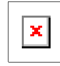

News

Direct Tax Code – Conversation with SR Patnaik, Direct Tax Partner at Luthra & Luthra
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Finance Minister, Pranab Mukherjee on Wednesday released a draft of the Direct Taxes Code (DTC). The press release from the Government said "….Government will consider inputs and suggestions received from the public before finalizing the Direct Taxes Code Bill for introduction in Parliament sometime during the Winter Session." The DTC and the Discussion Paper are available here.

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The 35-page revised discussion paper on the draft DTC, seeks to replace the 50-year-old Income Tax Act. The current Income-tax Act that was enacted in 1961 replaced the pre-independence Income Tax Act of 1922. The Government had, therefore, announced its intention to introduce a revised and simplified Income-tax Bill while presenting the Union Budget for 2005-06. Finance Minister in his budget speech had said, "I propose to pursue structural changes in direct taxes by releasing the new Direct Taxes Code within the next 45 days and in indirect taxes by accelerating the process for the smooth introduction of the Goods and Services Tax (GST) with effect from April 1, 2010.

The Revenue Secretary, Sunil Mitra speaking to the Press had said the Finance Ministry had received more than 1,600 responses for the draft DTC that was circulated earlier in August 2009.

Bar & Bench spoke to SR Patnaik (*pictured*), Partner, Direct Tax, Luthra & Luthra on the changes to the draft DTC and its implications.

What is the one major effect of the new draft of the Direct Tax Code?

In my view, one of the most important effects of the recent Revised Discussion Paper on DTC issued by the Ministry of Finance yesterday is the change in position of the Indian Government dealing with the taxation of non-residents in India.

The revised discussion paper proposes that *"place of effective management"* may be considered for determining the residential status of a foreign company instead of the physical place from which "control and management" was exercised either fully or partially. To clarify, as per the earlier provisions, if certain amount of control or management was exercised from India even for a day (say an MNC holding its Board Meeting in India), it could have led to the constitution of a taxable presence of the foreign company in India. However, as per the revised Discussion Paper, foreign companies will no longer be considered as tax residents of India in cases where partial control was situated in India provided the effective control and management of the company remains outside India. This is a welcome change and could provide requisite relief to a number of multi-national entities who were very nervous when these provisions were initially introduced.

The Revised Discussion Paper also tries to dilute the other controversial "later in time" principle on the basis of which it suggested that in case of any conflict between the domestic law and the relevant Double Taxation Avoidance Agreements ("**DTAA**"), the provision that was introduced later should be applicable thereby making all DTAAs signed by India till the date of introduction of the DTC subservient to the provisions of the DTC since the DTC would have been a later legislation. However, the Revised Discussion Paper reiterates the existing principle and suggests that the provisions that are more beneficial to the taxpayer shall apply. This is another welcome change that will calm the nerves of many foreign investors.

Have there been any changes that have been left out in the new Direct Tax Code, which could have been included?

The revised discussion paper on DTC is silent on some of the other major issues, which could have been included. Some of them are:-

1. The Revised Discussion Paper does not provide the tax rates and seems to suggest that the tax rates could go up in view of the concessions granted through this discussion paper.
2. It does not specify the extent of adjustments to be allowed in respect of long term capital gains arising from the sale of equity and equity linked instruments.
3. The Revised Discussion Paper does not specify whether tax benefits available to Units operating outside the SEZ (e.g. deduction u/s 80IA / 80 IB / 80 IC, etc.) will be continued or not. The clarification deals only in respect of units operating in SEZs.
4. The Revised Discussion Paper does not deal with the issue of MAT Credit.
5. The DTC defines the term "associated enterprises" for the purpose of transfer pricing in a very stringent manner and has widened the scope of transfer pricing to a great extent. The main changes made by the DTC vis-a vis the provisions of the Income Tax Act, 1961 ("**the Act**") to expand the scope of transfer pricing are provided as follows:-

(a) The threshold limit of 26% in shareholding to constitute an enterprise as associated enterprise under the Act is reduced to 10% in the DTC;

(b) As per the DTC, an enterprise advancing a loan of 26% (as against 51% specified in the Act) or more of the book value of total assets of the loanee, would also constitute an associated enterprise.

(c) The threshold limit under the Act relating to nomination of directors has also been reduced to 1/3rd from ½ for the purpose of constitution of associated enterprise

(d) The threshold limit of purchase of 90% or more of the raw material from another enterprise in order to constitute associated enterprise has also been reduced to 2/3rd.

Thus, it is evident from the above that the amended definition of associated enterprise as prescribed under the DTC may include, within its ambit, a number of enterprises under the definition of associated enterprises. Concerns were raised in this regard as it could lead to significant increase in the compliance costs and may also lead to additional litigations, procedural requirements, etc. for a number of companies. However, the Revised Discussion Paper is silent.

Of all the major changes mentioned in the Direct Tax Code, India Inc. has hailed the competency of Minimum Alternate Tax. Your views on the previous computation versus the revised one?

The DTC provided for the computation of MAT on the basis of "value of gross assets" of the company. The computation of MAT on the basis of "value of gross assets" would have led to undue hardship in the case of capital intensive industries, industries with long gestation period and loss making companies as they would have ended up paying taxes despite of

incurring heavy losses. A number of business associations had also claimed that certain industries would become commercially unviable in case they were forced to pay MAT on the value of their gross assets.

The Revised Discussion Paper on DTC reverts to the earlier position of computation of MAT on the basis of “book profits”. Though the exact manner of computation of book profits has not yet provided in the Revised Discussion Paper on DTC, it can be expected to be on the similar lines as provided under the Act. In my view, the proposed change in the MAT computation can be considered as a welcome change.