Rebuilding bharat

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The Indian Union Budget for the financial year 2017-18 was announced on 1st February 2017. The framework of the Budget was impacted on account of various issues such as demonetisation; uncertainties on indirect transfer taxes, adoption of General Anti Avoidance Rules and treaty negotiations.

Further, departing from the earlier practice of presenting the Budget on last day of February, it was presented much earlier on 1st February thus making it distinctive. The Budget is even historic as for the first time, the Railway Budget is not a separate event but merged with the Union Budget.

The Budget has been a progressive as the Hon'ble Finance Minister (FM) has sought to provide amicable solutions to various pressing issues raised by different group of investors both locally and globally. The budget has suggested policy measures to re-build the investors' confidence into the Indian markets which were shaken in the recent past on account of governments inaction on various issues and tax policies.

We have provided below a detailed analysis on the 2017 Budget proposals.

Corporate Income Tax

In the earlier Budgets the FM had proposed a gradual reduction of corporate income tax rates to 25%. In Finance Act, 2016 a small step in this regard was taken by lowering the corporate tax rate for a limited number of small companies. In the Budget Speech, the FM noted that in spite of their pivotal role in the economy, medium and small enterprises pay tax at effectively higher rates than large companies. In order to make medium and small enterprises more viable and to encourage firms to shift to company structure, the Budget has proposed a reduced tax rate of 25% (as opposed to the current rate of 30%) for domestic companies whose total turnover or gross receipt does not exceed INR 50 Crore.

The aforesaid proposal is expected to affect nearly 96% of companies in India and reinforces the motto of pro-poor government. It also should come as a welcome move for small and medium enterprises (MSME), many of which were adversely affected by demonetization. While this is a welcome move by the MSME sector it could encourage tax planning and mitigation practices.

Indirect Transfers

The indirect transfer tax provisions provides that where there is a transfer of shares or interest of a foreign company or entity, whose value is derived substantially from assets located in India, in such case, income arising from such transfer can be brought within the Indian tax net.

A circular was released by the Central Board of Direct Tax ("CBDT") in December last year which was intended to provide clarity on the circumstances in which the indirect transfer provisions could apply, but ended up creating more confusion and failed to address key industry concerns with regard to potential multi-stage taxation and stringent compliance requirements. Various representations were filed due to lack of clarity on taxation of indirect transfers and accordingly the circular was kept in abeyance.

Having said the above, the industry expected that the Budget would address the various concerns raised, and provide clarity on the pressing issues of such double taxation.

The Budget proposes to add a new explanation to Section 9(1)(i) which clarifies that the provisions contained therein shall not be applicable to an asset or capital asset that is held directly/ indirectly by way of investment in a category I or category II FPI. This resolves

concerns for a class of offshore funds which are registered as a category I or category II FPIs as redemptions by investors at the level of the fund shall not be subject to the indirect transfer taxation. Further, in multi-tiered structures, if the entity investing into India is a category I or category II FPI, any up-streaming of proceeds by way of redemption / buyback will not be brought within the Indian tax net. The provisions also exclude, from applicability of the indirect transfer tax provisions, situations where any redemptions or re-organizations or sales result in capital gains by investors in category I or category II FPIs.

The clarificatory explanations are applicable retrospectively from FY starting April 1, 2012, and therefore should help bring about certainty on past transactions that have been entered into by category I and category II FPI entities.

While the above move is beneficial for the category I and category II FPIs, the budget fails to provide any relief to category III, Private Equity, Venture Capitalist investors.

Capital gain on conversion of Preference shares to Equity Shares

The Budget has proposed an amendment to Section 47 of the ITA to exempt gains arising upon the conversion of preference shares into equity shares from capital gains tax. The memorandum explaining the provisions of the Finance Bill has also proposed corresponding amendments to Section 2(42A) and Section 49 of the ITA to provide for determination of holding period and cost of acquisition of the equity shares receivable on conversion of the preference shares. The holding period for the resulting equity shares will now include the holding period of the preference shares and the cost of acquisition of the resulting equity shares will be the cost of acquisition of the preference share in relation to which the equity share was acquired by the investor. The amendments are prospective in nature and will come into effect from FY 2017-18.

