TAXATION

Indian Tax System – An Overview

A Brief Overview

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Taxation System in India

India has a well-developed tax structure with clearly demarcated authority between Central and State Governments and local bodies.

Central Government levies taxes on income (except tax on agricultural income, which the State Governments can levy), customs duties, central excise and service tax.

Value Added Tax (VAT), stamp duty, state excise, land revenue and profession tax are levied by the State Governments.

Local bodies are empowered to levy tax on properties, octroi and for utilities like water supply, drainage etc.

Indian taxation system has undergone tremendous reforms during the last decade. The tax rates have been rationalized and tax laws have been simplified resulting in better compliance, ease of tax payment and better enforcement. The process of rationalization of tax administration is ongoing in India.

Direct Taxes

In case of direct taxes (income tax, wealth tax, etc.), the burden directly falls on the taxpayer.

Income tax

According to Income Tax Act 1961, every person, who is an assessee and whose total income exceeds the maximum exemption limit, shall be chargeable to the income tax at the rate or rates prescribed in the Finance Act. Such income tax shall be paid on the total income of the previous year in the relevant assessment year.

Assessee means a person by whom (any tax) or any other sum of money is payable under the Income Tax Act, and includes -

a) Every person in respect of whom any proceeding under the Income Tax Act has been taken for the assessment of his income or of the income of any other person in respect of which he is assessable, or of the loss sustained by him or by such other person, or of the amount of refund due to him or to such other person;

b) Every person who is deemed to be an assessee under any provisions of the Income Tax Act;

c) Every person who is deemed to be an assessee in default under any provision of the Income Tax Act.

Where a person includes:

- Individual
- Hindu Undivided Family (HUF)
- Association of persons (AOP)
- Body of individuals (BOI)
- Company
- Firm
- A local authority and,
- Every artificial judicial person not falling within any of the preceding categories.

Income tax is an annual tax imposed separately for each assessment year (also called the tax year). Assessment year commences from 1st April and ends on the next 31st March.

The total income of an individual is determined on the basis of his residential status in India. For tax purposes, an individual may be resident, non-resident or not ordinarily resident.

Resident

An individual is treated as resident in a year if present in India:

1. For 182 days during the year or;
2. For 60 days during the year and 365 days during the preceding four years. Individuals fulfilling neither of these conditions are non residents. (The rules are slightly more liberal for Indian citizens residing abroad or leaving India for employment abroad.)

Resident but not Ordinarily Resident

A resident who was not present in India for 730 days during the preceding seven years or who was non-resident in nine out of ten preceding years is treated as not ordinarily resident.

Non-Residents

Non-residents are taxed only on income that is received in India or arises or is deemed to arise in India. A person not ordinarily resident is taxed like a non-resident but is also liable to tax on income accruing abroad if it is from a business controlled in or a profession set up in India.

Non-resident Indians (NRIs) are not required to file a tax return if their income consists of only interest and dividends, provided taxes due on such income are deducted at source. It is possible for non-resident Indians to avail of these special provisions even after becoming residents by following certain procedures laid down by the Income Tax act.

Status	Indian Income	Foreign Income
Resident and ordinarily resident	Taxable	Taxable
Resident but not ordinary resident	Taxable	Not taxable
Non-Resident	Taxable	Not taxable

Personal Income Tax

Personal income tax is levied by Central Government and is administered by Central Board of Direct taxes under Ministry of Finance in accordance with the provisions of the **Income Tax Act.**

Rates of Withholding Tax

There is an obligation on the payer (either resident or non-resident) of income to withhold tax when certain specified payments are credited and/or paid. Some of the expenses that require tax withholding are as follows:

Payments by resident companies

Nature of payment	**Payment threshold for withholding Tax(WHT) (INR)**	**WHT Tax rate (%)**
Specified type of interest	5000	10
Non-specified type of interest	5,000	20
Professional or technical service	30,000	10
Commission and brokerage	5,000	10
Rent of plant, machinery, or equipment	180,000	2
Rent of land, building, or furniture	180,000	10
Contractual payment (except for individual/Hindu undivided family [HUF])	30,000 (single payment) 75,000 (aggregate payment)	2
Contractual payment to individual/HUF	30,000 (single payment) 75,000 (aggregate payment)	1
Royalty or fees for technical services	30,000	10

If the Permanent Account Number (PAN) of the deductee is not quoted, the rate of WHT will be the rate specified in relevant provisions of the Income Tax Act, the rates in force, or the rate of 20%, whichever is higher.

