India

Finance Act 2016 – A Shot in the Arm for India's Finance Sector

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This article discusses tax and regulatory reforms in India's financial sector, arising from the government's 2016 Budget and subsequent legislation, particularly relating to taxation of gains on the transfer of securities and the impact of the changes on investment funds and securitization. The authors also address the newly introduced Insolvency Code and highlight areas still requiring reform.

1. Introduction

The Indian Finance Minister, Mr Arun Jaitley, announced India's 2016 Budget proposals before Parliament on 29 February 2016. The Budget focused on remedying certain critical points of concern to foreign investors, and announced a slew of reforms of the Indian tax and regulatory framework. Among several overhauling changes on the tax and legal front, the Budget proposed several reforms in the financial sector. The Finance Bill 2016, tabled before the Lower House of Parliament on the day of the Budget, contained amendments to the taxation laws. The Bill has now been enacted as the Finance Act 2016, after receiving Presidential assent on 14 May 2016. The legal and regulatory changes announced in the Budget have now been implemented by passing the necessary notifications.

In addition, the much-awaited Insolvency and Bankruptcy Code 2016 (the Code) has been notified in the Official Gazette, after receiving Presidential assent on 28 May 2016. The Code is introduced as a comprehensive and consolidated law regarding insolvency and bankruptcy. It creates time-bound processes for the resolution of insolvent companies and bankrupt individuals.

This article focuses on changes in the Income Tax Act 1961 (ITA), which affect the finance sector in India, as well as certain key reforms in the regulatory framework affecting foreign investment in the finance sector.

2. Changes to the Corporate Tax Regime

2.1. Tax rate

Presently, the corporate tax rate in India for domestic companies is 30% (excluding surcharge and cess). In his 2015 Budget Speech, the Finance Minister announced a reduction in the rate from 30% to 25%, in a phased manner over the next four years, in consonance with a reduction in available exemptions. This was proposed with the view to make domestic industry in India more competitive vis-à-vis other major Asian economies, where corporate tax rates are significantly lower. Accordingly, there was wide anticipation for a reduction in the corporate tax rates for the 2016-17 fiscal year.

While the corporate tax rate in general for the 2016-17 year remains at 30%, it has been reduced to 29% in the case of small companies having a turnover in the 2014-15 financial year not exceeding INR 50 million (approx. USD 750,000). Further, companies which are set up on or after 1 March 2016 and engage solely in the business of manufacture or production, have been given an option to be taxed at the rate of 25% (instead of 30%), without claiming certain deductions and incentives under the ITA.

In addition, provisions have been introduced into the ITA[1] allowing for an additional 10% levy on dividends of more than INR 100,000 received by resident individuals, Hindu Undivided Families (HUFs) and firms. Given that dividend distribution tax is, in any event, a tax on distributed income at the company level, the additional tax on residents receiving dividends seemingly results in an additional layer of tax, albeit aimed only to target the "super-rich" income group.

2.2. External commercial borrowings

While the Indian government has aimed to increase tax certainty for foreign investors and lower tax rates, the Reserve Bank of India (RBI) also recently revised the external commercial borrowings framework to permit Indian corporates to issue rupee-denominated bonds outside India.[2] This measure was complemented by an amendment to section 48 of the ITA, whereby any gains arising to a non-resident

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1. Sec. 115BBDA ITA.
2. A.P. (DIR Series) Circular No. 17, 29 September 2015, available at https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10049&Mode=0.

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lender on account of appreciation in the value of the Indian currency at the time of redemption of rupee-denominated bonds subscribed by it are exempt from capital gains tax.

On 29 October 2015, the Central Board of Direct Taxes (CBDT) issued a notification stating that withholding tax (WHT) at a concessional rate of 5% would apply to interest paid to non-resident investors that invested in rupee-denominated bonds, as is the case for United States dollar-denominated bonds. The Finance Act 2016 is, however, silent on this.

2.3. Decrease in holding period for unlisted securities

Under the ITA, capital gains are categorized as long-term and short-term, based on the period that the asset is held by its owner before transfer. Long-term capital gains are taxed at a lower rate. Generally, an asset qualifies as a long-term capital asset if it is held for more than 36 months. Prior to 2014, the holding period for all securities was 12 months, for the gains to qualify as long-term capital gains. However, the Finance Act 2014 restricted the 12-month period to only listed securities and certain other classes of securities, such as units of an equity-oriented mutual fund. The Finance Act 2016 has now reduced the holding period for unlisted securities from 36 months to 24 months.

