tax notes international
Volume 55, Number 4 ■ July 27, 2009

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

News Analysis: Indian Budget 2009: Moving Toward a Neutral Tax System

by Harshal Shah and Parul Jain

Reprinted from *Tax Notes Int'l*, July 27, 2009, p. 260

taxanalysts®

HIGHLIGHTS

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

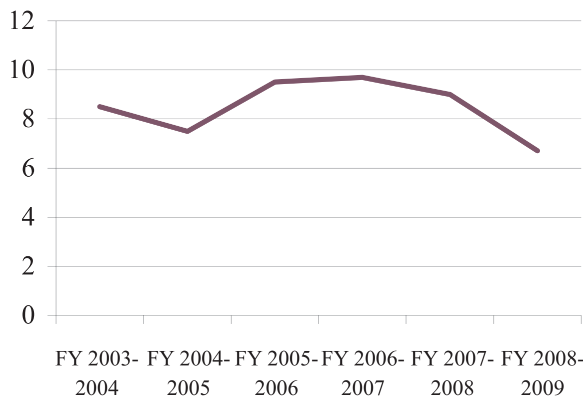
News Analysis: Indian Budget 2009: Moving Toward a Neutral Tax System

by Harshal Shah and Parul Jain

> Just as one plucks fruits from a garden as they ripen, so shall a King have revenue collected as it becomes due. Just as one does not collect unripe fruits, he shall avoid taking wealth that is not due because that will make the people angry and spoil the very sources of revenue.

With these words of Kautilya, ancient India's finest philosopher and political thinker, Finance Minister Pranab Mukherjee on July 6 introduced the tax proposals of the Indian Budget 2009-2010 in Parliament. (For prior coverage, see *Tax Notes Int'l*, July 13, 2009, p. 89, *Doc 2009-15287,* or *2009 WTD 128-1*.) These words show the intent of the government to move toward a trust-based, simple, equitable, and neutral tax system and promise to fulfill its commitment to further tax reforms.

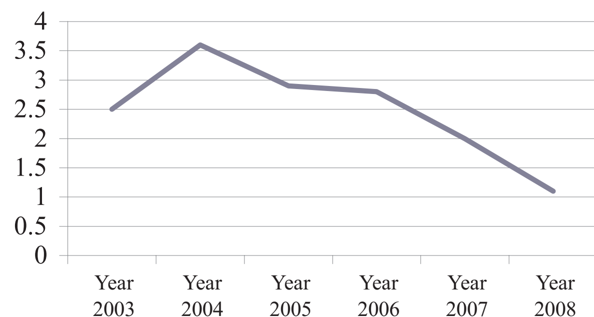
Figure 1. India's GDP Growth Rate



Source: Complied on the basis of information provided by the Economic Survey of Government of India.

As can be seen in Figure 1, even though the Indian GDP growth rate dipped from an average of over 9 percent per annum in the previous three fiscal years to 6.7 percent per annum in the last year, India has taken a bold step to reduce its effective tax rates. The tax rates applicable to individuals have been reduced from 34 percent to 31 percent, and while those applicable to domestic companies have been kept constant, however, elimination of fringe benefit tax (FBT) has resulted in reduction of the effective corporate income tax rate. This approach seems to be in contrast to the approach adopted by developed countries such as the United States and United Kingdom, which have responded to a similar economic crisis (as shown in Figure 2 for the U.S.) by increasing the quantum of taxation. India has thought differently; by adopting this approach, it has increased the purchasing power in the hands of individuals and thereby sought to boost consumer spending.

Figure 2. U.S. GDP Growth Rate



Source: Compiled on the basis of information provided at http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=1&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2003&LastYear=2008&3Place=N&Update=Update&JavaBox=no.

Based on his interaction with various stakeholders, who provided valuable input, Mukherjee has appreciated the need for structural changes in the Indian tax system. In line with the structural recommendations,

Mukherjee has proposed the acceleration of the process for the smooth introduction of the goods and services tax effective April 1, 2010. He has also proposed the introduction of a new Direct Taxes Code, a draft of which should be released for public comments on or about August 21. The Direct Taxes Code Bill, which seeks to replace the existing direct tax law, is expected to be tabled in Parliament's winter session.

