

# Tax Hotline

February 02, 2023

## INDIA BUDGET 2023: GROWING THE ECONOMY!

On February 1, 2023, the Indian Finance Minister ("FM"), Nirmala Sitharaman, presented the Union Budget ("Budget") of India for the financial year ("FY") 2023-24. With India's economic growth in the current year estimated to be 7% (highest among all large economies), the Budget envisions an empowered and inclusive economy which is technology-driven, knowledge-based with strong public finances and a robust financial sector. Infrastructure and investment, green growth and the financial sector are amongst the top priorities listed down by the FM in her speech.

As part of the boosters for infrastructure and investment, the Budget proposes to increase the capital expenditure outlay to INR 10 lakh crores; support state governments by increasing tenure of the 50-year interest free loans and enhance opportunities for private investment in infrastructure. For realizing the vision of "Make AI in India and Make AI work for India", three centres of excellence for Artificial Intelligence are proposed to be set-up in top educational institutions. The Budget also proposes to provide for a system of usage of anonymized data to facilitate innovation and research by start-ups and academia. To further enhance ease of doing business in India, the Budget proposes adopting a simplified KYC process that is geared to meet the needs of digital India. It also proposes various relief measures for Micro, Small & Medium Enterprises ("MSME") and intends to introduce 'Vivad se Vishvas II' for settling contractual disputes with the Government in cases where the arbitral award is challenged before the court of law. A central processing centre is also proposed to be setup for faster response to companies through centralized handling of various forms filed with field offices under the Companies Act, 2013. The Budget also proposes to ease the process of claiming amortization of preliminary expenses which are incurred prior to the commencement of business or after commencement, in connection with extension of undertaking or setting up of a new unit.

On the green growth front, the focus appears to be to promote businesses that are environmentally sustainable and facilitate India's goal to reduce carbon emissions. A marked policy shift in the financial sector is evident as Budget encourages public consultation in law making process along with a comprehensive review of the existing regulations.

On the healthcare front, the FM's key focus for the pharmaceutical and healthcare industry is to promote India as a research and innovation hub. While India has long been known as the "pharmacy of the world", it is still to establish itself as an innovator. Thus, in addition to encouraging the industry to invest in R&D, the government is also taking steps to actively foster it. To support faculty from medical colleges and R&D teams from the industry, access is being granted to facilities at select laboratories that are run by the Indian Council of Medical Research where they can undertake research activities. Further, in a bid to inculcate a penchant for research in the workforce, a program to promote research in pharmaceuticals is proposed to be taken up through centres of excellence, and a multidisciplinary course to promote the research and manufacturing of futuristic medical devices is to be introduced in existing colleges.

As part of the government's initiatives to promote Gujarat Infrastructure Finance Tec – City ("GIFT City"), the Budget proposes several measures - the key one being strengthening the powers of the International Financial Services Centres Authority ("IFSCA"). Other incentives include setting up a single window IT system for registration and approval from IFSCA, Special Economic Zone ("SEZ") authorities, Goods and Services Tax Network ("GSTN"), Reserve Bank of India ("RBI"), Securities and Exchange Board of India ("SEBI") and Insurance Regulatory and Development Authority ("IRDAI"). The Budget also proposes extension of period of tax benefits to funds relocating to International Financial Services Centre ("IFSC"), GIFT City up to March 31, 2025 as against the current limitation of March 31, 2023.

On the direct tax front, the Budget has overhauled the taxation regime for income from online games and proposes to create a distinction between taxation of online and offline games. A new section for deduction of tax at source on net winnings from online games has been introduced. For the start-up ecosystem, the Budget proposes to extend the date of incorporation for income tax benefits to start-ups from March 31, 2023 to March 31, 2024 and also proposes to provide the benefit of carry forward of losses on change of shareholding of start-ups from seven years of incorporation to ten years.

Another key amendment that has been proposed is the inclusion of non-resident within the ambit of Section 56(2) (viib) in respect of issuance of shares by a private company. The proposed amendment will have significant impact on several private equity investments (as well as strategic investments) that are primary in nature.

Personal income tax has been rationalised to provide more liquidity in the hands of the individuals. The Budget also proposed to reduce personal income tax for High Net Worth Individuals ("HNIs") whose income is more than INR 5 crores (approx. USD 600,000) from the earlier 42.74% to 39%.

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Other direct tax proposals include clarification of ‘cost of acquisition’ (“COA”) in relation to any intangible asset or any other right as nil for the purpose of computing capital gains. To curb anti-avoidance of tax when gifts were being made by residents to non-residents, the Budget has proposed a deeming provision under which any gift made by a resident Indian to a resident but non-ordinarily resident would be subject to tax in India. A cap on deduction from capital gains on investment in residential house has been proposed along with limiting income tax exemption from proceeds of insurance policies with very high value. The Budget has introduced a new provision which proposes to tax the capital gains arising from the transfer or redemption or maturity of Market Linked Debentures<sup>1</sup> as short-term capital gains and also proposes rationalisation of the carry forward of losses provision on strategic disinvestment by the Government in public sector undertakings.

A slew of changes has also been made to the scheme under the Income-tax Act, 1961 (“ITA”) for charitable organisations, search and seizure related provisions, faceless assessment and penalty related provisions.

To conclude, the Budget focuses on macro level issues to promote overall economic growth. While relief for individual tax payers was much awaited, the reduction in the rate of tax for the HNIs is a surprise move. However, it appears the Government has refrained from making significant policy changes such as, rules on offshore listing for Indian companies, concessional tax rates for businesses engaged and investing into green technology, capital gains tax rate etc. Further, considering the economic survey which was tabled in parliament prior to the Budget discussed possible measures which the FM may take to accelerate internalisation (reverse flipping) of start-ups, it was expected that the FM may bring about other tax incentives to promote such internalisation. We have provided below a more comprehensive analysis and further insights on the 2023 Budget proposals. Hope you enjoy reading it.

Join us for an interactive [Webinar](#) on Friday, February 3, 2023 for insights on India’s 2023 Budget.

– International Tax Team

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1. TAX RATES

The corporate income tax rates for companies remain the same for FY 2023-2024. Companies will continue to be taxed at 30% if their total turnover (in the FY 2021-2022) exceeds INR 4,000 mn (USD 48 million approx), and at 25% if it does not exceed INR 4,000 mn (USD 48 million approx). Concessional tax regimes under Section 115BAA (22% rate for certain domestic companies) and Section 115BAB (15% rate for new manufacturing companies) continues to remain intact. The Budget proposes a lower tax rate of 15% to new co-operatives that commence manufacturing activities till March 31, 2024, thereby putting them at par with new manufacturing companies

a. Changes in New Regime for Individuals and HUFs

- Currently, individuals and HUFs have an option to compute and pay personal income taxes under either of the two tax regimes:
- Old Regime (i.e., at the slab rates as set out in Schedule 1 of the Finance Act) where individuals and HUFs are allowed to claim a number of deductions and exemptions under various provisions of the ITA; and
  - New Regime (i.e., at the slab rates as set out in Section 115BAC of the ITA) where individuals and HUFs are not allowed to claim any of the exemptions, deductions, depreciation, set offs as enumerated under Section 115BAC(2) of the ITA [Note: Certain standard deductions such as income in the nature of family pension, etc. continue to remain permitted even under the New Regime].

