

Tax Hotline

July 05, 2019

INDIA BUDGET ANALYSIS 2019-20

Earlier today, the Indian Finance Minister (FM) presented the 1st Budget of the newly formed government for financial year (FY) 2019-20. While there were many expectations before the Budget to revive animal spirits in the economy, the Budget has presented a mixed bag. The focus of the Budget was on the rural economy and Make in India, while limited proposals appear to have been made to increase disposable income and increase consumption.

At the outset, while the FM has not changed corporate tax rates, the Budget proposes to extend the reduced corporate tax rates of 25% for Indian companies whose turnover is less than INR 4 billion, which would cover almost 99.3% of domestic companies. However, for individuals falling in the rich and super-rich category, the Budget proposes a higher surcharge on income tax resulting in the highest effective tax rate of between 38-42%. Increasing taxes through surcharges is not an appropriate way of increasing taxes, especially when surcharges which are introduced never get removed. The rates for the rich are amongst the highest in the world for developing countries and we will see increased movement of the rich and super rich out of the country.

From a foreign investor perspective, relaxations have been proposed to the investment norms in aviation, media, insurance, insurance intermediaries and single brand retail sectors. For incentivizing Foreign Portfolio Investors (FPI), the Budget proposes: (i) a deemed increase in the statutory limit for FPI investment in a company from 24% to the sectoral foreign investment limit; (ii) to permit FPIs to subscribe to listed debt securities issued by Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs); and (iii) to ease KYC norms for FPIs.

The Government appears to have recognized some of the issues pertaining to start-ups and they continue to benefit in this year's proposals. To resolve the 'angel tax' issue on capital subscription, the Budget proposes that start-ups will not be subjected to any kind of scrutiny in respect of valuations of share premiums, if requisite declarations and tax filings are made. Other changes include: (i) the removal of angel tax on investment by Category II Alternative Investment Funds (AIFs) in start-ups; and (ii) extended roll-over benefits in respect of capital gains from the sale of residential property, if invested in an eligible start-up. On the softer side, the FM has also indicated that a television channel will be broadcast exclusively for the promotion of start-ups.

Another area where the Budget has tried to address concerns is in relation to Non-Banking Financial Companies (NBFCs), which have been under a lot of stress in the recent past. In order to facilitate securitization transactions by financially sound NBFCs with public sector banks, the Budget proposes a six-month partial credit guarantee for the first loss up to 10%. The requirement to create a Debenture Redemption Reserve for public debt issuances by NBFCs has also been dispensed with. Additional tax rationalization for NBFCs has been undertaken to put them on par with banks and allow for interest on bad or doubtful debts to be recognized in the year of receipt.

Interestingly, the FM has addressed certain conflicts in case of insurance and housing finance sector. The nodal regulator for housing finance companies will now be the Reserve Bank of India (RBI) instead of the existing regulator i.e., the National Housing Bank (NHB). In case of the National Pension System, separation of the National Pension Trust from the regulator, Pension Fund and Regulatory Authority (PFRDA), has been proposed.

The FM has also proposed a slew of changes to provide further thrust to financial services enterprises operating in International Financial Services Centres (IFSCs), such as GIFT City. These include (i) the expansion of exemptions on transfers of specified instruments by a non-resident through stock exchanges set up in IFSCs; (ii) exemption from tax on interest payable to a non-resident by units in IFSCs; and (iii) exemption from tax on distributions by companies and mutual funds in IFSCs.

The Budget proposes to extend buyback tax to listed companies. This seems to have been done to check the practice of listed companies resorting to buybacks of shares instead of payment of dividends. This would effectively limit the quantum of distributions that listed companies make in light of the tax inefficiencies and does not make any economic sense. One fails to understand why policy makers do not appreciate that imposing an effective tax of more than 42% on profits distributed to shareholders is counterproductive to reviving animal spirits in the economy.

In the interim budget presented earlier this year, an impetus was given to technological development, creation of digital infrastructure and digitization of governance. To this end, the Budget proposes to implement e-assessments in a phased manner in order to eliminate human intervention, which would lead to simplification and greater transparency. Specifically, the Budget proposes: (i) online application for nil / lower withholding certificate for payments made to non-residents; and (ii) electronic filing of statements in respect of payment of interest income. Another important facet of the Budget is the introduction of pre-filled tax returns to taxpayers with the objective of reducing time and increasing accuracy in tax filing. It will be interesting to see how these changes actually benefit the taxpayer in practice.

Another interesting takeaway from the Budget has been the Government's increasing interest in environment

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protection measure which include incentivising the purchase and manufacture of e-vehicles, promote use of solar stoves and battery chargers in the country.

In summary, the Budget seems to give the picture that revenues for meeting expenditure are in place and hence there is no need to further widen the tax base. The tax measures proposed are limited to rationalization of existing provisions and providing a boost to certain targeted sectors. Whether the proposals will rekindle the flagging growth in the economy is something that will need to be seen in the coming months.

We have provided below a more comprehensive analysis and further insights on the 2019 Budget proposals. Hope you enjoy reading it. Join us for an interactive [Webinar](#) on Tuesday, July 9, 2019 for insights on India's 2019 Budget.

- Nishith M. Desai

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PART A: REGULATORY PROPOSALS

The Budget has introduced substantial changes on the regulatory front, with an intent to increase foreign investment into India Inc. In addition, the proposals are intended to further the Government's push towards digital payments and give further impetus to infrastructure.

1. PUSH FOR FOREIGN INVESTMENT

(a) Liberalization of foreign direct investment

In light of the Government's continuous liberalization of the Foreign Direct Investment ("FDI") regime, the Budget has announced relaxation of the FDI regime for aviation, media, insurance and single brand retail. The Budget does not specify the changes proposed, which will be enacted through amendments to Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 ("TISPRO").

■ Insurance

Currently, FDI up to 49% is permitted under the automatic route in the insurance sector (insurance companies and intermediaries like insurance brokers, third party administrators, surveyors and loss assessors). The Finance Minister ("FM") in the Budget has announced relaxing the FDI limit for insurance intermediaries to 100%. The Budget does not make any reference to whether the investment would be permitted under the automatic route or the approval route. However, considering that the Government has been relaxing investment restrictions (especially in sectors like insurance, where a sectoral regulator is present), it is possible that the 100% FDI limit would be under the automatic route.

