

Tax Hotline

February 01, 2020

INDIA BUDGET 2020: NO BOLD SOLUTIONS TO IMMEDIATE CHALLENGES!

Founder's Note:

The Budget seeks to bring in a wide variety of complicated and substantive tax changes in the income tax act. Last year too, a similar exercise was done by the FM and the Finance Bill, 2019 was passed without any proper discussion by the Parliament within 21 days of its introduction and without offering an adequate opportunity of representation to the public. This caused a negative impact on small investors on the stock market as large amounts of funds were withdrawn by foreign institutions from the stock market. After major pushback from the investor community, and intervention of the PM, the changes were withdrawn.

Adequate opportunity must be given to the public for discussing the tax proposals thread bear. Taxation without representation is a 'tyranny' said James Otis in 1761 in the context of American colonists at being taxed by a British Parliament to which they elected no representatives and became an anti-British slogan before the American Revolution. Although we have elected representatives, the way in which the Finance Bill is passed needs a serious rethink.

One good thing that has happened in this budget is a proposal to incorporate Charter of Tax Payers Rights in the income tax act itself. While we still need to see the text, FM deserves real compliments for this fundamental initiative.

We **appeal** to the Prime Minister and Finance Minister not to introduce substantive changes alongside the Budget. They require dialogue with public and serious discussion in the Parliament. We suggest Parliament must give more time to the stake holders to understand in detail the budget provisions, do public hearings and then pass legislation.

- Nishith M. Desai

SUMMARY

The Indian Finance Minister (FM), Nirmala Sitharaman, yesterday, presented the Union Budget of India for financial year (FY) 2020-21. 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. However, the Budget failed to adequately address the challenges faced. The fact that USD 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. 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 who 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

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2020, 2019, 2018, 2017, 2016, 2015

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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 July 1, 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 July 1, 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: (i) 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 INR 5 billion (approx. USD 70 million) to asset size of INR 1 billion (approx. USD 14 million) or loan size from existing INR 10 million (approx. USD 140,000) to INR 5 million (approx. USD 70,000); (ii) extend invoice financing to the MSMEs, thereby enhancing their economic and financial sustainability; and (iii) 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 INR 250 million (approx. USD 3.5 million) to INR 1 billion (approx. USD 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 INR 5 million (USD 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.

Sleepless Nights?

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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 March 31, 2020. Lastly, the FM 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. We have provided below a more comprehensive analysis and further insights on the 2020 Budget proposals. Hope you enjoy reading it. Join us for an interactive [Webinar](#) on Wednesday, February 5, 2020 for insights on India's 2020.

- International Tax Team

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15. TAX ADMINISTRATION

1. DIVIDEND DISTRIBUTION TAX ABOLISHED

Section 115-O of the ITA, as it currently stands, imposes a 15% additional income-tax (“**DDT**”) on any amount declared, distributed or paid by a domestic company by way of dividends (whether interim or otherwise), whether out of current or accumulated profits, in the hands of the company. The tax so paid by the company is treated as the final payment of tax in respect of the amount declared, distributed or paid by way of dividend. Such dividend is exempt in the hands of shareholders.

Similarly, mutual funds are liable to pay additional income-tax at the specified rate on any income distributed by them to their unit holders, which income is then exempt in the hands of unit holders under Section 10(35) of the ITA.

The DDT was first introduced in 1997 as means of encouraging companies to retain earnings and make fresh investments, and also to simplify the then existing scheme for deduction and reporting of withholding tax on dividend. After briefly being discontinued in 2002 on account of its iniquitous and regressive nature, the DDT was reintroduced in 2003 based on the administrative ease of collecting at a single point i.e. from the company declaring, distributing, or paying dividend, instead of compelling the company to compute the tax deductible in the hands of the shareholders.

The continued imposition of the DDT raised several urgent legal and commercial challenges, including the following:

- **Non-consideration of tax status:** DDT is payable by a domestic company irrespective of whether the recipient of dividend is subject to tax, or the marginal tax rate applicable. Even in cases where the shareholders are domestic or foreign statutory tax-exempt bodies, or foreign sovereign entities, domestic AIFs or even the Government of India, DDT continued to remain payable.
- **Cascading effect of DDT:** In cases where equity shareholding in a domestic operating company was structured through one or more intermediate onshore holding companies, with dividends declared and passed up the investment chain, the cascading effect of DDT at each level of dividend distribution resulted in substantial erosion of shareholder earnings at each level in the chain. While Section 115-O(1A) of the ITA attempted to mitigate this cascading effect by providing for a limited dividends received deduction (“DRD”) in computing net distributed profits chargeable to the DDT, in practice, the benefit of the DRD ended up being limited to a small subset of qualifying companies. This resulted in cascading effect of DDT at various levels of the shareholding structure.
- **Non-availability of local tax credit:** Section 115-O(4) of the ITA treats the dividend tax paid by a company as a final tax on dividend, and also provides that no credit of DDT paid shall be claimed by the company or by any other person. In other words, neither the company nor its shareholders could claim credit of the DDT paid by the company against the tax payable by them on their taxable income or even avail deductions against expenses.
- **Non-availability of foreign tax credit:** Given that the DDT was ostensibly an additional income tax on the domestic company, it was unclear if a non-resident shareholder would be entitled to claim foreign tax credit (“FTC”) against the DDT paid by the company in their home jurisdiction.
- **Additional tax on dividend income:** Section 115BBDA of the ITA, introduced vide Finance Act, 2016, imposes an additional 10% tax on income in excess of INR 1 million (approx. USD 14,000) by way of dividends declared, distributed or paid by a domestic company or companies and earned by certain specified classes of taxpayers. This additional tax is over and above both the corporate income-tax paid by the company and the DDT paid by the company at the time of declaration, distribution, or payment of dividend. This resulted in *triple taxation* of what is effectively the same income, which heavily disincentivized equity investments into Indian companies.

The Memorandum explaining the provisions to the Finance Bill, 2020 (“**Memorandum**”) notes that since dividend is income in the hands of the recipients (i.e., shareholders), the incidence of tax should normally be on the shareholders and not on the payer company / mutual fund. Consequently, in a landmark move, the Budget proposes to abolish the DDT and revert to a classical system of taxation of dividend / distributed income in the hands of shareholders / unit holders respectively, at the applicable marginal tax rate. Key aspects of the proposal are as follows:

- **Sunsetting Sections 115-O and 10(34):** The Budget proposes to amend Section 115-O of the ITA to specify that the DDT shall only apply in relation to dividends declared, distributed or paid by a domestic company on or before March 31, 2020. A corresponding amendment is proposed to Section 10(34) of the ITA, specifying that the exemption thereunder, shall not apply to any income by way of dividend received on or after April 1, 2020. With effect from this date, dividend income should be chargeable to tax as “income from other sources” under Section 56 of the ITA.

Equivalent amendments have been proposed to Sections 115R and 10(35) of the ITA in respect of income distributed by mutual funds registered with SEBI – such income should be taxable in the hands of the unit holder with effect from April 1, 2020. Consequent amendments have also been proposed in order to operationalize the new system of recipient-level taxation vis-à-vis the pass-through tax framework prescribed for business trusts as per these Sections. Combined with changes to the definition of “business trust” under Section 2(13A) of the ITA, the proposed amendments raise striking concerns for InvITs, as discussed separately below.

