PRE-BUDGET MEMORANDUM 2018 ON DIRECT TAXES

A. CORPORATE TAX RECOMMENDATIONS :

1. CORPORATE TAX RATES :

In Budget 2016, the Hon'ble Finance Minister had proposed to reduce the rate of Corporate Tax from 30% to 25% over a period, accompanied by rationalization and removal of various tax exemptions and incentives. Phasing out of multiple exemptions viz. accelerated depreciation, deductions for Research, 10AA, 35AC, 35 CCD etc. was also initiated.

While the exemptions are being phased out for all class of companies, the benefit of lower rate of corporate tax of 25% has been given only to companies whose total turnover or gross receipts of the previous year 2015-16 does not exceed fifty crore rupees.

Issues involved :

a. While the earlier year's budget laid down a plan for phasing out exemptions, no corresponding plan/roadmap has been indicated for reduction in corporate tax rates.

b. In the context of the worldwide economic problems and its consequent effect in India, it is suggested that the corporate tax rate be brought down to 25% within the next 2-3 years and surcharge and education cess be removed for all corporates – both big and small. This will result in generating more surpluses in the hands of companies with consequential boost to investment and growth and accelerate the GDP growth in India.

Recommendation :

It is recommended that a road map/plan for reduction in corporate tax rates should also be released in line with the plan of phasing out of incentives. In the interest of equity, the benefit of lower tax rate must be extended to all companies and this will definitely result in bringing about greater buoyancy in the overall investment climate in the country.

2. INCOME COMPUTATION DISCLOSURE STANDARDS (ICDS) :

CBDT has notified 10 "Income Computation and Disclosure Standards" with effect from AY 2017-18 which is to be followed by all assesses at the time of computation of income chargeable to income tax under the head "Profit and gains of business or profession" or " Income from other sources".

Issues involved :

ICDS in its present form is not adding any value and in fact, is bound to create uncertainty and deterrence in the conduct of business in India. It militates against the professed policy of the Government to simplify the taxation system which will consequently impact the "Make in India" objective as this will create major obstacles to doing business in India. While amendments in the law, guidelines and standards are made with the intent of reducing litigations, it is feared that notification of these ICDS will not achieve this objective. It is apparent that with a huge divergence in the accounting prescribed under IndAS regime, overwriting of the law established through judicial precedents, coinage of new terminologies, there would be an increase in unintended tax litigations.

ICDS is not serving any purpose and will only lead to duplication and wastage of efforts in maintenance of dual set of book keeping, increased complexity, high compliance cost, which is counter-productive to doing business with ease in the country.

In fact, **Justice R.V. Easwar Committee** in its report has rightly made the following observations w.r.t. ICDS:

"Taxpayers are already grappling with regulatory changes of the Companies Act, 2013, Ind-AS and the proposed GST. Industry should be allowed more time to deal with another change of this nature. The Committee understands that the taxpayers feel that many of the provisions of the ICDS are capable of generating a legal debate about which at present there is no clarity.

Further, multiple accounting methods, one for the books of accounts and other for tax purposes, creates confusion, interpretation issues, multiplicity of records and additional compliance burden which may outweigh the gains to be obtained by the application of ICDS. It has also been felt by the Committee that ICDS deals only with the method of accounting and at best it brings timing difference on recognition of expenditure or income as compared to the books of account. ***The Committee therefore feels that a fuller study of the implications of the ICDS is necessary before it is implemented."***

The proposals made in the Budget 2017 are silent on the status of ICDS.

Recommendation :

Due to the reasons stated above, it is suggested that ICDS be completely withdrawn.

3. PLACE OF EFFECTIVE MANAGEMENT (POEM) :

The Finance Act 2016 introduced the concept of POEM applicable with effect from 1st April, 2016. However, the exhaustive circular of CBDT was issued on 24th January, 2017 and subsequently the detailed draft notification was issued on 15th June, 2017 for necessary comments and feedback.

Issues involved :

- As obvious from the above, the clarificatory circulars and notifications have been badly delayed. Moreover, there is always a time lag in the Income Tax processes in respect of determination of residency status which may only get determined during the assessment proceedings.

- The detailed operating guidelines have still not been issued.

- Excessive focus on the form as opposed to substance is one of the main problems with the circular / notification (e.g. excessive importance given to the criteria on place of holding of Board meetings etc.). This militates against the latest concepts in international taxation where the primary focus is on substance.

- The concept of POEM as introduced in the Income Tax Law read alongwith the circular / notification would also make the tax laws excessively complex. This would severely dent the Government's professed policy of simplification, and ease of doing business in India with the consequential impact on uncertainty and high compliance costs.

Recommendations :

Therefore, it is imperative that POEM should be deferred by a few years from financial year 2016-17 and all the operating issues should be given serious consideration.

Further, the applicability of POEM should be restricted only to shell companies abroad not involved in active business and accordingly the CBDT notification should specifically focus on this aspect.
A detailed representation in relation to the Draft CBDT notification dated 15th June, 2017 is enclosed. (**Annexure 1).**

4. CORPORATE SOCIAL RESPONSIBILITY COSTS – TO BE ALLOWED AS DEDUCTION :

Section 135 of the Companies Act 2013 and The Companies (Corporate Social Responsibility Policy) Rules, 2014 (CSR Rules) as notified make CSR expenditure a statutory requirement for all practical purposes (as per the spirit of the law), in respect of companies falling under the ambit of such regulations. In this connection, it may also be noted that the CSR expenditure under law is in effect calibrated to the average Pre-tax profits (as computed under Section 198 of the Companies Act 2013, akin to managerial remuneration) earned during the preceding three years and is therefore a charge on profits (just like managerial remuneration) and not an appropriation thereof (which is a shareholder prerogative).

In the Finance (No.2) Act, 2014 it was mentioned that under section 37(1) Explanation 2, all CSR expenditure shall not be deemed to be an expenditure for the purpose of business on the rationale that it is an application of income.

Issues Involved :

It may be noted that every expenditure represents application of income and not an appropriation, if the charge/debit is made before determination of the PBT. In that context, CSR is an item of expenditure similar to any other standard item like rent, repairs and insurance. Moreover, such expenditure which is to be incurred under the new Companies Act and determined @2% of the pre-tax profits, is automatically an expenditure for business purpose even though it may not be incurred in the normal course of business. Also, statutorily sharing the burden with the Government "*in providingsocial services"* under law cannot be termed as getting subsidy from the Government through the said deduction since it is a statutory expenditure and is not in the nature of any tax or dividend.

In fact, the alternative argument of it not being an expenditure for tax computation purposes is itself not sustainable since it then becomes a "tax" which cannot be introduced under the Companies Act.
The industry therefore expects that such CSR expenditure would be allowed as a deduction under the Income Tax Act and Rules and all the more so, as certain elements of eligible CSR expenditure such as those covered under sections 30 to 36 are fully deductible even under the present tax laws, as explained in the Memorandum.

In fact, the High Level Committee on CSR formed by the Ministry of Corporate Affairs had observed that certain items of CSR are allowable under the Income Tax Act, whereas other items are not allowable and this has resulted in inconsistencies and lack of uniformity in the treatment for tax purposes and this has to be corrected.

Recommendation :

It is therefore recommended that the amendment made under section 37(1), Explanation 2 be dropped and the Income Tax Act expressly stipulate that all expenditure incurred by companies in accordance with Section 135 of the Companies Act 2013 and the CSR Rules be allowed as a deduction under law so as to bring about fairness and uniformity in tax treatment and eliminate potential disputes & litigation that would otherwise arise in this regard.

5. SECTION 80IA BENEFIT – POWER GENERATION :

Under Section 80 IA of the Income Tax Act, deduction in respect of profits and gains from power undertakings (including for captive power generation plants) is available for any ten consecutive assessment years out of fifteen years beginning from the year in which the undertaking generates power. This benefit is available provided the power undertaking has begun to generate power before 31st March, 2017.

Issues Involved :

In the current scenario, new power undertakings in the area of solar and other renewable energy sources are becoming critical, especially in the context of protection of the global environment alongwith the need for generation of adequate power in the present power-starved national economy.

Also, sub-section 12A to section 80IA imposes a restriction on any merged or demerged undertaking for not allowing the benefit of deduction from taxable income after such restructuring. In fact, this benefit is not passed on to the successor of business for the unexpired period after the said restructuring.

Recommendation :

Therefore, the provisions of section 80IA, should be extended till 31st March, 2020, specially in respect of generation of power from renewable sources like solar, wind etc.

Further, the restriction under section 80IA(12A) for mergers / demergers, is extremely unfair and should be deleted, since it adversely affects a lot of corporate restructuring decisions.

6. DEDUCTION IN RESPECT OF EXPENDITURE ON BRAND BUILDING :

In India, there is an over abundance of foreign brands. These range from run-of- the- mill to high-end luxury products. Even for items of daily consumption, the brands consumed by millions of household are predominantly owned by overseas enterprises. Be it baby food, home care, personal care products, tooth pastes, shaving creams, breakfast cereals, tea, coffee, ice creams, confectionary, chocolates, washing machines, laptops, personal computers, refrigerators, mobile phones, televisions, air conditioners, motor cars, etc., the leading brands in the Indian market are the property of foreign enterprises. Every time these products are consumed, value flows out of the country to pay for trademarks used, licenses provided, services consumed and so on.