Payment to non-resident companies

Nature of payment	**Tax rate (%)**
Dividend	20
Interest on foreign currency (subject to conditions)	5
Interest on money borrowed in foreign currency under a loan agreement or by way of long-term infrastructure bonds (or rupee denominated bonds) (time period for borrowing is July 2012 to July 2015)	5
Interest on investment in long-term infrastructure bonds issued by Indian company (rupee denominated bonds or government security)	5
Royalty and technical fees	25
Long-term capital gains other than exempt income	20
Income by way of winning from horse races	30
Other income	40

Corporate tax

Definition of a company

A company has been defined as a juristic person having an independent and separate legal entity from its shareholders. Income of the company is computed and assessed separately in the hands of the company. However the income of the company, which is distributed to its shareholders as dividend, is assessed in their individual hands. Such distribution of income is not treated as expenditure in the hands of company; the income so distributed is an appropriation of the profits of the company.

Residence of a company

A company is said to be a resident in India during the relevant previous year if:

- It is an Indian company
- If it is not an Indian company but, the control and the management of its affairs is situated wholly in India
- A company is said to be non-resident in India if it is not an Indian company and some part of the control and management of its affairs is situated outside India.

Corporate sector tax

The taxability of a company's income depends on its domicile. Indian companies are taxable in India on their worldwide income. Foreign companies are taxable on income that arises out of their Indian operations, or, in certain cases, income that is deemed to arise in India. Royalty, interest, gains from sale of capital assets located in India (including gains from sale of shares in an Indian company), dividends from Indian companies and fees for technical services are all treated as income arising in India.

At present the domestic companies are taxes @ 30% and foreign companies @ 40% subject to Education Cess of 3% and surcharge if income goes beyond threshold limit.

Different kinds of taxes relating to a company

Minimum Alternative Tax (MAT)

Normally, a company is liable to pay tax on the income computed in accordance with the provisions of the income tax Act, but the profit and loss account of the company is prepared as per provisions of the Companies Act. There were large number of companies who had book profits as per their profit and loss account but were not paying any tax because income computed as per provisions of the income tax act was either nil or negative or insignificant.

In such case, although the companies were showing book profits and declaring dividends to the shareholders, they were not paying any income tax. These companies are popularly known as Zero Tax companies. In order to bring such companies under the income tax act net, section 115JA was introduced w.e.f assessment year 1997-98.

A new tax credit scheme is introduced by which MAT paid can be carried forward for set-off against regular tax payable during the subsequent five year period subject to certain conditions, as under:-

- When a company pays tax under MAT, the tax credit earned by it shall be an amount, which is the difference between the amount payable under MAT and the regular tax. Regular tax in this case means the tax payable on the basis of normal computation of total income of the company.

- MAT credit will be allowed carry forward facility for a period of five assessment years immediately succeeding the assessment year in which MAT is paid. Unabsorbed MAT credit will be allowed to be accumulated subject to the five-year carry forward limit.

- In the assessment year when regular tax becomes payable, the difference between the regular tax and the tax computed under MAT for that year will be set off against the MAT credit available.

- The credit allowed will not bear any interest

- **At present the base rate of MAT is 18.50% subject to Education cess of 3% and surcharge if book profit exceeds threshold limits.**

Dividend Distribution Tax (DDT)

Under Section 115-O of the Income Tax Act, any amount declared, distributed or paid by a domestic company by way of dividend shall be chargeable to dividend tax. Only a domestic company (not a foreign company) is liable for the tax. Tax on distributed profit is in addition to income tax chargeable in respect of total income.

It is applicable whether the dividend is interim or otherwise. Also, it is applicable whether such dividend is paid out of current profits or accumulated profits.

The tax shall be deposited within 14 days from the date of declaration, distribution or payment of dividend, whichever is earliest. Failing to this deposition will require payment of stipulated interest for every month of delay under Section115-P of the Act.

Rate of dividend distribution tax for the current financial year is 20.538% (Net)

Securities Transaction Tax (STT)

Securities Transaction Tax or turnover tax, as is generally known, is a tax that is leviable on taxable securities transaction. STT is leviable on the taxable securities transactions with effect from 1st October, 2004 as per the notification issued by the Central Government. The surcharge is not leviable on the STT.

Tax Rebates for Corporate Tax

The classical system of corporate taxation is followed in India

Domestic companies are permitted to deduct dividends received from other domestic companies in certain cases.

Inter Company transactions are honored if negotiated at arm's length.

- Special provisions apply to venture funds and venture capital companies.