2.4. Capital gains on the transfer of shares of a private company

Under the ITA, long-term capital gains arising to a non-resident upon transfer of a capital asset situated in India are taxable at the rate of 20%. Long-term capital gains arising to a non-resident from sale of unlisted securities of a public company are taxable at 10% if the taxpayer does not avail itself of indexation benefits. The Finance Act 2016 extended this 10% beneficial rate to long-term capital gains arising to a non-resident from the sale of unlisted shares of a private company as well.

As far as long-term capital gains tax rates are concerned, this change puts private equity and venture capital investors (which primarily make investments in the private space) on the same footing as foreign portfolio investors (FPIs), who sell securities off the floor of the stock exchange.

The issue of characterization of income earned from the sale of listed or unlisted shares (i.e. whether in the nature of business income or capital gains) has been a highly litigated subject. In the past, courts[3] and departmental circulars[4] have been cognizant of this and have aimed to provide objective tests to assess characterization. These tests primarily state that factors such as the manner of maintaining books of accounts, the magnitude of purchases and sales, the ratio between purchases and sales, and the period of time that shares were held should provide guidance for determining the nature of the transaction. Further, ordinarily the profits from the sale of shares should be considered as business income or capital gains, respectively, based on whether the object of the purchase of the shares is to earn a profit from their sale or to earn dividends from the shares held as an investment.

Very recently, the tax department introduced a circular[5] which provides that, in the case where a taxpayer opts to treat listed shares and securities as stock-in-trade, income from the transfer of such shares and securities would be treated as business income, irrespective of the holding period. The circular further allows the taxpayer the option to treat listed shares and securities held for more than 12 months as capital assets in his books of accounts, and such treatment cannot be disputed by the tax authorities. Once made by the taxpayer, his election cannot be changed by him in subsequent years. In all other cases, the nature of the transaction (i.e. whether it produces a capital gain or business income) continues to be determined in accordance with earlier circulars.

3. Impact on Investment Funds

3.1. Removing WHT on distributions made to foreign investors

The Finance Act 2015 had introduced a tax pass-through regime for Category I and Category II Alternative Investment Funds (AIF),[6] i.e. domestic investment funds, whereby the income earned by AIFs (except for business income) was tax exempt in the hands of the AIF but taxable in the hands of the investor. However, the tax pass-through was negated by a 10% blanket WHT, which was imposed on all distributions made to investors, without accounting for tax-exempt investors and tax-exempt income streams. This created hurdles for foreign investors investing in AIFs, since beneficial provisions under tax treaties were not taken into account.

Following recommendations under the Alternative Investment Policy Advisory Committee's report,[7] the Finance Act 2016 provides that, when distributions are made by Category I and Category II AIFs to a non-resident investor, tax is required to be deducted at "rates in force", i.e. the applicable tax rate under a relevant double tax treaty (DTT) or the ITA, whichever is more beneficial.[8] This is a welcome change which will favour unified fund structures[9] and encourage participation by non-resident Indians and foreign nationals in AIFs.

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3. *See Fidelity Northstar Fund, In re*, [2007] 158 Taxman 372 (AAR) and *Aberdeen Claims Administration Inc., In re*, [2016] 65 taxmann.com 246 (AAR).
4. CBDT Instruction No. 1827, dated 31 Aug. 1989, and CBDT Circular No. 4 of 2007, dated 15 June 2007.
5. CBDT Circular No. 6 of 2016, dated 29 Feb. 2016.
6. AIFs are categorized into Category I, II and III under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012. Category I AIFs are funds such as venture capital funds, SME funds, social venture funds, infrastructure funds and other funds which the government or regulators consider socially or economically desirable and generally perceived to have positive spillover effects on economy. Category II AIFs are funds such as private equity or debt funds for which the government does not provide specific incentives or concessions.
7. Report submitted by Alternative Investment Policy Advisory Committee, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1453278327759.pdf.
8. "Rates in force" is defined in section 2(37A) of the ITA.
9. A unified structure refers to a structure where commitments from both domestic and offshore investors are pooled into a domestic pooling vehicle.

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Further, the amendment also states that no WHT is applicable to distributions made to non-resident investors in respect of income which is not taxable under the ITA. Hence, the amendment draws a distinction between taxable and exempt income streams. For example, when dividend income of an AIF is distributed to a non-resident investor, the AIF would not be required to deduct any tax since dividends are exempt in the hands of shareholders. This eliminates the administrative hurdle of an AIF otherwise having to obtain a nil withholding certificate under section 197 of the ITA.[10]

The Finance Act has not differentiated between exempt and taxable streams of income for distributions made to residents, so that the 10% WHT rate applies even when tax-exempt income is distributed to residents. The rationale behind this dichotomy between distributions made to non-resident and resident investors is not clear.

