enterprises. Applying these provisions to domestic transactions will lead to **increased costs** and a new area of **protracted litigation**.

Further, most of the specified domestic transactions may not result in much of a tax loss when viewed from a country-perspective. In our view, the present amendments, while necessary, must be restricted only to cases where there is a tax loss or tax arbitrage as pointed out by the Honourable Supreme Court in the Glaxo decision mentioned above.

3. Issue of shares by a private company [Section 68]:

3.1 Section 68 of the Income-tax Act deals with cash credits which cannot be explained. If any person has a deposit (credit) of money in his account, or makes a credit entry in his books of account, it is presumed that it is an income, unless the person can explain that it is not income. Typically people with black income, transfer it to other people by various means. Then they receive the funds from other people as loans or gifts. Loans and gifts from are normally not income.

If a person receives any amount from any person and the receipt is not accounted as revenue, he is required to explain the **nature** and **source** thereof to the satisfaction of the assessing officer. The income-tax officer asks for – identity of the person, genuineness of the amount, and the capability of person to give a gift or loan.

3.2 For funds received by the companies towards equity capital, normally questions were not asked. People are alleged to have accepted bribes by way of equity capital. Or persons with black money have converted the same into white money through share capital. The shares would be subscribed to by several shareholders. After subscribing to the shares, the shareholders would not be traceable. The transaction is explained by way of an illustration below.

Illustration:

A person (promoter) who has black money, can transfer money to some people (investors). The investors will become subscribers to shares at a large premium. The investors will only get a small percentage of equity capital.

Shareholder	Funds Contributed Rs.	Face Value Rs.	%
Promoter - (1,00,000 shares @ Rs. 10 per share – face value)	10,00,000	10,00,000	90.91
Investor – (10,000 shares @ Premium of Rs. 90 per share (total Rs. 100))	10,00,000	1,00,000	9.09
Total	20,00,000	11,00,000	100.00

The promoter will get money to use as he will have a major share in the equity capital.

3.3 It has now been proposed that apart from the private company raising share capital, even the **shareholder investing in the share capital** also has to explain the source of the funds. The logic is that in a private limited company, the investors are known people. If the shareholder cannot explain the source of his investment, such investment will be considered as income of the investee company.

The onus of establishing the source of funds applies to **resident shareholders**. If the shareholder is a non-resident, there is no onus on him. Also if the shareholder is a **Venture Capital Fund or a Venture Capital Undertaking**, there is no onus on such a fund or the company to establish the source of funds.

3.4 Dual onus / double tax:

A plain reading shows that the company and the shareholder **both** have to establish the source of funds – qua the investment in the share capital. However if the shareholder establishes the source of funds, normally, it should be sufficient compliance by the company as well. Thus there is in reality, compliance to be done substantially by the shareholder.

However what is the implication if the shareholder cannot establish the source of investment? Will the company be taxed or will the shareholder be taxed on the investment?

Let us consider the shareholder first. He can be charged to tax – not under section 68 – but under another section (section 69 – unexplained investment). If a person has any investment for which he cannot offer satisfactory source, it will considered as income.

If the amount is considered as taxable in the hands of the shareholder, it becomes an "explained source of funds". Once it is explained, the company which receives the funds, cannot be taxed. However under the law, both – the company and the shareholder – may be taxed. This may amount to one stream of income – being taxed twice. It will become an issue of litigation.

The purpose is tax people who convert their black money by way through issue of shares. Hence if the source if not explained, the company should be taxed.

3.5 One can understand the purpose. However this can affect a large number of bonafide investments. A shareholder may be willing to invest in a friend's private company. However if he has to provide his source of investment to the investee, he may not be willing to invest.

There could be two other kinds of transactions about which there are news reports. However these have not been covered by this proposal.

i) Some listed companies for which hardly any trading takes place, are known to be acquired by investors with a purpose to route their black money.

ii) FIIs help route funds of Indian businessmen/politicians through various structures and Participatory notes.

Nothing specific is provided to curb this kind of routing. What is sought to be covered is one kind of transaction – where some companies are alleged to receive bribes by way of share investment from Indian residents.

4. Share premium in excess of the fair market value to be treated as income [Section 56(viib)]:

4.1 If an investor invests funds in shares of a private limited company at a price more than the fair value (premium), the premium is not considered as income. The premium is a capital receipt. The amount is not even shown in the profit and loss account. It is shown directly as share premium in the balance sheet along with the reserves.

Now it has been provided that if a **resident** subscribes to shares at a price exceeding the face value (at a premium), the excess of the price at which it is issued over fair market value will be treated as income of the company. It should be noted that if the shares are issued at face value, then this section does not apply. So if the fair value is Rs. 2 per share, but the shares are issued at Rs. 10 per share (face value), the difference of Rs. 8 is not taxable. However if the shares are issued at Rs. 11 per share, then the entire Rs. 9 will be considered as income.

4.2 An illustration is given below to explain how share premium is used to convert black income into white income.

Illustration:

Assume that Mr. A & Mr. B have formed a private limited company - M/s. AB Private Limited. Suppose Mr. A has black money of Rs. 10 lakhs. He wants to use this black money in his business. He can give his black money to his relative Mr. C. Mr. C will invest this money in M/s. AB Pvt Ltd. at a huge premium. Suppose on a face value of Rs. 10, the share premium paid is Rs. 90 per share (total Rs. 100 per share). However the fair market value of the share is much less than Rs. 100. The above illustration is shown in the table below:

Shareholder	Funds Contributed Rs.	Face Value	%
Owner – A & B (1,00,000 shares @ Rs. 10 per share)	10,00,000	10,00,000	90.91
Mr. C (10,000 shares @ Premium of Rs. 90 per share (total Rs. 100)	10,00,000	1,00,000	9.09
Total	20,00,000	11,00,000	100.00

Thus A will have his money in his company without paying any income-tax.

This amendment has nexus to section 68 amendment proposed in the finance bill (note 3 above). The difference between the two proposals is as follows.

Under section 68 the private company has to explain the source of funds in the hands of resident shareholders. If the source in the hands of the resident shareholders cannot be established, the company can be taxed on the whole of the amount received towards shares. However, under section 56(viib), if the shareholder is able to establish the source of funds, but the price at which the shares are subscribed is more than the fair market value, the company will be taxed on the difference (between price at which shares are issued, and the fair value).

4.3 This provision will not apply where the consideration for issue of shares is received by a venture capital undertaking, from a venture capital company or a venture capital fund. This provision will also not apply, if the shareholder is a non-resident.

4.4 The fair market value of the shares will be considered as the **higher** of the following values –

(i) as may be determined in accordance with the method as may be prescribed (the detailed method will be prescribed by the Government); or

(ii) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value of its assets.

5. Tax rates on unexplained - cash credits, money, investments, expenditures and borrowings [Section 115BBE]:

5.1 Under the existing law, certain unexplained amounts **are deemed** as income under sections 68, 69, 69A, 69B, 69C and 69D. These incomes are subject to tax as per the **tax rate applicable** to the tax payer.

The Individuals and Hindu Undivided Family (HUF) are taxed as per slab rates. They enjoy a basic exemption plus rates of less than 30% upto Rs. 8,00,000 (Rs. 10,00,000 as per this budget). For senior citizens, the tax free limit is Rs. 5,00,000. Thus no tax is levied if such unexplained income and disclosed income is less than the amount of basic exemption limit.

5.2 It is proposed to tax the unexplained amounts at a **flat rate of 30% (plus education cess) [Section 115BBE]**. It is also proposed that no deduction of any expenditure or allowance shall be given in computing deemed income under the above sections.

5.3 The reason given in the Memorandum explaining the bill states that individuals and HUFs enjoy a tax free limit. People try and take advantage of this.

Illustration:

If 1,000 slum dwellers claim to have invested Rs. 2,00,000 each in a private company, the company will launder Rs. 20 crores and no one will pay any tax. New provision eliminates this loophole.

5.4 The amendments proposed can, however, affect some more important transactions.

Illustration:

A company has a loss of Rs. 100 crore. In a survey an amount of Rs. 10 crores is added on account of unexplained expenditure. Normally the loss should be reduced to Rs. 90 cr. However under the new provision, the amount of Rs. 10 crore will be taxed @ 30% (and the loss of Rs. 100 crore would be allowed to be carried forward). This amounts to paying tax on a loss. There could be other similar implications in different situations.

Apart from the above, the person can be liable to penalty, etc.

5.5 One area where this new provision should not apply is as under:

During an assessment, an assessing officer disputes the expenditure as not deductible. He adds the amount to income. This is not "unexplained amount". It is a "disputed amount" which is added as income. Such amounts will not be taxable @ 30% but at applicable rates after considering losses, slab rates, etc. It is only "unexplained amounts" for which the 30% tax will apply.