While the Finance Bill, 2023 (“Finance Bill”) has left the Old Regime untouched, it has further rationalized and reduced the slab rates under New Regime (resulting in tax saving of INR 37,500), to be applicable from assessment year (“AY”) 2024-2025, as set out below:

Old Regime		New Regime – Section 115BAC (prior to proposed changes)		New Regime – Section 115BAC (Proposed Changes)	
Taxable income	Tax rate	Taxable income	Tax rate	Taxable income	Tax rate

Up to INR 2.5 lacs	Nil	Up to INR 2.5 lacs	Nil	Up to INR 3 lacs	Nil
INR 2.5 lacs to 5 lacs	5%	INR 2.5 lacs to 5 lacs	5%	INR 3 lacs to 6 lacs	5%
INR 5 lacs to 10 lacs	20%	INR 5 lacs to 7.5 lacs	10%	INR 6 lacs to 9 lacs	10%
Above INR 10 lacs	30%	INR 7.5 lacs to 10 lacs	15%	INR 9 lacs to 12 lacs	15%
		INR 10 lacs to 12.5 lacs	20%	INR 12 lacs to 15 lacs	20%
		INR 12.5 lacs to 15 lacs	25%	Above INR 15 lacs	30%
		Above INR 15 lacs	30%		

At the outset, the Finance Bill has proposed to make the New Regime the default income-tax regime for individuals and HUFs. Consequently now, individuals and HUFs will have to opt out of the New Regime (in the prescribed manner under Section 115BAC) before the due date for filing the income-tax returns, in order to be taxed under the Old Regime. Such individuals or HUFs may exercise this option each year at the time of filing their income-tax returns. However, for those individuals and HUFs whose income consists of “*income from business or profession*”, and who choose to opt out of the default regime (i.e., the New Regime under Section 115BAC); they will only be permitted to opt back into the New Regime (i.e., Section 115BAC) once (and not annually).

#### b. **Reduction in Surcharge Rate**

The tax rates mentioned above are further increased by applicable surcharge and cess. For individuals and HUFs, a surcharge is applicable on the tax amount if the income of the taxpayer is more than INR 50 lacs in a financial year. For the highest tax bracket i.e. where the total income of the taxpayer (excluding the income by way of dividends, short term capital gains from sale of listed securities and long-term capital gains) exceeding INR 5 crores, the surcharge rate is currently 37% on the tax amount, which makes the effective tax rate at 42.74% (accounting for 4% of cess as well).

The Finance Bill proposes to restrict the surcharge rate in the highest tax bracket to 25% (as opposed to current rate of 37%), reducing the effective tax rate to 39%. However, the reduced surcharge rate is applicable only for individuals and HUFs opting for the New Tax Regime, and the highest effective tax rate under the Old Regime continues to be 42.74%.

#### c. **Increase in Rebate**

For resident individuals, a rebate of 100% of the amount of income tax is provided if the total income of the taxpayer is less than INR 5 lacs i.e. no tax is payable if the total income is less than INR 5 lacs. From AY 2024-25 onwards, for resident individuals opting for the New Regime, the threshold of total income for the rebate of 100% of the amount of income tax payable has been increased from INR 5 lacs to INR 7 lacs. However, please note that for the individuals opting for the Old Tax Regime, the threshold of total income for rebate is unchanged at INR 5 lacs.

#### d. **Increase in Thresholds for Availing Presumptive Tax Regime**

The ITA provides for a scheme for taxation of income on presumptive basis for small businesses and small professionals under section 44AD and section 44ADA respectively.

- Small Businesses (Section 44AD): A sum equal to higher of (a) 6% (if amount is received by an account payee cheque) or 8% of the total turnover or gross receipts of the taxpayer (being resident individuals, HUFs and partnership firms, excluding LLPs) or (b) amount claimed to have been earned by the taxpayer, is deemed to be the business income of such taxpayer. The section is only applicable to taxpayers, whose total turnover or gross receipts in the previous year do not exceed INR 2 crores.
- Small Professionals (Section 44ADA): A sum equal to higher of (a) 50% of the total gross receipts of the taxpayer (being individuals or partnership firms, excluding LLPs) on account of the profession (legal, medical, engineering or architectural and other specified professions) or (b) amount claimed to have been earned by the taxpayer is deemed to be the business income of such taxpayer. The section is only applicable to taxpayers, whose total gross receipts in the previous year do not exceed an amount of INR 50 lacs.

The limits under section 44AD and section 44ADA of the ITA are proposed to be increased to INR 3 crores and INR 75 lacs respectively by the Finance Bill, subject to the amounts received in cash not exceeding 5% of the total gross receipts.

This is a welcome change which will promote non-cash transactions and will benefit more persons in small and medium segment.

## 2. TAXATION OF DISTRIBUTIONS FROM BUSINESS TRUST: HALF THOUGHT ATTEMPT

### **Present construct**

The ITA contains special provisions for taxation of Real Estate Infrastructure Trusts (“**REIT**”) and Infrastructure Investment Trusts (“**InvIT**”) (hereinafter collectively referred to as “**Business Trusts**”). The provisions, *inter-alia*, provide a pass-through status to Business Trusts in respect of (a) interest income, dividend income received by the Business Trust from a special purpose vehicle (“**SPV**”) and (b) rental income in case of a REIT. Such income is taxable in the hands of the unit holders. Any other distributions received by the unit holders from a Business Trust are not taxable in hands of such unit holders.

Business Trusts typically make huge debt investments. Distributions by Business Trusts to its unit holders are generally structured in the form of dividend payment, interest, rental income and debt repayment / proceeds from amortization of debt.

Distribution by Business Trusts in form of debt repayment / proceeds from amortization of debt are capital payments and not regarded as income in hands of unit holders. In this regard, the Memorandum notes that distribution in form of debt repayment / proceeds from amortization of debt does not suffer taxation either in the hands of Business Trust or in the hands of unit holder resulting in double non-taxation.

### Proposed amendment and impact

The Budget has proposed the following amendments:

- a. Income under head other sources ("IOS"): Any sum received by the unit holder ("**Specified Sum**") of a Business Trust which is not in nature of interest, dividend or rental income (in case of REIT) and is not chargeable to tax in the hands of Business Trust at the maximum marginal rate will be taxable as IOS in hands of the unit holder.

Considering the nature of business of SPVs in which the Business Trusts invest, dividend payment is generally not possible due to lack of profits at SPV level. Consequently, the Business Trusts generally resort to distribute cash in form of interest or repayment of debt. Interest payment is also typically limited to the coupon rate.

