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The verdict: India Budget Highlights 2010

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The Indian Budget ("Budget") for the fiscal year 2010-11 was presented by the Finance Minister, Mr. Pranab Mukherjee before the Parliament on February 26, 2010. The Finance Minister started his Budget speech by giving an indication of the performance of the Indian economy and stated that Indian GDP growth rate has dipped to 6.7 percent in the last financial year from an average of over nine percent in the preceding three years. However, on a positive note, he announced that the economic scenario appears to be encouraging and the Government has set out an ambitious target to push the growth rate back to the erstwhile nine percent level and eventually to double digits.

The Finance Minister also spoke on the change in role of the government from being a provider to being an enabler. The government's focus on enabling the private sector and non-governmental actors to flourish marks a refreshing change in approach and augurs well for the private sector.

The Finance Minister has provided an indication of a change in the contours of the taxation landscape in India with the proposed introduction of the Direct Tax Code and the consolidated Goods and Services Tax ("GST") with effect from April 1, 2011. Both the legislations will bring about a complete change to the fiscal laws in the country and will have a significant impact on every business in India. While the move to introduce the GST legislation has been met favourably by the business community, as it would eliminate the multiplicity of indirect tax legislations in India, the same cannot be said in respect of the Direct Tax Code.

In light of the proposed implementation of the Direct Tax Code and GST from the next fiscal year, the Finance Minister has desisted in making significant taxation law changes in the Budget.

The Budget spelt some relief for domestic tax payers with its proposal to widen the tax slabs for individuals. With respect to domestic corporates, there is a marginal decrease in the overall corporate tax rate to 33.22 percent from the existing 33.99 percent. However, Minimum Alternate Tax ("MAT") is proposed to be increased from 15 percent to 18 percent, which will have an impact on the cash flows for companies, especially those enjoying tax holidays.

However, as is the case in most Indian Budget proposals, the devil lies in the detail. Some of the Budget proposals raise significant concerns for the international and domestic tax community. In this article we have provided insight into some of these controversial proposals which the Budget seeks to introduce.

I. Retrospective taxation of offshore services

As the heading to this section indicates, the Budget proposes to amend the existing law with respect to income earned by non-residents in the nature of interest, royalties and fees for technical services. As per the proposed amendment, non-residents may be taxed on income earned abroad, even if it has not rendered any services within India, or does not have a residence, place of business or business connection in India.

India currently follows the source rule of taxation, i.e. a non-resident is taxed on income which is sourced from India. An apt example of this rule would be a typical EPC contract which comprises of both, offshore and onshore service components. As per India's source rule of taxation, India would not have the right to tax services provided by non-residents outside India, especially if the services do not have any nexus with India. However, as per the Budget proposal, even the offshore component may be caught within the Indian tax net as the importance attached to the place of rendition of service is proposed to be done away with.

The Supreme Court of India in *Ishikawajima Harima Heavy Industries Ltd. v DIT*[1] held that the concept of territorial nexus is fundamental in determining taxability of any income from offshore services. This view has also been upheld in other decisions such as the *Clifford Chance*[2] case, where the Bombay High Court held that the twin condition that the place of rendition of services and the place of utilisation of services should be India, must be satisfied in order to tax such income in India.

The proposed change is likely to have adverse ramifications amongst others on traditional cross-border EPC contracts. As a result of this proposal, India may tax income earned by foreign advisors and consultants merely for the reason that the services are utilised in India.

The proposed change may also lead to foreign tax credit issues wherein a foreign country may refuse to grant its resident a credit for the taxes paid in India under an asymmetric source rule.

Further, considering that the amendment is proposed to be with retrospective effect from 1976, one can imagine the plethora of cases that the tax authorities may lay their hands on for reassessment within the limitation period of six years.

This proposal is likely to affect industries in the infrastructure sector, law firms and other advisors such as architects, etc. providing technical services.

Undoubtedly, this proposal may have a huge impact on foreign service providers and one may need to relook at cross-border service arrangement structures.

II. Endeavour to introduce domestic transfer pricing?

The Budget has introduced a proposal to tax companies (excluding public listed companies) and firms which receive shares of a company other than public listed companies for less than their actual market value or for nil consideration.

As per the proposal, the recipient would be taxed on the difference between the fair market value of the shares and the consideration paid for the transfer unless such difference is less than or equal to INR50,000 (£725).

Further, in cases of gift or transfer of shares without consideration, the aggregate fair market value of which is more than INR50,000 (£725), the recipient is proposed to be taxed on the aggregate fair market value of the shares.

