Direct Tax Code version 2.0…

The government of India has come out with a revised draft of the Direct Taxes Code (DTC) that proposes several changes over the first draft to deal with some of the major concerns raised in the first draft. It is open for public comments till June 30, 2010. The proposed changes in the revised draft, its impact and our views are mentioned herein below.

- **MAT to be calculated on book profits as compared to gross assets**

Revised provision is positive for companies that are eligible for MAT…

The revised draft suggests that book profits rather than gross assets, as proposed in the first draft, should be used to calculate the minimum alternate tax (MAT). However, the tax rate as a percentage of the book profits has not been specified. Under the previous draft, it had been proposed to calculate the MAT on gross assets (0.25% for banks and 2% for all other companies). However, the revised draft also does not allow for carry forward of MAT paid.

Our view: The revised provision is positive for companies that are eligible for MAT, as the calculation of MAT on gross assets, as provided in the first draft, could have led loss-making companies, newly set up infrastructure companies and companies undergoing major expansions to pay very high taxes.

- **Tax exemption on withdrawal for select saving schemes**

The revised DTC version seeks to provide marginal relief to taxpayers by allowing select saving schemes under EEE regime

Under the first draft, it was proposed that withdrawals towards saving schemes would be subject to taxation at the applicable marginal rate of tax (EET taxation). The revised draft now proposes complete tax exemption for government provident funds (GPF), public provident funds (PPF), recognised provident funds (RPF), pension schemes administered by Pension Fund Regulatory and Development Authority, approved pure life insurance and annuity schemes.

Our view: The provisions are marginally positive for individual taxpayers. However, the tax exemption on withdrawals applicable only on pure life insurance schemes is negative as unit linked insurance plans (ULIPS) would be subjected to tax on withdrawal. Also, it will be negative for mutual funds as withdrawal from equity linked savings schemes would be subject to tax post implementation of DTC. The new pension scheme will, thus, have an edge over the other market related savings instruments as it will be the only instrument providing equity exposure (50%) and have the withdrawals exempted.

Exhibit 1: Taxation regime for various tax savings instrument according to revised DTC

EEE tax Regime	EET Tax Regime
Provident fund	NSC
- Governement	Infrastrucuture Bonds
- Recognised Provident Fund	Bank FD
Pension Fund	Nabard Bonds
Pure Life Inurance	Unit linked Insurance Plan
Annuity Schemes	Equity Linked Savings Scheme

Source: Company, ICICIdirect.com Research

- **Retirement benefit & perquisites exempt from tax**

Under the first draft, retirement benefit was exempt only if deposited in the retirement benefit account. In the revised draft, all retirement benefits received are exempted subject to specific limits without the need to deposit the same in any specified account. Also, the first draft proposed to tax the medical facilities/reimbursements. The same has been removed in the revised draft with a proposal to enhance the monetary limits. Rent free accommodation is now taxed even for government employees. However, the value of such accommodation shall not be based on market value.

Our view: The revised provision is positive for salaried individuals as retirement benefits will not be taxed and taxable salary shall further reduce to the extent of enhancement in monetary limits of medical facilities/reimbursements. Not computing the value of rent-free accommodation on market value basis is more beneficial for government employees.

- **Income from house property**

Erstwhile provisions of the Income Tax Act allowed principal repayment of housing loan to be claimed under Sec 80C while interest on housing loans up to Rs.1,50,000 would be claimed separately under section 24 (b) for self occupied property. Now, clubbing of this deduction under threshold limit of Rs 3,00,000 under Sec 80C would not make much difference between individuals with or without housing loans

Under the revised draft, notional rent based on 6% of the rateable value or cost of construction has been removed. Hence, the rent from the property that is let out would be the amount of actual rent received or receivable. The revised draft also proposes to allow the deduction up to Rs 1,50,000 on account of interest on capital borrowed for acquisition/construction of self occupied property from "Gross Total Income".

Our view: The introduction of the deduction factor is a positive development as the earlier draft was silent on incentive given to interest paid on home loans. This led to widespread fears that this provision would be withdrawn.

Exhibit 2: Total available limits for deduction from total income

Particulars	As per the IT Act		As per the DTC ver 1		As per the DTC ver 2	
	Individuals with housing loan	Individuals without housing loan	Individuals with housing loan	Individuals without housing loan	Individuals with housing loan	Individuals without housing loan
Under 80C*	100,000.00	100,000.00	300,000.00	300,000.00	300,000.00*	300,000.00
Interest on Housing Loan u/s 24 (b)	150,000.00	-	-	-	-	-
Total available limit	**250,000.00**	**100,000.00**	**300,000.00**	**300,000.00**	**300,000.00**	**300,000.00**

** Interest on Housing loans have now been included in the revised DTC draft under thresold deduction limit of Rs.3 lac*

Source: ICICIdirect.com Research

Introduction of long-term capital gains on equity investments will be a negative development for the equity markets. However, the introduction of the deduction factor for long-term capital gain is a positive development

- **No difference between long-term, short-term capital gains for tax rate**

The revised draft proposes to raise the tax on short-term gains on equity investments to the marginal income tax rate from the current 15%. It is further proposed that the long-term capital gains, which are currently tax-exempt, should be taxed at applicable marginal/corporate tax rate after reducing a specific deduction factor. In the earlier draft no deduction factor had been provided for.