This change is likely to have a huge impact on unit holders of Business Trust. We have summarized below tax implications on different form of distributions by SPV to Business Trust and subsequently to unit holders below:

Level	Dividend	Interest	Repayment of debt
SPV	SPV not required to withhold under section 194	<ul style="list-style-type: none"> <li>■ SPV not required to withhold on payment of interest on loan under section 194A</li> <li>■ SPV required to withhold at rate of 10% on payment of interest on debenture held by Business Trust</li> <li>■ Interest payment deductible expense</li> <li>■ NA</li> </ul>	<ul style="list-style-type: none"> <li>■ Repayment of debt by SPV not in nature of expense, hence, not a deductible expense</li> </ul>
Business Trust	<p>Exempt from tax at Business Trust level under section 10(23FC)</p> <p>Business Trust to withhold tax in case where dividend is taxable in hands of unit holders as under:</p> <ul style="list-style-type: none"> <li>■ Resident unit holders: 10%</li> <li>■ Non-resident unit holders: 10%</li> </ul>	<p>Exempt from tax at Business Trust level under section 10(23FC)</p> <p>Business Trust to withhold tax as under:</p> <ul style="list-style-type: none"> <li>■ Resident unit holders: 10%</li> <li>■ Non-resident unit holders: 5%</li> </ul>	<p>NA</p> <p>No obligation on Business Trust to withhold tax on such distribution to resident unit holders</p> <p>Business Trust to withhold tax on such distribution to non-resident unit holders under section 195</p>
Unit holder	<ul style="list-style-type: none"> <li>■ Exempt under section 10(23FD), if SPV has not opted for concessional tax regime under section 115BAA</li> <li>■ Taxable as below where SPV has opted for concessional tax regime under section 115BAA: <ul style="list-style-type: none"> <li>- Resident unit holders: at applicable rate</li> <li>- Non-resident unit holders: 20% or rate as per applicable tax treaty, whichever is beneficial</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>■ Resident unitholders: Taxable at applicable rates</li> <li>■ Non-resident unit holders: Taxable at rate of 5%</li> </ul>	<ul style="list-style-type: none"> <li>■ Resident unitholders: Taxable at applicable rates</li> <li>■ Non-resident unit holders: Taxable at rate of 40%</li> </ul>

As is evident from the table above, the tax cost on investors on distributions received in form of repayment or amortization of debt is disproportionately high as compared to other modes of distribution. This seems to be an unintended consequence and will have an adverse impact on the Business Trusts.

Interestingly, while the Budget has provided that Specified Sum will be taxable in hands of unit holders as IOS, a corresponding withholding obligation has not been imposed on the Business Trust under section 194LBA. This seems to have been overlooked in the Finance Bill. Resultantly, Business Trusts may have to withhold tax under section 195 on distribution of Specified Sum to non-resident investors.

Another aspect on a principal level which should be considered is whether repayment of debt should be considered as taxable in the first place. While double non-taxation was not the intention of introducing a special tax regime for Business Trusts, in order to ensure that Business Trust remains lucrative, it is important to provide for a competitive tax regime.

- b. Reduction of COA: In case where a unit holder receives any sum from a Business Trust for redemption of units, the sum so received will be reduced by the COA of units.

Currently, income from transfer of units of a Business Trust is taxable as capital gains. While the proposed amendment has clarified that the COA will be reduced from distributions received from Business Trust for redemption of units, it appears that the implication of this amendment is that distributions received by unit holders on redemption of units by Business Trust will be taxable under head IOS instead of capital gains. Resultantly, Specified Sum distributed to unit holders on redemption of units will be taxable (a) at applicable rate in case of resident unit holders and (b) 40% in case of non-resident unit holders. Technically, distributions received from Business Trust on redemption of units qualifies as 'transfer' and should be taxable as capital gains. This seems to be an unintended consequence and puts non-resident investors at great disadvantage. Moreover, as discussed below, in case distributions on redemption of units is considered to be income under head IOS, non-resident investors may not be able to claim benefit of capital gains tax exemption under an applicable tax treaty.

- c. Limit to application of pass through under section 115UA: pass through provision contained in section 115UA will not be applicable to sum distributed by Business Trust taxable under head IOS in hands of unit holders.

### ***Impact on SWFs and pension funds***

Distribution of Specified Sum to sovereign wealth funds ("SWFs") / pension funds investing in Business Trust will be taxable at rate of 40%, subject to availability of benefit under relevant tax treaty. The 'other income' article in most Indian tax treaties (eg, India-UK tax treaty, India-Mauritius tax treaty, India-France tax treaty, India-USA treaty, India-Luxembourg tax treaty) provides that such income may be taxed in the Contracting State in which it arises (i.e. India). Other tax treaties like India-Singapore tax treaty provides that other income should be taxed as per domestic law provisions. Considering this, investors from these jurisdictions may not get any relief under tax treaty and are likely to pay tax at rate of 40% on distribution of Specified Sum. Investors from jurisdictions like Ireland and Netherlands (India-Netherlands tax treaty does not contain other income article), may be take benefit of their tax treaty and claim that distribution of Specified Sum is not taxable in India.

Section 10(23FE) of the ITA exempts income in nature of dividend, interest or long-term capital gains earned by specified SWFs/ pension funds from investment in InvITs. The amendment introduced by Finance Bill nullifies the benefit provided by section 10(23FE) to the extent distributions made to SWFs/ pension funds are in nature of Specified Sum. Considering the importance of infrastructure sector and the efforts of government to boost investments in this sector, the changes introduced by the Finance Bill may not auger well with SWFs and pension funds.

Separately, section 194LBA of the ITA provides for reduced withholding tax rate on payment of interest to non-resident unit holders by Business Trust. Considering the exemptions provided to SWFs/ pension funds under section 10(23FE), interest income earned by such investors should not be taxable. However, section 197 of the ITA did not provide a provision for application of a lower withholding certificate in case of section 194LBA. The Finance Bill has proposed amendment to section 197 of the ITA to allow obtaining a lower withholding certificate under section 194LBA. This amendment will be particularly useful for SWFs / pension funds which enjoy certain exemptions under the ITA.

## **3. TAXATION OF GAMING: ONLINE AND OFFLINE GAMES TAXED SEPARATELY!**

Online gaming industry has witnessed unprecedented rise in the recent years. Online gaming has been recognized as one of the sunrise sectors by the Government. The Memorandum to Finance Bill notes that there is a need to introduce specific provisions regarding withholding and taxability of online games due to its different nature, easy accessibility through internet and computer resources with a variety of playing options and payment options. The Finance Bill has overhauled the taxation regime for income from online games and proposes to create a distinction between taxation of online and offline games. Under the current provisions of the ITA, income from games (both online and offline) is taxed at a flat rate of 30%. There is a withholding provision which imposes an obligation to withhold tax on the person responsible for paying any winnings from lottery, crossword puzzles, card games and other games of any sort, at the rates in force, if the winnings are in excess of an amount exceeding INR 10,000 at the time of payment. Separate withholding provisions exist for winning from horse race.

The Finance Bill proposes to introduce a new provision – Section 194BA (applicable from July 1, 2023) for deduction of tax at source on winnings from 'online games'. Simultaneously, a new Section 115BBJ (applicable from April 1, 2023) has also been introduced to provide for tax on winnings from online game which shall be calculated at rate of 30% on amount of net winnings from such online game. Consequently, amendments have been proposed to Section 194B and Section 115BB to exclude income from winnings from online games from the purview of the said sections.