5.6 Disallowance of expenses:

As stated in para 5.2 above, no deduction of expenses will be allowed against unexplained income. Therefore, in a case where unexplained income or investment is sought to be taxed, this provision may also impact claiming of expenses against income already disclosed in the tax return. Consider the illustration and the explanation:

Illustration:

Co. A has disclosed a normal income of Rs. 1,00,000 in its return of income. After deduction of Rs. 30,000 of expenses, the taxable income is Rs. 70,000. On assessment, an unexplained income of Rs. 50,000 is added to his total income.

However, the officer can claim that out of the total expenses of Rs. 30,000, proportional expenses of Rs. 10,000 (1/3rd of Rs. 30,000 - in ratio of Rs. 50,000 : Rs. 1,50,000) are incurred to earn unexplained income. Therefore, over and above the addition of Rs. 50,000, the expense of Rs. 10,000 is also "not allowable". Hence he will further add that amount. This is explained in the table below.

Sr. No.	Particulars	Normal Income	Unexplained Income	Total Income
1.	Turnover	1,00,000	50,000	1,50,000
2.	Expenses	30,000		
3.	Normal taxable income	70,000	50,000	1,20,000
4.	Disallowance of expenses at 2 above – Added to income		10,000	10,000
5.	Total taxable income	70,000	60,000	1,30,000

Thus the addition may not be restricted just to addition of income, but also something more. However, it is debatable whether such addition towards expenditure which can be substantiated, would be taxable at normal rates or at the rate of 30% as proposed for "unexplained income".

6. Filing of income tax return in relation to the assets located outside India [Section 139, Rule 12]:

6.1 Under the existing provisions, a person (other than a company or a firm) is required to file his income tax return **if his Gross Total Income exceeds** the basic exemption limit. A company or a firm has to file a return irrespective of their income as they do not enjoy any basic exemption limit.

Now the Government has made it mandatory for a residents having **foreign assets** or **signing authority in any account outside India** to furnish their return of income. This type of reporting requirement is similar to the USA reporting requirements. This provision has been brought about to keep a watch on the residents having foreign assets, and consequent to recent information obtained by the Government from foreign countries in respect of foreign bank accounts of Indian residents.

6.2 If a person has taxable income, then in his return, most of the details including his foreign assets will have to be disclosed (the return form has been suitably modified through a separate amendment in the applicable rules).

It should be noted that a return for foreign assets has to be filed even if the person does not have taxable income and normally does not have to file a return of income. Along with the reporting of foreign assets, income (though below taxable limits) will also have to be reported.

6.3 Further, persons who return to India after being non-residents of 9 years or more, are considered as Not Ordinarily Resident (NOR). Such persons are not taxable on foreign incomes as long as they are NOR. Now even if the **NOR does not have taxable income in India,** but has foreign assets, he will have to file his return of foreign assets.

This can have serious implications. Many **expatriates** come to India for short assignments of 2-3 years. Such people are generally NOR for 2 years at least. They will have to file the return for their Indian income. However they will also have to disclose their foreign assets (even though their foreign incomes will not be taxable). Perhaps this was not the intention of the Government.

6.4 If a person has a **financial interest** in any entity, then also he is required to file a return. Thus if a beneficiary has an interest in a specific foreign trust, he has to file a return. In a discretionary trust, a beneficiary only has a possibility of receiving something from the trust if the trustees distribute anything to him. And these trust deeds are so drafted, that one cannot say that the tax payer has any interest in the trust. Properly drafted trust deeds will not be exposed by the above amendment. However, such beneficiaries are likely to face difficulties under sections 56 & 68 to 69D.

6.5 Assessment:

As per law, the tax officers have to complete their regular assessments within 21 months from the end of the relevant assessment year; and within 12 months from the end of the financial year in which notice is issued for reopened cases. Both these limits are proposed to be now increased by 3 months.

Earlier time taken in obtaining information from foreign tax authorities was excluded from the above-mentioned time period for completion of assessments. There was a cap of six months on this exclusion period. This is also proposed to be extended to one year.

7. Re-opening of assessments:

At present, the time limit for reopening of cases after the assessments are complete is 8 years from the beginning of the financial year. Thus for the year beginning on 1st April 2012, the assessment can be reopened up to 31st March 2020. For persons who are treated as agents of non-residents, the time limit is 4 years from the beginning of financial year. The time limit has been increased for following cases.

7.1 Foreign assets [Section 149 & Section 147]:

7.1.1 Getting access to foreign assets is time consuming process as the Indian tax authorities have to comply with the foreign laws. Further many foreign institutions have blanket non-disclosure bonds signed by the investors. The time limit of 8 years is too less for having access to such information. Therefore the time limit for reopening an assessment of 8 years has been increased to **18 years**. (Please note that we have stated financial year limits, while the income-tax act refers to assessment year limits). This extended time limit is applicable where the income on foreign asset has escaped assessment.

7.1.2 However, the Government has simultaneously made an amendment whereby a person who is found to have any asset (including financial interest in any entity) located outside India, will be **deemed** to have taxable **income** which has escaped assessment! The effect is that simple disclosure or finding of foreign assets will lead to reopening of assessments. **The tax officer does not need to prove that income has escaped assessment or not for reopening the case.**

This is a far reaching power given to the tax officers. Similar powers of deeming income to have escaped assessment are currently available in the Income-tax Act. However, these powers are restricted to **incomes** which are not reported or assessed. The above amendment enables the tax officer to reopen cases even where **only assets** were not disclosed. This would impact even persons who have not earned any

taxable income from such assets, or income earned from such assets is below taxable limits.

This provision seems to have been inserted after the revenue has received information from HSBC and other banks about Indian residents' foreign accounts. In many cases, the time limit of 8 years was over. Now with the amendment, the Government will have much more time.

7.1.3 It should be noted that above amendments will apply from 1st July 2012. As these are procedural provisions, these can apply to old incomes. Thus, the provision for reopening of assessments can apply to incomes earned or foreign assets found prior to the 8 year period. Thus a notice can be issued up to 31st March 2013 for incomes earned or foreign assets found after 1st April 1995.

7.2 Agents of non-residents [Section 149]:

7.2.1 There is a provision in case of non-residents earning income from India. If a non-resident earns income from any person which is taxable in India, then such a person from whom the non-resident earns income can be considered as the agent of the non-resident. Typically, it is the payer of consideration who can be treated as an agent. The agent can be charged to tax in place of the non-resident. This provision has been kept, because the Indian Government cannot catch the non-resident. Hence it is essential for the person who pays to a non-resident any income, to deduct tax at source. Otherwise, there is a risk of him being treated as an agent of the non-resident. The agent can be a resident or a non-resident. (In Vodafone case, Hutch earned income from Vodafone. Hence Vodafone can be considered as an agent.)

Before treating a person as an agent, a notice is required to be issued to the agent. The time limit for issuing the notice is 4 years from the beginning of the financial year. This limit is increased to 8 years.

7.2.2 It should be noted that this amendment applies from 1st July 2012. As these are procedural provisions, these can apply to old incomes. Thus, the provision can apply to income earned prior to the 8 year period. Thus a notice can be issued up to 31st March 2013 for incomes earned after 1st April 2005.

7.3 Applicability to non-residents:

Both the above provisions are intended to apply to Indian residents having foreign incomes. However, strictly the provision applies to non-residents also.

Illustration:

One non-resident (say 'A') obtains a license of technology for use in India from another non-resident (say 'B'). 'B' who earns royalty is taxable in India as the technology is used in India (even though the use of knowhow is by 'A'. In case of 'B', the assessment can be opened up to 18 years. Normally 'A' would deduct tax at source. However if he does not deduct tax at source, 'A' can be treated as an agent. The time limit in case of an agent will be 8 years, whereas for the principal, the time limit will be 18 years.

II. International Taxation:

8. Amendments made to overcome Honourable Supreme Court decision in Vodafone [Section 9, Section 2(14), Section 2(47), Section 195]:

8.1 Brief background:

8.1.1 In January 2012, the Honourable Supreme Court had delivered its decision in the case of Vodafone International Holdings B.V. (341 ITR 1 (SC) [2012]). It was in favour of Vodafone.

Briefly the facts were that Hutch group had invested in the Indian company (for mobile phone services). The investment was made in India through a series of offshore companies. It sold the shares in the Indian company and the Indian business to Vodafone group for a profit of US$ 11 bn.

The transaction was so structured whereby **one share of Cayman Island company** was sold – through which the entire holding of Hutch was transferred to Vodafone. **No transaction was carried out in India.**

The revenue claimed Hutch's capital gain was taxable in India and that Vodafone should have deducted tax at source at the time of making payment to Hutch.

The Vodafone's announcement to the public at large, declarations filed with the Stock Exchanges, Foreign Investment Promotion Board and the Share Purchase Agreement clearly brought out the fact that what was sold was the Indian company's shares. However to the revenue, Vodafone claimed that it had purchased the share of Cayman Island company. It had not purchased any Indian asset.

8.1.2 The Honourable Supreme Court gave its **decisions** and made **several observations** as under:

A. It held that:

- one has to see the **"legal effect" only**;
- as the one share of Cayman Islands company is situated outside India, sale between two non-residents of such asset will not lead to any tax payable in India.