It remains to be seen whether some of the anticipated changes that were not considered in the budget (for example, providing clarity on taxation of offshore mergers and acquisitions transactions involving Indian entities, removing restrictions on a complete passthrough for venture capital funds, and providing clarity on taxation of Indian Depository Receipts) will be brought about in the new code. In the meantime, the finance minister has considered some changes that were needed immediately. This article seeks to analyze some of the key direct tax proposals that the finance minister made that could affect the international community seeking to do business in India.

Clarity on Tax Treatment of LLPs

India had for a long time awaited the introduction of legislation governing the limited liability partnership.[1] This year, the LLP regime was finally introduced; however, its popularity was largely restricted because of uncertainty about its taxation. Before the introduction of the LLP regime, India — unlike most jurisdictions — had only the concept of general partnerships. A general partnership is treated as a separate taxable entity, and the partners of the partnership do not subsequently get taxed on the distributions received from the partnership.

The budget proposes to treat the LLP as a separate taxable entity and impose taxation similar to that imposed on a general partnership. If the proposals are enacted, the LLP will be taxed at an entity level (at the rate of approximately 31 percent) and the partners will not be taxed.

The budget has finally provided clarity on the taxation of an LLP in India. In many countries, an LLP is regarded as a separate body corporate for legal purposes but considered as a tax transparent entity for tax purposes. Although recognizing the separate corporate existence of an LLP, India has failed to regard an LLP as a tax transparent entity, which is inconsistent with the approach adopted by most countries. For example, in the United Kingdom and Singapore, an LLP is treated as a fiscally transparent entity for tax purposes and the partners are subject to tax in their individual capacity. The U.S. goes a step further by having a unique provision whereby an LLP is given an option to elect to be taxed as a corporation or as a fiscally transparent entity.[2]

Imposition of entity level taxation could lead to many complications in a domestic and international tax scenario. For example, losses incurred by the LLP may not be available to set off against other income of the partners. Further, the failure of the government to impart consistency in the approach adopted to tax an LLP by different countries around the world may lead to complexities in availing tax credits in a cross-border situation. For example, the foreign partners of an LLP may find it difficult to claim a credit of the tax paid by the LLP in India against the tax paid by individual partners in their country of residence.

From a liability perspective, while the LLP Act provides for a limited liability for all partners of the LLP, the newly introduced tax rules provide for an unlimited liability of all partners to the extent of any tax that is not recoverable from the LLP. However, these provisions apply only in the event the partner is responsible for gross neglect, misfeasance, or breach of duty on his part.

The current LLP legislation permits a foreign entity to be a partner; however, similar relaxations have not been granted from an Indian exchange control regulations perspective. While the budget fails to provide clarity, it is hoped that the government will issue notifications or clarifications addressing this issue soon. Also, a foreign LLP may be registered under the current LLP legislation so as to establish a place of business in India. The proposed tax could create issues in using tax credits because the LLP may be treated differently in India than in the foreign jurisdiction in which it would have been set up.

Further, because of the absence of a legal framework for a hybrid entity such as a limited partnership or limited liability company in India, typically an Indian venture capital fund is set up in the form of a trust. This form of entity, while providing for a single level of taxation, creates some practical issues in some situations regarding availability of tax credits and carryforward and setoff of losses for investors. To simplify fund structures, the venture capital and private equity fund managers were looking forward to using LLPs as suitable funds or fund management vehicles; however, because of the above limitations, LLPs may not be a viable option.

Because of the above unresolved issues, the LLP may not end up being an immediate popular entity form, as regulators have expected.

---

[1] Legislation on LLPs is available at http://www.mca.gov.in/MinistryWebsite/dca/actsbills/pdf/LLP_Act_2008_15jan2009.pdf.