Until December 16, 2009, the Government had imposed a cap on royalty payments for technological collaboration which was 5% on domestic sales and 8% on exports. Lumpsum royalty payments were capped at US $ 2 million. For use of a brand name, royalty could be paid at upto 1% of sales and 2% of exports. Beyond these levels, approval of the Foreign Investment Promotion Board (FIPB) was required. However, royalty payments have increased sharply since December 2009, when the caps were withdrawn and everything was put under the automatic route. In 2009-10, about US $ 4.44 billion was paid as royalty by Indian companies which was 13% of the Foreign Direct Investment (FDI) inflow into India that year. In 2012-13, Indian companies royalty payments increased to US $ 6.99 billion or 18% of India's FDI inflows that year. These pay-outs have increased 57.43% in the space of four years.

Issues involved :

This unenviable situation is indeed a disheartening reflection of the competitive capabilities of India's home grown brands which are few and far between. However, instead of bemoaning the huge outgo in terms of royalty and other payments, it is much more important to align national and corporate energies to create world class Indian brands. World class brands lend a huge intangible value to products and services enabling them to command a premium and loyalty from consumers. Moreover, successful brands reflect the innovative capacity of their countries and they enrich their national economies. For example, the net sales of Samsung is equivalent to 20% of GDP of South Korea. In fact, a successful global brand is a sustained source of wealth creation. Also, world class brands can contribute increasingly to import substitution, value added exports as well as larger value capture from global markets. In fact, this can transform the country from one dominated by foreign brands to a player of substance in the global arena.

The creation of world class brands demands tremendous staying power with substantial investment commitments over the long run. It requires deep consumer insight, continuous nurturing of R & D, differentiated product development capacity, brand building capability, cutting edge manufacturing and an extensive trade marketing and distribution network. This will also result in job creation and retention of value in the country.

Recommendation :

Therefore, it is vital that the policy environment incentivises the creation of Indian brands. For example, since foreign brands entail a royalty outflow, a similar percentage (say 5%) of turnover of Indian brands should also be admissible as a "standard deduction" for income tax purposes. Moreover, a larger deduction of say 10% of turnover should be admissible for new brands for the first 10-15 years of their commercial launch**.** Alternatively, a weighted deduction of 200% of the relevant expenditure on brand building should be allowed as a deduction. This will create a level playing field for domestic enterprises. Moreover, this will help in making the Indian brands globally competitive and thereby control the current account deficit problem on a sustainable basis.

7. **"MAKE IN INDIA" : ENCOURAGING INNOVATION TO DELIVER CORPORATE INITIATIVES FOR LARGER SOCIETAL VALUE CREATION** :

In line with the Hon'ble Prime Minister's call for qualitative and sustainable industrial growth in the form of "Make in India : Zero Defect and Zero Effect", there is a strong need to encourage and incentivise the immense transformational capacity of corporates in innovating business models that can synergistically deliver economic and social value simultaneously.

Issues Involved :

Sustainability in Business Development in its truest sense can only take place when economic growth fosters social equity. Growth must translate into the creation of sustainable livelihoods and replenishment of scarce environmental resources. Limits to future growth will be defined more by vulnerabilities flowing from social inequities, environmental degradation, and climate change than by any other economic factor.

Recommendation :

- Government can support the development of a Responsible Business "Trustmark" Rating System that could be used to convey to the consumer a company's environmental and social performance. An enterprise could be awarded credits by way of "Trustmark Rating", based on an objective evaluation of its triple bottom line performance. An accumulation of such credits could earn the enterprise Trustmark Ratings on a progressive scale. These Ratings could then be displayed on products and services of the company to help consumers make an informed choice.
- Government must consider the provision of a differentiated and preferential set of incentives, fiscal or financial, to companies that demonstrate leadership in sustainability performance. Companies with high "Trustmark" ratings should be provided with incentives like priority fast track clearances, purchase preferences, lower levies of central excise duty for manufacture of "green", eco-friendly

products, weighted deduction for the expenditure under the Income Tax Law and so on. This would spur powerful market drivers that will incentivise innovation for larger triple bottom line impact.

- Banks and Financial Institutions could also factor in the Trustmark Ratings in their lending operations providing benefits to more responsible corporations. Going forward, it may even be possible to trade in these "Trustmarks", if a system similar to carbon credits or energy efficiency certificates can be developed so that organisations with surplus credits are able to monetise their efforts.

8. LIMITLESS ROYALTY PAYMENTS – A DRAIN ON THE ECONOMY :

- India is now a global market with free competition by international players in most areas of economic activity.
- International companies are in India to exploit this global market and compete with other international and domestic players.
- To compete effectively, they bring their brands, knowhow, technology and other intellectual property in their own self-interest.
- Hence, incentives in the form of royalty pay-outs by their Indian subsidiaries are neither justified nor required.

Issues Involved :

Payment of royalty by Indian subsidiaries to their overseas parent entities is extremely illogical and injurious to India's current account balance, government exchequer and minority shareholders**.** In the year 2012-13, the pay-out was US$ 7 billion representing 20% of India's annual FDI inflows, and is growing exponentially in the subsequent years.

Recommendation :

It is therefore recommended that such royalty payments should not be permitted. Otherwise, the Income Tax Law should provide for higher quantum of withholding tax.

Indian players seeking access to intellectual property to compete effectively with the international players in the Indian global market should continue to be allowed to pay royalty to unrelated parties on an arm's length basis, without government intervention.

9. TAXABILITY OF EXPORT COMMISSION PAID TO NON-RESIDENT EXPORT AGENTS :

- A non-resident export agent renders export promotion and marketing services outside India and also receives payment for such services outside India. Generally, the services rendered by an export commission agent would restrict to soliciting customers in the foreign location, liaising with the customers, coordination, negotiation and procuring the export orders etc. They do not render any technical services and the payment is only towards the functions and responsibilities that a commission agent is expected to discharge.

- Accordingly, the export commission paid to such non-resident export agents does not accrue or arise/ be received or deemed to accrue or to be received in India and thus are not taxable in India as

per Section 5 of the Income Tax Act, 1961 (the Act). Further, the said export commission to non-resident agents cannot be deemed to arise from any business connection in India, as the entire service is carried out outside India and hence it not taxable in India as per Section 9(1)(i) of the Act . Accordingly, no withholding tax u/s 195 applies to such export commission paid to non-resident agents.

- Reliance is also placed on several Court rulings wherein it has been held that export commission paid to non-resident agents for services rendered by the agent outside India are not taxable in India :

  - ***In CIT vs Toshoku Ltd., Guntur and Ors [125 ITR 525 (SC)]*** – The Supreme Court has held that since non-resident taxpayer did not carry on any business operations in India, amounts earned for services rendered outside India could not be deemed to be incomes which had either accrued or arisen in India.

  - **In CIT vs Eon Technology (P) Ltd [(2011) [343 ITR 366 (Delhi)]** – The Delhi High Court has held that when an agent was not rendering any service or performing any activity in India itself, commission income cannot be said to have accrued, arisen to or received by agent in India.

  - **In the case of PanalfaAutolektrik Ltd [(2014) 49 taxmann.com 412 (Delhi)** – The Delhi High Court has held that services rendered by the non-resident cannot be said to be in the nature of ‘managerial’, ‘technical’ or ‘consultancy’ services and hence, the commission cannot be treated as ‘fees for technical services’. Thus, the export commission was not taxable in India.

  There are various other judicial precedents wherein it has been held that commission paid to export agents outside India would not be taxable in India and accordingly, no withholding tax would apply on such payments made by Indian assesses:

  - Armayesh Global vs ACIT, [51 SOT 564 (ITAT Mum)]
  - Gujarat Reclaim and Rubber Products Ltd vsAdd.CIT [60 SOT 22 (ITAT Mum)]
  - ITO vs Trident Exports [149 ITD 361 (ITAT Chennai)]
  - DCIT vsDivi’s Laboratories Ltd [10 ITR (Trib) 505 (ITAT Hyd)]
  - DCIT vs Transformers & Electricals Kerala Ltd. [35 ITR(T) 440 (ITAT Cochin)]
  - DCIT vs Sandoz (P) Ltd [137 ITD 326 (ITAT Mum)]
  - ACIT vs Farida Shoes (P) Ltd [(2013) 34 taxmann.com 268 (Chennai ITAT)]
  - ACIT vs Model Exims [(2014) 45 taxmann.com 140 (Lucknow ITAT)]
  - IVAX Paper Chemicals Ltd vs Additional CIT [(2014) 44 taxmann.com 173 (Hyd. ITAT)]

Issues Involved:

- The CBDT had issued Circular No 23 dated 23 July 1969 and Circular No. 786 dated 7 February 2000 wherein it was clarified that where the non-resident agent operates outside the country, no part of his income arises in India. Further, since the payment would be remitted directly abroad it cannot be held to have been received by or on behalf of the agent in India. Such payments were therefore held to be not taxable in India.

- However, CBDT vide Circular No. 7/2009 dated 22.10.2009, withdrew their earlier Circular no. 23 dated 23.07.1969 along with Circular No. 786 dated 07.02.2000.