B. It **ignored the Share Purchase Agreement** and various facts.

C. It further held that:

- corporate structures like the one Hutchison had made, were to be 'looked at' and not 'looked through';
- transactions made using such structures are not lacking substance.

D. It observed that for determining whether transaction has substance or not, various factors need to be considered. Some of them are:

- existence of the structure,
- planning of its exit strategy,
- payment of taxes in India, etc. (taxes of Hutch India were considered to determine taxability of Hutch Hongkong!)

E. The Honourable Supreme Court also mentioned that such transactions can be taxed only if the Government brings in law to tax such transfers.

In our humble submission, and with full respect to the Honourable Supreme Court, there were several errors in the decision. When the tax payer itself states the real facts, those have to be considered. It does not even require any specific provision to be made in the law. Our detailed article is available on our website. In our article we had suggested that provisions to tax Vodafone must be brought in through the Finance Bill. It seems the Government was also of the same view.

8.2 Amendments proposed in Finance Bill 2012:

The Finance Bill has **systematically sought to completely nullify the judgement** by making provisions against every major decision / observation made by the Honourable Supreme Court! The amendments reverse the effect of the judgement by including the exact phrases which were used as favourable reasons for the taxpayer as phrases which will now lead to tax being paid in India! The major amendments in this relation are:

8.2.1 Deeming provisions are brought in to 'clarify' that a **share or interest in a foreign company or entity** shall be deemed to be situated in

India, if substantial value of the share or interest is derived, directly or indirectly, from assets located in India. This rebuts the main argument of the Honourable Supreme Court judgement holding the transaction non-taxable.

8.2.2 Earlier, income accruing, directly or indirectly, "through" a business connection, property, asset, source of income or transfer of a capital asset situated in India was deemed taxable in India. This expression **"through" has been expanded to cover instances where income accrues or arises in India "by means of"; "in consequence of" or "by reason of".**

8.2.3 One of the alternative arguments taken up by the Government was that there is **transfer of management or control rights** in the Indian shares by transfer of one share in Cayman Islands. These rights were sought to be taxed in India. The Honourable Supreme Court held that such rights are not detachable from the ownership of shares and hence not taxable. The Government has now amended the definition of 'property' in section 2(14) to include rights in relation to an Indian company including management or control or any other rights.

8.2.4 Another argument of the Government was that **'transfer'** of a capital asset included both 'direct' and 'indirect' transfers; though it was not specifically mentioned in the Act. The Honourable Supreme Court did not agree. The Government has now amended the definition of the term 'transfer' in section 2(47) to include - *disposing of or parting with an asset or any interest therein; or creating any interest in any asset; directly or indirectly; absolutely or conditionally; voluntarily or involuntarily; by way of an agreement (entered in or outside India) or otherwise*.

Further, the fact that such transfer is dependent upon transfer of a share in a foreign company will be immaterial.

Notice the wide-sweeping nature of the language used. It can invite trouble for transactions not intended to be impacted by the Government.

8.2.5 Apart from taxability of such transfer of share, one of the learned Supreme Court judges hearing the arguments also held (in a concurring but separate order) that a non-resident need not deduct any tax at source, even if income is taxable in India, as the section does not refer to a non-

resident. Further, he also held that nexus of the deductor in India must be viewed in relation to the particular transaction and not otherwise.

This in our view was incorrect. The section clearly applied to a non-resident. There have been decisions in the past which have held that a non-resident is also required to deduct tax at source. Further, Vodafone had nexus in India, and was acting with full knowledge and advice in relation to this particular transaction. It had also agreed to abide by all Indian laws while obtaining approval from the Government. The issue is dealt with in detail in our article on our website.

The Government has now amended the section to clarify that the section extends to all person, resident or non-resident, whether or not the non-resident has any nexus with India or not. **Thus non-residents are also required to deduct tax at source.**

8.2.6 An important characteristic of all the above amendments is that they are all *clarifications for removal of doubts* and not *introduction* of new legal provisions. Further, they are all clarifications made retrospectively from 1962! They further clarify that the meanings now ascribed to the phrases by these amendments have "*meant and shall be deemed to have always meant*" – what is now ascribed. This is done with a view that all the above amendments were always the intention of the legislature and are hence need only clarification and are not expansion of scope.

8.2.7 Apart from the above, the Government has given a sweeping power to the tax department to deem all notices, assessments, demands, etc., as binding on the tax payers in all similar share transactions notwithstanding any favourable ruling of any court!

It seems this provision (Section 113 of the Finance Bill 2012) is brought in specifically to reverse the Vodafone ruling and revive the tax demand. The provision does not amend the Income-tax Act and is brought in only to cover demands raised before passing of the Finance Bill.

The provision is one of its kind and supersedes in a certain manner the power of the Judiciary. It is almost as if the Government wants to leave no stone unturned in reversing the Honourable Supreme Court decision in case of Vodafone.

8.3 Effect of the amendments:

8.3.1 Thus, if one sells the shares of foreign holding company whose "substantial value" is derived on account of Indian investment; such foreign sale will be exposed to Indian capital gains tax. And the provisions have been worded most widely. What is substantial has not been explained and can lead to protracted litigation.

There is a serious risk. **Many transactions, which would otherwise not be considered as taxable capital gains transactions are now exposed.** Let us consider an illustration:

Illustration:

A UK investor has formed a company in Netherlands. The objective of the Netherlands company is to invest for the group. The company has subsidiaries in India, Bangladesh and Sri Lanka. The substantial value is in India. The company has a board of directors from the promoter family. As the activity of the company is investment, the director goes to Netherlands once a week. Decisions are taken by the director. The company has proper accounts and has got the same audited. If the shares of such a company are sold with the result that the Indian, Bangladesh and Sri Lankan subsidiaries are transferred to the new investor, the capital gain could not be taxed. This was because there was substance. However, now such capital gain will be taxable.

Consider further that the Netherlands company also had genuine operating business. It had a factory to manufacture goods. However the substantial value still lies in India. Even in such cases, now the capital gains will be taxable in India.

The above kind of transactions are not taxable in India presently. But the budget clarifies that such transactions were always taxable in India!

This is where we consider that to rectify one wrong (Vodafone escaping tax), the Government has done another wrong (sweeping clarificatory amendments retrospectively). Two wrongs do not make a right. Such sweeping and absolute amendments create a complex law. It may become impossible to apply and enforce.

Since the amendment is with retrospective effect; many past transactions also are now exposed. Though the department cannot reopen assessments beyond a period of eight financial years, all assessments where proceedings are pending (any appeal is pending), can be analysed

again. It is advisable that one may not keep assessments "open" for small issues and amounts.

8.3.2 Further, corporate restructuring done for non-tax reasons may also be exposed to tax as transfer of any rights in respect of shares will also now be covered.

8.3.3 Transactions between two non-residents leading to income which may become taxable in India will bring them under the net of deduction of tax at source. Though, as per law, the non-residents will have to comply with the procedural requirements, it is not sure how the Government will enforce such a requirement in case of non-compliance.

8.4 The way forward:

8.4.1 Honourable Supreme Court has interpreted controversial legal provisions in favour of the tax payer many times in the past. The Government has resorted to retrospective amendments then too. However, never before have the amendments been made in such an exhaustive and pointed manner. It is almost as if the Government has acted with vengeance.

8.4.2 All the executives of the Finance Ministry, and more importantly, the Finance Minister himself, in all their interactions, have supported these amendments. Their view is that **India does not believe in double-non-taxation**. Since this income was earned in India, and no tax on the gain from this transaction was paid in any other country, India reserves its right to levy tax.

Note: This stand is directly contradictory to the stand taken by the Government in the case of Azadi Bachao Andolan (263 ITR 706 (SC) [2003]) for the India-Mauritius DTAA. It seems the Government is now changing its thinking on double-non-taxation.

The Government has also taken support from the fact that even the Honourable Supreme Court had, in its judgement, said that the Government needs to make its intention clear in case it wants to bring such transactions in the tax net. The Government is saying it is doing nothing other than following the Honourable Supreme Court directions.

As far as **retrospective amendments** are concerned, the Government is of the view that they have always come out with such amendments where in their belief, the legislature's intention was not correctly interpreted. Furthermore, the FM in one of his interviews rues that in case they do not retrospectively amend the law, they stand to lose the revenue which they have gathered from similar such transactions in the past.

What is not said is that these amendments will also impact other transactions which would probably have got a shot in the arm with the favourable Honourable Supreme Court ruling. These transactions will also now become taxable.

One may draw an observation that for every aggressive tax planning, the Government will come out with a harsh provision. This is why we have been recommending that one should always look at the substance of the transaction.

With the above-mentioned amendments and the GAAR provisions, tax payers must ensure that **each step of their transaction is rooted in substance**. It is also clear that if a tax payer wants to do business with or in India, tax is payable in India.

