

Date: 5th April, 2007.

Income Tax amendments proposed in the Budget 2007

General observations:

1. As in the previous year, there are not many changes. However this could be due to possible introduction of a new tax code in near future.
2. There has been a marginal increase in tax rates.
3. Some changes propose to undo what court decisions have decided. This has been the trend for the past few years. If any view is sought to be taken by the tax payer which is different from the intention, the government amends the law with retrospective effect.

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1. Tax rates:**1.1 The basic tax rates have been untouched.**

The **surcharge** of 10% will now apply on incomes above Rs. 1 crore, except for individuals & Hindu Undivided Families. For individuals & HUFs, the surcharge continues to apply on income above Rs. 10,00,000.

There is an additional education cess of 1% (total 3%) for all persons.

1.2 The rates of tax will now be as under:

Sr.	Persons	F.Y. 2006-07 (%)	F.Y. 2007-08 (%)
1.	Individual & HUFs. (Maximum marginal rates for income above Rs. 2,50,000.)		
1.1	Income upto Rs. 10,00,000 (1 million).	30.60	30.90
1.2	Income above Rs. 10 lakhs (1 million).	33.66	33.99
2.	Partnerships and Indian companies.		
2.1	Income upto Rs. 1 crore (10 millions).	33.66	30.90
2.2	Income above Rs. 1 Crore (10 millions).	33.66	33.99
3.	Foreign Companies.		
3.1	Income upto Rs. 1 Crore (10 millions).	41.82	41.20
3.2	Income above Rs. 1 crore (10 millions).	41.82	42.23

For incomes between Rs. 10 lakhs & Rs. 1 crore; individuals & HUFs pay a tax higher than firms & companies.

1.3 There are changes in rates of tax on dividends distributed by companies and mutual funds. (In India, tax is paid by the companies & mutual funds which pay dividends. Investors do not have to pay the tax.)

Sr. No.	Dividend Paid by	F.Y. 2006-07	F.Y. 2007-08
1.	Indian companies.	14.025	16.995
2.	Money Market, Mutual funds & Liquid funds.		
2.1	Paid to individuals & HUFs.	14.025	28.325
2.2	Paid to others.	22.44	28.325
3.	Other mutual funds.		
3.1	Paid to individuals.	14.025	14.1625
3.2	Paid to others.	22.44	22.66

Incomes on the surplus funds of companies parked in treasury bonds, or liquid instruments, were liable to tax @ 33.66%. To avoid this tax, they used to park the funds in a Money market fund. The income of the fund is exempt. Dividends paid by these funds were taxed at 22.44%. This gave an arbitrage opportunity of saving 11.22% tax. The budget seeks to reduce this opportunity to 5.235%.

2. Paintings and other Works of Art:

People have been investing in paintings, sculptures and similar work of art. If on sale, there is any income, is such income liable to tax?

2.1 Existing Position:

Different situations are possible.

If the work of art has been considered as a capital asset, any gain on sale will be considered as capital gains.

If a person is a dealer in work of art, the gain will be considered as business income.

If the work of art is a "personal effect", it is not liable to tax. People have claimed work of art as "personal effect" and avoided paying tax on gains. It has become a practice, that any sale of work of art is claimed as sale of "personal effect".

What is a "personal effect" has been dealt with by several Court decisions. Any item which has an intimate and personal connection with the person like apparel, furniture etc. is considered a "personal effect". A person's status, social standing etc, are also to be considered. What may be personal for a king may be an investment for a common man.

Therefore just because an item is a work of art, does not mean it is exempt from tax.

2.2 Proposal in the Budget:

Now the budget has clarified that all paintings and work of art will be considered as "capital asset". Therefore any income on sale will give rise to capital gain. Of course if a person is a dealer in work of art, then the income will be business income.

3. Employee Stock Options (ESOPs): FBT.

3.1 Companies grant Employee Stock Options (ESOPs) as a perquisite. India has a beneficial tax regime for taxation of ESOPs. Normally the ESOPs are taxed in the hands of the employee at the time of "exercise" of the options.

(i.e. the employee accepts the shares against the stock options granted to him.) In India the same are taxable only when the employee sells the shares (provided the rules of ESOP scheme are satisfied). If the rules of ESOP scheme are not satisfied, then the tax is payable on Exercise of Shares.

