Partners:

Rashmin C. Sanghvi

Naresh A. Ajwani

Rutvik R. Sanghvi

Rashmin Sanghvi & Associates

Chartered Accountants

109, 1st floor, Arun Chambers, Tardeo Road, Mumbai - 400 034, India.

Tel.:(+91 22) 2351 1878, 2352 5694 • Fax: 2351 5275

Website: www.rashminsanghvi.com • E-mail: rashmin@rashminsanghvi.com

Dear Sir / Madam,

4th March 2011

Sub: Finance Bill 2011 – Direct Tax provisions

It is our pleasure to provide our note on key provisions of Direct taxes proposed in the Finance Bill 2011.

The Government proposes to introduce the Direct Tax Code from 1st April 2012. It is with the select committee which is looking into various suggestions from different quarters. One of the principles under the DTC is that the Government does not want to amend the DTC with every budget. Keeping in line with the principle in the DTC, the finance bill has proposed only a few changes.

We hope this trend continues and we will not have to go through several amendments which are normally announced year after year. Should you have any issues, we will be glad to discuss with you.

We are continuing our analysis of the finance bill provisions. On our website, we will update more information on the Finance Bill.

Yours sincerely,

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Finance Bill 2011

4th March 2011

The budget has proposed the following changes in the Income-tax Act 1961.

1. **Tax rates:**

There are no major changes in the tax rates proposed for FY 2011-12. There are a few marginal reliefs for individuals and HUFs. The changes in the rates are explained below:

Individuals and HUFs:

The basic exemption has been increased from ₹ 1,60,000 to ₹ 1,80,000. This gives a relief of Rs. 2,000 to all tax payers.

For individuals resident in India and **aged 60 years and above**, the limit of tax free income has been increased from ₹ 2,40,000 to ₹ 2,50,000. This will also give a relief of Rs. 2,000 to the tax payer.

The limit of tax free income for resident woman tax payers has been maintained at ₹ 1,90,000.

Very senior residents:

The budget has introduced a new category of very senior residents. For Indian residents aged 80 years and above, the maximum tax free limit is ₹ 5,00,000. This gives a relief of upto Rs. 52,000 compared to non-senior resident individual. Moreover, it gives a relief of not filing any tax returns at all.

It is advisable that such senior residents can give a declaration to the banks for not deducting tax at source. This will save them the trouble of claiming refunds.

As earlier, these reliefs are not available to non-residents.

Corporate Tax:

Indian Companies:

The Income-tax rate has been maintained at 30%. The surcharge which is levied on income of more than ₹ 10 million, has been reduced from 7.5% to 5%. Thus effective rate of income-tax (including surcharge and education cess) for income of more than ₹ 10 million, will be 32.445% instead of 33.2175%. To compensate for the loss of revenue, the Minimum Alternative Tax has been increased from 18% to 18.5%.

Foreign Companies

Similarly for foreign companies, the income-tax rate has been maintained at 40% on business incomes. The surcharge which is levied on income of more than ₹ 10 million, has been reduced from 2.5% to 2%. Thus effective rate of income-tax (including surcharge and education cess) for income of more than ₹ 10 million, will be 42.024% instead of 42.23%.

To compensate for the loss of revenue, the Minimum Alternative Tax has been increased from 18% to 18.5%.

The table for income-tax is given in the Annexure.

2. SEZ Developers and units in SEZ:

2.1 Dividend Distribution Tax:

The Special Economic Zone (SEZ) Developers had been provided several reliefs. One of the reliefs is that if a company which is developing a Special Economic Zone declares dividend, it is not liable to pay Dividend Distribution Tax (DDT). Shareholders are also exempt from income-tax on such dividends. Thus dividends were totally tax free.

The finance bill has proposed that dividend paid by such a company on or after 1st June 2011, will be liable to DDT. Thus SEZ developers have been given about two months within which they can declare dividends without being liable to DDT.

The relief was not available to a unit in a SEZ. This position continues.

2.2 Minimum Alternative Tax:

SEZ developers and units in SEZ are not liable to Minimum Alternative Tax (MAT). The Finance Bill has proposed that the exemption from MAT will be withdrawn from F.Y. 2011-12. Thus from F.Y. 2011-12, all units in SEZ and SEZ developers will be liable for MAT.

3. Transfer pricing:

3.1 Variation of actual price as compared to Arms Length Price:

Under the Transfer Pricing rules, the market price or Arms Length Price (ALP) has to be considered for taxation, for international transactions between Associated Enterprises. The rules provide for several methods of computing the ALP. The most appropriate method has to be applied. Thus for example, an Indian subsidiary company purchases goods worth Rs. 10 crores from its holding company. The market price is considered as Rs. 8 crores. The Income-tax department will consider only Rs. 8 crores as the cost of purchase. On the difference of Rs. 2 crores, income-tax has to be paid by the Indian company.

