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Direct Taxes Code 2009

Clarifications on DTC

Date: 12th September, 2009.

1. Invitation to Participate in Law Making:

CBDT has invited representations, suggestions, comments, from all over. Any individual, association, assessee, who has any suggestions to make about the DTC, can send the same by an e-mail to the CBDT. This is for the first time that the department is actively & positively asking for all suggestions. The e-mail address provided by CBDT is as under:

directtaxescode-rev@nic.in

A circular issued by CBDT inviting suggestions is given at the end of this article. It suggests the format in which representations may be sent.

2. Clarifications:

I had an opportunity to listen to Joint Secretaries, TPL, CBDT- Mr. Arbind Modi and Mr. Ashutosh Dikshit in two conferences held at Mumbai in the last week of August 2009. Both of them have given several clarifications at the conference. I am trying to give some of the clarifications in this article. I have tried to be honest to their words to the extent possible. However, still there are chances of variations and errors on my part. And this article does not cover all that they have clarified.

This article is not to explain or dispute the provisions of Direct Taxes Code (DTC). Nor to give my views in the matter. This is an attempt to say what I have understood to be department's philosophy behind DTC.

This article cannot be considered to be a clarification by the Government. Government's formal clarifications are given in the Discussion Paper & future clarifications will be probably given by CBDT by way of circulars & revised draft. Still, however, I believe, a lot of misunderstandings can be cleared if their views are known to the profession. Hence I am presenting this article for the consideration of all the members.

The **language** of the DTC is “user friendly”, simple, with easy flow. All “provisos” & “explanations” are avoided. Each section has short sentences. Even a layman can understand. Attempt is made to draft the law in such a way that the taxability of income can be determined by asking simple “Yes” & “No” questions. Income-tax return should be filed with the help of a simple software.

Tax rates have been proposed to be reduced. Idea is that they will remain stable. However, if there are any contingencies, Parliament will always have powers to do what it considers appropriate. Law will be **stable, not rigid**. Direction of the law will remain uniform.

Both the Joint Secretaries have stated very clearly that there are many errors and mistakes in the draft. These may be grammatical mistakes, omission of some words etc. There may be some concepts which have not been fully developed. Several provisions will come through the rules. They have already received 200 suggestions. There may be a thousand more comments pointing out mistakes. They will consider all these comments & suggestions. This is a positive, open invitation for all comments & representations. In their words:

“Let this law be made by every one. It need not be a law drafted only by CBDT. When every one is given an opportunity to participate in law making process, every one should abide by the law.

“In a democracy every one has a right to be heard. Final decision will of course be taken by the Parliament.”

3. The proposed **Action Plan** is as under:

By 30th September, 2009 department wants to receive all representations from all interested parties. In the first week of October the department will review all the representations received. In October & November, 2009 these representations will be considered and DTC will be revised in consultation with the Law Ministry.

In the last week of December, 2009 the finalised bill will be presented before the Parliament. Thereafter this bill may be referred to a Select Committee or the Standing Committee of the Parliament. This committee may again invite representations from all concerned. Hence people will have a further time upto May or June, 2010 to make further representations.

Thereafter the Parliament may consider and pass the bill, hopefully by August, 2010. A process for drafting the rules under the Direct Taxes Code will start. Entire code with rules will be available to the people long before 1st April, 2011.

The DTC will be applicable to all incomes earned on and after 1st April, 2011. Interpretation of some provisions of DTC suggests that DTC will be applicable from assessment year 2011-12. Such provisions will be modified in line with department's intention stated here.

Let us make our representations considering the department's views. We may agree or disagree. That is democracy.

4. Economic Philosophy of Taxation:

How much tax may be levied on what basis is a subject of economics + politics + philosophy. Tax base on which tax may be levied may be any thing. Income need not be the only base. Ideally, a person's "**ability to pay**" should be the base for collection of tax. The concept is explained in Chapter III of the Discussion Paper issued with the DTC. A theoretical concept has to be modified to see what is practical. Hence the actual definition of Income ignores several items which may contribute to the assessee's ability to pay.

5. International Taxation

5.1 Rates:

Corporate tax rate has been brought down to a maximum of **25%**. Companies will pay tax @ 25%. Even **foreign companies** have been brought **at par with Indian companies**. In other words, the tax rate of 42.2% applicable to foreign companies has been brought down to 25% + taxes discussed in the next paragraph.