Given that Compulsorily Convertible Preference Shares (“CCPS“) are often the preferred instrument of choice for venture capital and early stage private equity investors, these amendments give such investors yet another reason to reconsider the most appropriate strategy and timing for conversion of their CCPS into equity shares in respect of their investments in Indian companies.

Withholding tax benefits

With a view to boost the foreign direct investment into India, the Finance Act 2016 had introduced a beneficial Tax Deducted at Source (“TDS”) rate of 5% in respect of interest payments made to non-residents.

This provision was applicable to agreements entered into / bonds issued on or after July 1, 2012 and had a sunset clause stating that the benefits would only be applicable to agreements entered or issuances carried out before July 1, 2017. However, considering the representations made by industry participants, the Budget proposes to amend Section 194LC to extend the term of the interest rate contained in provision to July 1, 2020. This shall be put into effect from FY 2017-18.

The benefit of lower TDS at a rate of 5% has also been extended to rupee denominated bonds (masala bonds) issued to non-residents.

Capital Gain Benefits and Exemption

In order to promote the use of rupee denominated bonds it is proposed to amend Section 47 of the ITA to provide that transfers of rupee denominated bonds of an Indian company by a non-resident to another non-resident shall not be considered to be a transfer under the ITA. This amendment shall be put into effect from FY 2017-18.

The Budget proposes amendment in respect of cost of acquisition for foreign companies that acquire shares out of a tax neutral demerger under ITA. Such demergers are covered under Section 47(vic) of the ITA which exempts transfers of shares of an Indian company is a demerger process if:-

i. The shareholders holding not less than three-fourths in value of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

ii. Such transfer does not attract capital gains tax in the country in which demerged foreign company is incorporated.

In the aforementioned scenario, the Budget provides that in such cases the cost of acquisition of shares which are consequently transferred to the resulting foreign company shall be the same as it was for the previous owner of the shares i.e. the demerged foreign company.

Holding Period of Immovable Property Decreased; Base Year Shifted

Capital gains are classified as long term or short term, based on the period for which the assets were held by the transferor. Long term capital gains are subject to reduced tax rates. Currently, for immovable property to be considered as a long term asset, a holding period of thirty-six (36) months is applicable. With the objective of incentivizing investment in real estate, the Finance Bill proposes to reduce this holding period to twenty-four (24) months and bring it in line with the holding period for unlisted shares. This is certainly an encouraging development for taxpayers with investments in real estate and should give a much needed fillip to the real estate sector by encouraging the mobility of real assets.

Further, the Finance Bill also proposes to amend Section 55 of the ITA to shift the base year for computing the cost of acquisition of property by twenty years (from April 1, 1981 to April 1, 2001) for all classes of assets including immovable property. The tax payer is allowed to use either the actual cost of acquisition or the FMV of the asset as on April 1 of the base year as the cost of acquisition. The proposal will definitely buoy the sentiment of taxpayers engaged in the real estate sector.

Special provisions for joint development agreement

The Finance Bill has provided relief to land owning individuals and HUFs by proposing to suitably amend the ITA in a manner which specifies that in case of any transfer of land/building by an individual or Hindu Undivided Families (“HUFs”) under a Joint Developing Agreement, the liability on the transferor to pay capital gains tax will arise in the year in which the project is completed. The project will be considered to be complete when the certificate of completion for the whole or part of the project is issued by the competent authority.

The amendment also clarifies that the consideration for the transfer of immovable property shall be the value adopted or assessed or assessable by any authority of Government for the purpose of payment of stamp duty in respect of that immovable property (as on date of certificate of completion) along with any monetary compensation which may have been received by the land owner.

The Finance Bill also proposes to insert a new Section 194-IC with effect from April 1, 2017, which puts an obligation on every person making a payment as part of the consideration under a JDA, to withhold 10% of the sum being paid, either at the time of crediting the amount to the account of the payee or at the time of making actual payment to the payee.

Exemption from taxing notional rental income

Section 23 of the ITA provides that the annual value of any property shall be the sum for which the property might reasonably be expected to be let out. This Section lays down the manner of determination of annual value of house property and currently requires house owners to pay tax on notional income arising from house property even if no actual income is realized through rent.