The new Section 194BA departs from the current provisions for withholding taxes on games. Under the new provisions, the withholding is proposed will take place on 'net winnings' in the user account at the end of the financial year. In case there is withdrawal from user account during the financial year, tax shall be deducted at the time of such withdrawal on net winnings. In addition, income-tax shall also be deducted on the remaining amount of net winnings in the user account at the end of the financial year. This puts an end to debate on the timing of applicability of withholding in relation to winnings from games. Computation of net winnings will be prescribed in due course. Additionally, unlike the current provisions, Section 194BA does not prescribe a threshold and tax has to be withheld on the whole of the net winnings. Some other points in respect of the new section that should be noted are as follows:

- a. Definition of '*online game*': The Finance Bill has defined 'online game' to mean a game that is offered on the internet and is accessible by a user through a computer resource including any telecommunication device. The definition seems to be broadly drafted and is likely to include both game of skill and game of chance offered on the internet and accessed by user through a computer resource. It is interesting to note that a new definition of 'online games' has been proposed by the Finance Bill. It is, however, unclear why the definition proposed under the amendment to the Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Rules, 2021 has not been used by the Finance Bill. From an industry perspective, it may be useful to have consistent definitions.
- b. Definition of 'net winnings': The term 'net winnings' has not been defined by the Finance Bill. Pertinent to note

that section 58(4) of the ITA provides that no deduction shall be allowed under any provision of the ITA in computing the income by way of any winnings from lotteries, crossword puzzles, races, card games and other games of any sort or from gambling or betting. It should be noted that the deduction referred in section 58(4) is with respect to expenses which the player would incur to play a game and is not referring to the deduction of capital from his / her winnings to arrive at the winning which should be subject to tax. Therefore, the term 'net winnings' may be clarified to mean winnings of a user as reduced by the stake amount. The term winnings under Section 194B of the ITA has always been debated as to whether it should be considered as gross winning or net winnings. Therefore, clarity in this regard is highly welcomed and has been a long-standing demand of the industry. However, the removal of threshold for application of withholding under section 194BA does not seem to be an industry friendly move. If the concern was avoidance of withholding by splitting of withdrawals, such concern could have been addressed by providing a language triggering the requirement to withhold tax in case where winnings are more than a specified threshold. Complete removal of threshold for withholding tax will increase compliance burden.

- c. Definition of '*online gaming intermediary*': The Finance Bill defines '*online gaming intermediary*' to mean an intermediary that offers one or more online game. Further, 'user' has been defined to mean any person who accesses or avails any computer resource of an online gaming intermediary. 'User account' has been defined to mean account of a user registered with an online gaming intermediary. Thus, withholding provisions should be applicable on the user account even if the user account is registered with an online gaming intermediary.

With respect to withholding tax on offline games, section 194B of the ITA has been proposed to be amended such that the withholding obligation will apply in case where the amount or aggregate of amount of winnings exceed INR 10,000 in an FY. The provision as it currently stands does not provide for a time period with respect to withholding and hence, there were multiple views on whether the INR 10,000 was a per day basis / per FY basis / per month basis etc. Due to this reason, users were splitting winnings into multiple transactions below INR 10,000 resulting in avoidance of tax deduction. Accordingly, clarity in this regard is welcomed. This change has been done to avoid non-deduction by way of splitting winnings in multiple transaction.

The Finance Bill creates two distinctions between taxation of online and offline games. First distinction is with respect to the amount of tax base. In case of online games, it is provided that user will pay tax on 'net winnings', whereas, in case of offline games, it appears that the intention is to levy tax on 'gross winnings'. From a practical standpoint, it is not clear how this provision will be implemented. Second distinction is with respect to the withholding tax threshold. In case of online games, withholding obligation under section 194BA applies irrespective of the amount of winnings, however, in case of offline games, withholding under section 194B applies in case where amount of winnings exceed INR 10,000. While the Finance Bill has clarified several industry questions, it is not clear why distinction between online and offline games has been created.

#### 4. ANGEL TAX EXPANDED TO NON-RESIDENTS

##### ***Present Construct***

Since April 1, 2013, Section 56(2)(viib) has imposed a tax liability on unlisted companies on the receipt of consideration for the issuance of shares to the extent it exceeds the fair market value ("**FMV**") of the shares of such company. However, this was limited to investments received from residents of India. In cases of such excessive consideration being received by companies from Indian residents, the aggregate consideration received in excess of the FMV is taxable at the hands of the issuer of shares as under head IOS.

The introduction of Section 56(2)(viib) by the Finance Act of 2012 resulted in certain controversies. For example, start-ups which received capital injections to meet their cash needs, had to contend with obstacles posed by tax liabilities under this provision.

This issue arises due to the potential differences of opinion between a taxpayer and the tax authorities over what the FMV should be. Clause (a) of the explanation to Section 56(viib) of the ITA states that FMV shall be the greater of the value:

- Determined by way of a prescribed method; and
- As may be substantiated by the company to the satisfaction of the income tax authorities.

The "prescribed method" under Rule 11UA of the Income-tax Rules, 1962 ("**ITR**") allows a taxpayer to value the unquoted shares of a company either on the basis of the net asset value per share, or by way of the discounted cash flow ("**DCF**") method, determined by a merchant banker.

Despite it being a "prescribed method" under Rule 11UA for the purpose of Section 56(2)(viib), some ITAT decisions reveal that tax authorities had gone so far as to challenge the application of the DCF method.<sup>2</sup> Further, given that most start-ups raise capital on the basis of their cash needs and an investor's perception of their growth potential, their valuations are likely to exceed the one arrived at through the net asset value or the discounted cash flow methods. The discretionary powers granted to the tax authorities under Section 56(viib) to reject such a valuation is cause for controversy, which led to a plethora of litigation.

To ameliorate the effects of such discretion, the Finance Act of 2012 had also introduced an exemption in respect of investments from venture capital companies or venture capital funds ("**VCFs**"). This exemption was extended by the Finance Act of 2019 for considerations paid by Category I and Category II Alternative Investment Funds ("**AIFs**"). Subsequently, the government also notified certain classes of persons who would be excluded from the purview of Section 56(2)(viib) (For example, the Ministry of Commerce and Industry notified companies that would qualify the definition of "start-up" as being exempt.)

Be that as it may, other start-ups and smaller private companies do not raise capital exclusively from VCFs and AIFs. Therefore, the issue of differences of opinion with respect to valuation between investee companies and the tax authorities remains controversial, and the provision has earned the moniker of being an "angel tax".

##### ***Proposed Amendment and Impact***

Noticing that the angel tax applied only to investments from resident investors, the Finance Bill of 2023 has sought to



extend its applicability to non-resident investors as well. Consequently, with effect from April 1, 2023, the controversies outlined above are likely to arise also with respect to foreign investment into unlisted Indian companies. As such, any consideration for the issuance of shares (above the FMV) received under the foreign direct investment ("FDI") or foreign venture capital investor ("FVCI") routes are likely to trigger Section 56(2)(viib), making it taxable at the hands of the Indian company issuing shares in excess of FMV.

Although not equivalent in substance, the effect of the proposed changes is reminiscent of the Shell<sup>3</sup> and Vodafone<sup>4</sup> cases in which the tax authorities sought to apply the Arm's Length Principle to cross-border equity financing transactions between associated enterprises.

Though not litigated so far, we believe that Section 56(2)(viib) may also raise question of constitutional validity. These issues may arise inasmuch as the delegation of authority to the income tax authorities whereby they may replace share valuations arrived at through commercial negotiations, in exercise of the freedom of contract, may be seen as being excessive and arbitrary. The tax on capital may also be viewed as being an unreasonable restriction of the right to carry on business, which is guaranteed under Article 19(1)(g) of the Constitution of India.