[2] *See* "Limited Liability Partnership Overview: What Is a Limited Liability Partnership?" *available at* http://www.neiderboucher.com/LLPOverview.cfm.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Power to Enter Into TIEAs

In what is viewed as India's contribution to the global crackdown on tax havens, which had been initiated by countries across the globe after the G-20 London summit, the budget proposes to amend the relevant sections of the Income Tax Act, 1961, and the Wealth Tax Act, 1957. The central government will be empowered to enter into double taxation avoidance agreements and tax information exchange agreements with nonsovereign countries as well. Examples of nonsovereign countries are Bermuda, the Cayman Islands, Guernsey, Isle of Man, Jersey, the British Virgin Islands,[3] and so forth, most of which have been under the OECD's radar.

This move is significant in the struggle against tax havens being used for activities like money laundering, terrorist financing, and trafficking. Conscious of this issue, the OECD Global Forum Working Group on Effective Exchange of Information had rolled out the ''Agreement on Exchange of Information on Tax Matters'' after its 1998 report on harmful tax practices identifying lack of information exchange being responsible for malpractice. The model agreement did not seek to dictate tax rates to any country but rather sought to establish a formal and effective channel for the sharing of valuable tax-related information between various jurisdictions.

At the recent G-20 summit, concerns were raised about information sharing and cooperation among nations, in a bid by the world community to trace the illegal money parked in tax havens. This was followed by a list being published by the OECD categorizing various jurisdictions under three headings: jurisdictions that have substantially implemented the internationally agreed standards; jurisdictions that have committed but not implemented internationally agreed standards; and those jurisdictions that have neither committed nor implemented the standards. After the list was published, many countries entered into TIEAs with each other, the most recent TIEA being between the Netherlands and the Cayman Islands.[4] Approximately 85 agreements exist as of today, and India is now poised to join this league.

India has always valued the importance of effective information exchange channels, which may be seen from the memorandum of understanding entered into by India with Mauritius to facilitate free flow of information to support the sound development of their securities markets.[5] The budget proposal to enter into TIEAs with nonsovereign countries can be seen as an expression of India's commitment to harmonize its policy toward tax havens, along with that of the OECD and the global community.

Despite its widespread acceptance, the TIEA suffers from some complications. The entire process prescribed under the TIEA for obtaining information is highly time consuming. For example, unless the country requesting the information furnishes the exact particulars of the information requested (such as the name and address of the person who possesses the information, the grounds for believing that the said person possesses it, and so forth), the other country has a right to refuse it.

Considering the long process prescribed under TIEAs, the time taken to enter into such agreements, and India's target of a GDP growth rate of 9 percent over the next five fiscal years, the government may consider introducing an amnesty scheme for the voluntary disclosure of money unlawfully parked offshore. This scheme would not only provide taxpayers with an opportunity to disclose offshore income acquired through illegal and unlawful means, it would also provide the Indian economy with the necessary stimulus to achieve the targeted GDP growth rate. The amnesty scheme combined with the TIEA could help India achieve its goal of combating tax evasion and money laundering activities.

SEZs, STPIs, and EOUs

The Indian government introduced the special economic zone (SEZ) regime to attract large foreign investments into India by providing world class infrastructure, minimum regulatory requirements, and a favorable fiscal regime. For that purpose, a provision was added in the ITA to provide newly established units in the SEZs an exemption of 100 percent of profits and gains derived from export for five years, and of 50 percent for the following five years. The provision contains a controversial formula for computation of exempt profits, which, because of a lacuna in the drafting, resulted in an ambiguity wherein an entity having SEZ and non-SEZ units housed under it could not claim a 100 percent exemption of its export profits.

The budget proposes to cure the ambiguity by removing the lacuna in the formula, so that SEZ units would be able to receive full exemption in furtherance of the section's intention. However, while this would

---

[3] *Bank of Valleta Review*, No. 35 (Spring 2007), ''Financial Services and Small Island Jurisdictions,'' *available at* http://www.bov.com/filebank/documents/BR%2035%20p039-054%20carmen%20saliba.pdf; Annexure 1 of this document contains the list of nonsovereign jurisdictions.