Finance Bill proposes to amend Section 23 of the ITA to exempt them from having to pay tax on notional rental income from house property which is held as a stock-in-trade (provided that the property in question or any part of it is not let-out for any part of the previous year), for a period of one year from the end of the FY in which the certificate of completion of construction of the property is obtained from the competent authority.

General Anti-Avoidance Rules

GAAR which was introduced in the ITA by Finance Act, 2012 is going to come into effect from April 1, 2017. GAAR confers broad powers on the tax authorities to deny tax benefits (including tax benefits applicable under tax treaties), if the tax benefits arise from arrangements that are 'impermissible avoidance arrangements'

While there was no mention of GAAR in the Budget Speech or any of the other Budget documents, the CBDT recently released a circular providing clarifications on implementation of GAAR.

Thin Capitalization Rules:

The Finance Bill proposes the introduction of Section 94B ("Thin Capitalization Rules") to provide that where an Indian company or PE of a foreign company makes interest payments (or similar consideration) to its associated enterprise, such interest shall not be deductible at the hands of the Indian company/ PE to the extent of the "Excess Interest". Excess Interest means an interest amount that exceeds 30% of the Earnings before Interest, Taxes, Depreciation and Amortization ie EBIDTA of the Indian company / PE. In the event the interest payment payable/ paid is less than Excess Interest, the deduction will only be available to the extent of the interest payment payable/ paid.

Capital gains on transfer of unlisted shares

The Finance Bill has proposed an amendment whereby in respect of transfers of unlisted shares of a company, at less than the FMV, the FMV would be deemed to be the full value consideration for computing capital gains. This essentially results in increasing the capital gains tax burden for the transferor by bringing into the tax net a concept of notional gains which is actually not received by the transferor.

The amendment has been introduced as anti-abuse provision, the test lies in the fact that even commercial transactions between unrelated parties can be subject to this notional tax. Also, this provision when read with Section 56, it leads to a situation of double taxation since (a) the transferor company is taxed on a notional capital gains on the difference between the notional

fair market value of the shares and the actual consideration received; and (b) the transferee company is taxed under Section 56 in respect of the difference between the notional fair market value of the shares and the consideration actually paid.

Definition of person widened

The Budget now proposes to expand the definition of person under section 56 to cover all persons including inter alia, Association of Persons, listed companies and foreign persons, with only limited exceptions for charitable organisations, educational institutions, hospitals, etc. Further, the provisions are proposed to be expanded to cover acquisition / receipt of almost all types of assets (and not just shares), with an exception only in limited cases such as marriage, etc., which are already currently excluded in case of individuals.

Long Term Capital Gains: Restrictions on exemption for sale of listed shares

The Budget has proposed restrictions on the existing exemption provided under Section 10(38) of the ITA for long term capital gains arising on the sale of Indian listed equity shares on the stock exchange. The ITA currently does not tax long term capital gains earned from such transactions as long as the transactions were entered into after the coming into force of the Securities Transaction Tax ("STT") and were chargeable to STT.

The Memorandum to the Finance Bill notes that the exemption from tax provided for long term capital gains upon transfer of listed shares, is being misused by persons for declaring unaccounted income as exempt long term capital gains by entering into sham transactions. The Budget has therefore proposed a proviso to Section 10(38) to the effect that the exemption therein will not be available where the acquisition of the equity shares being transferred was not chargeable to STT.

Transfer Pricing: Secondary Adjustment announced

The Budget has proposed two important changes with respect to transfer pricing under the ITA which will come into effect on April 1, 2018,

a) International Transaction

The first amendment introduces Section 92CE which requires a resident taxpayer who has entered into an international transaction to make a secondary adjustment in the event that a primary adjustment as per transfer pricing provisions:

i. has been made suo moto by the taxpayer in his income tax return,

ii. has been made by the Assessing Officer and accepted by the taxpayer,

iii. has been determined by an advanced pricing agreement,

iv. is made as per safe harbor rules under the ITA,

v. is a result of mutual agreement procedure under a tax treaty

The provisions further prescribe that where, as a result of primary adjustment, there is an increase in the taxpayer's total income or a reduction in allowable loss, a secondary adjustment shall have to be made. The purpose of such secondary adjustment is also to eliminate the imbalance between the taxpayer's accounts and actual profits. The Section prescribes that the excess money (difference between the arm's length price determined in the primary adjustment and the actual consideration price) shall be deemed to be an advance

made by the taxpayer to its associated enterprise, if it is not repatriated to India within a prescribed time. Once deemed to be an advance, interest shall also be payable on the excess income until the obligation to repatriate such amount is discharged.

