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#Budget2016: BigLaw India on Tax Litigation, Startups, REITs, Patents & more

In this summary, law firms from across the country share their views on the Union Budget 2016. We get Cyril Amarchand's **SR Patnaik** and **Mekhla Anand**, ELP's **Rohan Shah**, Khaitan's **Daksha Baxi**, Nishith Desai Associates' **Nishith Desai**, and a host of others to share their analysis of Finance Minister Arun Jaitley's 2016 Budget.

Rohan Shah, Managing Partner, Economic Laws Practice

On the **indirect tax** front there are some clear positives for the corporate community. The thrust on measures to **reduce tax litigation** is welcome as it will help resolve

Rohan Shah

pending disputes and also create certainty for the future. In view of the impending move to **GST**, certain measures have been taken including the imposition of an additional cess of 0.5% *ad valorem.* There here has also been a rationalisation of the CENVAT credit structure and certain items like clothing and jewelery will now be subject to excise duty.

If one were looking for something which ought to have been addressed and was missed, the provisions for arrest on indirect tax disputes which have been plaguing the sentiment of the Indian industry should have been definitively modified to prevent arrest for custodial investigations. Qua GST, while some subtle steps have been taken, some might have wished for a more positive affirmation of an action plan and dates. Personally, I think there will be more concrete announcements on GST in the latter half of this Budget Session of Parliament.

On **direct taxes**, the beneficial taxation regime for new manufacturing units, start-ups, asset reconstruction companies and global patent incomes are all positive and supportive steps. The introduction of a fresh scheme of amnesty in direct taxes with a more benign interest and penalty, as also assurances against prosecution, may well elicit a far greater participation.

The adoption of the Easwar Committee Report on simplifications is also welcome.

The settlement scheme on "indirect transfers" is however a dampener as the requirement for tax payment is in a manner an endorsement of the retrospective amendment introduced by the previous Government. While the resolution of this issue is not easy, this Budget proposal for settlement of indirect transfers by payment of the tax amounts may not garner adequate support. This critical issue unfortunately continues to remain unresolved.

(You can read the detailed Budget Analysis by ELP here)

Daksha Baxi, Executive Director – Direct Tax, Khaitan & Co

Daksha Baxi

Tight rope walking in the budget is visibly seen. The devil or the angel is going to be in the fine print, but here are some comments on the Budget speech:

- The commitment to keeping to the fiscal discipline of deficit of 3.5% of GDP is laudable but the question remains how they will manage it.
- The special lower income tax regime of 10% on income from licensing of patents developed and registered in India is a major push to the innovation box and should spur and inspire locating of intellectual property in India and reduce the outflow of IP from India.
- Ducking the fear of change in long term capital tax regime, and on the contrary, reducing the holding period for unlisted shares to 2 years from the 3 year period is a good compromise and should be seen in positive light.

- While the total outlay on infrastructure has been pegged to be the highest so far, it remains to be seen if this will act as an incentive to kick-starting investment decisions in the country.

- Some amount of relief to the small tax payers is coupled with 10% additional tax on dividend income above Rs 10 lakhs and additional surcharge of 3%, increasing the rate of surcharge for higher income to 15%. This may have some negative impact on the equity infusion in companies.
- The asset reconstruction sector would get a boost on account of complete pass through of income-tax to securitization trusts including trusts of ARCs.
- Despite a not so encouraging response to the Black Money Law, it is interesting to see that the government is looking to unearth domestic undisclosed income by offering immunity to taxpayers to come clean. Undisclosed income represented in the form of any asset can be legalised by paying a tax of 30%, surcharge of 7.5% and penalty pegged at a low rate of 7.5%, aggregating to a 45% tax rate with immunity from prosecution can be seen as encouraging.
- The FM's announcement that the Tax Simplification Committee's recommendations are being seen as a very big positive.

Nishith Desai, Managing Partner, Nishith Desai Associates

The Finance Minister has focused on remedying a number of critical points of concern to foreign investors and he certainly deserves a few Oscars for addressing some painful issues.

The Government has continued the path of systemic reforms by bringing about a number of changes to the tax and regulatory framework. These reforms include relaxing foreign investment limits in certain key sectors. A number of other low hanging fruits such as removing dividend distribution tax for REITs and InvITs (Real Estate Trusts and Investment Trusts respectively) and reducing the long term capital gains tax on unlisted securities of private companies from 20% to 10% have been addressed as part of the Budget. Importantly, the Government has stuck to the fiscal deficit target of 3.5% of India's gross domestic product for FY 2016-17.

On the regulatory side, significant relaxations have also been announced in respect of the Foreign Direct Investment Policy, including allowing foreign investment in insurance and pension sectors under the automatic route upto 49% as well as allowing for 100% foreign investment under the automatic route in case of asset reconstruction companies and entities engaged in marketing of food products produced and manufactured in India.

