POST BUDGET MEMORANDUM 2016-17

1. TAX RATES :

Corporates :

The Government had announced in the Budget for 2015-16 that tax benefits / exemptions would be withdrawn and simultaneously, the basic corporate tax rate would be reduced from 30% to 25% over a period of four (4) years. In this year's Budget a road map has been given for withdrawal of the various tax benefits / exemptions but the time plan for reduction of Corporate Tax Rates has not been given.

Also, the surcharge and education cess was originally introduced for a short period of time but the same is being continued from year to year. This has pushed up the overall tax rate sharply for the corporate sector to 34.608%.

Therefore, it is suggested that the Government gives the road map / schedule for reduction in corporate tax rates and withdrawal of surcharge and education cess.

The above measures would help in giving more funds to the Corporate sector for investment and growth and also generate confidence and certainty. This in turn will result in overall buoyancy in the national economy.

Recommendation **:**

It is suggested that the Government gives a road map for the said reduction in corporate tax rates.
It is also recommended that the Government gives a time schedule for withdrawal of the said surcharge and education cess.

2. RETIRAL FUNDS:

Budget 2016 has proposed the following measures in respect of retiral funds :

- *Recognised Provident Fund* :

The accumulated balance attributable to employee contributions from 1st April, 2016 would be taxable to the extent of 60% of the said balance.

The employer's contributions in excess of 12% of salary or Rs.1.50 lacs, whichever is less, would become taxable as salary income.

- *Superannuation Fund* :

Payment in commutation of an annuity purchased out of contributions made on or after 1st April, 2016 shall be taxable to the extent of 60% of the said commuted amount.

However, the annual contributions to the said fund would be exempt to the extent of Rs.1.50 lacs against the earlier limit of Rs.1 lac and any contribution above that amount would be taxed as salary income.

In India, the social security systems are very weak and therefore, tax incentives were provided over the years to the salaried class. In fact, provident fund and pension fund have slowly emerged as the back bone in the corporate sector for the salaried population and the above taxation measures will hit them hard.

The Government has already issued some clarifications vide Press Note dated 1st March, 2016. As per the same, in respect of the accumulated balance in the Recognized Provident Fund, the taxability of the stipulated 60% balance will not apply in case the same is invested in an annuity. This is an extremely controversial suggestion since money (lumpsum) is generally utilized from the Provident Fund for various important purposes like construction of housing, children's wedding etc. and the salaried class cannot be forced to invest in any annuity scheme for tax saving purpose when lumpsum money is required post-retirement. It may be noted that it is an individual's call for deciding on utilization of the said lumpsum amount post retirement and the Government should not interfere in that area. Further, getting a cash salary and contribution to PF becomes tax neutral, then it would be preferable to obtain cash salary rather than paying tax in current year and getting the money after a long gestation period. Moreover, this would result in mixing up the entire retiral benefits schemes since the Provident Fund would effectively get converted into a pension scheme.

PF for Government employees continue to get a completely tax free status by virtue of section 10(11). Consequently, it would result in providing preferential treatment with regard to taxability of PF for Government sector vis-à-vis private sector employees.

In respect of commutation of pension, the same logic would equally apply because the commuted lumpsum amount is utilized for various important purposes for the salaried class and therefore historically the 100% tax incentive was provided in the Income Tax Law. This also will result in discrimination vis-à-vis Government Employees who continue to get the commuted annuity totally tax free. As such, it is suggested that the stipulation for taxing 60% of the commuted amount is withdrawn.

Further, the taxability of Employer's contribution in the Superannuation Fund beyond Rs.1.50 laksh is an extremely arbitrary measure since Superannuation benefits are only given post – retirement and therefore employees would be required to pay income tax immediately for a retirement benefit which will only be available after his superannuation. Moreover, Superannuation benefits are of a contingent nature which are available only if various conditions are complied with like certain number of years of service, the individual remaining alive at that stage etc.In fact, in **CIT vs. L W Russel [2002-TIOL-686-SC-IT-LB],** the Supreme Court had held that no tax can be levied in respect of a contingent interest in future which is not certain. Also, there is no monetary limit in the NPS scheme of the Government. As such it is recommended that the financial limit of Rs.1.50 lacs be withdrawn.

Recommendation :

It is recommended that all the stipulations relating to taxability of the accumulated balance / annuity for Recognised Provident Fund and Superannuation Fund as well as the financial limit of Rs.1.50 lacs for employer's contribution to Superannuation Fund be withdrawn.

3. **DISALLOWANCE OF EXPENDITURE RELATABLE TO EXEMPT INCOME IN TERMS OF 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 as per which the disallowance determined as follows:

(i) The amount of expenditure directly relating to exempt income.
(ii) Amount of interest expenditure in the proportion of the average value of investments to total assets.
(iii) 0.5% of the average value of the investment, income from which does not or shall not form part of the total income (for indirect expenses).

