Japan Desk

May 21, 2019

INDIA BUDGET INSIGHTS (2015-16)

2015 UNION BUDGET: THE MODI-LED GOVERNMENT HAS UNDERTAKEN CERTAIN POLICY MEASURES THAT ARE BOLD, DECISIVE AND CLEARLY A STEP IN THE RIGHT DIRECTION. KEEPING THIS IN MIND, THE INDIAN FINANCE MINISTER ANNOUNCED THE BUDGET FOR 2015- 2016. WE HAVE PROVIDED BELOW SOME KEY FEATURES OF THE BUDGET AND ITS IMPACT ON JAPANESE COMPANIES DOING OR INTENDING TO DO BUSINESS IN INDIA:

TAX RATES : STABILITY AND RATIONALIZATION MEASURES

- There has been no change in the corporate tax rate of 30% for domestic companies. However, the Finance Minister has stated that the corporate tax rate would be reduced from 30% to 25% (excluding surcharge and cess) over the next four years, coupled with rationalization and removal of various exemptions and rebates.
- Withholding rates applicable in case of royalty and fees for technical services to offshore entities are proposed to be reduced from 25% to 10% (on a gross basis). This would be important for technology transfers, knowledge sharing and collaboration agreements across sectors and will boost domestic manufacturing / service industry.
- The existing regime of allowing a lower withholding rate applicable on interest paid on non-convertible debentures to Foreign Portfolio Investors (‘**FPIs**’) of 5% is proposed to be extended for payments up to June 2017 (*currently applicable only up to May 2015*).

REGULATORY MEASURES: SIMPLIFYING REGULATIONS

1. Foreign equity investment to be regulated by Central Government

- Thus far, Section 6 of the Foreign Exchange Management Act, 1999 (‘**FEMA**’) granted powers to the Reserve Bank of India (‘**RBI**’) to regulate, restrict or prohibit capital account transactions, in consultation with the Central Government. The Finance Bill (‘**Bill**’) now seeks to shift the power to regulate non debt capital account transactions from the fold of RBI to the Central Government, limiting the powers of RBI to only capital account transactions involving debt instruments. It would be pertinent to note that the definition of debt instruments shall be as defined by the Central Government.
- To that extent, this change is a positive move as it removes multiple regulators for the same matter. However, at this stage it is not clear as to which entity will be the nodal entity for any regulatory approvals pertaining to capital account transaction.

2. Composite caps

- Under the FDI Policy, while foreign investment in most sectors is permitted up to 100% under the automatic route, there are certain sectors in which there are sectoral caps. Further, in some such sectors, there are separate caps for FDI and FPI route investments. For instance, in the power exchange sector, there is a composite cap of 49%, but sub-caps of 26% for FDI and 23% for FPI investments. The Finance Minister has, in his Budget Speech proposed to replace these sub-caps with composite caps for both FDI and FPI.
- This is a welcome move, as it provides greater flexibility for stakeholders to structure foreign investment and it may create further investment headroom for specific category of investors. For example, in the defence sector, investment by FPIs is currently not permitted. Once the Bill has been notified, FPIs would be able to utilize the 26% foreign investment limit currently reserved only for FDI investors.

3. New Bankruptcy Code

- Considering the failure of the Sick Industrial Companies (Special Provisions) Act, 1985 (**SICA**) and Board for Industrial and Financial Reconstruction (BIFR) as suitable mechanism for regulating bankrupt companies in India, the Finance Minister has announced the Government’s intention to introduce a ‘***comprehensive Bankruptcy Code***’ for dealing with bankrupt companies in India.
- This is a welcome and much needed move to bring Indian insolvency regulations and processed in line with well-established international practices. The lack of efficacious and efficient remedies in cases of insolvency and restructuring, which functioned with the intent to protect the companies, makes the newly suggested Bankruptcy Code more important.

4. Extending SARFAESI protection to Non-Banking Financial Institutions

- The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (‘**SARFAESI Act**’) provides certain measures for recovery of non-performing assets to ‘financial institutions’ as defined under the Act. However, non-banking financial companies (‘**NBFC**’) were not included in the definition of ‘financial institutions’.
- The Finance Minister has in his Budget Speech announced that NBFCs that (a) are registered with the RBI *and* (b)

have an asset size of INR 500,00,00,000 (Rupees Five Hundred Crores) (INR 5 billion) shall be considered as 'financial institution' for the purposes of the SARFAESI Act.