- **This withdrawal of the circular have led some Assessing Officers to erroneously believe that export commission paid to non-resident export agents are taxable in India and they are arbitrarily disallowing all the export commission expenditures under section 40(a)(i) during assessments on the pretext of non-deduction of tax at source on such export commission , which are legally not taxable in India.**

  This has led to unnecessary harassment of the assessees and has needlessly increased the litigation cost of the assesses.

- It may be worthwhile to point out that the Circular 23/1969 was introduced after a Supreme Court ruling in the case of CIT v. R.D. Aggarwal & Co. [(1965) 56 ITR 20] , as explained in Para 2 of the said circular. **Thus, the position stated in Circular 23/1969 or Circular No. 786 dated 07.02.2000were mere clarifications regarding applicability of the provisions of Section 9 of the Act, and are in no way any alteration to the principals laid down in Section 9 of the Act. Thus, withdrawal of this Circular by the CBDT will not change the provisions of the law which clearly expounds that export commission paid to non-resident are not taxable in India since the export agents have rendered all services outside India (no income accrues or is deemed to accrue in India) and payments have been received by them in their foreign bank accounts (no income is received or is deemed to be received in India).**

Recommendation:

CBDT should come out with a clear clarification that export commission payments to non-resident agents are not taxable in India, in case:

- They render the services entirely outside India
- They receive the payment abroad i.e. do not receive the payment in India.

10. SCIENTIFIC RESEARCH EXPENDITURE:

The income tax law provides for certain tax benefits in respect of scientific research expenditure. In-house R&D is separately incentivized under section 35(2AB) of the Income Tax Act 1961. This specifically requires that the in-house research and development facility be approved by the Department of Scientific & Industrial Research (DSIR). The deduction is available @ 200% till FY 2020-21 and thereafter @100% for the following expenditures -

1) Revenue expenditure, and
2) Capital expenditure (not being expenditure in the nature of cost of land and building)

For claiming deduction, there are certain conditions laid down in the Section and in DSIR Guidelines that are required to be fulfilled.

Issues Involved :

(a) ***First Issue :***

Negative list of articles/ things specified in the Eleventh Schedule of the Income Tax Act – should be deleted

Section 35(2AB) specifically lays down that weighted deduction is NOT available for the articles/ things specified in the Eleventh Schedule. Eleventh Schedule, inter-alia, among other things contains various products like beer, wine and other alcoholic spirits, Tobacco and tobacco preparations (such as cigar and cheroots, cigarettes, biris, smoking mixtures for pipes and cigarettes, chewing tobacco and snuff), Confectionery and chocolates, Cosmetics and toilet preparations, Tooth paste, dental cream, tooth powder and soap etc.

It is highly discriminatory that weighted deduction is not available in respect of the in-house research and development carried out for the above articles/ things. India is a developing market and the need for quality and internationally competitive products cannot be undermined. In fact, in the absence of quality in-house R & D in India, significant expenses are incurred in respect of royalty payments for use of imported technology, packaging/technical specifications etc. Such forex remittances on account of royalty and technical knowhow are putting serious strain on the Current Account Deficit and this needs to be addressed on an urgent basis. Moreover, the menace of contraband products also becomes another area of concern in the country which is a direct fallout of the above problem.

Therefore, companies which are in the business of manufacture/ production of the above products and are incurring expenditure in carrying out in-house research and development should not be denied the benefit of weighted claim, which otherwise would result in excessive payments in foreign exchange for royalty / technical knowhow and poor quality/contraband products flooding the market as explained in the earlier para. In fact, domestic production of international quality products can help not only in saving precious foreign exchange, but also in bringing foreign exchange into the country through exports and royalty earnings. Further, to boost domestic production and empower the domestic companies against big foreign players, it has become imperative to extend the benefit of weighted claim to all manufacturers.

Recommendation :

Therefore, it is suggested that the negative list as given in the Eleventh Schedule be removed in the context of section 35(2AB).

(b) ***Second Issue :***

Revenue expenses eligible for weighted claim – scope of expenses to be enlarged :

DSIR Guidelines (last updated May 2010) has identified various revenue expenses which are not eligible for weighted claim. However, it is the need of hour that the exclusion list be stream-lined and narrowed down. There is no doubt that weighted deduction is intended to be made available only for in-house R&D activities carried out. However, it cannot be denied that there are certain activities, which though forming

part of the overall R&D activities, are carried out outside the approved R&D facility. Weighted claim should be available for these activities also. Also, considering the increasing complexities in R&D, there may be foreign consultants involved. However, there is no reason why foreign consultancy expenditure should not be eligible for claim.

Recommendation :

It is therefore recommended that to encourage greater in-house R&D activity, the ambit of eligible revenue expenses be increased to include –

- Expenditure on outsourced R&D activities
- Lease rent paid for research farms or research labs
- Foreign consultancy expenditure
- Building maintenance, municipal taxes and rental charges
- Clinical trial activities carried out outside the approved facilities
- Contract research expenses

(c) ***Third Issue -***

***DSIR* Guidelines – Excessively Restrictive**

Among various other conditions, the DSIR Guidelines specifically lay down that -

(i) The manufacturers who wants to lodge weighted claim should enter into an agreement with the DSIR for 'co-operation' in such research and development facility.

The word 'co-operation' shall, inter-alia, mean that the company shall be willing to undertake projects of national importance, as may be assigned to it by the DSIR, on its own, or in association with laboratories of CSIR, ICAR, ICMR, DRDO; DBT, MCIT, M/O Environment, DOD, DAE, Department of Space, Universities, Colleges or any other public funded institution(s). The company would be free to exploit the results of such R&D projects, subject however, to any conditions which may be imposed by Government of India, in view of national security or in public interest.

(ii) Assets acquired and products, if any emanating out of R&D work done in approved facility, shall not be disposed of without approval of the DSIR.

Recommendation :

It cannot be denied that such conditions, as above, are very restrictive in nature and instead of promoting in-house R&D, hamper the willingness of corporates to carry out in-house R&D. There is already a condition that the in-house R&D facility should be approved by DSIR. Once the R&D facilities are DSIR approved, there should not be any requirement for entering into a separate agreement with DSIR. In fact, such requirements would do nothing except burdening the corporates with administrative hassles. ***There is an urgent need to relax these stipulations so that in-house R&D activities are encouraged and in-house***

scientific research gets the necessary tax benefits. This will result in incentivising R & D expenditure for promoting "Make in India" manufacturing.

11. DISALLOWANCE OF EXPENSES RELATING TO EXEMPT INCOME UNDER SECTION 14A:

As per section 14A of the Income Tax Act, 1961, no deduction is allowed in respect of expenditure incurred in relation to exempt income. In the context of the same, the Government has prescribed rule 8D (amended vide notification no.43/2016 dated 2nd June 2016) as per which the disallowance will be determined as below :

(i) The amount of expenditure directly relating to exempt income.
(ii) 1% of the annual average of the monthly averages of the opening and closing value of investments.

Issues Involved :

The stipulation regarding the disallowance of 1% of the monthly averages of the value of investment is very harsh since it has no relationship with the earning of exempt income. In fact, this could result in adhoc and excessive disallowance and in some instances, there could be cases of the disallowance exceeding the total exempt income. This is even worse when investments are made at the end of the accounting year, say on 31st March. Also, as per current accounting systems, corporates are not required to do any book closing on a monthly basis and therefore this would result in additional work for the sole purpose of determination of disallowance. Moreover, in respect of exempt income from dividends arising out of investment in companies and mutual funds, the payers also pay the dividend distribution tax. Therefore, technically this could not be termed as tax free income in the hands of the recipient and the above disallowance results in double taxation.

Recommendation :

Therefore, it is suggested that rule 8D be amended and should be restricted to the following :

- Exempt income to exclude dividend income on which dividend distribution tax has already been paid.
- Expenditure directly attributable to earning of exempt income be disallowed.
- Interest expenditure to be disallowed in line with the existing law based on the proportion of average value investments to total assets after excluding the interest expenditure specifically related to the business of the company.
- The disallowance for administrative expenditure should be made by estimating the time of the personal and resources involved for undertaking the activities which result in earning of the exempt income. The aforesaid estimation to be done on a reasonable basis after considering the facts of each case and this should be certified by the Tax Auditor. In case this is not feasible, then the disallowance be restricted to 0.5% of the exempt income.
- The disallowance should not be made for strategic investments which are incurred for gaining a controlling stake in another company/subsidiaries, JVs and associates.

12. HOTEL INDUSTRY :

(i) *Restriction on the adjustment of the section 35AD benefit* :
Currently, under section 73A, the benefit of investment in new hotels available under section 35AD, is allowed as a deduction only from the profits of the hotels business.

Issues involved:
Investment in new hotels requires huge capital outlay with a high gestation period and this restriction under section 73A results in the benefit getting badly deferred with consequential impact on liquidity and future investments.

Recommendation :

With a view to giving a boost to further investments and growth in the hotels/tourism sector which has a massive untapped potential in India it is suggested that the adjustment of the section 35AD benefit should be made permissible against the profits of the entire company rather than restricting it to the particular business.

(ii) *Tax Incentives for eco-friendly Hotels* : The need for building eco-friendly hotels cannot be over-emphasized for long term sustenance of the environment.