- **Reintroducing a 100% deduction in respect of inter-corporate dividends:** In order to remove the cascading effect of taxes on dividend, the Budget proposes to reintroduce Section 80M to the ITA (which had been omitted vide Finance Act, 2003), to provide a 100% DRD in respect of dividends received by one domestic company from another domestic company, in computing the total income of the first domestic company. In other words, where the gross total income of a domestic company in a particular year includes any income by way of dividends from any other domestic company, the total income of the first company shall be computed after deducting an amount equal to the amount of dividend income received from the other domestic company. The DRD is available only where the first domestic company distributes dividends to its shareholders on or before one month prior to the due date of filing of return of income and is available to the extent of dividends received from the other domestic company. This is more comprehensive when compared to the limited DRD under Section 115-O(1A) of the ITA, which applied only with respect to dividend received from an

immediate subsidiary, with the 'subsidiary' itself being narrowly defined. It may also be noted that the limited DRD under Section 115-O(1A) of the ITA was restricted to dividends received by the distributing company in the *same financial year* in which it itself received dividends from its subsidiary – no such restriction is contained in the proposed DRD, which should provide some flexibility in claiming the DRD on a going forward basis.

However, the Budget has not proposed corresponding amendments to Section 115BBD of the ITA, which imposes a 15% tax on inbound dividends received by an Indian company from specified foreign subsidiary companies. Such dividends continue to remain taxable at 15% in the hands of the Indian company but without the benefit of set-off through a DRD – thereby creating an unequal playing field between onshore and offshore holding structures with the problem of cascading effect of taxes continuing to plague the latter set of structures.

- **Removal of additional tax on dividend income:** Consistent with the abolition of DDT and reversion to a classical system for taxation of dividends, the Budget also proposes to sunset the additional 10% tax on dividend income under Section 115BBDA of the ITA, with effect from March 31, 2020.
- **Reintroducing withholding taxes on all dividends:** The Budget also proposes to extend the scope of Section 194 of the ITA by imposing a 10% withholding tax on *all* dividends paid by an Indian company *by any mode whatsoever*, over and above a higher threshold exemption of INR 5,000 (approx. USD 70) in place of the current threshold exemption of INR 2,500 (approx. USD 35). A similar amendment is proposed to be made to Section 194LBA of the ITA in order to impose a 10% withholding tax on *all* dividends distributed by a business trust to a non-resident unit holder and also to Section 195 of the ITA in order to extend the scope of that Section to *all* dividends paid to a non-resident chargeable to tax under the provisions of the ITA.

Equivalent withholding tax obligations are also proposed to be introduced on income in respect of mutual fund units.

- **Limiting deductions in computing dividend income:** The Budget also proposes to amend Section 57 of the ITA to provide that: (i) in computing the dividend income chargeable to tax under Section 56 of the ITA, no deduction shall be allowed from dividend income other than deduction on account of interest expense; and (ii) in any previous year, such deduction shall not exceed 20% of the dividend income included in the total income for that year without taking into account the deduction under Section 57 of the ITA. This is a significant proposal given that currently, as per Section 14A of the ITA, no deduction is allowable against expenditure incurred by a taxpayer in relation to income which does not form part of the total income under the ITA. Since dividend income was exempt in the hands of shareholders by virtue of Section 10(34) of the ITA, no deduction could be claimed against expenditure incurred by a shareholder in relation to such income, by virtue of Section 14A of the ITA. By making dividends taxable in the hands of shareholders, the Budget has rendered such Section 14A inapplicable in computing the dividend income chargeable to tax as "income from other sources".

Participants in Indian public markets have long advocated the removal of DDT due to its regressive nature and cascading effect and as such, its proposed abolition of both DDT as well as the additional tax on dividend under Section 115BBDA of the ITA will surely be met with cheer and increased investor participation. Further, the reversion to a classical system for taxation of dividends is in line with India's progressive tax framework and should therefore go some way towards addressing horizontal equity considerations in tax policy while at the same time, ensuring the availability of foreign tax credit in the state of residence of the recipient against the tax payable on distributed income received. The proposed introduction of a 100% DRD, irrespective of the shareholding held by the recipient company in the distributing company, is also a welcome move as it neatly sidesteps potentially contentious interpretations on the scope of the DRD, despite its inapplicability to foreign inbound dividends. Companies distributing dividend should no longer have to adjust or gross up dividend payouts for DDT, which should ultimately result in greater returns for equity investors, at least for public companies having substantial foreign institutional shareholding. However, closely held companies with substantial promoter shareholding may remain reluctant to increase dividend distribution, in light of the higher rate of tax applicable in the hands of domestic shareholders. Consequently, companies would have to carefully analyse whether to retain earnings and make fresh investments or distribute earnings to shareholders on a case-by-case basis. The ability to claim deductions against interest expenditure incurred for earning dividend income is a welcome move for domestic investors who commonly borrow funds to make equity investments and earn such income.

Moreover, by tying the tax on dividend to the marginal rate of tax applicable to the recipient, the proposal should also provide a fillip to equity participation in Indian entities, particularly for shareholders residing in countries with which India has executed tax treaties, which typically cap the total tax chargeable by India for dividends well below the 20% tax applicable to non-residents under the ITA. Given that lower rates under tax treaties are usually restricted to a recipient being the 'beneficial owner' of the income received, the question of beneficial ownership of dividend income becomes much more significant, and issues relating to the beneficial ownership of such income are poised to become flashpoints in the Indian tax litigation landscape potentially for years to come. Nevertheless, the proposed abolition of DDT should limit the scope for tax arbitrage through offshore leverage in favour of equity participation in Indian entities. On the flipside, the proposed abolition of DDT may incentivize investors, especially those in the higher tax brackets, to invest in mutual fund

units over direct participation in equity shares, in light of the more favourable capital gains tax regime available on redemption of mutual fund units vis-à-vis higher tax applicable on dividend income from shares.

While the proposal for abolition of DDT is certainly a welcome move, one feels the Budget could have gone even further in its scope. For instance, small shareholders (say holding less than 10% of the share capital of the distributing company) may have been exempted from being taxed on dividend income below a prescribed threshold (say INR 100,000), while in all other cases, dividend income may be taxed in the hands of shareholders at a reduced rate of 15% (i.e., on par with short-term capital gains tax on listed securities). The United States, for instance, follows such a model – “qualified dividends” received by individual taxpayers are taxed at the reduced rates (0-20%) applicable to long-term capital gains. For this purpose, “qualified dividends” include dividends paid by all domestic corporations and dividends paid by certain specified foreign corporations.

2. TAXATION OF INVITS – TAX PARITY IN THE FACE OF FRESH UNCERTAINTY?

Presently, Section 2(13A) of the ITA defines the term “business trust” to mean a trust registered as an infrastructure investment trust (“InvIT”) or a real estate investment trust (“REIT”) under their relevant regulations under the SEBI Act, 1992 and the units of which are required to be listed on a recognised stock exchange in accordance with their relevant regulations. Through amendments in April, 2019¹ SEBI removed the requirement for units of an InvIT to be listed on a stock exchange. With a view to provide the same tax treatment to private unlisted units of InvITs as is provided to public listed InvITs under Section 115UA of the ITA, the Budget proposes to omit the requirement relating to listing the units of the business trust on a recognised stock exchange from the definition of “business trust”.