- This is a welcome move for the NBFC industry in India for the following key reasons. Firstly, eligible NBFCs would now be able to enforce security interest without court intervention thereby considerably expediting the security enforcement mechanism. Secondly, assets of eligible NBFCs can now be sold to asset reconstruction or securitization companies. Additionally, eligible NBFC would now also be considered a qualified institutional buyer and would be able to acquire security receipts issued by an asset reconstruction company or a securitization company.

5. Boost for Insurance sector

- The Budget has proposed that employees of specified income brackets would now have the choice between contribution to Employee State Insurance or to any other private health insurance offered by an insurer recognised by Insurance Regulatory Development Authority of India. The budget has also increased the income tax deduction limits on account of contributions made towards life insurance pension plans.
- These proposals along with the recently raised foreign investment cap in the Insurance sector should attract more private players and investments in this high potential space.

6. Infrastructure Financing

- Infrastructure was named as one of the key focus areas of the Government for the coming financial year. Two of the key developments that have been proposed are:
  - creation of a National Investment and Infrastructure Fund (NIIF) with an annual flow of INR 20,000 Crore into it, which would be raised through debt. The fund would invest in equity of infrastructure finance companies; and
  - introduction of Public Contracts (Resolution of Disputes) Bill to streamline resolution disputes arising from public contracts.
- Both these measures should increase much needed investor confidence in the infrastructure sector. In fact, the introduction of a specific dispute resolution mechanism will add predictability and expedite conflict resolution, which in the past has been a major concern for investors, private participants and financing of such projects.

GENERAL ANTI-AVOIDANCE RULES: TEMPORARILY AVOIDED

- The GAAR provisions were introduced in were slated for implementation from April 1, 2013. The 2013 Budget deferred the implementation of GAAR for 2 years and made it applicable from April 1, 2015. However, in spite of significant changes to the provisions, GAAR still empowers the Revenue with considerable discretion in taxing 'impermissible avoidance arrangements'.
- This year's Budget has reviewed the GAAR provisions and has deferred GAAR further by 2 years i.e. GAAR will now be applicable from April 1, 2017. Further, it has also been proposed to grandfather investments made upto March 31, 2017 and make GAAR applicable prospectively, i.e. to investments made only after April 1, 2017. The Finance Minister has stated that considering that investor sentiment has turned positive and with a view to accelerate this momentum, it would be prudent to defer the implementation of GAAR.
- The deferral of the GAAR provisions is definitely a huge positive. Investors have been worried about the scope of the GAAR provisions and concerns have been raised on how they would be implemented. A re-look at the scope of the provisions will definitely be welcomed by the investment community and it is hoped that when revised provisions are introduced, they will be in line with global practices.

CLARITY ON INDIRECT TRANSFER TAX

The Finance Minister, during his Budget speech, spoke about moving towards a tax regime which would be in consonance with global policy. In doing so, he has tried to address the concerns of investors by making significant changes to the indirect transfer tax provisions in the Income Tax Act ('**ITA**'). The Finance Bill (Bill) proposes to make various amendments to these provisions which are summarized below:

- *Threshold test on substantiality and valuation:* The Bill provides that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 10 crores (INR 100 million); and (ii) represents at least fifty per cent of the value of all the assets owned by the company or entity. The value of the assets shall be the Fair Market Value (FMV) of such asset, without reduction of liabilities, if any, in respect of the asset.
- *Taxation of gains:* The gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis -a-vis global assets. While the Bill does not provide for determination of proportionality, it is proposed to be provided in the rules.
- *Exemptions*: The Bill also provides for situations when this provision shall not be applicable. These are:

1. Where the transferor of shares of or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total share capital in the foreign company or entity directly holding the Indian assets (Holding Co).
2. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it along with related parties does not hold (i) the right of management or control in relation to such company or the entity; and (ii) any rights in such company which would entitle it to either exercise control or management of the Holding Co or entitle it to voting power exceeding 5% in the Holding Co.
3. Therefore, no clear exemption has been provided to portfolio investors as even the holding of more than 5% interest could trigger these provisions. This is a far cry from th e 26% holding limit w hich was recommended by the Committee. Further, no exemption has been provided for listed companies, as was envisaged by the Committee

Investment
April 03, 2024

Cyber Incident Response Management
February 28, 2024

4. In case of business reorganization in the form of demergers and amalgamation, exemptions have been provided. The conditions for availing these exemptions are similar to the exemptions that are provided under the ITA to transactions of a similar nature.

