India Budget Insights (2013-14)

For International Business Community

February 28, 2013

INDIA BUDGET 2013: WHERE'S THE EXCITEMENT?

NO BIG BANG REFORMS, MISSED OPPORTUNITIES & TAX RISKS FOR FOREIGN INVESTORS

Dear Friends,

Budget 2013 presented by the Indian Finance Minister offers very little, if not nothing, to excite foreign investors. To start with, the Finance Minister made the right noises when he said that: "Investment is an act of faith" and that "clarity in tax laws, a stable tax regime, a non-adversarial tax administration, a fair mechanism for dispute resolution, and an independent judiciary will provide great assurance". These words however were soon rendered rhetoric.

While venture capital funds continue to enjoy pass-through status, the Budget has not extended the same pass through status to social venture funds, infrastructure funds, private equity funds and other types of domestic alternative investment funds. Foreign tax residency certificates will no longer be sufficient for the purpose of relief under tax treaties, which considerably increases tax risks for cross-border M&A, joint venture and private equity investments. While the deferral of general anti-avoidance rules for 2 years is welcome, there is much ambiguity on its scope and application to current investment structures. Unlisted Indian companies buying back shares will be subject to a 20% distribution tax, a cost which will ultimately be borne by the investor, but which may not be subject to treaty relief or creditable in the investor's home country. Withholding taxes on royalty, technical and consultancy fees paid to non-residents is proposed to be increased from 10% to 25% on a gross basis. This will directly impact FDI in joint ventures and technology transfers and the additional tax burden may be shifted to the Indian company.

On the positive side, the Finance Minister announced a few capital market reforms including rationalization and simplification of procedures and KYC norms for foreign portfolio investors such as FIIs and QFIs. FIIs will be allowed to participate in exchange traded currency derivatives, thereby improving their hedging options. Stock exchanges will be able to open a dedicated debt segment. The development of a robust debt market and boost to infrastructure debt funds is a step in the right direction. However, the structuring of foreign investment into such funds and are often hit by tax related challenges. Likewise, the proposal to deem sale consideration from transfer of land or building at the reckoner value creates challenges for infrastructure and real estate companies at the time of restructuring. The investment allowance of 15% provided for specific investments into plant and machinery will have some trickle down benefits. So will the recognition of angel investor pools allowing smaller ventures to have better access to capital. Such proposals however are only palliatives and are far from the big bang reforms that investors were looking forward to.

It is unfortunate that the Budget does not incorporate several excellent recommendations of the Shome Committee especially on the retroactive tax on offshore share transfers introduced last year. At least 11 countries including Brazil, Russia and Sweden have formally banned retroactive taxation, and there is no reason why India should not follow suit. The Shome Committee was of the view that the new tax is not clarificatory in nature and should be applied prospectively. The tax on offshore share transfers has given rise to immense compliance challenges for foreign investors due to the vagueness in the statutory provisions. Addressing investor concerns, the Shome Committee recommended incorporation of specific definitions, clarifications and safe harbors to provide certainty on the specific scenarios where the tax is applicable. It is imperative that these recommendations are translated into law.

With a number of proposals focusing on public welfare projects and other populist measures such as an additional surcharge on the super-rich, it seems that the emphasis of Budget 2013 is largely domestic, possibly with a view towards next year's election. However, if the object is to raise the growth rate, strengthen the rupee and boost capital formation, it is important to proceed on a war footing by

Webinar+Roundtable

REGISTER

Budget 2013 Impact on International Business Community with a special focus on Fund Industry

MORNING SESSION:
Tuesday, March 5, 2013, 11:30 AM (IST)

EVENING SESSION:
Tuesday, March 5, 2013, 7:30 PM (IST)

Bangalore Meet

SAVE THE DATE

Technology and Outsourcing Industry: Legal, Regulatory and Tax challenges in light of Budget - 2013

DAY & DATE:
Thursday, March 7, 2013
5:00 pm (IST): Session and Q&A

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Nishith Desai Associates receives "**In-house Community Firm of the Year, 2012**" for Life Sciences practice reinstating the confidence of investors, removing all strands of uncertainty in the law, and taking proactive steps to attract foreign capital. This should form a key focus of the Tax Administration Reform Commission proposed to be set up by the Government. It is also important that the Commission comprises of independent members from the judiciary, legal and other professions.

We have provided below a more comprehensive analysis of the Budget proposals. Hope you enjoy reading it.

Yours Sincerely,

Nishith M. Desai

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INCOME TAX RATES

The base income-tax brackets for the assessment year (AY) 2014-15 for individuals, Hindu Undivided Family, association of persons and body of individuals have not been changed, except with respect to some minor tax rebates provided to individuals whose income does not exceed INR 500,000. However, the Budget has sought to introduce a surcharge at the rate of 10% on such persons if their total income exceeds INR 10 million, thereby increasing the maximum tax rate to 33.99%.

