FOREIGN INVESTORS ON INDIA

Budget 2020: The Big Bang Is Missing

By **Gurdip Singh** On **Feb 2, 2020**

Tax exemptions for sovereign wealth funds

Minister Sitharaman with Minister of State for Finance Anurag Singh Thakur and the senior officials before presenting the General Budget 2019-20 on 1 Feb 2020.

The Budget 2020 has failed to adequately address the challenges faced by the economy, says Nishith Desai Associates. Given the continuing economic slowdown and the current social unrest that the country is witnessing, there was a lot of hope from the Budget to revive the plummeting growth, the consultancy pointed out.

Finance Minister Nirmala Sitharaman presented the Union Budget for financial year 2020-21 on 1 Feb 2020.

The fact that US$50 billion of the market capitalization was wiped off on the Budget day is a clear reflection of the market sentiment.

Having said that, the Budget has brought some changes to increase disposable income and consumption in the middle class and boost investor sentiment, according to Nishith Desai readings.

But it is questionable to what extent it will result in increasing the demand-supply mismatch that is significantly been responsible for the economic slowdown.

The biggest announcement was the removal of Dividend Distribution Tax (DDT) which was an additional tax paid at the company’s level.

Instead, shareholders will now have to discharge taxes on dividends received. This is a welcome move and comes as a huge relief to the foreign investor community, said Nishith Desai in commentary on 1 Feb 2020 after the budget was tabled in parliament.

Foreign investors are often faced with the difficulty of not being able to claim tax credit in the country of residence or take benefit of withholding tax rates under the applicable tax treaty.

While this creates significant benefits for foreign shareholders (including corporates and private equity investors), the trade-off is that for domestic shareholders, the taxes paid on amounts received as dividend may increase, depending on the tax rates applicable for such shareholders.

On the flip side, Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs) seem to be bearing the brunt of this change with dividend income which was earlier exempt from DDT now being subject to tax in hands of investors of the InvITs and REITs.

An attempt seems to have been made to boost the infrastructure sector by expanding the scope of pass through taxation to private unlisted InvITs.

This was a long-standing demand of the investor community especially considering that the SEBI regulations have done away with the mandatory listing requirement of InvITs.

However, in an unanticipated and completely regressive move, the removal of DDT has resulted in investors in InvITs having to bear an increased tax burden on dividends that are distributed to them.

In addition, a thread bare reading of the provisions of the Finance Bill, 2020 leads to a conclusion that investment by sovereign funds into InvITs may not provide them with tax exemption even though they may be investing indirectly into infrastructure companies.

Another big reform that the Budget introduces are tax exemptions to sovereign wealth funds. The Budget has exempted income in the nature of dividend, interest or long-term capital gains earned by sovereign wealth funds through investments in the infrastructure space who fulfil certain criteria.

Notably, the Abu Dhabi Investment Authority (ADIA) and its subsidiaries have been specifically exempted.

Although, under some tax treaties, sovereign wealth funds are exempted, specific provisions under the Income Tax Act, 1961 (ITA) will provide more certainty and clarity in this respect.

The intent behind this move is to encourage long term stable capital participation from sovereign wealth funds, to replace government spending in the creation of infrastructure assets and also foster economic relations with such countries.

In continuation with the Government’s efforts to deepen the bond market, the Budget has extended the reduced withholding taxes on coupon payments on rupee denominated debt (RDB) instruments and foreign currency loans for another 3 years i.e. issued before 1 July 2023.

It has also proposed to reduce the withholding tax rate from 5% to 4% in respect of any long-term bond or RDB listed on a recognised stock exchange located in any International Financial Services Centre (IFSC).

Similarly, the lower withholding tax rate in case of interest payments to Foreign Institutional Investors (FII) and Qualified Foreign Investors (QFIs) on their investment in Government securities and RDB of an Indian company has been extended to 1 July 2023.

The Non-Banking Finance Companies (NBFC) sector has gone through a period of extended stress.