If the ESOP scheme guidelines are satisfied, it gives two benefits:

- i) The tax is deferred till the time the shares are sold.
- ii) On sale of shares, the income is considered as Capital Gains. It may result in lower taxes. Normally, the shares are of a quoted company. In case of long term capital gains, income-tax will be reduced to "NIL". For unquoted shares, one may be able to reduce tax on Long Term Gains by investing in specified bonds / property.

3.2 The budget now proposes to levy Fringe Benefit Tax (FBT) on ESOPs on "exercise" of option. The tax will be payable as Fringe Benefit Tax (FBT). Therefore the employer company will pay FBT on share options exercised by its employees.

3.3 The FBT is payable @ 33.99% on difference between the market price (on the date of exercise of option), and the exercise price.

An example explains the new tax system:

Sr.	Particulars.	Rs.
1.	Market price of share on the date of exercise of option.	2,000
2.	Price at which employee has been granted the share (exercise price).	1,500
3.	Fringe Benefit (2,000 - 1,500)	500
4.	Fringe Benefit Tax @ 33.99% - payable by employer.	170
5.	Sale of shares by the employee after a certain period of time.	3,000
6.	Capital Gain in employee's hands (3,000 - 2,000) (Market price on the exercise of the share will be the cost.)	1,000
7.	Tax on Capital Gains.	
7.1	Shares of Indian public listed company - sold on stock exchange:	
	- held for more than 12 months.	NIL
	- held for upto 12 months (assuming that income is more than Rs. 10 lakhs).	11.33%
7.2	Shares of Indian unlisted company, or foreign company	
	- held for more than 12 months.	22.66%
	- held for upto 12 months (assuming that income is more than Rs. 10 lakhs).	33.99%

(Securities Transaction Tax is in addition to the above referred income-tax.)

3.4 Thus the taxation of ESOPs is restored back on the lines of international practices.

There is one practical advantage is the new scheme of taxation.

In the earlier regime (prior to 2001), the employee had to pay the tax on exercise of options. In the example given above in paragraph 3.3, the employee had to pay tax on Rs. 500. However, at that time, there was no “**cash flow**” to the employee. The employee got cash only on sale of shares. Whereas the tax due was payable on exercise. The tax had to be paid out of employee’s other income resources. This could create practical difficulties especially in case of companies where prices had appreciated substantially.

Now with companies paying the tax as FBT, the cash flow situation for the employee is more or less sorted out. Company pays the tax. And yet, for the employee; it helps increasing the ‘cost’ of shares; and thus reducing tax.

3.5 Cross border issues:

The movement of employees across the countries has increased considerably. ESOPs have their own peculiar problems. The options may be - granted when an employee is in one country, vest when employee is in second country, exercised when he is in a third country, and finally sold when he is in a fourth country. Taxation can occur on grant, vesting, exercise or sale. This leads to its own problems. These are existing problems, and hence not discussed.

Now with FBT, there could be a different set of problems. Some of these are discussed below. There could be others.

FBT is paid by the employer on its expenditure on salaries - perquisites. DTA relief is available to the assessee who suffers the tax on his income. Hence legally, neither the employer, nor the employee will get credit for FBT under DTA.

In fairness, one of the two should get the credit. This unfair position is illustrated below:

3.5.1 Indian employer - Non-resident employee:

An Indian employer provides stock options to its employee when he was an Indian resident. Subsequently the employee is deputed abroad, or the employee joins some other employer outside India.

After going abroad an employee may exercise his options i.e. at the time of exercise, the employee is a non-resident. The Indian company will pay FBT. (There can be situations, when FBT is not payable.)

In the foreign country, the tax may have to be borne by the employee, as he will be a resident of that country. This is a situation of double tax.

3.5.2 Foreign employer - Resident employee:

A foreign company gives ESOPs to an Indian employee. On exercise of the options, it pays FBT.

Assume that the foreign employer has income taxable in India. The Indian income will also be taxable in its home country. The tax on income in India, will be available as credit against the tax in home country.

Will this FBT be available as a credit against taxes payable in its country of residence? Is it a tax on income?