The income tax rate on companies has not been changed, but there have been marginal changes to the rates of applicable surcharge. In case of domestic companies whose total income exceeds INR 100 million, a surcharge will be levied at 10% on tax payable. The rate of surcharge on domestic companies whose total income is less than INR 100 million will continue to be 5%. Foreign companies with income in excess of INR 100 million will pay a surcharge of 5% on tax while foreign companies whose total income is less than INR one hundred million will continue to pay 2% surcharge on tax.

Dividends received from foreign subsidiaries

Currently, the repatriation of dividends by an Indian company from offshore companies is eligible to a reduced tax rate of 15%, provided that the recipient entity holds shares of 26% or more in the distributing offshore entity. This benefit has been extended for one year. In addition, provisions have been introduced to reduce the cascading effect of further distribution by the recipient Indian company to its Indian parent company. If the dividends received by an Indian holding company from a foreign subsidiary are subject to tax at the above 15% rate (under section 115BBD (*Tax on certain dividends received from foreign companies*), then if such dividends are distributed by the Indian company to its parent company in the same year, no further DDT will be levied on the Indian parent company.

Securities Transactions Tax and Commodities Transaction Tax

Securities transaction tax ("**STT**") has been reduced in the following cases:

- STT has been exempted on purchase of units of equity oriented funds in a recognized stock exchange in India.
- STT has been levied at a rate of 0.001% on sale of units of equity oriented funds in a recognized stock exchange in India.

- STT has been reduced from 0.025% to 0.001% on sale of equity oriented fund to the mutual fund.
- STT has been reduced from 0.017% to 0.01% on sale of futures in securities.

Additionally, the Finance Minister has also proposed the introduction of Commodities Transaction Tax in respect of non-agricultural commodities futures contract in the same manner as in case of equity futures i.e. 0.01%.

IMPACT ON THE FUND INDUSTRY

Rationalization of the foreign investment regime

Currently, there are multiple avenues for investment into India, namely – the Foreign Direct Investment ("**FDI**"), Foreign Institutional Investment ("**FII**"), Foreign Venture Capital Investment ("**FVCI**") and the newly introduced Qualified Foreign Investor ("**QFI**") regimes. In light of the overlap between the various regimes and regulators overseeing them, which enabled the use of creative structures to circumvent the law, there have been indications that the regulatory framework may shift from a classification-based regime to a regime based on investment size. The Finance Minister confirmed this understanding today by announcing that persons investing 10% or less in a company would qualify as portfolio investors while and investments beyond 10% would be classified as FDI. The details of how this broad principle will be implemented are yet to be decided by a committee which is proposed to be constituted in the near future. The broad principle seems to be based on the recommendations of the UK Sinha Committee report, which suggested abolishment of different classes of investors (such as FDI, FII, FVCI and NRI) and recommended having only two classes of investors, namely FDI and QFI, where investments up to 10% would qualify as portfolio investments and investments beyond 10% would be classified as FDI. To the extent investments are considered portfolio investments, FDI restrictions are proposed not to be applicable. While the details are yet to be thrashed out, it appears that the regulatory thought process may be to exempt investments below 10% from FDI conditionalities such as pricing, sectoral restrictions, minimum capitalization, lock-in etc. Further, in many sectors where FDI is currently prohibited, there is a possibility that investments below 10% may be permitted once the new regime is implemented. This shift to a regulatory regime based on investment size is in line with international practice and may be cautiously welcomed though questions will arise based on the fine print of the policy, once it is released. Also, with a simplified foreign investment regime, as a next step, the Government may consider simplifying the taxation of foreign investors which currently is complicated with different tax rates applicable to different categories of investors i.e. NRIs, FIIs, FDI investors, etc.

Simplification of portfolio investor norms – relaxation of FII conditions

Currently, there are separate sets of regulations for QFIs, FIIs and sub-accounts, with respect to registration, investment restrictions etc. As part of the process of rationalization of portfolio investor norms, it has now been proposed to treat all portfolio investors at par and to that extent, converge Know Your Customer ("**KYC**") norms and simplify the registration requirements. This is a progressive move as it will introduce clarity with regard to the increasingly complicated investment regulations and make foreign investments into India a lot easier.

Additionally, the Finance Minister has indicated that FIIs will be permitted to use their investment in corporate bonds and government securities as collateral to meet their margin requirements. This can potentially result in unlocking of the cash collateral, which can be used for further investments.

A further relaxation provided by the Finance Minister is to allow FIIs to participate in exchange traded currency derivatives to the extent of their Indian rupee exposure. This move may be helpful for FIIs to hedge against the volatile currency fluctuations in case of their existing rupee exposures in India and will also assist in the development of the currency derivative market in India.