5.2 BPT:

Indian companies pay an additional tax called "**Dividend Distribution Tax**" (DDT). To bring foreign companies at par with Indian companies, a "**Branch Profit Tax**" (BPT) is proposed. Both the rates are 15%. It is true that in case of an Indian company, the DDT is payable only when it declares dividend. Whereas for the Indian branch of a foreign company; the BPT will be payable irrespective of any remittance abroad.

5.3 There is an error in draft DTC section 100. A clear interpretation would indicate that BPT is payable by all foreign companies on all their Indian incomes. The department's intention is to tax only the Indian income earned by a branch or a permanent establishment of a foreign company. The "special source" incomes like interest, dividend, royalty etc. are not liable for BPT. Appropriate amendments will be made in the DTC.

6. Treaty Override:

- 6.1 The Joint Secretaries have declared and have requested all professionals to tell their clients and associates abroad the following: **“India shall stand by all its international commitments.** India has never violated its international commitments & it will not. We have no intention of violating any agreement that we have entered into. We are committed to the **Vienna Convention.** It requires both countries to an agreement to implement the agreement in good faith. **‘In good faith’** applies to both the countries to the agreement and not just to India. If one party to the agreement does not implement the same in good faith, we are acquiring enough powers under the law to take care of the situation.”

This statement may be elaborated as under:

Intentions of the Income-tax department are: (i) Treaty abuse shall not be permitted. (ii) GAAR provisions will override Treaty provisions. (See paragraph 7 below.) In all other cases including rate of tax (TDS), treaty provisions will override DTC.

Section 90 of the Income-tax Act provides that between the treaty and the Income-tax Act, whichever provision is **more beneficial** to the assessee shall prevail. This is understood as “Treaty over riding Act”. It will continue to do so for normal provisions. However, as far as “General Anti-Avoidance Rules” (GAAR) are concerned, Act will over ride the treaty. In other words, if an assessee abuses a treaty and avoids tax, Income-tax department will invoke GAAR. The department will nullify all attempts to avoid Income-tax by abusing a treaty.

- 6.2 Direct Taxes Code (DTC) provides that between the treaty and the Act, whichever provision is **later shall prevail.** If every thing goes as per the plans, DTC will come into effect from 1st April, 2011. Foreign Taxes Division of the CBDT is preparing protocols for all the treaties signed by India. Where a treaty is normal, India will issue protocol with effect from 2nd April, 2011. Hence the treaty shall over ride the Act. However, wherever the treaties are open to abuse, or where the treaty is not equitable, department will negotiate with the Income-tax department of the relevant country. After negotiation, a revised protocol will be issued. Until the revised protocol is issued, DTC provisions shall over ride the treaty.
- 6.3 DTC provides for tax rates higher than the rates provided in most of the treaties. If different governments co-operate in issuing fresh protocols, then the treaty rates will come into effect. If they insist on permitting or encouraging treaty abuse, then the DTC will take care.

7. GAAR - General Anti Avoidance Rules.

Sections 112, 113 & 114 provide for GAAR and sections 161 & 166 provide for consequent action. Deeming provisions of S. 5 also help. The department's messages and the provisions:

7.1 For Indian Income-tax department "**Substance will prevail over Form**". It is not anyone's "Right" to do tax planning & to avoid tax. If anyone does a "planning" and avoids tax; department will ignore the planning & collect full tax. For example, "Treaty Shopping" is "not on". If anyone does treaty shopping, the same shall be ignored & taxes will be collected. GAAR will of course apply to domestic incomes as well as international incomes.

7.2 Wherever department has found an "**Impermissible Avoidance Arrangement**" (IAA), income-tax department wants to acquire right to "**blow whistle**" at the earliest practical time. Department will send a clear message that such an IAA will not be allowed. To make necessary rules & declarations to tax incomes which otherwise would escape; department now is acquiring rights through the rule making exercise.

7.3 Reversing Judicial Decisions.

Wherever the assessee receives a judicial order in his favour, the law may be amended with retrospective effect. Tax will be recovered even from the assessee who has won the appeal. And where the appellate order is in favour of the department, the DTC enables the department to reopen completed income-tax assessments for the concerned assessee as well as all other assesseees who have similar issues. This takes away certainty of completed assessments and keeps the tax payers in suspense for too long a period. Is it fair?

Department's view is:

"There should be a **level playing field** amongst all tax payers. Most of the assesseees do not/cannot do elaborate planning. They would comply with the law & pay full taxes. Some people who can afford the advices of international tax consultants can do elaborate planning and avoid Indian taxes. Tax compliant assesseees are in effect suffering for the actions of non-complaint assesseees. It is the duty of the income-tax department to prevent such **cross subsidisation**."