Issues involved:

Building of such hotels comes at a much higher cost and therefore some special incentives needs to be considered.

Recommendation :

Section 35AD does take care to some extent by allowing the deduction of the capital expenditure. However, an additional incentive is required in the form of a weighted deduction of the costs to offset the additional costs incurred.

(iii) *Depreciation and Additional Depreciation : Hotels were eligible for the depreciation allowance of 20% on their building till 31st March, 2002. The depreciation allowance for hotels buildings was, however, scaled down to 10% vide Notification No. 291/2002 dated 27.09.2002.*

Issues Involved :

Hotel buildings constitute the ‘plants’ for the hotel industry as their usage is round the clock for 24 hours. The industry has to make very heavy investments in renovation, up-gradation and upkeep of the hotel buildings.

Recommendation :

Section 32 of the Income Tax Act should therefore be amended to restore the depreciation rate to 20%. The additional depreciation applicable to Plant & Machinery u/s 32 1 (ii a) should also be allowed to hotels which have to make heavy investments in plant and machinery.

(iv) Hotel Charges for long stays are currently subject to TDS(rent) under section 194 I :

Issues involved and Recommendation :

Payments made to hotels are not the payment of rent, per se and hence Hotels should be excluded from the purview of Section 1941 for the purpose of Tax Deduction at Source. CBDT may issue appropriate circular in this regard.

(v) Claim for additional deduction on expenditure incurred on civil construction (maintenance and upkeep of Hotels more than 30 years old)

Issues involved :

The main revenue generating asset of any Hospitality Industry i.e. a Hotel, essentially relates to its property - buildings. Though the Income Tax Act had granted certain relief on profits generated by Hotels set up in a backward State with the intention of improving Tourism, no benefit is extended to existing Hotels including Heritage Hotel buildings, which needs continuous updation and construction. Due to various local laws and the laws relating to Heritage buildings several Hotels has to undertake various construction and strengthening projects which ensures the compliance of various laws. However this is only at the cost of stopping the business for the entire hotel or a section thereof. However such Hotels does not get any benefit in taxation and it takes quite a number of years to recoup the cost of capital and investments.
On the contrary an existing manufacturing unit undertaking expansion of its manufacturing facilities or enhancement of capacities by modification or replacement of existing machinery are allowed additional deduction (u/s 32AC) as well as additional deprecation [u/s 32(iia)].

Recommendation :

To allow additional or accelerated deduction from business profits on preservation of Heritage Hotels on entire civil construction expense (irrespective of capitalisation in books of accounts).

13. DEDUCTION IN RESPECT OF EMPLOYMENT OF NEW EMPLOYEES- 80JJAA

Issues Involved :

The amended provision u/s 80JJAA effective from AY 2017-18 allows the companies (including existing companies) to claim additional deduction @30% of the additional cost of the employee joining employment. The said deduction is available over subsequent years as well. The term “employee” however excludes employees with salary more than Rs 25,000 per month; retainers and contractual

employees (without retiral benefits) and employee employed for less than 240 days (apparel industry less than 150 days). Incidentally hotel industry is also seasonal and similar benefit should be extended to hotel industry as well. Further the requirement spells out whole-time employees of the company leaving aside a large spectrum of employees who are contractually engaged by hotel industry and such hotels are legally liable to pay their salary and the contribution to PF & ESI. In such cases the effective employment is with the Hotel as the manpower supplier merely enjoys the profit margin as well as the tax deduction on the salary paid under this section.

Recommendations :

The ceiling of salary for employee eligible should be increased from Rs 25,000 pm to Rs 50,000 pm with the total deduction spread over 2 years instead of 3 years

All whole time retainer and contractual employee who are employed with the company who falls under the above salary ceiling should be included

All payments to man-power supply agencies (excluding the PF and a profit margin of 20%) should be included in the computation if the total days of engagement exceed 150 days.

14. TAX INCENTIVES UNDER SECTION 72A IN RESPECT OF AMALGAMATION OR DEMERGER (TO BE EXTENDED TO ALL BUSINESSES):

The tax benefits under section 72A in respect of amalgamation or demerger are currently limited to industrial undertakings or a ship, hotel, aircraft or banking.

Issues involved and Recommendation :

It is suggested that in the current liberalised and buoyant environment where various new sectors are growing at a rapid pace, this should now be extended to all businesses including financial services, entertainment/sports, information technology (IT) and IT enabled services.

Further, the provisions of section 72A should be simplified specially in respect of the conditions applicable for the amalgamating company like losses / depreciation being unabsorbed for at least three years and holding assets on the amalgamation date upto ¾ of the book value of fixed assets held two years prior to the said date.

15. **TAX DEDUCTION FOR THE EMPLOYEE REMUNERATION COST INCURRED DUE TO GRANT OF EMPLOYEE STOCK OPTIONS (ESOP) TO THE EMPLOYEES :**

(a) As per the Guidance Note issued by Institute of Chartered Accounts of India ('ICAI'), the SEBI Guidelines and the IndAS the main objective to issue shares under an Employee Stock Option Plan (ESOP) is to remunerate the employee for his services. The SEBI guidelines and the IndAS requires a company to recognise the charge incurred for issue of ESOPs as an employee compensation in the Financial Statements/Books of Account of the Company over the vesting period.

For computing the related employee cost, the IndAS mandates companies to adopt the Fair Value valuation of the share options granted to the employee unless that fair value cannot be estimated reliably. Thus, under the IndAS regime, even if the companies have granted the options at the prevailing market prices on the date of grant, they have to do a fair valuation of the options granted to the employees using option pricing models (which essentially calculates the difference between the exercise/grant price and the expected price of the underlying shares on the date of vesting) and recognise the charge in the profit and loss account over the entire vesting period.

(b) Such share- based payments to employees is construed, both by the employees and the company, as a part of package of the remuneration. There is no difference in two situations viz. (i) when the company issues shares to public at market price and a part of the premium is given to the employees in lieu of their services (ii) when the shares are directly issued to employees at a reduced rate.

(c) Further, it is pertinent to note that under the Income Tax Act too, under section 17(2)(vi) the difference between the fair market value of the ESOPs allotted and exercise price is treated as a perquisite ie. part of salary given to the employees, on which tax is payable by the employees. Hence, income tax itself cognizes the difference ie value of the share options granted to the employees as part of employee remuneration, taxable in the hands of the employees.

(d) Thus, it is evident that the legislature contemplates this to be an employee cost ie. a consideration for employment, which entails giving the employees the shares of the company at a particular exercise price and therefore, the same should be treated as an allowable business expenditure u/s 37 of the Income Tax Act.

(e) **It is an ascertained liability and not a contingent liability, since the employer incurs obligation to compensate the employees over the vesting period, notwithstanding the fact that the exact amount of related cost is quantified only at the time of the exercising the options**. The company becomes liable to issue shares at the time of the exercise of option and it is in lieu of the employees-compensation liability which it incurred over the vesting period to obtain their services. Therefore, the company incurs the liability only during the vesting period, which is neither incurred at the stage of the grant of options nor when such options are exercised.

Reference to the decisions of the Supreme Court in the case of Bharat Earth Movers vs CIT [245 ITR 428] and Rotork Controls India (P) Ltd [314 ITR 62] also indicate that a definite business liability arises in an accounting year which qualifies for deduction even though the liability may have to be quantified and discharged at a future date. Thus, following the decision of the Supreme Court, the employee cost incurred during the vesting period on account of fair valuation of the share options granted to the employees during the year, cannot be treated as a contingent liability and hence should be allowed as a deduction u/s 37 of the Act, as and when it accrues over the vesting period, as per the Guidelines of SEBI and Accounting Standards and Principles.

(f) **Further, the Supreme Court in the case of Woodward Governor India (P) Limited [312 ITR 254] has also held that the term 'expenditure' in certain circumstances can also encompass 'loss' even though no amount is actually paid out.** Following the rationale of this Apex Court decision, the

employee cost accruing on account of issue of ESOPs should be treated as an allowable expenditure u/s 37(1) of the Act, since by undertaking to make share-based payments, the company does not pay anything to its employees but incurs obligation of issuing shares at the determined exercise price on a future date(s) in lieu of their services.

(g) Reliance can be placed on the following decisions which have upheld the allowability of the employee cost incurred on issue of ESOPs to employees as a business deduction during the vesting period-

(a) Special Bench , ITAT Bangalore, in the case of Biocon Limited v DCIT –[TS 322]
(b) Madras High Court in the case of CIT vs PVP Ventures Limited [211 Taxman 554]
(c) Chennai Tribunal in the case of S.S.I. Ltd vs DCIT [85 TTJ 1049] [211 Taxman 554]
(d) Chandigarh Tribunal in the case of ACIT vs Spray Engineering Devices Limited [53 SOT 70]

Legal issue involved:

a. The issue with respect to deductibility of employee cost incurred for grant of options to employee has been a matter of debate before the Courts/Tribunal. The Income Tax Authorities are not allowing such employee compensation expense as an allowable business expenditure u/s 37 of the Act, inspite of the various judicial precedents, as mentioned above, to the contrary.

b. Further, since the Income tax Law has not expressly specified , there is also a debate on the amount to be allowed as employee compensation expense, the method used for calculating the value of the stock options granted , the year in which the cost should be allowed etc.

c. Without prejudice to the above, it may kindly be noted that deduction for ESOP to employers is provided even by the developed nations:

United States of America
Sec. 83(h) of Internal Revenue Code (IRC) allows the companies deduction for ESOP Expenditure equal to the amount offered to tax by employee in the year it is offered to tax by the employees.