Dedicated debt market

With the objective of developing a vibrant debt market, it has been proposed to allow stock exchanges to introduce a dedicated debt segment on the stock exchange. This seems to be in furtherance of a Securities and Exchange Board of India ("**SEBI**") circular "*Guidelines for providing dedicated Debt Segment on Stock Exchanges*" dated January 24, 2013,[1] which mentioned about the lack of trading infrastructure for debt markets in India, as compared to equity markets.

The debt market in India should be bolstered by: (i) the provision of such a dedicated debt segment; (ii) the inclusion of banks and primary dealers as proprietary trading members; and (iii) permitting insurance companies, provident funds and pension funds to trade directly in such segment with the approval of sectoral regulators.

Investment in Infrastructure sector – Infrastructure Debt Fund

The Finance Minister has recognised the need for large scale investment in the infrastructure sector. As per the 12th Plan, this amount should be to the tune of USD 1 trillion. Accordingly, to boost investment in this sector, the Finance Minister has stated that Infrastructure Debt Funds ("**IDFs**") will be encouraged. IDFs are expected to raise resources and, through take-out finance, credit enhancement and other innovative means, provide debt for infrastructure projects. Further, to make the bond markets more attractive and viable, many institutions have been permitted to issue tax-free bonds. At the same time, it has been proposed to provide credit enhancement to infrastructure companies that wish to access the bond markets to tap long term funds.

Tax Pass-Through Status For VCFs Registered as Category I AIFs

World over, investment funds strive for 'tax pass-through status' wherein the income of the investment fund is taxed directly in the hands of its investors, but not at the level of the fund itself. This provides fiscal neutrality to the funds as it eliminates tax at the pool level while maintaining taxation at the investor level.

In India, until the year 2007, the regime for taxation under the erstwhile Section 10 (23FB) (*Incomes not included in total income*) of the Income Tax Act, 1961 ("**ITA**") offered a tax pass through treatment to Venture Capital Funds ("**VCFs**") and Venture Capital Companies ("**VCCs**") registered with SEBI under the SEBI (Venture Capital Funds) Regulations, 1996 ("**VCF Regulations**"). Subsequently, the amendments brought under this provision through the Finance Act, 2007 limited the 'pass-through' benefits to only certain identified sectors (like nanotechnology, information technology relating to hardware and software development, bio-technology, infrastructure, etc.). However, Budget 2012 further extended the tax 'pass-through' status to VCFs/VCCs for their income from investments in Venture Capital Undertakings ("**VCU**") operating in all sectors, except the ones specified in the negative list by SEBI (*viz*. non-banking financial services other than non-banking financial companies registered with the Reserve Bank of India ("**RBI**") as equipment leasing or hire purchase companies, gold financing, etc.).

Recently, SEBI formulated the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") effective from May 21, 2012 which supplants the VCF Regulations. The AIF Regulations too recognize VCFs as a sub-category of funds under the broader category named 'Category I Alternative Investment Funds'. Ever since the advent of the AIF Regulations, there has been a demand by the venture capital and private equity players for the extension of the tax pass-through status to funds registered as AIFs under the AIF Regulations.

Budget 2013 has partly accepted the above demand by extending the aforesaid benefit to VCCs and VCFs registered with SEBI as Category I AIFs which: (i) have invested not less than two-thirds of their investible funds in unlisted equity shares or equity linked instruments of VCUs; and (ii) which have not invested in any VCUs in which the trustee or the settlor (in case of VCFs) or the directors or substantial shareholders (in case of VCCs) hold individually or collectively equity shares in excess of 15% of the paid up equity share capital of the VCU.

Following such a proposal, the income of VCFs/VCCs, registered with SEBI as Category I AIFs, from VCUs will be taxed directly in the hands of their investors. Although a welcome proposal, in our view the tax pass-through status should have been extended, in line with standard international practice, to all pooling vehicles/funds including to Category II AIFs, Category III AIFs and other Category I AIFs such as infrastructure funds, Small and Medium Enterprise funds etc. which may not necessarily fall within the definition of a VCF or a VCC as defined under the AIF Regulations. It must be noted that the tax pass-through status does not *per se* result in non-payment of taxes, but merely ensures that taxation of income is in the hands of its ultimate beneficiary. Unfortunately, the Government of India has not approved of such a measure.

Having said the above, it should also be borne in mind that private equity funds organized in the form of a trust may still be able to achieve a tax pass-through status, notwithstanding the limitations placed under Section 10 (23FB) on the basis that a trust in India is not a separate legal or taxable entity and taxation of a trust is always *qua* its beneficiaries as per sections 161 (*Liability of representative assessee*) to 164 (*Charge of tax where share of beneficiaries unknown*) of the ITA even where tax liability is discharged by the trustee of the trust. However, due to cumbersome tax credit issues faced by the ultimate beneficiaries on account of complexities associated with the principles of trust taxation, there is still 'many a slip, between the cup and the lips' in the context of taxation of such trust funds.