While this amendment should allow unlisted InvITs to avail of and be subject to the tax regime accorded to business trusts under the ITA (including the tax pass-through status under Section 115UA), consequent amendments made to the tax regime for business trusts pursuant to the abolition of DDT may end up overshadowing the potential benefits of tax parity with listed InvITs. The primary culprit in this instance is the proposal to amend the tax treatment of dividend income received by unit holders of an InvIT. Currently, under the provisions of the ITA, no DDT is chargeable on any amount declared, distributed or paid by a 100% SPV by way of dividends (whether interim or otherwise) to a business trust out of its current income. Furthermore, under Section 10(23FD) of the ITA, while distributed income in the nature of interest received or receivable from an SPV (which is upstreamed by the InvIT as a pass-through entity) is taxable in the hands of the unit holders, income in the nature of dividend is exempt from tax in the hands of unit holders. Thus, there were no taxes on distribution of dividend income by the SPV to the business trust, and on subsequent distribution by the business trust to the unit holder.

Along with the removal of the DDT regime, the Budget also proposes to amend Section 10(23FD) to exclude dividend income received by a unit holder from a business trust from the exemption. This effectively implies that the dividend income becomes taxable in the hands of the unit holder. This results in a situation that while the dividend income distributed by an SPV to a business trust would not be taxed in the hands of the business trust, it would however be deemed to be income of the unit holder and would be taxed in the hands of unit holder.

Existing investments in InvITs will be substantially impacted by the proposed amendment, given that such investments have been structured with a certain tax impact in mind. No grandfathering has been provided for investments made prior to the date on which the amendment is proposed to take effect. Instead of staying true to the Government’s stated objective of providing tax certainty, the Budget has disappointingly upended the law without providing any relief to existing investors. This is likely to result in significant heartburn for existing investors in InvITs, with future investments through the InvIT route seen to be commercially unattractive or unfeasible when compared to other alternatives.

3. SOVEREIGN WEALTH FUNDS: EXEMPTION FROM INCOME FROM INFRASTRUCTURE INVESTMENTS

Section 10 of the ITA provides for exemption in respect of certain incomes and activities under specific circumstances. In order to promote investment by certain sovereign wealth funds (“SWFs”), which are in the form of long term stable capital, the Budget proposes to exempt income of an SWF that is in the nature of dividend, interest or long-term capital gains arising from an investment made by it in India in infrastructure facilities.

Timing and Term of Investment

To be eligible for exemptions, the investment should be made on or before March 31, 2024 and should be held for at least three years. It appears that the exemption may also apply to foreign investments already made. It is to be noted that Long Term Capital Gains (“LTCCG”) tax applies in case of transfer of a capital asset held for more than two years, therefore it would have been preferable if the investment holding period for such exemption was two years, making such investment exempt from LTCCG tax in entirety. Further, the requirement to hold for three years would mean that certain streams of income which are regular in nature, such as dividend and interest, will not be covered under such exemption until the three year period is fulfilled. As such, this does not seem to flow from the intent of the introduction of the provision since it restricts the terms of the benefit significantly.

Type of Investments

The investment may be in the form of debt or equity. Further, such investments will only be eligible for exemption in case where it is made in a company or enterprise carrying on the business of developing, operating or maintaining any infrastructure facility (as defined in explanation to Section 80-IA(4)(i)² of the ITA) or as may be otherwise notified. Such linkage implies that certain sub-sectors which are covered under other notifications by other wings of the Government may not be included here. For example, while roads, highway projects (including housing or other activities being an integral part of such highway project), water supply projects, ports, airports etc. are covered, "affordable housing", which is included in the updated harmonized master list of infrastructure sub-sectors notified by the Department of Economic Affairs, Ministry of Finance³, may not be covered under the explanation to Section 80-IA(4)(i). This may be seen as a missed opportunity, especially considering the new affordable housing fund⁴ where the Government is an anchor investor and where SWFs are potential investors.

Eligible Investors

It is important to note the definition of 'specified person' to understand the SWFs which may avail of the proposed exemption. While wholly owned subsidiaries of Abu Dhabi Investment Authority ("ADIA")⁵ resident in UAE and making investments out of funds owned by the Government of UAE are deemed to be 'specified person', other SWFs are required to fulfil the following conditions to qualify for the exemption:

1. The SWF should be wholly owned and controlled, directly or indirectly, by the Government of a foreign country;
2. The SWF should be set up and regulated under the law of such foreign country;
3. The SWF's earnings should be credited either to the account of the Government of that foreign country or to any other account designated by that Government so that no portion of the earnings inures any benefit to any private person;
4. The SWF's assets should vest in the Government of such foreign country upon dissolution;
5. The SWF should not undertake any commercial activity whether within or outside India;
6. The SWF specified by the Government, by notification in the Official Gazette, for this purpose.

The conditions stated above have various implications. First, it is unclear whether pension funds (although the word "indirectly" indicates it to be the intent) will be covered, even though they may be managed by sovereign authorities. It may also have been helpful to clarify that the exemption extends to SWFs established by states or provinces of foreign countries, although provision of the exemption to subsidiaries of ADIA (with Abu Dhabi being an emirate of UAE, the foreign country in this case) and the immunity enjoyed by states under Article 289 of the Constitution of India should suggest that the exemption should extend to SWFs established by states or provinces of foreign countries. In fact, any SWF should normally enjoy sovereign immunity without restriction, if it is constituted as an arm of the state, though this position has been ambiguous in India. Finally, there is a requirement for establishment of the SWF in the foreign country. In this regard, it should be noted that SWFs investing through intermediate jurisdictions, including common fund jurisdictions such as Singapore and Mauritius, may not necessarily enjoy the exemption, in case where the subsidiaries are not set up in the jurisdiction of such SWF. It is also unclear as to why the exemption has only been limited for investments made till March 31, 2024.

Implications for InvITs and AIFs

Another area where clarification from the Government would be welcome is with respect to whether the exemption applies to investment by SWFs through investment vehicles which generally operate as a tax pass-through, such as InvITs and AIFs. It may be noted that a substantial portion of investments by SWFs is through InvITs and AIFs. Section 115UA, which accords tax pass-through status to investments through InvITs, provides that "*any income distributed by a business trust to its unit holders shall be deemed to be of the same nature and in the same proportion in the hands of the unit holder as it had been received by, or accrued to, the business trust*". Section 115UB employs slightly different wording to provide a tax pass-through status generally to investments made through Category I and Category II AIFs by providing that "*any income accruing or arising to, or received by, a person, being a unit holder of an investment fund, out of investments made in the investment fund, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person had the investments made by the investment fund been made directly by him*". For investments made by SWFs in Category I AIFs and Category II AIFs focussing on infrastructure, while it is unclear whether income earned from such investments would be eligible for the proposed exemption, Section 115UB creates a deeming fiction to tax income from investments as if the investments were made directly by such SWFs. On the other hand however, an SWF investing into an InvIT appears to be worse off since no such deeming fiction is created by virtue of Section 115UA and the income is taxed in the hands of the unit holders as if the income is accrued to the business trust (and not to the SWF).

Interestingly, there is a difference in the language of the exemption for wholly owned subsidiaries of ADIA and that for other SWFs. While it appears that wholly owned subsidiaries of ADIA may make the

investment directly or indirectly, which may be read as including through the aforementioned investment vehicles, the language for other SWFs does not clarify that investments may be made indirectly. It is unclear whether it is the Government's intent that wholly owned subsidiaries of ADIA should be treated differently from other SWFs.

In view of the above, it is important that the Government comes up with a clarification and guidelines on application of the exemption to SWFs as soon as possible.