- Long-term capital gains have lower tax incidence.
- There is no concept of thin capitalization.
- Liberal deductions are allowed for exports and the setting up on new industrial undertakings under certain circumstances.
- There are liberal deductions for setting up enterprises engaged in developing, maintaining and operating new infrastructure facilities and power-generating units.
- Business losses can be carried forward for eight years, and unabsorbed depreciation can be carried indefinitely. No carry back is allowed.
- Dividends, interest and long-term capital gain income earned by an infrastructure fund or company from investments in shares or long-term finance in enterprises carrying on the business of developing, monitoring and operating specified infrastructure facilities or in units of mutual funds involved with the infrastructure of power sector is proposed to be tax exempt.

Capital Gains Tax

A capital gain is income derived from the sale of an investment. A capital investment can be a home, a farm, a ranch, a family business, work of art etc. In most years slightly less than half of taxable capital gains are realized on the sale of corporate stock.

The capital gain is the difference between the money received from selling the asset and the price paid for it.

Capital gain also includes gain that arises on "transfer" (includes sale, exchange) of a capital asset and is categorized into short-term gains and long-term gains.

The capital gains tax is different from almost all other forms of taxation in that it is a voluntary tax. Since the tax is paid only when an asset is sold, taxpayers can legally avoid payment by holding on to their assets--a phenomenon known as the "lock-in effect."

The scope of capital asset is being widened by including certain items held as personal effects such as archaeological collections, drawings, paintings, sculptures or any work of art. Presently no capital gain tax is payable in respect of transfer of personal effects as it does not fall in the definition of the capital asset.

To restrict the misuse of this provision, the definition of capital asset is being widened to include those personal effects such as archaeological collections, drawings, paintings, sculptures or any work of art. Transfer of above items shall now attract capital gain tax the way jewellery attracts despite being personal effect as on date.

Short Term and Long Term capital Gains

Gains arising on transfer of a capital asset held for not more than 36 months (12 months in the case of a share held in a company or other security listed on recognised stock exchange in India or a unit of a mutual fund) prior to its transfer are "short-term". Capital gains arising on transfer of capital asset held for a period exceeding the aforesaid period are "long-term".

Section 112 of the Income-Tax Act, provides for the tax on long-term capital gains, at 20 per cent of the gain computed with the benefit of indexation and 10 per cent of the gain computed (in case of listed securities or units) without the benefit of indexation.

Double Taxation Relief

Double Taxation means taxation of the same income of a person in more than one country. This results due to countries following different rules for income taxation.

There are two main rules of income taxation i.e.

a. Source of income rule and
b. residence rule.

As per source of income rule, the income may be subject to tax in the country where the source of such income exists (i.e. where the business establishment is situated or where the asset / property is located) whether the income earner is a resident in that country or not.

On the other hand, the income earner may be taxed on the basis of the residential status in that country. For example, if a person is resident of a country, he may have to pay tax on any income earned outside that country as well.

Further, some countries may follow a mixture of the above two rules. Thus, problem of double taxation arises if a person is taxed in respect of any income on the basis of source of income rule in one country and on the basis of residence in another country or on the basis of mixture of above two rules.

In India, the liability under the Income Tax Act arises on the basis of the residential status of the assessee during the previous year. In case the assessee is resident in India, he also has to pay tax on the income, which accrues or arises outside India, and also received outside India. The position in many other countries being also broadly similar, it frequently happens that a person may be found to be a resident in more than one country or that the same item of his income may be treated as accruing, arising or received in more than one country with the result that the same item becomes liable to tax in more than one country.

Relief against such hardship can be provided mainly in two ways: (a) Bilateral relief, (b) Unilateral relief.

Bilateral Relief

The Governments of two countries can enter into Double Taxation Avoidance Agreement (DTAA) to provide relief against such Double Taxation, worked out on the basis of mutual agreement between the two concerned sovereign states. This may be called a scheme of 'bilateral relief' as both concerned powers agree as to the basis of the relief to be granted by either of them.

Unilateral relief

The above procedure for granting relief will not be sufficient to meet all cases. No country will be in a position to arrive at such agreement with all the countries of the world for all time. The hardship of the taxpayer however is a crippling one in all such cases. Some relief can be provided even in such cases by home country irrespective of whether the other country concerned has any agreement with India or has otherwise provided for any relief at all in respect of such double taxation. This relief is known as unilateral relief.

Double Taxation Avoidance Agreement (DTAA)

India has signed various Double Taxation Avoidance Agreement with countries to provide tax relief.