Securitization Trusts: not quite 'pass through' status

Lack of clarity on taxation of securitization trusts had led to a decrease in the use of Pass Through Certificates to invest in securitization, especially by tax-exempt investors. In the recent past, the income tax authorities have alleged that a securitization trust should be regarded as a business trust and accordingly tax must be charged at the trust level in respect of the income of the trust at the maximum marginal rate, as opposed to taxation *qua* the beneficiaries. This resulted in situations of an additional tax consequence in respect of the income earned by mutual funds, which were otherwise not taxable on such income, in respect of their investment in the securitization trust. Budget 2013 has sought to address this concern by introducing in the ITA, Chapter XII-DA titled 'Special Provisions relating to Tax on Distributed Income by Securitization Trusts'. The provisions of this Chapter will take effect from 1 June 2013.

The newly introduced regime mirrors the taxation of distributions made by mutual funds. The income of a securitization trust (as regulated by the Reserve Bank of India ("**RBI**") or SEBI) from the activity of securitization has been exempted from income tax (new Section 10 (23DA)). Tax shall be levied but only at the time of distribution of income by the securitization trust and that too only at the entity-level, i.e. the distributed income once received by investors will not be taxable in their hands (new Sections 115TA-TC). The tax rate on distribution of income will be 25% in case of individuals and HUFs and 30% in case of all other types of investors. The proviso to Section 115TA states that income distributed to tax-exempt investors will not be brought to tax, i.e., those whose "income, irrespective of its nature and source, is not chargeable to tax". Based on the same, while this offers a fillip for mutual funds to invest in such securitization trusts, foreign investors will not be too enamoured with the proposal as any distribution made to FIIs will now be subject to tax in the hands of the trust.

While the new provisions have addressed the concern of clarity in taxation, they have also taken away the benefit of pooling and investing via a pass-through intermediary. Additionally, due to the exemption provided in the hands of the investors (akin to taxation on dividend distribution by corporates), additional issues could arise in respect of expenditure deduction and there could be a proportional disallowance of the expenditure as per the provisions of section 14A (*Expenditure incurred in relation to income not includible in total income*) in the hands of investors.

Mutual Funds

The Finance Minister has sought to incentivize household savings to be channelized into financial investments (and reduce dependence on savings in gold) and accordingly provided for certain relaxations in respect of such investors which would serve to expand the investor base. Mutual fund transactions will also benefit by the reduction in the Securities Transaction Tax which will take effect from 1 June 2013 and will apply to transactions made on or after that date. From a foreign investor perspective, the more relevant amendment is in respect of income distribution by a mutual fund under the Infrastructure Debt Fund ("**IDF**") scheme to a non-resident, where the applicable rate of tax in the hands of the mutual fund has been reduced to 5% of the income so distributed. This is to bring the withholding tax rate for an IDF set up as a mutual fund at par with an IDF set up as a non-banking financial company, where the applicable rate of tax for a non-resident investor is reduced to 5%.

Although the measures proposed are positive, all demands/expectations of the mutual fund industry have not been met, especially those in relation to additional tax relief and reduction in the applicable rates which if adopted might have had more positive impact on the mutual fund industry.

ENTITLEMENT TO TREATY BENEFITS- WHAT CONSTITUTES CONCLUSIVE EVIDENCE OF RESIDENCE?

India is no stranger to discussions surrounding the issue of entitlement to tax treaty benefits. Way back in 2003, the Supreme Court of India was required to decide upon the validity of a circular confirming that entities with a valid Mauritius tax residency certificate ("**TRC**") would be entitled to the benefits of the India-Mauritius tax treaty. Circular 789 dated April 13, 2000, was introduced to provide clarity on the availability of treaty benefits. It was however challenged on the basis that it restricted revenue authorities from exercising their statutory duties relating to assessment and determination of residence on a case to case basis. The Supreme Court, in an expansive judgment examining issues of Indian constitutional law, international law and administrative law, upheld the validity of the circular and confirmed that Mauritius tax treaty benefits would be available to persons with a valid TRC. Last year, with a view to obtaining complete information for determining the applicability of tax treaty benefits to a taxpayer, the Government introduced an amendment to the ITA requiring taxpayers to obtain TRCs from their countries of residence with such TRCs in a format capturing certain particulars prescribed by the Government of India, in order to be eligible to claim treaty benefits.