### **Impact**

The multiplicity of regulatory laws applicable to cross-border investments made by non-residents into equity shares of Indian companies are likely to result in a lack of cohesion. For instance, the pricing guidelines under the Foreign Exchange Management (Non-Debt Instrument) Rules, 2019 require that foreign investments must be made at or above FMV (as determined by a merchant banker, usually following the DCF method). The extension of the tax liability on foreign investments under section 56(2)(viib) appears to be ill at ease with the policy objectives of the foreign exchange control regulations under the FDI and FVCI routes. For example, FVCIs are not required to follow the pricing guidelines from a foreign exchange control perspective (although valuation from a company law perspective for preferential allotments may still be required).

In this context, whether tax authorities will begin challenging valuations submitted to AD banks and the RBI (for the purposes of foreign exchange control regulations) is a question that remains unanswered. Ideally, given that such valuations are already accepted for the purposes of RBI filings under the foreign exchange control laws, and under the Companies Act, the hope is for tax authorities too to accept such valuations.

From a private equity and venture capital deal perspective, while FMV determination based on DCF is a foreign exchange compliance requirement; commercially, investments are made at a price higher than the FMV. This is because there is a gap between how founder perceives the valuation of the company and how Investors perceives the value of the company. To bridge this gap, Investors often invest at a price higher than FMV but with balancing rights such as, anti-dilution rights, liquidation preferences, etc. Consequently, the change to the provision is likely to create issues in the negotiation of such rights at the time of fund raising by such Indian companies. For Private Equity, this will make investment in Indian companies less attractive.

Lastly, at the time of conversion of certain instruments such as CCPS into equity shares, similar concerns around the characterization of the conversion as an issuance of equity shares (and the extinguishment of rights in the CCPS as the consideration), may also arise. In such circumstances, given that the FMV of CCPS follows the FMV of the equity shares, there should be no resultant tax implications.

In this context, it should also be noted that the provisions of Section 56(2)(viib) should not apply to secondary transactions or debt instruments. Consequently, overseas private equity and venture capital investors may begin preferring debt instruments (such as CCDs), over equity instruments. This may lead to significant changes to the dynamics of how such deals are structured in India.

Given that 2022 saw a drop in foreign investment as compared to 2021, and given the unparalleled boom of the start-up industry, the expectations from the Budget were to rationalize provisions allowing for greater ease in structuring inbound investments. However, such proposed changes may indeed have quite the contrary effect, in so far as driving away foreign investment from India. While we have witnessed several companies contemplating internalization of their structures in the recent past, the suggested amendments to Section 56(2)(viib) may lead to a preference towards externalization of structures to allow flexibility in deal structuring

## **5. GIFT CITY – A FEW BIG HITS!**

### **a. Non-tax changes**

#### *Current Construct*

For many stakeholders still on the fence about GIFT City, one of the highly anticipated aspect of the Budget was how the Government planned to continue to bolster the IFSC's growth. For the past couple years, the Government has consistently been providing various regulatory and tax incentives to units set up in the IFSC. [Please refer to our [2021-2022](#) and [2022-23](#) hotlines] While these incentives have resulted in exponential growth in certain sectors like banking and fund formation, various regulatory and tax issues continue to plague market participants.

Keeping in mind that the IFSC is also a designated SEZ, one of the most critical aspects which has made it harder to set up businesses in the IFSC has been the requirement to obtain registrations from both IFSCA as well as the SEZ Regulator (ie. The Development Commissioner of Kandla SEZ). While IFSCA has been set up to specifically deal with businesses engaged in financial services, the SEZ Regulator's office and related SEZ Regulations were originally designed to regulate manufacturing and IT related entities. Accordingly, many of the registration and ongoing compliance related requirements emanating from the SEZ regulations prove to be irrelevant and quite cumbersome for financial services related entities set up in the IFSC. Moreover, requiring applicants to obtain a registration and adhere to ongoing compliances governed by the SEZ Regulator was not in line with the Government's objective of establishing IFSCA as a unified regulator.

#### *Proposed changes and impact*

As per the Budget Speech, the Government has announced that the powers of the SEZ Regulator will now also vest with IFSCA and that a single window IT system will be put into place for registration and approval from IFSCA, SEZ authorities, GSTN, RBI, SEBI and IRDAI. This change is a significant step towards promoting ease of

doing business in GIFT City for all industries, but even more so for funds. Currently, even though only fund managers are required to obtain registration from IFSCA, both the fund manager and the *fund* are required to obtain separate approvals from the SEZ Regulator. This means that not only two separate applications are required to be filed with the SEZ Regulator, but that each entity (fund and fund manager) has to lease their own separate office space and separately comply with all registration and ongoing compliance requirements. Accordingly, by granting IFSCA the powers of the SEZ Regulator, entities will not only save time and costs with respect to initial set up, but depending on the scope of powers transferred to IFSCA it is likely that IFSCA may also reframe the cumbersome ongoing compliance requirements that the SEZ Regulations currently provide so that they are more appropriate for businesses undertaking financial services activities.

Another important development in GIFT City which was originally announced in last year's Budget was the establishment of an international arbitration center in GIFT City. The Government has now announced that specific amendments to the IFSCA Act, 2019 ("**IFSCA Act**") will be undertaken to ensure statutory provisions for the establishment of such arbitration center. While no further details have been given, having an international arbitration center within GIFT City will help to promote the IFSC's creditability and boost investor confidence. Further, the Budget Speech has also indicated that a subsidiary of Export Import Bank of India ("**EXIM Bank**") will be established for trade financing. Exim Bank is fully owned by the Government, and is the principal financial institution facilitating India's integration with the global economy by financing India's international trade and investment. Its presence in GIFT City will add to the jurisdiction's reputation and provide an incentive for companies engaged in various industries like aircraft and ship leasing to enter GIFT City.

Moreover, the Budget proposed to recognize Offshore Derivative Instruments ("**ODIs**") as valid contracts. Currently, Section 18A of the Securities (Contracts) Regulations, Act 1956 ("**SCRA**") provides that contracts in derivative shall be legal and valid only if such contracts are traded on a recognized stock exchange and settled on the clearing house of the recognised stock exchange. Accordingly, as ODIs are privately placed instruments, no FPI located in the IFSC is permitted to issue ODIs. However, offshore FPIs are permitted to issue such ODIs as such offshore entities are not residents of India and therefore not subject to the provisions of SCRA.

With the proposed amendment to section 18A of the SCRA, the Government has now recognised privately placed ODIs as valid contracts provided that the contract is regulated by the IFSCA and is issued by an FPI. This is another welcomed amendment which aims to bring FPIs in GIFT City on par with FPIs in other jurisdictions like Mauritius and Singapore.

Lastly, the Budget Speech has also indicated that IFSC Banking Units of foreign banks will now be permitted to undertake acquisition financing. This is another welcomed incentive to place IFSC banking units on par with banks located in other jurisdictions where acquisition financing by banks is permitted.