- DTAA Comprehensive Agreements - (With respect to taxes on income)
- DTAA Limited Agreements – With respect to income of airlines/ merchant shipping
- Limited Multilateral Agreement
- DTAA Other Agreements/Double Taxation Relief Rules
- Specified Associations Agreement
- Tax Information Exchange Agreement (TIEA)

Indirect Taxation

Sales tax / Central Sales Tax (CST)

Central Sales tax is generally payable on the sale of all goods by a dealer in the course of inter-state trade or commerce or, outside a state or, in the course of import into or, export from India.

Value Added Tax (VAT)

VAT is a multi-stage tax on goods that is levied across various stages of production and supply with credit given for tax paid at each stage of Value addition. Introduction of state level VAT is the most significant tax reform measure at state level. The state level VAT has replaced the existing State Sales Tax.

There is provision for eliminating the multiplicity of taxes. In fact, all the State taxes on purchase or sale of goods (excluding Entry Tax in lieu of Octroi) are required to be subsumed in VAT or made VATable.

Provision has been made for allowing "Input Tax Credit (ITC)", which is the basic feature of VAT. However, since the VAT being implemented is intra-State VAT only and does not cover inter-State sale transactions, ITC will not be available on inter-State purchases.

Roadmap towards GST

The Empowered Committee of State Finance Ministers has been entrusted with the task of preparing a roadmap for the introduction of national level goods and service tax and is expected to roll it from 1st April 2016.

Excise Duty

Central Excise duty is an indirect tax levied on goods manufactured in India. Excisable goods have been defined as those, which have been specified in the Central Excise Tariff Act as being subjected to the duty of excise.

There are three types of Central Excise duties collected in India namely:

Basic Excise Duty

This is the duty charged under section 3 of the Central Excises and Salt Act,1944 on all excisable goods other than salt which are produced or manufactured in India at the rates set forth in the schedule to the Central Excise tariff Act,1985.

Additional Duty of Excise

Section 3 of the Additional duties of Excise (goods of special importance) Act, 1957 authorizes the levy and collection in respect of the goods described in the Schedule to this Act. This is levied in lieu of sales Tax and shared between Central and State Governments. These are levied under different enactments like medicinal and toilet preparations, sugar etc. and other industries development etc.

Special Excise Duty

As per the Section 37 of the Finance Act,1978 Special excise Duty was attracted on all excisable goods on which there is a levy of Basic excise Duty under the Central Excises and Salt Act,1944.Since then each year the relevant provisions of the Finance Act specifies that the Special Excise Duty shall be or shall not be levied and collected during the relevant financial year.

Customs Duty

Custom or import duties are levied by the Central Government of India on the goods imported into India. The rate at which customs duty is leviable on the goods depends on the classification of the goods determined under the Customs Tariff. The Customs Tariff is generally aligned with the Harmonised System of Nomenclature (HSL).

In line with aligning the customs duty and bringing it at par with the ASEAN level, government has reduced the peak customs duty from 12.5 per cent to 10 per cent for all goods other than agriculture products. However, the Central Government has the power to generally exempt goods of any specified description from the whole or any part of duties of customs leviable thereon. In addition, preferential/concessional rates of duty are also available under the various Trade Agreements.

Service Tax

Service tax was introduced in India way back in 1994 and started with mere 3 basic services viz. general insurance, stock broking and telephone. Today almost all the services come under the ambit of service tax barring those mentioned in negative list. There has been a steady increase in the rate of service tax. From a mere 5 per cent, service tax is now levied on specified taxable services at the rate of **14.5 per cent of the gross value of taxable services**. Service tax is a tax levied by the government on service providers on certain service transactions, but is actually borne by the customers.

In this case, the service provider pays the tax and recovers it from the customer. Service Tax was earlier levied on a specified list of services, but in the 2012 budget, its scope was increased. Services provided by air-conditioned restaurants and short term accommodation provided by hotels, inns, etc. were also included in the list of services.

It is charged to the individual service providers on cash basis, and to companies on accrual basis. This tax is payable only when the value of services provided in a financial year is more than Rs 10 lakh. This tax is not applicable in the state of Jammu & Kashmir.

There is concept of Input credit for Service tax paid under Cenvat Credit Rules. Also on certain services there is abatement towards cost of material consumes resulting in lower rates of service tax. Certain services are charged under Reverse Charge Mechanism in which the service recipient has to pay tax instead of service provider as in any other case.

About Habibullah & Co.

Habibullah & Co. (HCO) is a professional services firm providing audit, assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. Guided by core values including competence, honesty and integrity, professionalism, dedication, responsibility and accountability.

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- 100 staff
- 6 offices across India
- International Representation through "Antea- Alliance of Independent Firms"

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Thanks