This year's Budget goes one step further with its amendment to sections 90 (*Agreement with foreign countries or specified territories*) and 90A (*Adoption by Central Government of agreement between specified associations for double taxation relief*) of the ITA. The amendment provides that a TRC "*shall be necessary but not a sufficient condition"* to claim tax treaty benefits. While no criterion has been prescribed in the Finance Bill to determine what constitutes 'sufficient condition', statements have been made by the Finance Minister that only persons having 'beneficial ownership' of assets would be eligible to claim tax treaty benefits. It is unclear at this point in time, what should constitute beneficial ownership since India has historically been a jurisdiction which does not recognize duality of ownership, and which follows the doctrine of form over substance in tax laws. Further, it should be noted that tax treaties specify circumstances e.g. income from royalties, fees for technical services, where beneficial ownership is a criterion for application of tax treaty rules, but it does not provide that beneficial ownership is a criterion for determination of residence for application of tax treaty benefits (which may be subject to the limitation of benefits article in the tax treaties). From a practical perspective, another concern worth noting is that this amendment is proposed to be introduced retroactively, with effect from financial year 2012-2013, a move which could impact non-resident investors across the board if they intend to claim tax treaty benefits. Further, there is currently no clarity by the Central Board of Direct Taxes on the application of the amendment vis-à-vis Circular 789 which provides that a Mauritian TRC would suffice for application of tax treaty benefits. The issue whether a 'later in time doctrine' can be applied in such context is also a question open for debate.

While the enactment of the GAAR has been postponed to financial year 2015-16 pursuant to the recommendations of the expert committee led by Dr. Parthasarathi Shome, non-residents may need to consider carefully the possibility that disallowance of tax treaty benefits by Indian revenue authorities may have already begun albeit in another form.

GAAR: SOME RELIEF BUT UNCERTAINTY PREVAILS

Budget 2013 has proposed a few amendments to the general anti-avoidance rules ("**GAAR"**) introduced into India's tax statute last year. GAAR which was initially slated for implementation from April 1, 2013 has been widely criticized on account of ambiguities in its scope and application, lack of safeguards, and possibility of misuse by the tax authorities. GAAR empowers the Revenue with considerable discretion in taxing 'impermissible avoidance arrangements', disregarding entities, reallocating income and even denying tax treaty benefits to a non-resident investor.

With a view to address the dampening investor sentiment, the Government appointed the Shome Committee to consult with stakeholders and review GAAR as well as the retroactive amendment for taxing offshore share transfers. In its detailed report, the Shome Committee had recommended a substantial narrowing down of the GAAR provisions and other safeguards in the interest of fairness and certainty. Click here to read our insights and analysis of the Shome Committee's report.

The Budget proposes to defer the implementation of GAAR for 2 years. The decision to defer GAAR till April 1, 2015 will provide taxpayers with much needed time to grapple with the new provisions and rationally plan and (re)organize their affairs. It will also help the tax department to prepare themselves for the enforcement challenges that lie ahead.

It is proposed that GAAR shall apply only if the main purpose of an arrangement is to obtain a tax benefit. Currently, GAAR may apply even if obtaining the tax benefit is one of the main purposes of an arrangement. Presumably, the new GAAR provisions may not apply if an arrangement is backed by sufficient business purpose.

It has been proposed that factors such as the holding period of the investment, availability of an exit route and whether taxes have been paid in connection with the arrangement may be relevant but not sufficient for determining commercial substance. Interestingly, these were the key factors considered by the Supreme Court of India when it decided that the USD 11.1 billion Vodafone-Hutch transaction was not a sham and could not be taxed in India.

The Budget also proposes that GAAR cases shall be scrutinized by an Approving Panel chaired by a retired High Court Judge, a senior member of the tax office (of the rank of Chief Commissioner of Income Tax) and a reputed academician or scholar with expertise in taxation or international trade and business. The existing provisions relating to the Approving Panel only contemplate members from the tax department, which raises issues of independence, lack of objectivity and bias.

Although not reflected in the Budget, the Finance Minister announced in January of this year that investments made prior to August 30, 2010 would be grandfathered and GAAR shall not apply to exits from such investment. To the contrary, the Shome Committee has recommended that GAAR should only apply to investments made subsequent to the implementation of GAAR. Therefore, GAAR may retroactively apply in relation to transactions and investments taking place between August 30, 2010 and the date when GAAR comes into force, thereby creating issues for post 2010 deals where divestments take place subsequent to April 1, 2015.

The Government's decision to accept some of the recommendations of the Shome Committee is definitely a relief, especially at a time when investors have become increasingly wary about India's 'policy paralysis' and the prevailing uncertainty. However, no comments have been made on other critical issues addressed by the Shome Committee including tax treaty override and the impact of GAAR on investments via the Mauritius route. For instance, it was recommended that foreign investors which satisfy specific substance criteria within a tax treaty should be immune from GAAR. A number of safe harbors were also recommended where GAAR would not apply. The object is to ensure that GAAR is not used as a weapon against the taxpayer but rather as a shield for the tax system as a whole.