8.5 Unanswered Questions:

While the amendments are made to corner Vodafone in to paying up the tax, the sweeping way in which it is done brings many questions to mind. There are already questions amongst professionals on the constitutional validity of the retrospective amendments. Retrospective amendments have been upheld in the past by the Honourable Supreme Court. However, expansion in scope of taxation by intending the same to be a mere clarification may be strongly fought against.

Further, the specific provision to nullify all court decisions and revive demands also seems to undermine the whole judicial process.

Further, with the rewriting of all the sections, the substantial question of taxability of this transaction may be litigated once again.

The recent Honourable Supreme Court decision may not be the end of the battle between Vodafone and the Finance Ministry. There may be protracted litigation on the above questions.

9. Transfer Pricing Amendments:

9.1 Advance Pricing Agreements [Sections 92CC & 92CD]:

In recent years, additions made by the tax department under Transfer Pricing provisions are enormous. Further, there is a significant litigation that takes place on this issue. It was felt and advocated that a provision to enable an Advance Pricing Agreement (APA) is required.

A detailed scheme has been formulated for the same now. An APA is an agreement entered in to between the tax department and the tax payer binding both to either a specific arm's length price or a specific method to derive the arm's length price. It would offer assurance on transfer pricing methods and provide certainty of approach to the tax payer. It would also reduce litigation. This practice is adopted in certain countries where transfer pricing provisions have been present since many years. Such agreements would be negotiated between the tax payer and the department. Entering in to an APA takes a long time and intense negotiations and hence is also a costly procedure. It would be used mainly by multi-national companies facing huge transfer pricing additions.

9.2 Expansion in scope of Transfer Pricing applicability [Section 92B]:

9.2.1 Transfer Pricing is applicable only to incomes arising from international transactions. The Government is of the view that the present definition of 'international transaction', though broadly worded, does not mention certain details of covered transactions. Therefore, a large number of such transactions are not reported by the tax payers in the transfer pricing audit report. The Government has now **expanded the definition** by bringing in specific transactions. The transactions that are covered now include purchase, sale, transfer or lease of various kinds of tangible and intangible properties; various modes of capital financing; provision of services; and business restructuring or reorganisation transactions.

Further, as per the revised definition, **business restructuring** transactions include all transactions, whether they have a bearing on profit or loss or not, either at the time of the transaction or at any future

date. This has been done in light of recent judicial precedents in Dana Corporation ([2010] 186 Taxman 00187 (AAR)), Amiantit International Holding Ltd. ([2010] 189 Taxman 00149 (AAR)), Vanenburg Group B.V. (289 ITR 464), which held that transfer pricing provisions cannot apply in a case where there is no impact on profit or loss or income.

9.3 The term 'international transaction' included transactions in the nature of purchase, sale or lease of intangible property. The term 'intangible property' was not defined. The term 'intangible property' has now been defined and expanded to a large extent, by including various types of intangible properties related to marketing, technology, artistic, data processing, engineering, customer, contract, human capital, location, goodwill, and any similar item which derives its value from intellectual content rather than physical attributes.

10. Taxation of Royalty incomes [Section 9]:

10.1 Taxability of Software payments:

Taxation of software payments has been a frequent litigation subject in taxation laws. The Government would like to tax all software payments as royalty as they consider it as payment towards 'licence to use', while the tax payer would not like to pay the tax on the same as they consider the same as a 'copyrighted article' akin to any other commodity. This is a very simplistic explanation. Several technical issues related to taxation on royalty incomes, licensing and copyrights are debated in numerous court cases. Further, Court rulings are also with diametrically opposite reasoning and conclusions.

With an intent to put matters to rest, the Government has proposed a retrospective amendment to clarify that transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right to use or right to use a computer software including granting of a licence. Further, the medium through which such right is transferred is not relevant.

This issue has become very technical. There can be ways and means to wriggle out of the above amendment. However, going by the intent of the Government, it would be better to pay up tax on software, especially in a case where the issue can be taken up by the income-receiver in his tax return.

The only saving grace can be in the form of a sufficiently clear DTAA provision. However going by the "restrospective amendments", it is doubtful whether a DTAA will provide any assured relief.

10.2 Taxability of payments for use of Satellites:

The other significant contested claim is the taxability of payments by Indians to foreign satellite operators for transmission of signals from outside India over the Indian geographical area. The Government took a stand that transmission by a satellite is use of a 'process' which is taxable as royalty under the Income-tax Act. The tax payers took a stand that the transmission was from outside India and was for use of a regular service (facility). There were differing views given by the courts.

The Government has, once again, tried to put a rest to the never-ending litigation by reversing most of the stands taken by tax payers. The amendment clarifies that the expression 'process' includes and always deemed to include transmission by a satellite including its various facets like up-linking, amplification, etc. Transmission by cable, optic fibre or by any other similar technology is also covered within a 'process'.

10.3 Other clarifications:

Various Courts have distinguished the taxability of royalty incomes on the basis of factors such as under whose control or possession is the particular right or property; whether such information, etc. is directly used by the payer or not; and whether such property is situated in India or not.

The Government has now clarified that royalty has included and always included consideration in respect of a right, property or information irrespective of whether the payer has **control or possession**; whether it is **used directly** by the payer or not; and whether or not it is **located in India or not**.

With this amendment, several court rulings are set to be reversed. Further, as this is amendment applies to royalty, property and information, most royalty payments including those for software and transmission would be covered.

10.4 All the above amendments are made retrospectively from 1st June 1976 and with the wordings *'For the removal of doubts, it is hereby clarified…'*

As mentioned above with reference to other amendments related to the Honourable Supreme Court decision in Vodafone, the Government is expanding the scope of taxation in India through clarifications. Professionals are questioning whether such amendments will stand scrutiny with respect to their constitutional validity.

11. Understanding Retrospective Amendments:

It seems very simple: "retrospective" means "with effect from a date earlier than the date on which the law was passed". That is true. But it has several implications. What happens to transactions executed before the law was passed? What happens to contracts already entered into which continue to be effective after the law has been passed?

Illustration:

Hindu Marriage Act, 1955 and Special Marriage Act, 1954 prohibit under age marriage. These laws provide that a boy can get married only after completing 21 years of age. For the girl the age is 18 years. So, after 1955; if anyone conducted a child marriage, he can be proceeded against under the applicable law.

Consider a case where an underage couple got married in the year 1950 and they had two children. If the Hindu Marriage Act had been passed with retrospective effect, would the marriage conducted before 1955 be void? Would the parties be liable for penalty? Would their children be considered illegitimate?

Now consider Income-tax Act and Finance Bill, 2012. Let us assume this bill will be passed and the "Anti-Vodafone" provisions will become law with retrospective effect.

11.1 Income-tax Act does not invalidate any business transaction. It is only a revenue law and not a regulatory law. Whatever sale/ transfer have been made, remain legally valid. Only tax may become payable.

11.2 No penalty can be imposed and no prosecution can be made for non-payment of tax. For these two, requirements are different as compared to tax payment

For penalty, intent to violate the law is necessary. Section 271 makes deeming provisions for holding the tax payer guilty and makes it difficult for the tax payer to defend his position.

Section 273B provides that if the tax payer proves that he had a reasonable cause for not paying tax; he cannot be penalised. Honourable Supreme Court decision in Vodafone case is sufficient to establish that the tax payer's interpretation of law was correct.

For prosecution, the burden of proof is on the department to prove that the tax payer had wilfully violated the law. The Honourable Supreme Court decision has laid down the interpretation of law that prevailed prior to Finance Act, 2012. Hence no judicial authority would hold transaction similar to Vodafone case – to be violation of law.

In short, Government can collect taxes. But cannot levy penalty, nor can launch prosecution.

Section 215 considers interest payable on non-payment of advance tax. Wording of the section is simple. If tax has not been paid, interest becomes automatically due. However, in my submission, this would be a fit case for waiving the interest.

12. Tax Residency Certificate [Section 90(4)]:

12.1 Presently, treaty relief is provided once a tax payer provides a standard tax residency certificate from the Government of that country.

However, tax haven countries provide tax residency certificates to their residents without going in to details of whether they are actually resident or liable to tax in their country. Their purpose is to say that the companies are tax resident of their countries. Obviously their tests of residency are far more liberal than those of India.

12.2 Therefore, the law is now amended to provide that a non-resident can claim relief under a treaty only if a certificate (containing such particulars as may be prescribed) of his being resident of that country is obtained by him from the Government of that country. Through this provision, the Government may bring in further requirements to ensure that the non-resident claiming DTAA tax relief is able to prove that:

- He is indeed a resident of the relevant DTAA country; or
- In case he is a recipient of incomes, that he is the 'beneficial owner' of those incomes; or
- That he has substance in the form of personnel, office, etc. in the country in which he claims he is resident.

Such measures are adopted by countries like China and Indonesia to prevent abuse of DTAAs. The above mentioned requirements are standard requirements in such countries. The exact details required by the Indian tax department will be known only when the rules in this context are provided.