In addition, the Budget also provides that the FDI norms for insurance would be relaxed in consultation with stakeholders. While it is unclear what relaxations are contemplated, it is likely that any change would relax the mandatory requirement of insurance companies being owned and controlled by resident persons only. It is to be seen if the relaxations contemplated include merely relaxing the mandatory resident owned and controlled requirement, or in addition, an increase in the FDI limit for insurance companies as well.

This would be a major shot in the arm for the insurance sector, since the industry has been requesting for relaxation in the sector since 2015, when the resident 'owned and controlled' requirement was included. This is highlighted from the fact that various offshore partners in Indian insurance companies have been demanding for removal of the restrictions to enable them to increase their shareholding in Indian insurance companies. In

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addition, the entry of various global insurance players has been restricted by the 'owned and controlled' requirements.

■ **Aviation**

Currently, FDI up to 100% is permitted in Scheduled Air Transport Services (which includes Domestic Scheduled Passenger Airline and Regional Air Transport Services), wherein only 49% of such foreign investment is under the automatic route and the remaining is under the government approval route. Further, foreign airlines can currently invest only up to 49% of the share capital in Indian companies operating Scheduled and Non-Scheduled Air Transport, with such investment being under the government approval route and subject to certain conditions.

The Budget does not clarify what relaxations are contemplated and proposes that the nature of relaxation will be discussed with the relevant stakeholders. This may focus around relaxing FDI beyond 49% under the automatic route, or open up domestic Scheduled and Non-Scheduled Air Transport to FDI beyond 51%.

The proposal for relaxation of foreign investments in aviation is a welcome move since it opens additional avenues for airlines in India which are under insolvency (such as Jet Airways). Further, if foreign investments by foreign airlines in aviation is relaxed, it may also encourage further investments in airlines such as Vistara and AirAsia India.

■ **Media**

The Budget has also announced for relaxation for foreign investments in the media sector (including animation). It is unclear if the references to media includes print (where FDI up to 26% is permitted under the governmental route) or broadcast (wherein certain sub-sectors such as FM Radio are under the governmental route).

■ **Relaxation in Local Sourcing Requirements**

Currently, FDI up to 100% in single brand retail is permitted under the automatic route. In case of foreign investments exceeding 51% in an Indian company undertaking single brand retail, 30% of the value of goods purchased is required to be sourced from India. Whilst entities having global operations can set off the incremental sourcing requirements from India during their initial 5 years to comply with the local sourcing norms, a company can seek exemption from sourcing norms for up to 3 years from commencement of the business for products having 'state-of-art' and 'cutting-edge' technology and where local sourcing is not possible. This has impacted the entry of large multinationals like Apple and OnePlus. Like with respect to other sectors, the Budget does not detail the relaxations provided. However, any relaxation in this norm (be it a reduction in the percentage of goods to be sourced locally, or extension of the time period within which the local sourcing requirements need to be complied with) would be a welcome move for the single brand retail sector.

(b) More benefits for FPIs

With a view to encourage more FPI investments into India, the Budget has proposed a number of major changes to the FPI regime, mostly in line with the observations of the report of the working group constituted by the Securities and Exchange Board of India ("**SEBI**") under the chairmanship of Mr. Harun R. Khan, published in May 2019 ("**Khan Report**").

■ **Removal of Statutory Limit**

Currently, under exchange control laws, the aggregate holding of all FPIs in one company is restricted to 24% of the paid-up equity value of the company on a fully diluted basis (unless increased to the relevant sectoral cap by the company). In line with the recommendation in the Khan Report, the Budget has proposed that FPIs will be permitted to invest up to the relevant sectoral cap, provided the investee company will have the choice to limit this investment to a lower threshold. The amendments to TISPRO and operational guidelines on the same would be required to note how the reduction of the limit by the investee company would practically work. This move may be important since a number of companies have not increased their foreign investment limit even though otherwise permitted under TISPRO. This will enable a greater participation of FPIs in the Indian capital markets and will also allow for increase in the India allocation for foreign ETFs, which track global indices.

■ **Merger of NRI-PIS and FPI Route**

Currently, non-resident Indians ("**NRIs**") are only permitted to invest in listed securities of Indian companies through the Portfolio Investment Scheme ("**NRI-PIS**") route, and subject to an aggregate statutory cap of 10%, which may be increased to 24%. NRIs are, in aggregate, not permitted to be more than 50% investors in an FPI. The Budget recognizes that the participation of NRIs in Indian capital markets is comparatively less. With a view to provide NRIs seamless access to the Indian equities market, the Budget has proposed the merger of the NRI-PIS route with the FPI Route, in line with the Khan Report.

■ **Easier and streamlined KYC Norms**

Existing Know Your Customer ("**KYC**") norms applicable to FPIs are proposed to be rationalized and streamlined, to make them investor friendly and promote ease of investment.

■ **Expanding basket of instruments of FPIs**

REITs and InvITs are investment trusts that were introduced in 2014 and one of the critical aspects which make the regimes viable is the ability of the REIT / InvIT to leverage and extract funds. The avenues for REITs and InvITs raising leverage were limited, and this impacted the ability of the REIT / InvIT to benefit from higher debt to equity ratio. The FM in the Budget has proposed expanding the list of instruments into which FPIs can invest, to include listed debt securities issued by REITs and InvITs. This would be a major shot in the arm for further encouraging the REIT and InvIT regimes in India.

■ **Exit from IDF-NBFCs**

Noting the need for infrastructure financing and with a view to incentivize FPI investments in infrastructure, the Budget proposes to permit FPIs to sell investments made by them in debt securities of Infrastructure Debt Fund – Non-Bank Finance Companies (IDF-NBFCs) to any domestic investor within the applicable lock-in period.