## b. Tax Changes

### *Current construct and proposed amendments*

Although the IFSC at GIFT City is considered an offshore jurisdiction for foreign exchange purposes, businesses set up in the IFSC are still subject to the provisions of the ITA. Over the course of the last few years the Government has been slowly, but steadily, building a favorable IFSC tax regime. In fact, IFSC businesses are already afforded tax incentives like a 100% income tax holiday for any 10 consecutive years out of the entity's first 15 years of operation from the IFSC, reduced minimum alternate tax, exemption from capital gains tax on transfer of specified securities, etc. Another important incentive provides for a tax neutral relocation of offshore funds to GIFT City. In order to avail this benefit several conditions have to be met<sup>5</sup>, including the requirements that the transfer of assets of the original fund (or of its wholly owned SPV) to the IFSC fund should have taken place on or before March 31, 2023. The Budget now proposed to extend this incentive to transfers taking place on or before March 31, 2025.

Further, as per section 10(4E) of the ITA, income in the hands of non-residents on transfer of (i) non-deliverable forward contracts or Offshore Derivative Instruments ("**ODI**") or (iii) over the counter derivatives entered into with an IFSC Banking unit ("**IFSC IBU**") is exempt. Pursuant to the ODI contract, the IBU makes investments in certain permissible securities in India. Accordingly, any income the IBU receives is taxed as capital gains, dividends or interest under section 115AD of the ITA. After such tax is paid, the remaining income is distributed to the non-resident investors. Currently, the exemption under 10(4E) is only provided on the transfer of ODIs by non-residents and not on the distributions made to such non-residents. Accordingly, such distributions would end up being taxed twice – once when the funds were originally distributed to the IFSC IBU (as gains, interest or dividends), and again when distributed to the non-resident. In order to address this event of double taxation, the Budget proposes to amend 10(4E) of the ITA to also provide an exemption for any income distributed (on which the IBU has already paid tax under section 115AD) by the IFSC IBU to a non-resident investor. This proposed amendment provides for a particularly important exemption as it brings the tax treatment of income earned from ODI contracts entered into with IFSC IBUs on par with ODI contracts entered into with FPIs located in tax friendly offshore jurisdictions like Mauritius and Singapore.

Lastly, in May 2022, the IFSCA had released the IFSCA (Fund Management) Regulations, 2022 ("**FME Regulations**") providing the regulatory framework for setting up investment funds in IFSC. The FME Regulations require all fund managers, and not the funds, to be registered with IFSCA. In stark contrast, the SEBI (AIF) Regulations require funds, and not the managers, to be registered with SEBI as Category I, Category II or Category III AIFs. The ITA defines Investment Fund to *inter-alia* mean any fund established or incorporated in India in the form of a trust which has been granted a certificate of registration as a Category I or a Category II AIF and is regulated under the SEBI (AIF) Regulations or the IFSCA Act. Considering that funds set up in IFSC pursuant to the FME Regulations will no longer be registered with IFSCA, the Finance Bill proposes to correct this technical oversight and amend the definition of 'Specified Fund' under section 10(4D), 'Resultant Fund' under section 47(viia) and 'Investment Fund' under section 115UB. The amendment proposes to remove the requirement for a fund set up in IFSC to be registered as a Category I, II or III AIF and regulated by IFSCA Act, and simply requires that it be regulated by the FME Regulations.

### *Impact*



One of the objectives for establishing the IFSC at GIFT City was to bring offshore businesses onshore. Accordingly, one of the most efficient ways to incentivise this shift in the funds industry was to provide tax neutral relocation of offshore funds to GIFT City. However, keeping in mind that GIFT City is still an emerging jurisdiction which still needs to develop a strong track record, many GPs continue to be on the fence with respect to setting shop in the IFSC. Perhaps due to this reluctance coupled with the administrative hassle of relocating a fund, we have not seen many offshore funds relocate to GIFT City. Accordingly, the Government's decision to extend the applicability of the tax neutral relocation to transfers which happen up until March 31, 2025 is a welcome extension which more GPs may take advantage of as GIFT City continues to grow in scale and reputation.

The proposed amendment to section 10(4E) of the ITA was also a critical ask that stakeholders have been demanding for some time. By closing the loophole for double taxation, the Government has shown its commitment to a fair tax regime. Moreover, this amendment should also incentivise non-resident participation in ODI's issued by banking units in the IFSC thereby boosting the IFSC's banking industry.

While the rationalisation of definitions with FME Regulations is useful, it is important to note that several exemptions/ relaxations (like exemption from filing of income-tax returns, obtaining PAN etc.) have been notified by CBDT through notifications/ amendment in ITR. Rationalisation in definitions provided for these exemptions will also be useful.

Over the past few years, the Government has taken numerous measures to provide a regulatory and tax regime for businesses set up in the IFSC which is fairly on par with global standards. While further incremental regulatory and tax reforms may still be required, the most significant boost to GIFT City may come from socio-cultural changes to the city. Currently, GIFT City has not yet developed the socio-cultural infrastructure (ie. shops, restaurants, parks, cafes, movie theatres, etc.) that would motivate individuals to move there. Without giving due importance to such infrastructure, it may become all that more difficult to expand the city and truly make it into a global financial destination.

## 6. INCREASING TCS RATE ON LRS

In an attempt to increase tax collections, Finance Act, 2020 had introduced a Tax Collection at Source ("TCS") requirement of 5% on foreign remittances made by a 'buyer' under the liberalized remittance scheme ("LRS"), provided the aggregate amount of remittance during any financial year exceeds INR 7 lakhs (~USD 8573). The obligation of the said TCS is on the Authorised Dealer Bank (AD Bank) through which the remittances are made. In this regard, Finance Bill proposes to increase the rate of TCS from 5% to 20% and also proposes to remove the monetary threshold of INR 7 lakhs (~USD 8573) for its applicability. This amendment will take effect from July 1, 2023.

Provided such remittances are not taxable in the hands of the overseas recipients, it should be possible to obtain a credit / refund of such TCS, however, it may create cash flow issues for the remitter (buyer), which issue is likely to get aggravated by the rate increasing from 5% to 20%. Further, given that it is a tax on capital exports, such TCS along with the recent overhaul of the Overseas Investment Regulations, is likely to make the LRS route more challenging than earlier.

## 7. AMENDMENTS FOR START-UPS - HITS AND MISSES

### a. Carry forward of losses

#### *Present construct*

Companies are generally allowed to carry forward the accumulated losses from the prior years and set off their income of the current year using them. However, section 79 of the ITA provides a restriction on carry forward and set off of losses in case there is a change in the shareholding pattern of the company, such that 51% of the voting power of the company is no longer beneficially held by persons who beneficially held 51% of the voting power of the company on the last of day of the year in which the losses are proposed to be carried forward and set off.

However, for the eligible start-ups (as specified under section 80-IAC of the ITA), the benefit of carry forward and set off provisions would be available even when the above condition is not satisfied, subject to the following:

- Condition A: all the shareholders of such company who held shares carrying voting power on the last day of the year in which the loss was incurred, continue to hold those shares on the last day of the year in which the losses are proposed to be
- Condition B: such loss has been incurred during the period of 7 years beginning from the year in which such company is incorporated.

#### *Proposed amendment and impact*

As per section 80-IAC of the ITA, an eligible start-up can claim a deduction of an amount equal to 100% of the profits and gains derived from an eligible business for 3 consecutive assessment years out of the 10 years beginning from the year in which the start-up was incorporated. The Finance Act, 2021 had increased the window from 7 years to 10 years.

