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DIRECT TAXES CODE 2013: AN OVERVIEW

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ABSTRACT

After releasing Direct Tax Code on August 12, 2009 (DTC-I) and revised Direct Taxes Code on August 30, 2010 (DTC-II), again a fresh bill in the form of Direct Tax Code 2013 (DTC-III) was tabled on April 1, 2014 by the Indian Ministry of Finance (MoF) for public comments and review, with the aim to replace the more than five-decade-old Income-Tax Act, 1961 and Wealth Tax Act, 1957. Various stakeholders submitted their suggestions to the Standing Committee on Finance (SCF) on DTC-II. The SCF after deliberating with various stakeholders submitted their report to the Parliament on March 9, 2012. Finally, out of 190 recommendations made by the SCF, 153 have been accepted wholly or with partial modifications in DTC-III. The present paper seeks to highlight the major changes made in DTC-III from that of DTC-II accepting some suggestions of SCF. It encompasses introduction of and/or modification in significant concepts like indirect transfer of capital assets, place of effective management, super rich persons, wealth tax etc. It also pinpoints some of the recommendations that have been rejected by the MoF, e.g., proposal to link exemption limit to the consumer price index, deduction for CSR expenditure in backward regions and districts, general anti-avoidance rules (GAAR) while designing this new revised Direct Tax Code (DTC-III).

KEYWORDS

Direct Tax Code, Income Tax Act, Ministry of Finance, Standing Committee on Finance, Wealth Tax Act.

INTRODUCTION

The draft Direct Taxes Code (DTC), which aims to replace the archaic Income Tax Act,1961 and Wealth Tax Act, 1957, was released, along with a Discussion Paper (DP-I) on August 12, 2009 for public discussion and comments. Since then, a number of valuable inputs on the proposals were received from a large number of organisations and individuals. The inputs were examined and the major issues on which various stakeholders had given their views were identified. The Revised Discussion Paper addresses these major issues. The revised Direct Taxes Code (DTC-II) making changes in the earlier DTC (DTC-I), subsequent to the issue of Discussion Paper-II (DP-II) was introduced in the Lok Sabha on August 30, 2010. The Bill shows that in DTC-II, not only the changes mentioned in DP-II have been made, but a host of other changes and new provisions, like those relating to settlement of cases and settlement commission have also been incorporated (Gupta, 2012).

Various stakeholders have submitted their suggestions to the SCF on the DTC 2010. The SCF, after deliberating with various stakeholders, submitted their report to the Parliament on March 9, 2012. Since the Direct Taxes Code Bill, 2010 (DTC-II) was introduced in the Parliament, a good number of amendments were carried out in the Income-tax Act, 1961 and the Wealth-tax Act, 1957 through Finance Acts, 2011, 2012 & 2013. Incorporating these amendments and recommendations of SCF in the DTC Bill, 2010 would have made the Bill incomprehensible and the legislative process cumbersome. So, it was decided to present the Direct Taxes Code as a fresh Bill incorporating the amendments and most of the recommendations of SCF. Accordingly, a new revised Direct Taxes Code was drafted and unveiled on April 1, 2014 as Direct Tax Code, 2013.

OBJECTIVES OF THE STUDY

The current study has the following major objectives:

a) To highlight the major changes proposed in the direct tax legislation of India through DTC 2013.
b) To pinpoint some significant recommendations of SCF trashed by the MoF in designing DTC 2013.

MAJOR CHANGES PROPOSED IN DTC 2013

Out of 190 recommendations made by the SCF, 153 are proposed to be accepted as it is or with partial modifications. In addition to the recommendations forming part of the report, 61 suggestions forwarded by the SCF at the discussion stage, have also been accepted for incorporation in the revised Code i.e., DTC 2013. Some of the recommendations of the SCF which have been proposed to be accepted are as under:-

(A) **AN INDIRECT SHARE TRANSACTION WILL BE TAXED IN INDIA IF ATLEAST 20% OF THE ASSETS ARE BASED IN INDIA:** DTC 2010 introduced provisions to tax income of a non-resident, arising from indirect transfer of a capital asset situated in India. It provided for a 50% threshold of global assets to be located in India for taxation of income from indirect transfer in India. However, this threshold of 50% has been perceived by the Finance Ministry to be too high. In their opinion, "there could be a situation that a company has 33.33% assets in three countries but it will not get taxed anywhere" (MoF explanatory notes). The revised DTC 2013 provisions relating to tax incidence arising on indirect transfers provide for a threshold of 20% of the value of global assets to be located in India for triggering a tax incidence in the country. This would pertain to deals such as the one between Vodafone International Holdings BV and the Hutchison Telecommunications International Ltd (HTIL) (www.livemint.com). Further SCF's recommendations relating to exception to intra group restructuring outside India and transfer of listed shares outside India have not been accepted in DTC 2013. The only silver lining is that an exemption has been provided for transfer of small shareholdings (up to 5%) outside India (TOI, April 2, 2014).