The Hon'ble Finance Minister in the budget speech has stated as under:
"I propose to rationalize the formula in Rule 8D governing such quantification. The said Rule is being amended to provide that disallowance will be limited to 1% of the average monthly value of investments yielding exempt income, but not exceeding the actual expenditure claimed."

Issues involved:

Considering a spate of litigation on the application of this section, the Justice R.V.Easwar committee in its report had suggested the following:

(a) Dividend received after suffering dividend-distribution tax should not be treated as exempt income and no expenditure should be disallowed as relatable to them.
(b) Expenditure disallowed shall not exceed the amount claimed.

Recommendation (b) of the committee has been accepted, however recommendation (a) has not been accepted.

Further, the budget proposes a formula of *1% of the average monthly value of investments yielding exempt income.* The proposedformula in addition to being complex, has the following issues:

- For doing the proposed calculation, it is imperative that a detailed (item wise) monthly schedule of investments is available. At present, there is no statutory requirement for maintaining monthly details and getting it audited. In absence of an audited figure, the department will always dispute the values considered by the assessee for the calculation. This will only increase the litigations.

- For large companies, where the volume of investments is huge, it will be very cumber some and complex to determine the average monthly value.

Also, the proposal in the budget speech does not address the following issues:

- Should investment held for strategic purpose (subsidiary Company, companies in similar industry) be included for purpose of Rule 8(1) (iii) disallowance.

- Should Rule 8D be applied where the securities on which exempt dividend income is received is held as stock in trade of the business of the assessee.

Recommendation:

To avoid the plethora of litigation in these matters and keeping in mind the practical difficulty in implementing the budget proposal, it is suggested that the disallowance under Rule 8D (2)(ii)& (iii) should be computed as a percentage of the exempt income earned during the financial year. In fact, the various legal authorities have already given a number of judgements (specially at the Tribunal level which is the last leg for factually determining the disallowance), where it has been held that the disallowance should be restricted to 1% of the exempt income (ref. Punjab Produce Holdings Ltd. vs.ACIT Kolkata {2016(1) TMI 309- ITAT Kolkata}, DCIT, Kolkata vs.Philips Carbon Black Ltd {133 ITD 189 (Kolkata Tribunal}

Also, the various issues listed above like treatment of strategic investments done in earlier years, securities held as stock-in-trade etc. as well as the recommendation of the Easwar Committee should be clarified.

4. **INCOME COMPUTATION AND DISCLOSURE STANDARDS (ICDS):**

CBDT has notified 10 “Income Computation and Disclosure Standards” with effect from 1-4-2015 (AY 2016-17) 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”.

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. 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 will 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.

Infact, **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 2016 are silent on the status of ICDS, specially with regard to the representations made earlier for its withdrawal as suggested by the various Chambers of Commerce / Trade Bodies and by the Institute of Chartered Accountants of India i.e. ICAI (the covering letter of ICAI is enclosed – **Annexure 1**).

Recommendation**:**

Due to the reasons stated above, it is suggested that ICDS should be completely withdrawn at this very critical stage of the national economy when there is an urgent need for ensuring the ease of doing business in India and reducing all possible complexities and consequential legal disputes.

5. **IMPLEMENTATION OF POEM :**

The Finance Act, 2015 made an amendment to provide that a company would be resident in India in any previous year if it is an Indian company or its Place of Effective Management (POEM) in that year is in India. The POEM was defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are in substance made.

CBDT had issued draft guidelines w.r.t. the same on 23rd December 2015. The same have not yet been finalised. In the Budget speech, the Hon'ble Finance Minister has stated that determination of residency of foreign company on the basis of Place of Effective Management (POEM) is proposed to be deferred by one year i.e. it will be applicable from FY 2016-17.

The budget Memorandum states that guidelines will be provided regarding the implementation of POEM.

Issues involved:

It may be noted that if the actual operations / business is done in a specific country, the taxability of income / profits should be also done in that country. Profits are an outcome of competitive superiority in an operating situation and it cannot be divorced from the market place. Therefore, it should be linked to commercial activity rather than to normative characterization of income. It is strongly felt, that the implementation of POEM is not being done in this direction.

Moreover, management and commercial decision making is completely different from Board oversight and supervision but if this does not result in diversion of incomes, it should not result in influencing the POEM.

The primary objective of implementing POEM is to target shell structures in low/nil tax jurisdictions. This needs to be dealt in a specific manner rather than bringing all the companies under the umbrella of POEM. Also, this concept of POEM for determining residency of foreign companies would affect the Government's strategy of attracting international companies for setting up Regional Headquarters in India. It will be prudent to implement the provisions based on the peculiarities specific to our country rather than merely adopting the concept from west.

Further, taxpayers are already grappling with multiple regulatory changes of the Companies Act, 2013, Ind-AS, proposed GST, etc. Industry should be allowed more time to deal with another change of this nature. In fact, this will impact the Government's initiative of improving ease of doing business in India and reducing all complexities and legal disputes. Therefore, in the present scenario, there is no requirement for implementing POEM in India.