Similarly, the investment limit for individual foreign investors in stock exchanges has been increased from 5% to 15%, which is important in the context of the proposed listing of the Bombay Stock Exchange and the National Stock Exchange. However, similar relaxation for foreign investment in power exchanges and commodity exchanges has not been announced. The Budget further proposes to expand the basket of eligible FDI instruments to include hybrid instruments. This may allow for innovative structures to be effectuated.

The Government has also recognized that the bond markets in India need greater depth. For this purpose, they have announced that large borrowers will be encouraged to meet their financing needs through the market mechanism. In similar vein, Foreign Portfolio Investors (FPI) will also be allowed to invest in unlisted debt securities issued by corporates and

pass through securities issued by securitization SPVs. While these moves will assist in deepening the bond market, one will have to wait to see the guidelines issued by the Reserve Bank of India in this regard.

On the tax side, last year the Government had proposed a gradual reduction in corporate tax rates from 30% to 25% over a period of four years. The Government appears to have taken the first step in this direction by providing that new manufacturing entities that are set up, will be entitled to a lower rate of 25% plus surcharge and cess on meeting certain conditions. Furthermore, the corporate tax rate is proposed to be lowered to 29% for a domestic company whose turnover in the FY 2014-15 does not exceed INR 5 crores.

However, for large companies, while the Government has proposed phasing out incentives such as limiting accelerated depreciation, other investment linked incentives etc., it has desisted from reducing corporate tax rates this year. Another surprising change has been the introduction of a new dividend tax to be levied in the hands of an identified class of shareholders, i.e. those who receive dividend of more than INR 1 million in any financial year. This is a new tax apart from the existing dividend distribution tax which is levied in the hands of the company paying dividend.

On the positive side, the Government has reduced the long term capital gains tax rate levied on the sale of shares of unlisted private companies to 10% from 20% for foreign investors. It has further reduced the holding period for an investment to qualify as long term capital asset to 2 years from the earlier qualifying period of 3 years. The reduction in rates for foreign investors will provide significant relief and re-emphasize the commitment of the Government to making India an attractive investment destination for foreign investors.

The fund industry was a major beneficiary of the Budget proposals last year and continues to benefit in this year's proposals. The Government last year had permitted foreign investment into Alternative Investment Funds (AIFs) under the automatic route. However, significant ambiguity was prevalent on distributions made to foreign investors by Category I and Category II AIFs where the withholding tax provisions provided for a 10% withholding rate. The Budget has now proposed that benefits under tax treaties will be extended to non-residents with respect to distributions from an AIF to such non-residents. This move will enable Indian GPs to structure fund raising through unified structures as against co-investment structures without any tax leakages. In similar vein, the Government has also eased the safe harbor norms for fund managers in India, and mere control or management of any business from India will not constitute a business connection. However, the expectation of easing a number of other safe harbor norms for fund managers has not been met.

REITS and InvITs have also been on the radar of the Budget this year. One issue that the industry is facing is that the upstreaming of amounts through dividends to REITs/InvITs is subject to dividend distribution tax ("**DDT**"). The Budget proposes the removal of such DDT. With these changes in addition to those proposed last year, it is hoped that REITS / InvITs will finally take off in India.

An interesting measure introduced in the Budget is the proposed tax incentives applicable to units that are set up in an International Financial Services Center (IFSC). The first IFSC has been set up at the GIFT city with the intent of capturing a share of the international offshore financial services market.

While there have been a number of positive measures that have been announced, the Budget still leaves an overhang over some important issues such as the retrospective tax on indirect transfers, place of effective management ("**POEM**") and General Anti Avoidance Rules, which leave it short of an Oscar clean sweep.

The Government has decided to postpone the introduction of the POEM Rules to FY 2016-17 with detailed provisions being introduced on the treatment of when a foreign company becomes a resident of India in the first year. The change introduced last year with respect to the POEM Rules was an ill thought out decision and it would have been much better if the Government had decided to revert to the old provisions which provided for the "control and management" test for a foreign company to be treated as resident in India. Similarly, the General Anti Avoidance Rules continue to be effective only from FY 2017-18 and it is hoped that the rules for their application will provide for enough checks and balances to ensure tax payer protection.

The Budget has tried to tackle the ghost of the retrospective nature of the indirect transfer provisions by providing for a dispute resolution scheme for resolving such disputes. The Scheme provides that if tax payers withdraw a litigation/arbitration arising out of such issues, the Government will waive the interest and penalties on such tax payable.

It is unfortunate that the Government has not taken the bold step to bury the ghost by removing the retrospective nature of the provisions. Even today, there are neither rules that are in place to determine fair market value for application of the indirect transfer tax provisions nor are there provisions to determine the manner of apportionment of gains attributable income purportedly derived from India.