GAAR is likely to emerge as a Pandora's box of litigation. The successful and judicious enforcement of GAAR will depend on the nature and quality of guidance provided on the scope and application of GAAR. Detailed explanations are required on the meaning of expressions such as 'commercial substance', 'bonafide', 'misuse or abuse' and other ambiguous terms that are used in the provisions. It is hoped that the guidance which the Government will provide in the near future shall have the same depth and quality of the Shome Committee report or similar guidance issued in other countries such as the US, Canada, New Zealand, Australia, UK and South Africa.

DISTRIBUTION TAX ON BUY-BACK OF SHARES BY UNLISTED COMPANIES

The Budget proposes to levy a tax of 20% on domestic unlisted companies, when such companies make distributions pursuant to a share repurchase or "buy back". While 'buy-back' has been defined to mean "*purchase by a company of its own shares in accordance with the provisions of Section 77A*[2] *of the Companies Act, 1956*", the Budget defines 'distributed income' to mean "*the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares*". Thus, tax at the rate of 20% has been proposed to be imposed on a domestic company on consideration paid by it which is above the amount received by the company at the time of issuing of shares.

The Budget proposes that tax as imposed under these provisions shall be payable by the company irrespective of whether income tax is payable on its total income as computed under the ITA. The tax paid to the Central Government for the buy-back has been proposed to be treated as the final payment of tax and no further credit can be claimed by the company or any other person in respect of the amount of tax so paid. Further, no deduction is allowed to the company or to the shareholder in respect of the income which has been subject to this tax or the tax thereon.

This seems to be a calculated move by the Government to undo the current practice of resorting to buying back of shares instead of making dividend payments especially in the international context wherein due to the availability of treaty benefits, such income from capital gains is chargeable to tax in India. Though the Budget does not make any change to Section 46A (*Capital gains on purchase by company of its own shares or other specified securities*) of the ITA which provides for capital gains tax on gains made by the shareholder on buy-back of shares of a company, it has proposed under Section 10 (*Incomes not included in total income*) of the ITA, a provision to exclude, from a shareholder's income, the income arising to the shareholder on account of a buy-back. Such income will thereby not be chargeable to tax.

The proposed provisions will have a significant adverse impact on foreign investors who have made investments from countries such as Mauritius, Singapore, Cyprus etc. where buy-back of shares would not have been taxable in India due to availability of tax treaty benefits. Further, being in the nature of additional income tax payable by the Indian company, foreign investors may not even be entitled to a foreign tax credit of such tax. The scope of these provisions are far reaching as they do not just tax gains but tax the difference between the share subscription amount and the distribution. These provisions thereby implicitly tax gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back. Additionally, in the context of the domestic investor, even the benefit of indexation would effectively be denied to such investor and issues relating to proportional disallowance of expenditure under section 14A (*Expenditure incurred in relation to income not includible in total income*) may also arise. This would therefore result in the buy-back of shares being even less tax efficient than the distribution of dividends.

TRANSFER OF 'REAL' ASSETS BY INFRA / REALTY COMPANIES AT RECKONER VALUE

The Finance Bill, 2013-14 has inserted section 43CA (*Special provision for full value of consideration for transfer of assets other than capital assets in certain cases*) in the ITA. Under this provision, where the consideration accruing/received by a transferor of an asset (other than a capital asset), being any land or building or both, is less than the value adopted/assessed/assessable by any authority of a State Government for the purpose of payment of stamp duty on such transfer, the value so adopted/assessed /assessable shall, for the purposes of computing profits and gains from transfer of such asset, be deemed to be the full value of the consideration received/accruing as a result of such transfer.

Earlier, per Section 50C (*Special provision for full value of consideration in certain cases*) of the ITA, a provision similar to section 43CA was introduced for computation of capital gains by a transferor. However, being limited only to capital assets, most real estate developers in the business of trading in real assets were outside the purview of that provision. But, now extending it to all assets is likely to be a major dampener for real estate developers who may want to do an intra-group transfer or restructuring at book value. This may also adversely impact potential restructuring by asset-heavy companies such as infrastructure and real estate companies looking to introduce foreign investment in SPVs where the land / building has been held at the holding company level – as the transfer by the holding company of the land /building at book value to the SPV into which foreign investors may invest may no longer be tax efficient.

ROYALTIES AND FEES FOR TECHNICAL SERVICES : AN UNEXPECTED BLOW!

Last year, the definition of royalty was amended to bring within the tax net a number of payments which would not commercially be considered royalty, such as payments towards the purchase of shrink wrap software, subscription to databases and clouds. This year, a further blow has been inflicted by way of an amendment to the rate of tax applicable to payments of royalty and fees for technical services ("**FTS**"). While previously a rate of 10% was applicable on a gross basis, going forward the rate is proposed to be 25% on a gross basis. The explanation that has been provided is that the 10% rate contained in Indian tax law is lower than the rates applicable to these payments under several of India's tax treaties and that non-residents situated in tax treaty jurisdictions will still be eligible to claim the beneficial rate. There is also a possibility that this move was intended to tap payments of royalty and FTS which have been used by foreign investors to repatriate profits even though the same is presently addressed under the transfer pricing provisions.