13. Non-resident sportspersons and entertainers [Section 115BBA & 194E]:

The Income-tax Act has special taxation rules for non-resident sportspersons (who are not citizens of India) and non-resident sports associations or institutions. These persons are presently taxed at a rate of 10% on the gross receipts earned by them in India. No deduction of expenses is allowed. Further, once the tax is paid, they are not required to file a tax return in India.

Similar facility has now been extended to **'entertainers'** who earn incomes from their performance in India. Entertainers who are non-residents and not citizens of India will be covered.

Further, the tax rate for all the above-mentioned persons has been increased from 10% to 20% on the gross income earned by them. Similar amendments are proposed for deduction of tax at source from incomes payable to these persons. While the change in tax rate will be applicable from 1st April 2012, the revised rate for deduction of tax at source will be applicable only from 1st July 2012.

III. CORPORATE TAXATION:

14. Dividend Distribution Tax - Removal of Cascading effect [Section 115-O]:

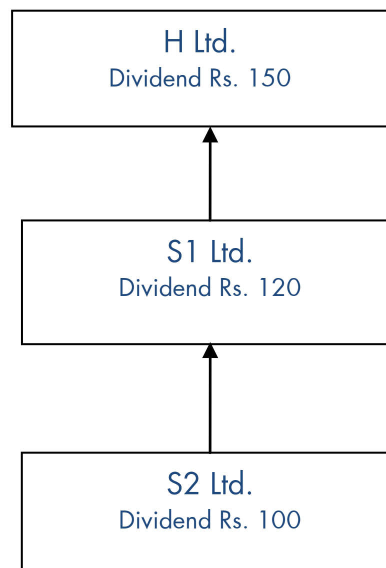
14.1 Presently a dividend distribution tax (DDT) @ 15% (surcharge and education cess are additional) is levied on payment of dividends by Indian companies to their shareholders. Such dividend is then exempt from tax in the hands of shareholders. As each company has to pay DDT on distribution of dividend, there can be a cascading tax effect on essentially the same income in a multi-layered corporate structure.

14.2 The present law was amended from 1st July, 2012 to remove the cascading effect of DDT in the hands of a top-level holding company of a multi layered corporate structure. This was done by providing a deduction of the amount of dividend on which DDT has been paid by the subsidiary from the amount of dividend declared by the Holding company to its shareholders. However, this relief was specifically not extended to holding cum subsidiary companies in a multi-layered corporate structure. An illustration is given below:

Illustration:

Current Provision:

H is the main holding company. S1 is the subsidiary of H & S2 is a subsidiary of S1.



As per the above example, S2 will have to pay DDT on the entire amount of Rs. 100 paid to S1. Now, at the time of payment of dividend of Rs. 120 by S1 to H, it will have to pay DDT on 120. This includes the dividend of Rs. 100 received from S2. Relief was specifically not made available at this stage as S1 is itself a subsidiary of H. However, when H declares a dividend to its shareholders, H will be able to reduce the amount of dividend which it receives from S2 (as H is is NOT a subsidiary of any other company, it is a top-level holding company). Thus there still remained a cascading effect of tax, though to a lesser extent.

14.3 To remove this cascading effect an amendment is brought into by the Government. As per the amendment even if the company is a subsidiary of any other company, it can still get the benefit of deduction of dividend received from its own subsidiary. This removes the cascading effect of DDT (though not completely as mentioned later on). This is explained below:

<u>Illustration:</u>

There is a multi-tier corporate structure as in the illustration above. The DDT is as under:

Sr. No.	Particulars	Amended Provision	Current Provision
1	DDT to be paid by S1 ltd. (Rs. 100 * 15/100)	15	15
2	DDT to be paid by S2 ltd. New - (Rs. 120 - Rs. 100) * 15/100 Old - (Rs. 120 * 15/100)	3	18
3	DDT to be paid by H ltd. (Rs. 150 - Rs. 120) * 15/100	4.5	4.5
	Total DDT paid by group companies	22.5	37.5

This shows now the cascading effect of dividends declared by domestic companies stands removed.

14.4 The present provisions remove the impact of multiple DDTs to a large extent. However, the provisions provide relief only when the dividend is distributed by all companies in the corporate structure in the

same financial year. Therefore, in our illustration above, if S2 receives divided from S1 in FY 2012-13, but distributes dividend to H in FY 2013-14, the present relief will not be available.

15. Tax on dividends received from foreign companies [Section 115BBD]:

Under section 115BBD dividends received by an Indian company from a foreign company during FY 2011-12 are taxable in the hands of the Indian company at a flat rate of 15%. The tax rate earlier was 30%.

The benefit of lower rate of tax has been extended for one more year, i.e., for F.Y. 2012-13.

Pre-condition for availing this benefit is that the Indian company should have a 26% equity stake in the foreign company. This continues.

16. Capital expenditure deduction [Section 35AD]:

Businesses generally only get a deduction of depreciation on the cost of capital assets purchased by them. However, to provide relief to certain industries, the Income-tax Act grants a deduction of the whole of the capital expenditure in the year in which it is incurred. For these industries, deduction is available for capital investments in plant and machinery and other capital assets (deduction is not available for land, goodwill or financial instruments). As per the present law, 8 different businesses are eligible for deduction under this section.

16.1 For the past few years, the Government is moving away from "income-based" reliefs, to "investment-based" reliefs. Therefore, the finance bill has proposed the relief for **three** more businesses as mentioned below:

i) setting up and operating an **inland container depot or a container freight station**;

ii) bee-keeping and **production of honey and beeswax**; and

iii) setting up and operating a **warehousing facility for storage of sugar**.

Entire amount of investment by these industries in capital assets is allowed as a deduction in the year in which the expenditure is incurred.

16.2 To provide increased incentive for setting up of certain businesses, it is proposed that a weighted deduction of 150% of capital expenditure incurred by them will be allowed as a deduction in the year of expenditure. These businesses are:

i) setting up and operating a cold chain facility;

ii) setting up and operating a warehousing facility for storage of agricultural produce;

iii) building and operating a new hospital with at least one hundred beds for patients;

iv) developing and building housing project for affordable housing; and

v) fertiliser production.

16.3 Further, looking at the common practices in the Hotel industry, a relief has been provided whereby, a taxpayer **owning a hotel** will be eligible to claim the deduction under this section, irrespective of the fact that he has **transferred the operation** of the hotel to another person while remaining the owner.

17. Weighted deduction for scientific research and development expenditure [Section 35]:

Under the existing provisions, a company is allowed weighted deduction at the rate of 200% of expenditure incurred on approved in-house research and development facilities. This relief was supposed to end by 31st March, 2012.

It is now proposed to extend this benefit for a further period of five years, i.e., up to 31st March, 2017.

18. Weighted deduction for expenditure for skill development [Section 35CCD]:

The Ministry of Commerce and Industry in their National Manufacturing Policy, 2011 had pointed out the large deficit of trained and skilled personnel for the manufacturing sector. The Policy statement provides a long-term plan for filling this gap. One of the steps envisaged was encouraging private sector in setting up of new training facilities either in separate facilities or as Industrial Training Institutes/Centres under the Public-Private-Partnership model.

In line with this policy, a new relief is proposed for a weighted deduction of 150% of expenditure incurred by a company (apart from cost of land or building) on a skill development project notified by the CBDT in accordance with prescribed guidelines.

19. Additional depreciation to Power sector [Section 32]:

19.1 Presently, under the Income-tax Act, additional depreciation is available @ 20% of the cost of new assets for manufacturing sector. This benefit was earlier not available for the power sector. The provision has now been amended to provide additional deprecation to power sector companies too. This benefit is available to all persons engaged in the generation of power or generation & distribution of power.

19.2 The additional depreciation is available over & above the normal depreciation claim (available at applicable rates). The depreciation is available only for one year, i.e., the year in which the asset is purchased & installed. The conditions presently applicable to additional depreciation claim for the manufacturing sector will be applicable here also. To list some of them - the assets should not be second–hand, or office appliances, or road equipment, etc. This step is taken to boost the investment in the power sector.

Additional depreciation is essentially "accelerated depreciation". The total depreciation over all the years can never exceed the cost of the asset. By providing additional depreciation, one will claim a higher depreciation in the initial year. In the subsequent years, the claim will be lower.

20. Profit-linked deduction for Power sector [Section 80-IA]:

As per the Income-tax Act, a deduction equal to 100% of the profits is currently available for any 10 consecutive years out of the first 15 years of operation by an enterprise engaged in generation of power or generation & distribution of power. This deduction was available if any enterprise starts generating power; or lays down distribution system for transmission of power; or undertakes major renovation & modernisation of the existing network of distribution & transmission; on or before 31st March, 2012.

The provision is now amended to extend this sunset clause by one more year until 31st March 2013. This extension of time period is primarily for encouraging investments in the power sector.

21. Funding of certain Infrastructure Sectors [Section 115A]:

21.1 Under the existing law, interest income paid by the Government or an Indian Concern to a non-resident is liable for withholding tax @ 20%. Further, any interest income received by a non-resident from a notified Infrastructure Debt Fund is taxable @ 5%.