(B) **PLACE OF EFFECTIVE MANAGEMENT:** Currently, a company is treated as a tax resident of India and subject to tax on worldwide income if it is registered in India or, during a year, the control and management of its affairs is situated wholly in India. DTC 2010 had introduced the globally accepted norm of POEM to determine tax residency. However, an ambiguous definition meant that even a stray Board meeting by a foreign company in India could result in its global income being taxed in India.

Now, there is much clarity in determining tax residency for companies as the revised DTC 2013 has suitably amended the definition of place of effective management (POEM). DTC 2013 has provided that POEM means the place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are in substance made (www.businessworld.in).

(C) **TAX PINCH FOR 'SUPER-RICH' PERSONS:** DTC 2013 focuses on raising more revenue from high net worth individuals, Hindu Undivided Families (HUFs) and artificial juridical persons by levying 35% tax rate on annual total income over Rs. 10 crore, while leaving the tax slabs unchanged for others. In this connection it is worth mentioning that the MoF has rejected several recommendations made by SCF, including a change in income tax slabs and removal of some of the cesses, arguing that the move will result in an approximate revenue loss of Rs. 60,000 crore. The panel (SCF) headed by former Finance Minister Yashwant Sinha had favoured revising the slab with no tax on income up to Rs.3 lakh (now Rs. 2 lakh), 10 per cent on income between Rs.3 lakh and Rs.10 lakh (Rs.2-5 lakh), 20 per cent on Rs.10-20 lakh (Rs.5-10 lakh) and 30 per cent for income beyond Rs.20 lakh (now Rs.10 lakh and above). So, the country's super-rich may end up paying more tax on their earnings if the recommendations in the draft Direct Taxes Code Bill, 2013, become a reality. With a view to maintaining overall progessivity in levy of income tax, the revised Code has provided for this fourth slab for individuals, HUFs and artificial judicial persons.

(D) **WEALTH TAX WILL COVER FINANCIAL ASSETS TOO :** Financial assets, as per DTC 2013, will be included under the ambit of wealth tax as compared to only physical assets at present. It is another bad news for the moneyed as the proposal says that Wealth Tax will now extend to financial assets as well. The good news is that the threshold is being raised from Rs. 30 lakh to 50 crore and the levy is proposed to be brought down from 1% at present to 0.25%. So, if DTC 2013

is accepted in the present form, the distinction between physical and financial assets will be removed for wealth-tax which is proposed to be levied on individuals, HUFs and private discretionary trusts.

(E) **LEVY AN ADDITIONAL 10% TAX ON THE RECIPIENT OF DIVIDEND PAYMENTS IF THE DIVIDEND INCOME EXCEEDS Rs. 1 CRORE:** Under the Income-tax Act as well as in the DTC Bill, 2010, a dividend distribution tax of 15% is levied on the company distributing the dividend and not on those who receive the dividend. This favours high net worth taxpayers who pay only a fraction of their earnings as tax on their investments in the capital market. The draft DTC (i.e., DTC 2013) proposes to remove this anomaly by levy of 10% additional tax on the resident recipient if the total dividend in his hand exceeds Rs.1 crore (Direct Taxes Code,2013). This could bring promoters of big companies who receive a huge amount of income as dividend under the net.

(F) **RATIONALISATION OF PROVISIONS FOR NON-PROFIT ORGANISATIONS:** Taxation of non-profit organisations (NPO) has been rationalised by taxing their surplus at a concessional rate of 15%, at the same time allowing basic exemption limit of Rs.1 lakh and permitting all capital expenditure as revenue outgoing as well. In addition, the draft Code does not provide for specific modes of investments. It says that an NPO would be free to make its investments, other than the limited prohibited modes of investments. Consequently, specific deduction for accumulation and the provision for carry forward of deficit are proposed to be removed in DTC 2013(www.incometaxindia.gov.in).

(G) **SCALE DOWN THE R&D BENEFITS FROM TAXATION:** DTC Bill, 2010 provides for weighted deduction of 175% to the donor on any donation made by it to the specified institutions to be utilised by them in scientific research. Weighted deduction of 200% is also provided for in-house scientific research. Since, the weighted deduction reduces the actual expenditure on research and there is significant potential for its misuse, the new Code now provides for a reduced weighted deduction of 150% for in-house scientific research and only 125% deduction for donations to specified institutions. This may prove to be a major setback for institutions who had geared up to set up R & D facilities for availing the attractive deductions (www.thehindubusinessline.com).