4. 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 July 1, 2020, is subject to a lower withholding tax rate of 5%, *provided that* the interest paid does not exceed the all-in-cost ceiling per annum on INR denominated External Commercial Borrowings ("ECB") prescribed under the New ECB Framework of 2019.

With a view to attract fresh investments and stimulate the economy, the Finance Bill, 2020 ("Finance Bill") proposes to (i) extend the period of the lower withholding tax rate of 5% to July 01, 2023 from July 01, 2020; and (ii) provide a withholding tax rate of 4% on the interest payable to a non-resident in respect of monies borrowed in foreign currency from a source outside India, by way of issue of any long term bond or RDB listed on a recognised stock exchange located in any IFSC, during the period beginning from April 01, 2020 and ending on July 01, 2023.

Further, Section 194LD of the ITA provides for a beneficial withholding tax rate of 5% on interest payments made to FPIs and Qualified Foreign Investors ("QFIs") before July 01, 2020 in respect of their investments in RDBs and government securities. Similar to the above proposal, the Finance Bill proposes to (i) extend the term of the lower interest rate of 5% to July 01, 2023 from July 01, 2020; and (ii) provide the lower withholding tax rate of 5% on the interest payable to a FII or QFI in respect of the investment made in municipal debt security, during the period beginning from April 01, 2020 and ending on July 01, 2023.

The extension and expansion of sunset clauses in respect of withholding tax benefits under Section 194LC and Section 194LD will enable Indian companies to continue accessing foreign capital with greater ease and will attract incremental investment through this mode.

5. INDIRECT TRANSFER PROVISIONS: CLARIFICATIONS FOR FPIs

Indirect transfer tax provisions, introduced under the Finance Act, 2012, are a controversial set of provisions brought about in light of the *Vodafone*⁶ case, which expanded the source rules for taxation of capital gain income arising from sale of shares of entities situated outside India. Indirect transfer tax provisions essentially provide that where there is a transfer of shares or interest of a foreign company or entity, whose value is derived substantially from assets located in India, income arising from such transfer can be brought within the Indian tax net. Over time, exemptions have been introduced from the applicability of indirect transfer provisions in certain cases. The Finance Act, 2017, introduced an explanation to Section 9 of the ITA, which exempted investments held in Category I FPIs and Category II FPIs⁷ registered under the SEBI (Foreign Portfolio Investors) Regulations, 2014 ("FPI Regulations 2014") from the applicability of indirect transfer provisions. In September 2019, SEBI notified the SEBI (Foreign Portfolio Investors) Regulations, 2019 ("FPI Regulations 2019"), to repeal and replace the FPI Regulations 2014. Among other changes, SEBI rationalized the categories of FPIs, with most sub-categories of Category I FPIs and Category II FPIs under the FPI Regulations 2014 being grouped together as Category I FPIs under the FPI Regulations 2019. As was expected, the Finance Bill proposes to exempt the applicability of indirect transfer provisions to Category I FPIs under the FPI Regulations 2019.

Further, the Finance Bill proposes to grandfather the exemption with respect to investments held in Category I FPIs or Category II FPIs under the FPI Regulations 2014 prior to its repeal. This is especially pertinent for Category II FPIs under the FPI Regulations 2014 which are not reclassified as Category I FPIs under the FPI Regulations 2019, such as Mauritius-based funds with Mauritius-based investment managers⁸. While investments made prior to the repeal of FPI Regulations 2014 should continue to be exempt, further investments made in such FPIs after such repeal, may be subject to taxability under indirect transfer provisions. Such FPIs may consider reviewing their holding structure and / or management structure for classification as a Category I FPI under the FPI Regulations 2019 if they wish to maintain the applicability of the exemption from indirect transfer provisions.

6. SAFE HARBOUR PROVISIONS: FURTHER RELAXATIONS

Section 9A of the ITA was introduced under the Finance Act, 2015 to encourage onshoring of fund management activity in India. The provision laid down certain conditions, which if fulfilled, the fund management activity would not constitute a "business connection" and further, the offshore fund would not be deemed to be a resident in India merely because its fund manager carried on management activities from India. The Budget proposes to relax two such conditions – one in relation to resident Indian ownership and another in relation to timelines to achieve minimum corpus.

One of the conditions as laid down under Section 9A of the ITA requires the aggregate direct or

indirect investment in the fund by Indian residents to not exceed 5% of the corpus of the fund. Often, fund managers are commercially required to invest capital in funds managed by them as “skin in the game” in order to build reputation and attract more investors. The 5% limit makes it difficult for such fund managers to meet commercial expectations. The Budget proposes to exclude contributions by eligible fund managers for up to INR 250 million (approx. USD 3.50 million) during the first three years of the operation of the fund for the purposes of calculation of such 5% limit. The words “operation of the fund” lend some ambiguity to interpretation i.e. whether it would mean three years from the date of receipt of applicable fund license, the date of first closing, the date of first investment into India or otherwise. Further, if after the completion of three years of the operation of the fund, the 5% threshold is breached upon taking into account the investments made by the eligible fund manager, the eligible fund manager would have to redeem its investments in order to bring the aggregate contributions by Indian residents within the 5% threshold. An aspect which should be considered is that “skin in the game” requirements for a manager typically go hand in hand with contributions by investors over the life of the fund. Therefore, eligible fund managers should carefully consider the implications of their contributions to the fund following the expiry of the three year period.

Another condition under Section 9A of the ITA is that the monthly average of the corpus of the offshore fund should not be less than INR 1 billion (approx. USD 14 million) provided that, if the fund was established or incorporated in the previous year, the corpus of fund should not be less than INR 1 billion (approx. USD 14 million) either (i) at the end of a period of six months from the last day of the month of its establishment or incorporation; or (ii) at the end of such previous year, whichever is later. The Finance Bill recognizes the anomaly under this proviso, which resulted in discrimination between funds based on their time of incorporation, with periods for achievement of minimum corpus requirements ranging from six months to eighteen months. With a view to resolve the same, the Finance Bill proposes to provide a definitive timeline whereby, for a fund established or incorporated in any previous year, this condition should be fulfilled within twelve months from the last day of the month in which the fund was established.

Separately, considering the amendments made to India’s tax treaties with Mauritius, Singapore and Cyprus, income earned by the offshore fund in the nature of capital gains from sale of Indian shares would be subject to tax in India irrespective of whether the offshore fund constitutes a business connection in India. Accordingly, the utility of this section is outlived. It also remains to be seen whether given the detailed list of conditions which need to be satisfied in order to be eligible for the safe harbor provided under this section, these relaxations will have the effect of giving impetus to the safe harbour regime, which has seen limited utilization till date.

7. EXPANDING TAXING RIGHTS AND DEFERRING IMPLEMENTATION OF SIGNIFICANT ECONOMIC PRESENCE

The Budget seeks to expand the scope of income attributable to Indian operations which is within India’s taxing rights as a source country, primarily in the context of the digital economy and use of data. The Budget proposes the following activities to be attributable to operations in India (“**Attribution Rules**”):

- Targeted advertisements at customers who reside in India;
- Sale of data collected from a person residing in India;
- Sale of goods or services using data collected from a person residing in India;
- Data collected from a person who uses internet protocol address located in India;
- Sale of goods or services using data collected from a person who uses internet protocol address located in India;
- Advertisements accessed by customers through internet protocol address located in India.