3.2. No pass-through for Category III AIFs

Contrary to requests by the fund industry, no pass-through status has been provided to domestic hedge funds and funds that employ diverse or complex trading strategies (including leverage). This type of funds fall within the purview of a Category III AIF, which is defined under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012, the regulatory framework for investments by domestic funds.[11] Since most of these funds are organized as determinate trusts, their taxation is governed by the tax regime applicable to private trusts. This entails a risk of characterization of income from share sales as business income, rather than as capital gains, due to their high frequency of trades. This results in a significant disadvantage to hedge fund players, especially when compared to FPIs having similar investment strategies, because income from share sales arising to all FPIs, irrespective of their investment strategies and holding periods, is characterized as capital gains according to a specific provision introduced into the ITA.[12]

3.3. Amendment to conditions for eligible investment funds

The Finance Act 2015 had also introduced section 9A into the ITA, which provides that fund management activity carried out by an "eligible fund manager" on behalf of an "eligible investment fund" (EIF) would not constitute a business connection of the investment fund in India. It further stated that the eligible investment fund would not be deemed to be resident in India under the place of effective management test merely because the eligible fund manager is situated in India. The section lays down conditions which the investment fund must satisfy in order to qualify as an eligible investment fund. These conditions were criticized for being too onerous.

The Finance Act 2016 has relaxed the conditions to qualify as an eligible fund manager, in the following manner:

(1) As an alternative to the condition that the fund must be a resident of a country or a specified territory with which India has a DTT or Tax Information Exchange Agreement, the amendment adds that the fund may be "established or incorporated or registered in a country or a specified territory notified by the Central Government in that behalf". It seems that the rationale behind this addition is to include pension funds, Luxembourg SICAVs,[13] etc., which may not qualify as tax residents of their respective jurisdictions due to the way they are structured (viz. as tax transparent entities).

(2) An earlier condition required that the fund could not control or manage or carry on any "business in India" or "from India". This condition has now been relaxed to omit references to any "business from India". The rationale for this change is that the condition should only relate to fund activities that are carried on in India. However, ambiguity continues to surround what constitutes "control and management" and whether shareholder rights, such as affirmative rights and management rights, come within its purview.

The above relaxations come in addition to guidelines[14] under the Income Tax Rules 1962, introduced in connection with section 9A of the ITA, which provide for, inter alia, relaxation of investor diversification requirements, such as (i) looking through an institutional investor to determine the number of members and participation interests, (ii) relief from the diversification requirement for 18 months during the setting up phase and one year during the winding up phase, and (iii) providing a safe harbour of 90 days in case of temporary non-fulfilment of the diversification requirements.

4. Taxation and Regulatory Changes in the Finance Sector

4.1. Securitization and its regulatory framework in India

Securitization is the process of selling financial assets to a bankruptcy-remote special purpose vehicle (SPV), which in turn repackages the assets and sells them as securities (generally known as "pass-through certificates") to investors. Securitization in the financial sector is governed by the RBI. Further, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI Act) facilitates securitization of non-performing assets by asset reconstruction companies (ARCs) registered with the

10. Section 197 of the ITA was amended to allow AIFs to obtain nil or reduced-rate withholding certificates with respect to exempt investors and exempt income streams.
11. It has further been explained in the regulations that AIFs, such as hedge funds or funds that trade with a view to making short-term returns or other funds which are open ended and for which no specific incentives or concessions are given by the government or any other regulator, are included in Category III.
12. Section 2(14) of the ITA defines "capital asset" to specifically include securities held by a foreign institutional investor.
13. A SICAV (*société d'investissement à capital variable*) is an open-ended collective investment company with variable capital.
14. Rule 10V, inserted by the Income-tax (Fifth Amendment) Rules 2016, with effect from 15 March 2016.

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RBI, which are, inter alia, empowered to undertake securitization and issue security receipts (SRs) to investors, and to enforce security interests directly against a borrower by empowering ARCs to (among other things) take over the management of the borrower.[15]

4.2. Tax pass-through provided for securitization trusts

Before 2013, there was no special regime for taxation of securitization trusts. Accordingly, investors and trustees of SPVs followed the general trust taxation rules in the ITA. These general rules[16] provide that, for a determinate trust where the beneficiaries and their shares are identifiable, tax is levied upon, and recovered from, the representative assessee in like manner and to the same extent as it would be leviable upon and recoverable from the person represented by him. Accordingly, SPVs claimed exemption in respect of the income received on behalf of investors in the SPV, such as mutual funds whose income is exempt[17] under the ITA.