2. LISTING REQUIREMENTS: ADDING SOME MORE 'PUBLIC'

Every listed company is required to have a minimum public shareholding of at least 25%. In case any listed company's public shareholding falls below 25%, it is required to increase its public shareholding by adopting any of the mechanisms prescribed by SEBI. However, the FM in the Budget has indicated a willingness to increase the minimum public shareholding from 25% to 35%, and has mentioned that SEBI has been asked to consider this proposal. While the intent of increasing the minimum public shareholding seems to be to encourage further retail and institutional participation in the capital markets, it is to be seen if the proposal is accepted by SEBI. The increase in minimum public shareholding norms may also encourage companies with large promoters to delist and go private in a bid to avoid further dilution.

3. FINANCIAL INSTITUTIONS: NBFCs

The significance of NBFCs in deepening access to capital and channeling the deployment of capital across the economy justifies the continued funding from commercial banks and other financial institutions, and the FM in the Budget has acknowledged the same. Considering the recent liquidity crunch faced by NBFCs, coupled with the systemic risks posed by large NBFCs, the Government intends to work with a two-pronged framework viz., enhancing NBFC's access to funds and bolstering regulatory oversight.

(a) Enhancing access to funds

■ Credit guarantee

The Government proposes to provide a 6 months' credit guarantee to public sector commercial banks to cover the first loss of up to 10% incurred by such banks while investing in high-rated pooled assets of financially sound NBFCs. The Budget does not, however, provide any further details of this scheme. It is expected that such guarantee would be dependent on appropriate diligence and credit analysis. Further, it is to be seen what the Government implies by 'financially sound NBFCs', i.e. whether the 'financially sound' aspect of the NBFCs are linked to net assets, capital adequacy or any other financial ratios. Further, the rationale for keeping private sector banks outside the scheme seems to be unclear. However, considering the recent stress in the NBFC sector, the use of credit guarantee can be an effective method of incentivizing securitization transactions by NBFCs, and having public sector commercial banks participate in securitization transactions.

■ Debenture Redemption Reserve

Every NBFC which raises funds by issuance of debentures by way of public issuance is required to create and maintain a debenture redemption reserve ("**DRR**") at the prescribed rates, while the issuance by private placement is exempted from the requirement to maintain a DRR.

The Budget further proposes exempting NBFCs from the requirement to create DRR while raising finance through public issue of debentures as well. The proposed removal of the requirement to maintain DRR should free up funds for NBFCs, resulting in more liquidity for such NBFCs to lend. It is expected that changes to Companies Act, 2013, Reserve Bank of India Act, 1934 and the relevant NBFC regulations shall also be notified in this regard.

■ Lower net owned funds

The Finance Bill, 2019 ("**Finance Bill**") has proposed an amendment to Section 45-IA of the Reserve Bank of India Act, 1934 ("**RBI Act**") wherein the requirement for NBFCs to demonstrate minimum net owned fund of INR 20 million shall be relaxed to INR 10 million. This should permit NBFCs to use additional funds and also encourage entry of new smaller NBFCs.

(b) Regulatory oversight

Acknowledging the RBI's limited regulatory authority over NBFCs, and considering the systemic risk posed by the mismanagement of large NBFCs, the Finance Bill now proposes to provide the RBI with broad powers to monitor the activities and governance of NBFCs.

■ Power to override management

As per the proposed amendments to the Banking Regulation Act, 1949, the RBI shall be provided with the power to determine whether the activities of an NBFC are being carried out in a manner that is detrimental to the interests of the public, depositors, its creditors, or financial stability, or for securing the proper management of the NBFC. If the RBI is satisfied that circumstances warrant corrective action, it may order the removal or the substitution of a director of such NBFC. The director so removed shall be barred from being concerned or participating in the management of any other NBFC for a period of up to 5 years. In the alternative, where circumstances warrant, the RBI shall also be empowered to supersede the board of directors of such NBFC for a period of up to 5 years and place the management of the NBFC under an administrator. The administrator may be assisted by a committee of experts (comprising of accountants, lawyers, bankers, and so on) in the governance of the NBFC. The powers are akin to the powers of the RBI vis-a-vis scheduled commercial banks and ensure that the RBI has ability to step-in at the appropriate time in cases where it deems fit. This proposed amendment now institutionalizes what the RBI has done in the past in the case of the Peerless Group.

■ Oversight of auditors

Having learnt its lesson from the IL&FS saga, the Government has emphasized on the role of auditors of NBFCs as one of the key pillars of the corporate governance framework, and proposes to empower the RBI to debar an auditor from acting as an auditor to any financial institution under the regulatory oversight of the RBI for a period of up to 3 years, if such auditor fails to comply with the directions or orders of the RBI. While this seems to empower the RBI, it is to be seen if the intent of the change is to debar IL&FS auditors from acting as auditors for all financial institutions.

■ Restructuring of NBFCs

The Finance Bill proposes to empower the RBI to re-organize NBFCs if it is satisfied upon an inspection of the books and records of the NBFC that the circumstances so warrant in public interest or in the interest of financial stability. The RBI shall have the authority to amalgamate the NBFC with any other NBFC, restructure the NBFC, or otherwise split the NBFC into several units or companies in the manner it deems fit, including by way of creating

“bridge institutions”, i.e., temporary institutional arrangements to preserve the continuity of operations and other activities that are critical to the functioning of the financial system. This is also akin to RBI's powers vis-a-vis scheduled commercial banks.

■ Regular inspections

The Finance Bill proposes to allow the RBI to carry out regular inspections of the books and records and the functioning of NBFCs. It is expected that such regular inspections will empower the RBI to detect systemic issues early.

4. OTHER FINANCIAL INSTITUTIONS

1. Incentivizing foreign reinsurers: The Finance Bill proposes to relax the net owned fund criteria under the Insurance Act, 1938 for foreign reinsurers seeking to open branches in IFSCs. The proposed amendment to the Insurance Act, 1938 seeks to reduce the net owned fund requirement to INR 10 billion from INR 50 billion.
2. Regulation of housing finance: Regulation of housing finance is proposed to be moved under the regulatory supervision of the RBI from the National Housing Bank. The Finance Bill has proposed amendments to the National Housing Bank Act, 1987 in order to facilitate the transition of regulatory oversight to the RBI.