There can be situations where more than one ALPs are determined. In such a situation, an **arithmetical mean** of the ALPs is considered as the ALP. If the actual price at which the associated enterprises have conducted their transaction varies by upto 5% of the arithmetical mean of the ALPs, then the actual price is considered as the ALP. In other words, no adjustment is required to be carried out to the income. This variation of 5% is permitted for all industries. It is well known that different industries have different profit margins. Typically some trading has a margin of less than 5%. In such cases, all the prices will be within the permitted variation. Theoretically, all commodity traders will never be subject to any adjustment of prices.

The memorandum to the finance bill has explained that the variation of 5% across all industries has outlived its utility. The rate of variation will now be provided according to the industry. The finance bill has enabled the Central Government to notify the percentage of variation permitted between the actual price and the arithmetical mean of ALPs. Thus for different industries, a different rate of variation will be provided for.

3.2 Reference to the Transfer Pricing Officer (TPO):

The Income-tax department has different wards for regular assessments, and transfer pricing assessments. The Income-tax return is filed in the respective wards. The officers dealing with regular assessments may not be fully aware of the issues under transfer pricing. Therefore if there is any matter where there is an issue of transfer pricing, the Income-tax Officer (ITO) is required to refer the matter to the Transfer Pricing Officer (TPO). Under the administrative rules, if the value of international transactions is ₹ 15 crores or more, the matter has to be referred to the TPO.

The TPO can then make necessary enquiries and call for information from the assessee. There was a controversy on whether the TPO can consider any transactions for transfer pricing assessment apart from those which have been referred by the ITO. There was a recent ruling in Delhi Tribunal in the case of Amadeus India Pvt. Ltd. As per the decision, the TPO could consider only those matters which were referred to by the ITO. He **could not consider other matters**.

The finance bill now provides that if the TPO notices any other international transaction (unnoticed transaction) which has not been referred to by the ITO, the TPO can make an assessment for such transactions. All provisions of the Transfer Pricing chapter will apply to the unnoticed transaction.

This proposal in the finance bill will overrule the decision of Amadeus India Pvt Ltd. With the amendment in the finance bill, the TPO can now compute the ALP for previously unnoticed transactions.

3.3 Power of survey:

The finance bill has been amended to provide that the TPO has the power to conduct a survey. Earlier the TPO had the power to call for information only. He could not conduct a survey. The amendment increases the powers of the TPO to suo moto make a survey of the premises of the assessee.

4. Infrastructure debt fund:

The infrastructure sector in India requires large amount of funds. For this purpose, the Government will come out with a scheme for Infrastructure Debt Fund (IDF). FIIs and other foreign investors will be able to invest in the fund. The finance bill has proposed concessions for IDF, and also for non-resident investors in the IDF. These are explained below.

It has been proposed that the income of the IDF will be exempt from income-tax.

For non-resident investors, it has been proposed that they will be charged income-tax @ 5% on the interest earned by them. There is already a provision in the Income-tax Act which provides for income-tax of 20% on interest earned by non-residents if they have given loans in foreign currency to Indian residents. For IDF, the rate is further reduced to 5%.

Further it is not necessary that the loan given to the IDF should be in foreign currency. Thus if FIIs in India lend money in rupees to the IDF, they will have to pay tax @ 5% only.

The detailed IDF scheme should be released by the Government soon. The practical conditions for investment will be known then.

5. Dividend received from foreign subsidiary companies:

5.1 Several Indian companies have invested abroad in foreign businesses and earned profits. If the investor wants to bring back the dividends to India, it has to pay a tax of 30%. As compared to foreign company, when an Indian company declares dividend, the tax payable is only 15% - (The Indian company paying the dividend will pay Dividend Distribution Tax @ 15%.)

Normally, the foreign operating / business company would have paid corporate tax. This rate may be around 30%. Then again if the Indian holding company has to pay 30% tax no dividend, the cascading effect will be too high. (Total tax will be 51%). India does not give Underlying Tax Credit as given in U.K. and some other countries. Hence Indian companies would try their best to avoid receiving dividends.

5.2 In order to receive dividends and yet not pay any income-tax in India, investors interpose an intermediate company. Thus the Indian company will invest in a company in Singapore / Netherlands / Mauritius. That company will in turn invest in the business company. If the business company declares a dividend, it is received by the intermediate company. On such dividend, there is no tax in India, as well as the intermediate country.

5.3 To plug such tax planning, the Direct Tax Code has proposed Controlled Foreign Corporation (CFC) Rules. Under these rules, if intermediate companies receive any dividend, it will be taxed in India in the hands of the holding company.

5.4 The Indian investors have represented that instead of CFC rules, the tax rate on the foreign dividend be reduced to 15%. This will mean that the tax rate is at par for dividends from Indian companies and foreign companies.

5.5 To enable Indian companies to bring back money outside India, it has been proposed to reduce the income-tax to 15%. No expenditure will be allowed against such foreign dividend. This relief is available only for one year – dividend received upto 31.3.2012. Depending on how the companies respond, the provision will be reviewed next year. The

Government may still bring in CFC provisions as proposed through the DTC. One will have to wait and see.