[4] Recent bilateral agreements (by date of signature), *available at* http://www.oecd.org/document/7/0,3343,en_2649_33767_38312839_1_1_1_37427,00.html.

[5] *See* http://www.expressindia.com/news/fullstory.php?newsid=17607. *See also* http://www.tax-news.com/archive/story/Details_Emerge_Of_IndiaMauritius_Information_Exchange_Agreement_xxxx10335.html.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

encourage foreign investment in the SEZs, unfortunately the proposed amendment, if enacted, would be effective prospectively so that the part of the exemption for previous years, to which the old formula may apply, may still be lost.

Units set up in software technology parks (STPIs), hardware technology parks, free trade zones, and 100 percent export-oriented units (EOUs) currently receive tax holidays. The exemptions are due to expire in the financial year ending in March 2010. The budget has addressed the concerns of units set up as an STPI/ EOU by extending the sunset clause by one year. The tax exemptions would now be available up to March 31, 2010.

With this proposed amendment, the information technology (IT) community has reason to smile for another extended year. However, a slight shadow is cast on the relief granted because these units may still be required to pay an additional minimum alternate tax (MAT) on their book profits. The applicability of the MAT provisions to STPI/EOU units was introduced by the Finance Act 2007, and the finance minister has added to the woes of the IT community by increasing the MAT rate from 11.33 percent to 16.995 percent.

The International Community

Alternate Dispute Resolution Mechanism

With *Forbes* having identified India as being the country adding the most teeth to its tax regime in the previous year,[6] compounded by the aggressive approach adopted by the revenue authorities in the recent past toward foreign investors, the budget proposes to constitute a new forum, the Dispute Resolution Panel (DRP), especially for the benefit of foreign companies. The main objective of the forum is to grant relatively quick certainty regarding the transfer pricing disputes and tax liability of a foreign company in India.

The DRP would comprise three commissioners of income tax, who will review the tax officer's orders, which are prejudicial to a taxpayer before they are finalized. The directions of the DRP would be issued within nine months and would be binding on the tax authorities. However, the decision would not be binding on the taxpayer, and any appeal against the order would lie before the Income Tax Appellate Tribunal.

While this is a unique attempt at providing an efficient dispute redressal mechanism at an early stage, it remains to be seen whether the panel would make any difference in the quick determination of dispute, largely because of the adversarial mindset of the officials constituting it and the low rank in the judicial hierarchy of the panel. However, this mechanism may be useful for resolving transfer pricing disputes, especially when the applicability of the alternative remedy of approaching the Authority for Advance Ruling for transfer pricing transactions is currently debatable.

Introduction of Safe Harbor Rules

The second significant proposal provides authority to the government for framing safe harbor rules, aiming to reduce the impact of judgmental errors in determining the transfer price in international transactions and to specify circumstances under which the transfer price declared by a taxpayer would be accepted.

Demands for an advance pricing agreement regime have been made by international corporations doing business in India. However, the finance minister, while realizing that complications behind the introduction of an APA regime in India, has tried to increase predictability of transfer pricing in India by introducing the concept of safe harbor rules. It remains to be seen whether these rules will result in the elimination of unnecessary transfer pricing litigation.

Elimination of Fringe Benefit Tax

The passing of Finance Act, 2005, saw the introduction of FBT levied on the employer for benefits provided collectively to all employees. Since its introduction, FBT has applied to more benefits each fiscal year. This levy substantially increased compliance costs and created ambiguities regarding obtaining tax credit in cross-border situations. For these reasons, corporate India was hoping that the entire FBT regime would be eliminated.

The budget seeks to abolish FBT effective with fiscal 2009-2010. However, some of these benefits would now be considered as a perquisite and would be subject to tax at the employee level.