Denying such benefits to securitization trusts, the income tax authorities began to assess the income of the SPVs under section 161(1A) of the ITA, which provides that business income of a trust is taxable on behalf of the trustee at the maximum marginal rate.[18] Further, the income tax authorities also assessed the investors as beneficiaries of the securitization trusts, claiming that they were members of an association of persons (AOP).[19],[20] Hence, a need was felt for a special taxation regime for securitization trusts.

In light of the uncertainty and in order to facilitate the securitization process, the Finance Act 2013 introduced a special regime in the ITA for taxation of securitization trusts. The income of a securitization trust from the activity of securitization was exempted from tax.[21] Further, a separate Chapter XII-EA was introduced into the ITA, whereby income distributed to an investor by a securitization trust was subject to a distribution tax, levied on the securitization trust, at the rate of 25% of the distributed income if paid to an individual or a HUF, and at the rate of 30% of the distributed income if paid to a person other than an individual or a HUF.[22] This is complemented with a corresponding tax exemption for the distributed income in the hands of the investors.[23] No distribution tax is applicable on distributions made to any person whose income is exempt under the ITA.

In response to the persistent demand for reforms in the tax regime applicable to securitization trusts, the Finance Act 2016 introduced a host of changes which overhaul the securitization trusts taxation regime, as inserted by the Finance Act 2013. One of the major criticisms of the earlier regime was that trusts set up by ARCs or securitization companies established for the purposes of the SARFAESI Act were not covered under the definition of a “securitization trust”. The Finance Act 2016 addressed this concern by including such trusts within the regime with effect from 1 June 2016.

While the Finance Act 2013 had sought to bring in tax transparency for securitization trusts by exempting them from tax on income received, the levy of distribution tax led to tax being imposed on the gross income of the investors, thereby causing tax inefficiency. This is because the investors were unable to claim deductions for expenses incurred in relation to the exempt income received from the securitization trusts.[24] Further, since the distribution tax was borne by securitization trusts, non-resident investors were often unable to claim a foreign tax credit in their home country for the distribution tax paid in India.

Moreover, the tax pass-through status for investment funds has long been a global practice to ensure tax neutrality. It also ensures that investors in a fund or pooling vehicle are able to claim benefits and deductions applicable to their tax status in their respective home jurisdictions. In line with this principle, the Finance Act 2016 has provided a complete pass-through to the securitization trusts. The distribution tax no longer applies from 1 June 2016. Under the newly introduced section 115TCA of the ITA, income arising to an investor in a securitization trust is chargeable to tax in the same manner and to the same extent as if it were received by such investor directly, and not through the securitization trust.

The distribution tax has now been replaced by a WHT under the newly introduced section 194LBC of the ITA. When income is payable to a resident, a securitization trust is obliged to withhold tax at the rate of 25% if the investor is an individual or a HUF, and at the rate of 30% if the investor is any other person. It has been clarified that if the investor is a non-resident, the tax will be withheld at the “rates in force”.[25] It is pertinent to note that the obligation to withhold tax applies even for a deemed credit of income which has not actually been paid. In order to obtain a nil WHT rate, investors will have to face the additional burden of first obtaining a nil WHT certificate under section 197 of the ITA.

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15. Sec. 13 SARFAESI Act.
16. Sec. 161(1) ITA.
17. Sec. 10(23D) ITA.
18. Section 2(29D) of the ITA states that “maximum marginal rate” means “the rate of income-tax (including surcharge on income-tax, if any) applicable in relation to the highest slab of income in the case of an individual, association of persons or, as the case may be, body of individuals as specified in the Finance Act of the relevant year”.
19. An AOP is considered a separate taxable person under the ITA. An AOP has not been defined in the ITA. The Supreme Court, in *CIT v. Indira Balkrishna*, [1960] 39 ITR 546, defines an AOP as “one in which two or more persons join in a common purpose or common action, and as the words occur in a section which imposes a tax on income, the association must be one the object of which is to produce income, profits or gains.”
20. This happened particularly in the case of *UTI Mutual Fund v. Income Tax Officer* [2013] 31 taxmann.com 222 (Bombay), where tax was sought to be recovered against a mutual fund, which was an investor in a securitization trust, on the ground that the trust was a smokescreen, which should be disregarded as a taxable entity since it was an AOP having members in the form of mutual funds. The Bombay High Court did not go into the merits of the case, but granted an interim injunction against the recovery of tax from the mutual fund.
21. Sec. 10(23DA) ITA.
22. Sec. 115TA ITA.
23. Sec. 10(35A) ITA.
24. Under section 14A of the ITA, expenses that are incurred in relation to earning exempt income are not allowed as deductions from taxable income.
25. *See* discussion at *supra* n. 7.