21.2 The Finance Bill 2012 proposes to extend the rate of tax of 5% to interest received from any company in certain infrastructure sectors. Interest paid to a non-resident by an Indian company engaged in the prescribed businesses shall be taxable @ 5%. Such borrowing shall be subject to certain terms and conditions which is to be approved by the Central Government.

The company should be an Indian company engaged in any of the following businesses:

i) construction of dam,
ii) operation of Aircraft,
iii) manufacture or production of fertilizers,
iv) construction of port including inland port,
v) construction of road, toll road or bridge,
vi) generation, distribution of transmission of power,
vii) construction of ships in a shipyard,
viii) developing and building an affordable housing project as is presently referred to in section 35AD(8)(c)(vii).

22. Iran problem [Section 10 (48)]:

22.1 India imports a substantial amount of crude oil from Iran. Due to sanctions by the US and the world community, there are difficulties being faced by countries for doing business with Iran. The key issue is how to make payments to Iran in US$ or Euro or any other currency. India and Iran have worked out a solution so that Oil companies in India can make payments in rupees.

This solution has some difficulties. One of the issues is that payment will be made in India in Indian Rupees in Indian Banks to Iranian oil companies. Under the Income-tax act, if the money is **received** in India, it is taxable in India. India and Iran do not have a full-fledged. Therefore Iranian oil companies would be liable to Indian tax on the entire receipts.

To take care of this problem, a new section 10(48) has been introduced by the Government exempting from tax any amounts received by any foreign companies in Indian Rupee for the sale of crude oil. This section will take effect retrospectively & will cover all the notified agreements entered into from 1st April, 2011.

IV. Provisions for Individuals and HUFs:

23. Tax reliefs for senior citizens:

Citizens aged 60 years and above are considered as senior citizens for most of the Income-tax Act provisions. They have a higher slab limit for basic exemption from income-tax . Apart from the higher slab available to them, they have been provided following additional reliefs.

23.1 Exemption for Senior Citizens from payment of advance tax [Section 207(2)]:

Senior citizens having income other than "income from business or profession" will now be exempted from payment of advance tax. The tax liability can be paid as self-assessment tax by the due date of filing the return.

23.2 Reduction of Eligible Age of Senior Citizens for certain deductions [Sections 80D, 80DDB & 197A]:

There are certain relief provisions related to senior citizens where the qualifying age has remained at 65 years, even though the higher basic exemption limit is provided for all citizens above 60 years. In order to make the effective age of senior citizens uniform across all the provisions of the Income Tax Act, it is proposed to reduce the age for availing of the benefits by a senior citizen from 65 years to 60 years in the following provisions:

(i) Deduction in respect of health insurance premium paid by the tax payer for himself or his family [Section 80D]. Where the premium is paid towards health insurance of a senior citizen, the deduction is allowable up to a sum of Rs. 20,000 instead of Rs. 15,000. This relief is available to any tax payer and not only to senior citizens.

(ii) Deduction for the medical treatment of a specified disease or ailment in the case of an individual or his dependant [Section 80DDB]. If such expenditure is towards medical expenditure of a senior citizen, deduction is allowable upto Rs. 60,000 instead of Rs. 40,000.

(iii) No deduction of tax at source in the case of a senior citizen on furnishing of a declaration in Form No. 15H that the tax on his estimated total income of the previous year will be nil. This change will be applicable from 1st July 2012.

24. Deduction in respect of interest on deposits in savings accounts [Section 80TTA]:

It is proposed to allow deduction up to an extent of Rs. 10,000 to individuals and Hindu undivided families, in respect of any interest income earned on from a **savings bank** account. No relief is available for fixed deposit interest or any other interest.

25. Deduction for investment in Life Insurance Policy [Section 10(10D) and Section 80C]:

Incomes received from qualifying life insurance policies are exempt. Similarly, premiums paid for such policies are also allowed as a deduction under the overall Rs. 1,00,000 limit per financial year.

Presently, life insurance policies where premiums paid in any of the term years is 20% of the sum assured or below are qualified life insurance policies. To encourage investment in long-term policies, it is proposed to reduce the threshold of premium payable to 10% of the sum assured for both reliefs. Thus the policies will now have to be of at least 10 years.

26. Deduction for expenditure on preventive health check-up [Section 80D]:

26.1 Under the existing provisions, a deduction is allowed in respect of premium paid towards a health insurance policy of self, spouse and dependent children up to a maximum of Rs. 15,000 in aggregate. A further deduction of Rs. 15,000 is also allowed for health insurance premium in respect of parents.

26.2 It is proposed that any payment made by an individual or HUF on account of **preventive health check-up** of self, spouse, dependent children or parents shall also be allowed as deduction. The proposed deduction on account of expenditure on preventive health check-up can be upto Rs. 5,000.

The amount of health insurance premium is allowable, if payment is by account payee cheques. However, expenditure towards preventive health check-up can be in cash also. The payment can be made to any hospital or medical practitioner.

27. Relief from long-term capital gains tax on investment in SMEs [Section 54GB]:

The Ministry of Commerce and Industry has announced its National Manufacturing Policy in 2011. The goal of this policy is to promote investment in the Small and Medium Enterprises (SME) in the manufacturing sector.

To help achieve the above purpose, the Government has proposed to provide an exemption from long term capital gain to an individual or an HUF on sale of a residential house property. The exemption is available via a two-step process:

(a) First the net sale consideration has to be utilised for subscription of equity shares in a newly set-up SME Company in the manufacturing sector in which the tax payer would have majority control or majority share capital.

(b) This SME has then, within one year from the date of subscription in equity shares, utilises the amount for purchase of new plant and machinery.

The exemption will be available in the proportion of net sale consideration to the amount invested in the purchase of new plant and machinery by that SME.

Several conditions in relation to the SME, the new asset, etc. need to be fulfilled before claiming this exemption.

The relief would be available in case the transfer of residential property is made on or before 31st March, 2017.

V. OTHER IMPORTANT PROVISIONS:

28. Alternate Minimum Tax [Section 115JC to 115JF]:

28.1 For the past few years, the Government has taken a decision that any person claiming income-linked or profit-linked deductions must at least pay a minimum amount of tax. Therefore, amendments were made whereby companies claiming such deductions have to pay a Minimum Alternate Tax (MAT). However, since the introduction of LLPs, certain tax payers have started claiming such deductions under LLPs.

Therefore, from Financial Year 2011-12, an Alternate Minimum Tax (AMT) was levied on Limited Liability Partnerships (LLPs).

Now, to further tighten the provisions, from F.Y. 2012-13, the levy of AMT is widened to cover all persons other than Companies.. Thus, AMT will now apply to LLPs, **Individuals, Partnership firms, Hindu Undivided Family (HUF), Body of Individuals, Association of Person (AOP), Local authority & every other artificial juridical person**. AMT will be levied @ **18.5%** of its adjusted total income.

Thus a comparison will be made of – Normal tax, and AMT. The higher amount is payable as tax.

28.2 AMT provisions will apply to all of the persons mentioned above if they satisfy **any of the two conditions** mentioned below:

(1) Persons have claimed profit linked/income linked tax reliefs from the gross total income. It covers incomes like royalty on patents (Sec. 80RRB), profit from infrastructure development projects (Sec. 80-IA), profits of a developer of a Special Economic Zone (SEZ) (Sec. 80-IB), and other deductions available under the heading "Deduction in respect of certain incomes" of Chapter VI-A of the Act.

(2) Persons have claimed deduction from export incomes as units of a SEZ under section 10AA of the Act.

28.3 AMT is payable on adjusted total income which in essence is total income of a person before claiming any of the afore-mentioned profit-linked or income-linked deductions or under Section 10AA.

Illustration of working of AMT is as follows:

Particulars	Rs.	
Profit before relief u/s. 10AA	1,00,000	
Less: Relief u/s. 10AA	(40,000)	
Taxable income	60,000	
Normal income-tax @ 30% on Rs. 60,000	18,000	(A)
AMT @ 18.5% on Rs. 1,00,000 (income before deduction)	18,500	(B)
Tax payable (Higher of A or B)	18,500	

28.4 An exemption from AMT is provided if the total income before the specified deductions is Rs. 20 lakhs or below in a financial year. However, this exemption is not available for firms & LLPs. Normal tax will be paid by them in such cases.