Without prejudice to the above, it is stated that detailed guidelines need to be provided w.r.t the implementation of POEM. The process would involve issuing draft guidelines, engagement with all stakeholders and finalisation of the guidelines based on discussions and suggestions in public domain. Further, as per the budget Memorandum, every notification issued by the Central Government in this regard shall be laid before each house of the Parliament. Therefore, it is evident that this process is likely to take some time and it is very unlikely that the same will be completed by 31st March 2016. Therefore, in all probability, the guidelines will be issued later and will have to be applied by the companies retrospectively from 1st April 2016. The companies will have no time to gear themselves for applying these changes.

Recommendation:

Hence, it is strongly suggested that at present there is no need of implementing POEM in India and therefore it should be withdrawn so that international businesses can start operating in India because of the "ease of doing business" and without any complexities (like Singapore which has successfully attracted various multinational companies as a regional hub for the Asia-Pacific region). An article from the Financial Express dated 5th January, 2016 is herewith enclosed as **Annexure 2** which captures the critical implications of introduction of POEM on the Indian economy and therefore introduction of POEM should be withdrawn at this juncture.

6. **TAX ON DIVIDEND RECEIVED FROM DOMESTIC COMPANIES:**

Under the existing provisions of clause (34) of section 10 of the Act, dividend which suffer dividend distribution tax (DDT) under section 115-O is exempt in the hands of the shareholder. This year's budget has introduced a new section 115BBDA which provides that any income by way of dividend in excess of Rs. 10 lakh shall be chargeable to tax in the case of an individual, Hindu undivided family (HUF) or a firm who is resident in India, at the rate of ten percent.

Issues:

The above proposal has effectively lead to a situation of triple taxation namely, corporate tax, DDT and additional 10% tax. As a result the effective tax rate goes up drastically. The same has been explained with the help of an example:

e.g. Assuming there are 2 shareholders of a company. If the entire profits are distributed as dividend the following scenario will emerge:

	Particulars		**Rs. Crores**
	Profit before Tax		500
Less:	Corporate Tax @ 34.608%	**A**	173.04
	Profit After Tax (includes dividend and DDT)		326.96
Less:	DDT @ 20.36% on dividend paid	**B**	55.30
	Net Dividend Payout		271.66
Less:	Tax paid by shareholders @ 11.85% (10% + 15% surcharge + 3% cess)	**C**	32.18
	Total tax collected	**A + B + C**	**260.52**
	Total Tax as % of PBT		**52.10%**

This will have very negative impact on the capital markets. The investment by various promoters and large investors will get severely affected.

In addition, the following clarifications must be provided:

- Whether the tax will be levied on the entire dividend received or only on the amount exceeding Rs. 10 lacs?

- In case it is on the entire Rs. 10 lacs, then marginal relief must be provided.

Recommendation:

It is recommended that the tax on dividend income should be removed since it leads to a situation of triple taxation and the effective tax rate becomes very high. This in turn will also affect the investments in the capital market.

In case, it is not removed, the tax should be levied only on the amount exceeding Rs.10 lacs.

7. **BEPS (BASE EROSION AND PROFIT SHIFTING) ACTION PLAN - COUNTRY-BY-COUNTRY REPORT AND MASTER FILE:**

The Budget 2016 proposes to implement BEPS (based on OECD report on Action 13 of BEPS Action plan) as a part of transfer pricing documentation for certain class of companies. Therefore, Indian-headquartered Multinational Enterprises (MNEs) with ***global consolidated revenues exceeding 750 million Euro[appx Rs. 5395 crores (at current rates)]*** are required to file CbCR (Country by Country Report) from FY 2016-17 onwards. Thus the compliance documentation requirements and the compliance cost for such companies is expected to increase manifold.

It provides a framework for a 3 tier approach to transfer pricing documentation in the form of a Master file, Local file and CbC report.

(i) a master file containing standardised information relevant for all multinational enterprises (MNE) group members;

(ii) a local file referring specifically to material transactions of the local taxpayer; and

(iii) a country-by-country report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

The country-by-country report requires multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business; the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in. The Country-by-Country (CbC) report has to be submitted by parent entity of an international group, if it is resident in India. This report is to be based on consolidated financial statement of the group.

Issues :

The threshold proposed is global consolidated revenues exceeding 750 million Euro. This does not take into account the proportion of revenue derived from international transactions of the total revenue. Thus, for an enterprise where a very small portion of revenue is derived from international transactions will also have to maintain detailed documentation if it exceeds the threshold revenue limt. The same will result into unintended hardship to the assessee without any tangible benefit to the income tax department.

Recommendation:

Thus, it is recommended that a minimum threshold of revenue from international transaction must also be prescribed in addition to the global consolidated revenues. A threshold of 10% can be a reasonable requirement and therefore only those MNEs having more than 10% of the revenue from international

transactions out of the global consolidated revenues will be required to maintain the prescribed documentation under this framework.
This will have the following benefits:

a. Removal of unintended hardship for assesses.
b. Reduced burden of Income Tax department.
c. A selective approach will result into focused assessments and achieve the intended results.

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