"If all the assesseees are to be treated equally, in the case of a judicial decision against the department, one of the following two alternatives has to be adopted:

- (i) Either refund the taxes to all the assesseees who have complied with the law and paid taxes; or
- (ii) Recover the tax from the assesseees who have taken a different interpretation and won at appellate level.

We think the second course of action is better.”

The message is: Department does not appreciate much difference between tax evasion & tax avoidance. Both will not be permitted. If assessee loses an appeal, of course he will be liable to pay the tax. If department loses an appeal, the law will be changed with retrospective effect.

7.4 Apparently these powers are too wide in the hands of the department. Assessee is exposed to uncertainties as well as harassment. Appropriate system for **checks & balances** can be introduced in the law. Department invites suggestions from all concerned for such a system of checks & balances.

8. Illustration of an IAA & a Permissible Transfer:

The tax planning done by Vodafone and Hutchison Essar for avoiding capital gains tax is clearly a scheme which would be considered in Impermissible Avoidance Arrangement (IAA).

An issue arises: there may be several instances of **international mergers & acquisitions**. For example, a global multinational company having several subsidiaries all over may have one subsidiary or a branch in India. That holding company may be taken over by another company. In such a case, would GAAR apply?

Probably, this is a question of degrees. In the case of Vodafone & Hutchison, it was clear tax avoidance. One would admit that a plain tax haven company is not a company with substance. A tax haven company may not successfully claim that it is a separate legal entity. However, where the holding company has a real business and substance; the principle that “the company is a separate legal entity” and on transfer of shares in the company, the assets & liabilities of the company are not transferred; remains true. Hence wherever there is substance, a foreign transfer may not involve the transfer of Indian assets.

9. Residential Status of a Company.

9.1 Under the DTC even a foreign company would be held to be an Indian resident if even a part of its control & management was in India for a part of the previous year.

Department's stand is: At present there is a "**minimalist**" definition of a foreign company's residential status. This allows substantial tax avoidance. For example:

An Indian resident is liable to Indian tax on this global income. If he invests abroad or otherwise earns any foreign income directly in his personal name, he will be liable to Indian income-tax. However, if he simply incorporates a tax haven company abroad; and then makes the foreign investment or otherwise earns the foreign income; then he will escape the Indian tax on the foreign income. Department cannot do any thing with this "**Minimalist**" definition.

Department does not want to permit such tax avoidance. Hence they are proposing a "**Maximalist**" definition. The foreign company which is controlled by the Indian shareholder/s will be treated as an Indian resident and taxed in India. The issue is: "where is the dividing line!" In an attempt to curb tax planning, genuine foreign, non-resident companies may be put to avoidable troubles. For example, Tata group has acquired a British company - Corus. Corus is certainly controlled atleast partly from India. Will its global income be taxable in India?

Under the DTC as per the present draft, Corus's global income will be taxable in India. A proper system will have to be built in the DTC to avoid this kind of injustice.

9.2 Residential Status vs. CFC.

For controlling such tax avoidance, several countries have passed legislation for "Controlled Foreign Companies" (CFC). India has proposed to change the definition of residential status. The two concepts are fundamentally different.

Under the CFC provisions, normally only **passive** income is taxed. Under residential status, all income will be taxable. Normally, when CFC provisions are introduced, simultaneously, the provisions for **Underlying Tax Credit** (UTC) are also made. Under DTC, tax net is cast wider than CFC provisions & UTC is not granted.

10. E-Commerce:

DTC does not give a solution for taxation of income arising from E-Commerce transactions. Department's stand is:

"Business will continue to grow in many new manners. All developments cannot be envisaged in advance & cannot be provided in the law. Amending the law is a lengthy exercise. We would like to have adequate powers to make rules to determine the source of income, its location & taxability. Then CBDT can make rules as & when new situation warrants. All rules will be placed before the Parliament."

11. MAT:

It is proposed to change the basis for MAT from profits to Gross assets. Companies will be required to pay - normal income-tax; or 2% of their gross assets - which ever is higher.

Is imposition of **tax on assets** under **Income-tax Act** constitutionally valid! Department: "DTC will not be **Income-tax Act**. It will be **Direct Taxes Code**. For a direct tax, Government of India may adopt any value as tax base."

Is it fair to tax on **gross assets**! It would be logical to allow deduction of liabilities. Department: "This is not a tax on net wealth. There are companies that collect large funds from the market, then employ the funds in the inter-corporate funds market & delay the projects considerably. Some companies acquire large land banks & then do not start projects. We want to discourage companies holding large assets making an in-efficient use of scarce capital resources available in India."