- *Reporting Requirement:* The Bill provides for a reporting obligation on the Indian entity through or in which the Indian assets are held by the foreign entity. The Indian entity has been obligated to furnish information relating to the off-shore transaction which will have the effect of directly or indirectly modifying the ownership structure or control of the Indian entity. In case of any failure on the part of Indian entity to furnish such information, a penalty has been proposed to be levied. The proposed penalty ranges from INR 500,000 to 2% of the valu e of the transaction.

TAX ON INTEREST PAID BY BRANCH OFFICE OF BANKS TO HEAD OFFICE

- The Bill provides that any interest payable by a Permanent Establishment ('**PE**) to its head office or any other foreign PE or constituent of such head office would be chargeable to tax in India under the ITA, thereby introducing a withholding tax on such payments as well. For the purposes of this provision, PE is defined to include a fixed place of business through which the business of the foreign entity is wholly or partly conducted. Further, since such interest income has been made taxable in India under domestic law, the Indian PE would be deemed to be a 'separate and independent' person on whom the provisions of the ITA shall apply.
- While the finance minister had promised tax incentives for foreign players to set up shop in India, the newly added provision would act as an additional tax burden for a foreign financial institution at the time of payment of interest from its Indian branch to its head office (or any other foreign branch) since such interest payments have till date been free of tax in India.

INDIRECT TAX: MOVING TOWARDS GST

- One of the major announcements on the indirect tax front was the proposal to implement a unified Goods and Services Tax (**"GST"**) regime from April 1, 2016. The GST is a long pending demand that has been coming from the industry and the commitment to introduce the same from next year is welcomed by investors.
- Other major changes included the increase in the rate of Service tax and the standard ad valorem rate of central excise duty from 12.36% (inclusive of cesses) to 14% and 12.5% respectively.
- With a view to encourage digitization of indirect tax processes, the Finance Minister in his budget speech announced that electronic records and digitally signed invoices will be accepted for central excise and service tax purposes. Online central excise and service tax registration is proposed to be completed within two working days.

MISSED OPPORTUNITIES

While the budget announcements have set out the right direction from a broad policy perspective, there are opportunities that have not been addressed and missed. A few of them are set out below:

1. Clarity on Entitlement To Tax Treaty Benefits

Tax authorities have increasing been challenging the entitlement of non-residents to treaty benefits alleging tax avoidance, etc., ignoring commercial considerations - such as need for holding company to ring-fencing investments, ease of fund-raising, etc. Some clarity and certainty on acceptance of established principles would have been welcomed.

2. Deduction for Corporate Social Responsibility Spends

Currently, there is no deduction available for expenditure incurred by domestic companies towards fulfilling their Corporate Social Responsibility obligations under the new Companies Act, 2013. Introduction of such relief was a major expectation for large-scale companies with net worth or turnover or net worth exceeding prescribed thresholds.

3. Applicability of MAT to Foreign Strategic Investors

The Budget has specifically clarified that MAT is not applicable in case of FPIs. However, ambiguity still surrounds applicability in case of other residents availing treaty benefit, particularly, on capital gains earned on exit by strategic investors in Indian companies. In fact, by specifically only referring to FPIs, the budget announcements seemed to indicate that non-residents other than those specifically exempted are sought to be covered.

4. Dividend Distribution Tax and Buyback Taxation

At the time of dividend distribution and buyback, corporate profits so distributed are subject to additional tax in the hands of the company, contrary to the practice followed globally of taxing the shareholder for such distributions (though withheld by the company). This creates various difficulties, particularly for claiming tax treaty relief in India, claiming credit in the shareholder's country of residence, claiming interest deduction on borrowings, etc. A move back to withholding tax regime would have eased the cost of doing business in India.