Additionally, the implementation of the Significant Economic Presence (“**SEP**”) test which was introduced in the Finance Act, 2018 has now been postponed to April 2021 in light of evolving global discussions at the OECD and global level with respect to taxation of the digital economy. Further, the scope of SEP has been expanded to cover systematic and continuous soliciting of business activities or engaging in interaction with users in India through digital as well as any other means.

The proposed changes to expand the scope of attribution of income to India and changes to the SEP test do create the following significant ambiguities and challenges:

- Usage of the different terms ‘user’, ‘customer’ and ‘person’ in the SEP and Attribution Rules are likely to cause confusion.
- IP addresses in India being considered the crucial fact establishing nexus is at variance with the tests set out under the Goods and Services Tax laws for establishing that the online services are consumed in India which consider six different criteria out of which two non-contradictory ones need to be satisfied. Since it also considers factors such as registered address of the customer, it would be better to harmonise the approach between direct and indirect taxes with respect to digital services and how they are located in India.
- It may also be impractical for companies to keep track of the IP address of every user. It also raises questions regarding whether the IP address requirement is sufficient, reliable and verifiable

indicator of nexus in all cases.

- Further, reference to persons or customers 'resides' in India creates confusion whether it requires ordinary residence or residence for tax purposes, where different tests are prescribed. If the reference is not linked to residence for tax purposes, it is unclear what tests companies will apply to determine whether a person resides in India or not. Brightline tests in this regard are required to prevent unnecessary litigation.
- Further, if data collected in India results in revenues from operations in a third jurisdiction, it would appear that this provision may seek to allocate part of those revenues to India, which could result in complex triangular situations resulting in double or triple taxation of the same income in different countries with inability to claim tax credits.
- Expansive reading of the provision may mean that even indirect links to Indian user data, such as data acquired from a third party, could also increase tax risks.
- Mere collection and storage of data does not necessarily mean that the data is being *used* and establishing usage would also be a challenge.
- Tracking data flow, ensuring compliance and proving usage of such data is likely to be costly and impractical.
- Nuanced distinctions between the kinds of data such as primary or secondary, collected or processed and the manner of their monetisation appear to be missing thereby leaving a void in terms of assessing tax exposures from a company perspective.
- Impact would be on non-SEP cases as well since the Attribution Rules apply to all business connection situations.

The impact of the above is unlikely to be felt with respect to most digital companies in the short run since in the absence of any amendments to treaties, a permanent establishment ("**PE**") is required for any taxes to be levied under the above provisions. However, since proposed Attribution Rules also applies to non SEP situations and also where there is an existence of a PE, clients should review their current operations and assess potential risks from the implementation of this provision. Further, clients located in non-treaty jurisdictions could also be exposed to the impact of this provision will need to re-assess their operations. For transactions conducted from a treaty jurisdiction, various protections may be explored including whether attribution as set out in this proposed provision is in line with attribution under Article 7 of the relevant DTAA and whether some of the activities qualify as auxiliary or preparatory activities depending on the facts and circumstances.

Additionally, companies that are involved in the sale of data also need to be cognizant about the restrictions being proposed in the Personal Data Protection Bill, 2019 ("**PDP Bill**") regarding the transfer of data collected in India to places outside India. The PDP Bill has categorised data into critical personal data, sensitive personal data and personal data with varying conditions on transfer and data localisation. The extent to which this impacts the attribution under the proposed Attribution Rules is something companies must assess.

8. TOWARDS CERTAINTY IN PROFIT ATTRIBUTION: WELL-INTENTIONED BUT NOT WELL EXECUTED

To provide certainty to taxpayers against increasing disputes on determination of the Arm's Length Price ("**ALP**") under India's Transfer Pricing ("**TP**") laws, Section 92CB had been introduced under the ITA in 2009 to empower the Central Board of Direct Taxes ("**CBDT**") to make Safe Harbour Rules ("**SHR**"). Under the SHR prescribed thereafter, if the circumstances of a taxpayer's transaction subject to TP laws meet the requirements of the SHR, then the price of the transaction would be accepted by tax authorities, and there would be no further litigation on the issue. The Advance Pricing Agreement ("**APA**") regime was also introduced in the ITA in 2012 to allow taxpayers and the CBDT to agree on the ALP of a transaction or the TP methodology to be used, and hence be shielded from litigation on these issues for a specified period. The introduction of both: the SHR and the APA regimes, brought some relief to non-resident taxpayers plagued by the uncertainty in Indian TP laws and mounting litigation costs, evidenced by the government having signed its 300th APA in September of 2019.

Acknowledging similar uncertainty and the litigious nature of the issue of profit attribution to a taxable presence of a non-resident in India, the Budget proposes to extend the SHR and APA frameworks to attribution under Section 9(1)(i) of the ITA, which were hitherto limited to ALP determination.

(a) Safe harbour for profit attribution

The Budget proposes to amend Section 92CB which empowers the CBDT to make the SHR. Where 92CB earlier subjected the "determination of ALP" to the SHR, the amended provision will now subject the determination of "income referred to in clause (i) of sub-section (1) of section 9" to the SHR as well. Section 9(1)(i) deems the following income to accrue or arise in India: *"all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India"*.

The SHR prescribed by the CBDT is codified in Rules 10TA to 10THD of the Income Tax Rules, 1962

("Rules"). As they currently read, the SHR are specific to transactions to which TP provisions apply. For instance, the definitions of "eligible assessee" and "eligible international transaction" identifies the taxpayer based on the nature of the transaction and does not cover scenarios where a business connection or PE can be said to exist. Therefore, the prescribed SHR cannot apply for purposes of profit attribution under Section 9, and it is anticipated that the CBDT will prescribe a new set of SHR for profit attribution.

The Budget does not elaborate on the way the SHR will operate for purposes of Section 9, and to that extent taxpayers will need to await clarification from the CBDT. Since many cases involving such attribution under Section 9 involve an exercise undertaken solely by the Assessing Officer in accordance with Rule 10, as compared to cases involving TP where the taxpayer has already made a determination of the ALP, it is difficult to draw parallels between the two situations and their operation under the SHR. It is also expected that notification of new SHR for purposes of Section 9 may reflect aspects of the draft report circulated by the CBDT for public comments in April 2019 on proposed changes to rules for profit allocation.

Further, the Explanation to Section 92CB states that "safe harbour" means situations where income tax authorities shall accept the transfer price declared by the taxpayer. The Explanation remains unamended under the current Budget proposals. This may have been an oversight, and an amendment to the Explanation would be welcome, to include within the meaning of "safe harbour" circumstances where the income tax authorities accept the profit attribution undertaken by the taxpayer.

(b) Profit attribution brought under APA regime

The Budget proposes to amend Section 92CC by allowing the CBDT and the taxpayer to enter into an APA for determining the income to be attributed under Section 9(1)(i), or specifying the manner in which such determination is to be made, in addition to determination of ALP or manner of determination of ALP. The proposal envisages additional rules prescribing the method of making such a determination, and this amendment will be effective for APAs entered into April 1, 2020 onwards.

The intent of the government to provide greater certainty on tax litigation for profit attribution issues is welcome. Although a high number of taxpayers have signed APAs with the Indian Government, their long term effectiveness in reducing disputes remains to be seen. Further, the ranges of transfer price which would be accepted as ALP under the SHR have been regarded as being very high, with few taxpayers opting to go under the regime. The Budget proposals to include profit attribution issues within these regimes could provide such certainty and reduce costs of doing business in India, provided the ambiguities in the provisions and the ranges prescribed under SHR are rationalized.