The issue arises on account of the fact that the Budget also proposes changes to the situations governing the availability of tax treaty benefits. Further, pursuant to the introduction of the GAAR in financial year 2015-16, treaty benefits may be denied if the main purpose of an arrangement is to derive tax benefits. Whether the availability of a beneficial tax rate in a tax treaty could be considered to result in an invocation of GAAR provisions still remains to be examined. If so, the imposition of this 25% rate may need to be reconsidered.

However, the most significant issue with the rate change is that the 25% tax would be computed on a gross basis on all payments of royalty and FTS, and not merely on the net income amount. This could translate into the tax being potentially imposed even where there is a situation of loss in the hands of the foreign recipient. This is a retrograde move which is likely to be a significant blow to technology transfer, knowledge sharing and collaboration agreements across sectors, particularly as the foreign investor may never have sufficient tax obligations in its home country against which the substantial Indian taxes could be offset and foreign tax credits claimed. This can also have a significant impact in respect of joint ventures in India, where the Indian party relies on technical know-how and expertise of the foreign joint venture partners.

IT & ITES INDUSTRY : SOME SUCCOR AND FURTHER EXPECTATIONS FOR SAFE HARBOR NORMS

In the recent past, many IT and ITES companies had have to face significant litigation arising out of the tax holiday benefits granted to these companies. Issues such as taxation in the context of body shopping or on-site development have been often contested and have become a bone of contention with the tax authorities. Consequently, the Government had constituted a committee to review taxation of development centers and the IT sector (“**Rangachary Committee**”) to address these issues.

Based on the recommendations of the Rangachary Committee, the Government had recently introduced Circular no. 1/2013 dated 17th January 2013 (“**Circular**”) clarifying some of the issues pertaining to the IT and ITES industry. This included the following clarifications:

- On-site software development and deputation of technical manpower for “on-site” software development aboard will be eligible for tax holiday benefits;
- There is no requirement to have a separate Master Service Agreement for each Statement of Work and there cannot be a denial of tax holiday benefit on such grounds;
- Research and development activities embedded in “engineering and design“ will fall within the ambit of “computer software” for the purposes of provision of tax holiday benefit;
- Where there has been a sale of an undertaking as a going concern (slump sale), tax holiday benefit can still be claimed for the unexpired period even if there has been a change in ownership; and
- Tax holiday is not to be denied merely on the ground of physical relocation of an eligible Special Economic Zone (“**SEZ**”) unit from one SEZ to another which is in accordance with the law.

As part of its mandate, the Rangachary Committee also has to submit its report on safe harbour provisions for the IT and ITES sector which is due to be submitted on 31st March 2013. This is especially relevant in the context of high assessments that have been undertaken in respect of transfer pricing for services that are provided by such companies to their parent/group. The Finance Minister has assured that safe harbour rules are on the cards for the Government, which will provide a good measure for risk mitigation, certainty to the taxpayer and will provide some comfort to the IT and ITES industry which has been facing significant tax pressures in the recent past.

BUDGET : WHAT COULD HAVE BEEN DONE

Considering the timid nature of proposals introduced by the Budget this year, this concluding analysis is compelled to be less about the impact of the suggested changes and more of an overview of missed opportunities.

Offshore Transfers : The most prominent of these has been the non-consideration of the retrospective indirect transfer provisions which were introduced by the previous year's Finance Act. To rewind to that development, Indian revenue authorities had initiated litigation against Vodafone in 2007, seeking to tax the purchase by Vodafone of an offshore company which indirectly held assets in India. Claims were initiated on the basis that Vodafone had failed to withhold Indian taxes on payments made to the selling Hutch entity. The then provisions of the statute did not justify the levy of tax on gains from the transfer of an offshore asset between two non-residents and the matter was litigated up to the Supreme Court of India, which ruled in favour of Vodafone. The Supreme Court held that no Indian tax was required to be paid or withheld on that transaction as per the existing source rules for capital gains. This judgment was delivered in January 2012. A few weeks later, the Finance Act, 2012 introduced retrospective provisions "clarifying" the intent behind the Indian source rules and levying Indian tax on the transfer of offshore assets if such assets derived substantial value from India. As the provisions were introduced in a knee-jerk manner, they did not consider key questions relating to the applicability of indirect transfer provisions to listed companies, attribution of value, adjustment of cost of acquisition, availability of treaty benefits and foreign tax credits, etc. Unsurprisingly, the enactment lead to widespread investor discontent, and foreign direct investment into India fell sharply over the next quarter. In response, a high profile committee was set up under the leadership of Dr. Parthasarathi Shome to examine the indirect transfer provisions as well as the GAAR provisions which were also introduced by last year's Finance Act. While this year's Budget factors in the proposals made to the GAAR regime, no mention has been made as regards the proposals on indirect transfers in spite of the substantial efforts invested by the