5. TOWARDS A CASHLESS ECONOMY

Taking forward its 'digital economy' initiative, the Government has proposed certain measures to encourage cashless transactions:

1. Taxing large cash withdrawals: To encourage non-cash transactions by businesses, the Budget proposes to introduce tax deduction at source of 2% for withdrawals more than INR 10 million in a financial year. The tax is to be deducted by banks at the rate of 2% on cash withdrawals exceeding INR 10 million per year. It is to be seen if this to be implemented on a per-account basis or a per-person basis.
2. Mandatory acceptance of digital payments by large merchants: The Budget proposes to make it compulsory for certain large merchants (those with annual sales, turnover or gross receipts of more than INR 500 million in a year) to accept certain prescribed modes of digital payments. While the Budget refers to Unified Payments Interface (UPI), Aadhaar Pay, National Electronic Funds Transfer (NEFT) and Real Time Gross Settlement (RTGS), the modes which are to be mandatorily provided are expected to be notified by the Government. A penalty of INR 5,000 has also been proposed in case Section 269SU of Income-tax Act, 1961 ("ITA") is violated for every day that the violation continues. This should be a major shot in the arm for encouraging digital transactions.

To further encourage use of such digital payments, the Budget has also proposed to bar the charging of fees by banks and payment system operators for payments made using prescribed modes of digital payments.

PART B: DIRECT TAX PROPOSALS

1. RATIONALIZATION OF TAX RATES AND PROCEDURE

(a) Further Reduction of Corporate Tax Rates

In line with budget proposals to reduce corporate tax rates over the last couple of years, the Finance Bill has proposed to extend the beneficial corporate tax rate of 25% to all companies whose turnover in FY 2017-18 did not exceed INR 4 billion. Earlier, the exemption was available only to companies whose turnover in FY 2016-17 did not exceed INR 2.5 billion. The lower corporate tax rate is in line with global trends and should apply to 99.3% of Indian companies.

(b) Taxing the Super Rich

In addition to the existing surcharge of: (i) 10% on income tax payable by individuals earning in excess of INR 5 million but less than INR 10 million and (ii) 15% on income tax payable by individuals earning in excess of INR 10 million, the Budget has retained the 15% rate of surcharge to individuals earning more than INR 10 million but less than INR 20 million, and introduced a surcharge of: (a) 25% on income tax payable by individuals earning in excess of INR 20 million but less than INR 50 million; and (b) 37% on income tax payable by individuals earning in excess of INR 50 million. This would effectively increase the tax rates up to 42.7% for the highest slab of assesses.

(c) Tax-Filing Rationalization Measures

The Budget proposes to make an individual's permanent account number ("PAN") and Aadhaar number interchangeable, enabling individuals without a PAN to file their tax returns using their Aadhaar number. Further, in a move to improve accuracy and reduce time taken to prepare annual tax returns, the Budget proposes to make pre-filled tax returns containing details of various streams of income available to taxpayers. The information will be sourced from banks, stock exchanges, mutual funds and the like.

The Budget also proposes to launch an e-assessments scheme involving no human interface. Initially to be rolled out for scrutiny assessments, the scheme is expected to reduce undesirable practices by tax officials prevalent in the existing system of scrutiny assessments that involve a high level of personal interaction between the taxpayer and the Revenue.

2. EXEMPTIONS FOR START-UPS

As part of its 'Make in India' initiative launched in 2014 and in its continuing strive to incentivize start-ups, the Government of India has proposed the following changes in this year's Budget:

(a) Revisions to Angel Tax Provisions – will the ghost of Angel Tax be laid to rest?

Section 56(2)(viib) of the ITA provides that where a company, not being a company in which the public are substantially interested receives any consideration, from a resident for issuance of shares, that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value ("FMV") of the shares shall be charged to tax. However, this provision does not apply to consideration for issuance of shares received: (i) by a venture capital undertaking from a venture capital company or a venture capital fund; or (ii) by a

company from a class or classes of persons as may be notified by the Government in this behalf.

The definition of venture capital fund only includes Category I AIFs ("**Cat I AIFs**"). Accordingly, venture capital undertakings are exempt from Section 56(2)(viib) only in respect of investments by Cat I AIFs. With a view to facilitate venture capital undertakings to receive funds from Category II AIFs ("**Cat II AIFs**") as well, the Finance Bill proposes to amend Section 56(2)(viib) to exempt venture capital undertakings from its applicability in respect of investments received by Cat II AIFs. This is a welcome move by the Government as it is likely to boost investments by Cat II AIFs in venture capital undertakings. Further, most AIFs are set up as Cat II AIFs and hence this amendment will effectively benefit most of them. Going forward, the Government should consider extending this exemption in respect of all regulated entities since the intent behind Section 56(2)(viib) is to prevent tax abuse which is unlikely in case of regulated entities.

The Budget also proposes that start-ups will not be subjected to scrutiny in respect of valuations of share premium if necessary declarations and filings are made. In addition, the Budget proposes to ensure that no scrutiny will be carried out by the Assessing Officer without obtaining the approval of her supervising officer. It is hoped that these changes will result in decreased scrutiny and harassment of entrepreneurs who are raising capital, leaving them to focus on their business.

(b) Revisions to Carry Forward of Loss Provisions – Will Start-ups Benefit?

Section 79 of the ITA provides certain restrictions on set off of carried forward losses in case of companies in which the public are not substantially interested / closely held companies ("**Specified Companies**").

The current provisions relating to carry forward of losses categorize companies into two different buckets:

1. In case of Specified Companies not being 'eligible start-ups',¹ the provision for allowing carry forward of losses provides that on the last day of the previous year in which the carried forward loss has to be set off, 51% of the shares of the company carrying voting power shall be beneficially held by the same persons who beneficially held 51% of the shares carrying voting power on the last day of the year in which the loss was incurred.
2. In case of Specified Companies which are 'eligible start-ups', the loss incurred in any year prior to the previous year shall be carried forward and set off in the previous year only if: (a) all the shareholders holding shares carrying voting power on the last day of the previous year in which the loss was incurred continue to hold those shares on the last day of the such previous year; and (b) such loss has been incurred during the period of 7 years since the year in which the company was incorporated.