However, Section 92CE will not be applicable where the amount of primary adjustment made in any previous year does not exceed INR 1 crore and is made in respect of an assessment year commencing on or before the April 1, 2016.

b) Specified Domestic Transaction

The second amendment involves restricting the scope of *specified domestic transactions* which are subject to transfer pricing by introducing an amendment to Section 92BA of the ITA. Currently, transfer pricing provisions under the ITA are applicable to *specified domestic transactions* where the aggregate of such transactions in the previous year exceeds INR 20 Crore. The condition that transfer pricing will be applied in respect of determining the arm's length nature of expenditure incurred has now been removed.

Relief for Startups

As per the present Finance Act, 2016, there is a restrictions on carry forward of losses in case of substantial change in shareholders of the Indian company. Essentially, shareholders of the company at the end of the financial year in which the loss was incurred must own at least 51% of the shares in that company in the year that the carry forwarded loss is claimed as a deduction; otherwise, the company loses the ability to carry forward the loss. However, start-ups typically experience significant change in shareholding due to multiple investment rounds and are often unable to meet the above conditions for carry forward of losses.

As a relief to the above, the Budget proposes that as long as all the original shareholders of the Company at the end of the financial year in which the loss was incurred continue to be shareholders in the financial year in which it is claimed, the benefit of carry forward loss will be available. The loss can be carried forward and claimed only if it was incurred within seven years of the incorporation of the company. Hence the change in the current Budget to allow the carry forward of such losses is welcome.

Further, as per Section. 80-IAC a start-up can elect to have its income exempt from income tax for three successive years within a block of five years. Many start-ups could not practically avail of these benefits since they were mostly loss making in those years and they were unable to qualify as an 'eligible start-up' as well. To make this benefit more meaningful, the Budget appears to have taken into account the fact that start-ups may take a longer period to become profitable and has now made an amendment wherein a start-up could now elect to have its income exempt from income tax for three successive years within a block of seven years instead.

Minimum Alternate Tax ('MAT')

In light of the implementation of the new Ind-AS, detailed provisions have been proposed to compute MAT in accordance with the revised accounting standards. There are provisions for the first time adoption of MAT as well as for the accounting and MAT treatment in the future years.

In order to reduce the burden on the companies, the Budget proposes a 15 year carry forward of the MAT credit as opposed to the current 10 years carry forward

Interpretation of ‘terms’ in tax treaties:

Under the ITA, if India has a tax treaty with a foreign country, then the taxpayer may be taxed either under domestic law provisions or the tax treaty to the extent it is more beneficial. As it is the case with most treaties, all terms used in the treaty may not be defined in the treaty.

In order to mitigate unwanted litigation, the said provisions provide that if a 'term' is used in a tax treaty but not defined in the ITA or the tax treaty, it shall have the meaning assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf, provided the same is not inconsistent with the provisions of this Act or the agreement. The ITA further provides for an Explanation which states that when a meaning is assigned to a term by way of a notification as specified above, it shall be retroactively applicable from the date on which the treaty came into force.

The Finance Bill proposes to amend these provisions to add an Explanation which provides that where any 'term' used in a tax treaty is defined under the tax treaty it will be given the same meaning as provided in the said tax treaty. However, in a case where no meaning has been assigned to the ‘term’ in the treaty, but the ‘term’ has been defined in the ITA, it shall be assigned the meaning as provided in the ITA or any explanation given to it by the Central Government.

The motive behind the amendment, as provided in the Memorandum to the Finance Bill, is to avoid litigation related to taxation of non-residents as suggested by the income-tax simplification committee on interpreting terms in tax treaties.