Our view: The introduction of long-term capital gains on equity investments will be a negative development for the equity markets. However, the introduction of the deduction factor for long term capital gain is a positive development, as the earlier draft carried no mention of it.

Exhibit 3: Capital gains tax rate comparison

Particulars	Tax rate as per IT Act		Tax rate as per DTC ver 1		Tax rate as per DTC ver 2	
	LTCG	STCG	LTCG	STCG	LTCG	STCG
Listed Securities traded on recognised stock exchange	Nil	15%	As per the slab rate		As per the slab rate	
Other Securities	10% or 20%*	As per the slabe rate	As per the slab rate		As per the slab rate	
Assets other than securities	20%	As per the slab rate	As per the slab rate		As per the slab rate	

** taxrate of10% if indexation benefit not availed, 20% if indexation benefit is availed*

LTCG: Capital asset held for a period of more than one year from the end of financial year in which asset is acquired.

Source: ICICIdirect.com Research

- **Income arising on purchase and sale of securities by FIIs to be considered under capital gains**

Earlier, a majority of FIIs used to report their income from investments as capital gains. However, some of them were characterizing such income as “business income” and, consequently, claiming total exemption from taxation in the absence of a Permanent Establishment in India. This leads to avoidable litigation. The revised draft also clarifies that the capital gains arising to FIIs shall not be subjected to TDS and they will be required to pay tax by way of advance tax on such gains as is the existing practice.

Our view: Marginally negative for FIIs classifying the gains as business income. However, this proposal seeks to simplify the system of taxation, bring certainty, eliminate litigation and is easy to administer.

According to the present norms, SEZs are given 100% tax exemption for the first five years, 50% for the next five years and 50% of the ploughed back export profit for the remaining five years

A company incorporated outside India will be treated as resident in India if its "place of effective management is situated in India

- **Extension of profit linked deductions to units operating in SEZ**

  It has been pointed out that while the current profit linked deductions available to developers of special economic zones (SEZs) have been protected for their unexpired period in the first draft of DTC, there is no mention of granting these profit linked deductions in the case of units operating in these SEZs. Thus, the revised proposals accord tax holiday protection enjoyed by the business units currently operating out of SEZs for the unexpired period.

  Our View: The revised version brings in marginal relief for the companies currently operating under SEZs. This would also hasten the work of companies wanting to set up their units in the SEZs before March 31, 2011 as existing units and those, which would be approved before March 31, 2011, would continue to enjoy the tax holiday. However, it has remained silent on the issue of what sort of incentives they would be subjected to after the implementation of DTC from April 1, 2011.

- **Place of effective management – the test of residence for foreign companies**

  In the first draft, a foreign company will be treated as resident in India if, at any time in the financial year, the control and management of its affairs is situated "wholly or partly in India. It has now been made clear that the company incorporated outside India will be treated as resident in India if its "place of effective management" is situated in India. "Place of effective management" of the company means where the Board of directors/executive directors or officers perform their functions regularly.

  Our View: Positive for foreign companies as companies with partial management will not be considered as resident Indian. Hence, a foreign company conducting one odd meeting at any time in India will not get covered as the effective management provision requires execution of the management function on a regular basis

- **Double taxation avoidance agreement (DTAA) vis-à-vis domestic law**

  The earlier draft provides that between the DTTA and the domestic law, the provision that is later in time shall prevail. Hence, since DTC will come into effect later, it will override the DTAA agreements. In the current draft, the DTAA override provision has been rolled back and the one that is more beneficial shall apply. However, in cases where the General Anti Avoidance Rule, Controlled Foreign Corporation provisions, or when Branch Profits Tax is levied, the DTAA shall not have preferential status over domestic law.

  Our view: The rollback of DTAA override provision will benefit FIIs. FIIs play a major role in the Indian stock markets. A majority of them are located in such countries having DTAA with India, which effectively makes their tax liability nil for gains in India. Applicability of DTAA will therefore not affect foreign inflows form such FIIs. Also, it will be beneficial for all other institutions set up in countries having DTAA with India. India has a comprehensive DTAA with 79 countries.

Apart from the above there are a number of other issues which, though not part of this Discussion Paper, will be considered while finalising the Bill for introduction in Parliament. The government expects to present the final DTC to the Parliament during the monsoon session later this year.

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