28.5 **If AMT is more than the normal tax, then such excess will be available as credit for 10 future assessment years.** This can be used as a set off against normal tax if it exceeds AMT in the future. **By claiming the set off of excess AMT, the liability of tax can be brought down to the AMT level. But it cannot be reduced below AMT.** If any excess AMT is remaining after set-off, it will be carried forward to the subsequent years. An illustration is given below:

Illustration:

The working of carry forward & set off of AMT is shown below:

Sr. No.	A.Y.	AMT (Rs.)	Normal Tax (Rs.)	Tax payable (Rs.)	Tax set-off (Rs.)	Carried forward (Rs.)
1.	2013-14	700,000	400,000	700,000	NA	300,000
2.	2014-15	300,000	500,000	300,000	200,000	1,00,000

Notes to illustration:

i) In A.Y. 2013-14, when AMT (Rs. 7,00,000) exceeds normal tax (Rs. 4,00,000), theexcess tax (Rs. 3,00,000) which is paid by the tax payer will be allowed to be carried forward for 10 assessment years, i.e., up to A.Y. 2023-24.

ii) In A.Y. 2014-15, when the normal tax (Rs. 5,00,000) is more than AMT (Rs. 3,00,000), then the normal tax can be reduced to the extent of the excess (Rs. 2,00,000) . Balance excess of Rs. 1,00,000 can still be carried forward for further nine assessment years up to A.Y. 2023-24.

iii) One will have to pay minimum of AMT as tax in a year. Hence only Rs. 2,00,000 can be allowed to be set off. Thus normal tax can be brought down only to the extent of AMT & not below that.

iv) In A.Y. 2023-24 if any balance remains as AMT from the above Rs. 1,00,000 then it will lapse & will not be allowed for further carry- forward & set off . Such a situation might arise when AMT will be higher than the normal tax for several years after A.Y. 2014-15.

29. Venture Capital Funds or Venture Capital Company:

29.1 Sectoral restrictions removed [Section 10 (23FB)]:

Venture Capital Companies (VCC) or Venture Capital Funds (VCF) are exempted from income tax for incomes that they earn from the investments in Venture Capital Undertakings (VCU). Instead, the investors in the VCC or the VCF are taxed directly. VCC and VCF are treated as "pass-through entities". VCC, VCF and VCU are regulated by both SEBI and RBI.

The exemption was available for venture capital funding only in 9 specified businesses including nanotechnology, information technology, seed research & development, dairy industry, etc.

The Government now proposes to bring the sectoral restrictions on VCF or VCC at par with those already in place by SEBI or RBI. Therefore, exemption will be available to a VCC or VCF if the VCU is engaged in **any business** not prohibited by SEBI or RBI.

29.2 Income from VCC or VCF [Section 115U]:

As mentioned above, the incomes earned by VCC or VCF are exempt on satisfaction of certain conditions. These incomes are taxed in the hands of the original investor, i.e., investor in VCC or VCF, as if these incomes are directly received by the investor.

As per the current provisions, the tax is levied when the income is actually received by the investor from the VCC or VCF, i.e., it is taxed on receipt basis. It was noticed by the Government that many investors are taking advantage of this provision by retaining money with the VCC or VCF (being a tax free receipt in their hands). This resulted in a tax deferral. To plug this loop hole, this provision is now amended to provide for taxation of income in the hands of the invetor on accrual or receipt basis. Therefore, the tax will be levied on the investor if the income is credited to him by VCC/VCF or income is paid by VCC/VCF, whichever is earlier.

Further, in a case where income earned by a VCC or VCF in a particular year is not credited or paid to the investor, it will be deemed that such income is credited to the account of the investor on the last day of such year. The Government is trying to block the tax deferral with the help of these amendments.

30. Simplified assessment [Section 44AD]:

30.1 For small businessmen, a simplified scheme of tax payment has been introduced recently. If the businessman has turnover of up to Rs. 60 lakhs, 8% of his turnover or receipts would be deemed to be his profits from business. However, if he claims a profit of less than 8% of his turnover or gross receipts, then he is required to get his accounts audited.

30.2 This threshold limit of total turnover has been increased from Rs. 60 Lakh to Rs. 1 Crore. It has been however been provided that this scheme is not available to:

i) Professionals in the field of Law, Medicine, Engineering, Accountancy, Architecture, Interior Decorator, Technical Consultancy, Film Artists (Directors, etc.), Company Secretary and Information Technology;

ii) Persons earning income in the nature of commission or brokerage; and

iii) Persons carrying on any Agency business.

It is worthwhile to note that exclusion of the above persons is more a clarification & less of an amendment. In our view, the section was not applicable only to businessmen and not professionals. As this amendment is made to resolve any doubt, it is to take effect retrospectively from A.Y. 2011-12 (F.Y. 2010-11), the year in which this section become applicable.

However, the above list of professionals are ones who are required to maintain books of accounts. With this amendment, any professional not covered in the above list (and with other conditions being applicable) is now covered.

31. Capital Gains:

31.1 Reference to a Valuation Officer [Section 55A]:

In a case where the capital asset became the property of the tax payer (or of the previous owner) before 1st April, 1981, the tax payer has the option of substituting the cost of acquisition with the fair market value of the asset as on 1st April, 1981. Higher the fair market value adopted by the tax payer as cost, the lower would be his capital gains on sale.

As per present provisions of the Income-tax Act, the Assessing Officer could not refer this valuation to a Valuation Officer, even if he was of the opinion that the value claimed by the tax payer is higher than the fair market value, due to the specific wording of the relevant provision.

It is proposed to change the wording so that if the Assessing Officer is of the opinion that the value taken by the tax payer is higher than the fair market value of the asset as on 1st April 1981, then he can make a reference to the Valuation Officer. The valuation officer would then determine the fair market value of the property as on 1.4.1981.

This amendment is applicable with effect from 1st July, 2012

31.2 Fair Market Value to be full value of consideration in certain cases [Section 50D]:

Income chargeable as Capital gains on transfer of a capital asset are to be computed as sale consideration *less* cost of acquisition. In some recent rulings it has been held that where the consideration is incapable of being valued or it remains unascertainable, the gains arising from transfer are not taxable. (Goodyear Tire & Rubber Co. [2011] 199 Taxman 00121 (AAR), Amiantit International Holding Ltd.[2010]189 Taxman 00149 (AAR), Bharat Bijilee Ltd.[2011] 10 Taxmann.com 253 (Mum. - ITAT))

It is therefore proposed that in case of transfer of capital asset, if consideration is not determinable, fair market value of asset shall be the full value of the consideration.

32. Threshold Limit for audit of accounts [Section 44AB]:

For the purpose of tax audit requirement, a threshold has been specified. If the turnover of a person doing business is Rs. 60 lakhs or more; or if a professional has a turnover of Rs. 15 lakhs or more; he has to get his accounts audited.

These limits have been revised to Rs. 1 crore in case of a businessman. and Rs. 25 lakhs in case of professionals.

33. No deduction for cash donations in excess of ten thousand rupees [Section 80G and 80GGA]:

Section 80G and 80GGA provides deduction in respect of certain donations. Currently, there is no provision in either of the aforesaid sections specifying the mode in which donations can be made. Therefore, donations could be made in cash too.

It is now proposed that any donation exceeding Rs. 10,000 shall be allowed as a deduction only if such sum is paid by a mode other than cash.

VI. AMENDMENTS RELATED TO TAX DEDUCTIBLE AT SOURCE & ADVANCE TAX:

34. Purchase of Immovable Properties [Section 194LAA]:

34.1 It is proposed that from 1st October, 2012, all persons who purchase immovable properties from **residents of India** will be required to deduct tax at source when they make the payment of consideration. (For payment to non-residents, different provisions apply.)

34.2 The person making a payment will be required to deduct tax at source @ 1% on sale proceeds of the property & deposit the same with the Government.

The purpose is to make the people who earn income on sale of property, come within the tax net. Persons, who earn capital gain and claim full relief by investing in relief bonds, may not file any tax return as their income may be below the taxable limit. If tax is deducted, then to claim a refund, such person will have to file a return. The department then can look at the facts.

34.3 If the purchase is of agricultural land, no tax is required to be deducted while making the payment.

34.4 As a measure of relaxation, Government has provided threshold limits, below which no tax has to be deducted at source. A person is required to deduct tax at source only if the consideration paid or payable for the property exceeds:

- Rs. 50,00,000 for property situated in urban areas (i.e. Mumbai, Delhi, Kolkata, Chennai, Hyderabad, Bangaluru, Ahmedabad, Faridabad district, Gurgaon district, Gautam Budh Nagar district, Ghaziabad district, Gandhinagar district & Secunderabad).

- Rs. 20,00,000 for property situated in any other areas.

34.5 It should be noted that even **non-residents** making the payment for the purchase of immovable properties to residents will be hit by the provisions of this section.

34.6 In cases where the sale consideration will be less than the value determined by the State Government for stamp duty valuation, <u>the stamp</u>

duty valuation will be considered as sale consideration. Thus the payer will be required to deduct the tax at source on the stamp duty valuation or the agreed sale price, whichever is **higher**. It is also proposed that without the deduction of tax, the registration authority will not register the transfer of the immovable property in the name of the buyer.

34.7 Normally the deductor of tax has to file a Tax Deducted at Source (TDS) return. He has to obtain a Tax Deduction Account Number (TAN), file returns, issue TDS certificates, etc. Considering that purchase of property will be a rare transaction for most of buyers, the section provides some relief from procedural compliances. The purchasers will not be required to file any TDS returns nor obtain a TAN. Only a single page challan will have to be filled in by the purchaser at the time of making the payment of TDS to the Government. The seller would get credit for the TDS on the basis of this challan. It seems no separate TDS certificate will be required.