9. WITHHOLDING OBLIGATION ON E-COMMERCE OPERATORS: AN UNNECESSARY INTRODUCTION

Section 194-O of the ITA proposes to impose new withholding obligations on "e-commerce operators" from 1st April, 2020:

- E-commerce operators are persons who own, operate or manage digital or electronic facility or platform for electronic commerce and is responsible for paying the e-commerce participant.
- E-commerce is the supply of goods or services or both, including digital products, over digital or electronic network.
- Services include fees for technical services and professional services; and
- E-commerce participant means a person resident in India selling goods or providing services or both, including digital products, through digital or electronic facility or platform for electronic commerce.

In such a context, the e-commerce operator is required to withhold 1% of the gross amount of services or goods supplied through the platform. However, it is important to note that the obligation exists only in relation to Indian resident supplier of goods or services through the platform and not with respect to any goods or services facilitated by the platform from non-resident service providers or sellers.

It is important to note that amounts paid directly by the customer to the e-commerce participant shall also be included within the gross amount, on which the 1% TCS is required to be discharged. Therefore, even with cash on delivery shipments the e-commerce operator may have to withhold 1% TCS which could cause operational issues for the e-commerce operator.

Further, in the event the e-commerce participant is unable to provide Permanent Account Number ("PAN") or Aadhaar details to the e-commerce operator, the operator is obliged to withhold at 5% instead of 1%.

Interestingly, the provision also proposes that if a deduction is made under this section then no further deduction may be made under any other provision in Chapter XVII-B of the ITA. Considering technical services and professional services covered under Section 194J are also covered under this section, it may act as an incentive to provide such services through online platforms since the TDS should be 1% and not the newly proposed 2% for Fees for Technical Services ("FTS") or 10% for professional services.

10. START-UP RELATED PROPOSALS: GETTING ADDITIONAL BREATHING SPACE

In the start-up space, the Budget has proposed two welcome changes. With respect to Section 80-IAC of the ITA, which currently allows eligible start-up companies and LLPs the option to deduct up to 100% of the profits and gains derived from an eligible business for any three consecutive years out of seven years beginning from the start-up's date of incorporation, the same benefit has been extended to any three consecutive years out of ten years from the date of the start-up's incorporation. Section 80-IAC defines "eligible business" to mean an innovation, development or improvement of products, processes or services, or a scalable business model with a high potential of employment generation and / or wealth creation. The provision further states that for a company or LLP to qualify as an eligible start-up it must satisfy the following conditions:

1. be incorporated on or after April 1, 2016, but before April 1, 2021;
2. have a total turnover of less than INR 250 million (approx. USD 3.5 million) in the relevant year for which the deduction is claimed; and
3. hold a certificate of eligible business from the Inter-Ministerial Board of Certification

With a view to rationalize the treatment of start-ups, the Budget proposes to amend the definition of 'eligible start-up' by increasing the turnover limit from INR 250 million (approx. USD 3.5 million) in the relevant previous year to INR 1 billion (approx. USD 14 million) in any of the previous years beginning from the start-up's year of incorporation. In fact, the turnover limit for 'eligible start-up' under the Department For Promotion of Industry and Internal Trade had already been increased to INR 1 billion (approx. USD 14 million) in February 2019 and the tax changes on this account were overdue.

The Budget proposal also seeks to address the cash-flow problems faced by many start-ups and their employees holding ESOPs. Specifically, it has been acknowledged that ESOPs are an important component to most start-up employees' compensation packages as start-ups do not generally have the initial capital or cash inflow required to adequately compensate high level employees required to conduct business. However, as ESOPs are taxed as perquisites under Section 17(2) of the ITA, ESOP holders are required to pay tax upon exercise of the ESOPs as income from salary on the difference between the fair market value of the shares on the date on which the ESOP is exercised and the amount paid ("**Benefit**"). The fact that upon exercise, the employee only receives shares of the start-up and no cash results in a significant tax burden on the employee. A similar burden is also faced by the start-up, which is required to withhold tax on the Benefit accruing to its employee. The Budget proposes to ease both the employee's and start-up's tax burden by allowing them to defer payment / deduction (as the case may be) of tax on the ESOP to within 14 days:

1. after the expiry of 4 years from the end of the relevant assessment year;
2. from the date of sale of shares by the employee; or
3. from the date on which the employee ceases to be employed by the start-up,

whichever is earliest. However, the amount of tax payable / deductible will be calculated as per the rates in force at the time the shares were first allotted or transferred to the employee.

Considering that India continues to be the third largest start-up ecosystem in the world (according to Nasscom), with the addition of seven Unicorns (companies with valuation of over \$1 billion) in 2019 alone, it is no surprise that the Budget proposes to address the start-up sector's outcry for ESOP reform and rationalization of treatment for start-ups. However, while the Budget's proposed amendments provide some relief and are welcome steps in the right direction, the changes do not completely respond to the sector's asks for tax to be applicable only at the time of sale. The Budgetary proposal may still give rise to tax being payable before the employee / founder has a chance to sell shares / sweat equity acquired upon exercise of his ESOPs, especially given the typical lifecycle of a start-up.

11. EXPANDING THE SCOPE AND POWER OF THE GOVERNMENT TO ENTER INTO TAX TREATIES TO ACCOMMODATE MLI

Section 90 contains delegated powers of legislation conferred on the Government to enter into tax treaties for avoidance of double taxation, exchange of information for the prevention of evasion or avoidance of income-tax or recovery of income-tax and certain other circumstances.

In view of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("**MLI**") which comes into effect in FY 2020-2021, the Budget proposes to amend Section 90 to enable the Government to enter into the MLI. In consonance with the preamble of the MLI which states that it is "*Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory)*", the same language is proposed to be inserted into Section 90(1)(b) so as to enable the Government to enter into treaties for avoidance of double taxation only covering such circumstances.

The proposed amendment results in several issues. Firstly, in the landmark judgment of *Union of India*

*v. Azadi Bachao Andolan*⁹, the Supreme Court referred to the text of the preamble of the Mauritius treaty providing for “*encouragement of mutual trade and investment*” and legitimized treaty shopping as being consistent with India’s intention at the time when the Mauritius treaty was entered into. The question that arises is whether the result of the amendment will overrule the judgment in *Azadi Bachao Andolan*.

Secondly, the proposed amendment seeks to add language on power of the Government to enter into treaties which are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation by way of introduction of such language to Section 90(1)(b). However, this results in a dichotomy between the proposed Section 90(1)(b) and the existing Section 90(1)(a)(ii) which provides for the Government to enter into tax treaties for granting of relief in respect of income chargeable to tax under domestic law and the treaty country to “*promote mutual economic relations, trade and investment*”, which may in fact, lead to a potential situation of reduced or double-non taxation.

Thirdly, the effect of the proposed amendment on existing treaties, especially tax treaties not covered under MLI would also need to be examined, especially since the power of the Government to enter into double taxation avoidance agreements, where such agreement may potentially result in treaty shopping or double non-taxation has been curbed by way of the proposed amendment. In so far as tax treaties covered under MLI are concerned, depending upon the final language of the preamble as agreed upon by the countries i.e. whether the optional language being “*Desiring to further develop their economic relationship and to enhance their co-operation in tax matters*” is covered or not, the impact could be different.