3.5.3 Indian employer - FBT in India and foreign country:

There are some countries like Australia, which also levy FBT. (We are not aware whether FBT is levied on ESOPs.) An Indian company may have deputed its employee to Australia.

It grants stock options to the employees. On exercise of options, the Indian employer may pay FBT in Australia, and in India.

Will it be eligible for claiming credit for FBT paid in Australia?

Again we do not have answers.

3.5.4 A view should be taken that FBT is a tax paid. Credit should be available at one place and to one person. Double tax should be avoided. For that, countries should consider such issues as a part of DTA, and devise a mechanism to avoid double tax.

4. Interest, Royalty and Fees for Technical Services - paid by Indian residents to non-residents:

4.1 Under basic International Tax rules, a non-resident can be taxed in India only if the income has "territorial nexus" with India i.e. income is "sourced" in India. There are various provisions which deal with the issue of "source" of income in India.

For example, if immovable property is located in India, then the “source” of rent income, or capital gains on sale of property, will be considered to be “in India”, & therefore taxable in India.

In case of business income, the income is considered to arise in India, if the non-resident carries out operations in India.

4.2 In case of Interest, Royalty and Fees for Technical Services, the provisions are different. Prior to 1976, if the non-resident provided technology to an Indian resident, principles of normal business taxation would apply. Thus, if the agreement for supply of know-how was executed abroad, the know-how was delivered outside India, the payment was also made outside India, then no income could be said to arise in India.

In 1976, the Government changed the law for three kinds of payments – Interest, Royalty & Fees for technical services. [Section 9(1), clauses (v), (vi) & (vii)]. It stated that if an Indian resident makes a payment to a non-resident (on account of any of the three payments), the income will be considered to accrue in India. Whether the non-residents have any presence in India, or operation in India, is not relevant. The non-resident will be taxable in India. (There are some exceptions. However, these are not the subject of discussion here.)

Even other countries also levy tax on the above lines. Double Tax Avoidance Agreements also permit taxation on the above lines.

4.3 Recently in the case of Ishikawajima, the Supreme Court took a view that if the non-resident’s income does not have a territorial nexus with India, there cannot be any tax payable in India. i.e. Only if the non-resident has operations in India, then only Fees for technical services paid by an Indian resident is taxable in India. Thus effectively, the law which was existing for 30 years, got over ruled.

4.4 To overcome the decision, the government has inserted **an explanation** to clarify that such incomes will be taxable, whether the non-resident has a business connection or residence in India. The explanation is proposed to have effect from 1st June, 1976!

This is an example of how the law will be amended, if a view is taken which is against the thinking of the government.

4.5 There is however a problem with the language. The explanation inserted by the budget states that:

“Explanation – For the removal of doubts, it is hereby declared that for the purposes of this section, where income is deemed to accrue or arise in

India under clauses (v), (vi) and (vii) of subsection (1), such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India.”

Now if income is considered to accrue in India, it is always includable in the total income. Including in the total income, is only a mathematical exercise.

The main issue is that does it have a **territorial nexus**? The explanation does not say so. It should have said that such income will be considered to have a territorial nexus with India.

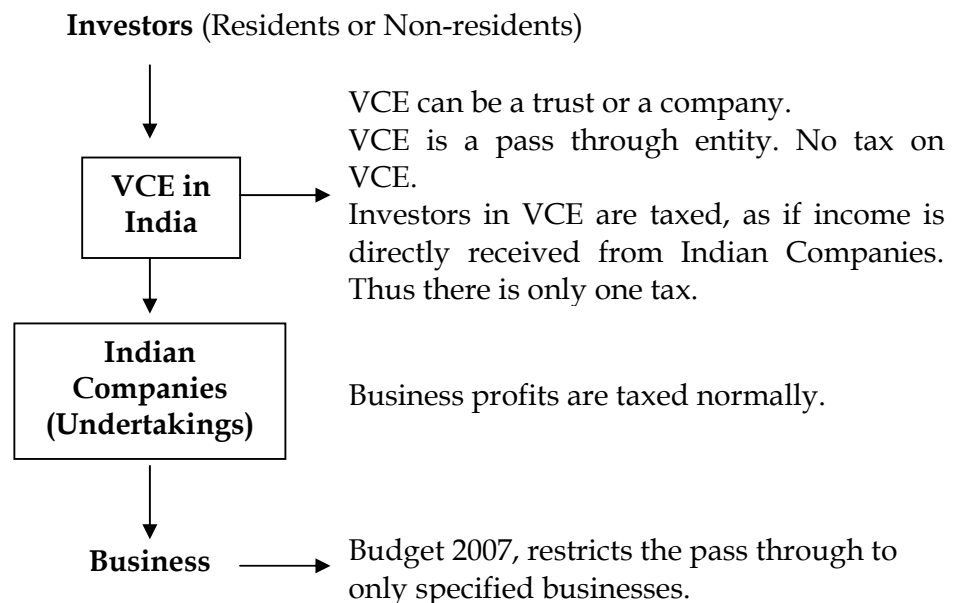
However as discussed earlier, if one takes a view different from the policy of Government, one may not succeed.