In an attempt to facilitate ease of doing business for 'eligible start-ups', the Finance Bill seeks to amend Section 79 to provide that for setting off carried forward losses by Specified Companies being eligible start-ups, satisfaction of either of the above conditions shall suffice for the benefit to be claimed. This provides Specified Companies being 'eligible start-ups' the flexibility of satisfying either the continuation of 51% of the beneficial ownership requirement or continuation of 100% of the legal ownership requirement (between the last day of the year in which the loss was incurred and the last day of the year in which the carried forward loss is sought to be set off) for setting off carried forward losses.

(c) Rollover Benefits on Capital Gains

Section 54GB of the IT provides relief from capital gains tax to an 'eligible assessee'² in respect of sale proceeds received from the transfer of a residential house, if such sale proceeds are reinvested in the equity of an 'eligible start-up' which then uses it to purchase new plant and machinery. Such relief is subject to certain specified conditions.

In order to incentivize investments in eligible start-ups, the Finance Bill proposes to amend Section 54GB to bring about the following changes: (i) extend the sun-set date of transfer of residential property to avail the benefit under this provision from March 31, 2019 to March 31, 2021; (ii) relax the condition of minimum shareholding by the 'eligible assessee' in the 'eligible start-ups' from 50% of share capital or voting rights to 20%; and (iii) relax the condition restricting transfer of new plant and machinery being computer or computer software by the 'eligible start-ups' from 5 years to 3 years.

While the proposed amendments under Sections 79 and 54GB seem to be a move in the right direction for incentivizing start-ups, their significance remains questionable. This is because the threshold for qualifying as an 'eligible start-up' as prescribed under relevant notifications issued by the Government continues to be very high. Hence, unless the Government liberalizes the thresholds for qualifying as an 'eligible start-up', the income tax benefits provided to them under the ITA will benefit only a few start-ups and not fulfill the objective of incentivizing start-ups in general.

3. INCENTIVES FOR IFSCS – BUILDING A LIBERAL FRAMEWORK!

In an endeavor to build a robust financial services centre in the country, the Budget has made various proposals to incentivize the operations in IFSCs. Currently, the only operational IFSC is GIFT City. Certain key proposals in respect of IFSCs in the Finance Bill are discussed below.

(a) Widening of exemption on capital gains

Currently, non-residents are exempted from capital gains tax on transfer of GDRs, rupee denominated bonds ("**RDBs**") and derivatives on a stock exchange in an IFSC. The Finance Bill proposes to extend such exemption to other securities which may be notified by the Central Government, thereby widening the ambit of exemptions which may be provided.

The Finance Bill has also expanded the list of beneficiaries of the aforesaid exemptions to include Category III AIFs ("**Cat III AIFs**") located in an IFSC, deriving income solely in convertible foreign exchange and having only non-resident unit holders. It should be clarified that units held in respect of sponsor commitment by sponsors of Cat III AIFs should not be reckoned towards determining whether the Cat III AIF is composed solely of non-resident unit holders. Otherwise, this exemption may be in conflict with SEBI's intent (that resident sponsors provide a minimum sponsor commitment) and thereby render the proposed exemption infructuous for Category III AIFs.

The permissibility to extend exemption through notification is an enabling provision for the Government to meet further industry demands and may be viewed positively for the flexibility that it provides.

(b) Facilitating external borrowing

In order to facilitate borrowings by a 'unit' (as specified in the Special Economic Zones Act, 2005) located in the IFSC, the Finance Bill has proposed to exempt interest income earned by a non-resident in respect of any money that has been borrowed by a unit in an IFSC from such non-resident. The said exemption will be applicable for any monies borrowed by units located in IFSCs on or after September 1, 2019. This may be viewed as a positive move towards deepening the bond market in IFSCs.

(c) Exemption from tax on distributions

A company operating from an IFSC and earning income solely in the form of foreign convertible exchange is currently exempt from Dividend Distribution Tax ("DDT") in respect of the dividend paid out of the current income earned from its operations in the IFSC.

However, to facilitate commercial flexibility for dividend distributions from units operating in IFSCs, the Finance Bill proposes an amendment to the ITA whereby a unit operating from an IFSC will now be exempt from DDT in respect of dividends distributed from income accumulated by such unit from its operations in the IFSC from April 1, 2017. Similar to DDT, the Government had introduced a tax on distributions made by mutual funds in 2018. The Finance Bill has proposed to exempt distributions by mutual funds located in IFSCs, deriving income solely in convertible foreign exchange and having solely non-resident unit holders. Further, similar to Cat III AIFs, it should be clarified that units held in respect of sponsor commitment by sponsors of mutual funds should not be reckoned towards determining whether the mutual fund is composed solely of non-resident unit holders.

By providing exemptions on distributions of income, along with existing exemptions on current income, the Finance Bill has taken positive steps towards greater achievement of real tax neutrality, which is a benchmark that IFSCs are judged against. This should be viewed positively.

(d) Tax holiday changes

Currently, the ITA provides tax holiday for units in IFSC by way of a deduction on the profits to the extent of 100% for the first 5 years and a deduction to the extent of 50% for the next consecutive 5 years. The Finance Bill has now proposed a 100% deduction on the profits of such assesses for any 10 consecutive years out of the first 15 assessment years from the commencement of operations by the unit. Such a proposal would allow IFSC units greater flexibility to optimize the use of the exemption by linking the tax holiday to commercial realities, since certain businesses may take time in earning higher levels of income.

4. TAX REGIME FOR AIFS AND OFFSHORE FUNDS

(a) Pass through treatment extended to losses of AIFs

The Finance Act, 2015 had extended the tax pass through status to Cat I and Cat II AIFs. As per the existing provisions, any income, barring business income, earned by such AIFs would be exempt in the hands of such AIFs, and taxable directly in the hands of its investor(s) in the same manner and proportion as it would have been, had such investor received such income directly and not through such AIFs. With respect to the losses incurred by such AIFs, whether in the nature of business losses or otherwise, the same could be set-off or carried forward by such AIFs. However, losses suffered by such AIFs (not being in the nature of business losses) could not be passed through to its investors for them to claim set-off of such losses against income earned by them.