United Kingdom
Part 12, Chapter 2 of the Corporation Tax Act, 2009 allows companies deduction for ESOP expenditure as excess of market value of shares over the amount recovered by the employer in the period when the shares are acquired.

Recommendation :

- To put an end to the litigations, it is recommended that the CBDT comes out with clear guidelines on the allowability, calculation and treatment of these employee compensation expenditure/cost incurred on account of issue of shares options to employees under ESOP for income tax purposes.
- Under the Ind AS the companies are required to account for the such employee cost for grant of ESOPs under fair value method which is a fair method used internationally to account for such cost. Hence, CBDT should also allow companies to claim deduction for the employee remuneration cost on

the basis of fair value method, to ensure less complications and hassles in the calculations and to avoid unnecessary litigation and dispute on this subject

16. ALLOWABILITY OF PAYMENT OF PREMIUM OF LEASEHOLD LAND AS A REVENUE EXPENDITURE :

Issues involved:

a. Under the IndAS 16, the upfront premium paid on leasehold land held under operating lease are being treated as prepaid expenses and would need to be charged to the Profit and Loss statement under the head "rentals" on a proportionate basis over the life of the lease period.
Under the current Accounting Standards, these premium payments leasehold land, are charged to the statement of profit and loss account as amortisation of leasehold land on a proportionate basis over the life of the lease period

b. These upfront lumpsum premium lease payments for leasehold landare essential business expenditure and do not generate any capital asset and hence are purely revenue in nature.

c. These are just like payments made under any operating lease to utilise the leased property for the purposes of the business of the lessee and hence should be allowed just like any business expenditure for tax purposes. Further, under the IndAS, these upfront premium paid on leasehold land, held under operating lease are being classified as rentals. Therefore, these expenditures should be treated as tax-deductible expenses.

Recommendation :

The CBDT should come out with instructions clarifying that these upfront premium payments for leasehold land, should be allowed for income tax deduction in the year of debit in the statement of Profit and Loss.

17. RETIREMENT FUNDS :

As per rule 87 of the Income Tax Rules, the employer is permitted to make a total contribution not exceeding 27% of the employee's salary in respect of Provident Fund and Superannuation. Further, as per schedule IV of Part A rule 6 of the Income Tax Act, the employer is permitted to contribute upto 12% of the employee's salary in respect of Recognised Provident Fund. In other words, the Income Tax Law permits contribution upto 15% for Superannuation and 12% for PF.

Issues involved and Recommendation :

In the context of the current rates of interest and the high cost of annuities and considering that pensions are in any case taxable in the hands of the employees at the time of receipt, it is suggested that the limit of 15% for Superannuation should be done away with.

In fact, employers should be encouraged to increase the quantum of contributions to ensure a proper annuity / pension for the employees. The law should only stipulate that the annuities should be purchased from recognized and approved Life Insurance agencies. Moreover, the stipulations under section 36(1)(iv)

and consequential limits fixed on initial contributions should be totally done away with. In fact, if there are gaps / deficits in the Retirement Funds in terms of the total fund position in relation to the actuarial value, the employer should be under a strict obligation under law to pay up the same for bridging the deficit and thereby avoiding a default. As an alternative, if the Government still wants to continue with an overall limit for PF and Superannuation contributions (in line with the current stipulations in the Income Tax Rules), then it should be increased to 35%.

18. TAXABILITY ISSUES FOR GRATUITY, LEAVE ENCASHMENT AND OTHER TERMINAL BENEFITS FOR LEGAL HEIRS OF A DECEASED EMPLOYEE :

There is a lot of confusion in respect of TDS/taxability of various payments like gratuity, leave encashment and other terminal benefits to the legal heirs of a deceased employee. The existing circulars are very old and needs to be updated based on the current Income Tax Law. Detailed note is enclosed (**Annexure 2)**. This matter needs to be clarified urgently.

19. CONFUSION IN RESPECT OF TDS ON PAYMENT FOR TELEPHONE BILLS (INCLUDING MOBILE BILLS), TELEPHONE BILLS, INTERNET CHARGES, ELECTRICITY CHARGES ETC. CONSEQUENT TO AMENDMENTS IN SECTION 9(1)(VI) EXPLANATIONS 2 AND 6 :

Issues Involved :

Consequent to the amendment to the explanations to section 9(1)(vi) of the Income Tax Act in the Budget for 2012, it could be construed that TDS is applicable in respect of payments for telephone bills, mobile bills, internet charges, payment to cable operators, broadband charges, electricity charges and wheeling and transmission charges. However, it should be noted that the said amendment to the definition of "royalty" is ambiguously worded and is inconsistent with the industry understanding as well as in conflict with the established position internationally that the right to use of any service does not result in "royalty" *per se* without the right to use the concerned equipment or process. The characterization of such payments as royalty would be dependent on the terms of use and degree of control over the industrial, scientific or commercial equipment. Indian Courts have consistently maintained this position. Detailed note is enclosed (**Annexure3)**. Further, companies like BSNL have given internal instructions that no TDS is applicable for payment of telephone bills. In fact, if TDS deduction is made by the subscriber, then telephone lines are being disconnected.

Recommendation :

Therefore, it is absolutely necessary for the CBDT to give a detailed circular explaining the applicability of this new explanation 6 to section 9(1)(vi) and specifically confirm that no TDS is applicable for payment of telephone bills including mobile bills, payment of internet charges, payment to cable operators, service providers for viewing television channels, payment of broadband charges, electricity charges, wheeling/transmission charges etc. where the payment is only for the right to use the service without any payment for the right to use/control on the equipment / apparatus.

20. APPEALS TO CIT APPEALS UNDER SECTION 246A TO INCLUDE INTEREST UNDER SECTION 220(2):

In the last few years, the list of sections under section 246A has been revised in the context of appeals with CIT(Appeals). However, interest under section 220(2) has been missed out and this is currently creating unnecessary harassment for all assessees.

21. **LONG TERM CAPITAL GAINS – BONDS UNDER SECTION 54EC :**

The Income Tax Law has stipulated a limit of Rs.50 lacs per assessee in respect of the long term capital gains tax saving bond under section 54EC. Currently, huge amounts are required to be deployed in the infrastructure sector and this vehicle could be used for raising such infrastructure development funds. Moreover, the interest income on such bonds is fully taxable. Therefore, it is suggested that this limit should either be removed or substantially increased.

22. **CARRY FORWARD OF EXCESS FOREIGN TAX CREDIT** :

The Income Tax Act allows for set off in respect of foreign taxes paid on overseas income. However, in case of loss/inadequate profits, no set off may be possible. In the current economic scenario of the global economy, business outlook has become extremely uncertain and results have become very volatile. Therefore, it is suggested that assesses be permitted to carry forward (say for five years) such unutilized credit (in USA such relief is granted vide section 904(c) of Federal Tax Act) for adjustment in future years.

23. REASSESSMENT - SECTION 147/SECTION 148 :

(a) Issues involved :

Nowadays, reopening notices under section 147/section 148 have become a very common occurrence and such notices are being served in large nos. all over the country. It appears that there is no consideration in following the principles on the subject laid down by the Hon'ble Supreme Court and High Courts over the years. Simple audit observations, even on points of law, are frequently being used as grounds for re-opening leading to extreme harassment to all assessees. In fact, the position has become so bad that even for legislations which have become obsolete like Interest Tax (withdrawn in Finance Act, 2001) re openings are being done for very old years since the relevant law permitted re openings without any time limit.

Further, the said reopening provisions are being misused in various locations, especially for salaried assessees, where scrutiny assessment is not possible as per the CBDT guidelines and this has become a breeding ground for corruption and harassment .

Recommendation :

Therefore, it is suggested that proper stipulations be laid down for any reopening and the period of reopening be also reduced to 3 years from the end of the assessment year.

(b) Issues Involved :

Proviso to section 147 has been inserted to provide that the Assessing Officer may assess or reassess other than matters which are the subject matter of any appeal, reference or revision. However, in respect of matters which have already been examined at the time of original assessment, the current law as laid down by the various courts categorically stipulates that reassessment of the same cannot be done since it will result in change of opinion. Moreover, it does not make sense to keep on assessing/reassessing the same matter again and again. The annual income tax assessment/reassessment procedure should be normal and routine and should not provide for excessive powers to harass assesses**.**

Recommendation :

Therefore, it is suggested that the new proviso to section 147 should also state that all matters which have been examined in the original assessment should not be reassessed.

24. BEPS - COUNTRY-BY-COUNTRY REPORT AND MASTER FILE :

In Finance Act, 2016 in order to implement BEPS, certain amendments were made in the Act, whereas remaining aspects were to be detailed in the Rules. The implementation was proposed from FY 2016-17.

Issue involved :

Till date, no guidelines or rules have been specified. It is clear that the finalization of the guidelines will take some time.

Recommendation :

It is suggested to defer the BEPS implementation by at least two years i.e. from FY 2018-19.