The Budget has provided the following measures for the NBFC sector:

reduction in limits for debt recovery under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) from asset size of Rs.5 billion (approx. US$70 million) to asset size of Rs.1 billion (approx. US$14 million) or loan size from existing Rs.10 million (approx. US$140,000) to Rs.5 million (approx. US$70,000);

extend invoice financing to the MSMEs, thereby enhancing their economic and financial sustainability;

and provide support in the form of liquidity.

In light of evolving global discussions at the OECD and global level with respect to taxation of the digital economy, the Significant Economic Presence (SEP) test for establishing business connection which was introduced in the Finance Act, 2018 has now been amended and its implementation postponed to April 2021.

Importantly, the scope of the income attributable to Indian operations would include activities relating to collection of data from and targeting advertisements at users in India.

While the postponement to April 2021 is a welcome move, the new provisions on attribution which apply to business connection established otherwise than because of SEP in India are likely to cause more confusion than clarify.

Providing certainty to non-resident taxpayers litigating the issue of attribution of profits to their business connections, Permanent Establishments (PEs) in India has been an oft repeated demand raised.

The Budget proposes to include attribution of profits within the framework of the safe harbour rules and the Advance Pricing Arrangement regimes, which were hitherto limited to Arm’s Length Price determination.

A welcome move has been addressing issues faced by employees on tax on stock options. Realizing the importance of Employee Stock Option Plan (ESOP) as a compensation for the employees in start-ups, the Budget has deferred withholding tax payments in respect of income pertaining to ESOP of start- ups.

Further, in order to rationalise tax provisions, 100% tax deduction is now available for any 3 consecutive years out of 10 years as against the earlier 7 years.

Additionally, the turnover threshold for obtaining the 100% tax deduction has been increased from Rs.250 million (approx. US$3.5 million) to Rs.1 billion (approx. US$14 million).

In a purported attempt to increase tax collection, the Budget has also introduced tax collection at source (TCS) on overseas remittances, sale of overseas tour packages and on sale of goods in excess of Rs.5 million (US$0.7 million) per year.

A withholding tax of 1% has also been introduced which is to be paid by e-commerce operators for sale of goods or provision of service by Indian suppliers facilitated through their digital or electronic facility or platform.

On the personal income tax front, the Budget provides for significant changes to the current rates and exemptions available and provides for an alternative scheme of taxation.

In a bid to widen the tax net, the Budget introduces a new residency test to loop in “stateless” Indian citizens who are not liable to tax in any other jurisdiction. This move is aimed to restrict the movement of the rich and super rich to tax havens and is some sort of an anti-avoidance measure.

In a similar vein, the Budget has also reduced the threshold for an Indian citizen to become a tax resident from 182 days to 120 days in certain cases.

In order to streamline the tax administration process, the Budget has proposed a slew of measures such as introduction of faceless assessments, widening the scope of matters taken up by the Dispute Resolution Panel to include foreign taxpayers other than foreign companies and also widen the scope of assessments that can be challenged by the taxpayers.

The Budget also introduces an amnesty scheme for direct taxes similar to the amnesty scheme introduced last year for indirect taxes.

Under the scheme, the taxpayer would be required to pay only the amount of the disputed taxes and will get complete waiver of interest and penalty provided the payment is made by 31 March 2020.

Lastly, the Finance Minister has proposed the introduction of a taxpayer’s charter which is intended to end tax harassment by setting out the rights of a taxpayer in the ITA with a view to facilitate trust between the tax administration and tax payers.

In summary, the Budget does not provide the big bang reforms that the economy required and the market expected. Despite asks from the market participants to reintroduce the long-term capital gains exemption on listed securities and reduction of the holding period for long-term gains, the Budget does not make any mention of it.

The tax measures proposed are limited to rationalization of existing provisions and providing a boost to certain targeted sectors, said Nishith Desai. *fiinews.com*