In order to address the above anomaly, the Finance Bill has proposed to allow losses incurred by such AIFs (not being in the nature of business losses) to be passed through to its investors to be able to set-off or carry forward such losses while computing their income. However, in order to avail such pass-through benefit, such investors should have held units in the AIF for a period of more than 12 (twelve) months. Therefore, if an investor holds units for a period of less than 12 (twelve) months, it should not be able to set-off or carry forward its losses.

Further, the Finance Bill has also proposed to insert a new sub-section under Section 115UB of the ITA whereby, accumulated or unabsorbed losses (not in the nature of business losses) of such AIFs as on March 31, 2019 would be passed through to its investors to be carried forward / set-off against their income, *provided that* the investor was a holder of units of the AIF as on March 31, 2019. Such losses could be carried forward and accordingly set-off by investors from the year in which the loss first occurred subject to the period of limitation provided under the Chapter VI of the ITA.³

The above proposal is a welcome change as it aligns investor level taxation in investment funds with global practices. However, there seems to be an anomaly wherein the pre-condition in relation to the 12 months holding period, to avail the pass-through benefit of losses (not being in the nature of business losses) at the AIF level, applicable to investors that acquire units of an AIF on or after April 1, 2019, seems to not be applicable to investors holding units as on March 31, 2019, who have been accorded the set-off / carrying forward loss pass-through status. The legislative intent behind such distinction seems unclear and leaves scope for varied interpretation amongst the managers and investors of AIFs.

(b) Taxability of offshore investments by non-residents through AIFs

Section 5(2) of the ITA imposes source-based taxation on non-residents whereby, income received or arising or deemed to be received or arising to a non-resident in India would be subject to tax in India. Therefore, income received by a non-resident becomes chargeable to tax either when it 'is received' or is 'deemed to be received' in India by him or when it 'accrues' or 'arises' or is 'deemed to accrue or arise' to him in India during the previous year.

The SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") provide the regulatory framework for privately placed domestic funds in India. They are permitted to make overseas investments and accept foreign investments subject to certain limits. Additionally, Cat I and Cat II AIFs have been accorded a tax pass-through status whereby, income earned by an AIF (not being in the nature of business income) would be exempt in the hands of the AIF, but such income would be taxed directly in the hands of the investor.

Where an AIF receives investments from a non-resident investor, and uses such capital contributions to make

verseas investments, the issue of whether or not the income earned by the non-resident from such offshore investments through the AIF could be deemed to be a direct investment by a non-resident, and hence not subject to tax in India under Section 5 of the ITA, was previously unsettled.

In this regard, immediately prior to the Budget, the Central Board of Direct Taxes ("CBDT") had issued a circular on July 3, 2019 to 'clarify' that such income received by non-residents from offshore investments made through Cat I and Cat II AIFs would not be subject to tax in India under Section 5(2) of the ITA. Further, the circular also clarified that any losses suffered from such offshore investments, being an exempt loss, shall not be allowed to be set-off or carried forward against the income of the Cat I and Cat II AIF.

The aforementioned clarification provides fiscal neutrality as it eliminates double taxation of the income earned by the non-resident both at the India level and in its country of residence and ensures that India based pooling vehicles are not put at a disadvantage compared to global standards.

5. INCENTIVES FOR OFFSHORE BORROWINGS

Under the provisions of Section 194LC of the ITA, interest income payable to a non-resident by an Indian company or business trust on offshore borrowings by way of issue of RDBs, before the July 1, 2020, is subject to a lower withholding tax rate of 5%, provided the interest paid does not exceed the all-in-cost ceiling per annum on INR denominated External Commercial Borrowings ("ECBs") prescribed under the New ECB Framework of 2019.

With a view to containing India's current account deficit and in order to augment forex inflow through low cost foreign borrowings, on September 17, 2018, the Ministry of Finance had issued a press release exempting the interest income payable by an Indian company or a business trust to a non-resident, in respect of RDBs issued outside India during the period from September 17, 2018 – March 31, 2019, from tax under the ITA. Consequently, no tax was required to be withheld under Section 194LC of the ITA on payment of interest on such RDBs.

The Budget now proposes to operationalize this exemption by inserting clause (4C) in Section 10 of the ITA, which exempts any interest income payable to a non-resident by any Indian company or business trust in respect of monies borrowed from a source outside India by way of issue of RDBs, during the period beginning from the September 17, 2018 and ending on March 31, 2019.

6. INCOME RECOGNITION INCENTIVES FOR NBFCs

Under Section 43D of the ITA, interest income on prescribed categories of bad or doubtful debts received by public financial institutions, scheduled banks, and certain other entities, is chargeable to tax in the year in which it is credited to the profit and loss account of the concerned entity for that year, or in the year in which it is actually received by that entity, whichever is earlier.

In light of the increasingly important role played by NBFCs in India's financial system, and given the enhanced levels of regulation that certain NBFCs are subjected to by the RBI, the Budget proposes to provide greater parity in the tax treatment of NBFCs vis-a-vis scheduled banks, by extending the benefit of Section 43D of the ITA to deposit-taking NBFCs and systemically important non deposit-taking NBFCs. This is a welcome measure as tax authorities have previously attempted to tax interest income on bad or doubtful debts held by NBFCs on an accrual basis, despite no income potentially arising or having been actually received.

The Budget also proposes to make a matching amendment in Section 43B of the ITA to provide that any sum payable by an assessee as interest on any loan or advances from a deposit-taking NBFC or a systemically important non deposit-taking NBFC shall be allowed as a deduction if it is actually paid on or before the due date of furnishing the return of income of the relevant previous year, provided the assessee has not claimed the same deduction in the year in which the liability to pay such sum was incurred by the assessee.