Lastly, Section 90(1)(a) is worded as a provision to grant tax relief in case of income chargeable in India and the treaty country, whereas the proposed amended Section 90(1)(b) is worded as the power of the Government to avoid double taxation provided that such avoidance of double taxation does not result in reduction or double-non taxation. The question then arises is whether cases where a full exemption is granted (for e.g. for capital gains arising to a Dutch resident from sale of Indian shares to a non-Indian resident buyer under the Netherlands Treaty), should that be treated as a relief provision covered under Section 90(1)(a) or a double tax avoidance provision under Section 90(1)(b).

The amendment to Section 90 is proposed to come into effect on April 1, 2021 applying to assessment year 2020-21 whereas MLI is to come into effect on April 1, 2020, although it has already been signed by India but is yet to be notified in the Official Gazette.

It may have been possible to argue that the current wording of Section 90 is wide enough to accommodate entering into MLI. However, the Government view appears to be that this amendment is necessary considering it has not been drafted as a clarificatory amendment.

12. NEW TAX RESIDENCY RULES FOR INDIVIDUALS

The incidence of taxation under the ITA is based on the residence of the taxpayer and source of income. While an Indian resident is taxed on its worldwide income, non-residents are only taxed on income arising from sources in India.

The ITA sets out specific criteria to determine residence of a person. Specifically, Section 6(1) of the ITA provides that an individual qualifies as a resident in India in a previous year if he (i) is in India during that year for a total of 182 days or more (“**Test 1**”); or (ii) is in India during that year for 60 days or more **and** has been in India for a total of 365 days over the course of the 4-year period preceding that year (“**Test 2**”).

Explanation 1 to this section further clarifies that with regard to Test 2, where the taxpayer is a citizen of India or a person of Indian origin (“**PIO**”) who was visiting India during the previous year, the requirement of having to spend 60 days or more in the previous year shall be extended to 182 days. This extension of time was specifically provided to Indian citizens and PIOs to allow them to visit India for a longer period of time without qualifying as residents.

Taking note of the fact that many Indian citizens and PIOs have taken advantage of the extension of time to carry on substantial economic activities in India without qualifying as residents, the Budget now proposes to limit the extension of time from 182 days to 120 days. In other words, pursuant to Test 2, an Indian citizen or PIO will qualify as a tax resident of India if he is in India during that year for 120 days or more **and** has been in India for a total of 365 days over the course of the 4-year period preceding that year. The decision to reduce the number of days to 120 seems an arbitrary choice as the residency test in most countries use the 183 day benchmark.

Moreover, the Budget has also proposed to add a new Section 6(1A) which provides that an Indian citizen shall be deemed to be Indian tax resident if s/he is not liable to tax in any other country, regardless of whether such individual meets the residency test requirements under Section 6(1) of the ITA.

Both these proposed amendments seem to seek to widen the Indian tax net by curbing the ability of Indian citizens and PIOs specifically, high net worth individuals (“**HNI**’s”), to avoid qualifying as Indian tax residents by simply ensuring that they do not meet the residency day count tests. While the new Section 6(1A) deviates from the historic day test requirements for residency, as set out in the Finance Bill the new provision specifically states that only those Indian citizens not *liable to tax* in any other

country by reason of their domicile or residence or similar criteria, shall be deemed to be tax residents of India. This would imply that even if a person is not subject to tax, but is still within the scope of taxation in a foreign country or jurisdiction, or if a foreign country exempts its residents from taxation, India's residuary right under Section 6(1A) should not come into play.

The Budget proposes to further streamline the test for Resident but not Ordinarily Resident ("RNOR") by simply providing that an individual shall qualify as an RNOR if such individual has been a non-resident in India for 7 out of the 10 years preceding the relevant previous year. The same amendment has also been proposed with respect to HUFs as well.

This new test is not only simpler, but makes it easier for an individual to qualify as an RNOR. The proposed amendment is a welcome move as it appears to lessen the burden on foreign nationals who may find themselves suddenly qualifying as tax residents within two years of residing in India.

13. PERSONAL TAX CUTS

In an attempt to increase consumption to boost the economy, the Budget has proposed to reduce personal tax rates for individuals and Hindu Undivided Families ("Individual (s)") through the introduction of section 115BAC, applicable from AY 2021-22 onwards. With the corporate tax rates being slashed last year, this was one of the most expected changes in this Budget in light of the current economic environment.

Importantly, the reduced tax rates are subject to specified conditions (discussed below). In view of the same, the Individuals have been given the option to continue to be taxed under the existing framework.

The proposed tax rates (along with its comparison with the existing rates) are as below:

Total Income	Proposed Tax Rates	Existing Tax Rates
Upto 2,50,000	Nil	Nil
From 2,50,001 to 5,00,000	5%	5%
From 5,00,001 to 7,50,000	10%	20%
From 7,50,001 to 10,00,000	15%	20%
From 10,00,001 to 12,50,000	20%	30%
From 12,50,001 to 15,00,000	25%	30%
Above 15,00,000	30%	30%

The primary conditions for availing the reduced tax rates under section 115BAC are as follows:

- The total income is computed without claiming certain specified deductions and exemptions provided for under the ITA and the Rules ("Deductions"). Some of the crucial Deductions which would fall away as a result of exercising the option to be taxed under section 115BAC include leave travel concession, house rent allowance, exemptions in respect of free food and beverages through vouchers provided by to employees by their employers.
- The Individual shall not be allowed to set off (i) any carried forward losses from earlier assessment years if such loss is attributable to the Deductions; or (ii) any loss under the head - house property with any other head of income;
- The Individual claims depreciation in the manner prescribed under the ITA.
- The Individual shall not be allowed to claim any exemption or deduction for allowances or perquisite provided under any other law for the time being in force.
- The reduced rate shall not apply unless the option is exercised by the Individual in the prescribed form and manner at such time as indicated below:
 1. *In case where the Individual has no business income:* along with the return of income to be furnished under section 139(1) of the ITA;
 2. *In any other case (where the Individual has business income):* on or before the due date for filing return of income under section 139(1).
- In case of Individuals who have business income, once the option to be taxed under section 115BAC is exercised, it shall apply for subsequent AYs. However, the option can be withdrawn by the Individuals only once for a financial year other than the financial year in which it was exercised. Pursuant to such withdrawal, the Individuals shall never be eligible to exercise the option to be taxed at the reduced rates unless they cease to have business income.

As a corresponding change, the Budget has also proposed to amend relevant provisions of the ITA to provide that provisions of Alternate Minimum Tax ("AMT")¹⁰ and the provisions relating to carry forward and set off of AMT credit¹¹, shall not apply to taxpayers opting to be taxed under section 115BAC. While exemption from AMT for Individuals opting to be taxed under section 115BAC is a welcome move, the accumulated AMT credit which may not be utilized by them may become an important factor

in deciding whether the option to be taxed under section 115BAC shall be exercised.

As was the case with corporate tax cuts, the personal tax cuts come with the rider of foregoing several Deductions available under the existing framework. Further, this move is likely to make the personal tax regime very complex for small tax payers due to multiple permutations that are possible. Moreover, since high net worth individuals are more likely to increase consumption, tax cuts were expected for large tax payers, which have not been provided.

Lastly, while the personal tax cuts are certainly a welcome move, they may not give rise to discretionary spending. There are several proponents of the argument that in the economic condition that India is currently in, the reduction in personal tax rates is likely to increase savings as opposed to consumption. It will be interesting to track whether this change actually helps in driving consumption and increasing economic activity.