34.8 There can be some practical issues which one will have to consider. Assume that a person pays booking amount to a builder for booking a flat. He will deduct tax @ 1% of the booking amount. Later the buyer decides to cancel the booking for some reason. The purchaser will not be able to refund the tax to the builder. In such a case, the purchaser must demand full refund of his payment including the TDS amount. The builder will have to claim a refund of the TDS in his return. One will need to have clarity with the builder.

As it is, purchase of immovable property requires several checks and compliances to be done. This is one more.

35. Remuneration to Directors of Companies [Section 194J]:

35.1 Companies have to deduct tax at source from salary paid to Directors. On payment of professional fees also, tax has to be deducted at source. However for payment of **any other remuneration or commission to directors,** there is no specific section.

35.2 From 1st July 2012, tax will be required to be deducted at the rate of 10% on such payments. Tax is required to be deducted only if the payments cross a threshold limit of Rs. 30,000 in a financial year. Once the payments exceed Rs. 30,000, then tax is to be deducted on the whole of the amount and not on the amount which exceeds Rs. 30,000.

36. Consequences of failure to deduct TDS – where tax has been paid by the payee [Section 201(1A) & Section 40(a)(ia)]:

36.1 There are stringent conditions for deduction of tax at source from specified payments covered under the TDS provisions and their payment to the Government within specified time limits. Where a person fails to deduct tax or does short-deduction, he is treated as an "assessee in default" and he can be proceeded against for recovery of the tax. He can also be levied a penalty. Further, as a disincentive, expense claimed on account of such payment would also be disallowed until the tax is actually deducted and paid.

36.2 However, a person deducting tax at source is doing so as an agent of the Government. There Honourable Supreme Court in Hindustan Coca Cola Beverage (P.) Ltd. V/s Commissioner of Income -Tax 293 ITR 226(SC) had held that in cases where the payer has defaulted in deducting tax; but the payee has suo-moto paid up the tax; no further default exists as far as the payer is concerned. The decision had given reference to CBDT Circular No. 275/201/95-IT(B), dated 29-1-1997. In the circular, it has been stated that such instance will not alter the liability to charge interest till the date of payment of taxes by the deductee-assessee and penalty.

36.3 As per the above circular and taking a practical view, interest in such instances was computed from the date when tax was deductible to the date when the tax was suo-moto paid up by the payee as advance tax. However, as tax paid by the payee was advance tax, it would be difficult to link the payment to the deduction of tax at source. Therefore, there would be issues related to computation of interest.

The payer could be levied penalty for his default in deduction of tax at source.

Also, technically, as no tax was deducted at source, the expense claim could be disallowed, irrespective of the fact that the tax on such income was paid by the payee.

36.4 The Government now proposes to make amendments to bring clarity in this area. Therefore, the tax payer will **not be** considered as an 'assessee in default' if the payee (who should be a resident of India):

i) furnishes his return of income; and

ii) includes the payments which are received from the tax payer (without the deduction of tax) in his total income while filing the return; and

iii) pays up the tax due on the total income as computed in his return of income.

Further, the date when return is filed by the payee will be considered as the date when the payer has deducted the tax at source and paid to the Government.

36.5 Therefore, for the purposes of calculating the interest on failure to deduct TDS, the period from the date on which the TDS should have been deducted by the payer, to the date on which the payee files the return of income would be considered.

36.6 As the payer would not be considered as an 'assessee in default', therefore, related penal provisions would not be applicable.

However, it should be noted that a separate penalty related to non-deduction of tax at source (equal to the amount of tax not deducted) would still be leviable. Of course, the penalty is not automatic and could be waived in genuine cases.

36.7 The payer will also get a deduction (if otherwise available) of the payment made by him. Deduction is available in such cases on the basis of the date when tax is actually deducted at source and paid. For this too, return filing date of the payee will be considered as the date of payment of TDS. Deduction would be available accordingly.

Illustration:

Foreign Co. A, employer of Mr. B (an Indian resident), is required to deposit TDS by 7th May 2012 from salary payments made to Mr. B on 24th April 2012. However, tax is not deducted at source by Co. A. Equivalent advance tax is paid by Mr. B on 6th May 2012. Mr. B in the above example, while filing his income tax return on 31st July, 2014, includes the amount of the salary on which tax is not deducted at source in his total income & pays tax on the same at rates applicable to him. In such a case, following would be the legal implications for Co. A under the current & amended provisions:

As per Current provision	As per Amended provision
a. Co. A would be considered to be in default even though full tax is paid by Mr. B.	a. Co. A will not be considered as an assessee in default. 31st July 2014 will be considered as date on which tax is deducted and deposited with the Government.
b. Co. A would not be required to pay interest as the advance tax is paid before the due date for payment of TDS.	b. Further, Co. A will be liable to pay interest on late deduction of tax at source from 24th April, 2012 to 31st July, 2014 on the amount of TDS. This is the case even though Mr. B has paid the equivalent tax before 7th May 2012.
c. Co. A would not get deduction of the amount of salary paid to Mr. B.	c. Co. A would get complete deduction of the salary amount paid to Mr. B in FY 2012-13.
d. Co. A would be liable to pay penalties both for being an assessee in default and for non-deduction of tax at source.	d. Co. A would not be levied penalties applicable to assessees in default. However, penalty for non-deduction of tax at source can be levied.

There are other minute issues which can be considered if and when the issue actually arises.

37. Liability to pay advance tax in case of non-deduction of tax [Section 209]:

37.1 Under the existing provisions of the Income-tax Act, the amount of advance tax payable is computed after reducing the amount of TDS that would be deductible on the estimated annual income. However, in a case where TDS is not deducted, tax is directly payable by the income receiver. A view was held by the Delhi Tribunal in **Pride Foramer SAS** ([2008] 24 SOT 59 (Delhi)), that 'direct payment' of tax is meant for recovery of tax and not for advance tax payment. Hence, interest on delay in payment of advance tax is not chargeable in cases where tax is not deducted at source from income nor advance tax is paid.

37.2 The finance bill proposes to amend the above position such that only tax already deducted at source will be allowed as a credit against tax payable while computing advance tax. Therefore, while estimating annual advance tax, tax deductible at source on estimated income cannot be claimed as credit for the computation of advance tax unless already paid.

37.3 While the amendment was aimed to correct the position as far as interest payable on advance tax was concerned, the wording is not good. A technical interpretation of this amendment would mean that even a **salaried employee** who earlier was not required to pay advance tax (as full amount of tax would be deducted from his salary) would be required to pay advance tax in respect of salary income not yet received.

The impact is that interest will become payable in case advance tax is not paid in respect of salary income to be earned. We would have to see whether any clarifications are issued by CBDT in this behalf.

VII. INCOME-TAX RATES:

38. Income tax rates for Individuals and HUFs:

38.1 Income tax rates for Individuals and HUFs have been maintained at the last year's level. Basic exemption limit for Individuals and HUFs has been marginally raised from Rs. 180,000 to Rs. 2,00,000.

There is a general category of individual taxpayers, senior citizens aged 60 years and above, and senior citizens aged 80 years and above. **Different slab rates for men and women have been done away with.**

38.2 The revised slab rates for individual taxpayers (not senior citizens) are as under:

Income	Rate of tax (percent)
Up to Rs. 200,000*	Nil
Rs. 200,001 to Rs. 500,000	10
Rs. 500,001 - Rs. 10,00,000	20
Rs. 10,00,001 and above	30

* In case of resident taxpayers who are senior citizens aged 60 years and above but below the age of 80 years, the basic exemption limit is Rs. 250,000.

* In case of resident taxpayers who are senior citizens aged 80 years and above, the exemption limit is Rs. 500,000.

Education and Secondary and Higher Education Cess has been retained at 3 percent.

The revised tax rates will save tax between Rs. 1,030 (income of Rs. 2,00,000) and Rs. 22,660 (income of Rs. 10,00,000). For income above Rs. 10,00,000, the tax on such additional income will remain same as that in last year.

39. Corporate Income-tax rates:

39.1 Domestic Companies:

The basic income tax rate has been retained at 30 percent in case of domestic companies. The surcharge which is levied on income above Rs. 10 million has been retained at 5%. Education cess has also been retained at 3%. So the **effective rate of income tax, for domestic companies with income over Rs. 10 million is 32.445%; and for companies with income of Rs. 10 million or below is 30.90%.**

39.2 Foreign Companies:

For foreign companies, the income tax rate has been retained at 40 percent. The surcharge which is levied on income above Rs. 10 million has been retained at 2%. Education cess has also been retained at 3%. So the **effective rate of income tax for foreign companies with income over Rs. 10 million is 42.024%; and for foreign companies with income of Rs. 10 million or below is 41.20%.**

x------------- Analysis Complete -------------x