The proposed amendments seek to put to rest longstanding litigation on the issue of taxability of interest on bad or doubtful debts held by NBFCs. In 2011, the Delhi High Court,⁴ in a decision upheld on appeal by the Supreme Court,⁵ had applied both the "real income" theory and the overriding effect of the prudential norms on income recognition issued by the RBI, to hold that interest income on a non-performing asset held by an NBFC could only be taxed on a receipt basis and not on an accrual basis. The proposed amendments are in line with the decisions of the Delhi High Court and the Supreme Court and should therefore quell any lingering uncertainty on the tax treatment of interest income on bad or doubtful debts held by adequately regulated NBFCs, although perhaps, the amendments could have been introduced with retrospective effect in order to settle pending cases on the issue as well.

7. AMENDMENTS TO ANTI-ABUSE PROVISIONS

(a) Amendment to Deemed Capital Gains on Transfer – Will it actually yield benefits?

Section 50CA of the ITA, introduced by Finance Act, 2017 provides that in case of transfer of unlisted shares of a company at less than FMV, the FMV would be deemed to be the full value of consideration for computing capital gains. While introduced as an anti-abuse provision, Section 50CA affected genuine transactions between unrelated parties and resulted in economic double taxation in the hands of both the transferor and the transferee, besides taxing notional income.

The Budget seeks to provide relief from the applicability of Section 50CA in cases where consideration for transfer of shares is approved by certain authorities and the transferor has no control over such determination. For the purposes of the same, the Finance Bill has proposed to amend the provisions of Section 50CA to empower the CBDT to notify transactions undertaken by a certain class of persons and subject to certain prescribed conditions to which the provisions of Section 50CA would not be applicable.

While the extent of relief this amendment is likely to bring about remains to be seen, it is unlikely that the inherent issues of Section 50CA such as double non-taxation and notional capital gains in case of genuine transactions between unrelated parties will get resolved.

(b) Buyback Taxation – A retrograde step

Section 115QA of the ITA was first introduced by the Finance Act, 2013 as an anti-abuse provision to curb the practice of unlisted domestic companies resorting to buyback of shares instead of payment of dividends as the capital gains tax rate applicable at the time was lower than the rate applicable to dividend distribution. Specifically, 115QA provides for the levy of a buy-back tax of 20% applicable on the amount of consideration paid for buying back

the shares in excess of the amount originally received by the company at the time of issuing shares.

Noting that publicly listed companies are now also indulging in the practice of resorting to buyback of shares, instead of payment of dividends, the Budget proposes to extend the purview of Section 115QA to listed companies as well. Thus, any buyback of shares from a shareholder by a company listed on recognized stock exchange, on or after July 5, 2019, shall also be subject to a 20% buyback tax.

While the insertion of Section 115QA in 2013 may have been an effective response to unlisted companies choosing buybacks over dividend distributions with the sole purpose of tax avoidance, the expansion of this anti-abuse provision to listed companies seems unwarranted and impractical. Considering how often publicly listed shares are traded, it is not very likely that the shareholder from whom a listed company buys back its shares is the same as the one who originally subscribed to such shares. Accordingly, it seems unreasonable, and even absurd to refer to the original subscription amount received by the company when computing such tax. The impracticality of the provision is further highlighted when considering the potential for economic growth that publicly traded shares have. For example, a share initially subscribed to for INR 10 may be worth INR 10,000 when the company buys it back several years later. A 20% tax on the INR 9,990 difference would likely restrict the company from buying back its shares even when such buyback is supported by bona fide commercial objectives like: (i) increasing their Return on Equity ('ROE') by reducing the number of equity shares outstanding; and (ii) utilizing its excess cash which may otherwise remain idle in the listed company. Such a significant tax burden will only result in a reduction of the ROE of listed companies and encumber the distribution of unutilized cash, which could otherwise be put to better use in the hands of shareholders and accelerate consumption.

8. RATIONALIZATION OF TAX NEUTRALITY FOR DEMERGERS

In a move to facilitate M&A activity in India, the Budget proposes to rationalize the requirements for tax neutral demergers under the ITA to align them with the Indian Accounting Standards ("IndAS").

One of the existing conditions for tax-neutral demergers is that the resulting company should record the property and the liabilities of the undertaking at the value appearing in the books of accounts of the demerged company. However, resulting companies that follow IndAS are required to record the property and the liabilities of the undertaking at a value different from the book value of the demerged company (i.e., their fair value), making it impossible to meet the conditions for a tax neutral demerger.

In order to facilitate tax neutral demergers involving IndAS compliant companies, the Budget proposes to amend Section 2(19AA) of the ITA to provide that the requirement of recording property and liabilities at book value by the resulting company shall not be applicable in a case where the property and liabilities of the undertakings received by the resulting company are recorded at a value different from the value appearing in the books of account of the demerged company immediately before the demerger (i.e., their fair value), due to the application of IndAS.

9. RELAXATION OF WITHHOLDING OBLIGATIONS

Section 201 of the ITA provides that where any person who is required to withhold tax, does not withhold tax, he shall be deemed to be an 'assessee-in-default' and subject to interest at the rate of 1% per month with the possibility of a penalty of up to 100% of the amount that should have been deducted. Further, under Section 40 of the ITA, the payer is barred from claiming such payments as deductions while filing his Indian tax returns.

However, in case of payments to a resident, a payer will not be deemed to be an assessee-in-default if, despite his failure to deduct tax, the resident payee has filed his returns, disclosed the payment and paid his taxes. He can also claim the payments as deductions, but will still be required to pay interest on the amount that should have been withheld for the period commencing on the date on which the payment was made till the date on which the non-resident furnishes his returns.

The Budget proposes extending this flexibility to similar situations involving payments to non-resident payees.

The Budget also proposes allowing a payer to file an electronic application for a nil withholding tax certificate under Section 195 of the ITA. At present, such applications can only be filed manually.

10. TARGETING UNDERVALUED TRANSFERS BETWEEN RESIDENTS AND NON-RESIDENTS

The Budget proposes to introduce a new clause under Section 9(1) of the ITA to tax undervalued transfers of property or money by residents to non-residents.

Presently, under Section 56(2)(x) of the ITA, the recipient of any undervalued property shall be taxed on the difference between the consideration actually paid for such property and its FMV, under the head "Income from Other Sources" except in certain specified circumstances (e.g., receipt from a close relative).