The Finance Bill proposes to extend the 7-year period under Condition B to 10 years and align it with the period specified under section 80-IAC of the ITA. Hence, an eligible start-up which has incurred a loss after 7 years (but before 10 years) of its incorporation should be allowed to carry forward such losses and set off the profits even when there is a change in more than 51% voting power of such start-up.

### b. Extension in the period of incorporation

The tax holiday under section 80-IAC is available to the following start-ups:

- the total turnover of its business does not exceed INR 1 billion (approx. USD 12 million),
- it is holding a certificate of eligible business from the Inter-Ministerial Board of Certification, and
- it is incorporated on or after April 1, 2016 but before April 1, 2023.

The Finance Bill proposes to extend the time period of incorporation by 1 year, from April 1, 2023 to April 1, 2024.

Both the above changes are welcome for the start-up ecosystem in India. However, many other wish lists of the industry including parity in the treatment of long-term capital gains on the sale of shares of a start-up company to long-term capital gains on the sale of listed equity shares and deferring ESOP taxation not only to start-ups which have a certificate from Inter-Ministerial Board of Certification have been kept unheard.

In the past, the Indian start-up ecosystem witnessed a wave of externalisations i.e. creation of holding companies in foreign jurisdictions, effectively making the Indian company into a 100% subsidiary of a foreign entity. Reasons for the externalisations included better access to capital markets (valuations and ticket size). However, recently, the market has become more Indian-driven, with relatively easier access to capital (due to the developing VC/PE ecosystem), changes in roundtripping rules, and the growing maturity of India's capital markets. Further, it has been reported that a few unicorns have even begun the process of redomiciling their base to India ("**Reverse Flipping**"). This is a good move for the Indian ecosystem and will also foster tax revenue on future liquidity events. However, the companies opting for Reverse Flipping may face significant tax costs during the process of redomiciliation.

The Budget was the right opportunity to introduce interim provisions for incentivising the start-ups to Reverse Flip and redomicile in India, albeit with certain checks and balances. Even under the Economic Survey 2022-23, a slew of measures to accelerate Reverse Flipping were suggested such as simplification in the process for grant certification from the Inter-Ministerial Board of Certification, simplification of taxation of ESOPs, simplification of multiple layers of tax and uncertainty due to tax litigation etc.

Unfortunately, no such changes have been proposed under the Finance Bill to incentivise the start-ups to redomicile and it seems to be a lost opportunity in the current Budget.

## 8. PENAL AND PROSECUTION PROVISIONS EXPANDED

The withholding tax provisions under the ITA generally impose an obligation on the payer of the consideration to withhold tax when making specified payments. However, in certain instances, the payment may be in kind or partly in cash and partly in kind, and hence complying with the withholding obligations may be difficult. For instance, in case a person wins a car in a lottery, withholding 30% of the value of car (being winnings) will be difficult for the lottery organizer. In such situations, the obligation on the person for paying is to ensure that tax has been paid in respect of the winnings, before releasing the winnings (for e.g., as per proviso to section 194B).

Section 271C of the ITA provides for a penalty of a sum equal to 100% of the amount of tax which was

- i. not deducted or paid in case the person fails to deduct tax as required under different withholding provisions; or
- ii. not paid (whole or part of it) as required by or under
  - section 115-O(2); or
  - proviso to section 194B.

Section 276B of the ITA provides for punishment with imprisonment for a term between 3 months to 7 years in case the person fails to pay tax to the credit of the Government for similar situations.

The Finance Act, 2022 introduced two new withholding provisions on the transactions wherein payment of consideration in kind is also common and accordingly, the obligation on the person responsible for paying was to ensure that the tax required to be deducted in respect of

- i. benefit or perquisite under section 194R; and
- ii. payment of consideration for transfer of VDA under section 194S;

has been paid before releasing such benefit or perquisite and consideration for transfer of VDA respectively.

However, corresponding amendments in the penalty and prosecution provisions for non-compliance of these newly introduced provisions were not made under section 271C and section 276B of the ITA.

The Finance Bill proposes to amend section 271C and section 276B with effect from April 1, 2023 to specifically mention default under section 194S (withholding on virtual digital asset) or section 194R (withholding on benefit or perquisite) or 194BA (withholding obligation for winnings from online games) as being subject to as penal and prosecution consequences.

It is pertinent to note that while proviso to section 194R(1) and proviso to section 194S(1) came into effect from July 1, 2022, the failure to comply with them or collect taxes as per these provisions but failure to pay or ensure payment of such taxes to the credit of the Government, would not result in any penalty or prosecution as no such provision existed. Hence, technically, there exists a hiatus during which the above-mentioned non-compliance should not result in any penalty or prosecution risk.

## 9. INTEREST DEDUCTION LIMITATIONS: EXTENSION OF EXEMPTION TO NBFCs

### *Present construct*

Thin capitalization rules were introduced under the ITA by the Finance Act, 2017, to check upon excess deductions claimed by way of higher interest payments to foreign associated enterprises ("**AE**"). As per section 94B of the ITA, the amount of deduction an Indian company or a permanent establishment of a foreign company can claim in respect of payment of interest to a foreign lender which is also AE of the borrower, should not exceed

- a. 30% of earnings before interest, taxes, depreciation and amortisation ("**EBITDA**") of the borrower in the previous year, or
- b. interest paid or payable to AE for that previous year,

whichever is less.

The borrowers who are engaged in the business of banking and insurance were kept outside the scope of section 94B, given the nature of businesses.

### ***Proposed amendment and impact***

The Finance Bill proposes to exclude non-banking finance companies (“NBFCs”) as well from the scope of section 94B as they are also engaged in the business of financing and their functions are similar to borrowers engaged in the banking business. Further, it is pertinent to note that, unlike the blanket exclusion for the borrowers engaged in the banking and insurance industry, the exclusion for the NBFCs is applicable only to the class of NBFCs which may be notified by the Government. Exclusion of the NBFCs from the scope of section 94B is a welcome move, however, it will need to be seen which types of NBFCs are actually notified to be excluded.

Section 94B was introduced under the ITA based on recommendations by the OECD in the BEPS Action Plan 4 report (“**AP 4 Report**”). AP 4 Report had also proposed an exclusion for banking and insurance groups because the rules proposed therein were not found to be suitable to tackle BEPS issues for these industries. However, it was also recommended that the scope of exclusion should be restricted and it should not include treasury companies, captive insurance companies or other non-regulated entities which carry out quasi-banking or other financial activities where there are no regulatory restraints, or to investment vehicles whether or not regulated. Given that NBFCs are regulated in India, the approach under the Finance Bill does not seem to be contradictory to the recommendations under the AP 4 Report.

### ***The problem with tax treaty non-discrimination provisions***

Section 94B limits interest deductions only in respect of payments made to non-residents. These payments may be made by residents of India or by non-residents on debts which are effectively connected with their permanent establishments in India. These limitations apply irrespective of whether these transactions occur between associated enterprises.

This raises the issue of whether Section 94B contravenes the provisions of Indian tax treaties similar to Article 24(3) and Article 24(4) of the OECD Model Tax Convention. It is our view that the discrimination of Section 94B is prohibited by Indian tax treaties.

Whilst industry concerns appear to have been heeded to on a piecemeal basis, there have been, and continue to be, fundamental tax treaty related issues with India’s adoption of the recommendation.