Personal Taxes

Individual Tax rates

From a personal taxation point of view, this continues to be tax the rich and give the poor budget. The Budget announced three major changes to personal income tax:

i. Changes in tax rate for tax slab of INR 2.5 Lakhs to 5 Lakhs to 5% from existing 10%

ii. Rebate continued however, reduced to INR 2,500 for income upto INR 3.5Lakh

iii. Surcharge at a rate of 10% levied for those earning income from 50 Lakh to 1 Crore

Rationalization of taxation of income by way of dividend

As per Section 115BBDA of ITA, income by way of dividend in excess of Rs. 10 lakh is chargeable to tax at the rate of 10% on gross basis in case of a resident individual, Hindu undivided family or firm.

With a view to ensure horizontal equity among all categories of tax payers deriving income from dividend, the Budget proposes to amend section 115BBDA so as to provide that the provisions of said section shall be applicable to all resident assessee except domestic company and certain funds, trusts, institutions, etc.

This amendment will take effect from 1st April, 2017 and will, accordingly apply in relation to the assessment year 2018-19 and subsequent years.

Withholding tax in the case of certain Individuals and Hindu undivided family

As per Section 194-I of ITA, inter alia, provide for deduction of tax at source at the time of credit or payment of rent to the account of the payee beyond a threshold limit. It is further provide that an Individual or a Hindu undivided family who is liable to get the books of accounts audited under the ITA shall be subject to deduction of tax at source under this section.

Therefore, under the existing provisions of the aforesaid section, an Individual and HUF, being a payer (other than those liable for tax audit) are out of the scope of section 194-I of the Act.

The Budget proposes to widen the scope to provide that Individuals or a HUF other than those who are required to get the accounts audited, be responsible for paying to a resident any income by way of rent exceeding INR 0.5 Lakh for a month or part of month d, shall deduct an amount equal to 5% as tax deducted at source.

It is further proposed that tax shall be deducted on such income at the time of credit of rent, for the last month of the year/ tenancy if the property is vacated during the year, as the case may be, to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier.

In order to reduce the compliance burden, it is further proposed that the deductor shall not be required to obtain tax deduction account number (TAN) as per section 203A of the Act. It is also proposed that the deductor shall be liable to deduct tax only once in a year.

This amendment will take effect from 1st June, 2017.

Proposals and Amendments under Indirect Taxes

The FM in his speech had expressed his views on the progress made in the area of Goods and Services Tax as the biggest tax reform since independence. The preparatory work for this path breaking reform is nearing its closure as the same is taken as a top priority project and the Government Offices are trying to give a finishing touch to the Model GST Law, Rules and other details and is trying to implement the same as early as April 2017.

In light of the above, the FM has not made many changes in the existing laws under Excise and Service Tax.

Service Tax

The amendments under Service Tax can be separated into two based upon the effective date for such amendments.

Changes Effective from 2nd February, 2017

Based upon the budget proposals and followed by Notification 7/2017 Service Tax dated 2nd February, 2017 the following changes shall be effective:

Under Serial 9B of the Mega Exemption Notification 25/2012 Service Tax –

Prior to the amendment, only Services Provided by IIMs to two year residential post graduate full time courses were exempt, going forward and on omission of the word “Residential” from the said notification, the scope of exemption is expanded even to the Services provided to non-residential post graduate courses offered by the IIMs.

Under Serial 23A of the Mega Exemption Notification, Exemption of Viability Gap funding –

It is proposed to exempt the amount of viability gap funding received by Airlines for providing services to the Government in the form of transport of passengers with or without accompanied belongings against consideration in form of viability gap funding under and from the date of commencement of operations of Regional Connectivity Scheme Airport as notified by the Ministry of Civil Aviation.

Amendment in CENVAT Credit Rules, 2004 –

The change in rules by inserting New Provisio under section 6(3) for reversal of CENVAT credits shall be applicable to Banking Companies, and Financial Institutions including Non Banking Finance Companies (NBFC).

Based upon the existing rules, reversal of either of the following was possible:

i. Reversal of Common Credit based on Turnover or 7% of the value of exempt services; or
ii. Pay 50% of the CENVAT credit availed during the month

For Banking Companies and NBFC under the calculation of common credit the amount of interest and discounts were not included in the calculations (neither for calculating the exempt turnover and nor the total turnover). However, now such interest will have to be included for the calculation of proportion to be reversed to the value of exempt services as well as to the

total value of services besides the value of other taxable services forming part of the total turnover.