Income that could potentially be taxed under Section 56(2)(x) must also, in the case of a non-resident recipient, accrue or arise in India, or be deemed to accrue or arise in India, which is the basis of the nexus principle of taxation. Section 9(1) of the ITA enumerates the circumstances where income can be deemed to accrue or arise in India.

Noting that there have been instances where gifts made by residents to non-residents have been claimed to be non-taxable in India on the basis that income does not accrue or arise in India, the Budget has proposed to introduce a deeming fiction under Section 9(1) through a new clause (viii) to ensure that such gifts made by residents to non-residents are subject to tax. The Finance Bill has proposed that any gifts of money or property situated in India by a resident to a non-resident (subject to exceptions for close relatives) for inadequate or no consideration would be taxable in India.

It may be noted that the scope of the provisions may even extend to cash situated outside India, which is transferred by a resident to a non-resident.

Further, the term "assets situated in India" has also been accorded a wide meaning under Section 9 to extend to shares or securities of a company incorporated outside India that derives substantial value from assets situated in India. Hence, even transfer of shares of a foreign company may potentially come within the ambit of the new clause (viii) in certain situations.

The exemptions to Section 56(2)(x), e.g., gifts to close relatives, should continue to be available even in the context of gifts to non-residents.

The Budget clarifies that treaty relief with respect to income of the nature described in Section 56(2)(x) can be availed

of, which is likely to fall to be available under the treaty article on "Other Income". This article is currently present in a number of tax treaties concluded by India. However, not all of India's tax treaties accord taxation rights over "Other Income" exclusively to the jurisdiction of residence of the non-resident (e.g., India's treaties with Mauritius, Singapore, USA and the UK provide that other income may be taxed in India).

11. TRANSFER PRICING AMENDMENTS

2 years ago, in order to align India's transfer pricing provisions with international best practices, Finance Act, 2017 introduced Section 92CE to the ITA. This section required an assessee who entered into an international transaction subject to transfer pricing to make a secondary adjustment in certain instances.

The purpose of these secondary adjustments in the books of account of the assessee and its associated enterprise were to reflect the actual distribution of profits between the two parties as per the primary adjustment determined under transfer pricing provisions, and thereby eliminate any imbalance between the assessee's accounts and actual profits.

In an effort to make the secondary adjustment regime easier to implement, the Budget proposes to amend Section 92CE in the following manner:

1. the requirement that interest (at the rates provided in Rule 10CB of the Income-tax Rules, 1962) shall be applicable on excess income not repatriated within the prescribed time limit has been further amended to provide the assessee an option to pay additional income tax at the rate of 18% on such non-repatriated income. Interest at the prescribed rates shall continue to be applicable until such time that the additional 18% income tax has been paid. However, once such additional income tax has been paid, the assessee shall not be required to make secondary adjustments or compute further interest from the date of payment. Further, once such additional income tax has been paid (a) no further deduction shall be allowed; and (b) no further credit shall be claimed with respect to the tax amount so paid;
2. the condition that a primary adjustment shall only be exempt if: (a) it does not exceed INR 10 million; and (b) is made in respect of an assessment year commencing on or before April 1, 2016, has been amended such that fulfillment of any one of the two conditions is sufficient to qualify for the exemption;
3. Section 92CE shall only be applicable where the primary adjustment has been determined by an advance pricing agreement entered into by the assessee under Section 92CC of the ITA, and signed on or after April 1, 2017; however, no refund of taxes already paid till date shall be allowed;
4. interest shall not only be calculated on excess money available to the foreign associated enterprise, but also on any part thereof; and
5. excess money may be repatriated from any of the associated enterprises of the assessee which are not residing in India.

Prior to these amendments, one of the practical difficulties faced by stakeholders was repatriation of excess money from countries having restrictive foreign exchange regimes. The option of making a one-time payment of 18% additional income tax means that the assessee no longer has to worry about making year on year interest payments on excess money locked outside India. The 18% additional income tax may also be considered akin to a dividend distribution tax, which would typically have been applicable if the excess money had been directly transferred to the associated enterprise as dividend, instead of having arisen by way of adjustment.

While this one-time additional income tax payment, along with the relaxation of the exemption thresholds under Section 92CE are both welcome changes, the issue relating to foreign tax credits does not appear to have been solved. The proposed amendments do not address a situation where a foreign country may have already taxed all or a portion of "excess income" as per their own transfer pricing provisions. In such case, application of Section 92CE may result in double taxation that may not have the benefit of treaty relief.

12. RATIONALIZATION OF BLACK MONEY PROVISIONS

The Budget proposes to expand the applicability of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 ("**BM Act**") by:

1. expanding the definition of "assessee" from only those persons who are residents in India within the meaning of Section 6(6) of the ITA, to also include a non-resident or a person not ordinarily resident in India within the meaning of Section 6(6) of the ITA, in the previous year, who was resident in India either in the previous year to which the income referred to in Section 4 of the BM Act relates, or in the previous year in which the undisclosed asset located outside India was acquired; and
2. expanding the scope of "assessment" in Section 10 of the BM Act to include "re-assess" and "reassessment" in sub-sections 3 and 4.

By expanding the scope of the definition of assessee, the provision has been amended to capture those individuals who may fall outside the scope of the BM Act solely by virtue of the fact that they no longer qualify as residents of India. Keeping in mind that the objective of the BM Act is to deal with and bring to tax undisclosed foreign income and assets held outside of India, it is only reasonable that the BM Act not be limited to only those assesseees who are Indian residents at the time of assessment or reassessment, but rather cover all individuals that are duly liable to tax. That being said, it will be interesting to see how the Indian government intends to enforce provisions of the BM Act on individuals who no longer reside in India.

- International Tax Team

You can direct your queries or comments to the authors

1 Section 80-IAC, ITA.

2 For the purposes of section 54GB, 'eligible assessee' has been defined as individual or a Hindu undivided family.

3 Aggregation of Income and Set off or Carry Forward of Loss.

4 CIT v. Vasisth Chay Vyapar Ltd., [2011] 330 ITR 330 (Delhi).

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