Is it fair to impose taxes on **loss making companies**! For example, Air India. Department: "More than 4,50,000 companies file their income-tax returns. Out of these, only around 50,000 companies pay income-tax. Rest declare losses year after year. They even continue to grow but do not pay any income-tax. How do we determine whether the loss declared is genuine!"

Similarly, **infrastructure companies** have long gestation period. They will have large assets & will start making profits after several years. If department starts taxing them even before they really make profits, is it not unfair!

Foreign companies will be liable to tax in India on their Indian incomes. Will they also be liable to pay MAT!

Several industrial houses have layers of **holding - subsidiary-subsubsidiary** companies. Share capital of a subsidiary is invested in assets by the subsidiary. Their shares also form assets in the books of the holding company. Thus the same asset may be taxed several times over.

Department: "DTC should be tax neutral for Government. While we are proposing tax rate reduction, we have to continue several tax exemptions like SEZ. These provisions are grand fathered. (Their time limits have been fixed.) However, until all tax exemptions are repealed, we need an alternative mechanism to protect tax revenue. Gross Assets at book value is a good stable tax base."

12. Rate of TDS on payments to Non-Residents:

An issue was raised as under. Many foreign suppliers of technical knowhow etc. insist that they will not bear the tax to be deducted at source (TDS) as per the Indian Income-tax Act. Hence the Indian payer has to bear the tax. Then the TDS has to be **grossed up**. Many times, the tax to be borne by the Indian party is **higher than the net profit margin** available in the business. What is the solution!

Department: "India is the third largest economy in the world and continues to grow at 6% plus rate per year. Rest of the world is either in recession or grows at 2% per year. Whole world wants to do business with India. If any one wants to do business with India, it has to abide by Indian law. They have to accept TDS as per the law. And if they want treaty reliefs, they have to obtain Permanent Account Number. Where necessary, they have to obtain Tax Deduction Number."

One reason for significant amendments in International tax provisions is as under. When Indian companies invest or do business abroad, they are treated shabbily by the foreign tax departments. When foreign companies are taxed in India, their tax officers rush to India making representations on their behalf. We want **reciprocal equality** in taxation for Indian & foreign companies. If a country treats our companies well, we will treat their companies well. If a country does not treat our companies well, we will have enabling powers in the Act & Rules to take appropriate legal actions.

Direct Tax Code is a substantial matter. In two conferences, several issues have been discussed. This note cannot give full justice to all the issues discussed. However, an attempt is made to give an idea of the department's philosophy behind the DTC. Kindly consider. If you have

any suggestions, either send to the Chamber, or send directly to the department.

Thanks,

Rashmin Sanghvi

Next page: CBDT circular inviting suggestions

**Constitution of a Committee to examine
the suggestions on the draft Direct Taxes Code**

**F. No. 402/78/2009-ITCC
Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes**

Dated : August 28, 2009

Sub : Constitution of a Committee to examine the suggestions on the draft Direct Taxes Code

In the Board meeting held on 27th August 2009 the following decisions were taken :

- (i) Suggestions will be invited from all the officers and the public regarding the Direct Taxes Code. Suggestions will be invited through the Cadre controlling CCITs and also directly from the officers through IRS officers online.
- (ii) The suggestions has to be received by the core Committee by 10th September and a draft based on suggestions and their studies will be prepared by the core Committee by 15th September which will be put before the full Board for consideration.
- (iii) The final suggestions as approved by the full Board shall be placed before the Finance Minister.
- (iv) The Core Committee will constitute of the following officers :
 1. CIT (C&S) - Convenor and the remaining sections
 2. CIT (ITA) - All sections relating to Exemptions and Assessment procedure
 3. CIT (Inv) - All Sections relating to Search and Seizure, Surveys, Penalty and prosecution
 4. CIT (IT&CT) - All sections relating to TDS, Recovery and Other taxes
 5. CIT (A&J) - All sections relating to Appeal, judicial work and Definitions
 - 6 and 7. JS (FT &TR)-I and II - All sections relating to International Taxation and transfer Pricing
 8. CIT (MC) - Structure of the Board

The suggestions may be invited in the following format : -

Sl.No.	Chapter of NDTC	Section of NDTC	Provisions of NDTC	Change Suggested	Brief reasons for the suggested change

NDTC - New Direct Taxes Code

It is therefore requested that this letter may be given wide publicity and suggestions on the Direct Taxes Code may be sent in the above format by 10th September. the same may also be sent by email to email id directtaxescode-rev@nic.in

This issues with the approval of the Chairman, CBDT.

(Mona Singh)
Dir (ITCC)