5.6 One should note that this relief is available only to Indian companies and not to all residents. If the dividend is declared by an Indian company, the rate is the same irrespective of the fact that the shareholder is a company or a firm or any other entity.

5.7 If however instead of dividend, the holding Indian company takes a loan from its foreign subsidiary, then such a loan is deemed as dividend (Section 2(22)(e)). This provision has been there for several years. It is an anti-avoidance provision. Such loan (treated as dividend) will not be eligible for concessional tax of 15%. It will be liable to normal rate of tax.

6. Transactions with persons in notified jurisdictional areas:

It is well known that a huge amount of tax evasion takes place through offshore centres (also known as tax havens). The offshore centres not only help in tax evasion, but also in avoiding other laws. Their laws are designed to thwart any enquiries from other countries. The Indian government has so far been ineffective in getting the required information from the offshore centres.

In order to discourage Indian residents from undertaking transactions with persons in such centres, the finance bill has provided for several measures. The provisions are explained below.

6.1 The Indian Government is trying to enter into agreements so that the offshore centres provide the necessary information. However **despite** such **agreements**, the information may not be forthcoming. In such situations, the Indian government can notify such a country or a territory as "notified jurisdictional area" (NJA).

6.2 If an Indian resident enters into a transaction with a person in NJA, it will have some consequences as under:

i) The transaction will be considered as an International transaction. All provisions of **Transfer Pricing** will apply. This can become a time consuming and costly exercise for the Indian resident. It may even become impossible to comply with the rules.

ii) If any **payment is made to a financial institution** in a NJA, the assessee will have to provide an **authorisation** to the Central Board of Direct Taxes to seek relevant information from the said financial institution. If an authorisation is not given, no deduction will be allowed for the payment made to the financial institution. Say a loan is taken from a bank in Cyprus, (and assume that Cyprus is notified as NJA), then no deduction for interest paid to the Cypriot bank will be allowed unless the assessee gives an authorisation.

iii) If any **expenditure or depreciation allowance** is claimed for a transaction with a person in NJA, no deduction will be allowed unless the assessee maintains documents and furnishes information as may be prescribed.

iv) If the assessee has **received any amount** from a person in a NJA, he will have to provide explanation for the **source of amount in the hands of the payer**. Thus if an Indian resident has received a loan from a company in British Virgin Islands (BVI) (and assuming that BVI is a NJA), the assessee will have to provide the source of amount in the hands of the BVI company. If the explanation is not provided, or the explanation is unsatisfactory, then the amount will be added as the income of the assessee.

v) If any payment is made to a person in NJA, and is liable to tax, then the **tax has to be deducted** at the highest of:

- rate in force (including the rate in a DTA),
- rate specified in the relevant provisions of the Income-tax Act,
- rate of 30%.

The disallowance of expenses (discussed in clauses (ii) and (iii)), and tax deduction at source, both can apply. The person can be taxed doubly in such situations.

6.3 Example:

Say an Indian resident – Mr. A has black money. He transfers the same by hawala to BVI. In BVI, the money is deposited in a bank account of a BVI company. The owner of the BVI company is a nominee company in BVI which holds shares in trust for Mr. A. The BVI company provides these funds as security to the BVI bank. The BVI bank based on the security of the funds, provides a loan to another BVI company (BVI company-II). BVI Company-II invests in the Indian company which is owned by Mr. A. Assume that the BVI is notified as NJA. Let us consider the implications.

Investment:

The Indian company which has received an investment, will have to explain the source of funds under section 68 which is the existing provision under the Income-tax Act. Under section 68, the identity of the investor, bonafides of the transaction and capability of the payer has to be established. Under this section, the officer can ask for prima facie evidence that the payer is capable of providing the funds. In case of non-residents, it is difficult to establish the source of funds as the person is outside India.

However under the proposed provision, the officer can not only ask for the source of investment received, but he can also ask for the **source of the funds of the BVI company**.

If for any reasons, the Indian company cannot provide explanation, the officer can consider the amount as taxable income. Thus the onus is quite onerous.

One issue that arises is that if the funds have been received prior to BVI being notified as NJA, can the officer ask for establishing the source of the funds with the BVI company? Under the proposed provision, no details can be asked. In the Income-tax Act, each year has to be considered independently. If a country is not notified as a NJA in the year in which the investment takes place, then the provision cannot apply.

After the notification as an NJA, any transaction with the BVI company will be subject to the new provisions. Assume that instead of investment in share capital, loan is taken from the BVI company-II. In the year in which the loan is taken, BVI is not a NJA. Hence the proposed provisions cannot apply. After BVI is notified as NJA, the interest will be subject to the new provisions.

6.4 The provisions are targeted at Indian residents. However the proposed provisions strictly apply to non-residents also. For example, a non-resident has a PE in India. He claims a deduction of fees for technical services paid to a person in BVI which is a NJA. To such a non-resident also, these provisions will apply.

Rashmin Sanghvi and Associates