25. **PENALTY UNDER SECTION 271** :

Issues involved :

A new sub-section (1B) has been inserted retrospectively from 1st April 1989 to provide that in case of any addition/disallowance in the assessment /reassessment order, the Assessing Officer can give a direction for initiation of penalty proceedings and this shall be deemed to constitute satisfaction for such initiation. It is apprehended that such general power will result in initiation of penalty proceedings in case of any addition/disallowance without justification. This will itself result in arbitrariness, harassment and risk of increased litigation. Moreover, the retrospective amendment will result in opening up a lot of past cases which have already been decided/closed.

Recommendation :

Therefore, it is suggested that this provision may be withdrawn. Even otherwise, it should not be made applicable retrospectively.

26. TAX REFUND PROCEDURE :

Issues involved :

Currently, there is no statutory time limit for grant and payment of refund by the tax authorities. Further, the challenge faced by tax payer in obtaining tax refund creates an unfavourable scenario since the tax payer would look to pay advance tax on a most conservative basis.
Having a time based procedure for grant and payment of refund would help in re-building tax payer's confidence on the tax system.
Recommendation :

Prescribe time limit for issuance of tax refund.

27. MINIMUM ALTERNATE TAX (MAT) RATE :

Issues Involved :

The present rate of tax under MAT provisions of 18.5% is extremely high and it adversely affects all MAT paying companies specially the ones in the infrastructure sector. Since India is massively deficient in the infrastructure arena, it is absolutely imperative to reduce the MAT rate to 15%.

Recommendation :

It is suggested that MAT credit should be reduced to 15%.

28. EXTEND TAX INCENTIVES TO TEA PROCESSING & PACKAGING INDUSTRY SETTING UP THEIR UNITS IN RURAL AREAS :

Issues and recommendation :

- By way of allowing weighted deductions under section 35CCC for eligible expenditure incurred for promotion of agriculture sector.
- Extend weighted deductions under section 35CCD for eligible expenditure incurred on skill development projects undertaken by companies engaged in agricultural products.
- Extend weighted deductions for research and development activities carried out for introducing healthy food variants by companies engaged in processing of food items like tea, coffee and water. Definition of scientific research may be widened to include research activities engaged in improving quality of drinks associated with tea, coffee and water.

B. **PERSONAL TAX RECOMMENDATIONS**:

29. TAXING OF ESOPS IN THE HANDS OF THE EMPLOYEES :

The current Income Tax Law, provides for the inclusion of ESOPs under section 17(2) to be taxed as a "*perquisite*", consequent to the abolition of FBT.

The section states that ESOPs issued free of cost or at concessional rates will be taxed on the date of exercise on the difference between the "*fair market value*" and the amount actually paid by the employee. The "*fair market value*" is to be determined based on stipulated methods which have been separately prescribed by the CBDT.

Issues involved :

This suffers from the following drawbacks :

(a) It seeks to tax a notional benefit at a time when the actual gain is not realised by the employee. In fact, it is possible that the actual sale of shares could result in a loss for the employee. Since the perquisite tax paid earlier cannot be set off against the capital loss, the employee suffers a double loss, namely tax outgo and loss on sale of shares.

(b) The question whether the ESOPs are granted at a concessional rate is being determined with reference to the "*fair market value*" on the date of exercise of the options. Technically, this is an incorrect approach. If the ESOPs are issued at the prevailing market price on the date of grant, the issue should be treated as "*non concessional*". This would be in line with the guidelines issued by SEBI. Any subsequent gain accruing to the employee due to favourable market movements by the date of vesting or exercise of option cannot be treated as a "*perquisite*" granted by the employer.

(c) Further, if such subsequent gains are a perquisite in the hands of employers, it would stand to reason that the value equivalent of such a perquisite should have been a deductible expenditure in the hands of the company issuing the ESOP. Since the tax law does not contemplate such a deduction, the taxation of the perquisite would result in double taxation.

(d) Also, from the strictly legal angle, there are a number of differences between ordinary shares and ESOP shares. Therefore, they are not comparable. The taxation principles currently existing, result in discrimination. The market value is also strictly not applicable since there are lock-in periods applicable. A detailed note on these aspects is enclosed (**Annexure 4).**

Since the actual sale of shares will attract capital gains tax, if applicable, it is unnecessary to subject the employee to perquisite tax. In fact, before FBT was imposed on ESOPs, specific provisions existed in the Income Tax Act for exempting the same from perquisites and subjecting it only to capital gains tax

It may be noted that ESOPs have emerged over the years as a critical, motivational and retention tool for companies in a highly competitive market for talent. It is a very effective instrument for encouraging employees to perform and excel and is a win-win proposition for the employers / shareholders on one hand and the employees on the other.

Recommendation :

It is suggested that the taxation of ESOPs as perquisite at the time of allotment / exercise should be avoided for the reasons explained above. If at all it is taxed, it should be based on the fair market value i.e. the market price prevailing on the date of grant. Any subsequent appreciation should only be taxed at the time of realization / sale as capital gains.

30. TAXING OF CONTRIBUTION TO SUPERANNUATION FUND BEYOND SPECIFIED MONETARY LIMITS (CURRENTLY IN EXCESS OF RS.1.50 LAKH) – IN VIOLATION OF SUPREME COURT JUDGEMENT :

The Finance Act, 2009 had imposed tax on employees in respect of the company's contribution to Superannuation Fund in excess of Rs.1 lac and this limit was increased by the Finance Act. 2016 to Rs.1.50 lakh.

Issues involved :

It may be noted that there are various types of superannuation funds. In case of the new pension scheme and similar superannuation funds, the contributions made by the employer vests with the employee and he can transfer it from one employer to another. However, in other cases, contributions made by the employer to a Superannuation Fund do not accrue to the benefit of the employee till such time he retires upon superannuation, when the Fund is used to purchase annuities and/or to pay the commuted pension to the retired employee. Such contributions may or may not result in superannuation benefits to the employees since there are various conditions to be fulfilled by the employees like serving a stipulated number of years, reaching a certain age etc. Therefore, this should not be taxed as perquisite as per the ratio of decision laid down by the Hon'ble Supreme Court in **CIT vs. L W Russel [2002-TIOL-686-SC-IT]**. Further, the pension payments are subjected to tax at the time of actual receipt by the employee.

Recommendation :

As such, it is suggested that contribution to superannuation fund should not be taxed as perquisite.

31. DEDUCTION FOR PERSONAL TAX COMPUTATION :

The Finance (No.2) Act, 2014 had increased the overall limit to Rs.1.5 lac in respect of deduction under section 80C. In the context of the current inflationary situation, it is suggested that this limit be increased to at least Rs.2.5 lac. This would act as a fillip to investments and also generate greater savings for the tax payer.

32. **LIMIT FOR MEDICAL REIMBURSEMENTS** :

Medical expenses reimbursed by the employer are exempted to the extent of Rs.15,000/- per annum. This limit has remained unchanged from the financial year 1998-99 onwards. Considering the sharp escalation in cost of medicines and medical treatment, it is suggested that this limit be increased to Rs.50,000/-.

33. MEDICAL REIMBURSEMENTS FOR RETIRED EMPLOYEES :

Under section 17 of the Income Tax Act, medical reimbursements to employees are exempted from tax in respect of general medical expenditure (upto Rs.15,000 per annum) and expenditure incurred in approved hospitals. Further, specific tax relief is also provided to employees in respect of medical treatment outside India for self and family. However, such tax benefits are not available to retired employees. It is suggested that the provisions of section 17 be amended to include retired employees for the tax benefit on medical reimbursements/hospitalization expenditure, both for domestic and foreign medical treatment.

34. LEAVE TRAVEL CONCESSION/ASSISTANCE– TAX RELIEF EVERY YEAR AND REPLACEMENT OF CALENDAR YEAR BY FINANCIAL YEAR :

As per the current provisions, Leave Travel Concession/Assistance is eligible for tax relief for 2 calendar years in a block of 4 calendar years. It is suggested that the concept of calendar year should be replaced with financial year (April – March) in line with the other provisions of the Income Tax Law. Moreover, the concerned tax relief should be granted annually and be extended to both domestic and foreign travel, to give a fillip to the Travel and Tourism Industry.

35. EXEMPTION FOR PAYMENT OF LEAVE ENCASHMENT TO BE RAISED TO RS.10 LAKHS:

The exemption limit for payment of leave encashment is notified by the CBDT in accordance with the powers given under section 10(10AA). The current limit of Rs. 3 lakhs is very old (since 1998) and needs to be raised substantially with immediate effect. It is suggested that the limit should be raised to Rs.10 lakhs.

36. **SENIOR CITIZENS** :

The population in the current senior citizens’ category did not have a robust social security / pension fund investment facility during their working life. As a result they are hugely dependent on interest income from fixed deposits etc. The rate of interest has come down drastically in the past one year leaving the senior citizens in financial difficulty. Further, actual inflation is much higher than headline inflation numbers. This has added to their misery.

Additionally, medical expenses shoot up heavily in the old age. Persons covered by mediclaim insurance policies have to cough up very high insurance premia after one or two claims.

Hence it is recommended that beneficial tax measures should be introduced for senior citizens in the upcoming budget.