What the court could have considered was whether the provision of taxing such incomes is constitutionally valid or not. If that was the case, perhaps the situation would have been different.

5. Venture Capital Entity (VCE):

5.1 Existing Position:

The Indian tax system allows a pass through mechanism for taxation of VCE. i.e. The VCE is not taxed on its income. The investors in the VCE are directly taxed on incomes earned from the investments in Venture capital businesses. The investment through VCE is explained graphically below.



Venture Capital businesses are those businesses as permitted by SEBI rules. Except for a small list of businesses, all businesses can be undertaken.

5.2 Budget Proposals:

Now the budget proposes to restrict the benefit to only the following businesses:

- i) nanotechnology;
- ii) information technology relating to hardware and software development;
- iii) seed research and development;
- iv) bio-technology;
- v) research and development of new chemical entities in the pharmaceutical sector;
- vi) production of bio-fuels;
- vii) building and operating composite hotel-cum-convention centre with seating capacity of more than three thousand;
- viii) dairy or poultry industry.

The VCE should invest in shares of unlisted Indian Company. The Indian company should be in any of the above activities.

If the business is in the specified activities, only then the pass through will be available. i.e. Investors in the VCE will be taxed. VCE will not be taxed.

Substantial foreign investment has come in through venture capital fund route. Real Estate sector has received a lot of investment under Venture Capital route. Now they will not get the benefit of the pass through status unless they have investment in the above activities. The tax costs will now increase. There will be a two levels of tax – one when income is distributed from the business entity to the VCE, and the other when the VCE distributes income to the investors.

6. Transfer pricing:

- 6.1** Transfer Pricing rules have been introduced only in 2002. There is a very little judicial precedent. Only now the cases have started coming up in the courts.

Recently a decision was delivered by the Delhi High Court in the case of Sony TV.

Under the transfer pricing rules, if there are transactions between Associated Enterprises exceeding Rs. 5 crores, the matter has to be referred to a Transfer pricing officer. The Transfer Pricing Officer determines the price under Transfer Pricing rules & passes a Transfer Pricing order.

After receipt of the Transfer Pricing order, the Assessing Officer has to pass the assessment order considering the order of the Transfer pricing officer.

CBDT Circular:

The CBDT has issued a circular on reference of cases to Transfer Pricing Officer. It provided that if the value of International transactions exceeds Rs. 5 crores, it should be referred to the Transfer Pricing officer. It has also explained the process of referring the matter to the Transfer Pricing officer & the assessment procedures.

One of the issues explained in the circular is that, after receipt of Transfer Pricing order, the Assessing Officer has to complete the assessment "having regard to" the Transfer Pricing order. The circular further states that the Assessing Officer should give one more opportunity to the Tax payer before making any adjustments.

Writ Petition:

A writ petition was filed challenging the circular on the ground that it required compulsory reference to the Transfer Pricing officer if the international transactions exceed Rs. 5 crores. It challenged the circular as it took away the power of the Assessing Officer to decide whether the matter should be referred to the Transfer Pricing officer. The circular makes it mandatory to refer the cases.

The court held that the circular does not violate the constitution. Laying down a limit for referring the matters to the Transfer Pricing officer is all right.