REJECTED RECOMMENDATIONS OF SCF

The recommendations of the SCF which were found to be inconsistent with the broad taxation policy of the Government have not been incorporated in the revised Code. Some of the significant recommendations of the SCF, still not discussed in the present paper and which have been rejected by the MoF while framing DTC 2013, are mentioned below:

(A) **PROPOSAL TO LINK EXEMPTION LIMIT TO THE CONSUMER PRICE INDEX:** MoF felt linking exemption limit to the consumer price index impracticable for a number of reasons. Out of the reasons stated by them, one important doubt in their mind was the ambiguity as to why the Consumer Price Index (CPI) should be the base and why not the Wholesale Price Index (WPI). Their further defense in support of rejecting the recommendation was that, indexing the slabs to inflation index would not a be comprehensive approach as the slab structure is dependent on a number of factors, including other reliefs given to a taxpayer, number of taxpayers who would go out of the tax net and consequent potential revenue loss to the Government, etc. So, the suggestion to link the exemption limit to the consumer price index has been trashed by the ministry.

(B) **THE RATE OF TAX FOR LIFE INSURANCE COMPANIES KEPT AT 30% INSTEAD OF THE PROPOSED 15%:** Under the existing Income-tax Act, tax on a life insurance company is levied at the rate of 12.5% of the surplus generated in the profit and loss account of the company based on actuarial valuation. But, in the Code (DTC 2010), the tax base for a Life Insurance Company is limited to the surplus generated for the company in the shareholders account and the surplus determined in the policyholders' account (technical account) is not taxable. Therefore, rate of tax chargeable on life insurance companies, as proposed in DTC 2010, is also kept in line with that applicable to other companies, i.e., 30%. Hence, the proposal of SCF that the rate of tax applicable for life insurance companies be reduced to 15% , has not been accepted in DTC 2013.

(C) **PROPOSAL TO ABOLISH SECURITIES TRANSACTION TAX (STT):** The recommendation is also rejected by the MoF. It has argued that the levy is needed to regulate day trading and the burden has already been reduced by reducing STT rate significantly by the Finance Act, 2013. So, complete abolition of STT as was proposed by the SCF has been trashed by the Finance Ministry of India.

(D) **DEDUCTION FOR CSR EXPENDITURE IN BACKWARD REGIONS AND DISTRICTS:** The Companies Act, 2013 provides that every company, on fulfilment of certain conditions, is required to incur certain expenditure (2% of their net profits) on Corporate Social Responsibility (CSR). But, there is no specific provision to allow such expenditure either under the Act or DTC 2010. So, SCF wanted a deduction in respect of CSR expenditure in backward region and districts to encourage more CSR activities in those designated places. But, MoF argued that allowing deduction for CSR expenditure would imply that the government would be contributing one third of this expenditure as revenue foregone and hence, no provision has been proposed in DTC 2013 to allow CSR expenditure as a deductible expenditure.

(E) **GENERAL ANTI-AVOIDANCE RULES (GAAR):** Provisions of GAAR, originally introduced in DTC 2009, has been subsequently included in the Income Tax Act through amendments, applies to transactions which are 'impermissible avoidance agreement'. In its present form in the Act, even if a part of the arrangement is impermissible arrangement, the entire arrangement is considered as impermissible arrangement. It was proposed by the SCF that only part of the arrangement should be revoked which has been proved to be impermissible instead of the entire. But, the recommendation has not been accepted in DTC 2013.

Some other significant recommendations of the SCF which are proposed to be accepted are as under:-

(i) Deductions for individual taxpayers to be focused on long term needs like social security.
(ii) Maintaining uniformity in 'grandfathering' provisions so that the available benefits for different categories under the existing Income-tax Act are phased out in a uniform and non-discriminatory manner ensuring smooth transition to DTC provisions.
(iii) A distinction should be made between commercial and non-commercial renting of properties for the purposes of taxation of income under the head 'Income from house property'. The concept of unrealised rent should also be built in as is the position under the existing Income-tax Act.
(iv) In case of self occupied house property, for the purposes of deduction in respect of interest on loan taken, the loan given by the employer should also qualify for this concession.
(v) Tax neutrality should be provided on conversion of a partnership firm under the Partnership Act, 1932 into a limited liability partnership (LLP) or a company.
(vi) Where compensation is received on compulsory acquisition of an investment asset, the period for acquiring the new asset for the purpose of relief from capital gains should be calculated from the date of receipt of such compensation.
(vii) With a view to facilitate smooth transition from IT Act to Direct Taxes Code, provision be made to treat losses, remaining to be carried forward and set off as per the provisions of the existing Income-tax Act, on the date on which DTC comes into effect.
(viii) The non-profit organisations should be given an option to adopt either the cash system or accrual system of accounting for computing their income.
(ix) The Income-tax Act provides for carry forward of tax paid on book profit (MAT credit). A provision may be made in the DTC Bill to carry forward the unutilised MAT credit under the IT Act, on the date on which the DTC comes into force (www.incometaxindia.gov.in).

CONCLUSION

Finally, it can be said that the latest version of Direct Taxes Code, which was published on the website of income tax department website for comments from the stakeholders, is aimed at widening the tax net, removing ambiguities and plugging loopholes in the current tax laws**,** has been a mixed bag with some dampener for industry and also some positive surprises. But, the fate of DTC depends on the policies and priorities of the next Union Government.

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