(i) Easing of threshold Exemption Limit and TDS

- Budget 2018 should increase minimum tax exemption limit for senior citizens (60 years age to 80 years age) to Rs. 7.5 lakh from the current threshold of Rs. 3 lakh.

- Very Senior Citizens who are aged above 80 years should not pay tax if their income is uptoRs. 12.5 lakh.

- There should not be any TDS from payment of interest to Senior and Very Senior Citizens.

(ii) Better Tax Benefits For Health Insurance

- Currently, the health insurance premium for a senior citizen is eligible for deduction to the extent of Rs 30,000. This ceiling should be removed altogether allowing full deduction of medical insurance premium.

- Medical insurance premium for persons above the age of 60 should be exempted from GST.

37. CONTRIBUTION TO NATIONAL PENSION SCHEME (NPS) :

Issue and recommendation :

Deduction u/s 80 CCC should be extended to self – employed, salaried individuals contributing to NPS. Presently voluntary contribution of Rs 50,000 is exempt, however the amount should be increased to Rs 150,0000/-. In case of employees of private limited companies who are subscribed to NPS, 15% of the basic salary should be allowed as deduction instead of 10%.

38. CONTRIBUTION TO SUPERANNUATION FUND HELD AS PERQUISITE :

Issue and recommendation :

As per section 17(2)(vii) any amount of contribution to an approved superannuation fund by the employer in excess of Rs 1.50 lakhs is considered as a part of perquisite and subjected to tax. Incidentally the employees would be required to pay tax up-front on an amount which they would receive only on retirement. Further the annuity amount arising from such contribution would also be subjected to tax. Hence this leads to double taxation. Further there would be tax on the amount of contribution which is neither received nor accrued to the employee but would have the vested rights only upon retirement. Hence 17(2)(vii) should be deleted.

39. **CHILDREN EDUCATION ALLOWANCE** :

Issue and recommendation :

The current exemption limits for children education allowance may be raised from Rs.100/- per month to Rs.1500/- per month per child for maximum of two children.

40. OTHER TAX INCENTIVES FOR INDIVIDUALS :

The Income Tax Law currently provides for various tax exemptions for individuals like transport allowance relief @ Rs.1600/- per month, children education allowance exemption upto Rs.100/- per month upto 2 children, children hostel allowance exemption @ Rs.300/- per month etc. These tax reliefs have not been revised over a long period of time and needs to be suitably enhanced. Otherwise, these benefits should be withdrawn and replaced by a standard deduction for the salaried class to ensure tax simplification.

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BCC&I
THE BENGAL CHAMBER

<u>**Annexure 1 (Ref point no.3)**</u>

REPRESENTATION IN RESPECT OF THE DRAFT GUIDELINES DATED 15TH JUNE 2017 ISSUED BY CBDT IN RESPECT OF PLACE OF EFFECTIVE MANAGEMENT (POEM)

1. **URGENT NEED FOR DEFERMENT** :

The Finance Act, 2016 introduced the concept of POEM applicable with effect from 1st April, 2016. However, the exhaustive circular of CBDT was issued on 24th January, 2017. Finally, the draft notification on the subject has finally been issued by the CBDT on 15th June, 2017 for necessary comments and feedback.

As obvious from the above, the concerned circulars and notifications have been badly delayed and the same is still getting finalized well after the financial year 2016-17, when POEM is supposed to have become operational.

Moreover, there is always a time lag in the determination of the said residency status which will get determined only during the assessment proceedings. If a foreign company is deemed to be a tax resident for any Indian tax year under the POEM regulations for the first time by reason of the Indian tax authority holding so then the main section provides that the same rules will apply for all the succeeding Indian Tax years as well.

As such, if the concerned foreign company is held to be resident company for the first time for financial year 2016-17 and this is determined during the assessment proceedings, say in December 2020 (by virtue of the Time Limit Regulations under section 153), then it will be presumed that it will also be a tax resident in financial years 2017-18 and 2018-19. Also, most part of financial year 2019-20 would have been completed by then. Accordingly, the foreign company would be required to comply with the Indian Tax Rules without any advance notice of the Indian tax authority's intention. In other words, although POEM is to be separately determined for each tax year, it is most likely than not that the said position will be continued for the succeeding three years as well by the Income Tax Authority.

Therefore, it is imperative that applicability of POEM should be deferred by a least three (3)years from financial year 2016-17. In fact, if the deferment is not done, it will amount to a restrospective legislation which the present Government has vowed to avoid.

2. **HIGH TAX RATEAND COMPLICATED TAX STRUCTURE** :

In the draft notification, it has been mentioned that the foreign company shall be continued to be treated as a foreign company for all other Indian tax purposes, even if it is deemed to be resident in India and it will be subject to the tax rate of 40% applicable to a foreign company as against the headline tax rate of 30% for domestic companies.

The above appears to be a case of the Government wanting best of both worlds. In a unipolar world, where all tax rates are falling and countries are competing for moving businesses to their shores, the approach of

our Government appears to be in conflict. In fact, it appears to be virtually penal in nature and **may not pass the test of discrimination**.

Moreover, quick and radical changes are being brought about in the Tax Rules in a wide variety of areas like BEPS initiatives, General Anti Avoidance Rules, Information Sharing (MLI), Thin Capitalization etc. It appears that too many things are happening too soon and at the same time. It is important that sufficient preparation time and notice is given to the impacted parties to comply with the fast changing regulations. Otherwise, this could severely impact the Government's 'Make In India' strategy and pull back progress and growth. Further, this will also militate against the professed policy of simplification of Tax Laws, by the introduction of the abovementioned complex and bureaucratic tax structure.

3. **OTHER ISSUES NOT ADDRESSED IN THE DRAFT NOTIFICATION** :

- **Book Keeping and Audit** : It is not expressly clarified whether the foreign company is required to maintain books of account in India and also get it audited as per the Indian Income Tax Law.
- **Transfer Pricing Compliances** : Transactions between the concerned enterprise deemed to have POEM in India and its group companies outside India should not be subject to Transfer Pricing compliances specially where it has been considered as resident for the first time, since this determination will happen fairly late, say after 2 to 3 years.
- **Operating companies** : The said provisions should only be made applicable to shell companies and this should be expressly notified in the regulations. Operating companies having primary assets/employees outside India should be definitely excluded from the ambit of POEM.
- **Board Meetings** : Excessive importance has been given to the place of holding of Board Meetings in the earlier notifications. In case of outbound investment from an Indian company where the Board is merely supervising the performance, deeming he POEM in India would lead to unnecessary harassment and complications. This aspect needs to be further addressed and clarified.
- **Exceptional Application** : The POEM provisions should be resorted to only in exceptional circumstances. Although, it has been specified earlier that the approval of a collegium of 3 members of Principal Commissioner's/Commissioners is required, it is suggested that owing to the onerous compliance, reporting and penal consequences, a mechanism of ruling from a Panel, Tribunal or Court is put in place, when the POEM determination is done for the first time.
- **Dual Residency under DTAA** : Each country has its own Tax Residency Rules and therefore, there will be a multiplicity of disputes in respect of dual residency. As such, the tie-breaker rule in the DTAA may have to be invoked. The models existing under Mutual Agreement Procedure (MAP) under the DTAA should be made applicable, wherever possible.

Annexure2 (Ref Point No.18)

TAXABILITY OF GRATUITY , LEAVE ENCASHMENT AND OTHER TERMINATION BENEFITS TO THE LEGAL HEIR(S) OF A DECEASED EMPLOYEE:

(a) **Regarding Leave encashment** –

There are CBDT circulars stating that leave salary paid to the legal heirs of the deceased employee in respect of privilege leave standing to the credit of such employee at the time of his/her death is not taxable as salary / not taxable. The gists of the 2 circulars are given below :

- Circular No. 35/1/65-IT(B), dated 5-11-1965 states if the legal representative of the deceased is to be taken to be the assessee, then the amount/proposed to be paid is certainly not due to him. It is an ex gratia payment on compassionate grounds in the nature of gift. Thus, the payment is not in the nature of salary.

- Circular No. 309 [F. No. 200/125/79-IT(A-I)], dated 3-7-1981 states this receipt in the hands of the family is not in the nature of one from an employer to an employee. The deceased had no right or interest in this receipt. This payment is only by way of financial benefit to the family of the deceased Government servant, which would not have been due or paid had the Government servant been alive. In view thereof the amount will not be liable to income-tax.

  Based on the above 2 circulars it would seem that CBDT intends to exempt in the hands of the legal heir the leave encashment salary received by the legal heir of a deceased employee.

(b) **Regarding Gratuity** –

- There is a CBDT circular No. 573 dated 21.08.90 which states that a lump-sum payment made gratuitously or by way of compensation or otherwise to the widow or other legal heirs of an employee, who dies while still in active service, is not taxable as income under the Income-tax Act, 1961**. Infact this circular will cover all other lumpsum termination benefits being paid to the legal heir of a deceased employee, who dies while still in active service.**

- Further, there are 2 caselaws **Smt. L.K. Thangammal Vs. Third Income Tax Officer (1 ITD 762 – ITAT Madras**) and **First Income Tax Officer Vs. Smt. A.A.Talati (31-TTJ-245- ITAT Mumbai)**which clearly established the law [before introduction of Section 56(1)(v)] that **gratuity received by the legal heir of a deceased employee is not taxable , even after taking into account the provisions of section 10(10)(iii) of the Act.**

(c) However, Section 56(1) and section 2(24) has been amended w.e.f AY 2005-06 to include gratuitous payments received by an Individual / HUF (any sum of money received not exceeding the prescribed amount without any consideration) with a view to widen the scope of Income. There are certain specific exclusion to such gratuitous receipts but such exclusions do not cover the leave

encashment, gratuity or other termination benefits received by the legal heir of any deceased employee in connection with the services rendered by him.