The court went further & stated that the **Assessing Officer is not bound to accept the order of the Transfer Pricing Officer**. He can consider other material which the assessee may place before him & come to a different conclusion.

Budget Proposal:

The budget proposes to amend the law and provide that the Assessing officer will “adopt” the Arms Length Price as computed by the Transfer Pricing officer. Thus the discretion of the Assessing Officer has been proposed to be done away with.

This is another example of the government overcoming an appellate decision by changing the law.

6.2 Time Limit for completing assessments where Transfer Pricing assessment is involved:

Another amendment is regarding the time available for completion of assessments where the matter is referred to a Transfer Pricing officer.

Currently the time limit of completing an assessment is 21 months from the end of the Assessment Year. This includes the time for Transfer Pricing assessment.

The budget provides that wherever there is a reference made to a transfer pricing officer, the time limit for completion of assessment will be 33 months from the end of the Assessment Year (more by 12 months compared to regular assessment).

Further, the Transfer Pricing officer is also required to complete the assessment within 31 months. This will give 2 months to the Assessing Officer to complete the assessment.

This is a welcome provision.

7. Minimum Alternative Tax (MAT):

Indian companies are liable to pay MAT. i.e. if tax calculated @ 11.22% on book profits, is more than the tax on taxable income, tax @ 11.22% on book profits has to be paid. There are exemptions available on some kinds of incomes, including profits from units in Free Trade Zones and those of Export Oriented Undertakings.

The budget now provides that MAT will be payable by companies in SEZ. Therefore most of the software companies and companies in Information Technology sector, will be liable to pay tax MAT.

However this tax is creditable against tax on normal incomes within a period of 5 years.

The benefits for units in Free Trade Zones and Export Oriented Units are in any case expiring from AY 2009-10. Therefore this amendment may not have much impact.

The exemption from MAT continues for registered charitable organisations, and incomes exempt under section 10. i.e. Incomes of Venture Capital funds, mutual funds and certain incomes like agricultural income continue to remain exempt from MAT.

8. Units in Special Economic Zone (SEZ):

There are common conditions for availing of exemptions for units located in free trade zones, Export Oriented units, etc. The conditions state that the unit should not be formed by splitting up or reconstruction of business & should not be formed by transfer of machinery or plant previously used for any purpose.

These conditions will now be applicable for availing exemption by units in SEZ also. Thus one cannot shift an old factory to a SEZ & claim exemption. A new unit / factory has to be set up, to claim relief.

9. Some other developments not related to budget:

During the past year or so, there have been some important developments in laws like FEMA.

For the past 2 years, the Indian Government has been restricting borrowings from non-residents. Some restrictions are as under:

9.1 Earlier foreign currency loans were permitted for almost any purpose. However in 2004, they have restricted foreign currency loans for capital expenses only.

9.2 NRIs were allowed to keep deposits with companies on repatriable as well as non-repatriable basis. In 2005, there was a ban on keeping deposits by NRIs on repatriable basis. NRIs are also prohibited to keep deposits from NRO account where the funds have come in from abroad or from NRE account. Thus even if the deposit is to be kept on a non-repatriable basis, it cannot be kept if the funding is from foreign funds. Only if the deposit is funded from local funds, it can be kept.

9.3 Recently in January 2007, RBI has put a restriction on banks to give loans based on security of FCNR funds. The banks cannot lend more than Rs. 20 lakhs. There are several NRIs who have invested crores of rupees in FCNR deposits. Based on the deposits, banks have given loans. Now suddenly, this restriction has come. The plans of the NRIs have to be changed.

Thus it appears that more restrictions are being placed on loans from non-residents.

10. In the budget note of 2006, we had discussed about the controversy about capital gain v/s. business income in case of share transactions.

This issue has still not been resolved statutorily. The government has issued a draft circular giving guidelines. These guidelines are again based on facts. So far there is no finality about the guidelines.

In the past year or so, several people who have claimed their income as capital gain even when they had large trading transactions, have received notices. The assessments are due to be completed by December 2007. We will know the situation then. There are of course others whose returns have been accepted.

In our view, the legal position is clear. This is matter of fact and not of law. If the number of transactions and the manner of conducting transactions give an impression that it is trading, tax should be paid as business income and not capital gains.