Shome committee and stakeholders in attempting to bring about clarity. This means that the retrograde provisions from last year's Finance Act continue to be applicable, and the inconsistencies flowing from their hasty conceptualization will carry over to this year, along with a validation clause which permits the overturning of court judgment in aid of these provisions. This raises questions over the status of the rule of law in India and is perhaps the most disappointing aspect of this year's Budget.

Definition of Royalty : Another retrospective amendment introduced last year related to the definition of royalty, which was expanded, with retrospective effect, to include several payments which would not be in the nature of royalty. Subsequent to this amendment, several Indian court/tribunal rulings have reconfirmed that in a situation where the payments are received by a non-resident situated in a tax treaty jurisdiction, the narrower definition contained in the tax treaty should apply. It would have been a positive measure to reconsider the wide nature of the deeming fiction introduced in 2012. Instead, the Budget has proceeded to retain the broad definition of royalty and to tax royalties at the rate of 25% on a gross basis, a retrograde move which is likely to be a big blow to several industries.

MAT on Foreign Companies : It would also have been useful to have clarity on the applicability of Indian minimum alternate tax ("**MAT**") to foreign companies. Considering that the MAT is a minimum level of tax required to be paid by a company on overall profits, it would logically be applicable to companies which are taxable in India on their worldwide income i.e. Indian resident companies. In a situation where the company is non-resident, it would not be appropriate to levy Indian tax at a specified percentage of book profits of the company, irrespective of the threshold of involvement of the company with India. At the most, such a tax should only be applicable with respect to the Indian source income of such a company. However, the current language of the MAT provisions is not clear on this issue and the matter has been litigated upon and discussed on a fairly constant basis.

Capital Gains on unlisted securities : Another point in which some clarity would have been helpful is the beneficial rate of 10% introduced by last year's Finance Act, on capital gains from the disposition of unlisted securities by a non-resident. As per the explanatory notes, the amendment was made to allow for parity between private equity investors and FIIs in terms of capital gains tax rates, since foreign institutional investors are entitled to a 10% rate on capital gains. Unfortunately, the language contained in Finance Act, 2012 made the rate applicable only to gains from the disposition of unlisted "securities", with securities being defined as per the Securities Contract and Regulation Act, 1956 ("**SCRA**"). As case law in the context of the SCRA prescribes marketability as a precondition for the classification of an instrument as a security, and does not consider shares of private limited companies as 'security', the intended consequence of the amendment was not achieved. There continues to be ambiguity as to whether private equity investors will be eligible to the 10% rate on sale of shares of private limited companies. With slight redrafting the entire controversy could have been put to rest, and the move would have provided a significant fillip to private equity investor sentiment.

Guidance on income characterization : The Budget could have also looked at adopting guiding principles similar to those introduced by countries such as Singapore in relation to the characterization of investment income as business income or capital gains, to resolve long standing issues relating to the tax treatment of investments. This would have resolved issues for a number of Foreign Institutional Investors who face the challenge of characterization of income as capital gains even where such income ought to have been classified as business income and not taxable in India in the absence of a permanent establishment (where treaty benefits are available).

Tax litigation and tax payer rights : There was also scope to introduce positive measures in relation to the tax litigation mechanism - while the FM has paid lip service to the state of tax administration in the country by initiating the setup of a review committee, it would have helped to prescribe a definitive timeline or agenda for the implementation of the reform process. A key aspect which has also not been considered is the question of tax payer rights and also abuse of process by the tax authorities. Time and again over the past year, the Courts have stated/discussed the high-handed approach of the tax authorities towards disputes. While the Finance Minister stated the intent of a having a non-adversarial tax process, the same can only be achieved if there are measures introduced to provide statutory rights for taxpayers as well as to curb the abuse of process of law. However, the Finance Minister has chosen to ignore the calls for these measures.

In sum, we come away from the Budget with a stronger sense of what could have been accomplished, and how significantly those accomplishments could have rejuvenated the Indian investment climate, rather than a recollection of the measures in fact put in place. It can only be hoped that the inaction shouldn't prove too damaging, considering the slowing growth rate and the looming threat of an investment rating downgrade.

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1 Available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1359035278359.pdf.

2 As a background, Section 77A of the Companies Act, 1956 provides the conditions and restrictions which need to be followed for a company to buy-back its shares.

- International Tax Team

You can direct your queries or comments to the authors