The elimination of the draconian provisions of FBT is likely to bring about relief for corporate employers by reducing their effective tax burden and compliance costs. Also, because FBT was not a deductible expense for companies, inequities were generated in the tax system. This proposal is also in harmony with the finance minister's objective of simplifying tax laws, and it goes a step further toward building a simple and equitable tax system. For employees, the elimination of FBT will likely result in a simplified salary structure.

ESOP Trend Expected to Bounce Back

The tax treatment of employee stock option plans in India has changed significantly over the past few years. In the 1990s, the difference between the market price and the exercise price was to be treated as a perquisite and taxed as salary income in the hands of the employee. However, by way of special exemption, there

[6] Jack Anderson, "2009 Misery & Reform Index," *Forbes*, Apr. 13, 2009, *available at* http://www.forbes.com/global/2009/0413/034-tax-misery-reform-index.html. *See also* http://www.hinduonnet.com/businessline/blnus/14061050.htm.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

was no requirement to pay the tax if the ESOP complied with the guidelines prescribed by the Ministry of Finance. It was only in 2007 that the finance minister expanded the ambit of FBT so that it could be levied on ESOPs.

The FBT regime brought with it an increase in compliance costs, which dissuaded many companies from granting ESOPs to their employees. For example, companies, including companies not listed in India, had to engage Securities and Exchange Board of India-registered Category I merchant bankers to determine the fair market value of ESOPs, which was expensive. Moreover, the method for determining fair market value was left to the discretion of the merchant banker because there were no specified rules on the method.

Much to the relief of corporate India, the budget proposes to revert to the original position, by eliminating FBT on ESOPs and treating them as a perquisite taxable in the hands of the employees. The budget proposes to tax the difference between the FMV on the date of exercise and the exercise price of the ESOP.

While this is a welcome move, the elimination of FBT is not without complications and practical difficulties. For example, while the elimination would begin with the fiscal year beginning April 1, 2009, many companies would have already paid the advance FBT installment due in June. It would be appropriate for the government to simply refund the FBT paid. Further, the perquisites that earlier were taxable under the FBT regime would now be subject to tax withholding; the question arises whether interest provisions would be applicable for failure to withhold taxes on these perquisites. For ESOPs, the ambiguity deepens because the mechanism of determining FMV for the calculation of the perquisite has yet to be clarified. Levy of interest in these circumstances may not do justice to the taxpayer, and it is hoped that the government will come out with suitable clarifications soon.

Nevertheless, with this reform, the trend of companies granting ESOPs is also expected to bounce back.

Backdoor Introduction of Gift Tax

Currently, any gift in cash in excess of INR 50,000 received by an individual is liable to be taxed under the provisions of the ITA. The budget seeks to expand the scope of these provisions by bringing within its purview all those transactions pertaining to movable and immovable property that are made without any consideration or made with inadequate consideration. However, the budget has included only some assets within the purview of this section, that is, immovable property, shares and securities, jewelry, archaeological collections, drawings, paintings, sculptures, and works of art. The budget has sought to bring in domestic transfer pricing for individuals by way of introducing this proposal.

This proposal is likely to have far-reaching consequences. To illustrate by way of a simple example, a private equity transaction in which an individual promoter of an Indian company gets a right to subscribe to shares of a company at a value lower than the fair market value could be brought under the tax scanner. A question also arises with respect to taxability of a transaction whereby a family trust setup would distribute assets to its individual beneficiaries. Although India does not levy gift tax, backdoor introduction of taxes not only distorts the taxing framework but also goes against the stated policy objective of simplification of tax laws. The method or calculation of FMV for these transactions will be prescribed by the government, and depending on the rules that are prescribed, taxation of the transactions without adequate consideration is expected to get complicated.