14. REDUCTION OF WITHHOLDING TAX RATE FOR FTS PAID TO RESIDENTS

Section 194J of the ITA imposes a tax deduction at source (“TDS”) obligation of 10% on certain payments, including FTS, to be made to residents. Separately, section 194C of the ITA imposes a TDS obligation of 2% on payments to a resident for carrying out any ‘work’ as defined in that section. Owing to the fact that FTS could also be interpreted as payment for ‘work’ – there are a large number of pending cases on the issue of short deduction of tax where the taxpayer deducts at the rate of 2% under section 194C, while the tax department claim that the tax should have been deducted at 10% under section 194J.

With the objective to reduce litigation in this regard, the Budget proposes to amend section 194J to reduce the TDS rate in respect of FTS from 10% to 2%. Importantly, the 10% TDS rate shall continue to apply for all other payments specified in section 194J including ‘fees for professional services’ and ‘royalty’.

This is a welcome step as it will likely reduce the litigation owing to the conflict between section 194C and 194J. Additionally, even on a standalone basis, it is a beneficial move as it has reduced the TDS rate in respect of FTS under the ITA.

15. TAX ADMINISTRATION

(a) ITAT Stay order extension: Clarity on pre-deposit

Currently, in cases where an administrative appeal is undertaken, the circulars issued by the Indian tax authorities stipulate a requirement of pre-deposit of 20% of the disputed demand for grant of stay till the disposal of the appeal. However, there is no such provision with respect to the appeals filed before the Income Tax Appellate Tribunal (“ITAT”) which is a quasi-judicial authority.

Section 254 of the ITA provides ITAT the discretion to grant stay and further extend the period of such stay, subject to satisfaction of certain stipulated conditions. The Finance Bill, now proposes to add an additional condition to state that the ITAT may grant a stay or extend the period of stay, subject to the taxpayer, inter alia, depositing at least 20% of the amount of tax, interest, fee, penalty, or any other sum payable as per the applicable provisions of the ITA, or furnishes security of equal amount in respect thereof.

The proposed provision does not seem to be in the best interest of the taxpayers and goes against the present Government’s idea of building a non-adversarial tax regime. Further, the said proposal also seems unnecessary considering that in cases where there is a high-pitched demand, ITAT should have the discretion to grant stay without satisfaction of the pre-deposit pre-requisite. It is worthwhile to note that statistically, a majority of the orders passed by the lower authorities get reversed by the ITAT in appeals filed by a taxpayer.

(b) Dispute Resolution Panel: Widening the scope of reference

Section 144C of the ITA provides for the constitution and working of a Dispute Resolution Panel (“DRP”). The said provision states that an Assessing Officer (“AO”) is required to send a draft assessment order to certain eligible assessee¹², if the AO proposes to make any variation in the income or loss returned which is prejudicial to the interest of such assessee. The assessee may file an objection with respect to such variation with the DRP, which shall pass its directions within 9 months from the end of the month in which draft order was forwarded to such assessee.

The Finance Bill proposes to remove the expression “in the income or loss returned” under sub-section (1) of Section 144C resulting in broadening of the scope of an assessee to approach the DRP. For instance, there seems to be a possibility that after this provision comes into effect an assessee would be able to approach the DRP in case of an AO making a best judgment assessment, prior to filing of any return by the assessee, subject to satisfaction of the stipulated conditions. Further, the proposal to include a non-resident individual (in addition to a foreign company) under the definition of assessee seems to be an effective step towards providing non-resident individual investors an early platform where their concerns could be addressed (instead of directly approaching CIT(A) and subsequent quasi-judicial and judicial forums).

(c) Provision for e-appeal

Currently, a taxpayer can file an appeal before CIT(A) through its registered account on the e-filing portal of the Indian tax department. However, the process subsequent to filing of appeal is not electronic. Therefore, in continuation of its efforts to make assessment procedures and operations, such as filing of return, processing of returns, issuance of refunds / demand notices, etc. electronic, faceless and transparent, the present government, under the Finance Bill, has proposed to make the first appeal process under CIT(A) fully electronic.

The Finance Bill, akin to an e-assessment scheme launched under the last year's budget, proposes that the Government may notify an 'e-appeal scheme' for disposal of appeal by, *inter alia*, introducing an appellate system with dynamic jurisdiction in which appeal shall be disposed of by one or more CIT(A).

Further, the Finance Bill, for effective implementation of the proposed scheme, also stipulates that the Government may notify the applicability / non-applicability of any provisions relating to jurisdiction and procedure of disposal of appeal along with any relevant exceptions, modifications and adaptations, as it may deem fit, *provided that* such directions are to be issued on or before March 31, 2022.

(d) Tax Amnesty Scheme

The Finance Minister in her Budget Speech proposed a tax amnesty scheme wherein the taxpayer will be required to only discharge the disputed tax liability involved in a litigation dispute and will receive complete waiver of interest and penalty, *provided that* the obligation to pay disputed tax is discharged by March 31, 2020. Further, the benefits conferred by the proposed provision can be availed post March 31, 2020 until June 30, 2020, subject to payment of additional amount, and the taxpayers can accordingly avail the benefit at any level of the appellate proceedings.

This scheme seems to be important and may result in a number of taxpayers availing it and settling the matter once for all. However, the proposed scheme has not been included in the Finance Bill and a separate notification by the Government may be expected in this regard.

- International Tax Team

You can direct your queries or comments to the authors

1 Securities and Exchange Board of India (Infrastructure Investment Trusts) (Amendment) Regulations, 2019.

2 "infrastructure facility" means—

- (a) a road including toll road, a bridge or a rail system;
- (b) a highway project including housing or other activities being an integral part of the highway project;
- (c) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system;
- (d) a port, airport, inland waterway 20[, inland port or navigational channel in the sea.

3 Updated harmonized master list of infrastructure sub-sectors is accessible at <https://dea.gov.in/sites/default/files/Gazette%20Notification%20dated%2017th%20October%2C%202017.pdf>

4 The Government of India has recently announced an INR 200 billion (approx. USD 2.8 billion) fund ("Housing Fund") to provide last-mile funding for completion of ongoing housing projects which are not non-performing assets or facing bankruptcy proceedings under National Company Law Tribunal. The Government had indicated, while Rs. 100 billion (approx. USD. 1.4 billion) will be contributed by the Government towards the Housing Fund, the rest will be raised by institutional investors including SWFs.

5 It may be noted that ADIA itself already enjoys immunity from taxation under the India-UAE Tax Treaty.

6 *Vodafone International Holdings BV v Union of India* 341 ITR 1.

7 Category I FPIs and Category II FPIs consist of institutional investors or funds registered with SEBI such as government entities, multilateral organizations, pension funds, regulated financial services entities and regulated funds.

8 One of the salient conditions for Category I FPI status under the FPI Regulations 2019 is for the entity or its manager to be based in a member nation of the Financial Action Task Force. Among the key foreign direct investment source nations, Mauritius is not a member nation whereas Singapore is a member nation.

9 [2003] 132 Taxman 373 (SC)

10 Section 115JC, Income Tax Act, 1961

11 Section 115JD, Income Tax Act, 1961

12 (a) any person in whose case transfer pricing adjustments have been made under sub-section (3) of Section 92CA of the ITA; and (b) any foreign company.

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