Hence, due to the introduction of Section 56(1)(v)/(vi)/(vii) the leave encashment, gratuity and other termination benefits received by the legal heir is now getting taxable though there were CBDT circular issued [before the introduction of Section 56(1)(v)/(vi)/(vii) of the Act] which had exempted such payments. As the earlier CBDT circulars have not been withdrawn there is a confusion as to whether these payments to legal heir are taxable income in their hands or not.

Since death of an employee creates a lot of financial hardship to the legal heirs and it will be difficult for the legal heirs to calculate and pay taxes on the termination benefits received, hence it is suggested that CBDT should come out with a clear instruction that leave encashment , gratuity or other termination benefits received by the legal heir of a deceased employee is not taxable , even after the introduction of Section 56(1)(v)/(vi)/(vii) of the Act.

Annexure 3 (Ref Point No.19)

IMPLICATIONS OF THE EXPLANATIONS INSERTED IN THE DEFINITION OF ROYALTY BY THE FINANCE ACT 2012

- As per explanation 2 to Section 9(1)(vi) of the Act, Royalty *inter alia* included within its ambit any lumpsum consideration for

  (a) the use of any patent , invention, model, design, secret formula or process or trademark or similar property.........

- **Explanation 6 to Section 9(1)(iv) has been introduced by Finance Act , 2012 which clarifies that the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking , amplification, conversion for down-linking of any signal), cable, optic fibre or by any similar technology, whether or not such process is secret.**

- Based on the above clarificatory explanation introduced by the Finance Act 2012, various transactions **(as listed below)which are actually not in the nature of royalty payments and were earlier not within the ambit of TDS may now come under the purview of Section 194J, based on the wordings of Explanation 6** :

  (a) Payment of Telephone (including mobile) bills

  (b) Payment of Internet charges

  (c) Payment to cable operators, service providers like tata sky, distributors of tata sky, dish TV etc. for viewing the television channels

  (d) Payment of Broadband charges

  (h) Wheeling/ transmission charges paid to the state-electricity grid or private electricity transmission and distribution companies for transmission of electricity of the electricity generated by the windmills installed by private assessees to their factory/units for captive consumption

  (i) Electricity charges

- However, **there should not be any levy of TDS on the above transactions** viz., telephone / mobile charges, internet charges , payment for viewing television channels, electricity charges based on the amendment of Finance Act 2012, since –

  i. **The subscribers/ customers are not getting any right/claim any property in the transmission lines by paying these amounts. The contract between the subscriber and the other party in none of these cases is for using any transmission lines** (say for telephone charges, electricity

charges, but it is a contract where the service provider (telecom co., electricity Co., etc.) are suppose to provide for a service by using their own infrastructure of cables, satellites, optic fibre line etc. Since no right is being given in respect of the transmission lines to the subscribers/clients , hence the payment made all the above transaction should not be treated as Royalty and no TDS should be deducted .

ii. The telecom co., electricity co., internet service providers are raising huge resistance against the deduction of Tax at source. <u>BSNL, which is a PSU Company, has clearly circulated a letter wherein they have said that no TDS is applicable on telephone charges and in case tax is deducted by the subscribers/clients then telephone services will be discontinued. Copy of their letter is attached. Further, there is also a letter from CBDT to BSNL, letter no. 275/72/2002 – IT(B) dated 16-2-2004, wherein the CBDT has stated that TDS under section 194J would not be applicable on payment made by subscribers to telecom companies.</u>

iii. There are case laws delivered prior to the Finance Act 2012 [Skycell Communications Ltd. (251 ITR 53) – Madras High Court] wherein it has been clearly held that services in the nature of a standard facility , provided with the use of highly sophisticated equipment cannot be considered to be a technical service and hence does not attract TDS. Hence, no TDS u/s 194J is applicable on payment for telephone services, internet services etc. Thus, till date the Income Tax Dept had contested that these are payment for technical services and courts have clearly held that such payments are not technical services. Thus, now the department cannot do a volte face and assert that the above listed transactions are royalty payments (since these cannot be technical services in the light of the HC decision) on which TDS u/s 194J will be attracted.

iv. Regarding, wheeling/ transmission charges paid to the state-electricity grid or private electricity transmission and distribution companies for transmission of electricity of the electricity generated by the windmills installed by private assessees to their factory/units for captive consumption , there are specific caselaws by various Tribunals that no TDS u/s 194C or 194J on wheeling and transmission charges paid to State Electricity Transmission Co; Charges not for 'carrying out work' or FTS; Such payment is made pursuant to order of State Authorities constituted under Electricity Act and represents mere reimbursement of cost[TS-511-ITAT-2012(Mum)]

- Since the amendment to explanation 6 has created a lot of confusion as to the application of TDS u/s 194J on payments which are not in the nature of royalty itself**, it is suggested that CBDT comes out with a circular explaining the applicability of this new explanation 6 and specifically exclude payments for telephone (including mobile) bills, payment of Internet charges, Payment to cable operators, service providers for viewing the television channels, Payment of Broadband charges, Electricity charges, Wheeling/ transmission charges paid to the state-electricity grid or private electricity transmission and distribution companies for transmission of electricity of the electricity generated by the windmills installed by private assessees to their factory/units for captive consumption**

Annexure 4 (Ref Point no.29)

ESOP shares vis-à-vis Market Shares

They are not comparable

1. ESOP shares are "issued" by the employer and "subscribed" to by the employee, whereas the shares acquired in the market ("market shares") are "transferred" from one shareholder to another. Consequently, while the market shares are goods, the ESOP shares do not become goods until they are allotted in favour of the subscribing employee.

2. It follows that the ESOP shares are not comparable with the shares that are already being traded. Therefore, it is incorrect to quantify any benefit to the employee with reference to the already trading shares or their so-called market value.

3. Even after allotment of the ESOP shares, the employee is prevented by law or the terms of the grant, from selling the shares during a lock-in period, whereas the shares bought in the market can be sold immediately without any restraint. The legal ability of disposition being one of the essential attributes of "property", the ESOP shares, unlike the market shares, are not property in the hands of the employee even after allotment.

4. When on the date of exercise the shares are subject to a lock-in condition, they cannot be considered to be a benefit; and if it is a not a benefit, it ought not to be fictionally treated as benefit and brought under "perquisites". In ***CIT v. Infosys Technologies Ltd.,(2008) 2 SCC 272*, at page 277**, the Supreme Court held as follows:

   "During the said period, the said shares had no realisable value, hence, there was no cash inflow to the employees on account of mere exercise of options. On the date when the options were exercised, it was not possible for the employees to foresee the future market value of the shares. Therefore, in our view, the benefit, if any, which arose on the date when the option stood exercised was only a notional benefit whose value was unascertainable. Therefore, in our view, the Department had erred in treating Rs.165 crores as perquisite value being the difference in the market value of shares on the date of exercise of option and the total amount paid by the employees consequent upon exercise of the said options."

   The Court further, at page 279, held:

   "It is important to bear in mind that if the shares allotted to the employee had no realisable sale value on the day when he exercised his option then there was no cash inflow to the employee. It was not possible for the employee to know the future value of the shares allotted to him on the day he exercises his option."

It may be borne in mind that in the Infosys case, the Supreme Court dismissed the Government's appeal not only because the ESOP shares were not enumerated under "perquisites" in S. 17 (2), but also because it does not amount to a benefit.

5. For this reason also the ESOP shares and the market shares are not comparable, and the latter cannot afford any basis for determining any benefit that may have accrued to the employee on account of the ESOP shares.

Discrimination

6. When a listed company issues IPO or rights shares at a price less than the market value (or bonus shares), the difference between the issue price and the market price is not taxed. If in such a case the difference does not take the character of income, it cannot be income in the case of ESOP shares too.

7. And, if such difference (in the case of IPO/rights/bonus) does take the character of income, then taxing ESOP share alone lacks any intelligible differentia that can validly explain this classification.

8. If a distinction is suggested on the ground that in the case of ESOP shares the benefit takes the character of income from salaries (which is apparent from treating it as "perquisite") which is not so in the case of market shares, it would be incorrect because such income, especially in the nature of salaries, would flow to the employee only when he realizes a gain upon the sale of the shares and not by mere allotment. Therefore, this is not a meaningful distinction.

Valuation

9. The "market value" is taken as on the date of exercise. But the ESOP shares are allotted after a lapse of time, when the market value may not be the same.

10. Even the market value on the date of allotment would not be relevant because the employee would not be able to realize that "value", being prevented from selling the ESOP shares during the lock-in period.

11. Further, the issue of ESOP shares results in expanding the capital base, and a consequent reduction in the intrinsic value of the existing shares. For this reason also, the alleged benefit flowing from ESOP shares cannot be reckoned with reference to the current value of the already existing market shares.