## **10. LITIGATION AND TRANSFER PRICING UPDATES**

### ***Unburdening the tax appeal process***

Under the current tax regime, the first appellate authority against any order issued under the ITA is the Commissioner (Appeals). The Commissioner (Appeals) has the power to make changes or reject an order of assessment or penalty. The order then made by the Commissioner (Appeals) may be appealed before the Appellate Tribunal.

In order to unburden the Commissioner (Appeals) from the large number of appeals pending before it, the Finance Bill has proposed to introduce a new authority for appeals at the Joint Commissioner / Additional Commissioner level (“**Joint Commissioner (Appeals)**”) to handle certain class of cases involving small amount of disputed demand.

These provisions provide an exhaustive list of orders<sup>6</sup> against which an appeal may be preferred before the Joint Commissioner (Appeals). It is however provided that orders passed by/with approval of Authority above Deputy Commissioner cannot be referred to the Joint Commissioner (Appeals). The proposed amendment also allows for a mechanism (through the CBDT or any authority authorised by the CBDT) to transfer any appeal pending before Commissioner (Appeals), or matter connected therewith, to the Joint Commissioner (Appeals) and vice-versa. The transferred appeal would be picked up from the stage it was at before it was so transferred. It is also provided that if an appeal is transferred, the appellant shall have an opportunity of being heard.

Lastly, in line with its intention to reduce burden and expedite appeal process, the Finance Bill empowers the Central Government to make a scheme for faceless processing of such appeals.

By allowing appeals at the first stage to be processed and adjudicated by the Joint Commissioner (Appeals), the Government has taken a positive step towards reducing the burden of the Commissioner (Appeals), and consequently, clearing the backlog of pending cases at the stage of first appeal. This would result in the quicker resolution of proceedings, providing speedy relief to taxpayers.

### ***Appellate Tribunal: Plugging the leak***

Section 253 of the ITA inter alia contains provisions regarding appeal to the Appellate Tribunal. It provides for appeal against orders of the Commissioner (Appeals). The Finance Bill enables remedy in the form of appeal against certain instances of imposition of penalty by the Commissioner (Appeals), which were not provided for earlier. Similar enabling measures have been made with respect to rectification and revision orders made by Principal Chief Commissioner or Chief Commissioner, for which recourse to Appellate Tribunal did not exist.

Additionally, in line with the earlier mentioned proposal of allowing appeals before Joint Commissioner (Appeals), provisions have been proposed to provide for recourse against such orders of the Joint Commissioner (Appeals) in the form of appeal within section 253, to the Appellate Tribunal.

The proposed changes are simply in the form of enabling provisions, which remedy the lacuna in the law as a result of previously introduced amendments. The right to appeal is a salient part of the dispute process, not only in tax matters, but all across. The Finance Bill takes a positive step in recognizing this, and remedying the lack of recourse currently present in the tax regime.

### ***TP Proceedings: Rationalizing the time-limit for submission of Local File***

Section 92D of the ITA, inter alia, provides that every person who has entered into an international transaction or a specified domestic transaction shall keep and maintain the information and documents as provided under rule 10D of the Income-tax Rules, 1962 (“**Rules**”) – (the “**TP Documentation**”).

Section 92D(3) of the ITA provides that during the course of any proceedings under the ITA, the assessing officer

("AO") or the Commissioner (Appeals) may require the production of any information or document in the TP Documentation within a period of 30 days from the date of receipt of a notice in this regard, which upon an application by the assessee in this regard, may be extended by an additional period of 30 days.

Representations were received from the Revenue that in several instances due to limited time available for transfer pricing ("TP") proceedings, it may not be feasible to provide minimum 30 days for producing the information and documents in the TP Documentation, which in any case is already in possession of the assessee.

In order to resolve the concern of the Revenue in this regard, the Finance Bill proposes to amend the timeline for production of documents and information in the TP Documentation by the assessee within 10 days of receipt of notice in this regard, which upon application for extension may be extended by a further period not exceeding 30 days.

### ***Streamlining the time-limit for completion of assessments, a welcome relief***

Currently under section 153 of the ITA, the time limit prescribed for assessing officers to complete the assessment is 9 months from the end of the AY in which the income was first assessable. Similarly, in case where an updated return is filed under section 139(8A) of the ITA, the time limit for completion of assessment is 9 months from the end of the financial year in which the return is filed. In this context, it is important to note that a notice under section 143(2) – requiring the assessee to produce any evidence which she may rely on in support of her return – can be served on the assessee up to 3 months from the end of the relevant AY. This effectively gives the AO a time of only 6 months for making the assessment which includes making investigations, giving assesses opportunities of being heard, analyzing judicial precedents etc. Further, with faceless assessment, different aspects of investigation are conducted by different units, the co-ordination for which takes even more time. As such the period of 6 months is short for completion of assessment and it compromises on the effective implementation of the principles of natural justice in terms of the taxpayers not getting ample time in making their submissions.

In light of this, the Finance Bill proposes to increase the time limit for completion of assessment to 12 months (from 9 months) from the end of the relevant AY. Consistently, the time limit for completion of assessment in case of an updated return is also proposed to be increased to 12 months from the end of the financial year in which such return is furnished.

This is a welcome move especially from the perspective of the Central Government trying to ensure that principles of natural justice are effectively implemented in course of assessment proceedings. It also ensures that harassment of taxpayers in case of rushed proceedings due to short limitation periods for completion of assessment is done away with. Most importantly, 9 months from the end of the relevant AY makes the deadline for passing assessment orders December 31 of the year. This move is also welcomed from a foreign taxpayer perspective who would otherwise be required to respond to tax notices during the holiday season.

## **– International Tax Team**

You can direct your queries or comments to the authors

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<sup>1</sup> 'Market linked Debenture' has been proposed to be defined as a security by whatever name called, which has an underlying principal component in the form of a debt security and where the returns are linked to market returns on other underlying securities or indices and include any securities classified or regulated as a Market Linked Debenture by SEBI.

<sup>2</sup> See: *Innoviti Payment Solutions P Ltd. V. ITO, (2019) 102 taxmann.com59 (Bangalore - Trib.)*; *GSE Commerce Pvt Ltd vs ACIT SP No 91/Bang/2020*.

<sup>3</sup> *Shell India Markets Pvt Ltd vs ACIT ITA no. 193/Mum/2013*.

<sup>4</sup> WP No. 871 of 2014 before the Bombay High Court.

<sup>5</sup> Please refer to [2022 Budget]

<sup>6</sup> (i) an order being an intimation under sub-section (1) of section 143, where the assessee objects to the making of adjustments, or any order of assessment under sub-section (3) of section 143 or section 144, where the assessee objects to the amount of income assessed, or to the amount of tax determined, or to the amount of loss computed, or to the status under which he is assessed;

(ii) an order of assessment, reassessment or recomputation under section 147;

(iii) an order being an intimation under sub-section (1) of section 200A;

(iv) an order under section 201;

(v) an order being an intimation under sub-section (6A) of section 206C;

(vi) an order under sub-section (1) of section of section 206CB;

(vii) an order imposing a penalty under Chapter XXI; and

(viii) an order under section 154 or section 155 amending any of the orders mentioned in (i) to (vii) above;

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