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However, there is a mismatch between the effective dates of application of the new rates. While section 115TA of the ITA (which imposes distribution tax) is inapplicable with effect from 1 June 2016, section 115TCA (which taxes the income in the hands of the investors) is effective from 1 April 2016. Hence, effectively, for the months of April and May 2016, both the distribution tax and taxation of the investors apply simultaneously. This may lead to confusion and possible litigation.

4.3. Changes to investment regulations

4.3.1. Foreign investment in ARCs

In response to a long-standing demand from the securitization industry, foreign direct investment in ARCs is now allowed up to 100% under the "automatic route",[26] compared to the earlier cap of 49%, and the cap on investment by foreign institutional investors and FPIs in SRs has been increased from 74% to 100%.[27] Additionally, a single sponsor, which could earlier hold a maximum shareholding of 50% in an ARC, can now hold a 100% shareholding.[28]

4.3.2. Foreign investment in non-banking financial companies

Foreign investment in non-banking financial companies has been permitted hitherto in only 18 identified activities. However, in his Budget Speech the Finance Minister mentioned that the list of permitted activities will be extended to other such activities that are regulated by financial regulators. No official notification has yet been given to put this announcement into effect.

4.4. The Insolvency and Bankruptcy Code 2016

In India, insolvency is dealt with under multiple laws, such as the Companies Act 2013, Presidential Towns Insolvency Act 1909, Provincial Insolvency Act 1920, SARFAESI Act 2002 and the Sick Industrial Companies Act 1985. As a result, there are different bodies under each law having overlapping jurisdictions, resulting in delays in resolving insolvencies. This has hampered the confidence of lenders, which has lead to diminished debt access for borrowers, which in turn is reflected in the state of credit markets in India.

With a view to consolidating and amending the laws relating to resolution of insolvencies in a time-bound manner, Parliament passed the Insolvency and Bankruptcy Code 2016 on 11 May 2016, which received Presidential assent on 28 May 2016. The Code aims to consolidate laws relating to insolvency of companies and limited liability entities (including limited liability partnerships and other entities with limited liability), unlimited liability partnerships and individuals into a single piece of legislation. Key highlights of the Code include:

(1) time-bound (180 days, extendable by 90 days) resolution of insolvencies;

(2) a Debt Recovery Tribunal and a National Company Law Tribunal to act as adjudicating authorities and to deal with cases related to insolvency, liquidation and bankruptcy processes for various entities and individuals;

(3) the requirement that resolution processes are conducted by licensed insolvency professionals, being members of insolvency professional agencies; and

(4) the establishment of an Insolvency and Bankruptcy Board of India, as the regulator of insolvency professionals, insolvency professional agencies and information utilities.[29]

5. Conclusion

As part of its general economic reform programme manifested in the 2016 Budget, the Indian government has amended the taxation and regulatory regimes relating to foreign investment in the finance sector, particularly by reducing the capital gains tax rates applicable to non-residents transferring Indian listed and unlisted shares, extending holding periods, removing WHT obligations for exempt streams of income distributed by Category I and Category II AIFs to non-resident investors, relaxing investment conditions for EIFs and more readily facilitating securitization of financial assets. The government has also introduced a stream-lined code to deal with insolvencies and bankruptcies.

However, outstanding issues remain, especially with the imposition of WHT on exempt streams of income distributed to resident investors by Category I and Category II AIFs and the absence of a tax pass-through for hedge funds. Nevertheless, the recent changes made by the government suggest that India is moving towards greater tax certainty and is attempting to create more favourable tax and regulatory regimes for foreign investors.

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26. Under the "automatic route", a non-resident investor or Indian company does not require any approval from Government of India for the investment: Department of Industrial Policy and Promotion, *Consolidated FDI Policy*, 2016, para. 3.4.
27. Press Note No. 4 (2016 Series), Department of Industrial Policy and Promotion, available at http://dipp.nic.in/English/acts_rules/Press_Notes/pn4_2016.pdf.
28. Id.
29. The Code provides for registration and regulation of information utilities which collect, authenticate and disseminate financial information of debtors in an electronic database.

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