Transfer of CENVAT Credit Rule 10 sub rule 4 inserted:

With the insertion of the said rule, in case of transfer of a business / business unit ie in case of Sale, Merger, Amalgamation, lease or transfer of factory the unutilized portion of CENVAT credit can be transferred to the acquirer within a period of 3 months from the date of application made by him to the Authorities which period shall not exceed 6 months if sufficient cause is shown. Under earlier provisions, such credit was only allowed to be transferred if the stock of inputs and the capital goods on which such credit was outstanding were also transferred as a part of the business reorganisation.

Changes to be Effective from enactment of Finance Bill

Based upon the budget proposals and followed by Notification 7/2017 Service Tax and subsequent to the assent of the President, the following changes shall be effective:

Under Serial 30 of the Mega Exemption Notification 25/2012 Service Tax –

Certain intermediate processes amounting to manufacture in relation to agriculture, printing or textile processing, cut and polished diamonds, gemstones etc. are exempted. Few other processes have been added to form a part of the current negative list such as processing of any goods excluding alcoholic liquor on which duty is paid by the principal manufacturer and also the processes like electroplating wherein value of taxable services not exceeding One Hundred and Fifty Lakh Rupees.

Advance Ruling Provisions –

It is proposed to increase the fees for making an application to the Advanced Ruling Authority from Rs.2,500 to Rs.10,000 under section 96C(3) of the Finance Act, 1994.

Further, the Authority under these provisions shall mean the Authority for Advance Ruling under Central Excise, Customs and Service Tax.

Moreover, the period for pronouncements of the rulings under these provisions is revised from ninety days to six months under section 96D(6) of the Finance Act

Insertion of Section 96HA for transference of the existing applications and proceedings as on the date of the Presidential Assent to the Authorities stated above at the stage they are present as on that date.

Retrospective amendment for Exemption of one time upfront amount paid for services provided by Government Industrial Development Corporation or Undertaking to Industrial Units –

No Service Tax shall be leviable on one time upfront amount (premium, salami, cost, price, development charge or by whatever name called) in respect of taxable service provided or agreed to be provided by a State Government Industrial Development Corporation or Undertaking to industrial units by way of grant of long term lease of thirty years or more. The amendment will be effective retrospectively from 1st June, 2007 and refund application for any taxes paid for such services shall be made within six months from the enactment of the bill ie assent of the President is received.

Retrospective amendment on Insurance Services to members of Army, Navy, and Air Force –

Further to the above, another retrospective amendment is proposed for exempting the Group Life Insurance schemes provided to the Army, Navy and Air Force with effect from 10th September, 2004. The application for refund for such taxes paid shall be filed within six months of enactment of the bill.

Changes in determination of value rules for Sale of Under Construction Flats –

The amendment under existing rules has been made to include the determination of value of services from the execution of works contracts involving transfer of goods and land or undivided share of land (under construction flats).

Period of effect of amendment	Description	Conditions	Taxable Portion
1st July, 2010 to 30th June, 2012	Gross amount charged for the works contract includes value of goods as well as land or undivided share of land	(i) the CENVAT Credit of duty paid on inputs or capital goods or the CENVAT Credit of service tax on input services, used for providing such taxable service, has not been taken under the provisions of the CENVAT Credit Rules, 2004; (ii) the service provider has not availed the benefit under the notification 12/2003-Service Tax	25%
1st July, 2012 to 28th February, 2013	Amount charged for the works contract includes value of goods as well as land or undivided share of land	Same as above	25%
1st March, 2013 to 7th May, 2013	Amount charged for the works contract includes value of goods as well as land or undivided share of land	Same as above	30%
	Works Contract for Construction of residential units having carpet area up to 2000 sq ft or amount charged is below 1 crore and includes value of goods and land or undivided share of land		25%
8th May, 2013 to 31st March, 2016	Amount charged for the works contract includes value of goods as well as	Same as above	30%

	land or undivided share of land		
	Works Contract for Construction of residential units having carpet area up to 2000 sq ft or amount charged is below 1 crore and includes value of goods and land or undivided share of land		25%
1st April, 2016 onwards	Amount charged for the works contract includes value of goods as well as land or undivided share of land	Same as above	30%

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