As a respite to this radical amendment, an exception has been provided for transfers that take place in the course of specified kinds of mergers and demergers, but not for acquisitions.

This proposal effectively seeks to introduce indirect transfer pricing requirements in case of transfer of a company's shares, even if such transaction takes place between unrelated parties. Further, the proposal also seeks to categorise the income as "other income" under Indian tax laws and not as "capital gains" or "business income".

Some cases where investors should consider the adverse tax implications of this proposal are as follows:

- Foreign Venture Capital Investors ("FVCI") have been specifically exempted from pricing restrictions for entry and exit of investments. In the absence of an exception for investments made by FVCI's, though the regulatory regime provides for special exemption from pricing requirements, the proposed amendment may result in adverse tax implications for FVCIs where the investments are at a price lower than the fair market value of the shares. Investments made by domestic Venture Capital Funds could also attract similar tax implications due to the absence of pricing guidelines.
- Distributions made pursuant to a buy-back by an Indian company are traditionally considered as capital gains for the shareholder. In light of the proposed amendment if the company's re-purchase price is less than the fair market value of such shares, the company may be taxed on the shares bought back.
- The provision may also result in adverse tax implications where there is transfer of shares between a parent to its subsidiary or vice-versa. Such transfers although not chargeable to tax on capital gains, may result in tax implications for the transferee.

Interestingly, the Budget proposals do not prescribe the valuation methodology to be used for arriving at the fair market value. Enacting of this provision could prompt the revenue authorities to question even genuine transactions on account of valuation issues and could lead to increased litigation.

III. Conversion into India's hybrid entity – The LLP

India's first hybrid entity, the Limited Liability Partnership ("LLP") was introduced last year. LLPs are taxed as an entity and unlike Indian companies, distributions made by an LLP to its partners is tax exempt. Further, as opposed to a corporate entity, an LLP is not subject to MAT. Due to this beneficial tax treatment it was anticipated that existing investment structures may be converted into LLPs.

Fortunately or unfortunately, the Budget has addressed the tax treatment with respect to the conversion of existing private and public unlisted companies into LLPs.

Transfer of assets from a company to an LLP upon conversion has been proposed to be exempt from tax with effect from April 1, 2011. However, alongside this exemption, the Finance Minister has introduced various other parameters for claiming this exemption. To the extent these parameters are not met, the conversion of a company into an LLP would become a taxable event in India.

On reading the fine print of the amendment, it appears that the prima facie intention of the FM was to give the tax exemption only to small companies converting into LLP. This is because of the fact that only such companies whose total sales, turnover or gross receipts are less than or equal to INR6 million (approximately £87,000), in any of the preceding three years qualify for the tax exemption. The Budget also proposes other restrictions with respect to distribution of accumulated profits of the company, introduction of new partners for a limited period and non-availability of credit for MAT upon conversion.

Thus, while the government, on the one hand, has tried to promote the conversion of existing companies into LLPs, it is unfortunately seeking to impose a whole lot of restrictions, thereby making it doubtful whether such conversion would be feasible.

IV. Miscellaneous proposals

A. Tax holiday for the software industry expires

Over the years India's technology sector has received several incentives including a tax holiday for units set up in software technology parks, free trade zones and 100 percent export-oriented units which is due to expire in the fiscal year ending in March 31, 2011. The Budget is silent on the extension of the tax holiday for these units. With the government's thrust on Special Economic Zones, it is unlikely that an extension of the tax holiday may be granted. Thus, foreign entities availing these incentives would need to restructure their operations or migrate such units to Special Economic Zones in India.

B. Taxability of services in connection with prospecting/ extraction of mineral oil

The Income Tax Act, 1961 provides a beneficial presumptive tax rate of 10 percent to non-residents providing services or facilities in connection with the extraction or production of mineral oils. With a view to limit the cases which may avail the benefit of this presumptive tax rate, the Budget has clarified that where a non-resident earns income by way of royalties / fees for technical services through a permanent establishment in India, such income earned by the non-resident would not be entitled to the presumptive tax rate of 10 percent. In such cases, the income earned by the non-resident will be computed as income from business or profession and taxable at the rate of 42.23 percent.

C. Incentivising export of services

Export of services from India is exempt from service tax. There has been much controversy in relation to applicability of this exemption which is restricted to services that are "used outside India". The Budget proposes to do away with the condition for usage of services outside India, thus service tax exemption should be available to most services as long as the recipient is outside India.