Upward Revision of MAT Rates

In a move that has caught the corporate world by surprise, the budget proposes to increase the MAT from 11.33 percent to 16.995 percent. MAT is levied on any company (including a foreign company) if the tax liability of the company is less that 10 percent of its book profits. The credit mechanism prescribed under the MAT provisions ensures that the taxpayer pays tax at a minimum rate prescribed under the MAT provisions. Any amount of tax paid under the MAT provision in excess of what a taxpayer is liable to pay sans the said provision is allowed as a credit to the taxpayer. The amount of credit can be carried forward to subsequent years and set off against the excess of tax payable under the normal provisions and the tax payable per the MAT provision. The budget seeks to provide relief to companies by allowing them to carry forward and set off these tax credits for a period of 10 years, up from the existing 7 years. This proposal is likely to affect startup companies adversely as the increase in the MAT rates may greatly affect their cash reserves.

Bad News for the Insurance Sector

Under the provisions of the ITA, any profits made by a non-life-insurance company on revaluation or sale of its investments are exempt, and any loss made thereupon is not available as a deduction. The rationale behind the exemption was to encourage the general insurance company to participate in the Indian capital market. However, the budget, much to the disappointment of the insurance sector, has sought to reverse this position by taxing the profits and allowing the company to claim the loss. It is difficult to understand the thought behind the proposal, especially at a time when the Indian markets need a boost in the inflow of capital.

Stimulus to In-House Research

Under the current provisions of the ITA, only a few specified categories of companies can benefit from a

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

weighted deduction of 150 percent of their expenditures incurred toward in-house research. To boost more companies conducting indigenous research in all sectors of the economy, the budget proposes to expand the ambit of the existing provisions, by allowing most (barring a few categories of companies specified in the negative list prescribed) companies that are in the business of manufacturing or production to have such a deduction.

Compulsory PAN for Foreign Companies

A permanent account number (PAN) is an identification number furnished by the Income Tax Department of India to every taxpayer. To strengthen the PAN mechanism in India, the budget would require every person who receives income that is subject to tax deducted at source to furnish his PAN to the person responsible for deducting his tax. For example, when an Indian company makes a payment to a foreign company, so that the income of the foreign company is chargeable to tax in India, the foreign company must furnish its PAN to the Indian company. If the PAN is not furnished, the Indian company must deduct tax at a minimum rate of 20 percent, irrespective of the actual tax deducted at source rate applicable.

Under the current domestic law provisions, payments made to a nonresident in the nature of royalties/fees for technical services are taxed at a basic rate of 10 percent. Similarly, interest payments made to a nonresident may be capped at rates lower than 20 percent under the provisions of the various double tax agreements. Therefore, if the nonresident fails to furnish his PAN to the person liable to withhold tax on his behalf, the basic withholding tax rate would increase to 20 percent. The nonresident subsequently may have to claim a refund of the excess tax deducted at source. Therefore, this amendment would indirectly make PAN compulsory for all foreign entities that have income liable to be taxed in India. It is intended to resolve procedural issues faced by the government because of deductees' nonuse of PANs, which creates problems in processing income tax returns and in granting credit for tax at deducted at source and leads to delays in issue of refunds.

Conclusion

The budget attempts to build a clear and equitable tax system. To quote Mukherjee:

> It is time that we complete the process that was started in 1991 for building a trust-based, simple, neutral tax system with almost no exemptions and low rates designed to promote voluntary compliance. We need a tax system which generates revenues on a sustained basis without use of coercive tax collection methods at the end of each year to meet targets. At the end of this process, I hope the Finance Minister can credibly say that our tax collectors are like honey bees collecting nectar from the flowers without disturbing them, but spreading their pollen so that all flowers can thrive and bear fruit.

The budget sets the tone for major economic reforms to come. Though the corporate community had high expectations of the new government to bring about drastic reforms in the tax rules, Mukherjee deserves credit for putting reforms back on the right track, considering he had been given just two weeks to present his budget. To cite Mukherjee in *The Economic Times*, ''I have just completed two weeks. Let me spend little more time, and perhaps we may wait for the D-day in February, 2010.''

Corporate India now waits for the next budget in 2010 to see whether the Indian government's dream for a simple, equitable, and neutral tax system turns into a reality. ◆

♦ *Harshal Shah and Parul Jain are with Nishith Desai Associates in India.*

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.