The Budget also proposes an equalization levy, which will affect the online advertisement income earned by foreign companies. A fall out of the discussions during OECD BEPS Action Plan (though not finally accepted), the Budget provides for a 6% equalization levy in respect of payment of advertisement revenues to foreign companies. In the normal course of things, this would not have been a taxable transaction and this provision can have significant ramifications for companies seeking to do business in India.

The Government has used the Budget to make incremental progress and introduce changes in the sphere of tax legislation, without making any big bang reforms. It has instead focused on the resolution of some of the smaller complexities in Indian tax legislation which have been pain points for foreign investors. Apart from substantive changes to the law, there have also been a number of procedural changes introduced with the intention of facilitating early resolution of disputes and reducing litigation backlog. The changes proposed by the Government, however, do not amount to bold action that could have sent out the strong message of welcoming foreign investors with open arms to India.

Pravin Anand, Managing Partner, Anand and Anand

This Union Budget brings opportunity for companies who wants to apply for patents with reduction of tax from 33% to 10% now. This move will only bolster demand for patent protection in the country.

On the other hand its disappointing to see a downgrading of R&D weighted tax deduction from 200% to 150% to three years and curtailing it further down to 100% in the next three years.

Mukesh Bhatani, Managing Partner, BMR Legal

It's a balanced budget with an overarching theme of realizing inclusive and staggered economic growth, without stepping down on the path of fiscal prudence. Amongst positives, focus on infrastructure development, fixing distressed asset concerns of financial sector, employment generation through indigenization stand out. Bankruptcy code and a framework for commercial dispute settlement under PPP framework are the two most significant regulatory reforms rolled out.

Amongst tax proposals, the budget is rife with new taxes – eg, tax on super-rich, and levy of additional cess on services; doubling of clean environment cess. While reduction in corporate tax rate for MSMEs is encouraging, FM's holding back across the board reduction in tax rate, perhaps constrained by budgetary compulsions. Exempting Project SPVs from dividends distribution tax accords nearly a complete pass through status to REITs and ARCs; this proposal ought to enhance competitiveness of REITs as the preferred pooling vehicle for investment in real estate /infrastructure sector.

A lot of other positives – eg, the Budget buries the bogey of retrospective tax, and provides one time opportunity for settlement of past disputes; implementing outcomes of BEPS in the form of equalization levy cess in B2B digital transactions of 6 percent shall help garner revenues.

The Budget rolls out a host of administrative reforms by way of fixing loopholes and measures to improve taxpayers' experience, and that is definitively a step in the right direction to evolving taxpayers' service focused administration. Improvised dispute resolution shall encourage settlement of languishing tax disputes and help unclog dispute resolution mechanism. One time window for voluntary disclosure by delinquent taxpayers finds its way back into legislation, and it's encouraging to see the FM not propose a prohibitive penalty on disclosure.

SR Patnaik, Head of Tax Practice and Mekhla Anand, Partner, Indirect Tax, Cyril Amarchand Mangaldas

In a report titled *First Impressions of Budget 2016*, the tax team from Cyril Amarchand Mangaldas discusses the proposed changes to the law governing direct taxes, and the incentives offered to startups. Here are excerpts from that report:

Buyback of shares: Under the existing tax laws, a buyback tax is charged on incomes distributed by a closely held company on buyback of shares in accordance with the provisions of section 77A of the Companies Act, 1956.

In cases where the buyback was executed by way of a court approved scheme, it was contended by taxpayers buyback tax was not required to be paid. The Budget now clarifies that buyback tax shall be payable in case of any buyback of shares undertaken by a company in accordance with the law and not necessarily only in respect of buyback under section 77A of the Companies Act, 1956.

Phasing out of exemptions and deductions: As announced by the Finance Minister in his Budget Speech last year and widely predicted by many, several deductions and exemptions that are currently available to the taxpayers are proposed to be driven away as a part of the plan to reduce the corporate tax rates from 30% to 25%.

For instance, the highest rate of depreciation is proposed to be restricted to 40%. A sunset date of March 31, 2020 has been inserted for SEZ units claiming tax holiday under section 10AA of the IT Act. As far as expenditure towards scientific research is concerned, the weighted deductions that are currently available are proposed to be reduced to 100% only.

Tax deduction on profits of Startups: Currently, profits earned by domestic companies, partnership firms and LLPs are subject to tax at the rate of 30%. The Finance Bill proposes to provide a deduction to the profits of Eligible Startups; set up before April 1, 2019. This would be available in any three out of five years beginning from the year in which the eligible startup is incorporated. However, such eligible Startups would be subject to Minimum Alternate Tax. .

Exemption from capital gains tax to investors:

(i) The Finance Bill proposes to provide an exemption from capital gains tax on long term capital gains from sale of capital assets to those investors, who invest in the 'Funds of Funds' recognized by the Government; subject to the conditions that the amounts shall remain invested for three years and that the investment in the Funds of Funds shall be up to INR 5 million.

(You can read Cyril Amarchand's detailed budget analysis here.)