D. Service tax on renting out immovable property

Whether or not renting immovable property attracts service tax has been a long standing debate. The Delhi High Court[3] had held that the "act of renting property" was not a taxable service. However, the Budget has proposed that such commercial rentals would be subject to service tax retrospectively with effect from June 1, 2007. This proposal is likely to run into heavy litigation if enacted, especially because of its retrospective nature. It is indeed surprising that the government has sought to make a retrospective amendment especially when the question regarding the validity of this service is currently pending before the Supreme Court of India.

E. Widening the service tax net

Recognising the significant contribution made by the service sector to India's GDP, the Budget seeks to widen the purview of the service tax legislation by capturing several new services such as temporary transfer / permission to use copyrights in relation to cinematographic films and sound recordings, services rendered for promoting or marketing of a brand of goods, services, event or endorsement of a name, marketing and organising lotteries and other games of chance. Further, information technology software is proposed to be subject to service tax irrespective of the software's end use.

With respect to the real estate sector, construction of real estate complexes will now attract service tax unless the entire consideration for the property is paid pursuant to receiving a completion certificate from the concerned authorities.

V. What the future holds: The dawn of the Direct Tax Code and GST

Last year, the infamous draft Direct Taxes Code Bill, 2009 ("Code"), which sought to replace the existing direct tax law in India, was released for public comments. The Code received an overwhelming number of comments due to the radical changes that it sought to bring about which would change the fundamental dynamics of tax laws in India.

The Code sought to introduce General Anti-Avoidance Rule ("GAAR") provisions which allow even a Commissioner of Income Tax to declare any transaction achieving a "tax benefit" as an impermissible avoidance arrangement. An anti-avoidance provision of this sort is expected to capture most cross-border investment structures and would have a negative impact on the investment climate in India. This being the reason, the US and UK have specifically rejected GAAR in favour of well defined anti-avoidance principles. If India chooses to adopt GAAR, it would necessarily have to define the precise parameters for its operation so that tax payers can plan their activities with a fair degree of certainty.

Other provisions which have received objections from industry representatives include the introduction of the "later in time" doctrine for applicability of treaty benefits. The Code had proposed that between the application of domestic law provisions and tax treaty provisions, only that provision which is later in time will prevail. This later in time doctrine could make all the treaties entered to date redundant since the Code would naturally be later in time and would amount to a conscious step back from India's international commitments. It is also doubtful if other countries would accede to such a unilateral stand taken by the Indian government.

The Finance Minister in his Budget speech has expressed his endeavour to introduce the Direct Tax Code from April 1, 2011. However, in a post Budget interview, the Finance Minister has stated that the Code would be rewritten and released for comments but for a shorter time. The revised Code would hopefully keep into consideration the representations made by the industry and will be looked forward to with trepidation considering the proposals which were introduced in the initial draft.

At the same time, the proposal to introduce GST is seen as a welcome move by the business community in India. With the multitude of indirect tax levies in the form of excise duties, service tax, value added tax, central sales tax and entry tax, the indirect tax regime in India has been a nightmare for most of the business community. GST seeks to bring into one fold the excise duties, service tax and the sales tax / value added taxes, which would bring much needed succor to the business community which has been faced with duplicity of taxes on the same transaction. The government has released the framework of the GST legislation which is being discussed with the State governments. Once an agreement is reached with the State governments, we can expect the legislation to be tabled, though there is a requirement for certain constitutional amendments in order to pass the legislation.

These fundamental changes to the taxation landscape in India will be watched with interest and baited breath considering the widespread impact that it would have.

VI. The verdict

As the Finance Minister stated in his speech, the 2010-11 Indian Budget belongs to the common man, the farmer, the agriculturist, the entrepreneur and the investor. With India emerging from the global meltdown faster than any other nation, this year appears to be the year of growth and on the whole the 2010 Budget proposals seem to be reasonably well received by the domestic audience. While this Budget has not introduced large scale changes in the Indian tax laws, with the proposed introduction of Direct Tax Code and GST, it would be interesting to wait and watch what the next budget has in store for the domestic as well as the international community.

The views expressed herein are personal. For further information relating to this article, please contact the authors by email at: shreyas@nishithdesai.com and radhika@nishithdesai.com

NOTES

[1] 288 ITR408 (SC).

[2] 318 ITR 237(Bom).

[3] *Home Solution Retail India Ltd. v Union of India* [2009] 20 STT 129.

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