INDIA BUDGET 2017-18 – KEY HIGHLIGHTS

Introduction

India's Union Budget (the "**Budget**") was announced on February 1, 2017, and the Finance Bill, 2017 (the "**Finance Bill**") was tabled in Parliament. Most of the income tax proposals in the Finance Bill will be effective from the financial year commencing on April 1, 2017, unless specified otherwise. The Finance Bill will be discussed in Parliament before its enactment, and therefore, it is likely that the Finance Bill may be amended as a result of these discussions.

We have summarized below some of the key income tax proposals.

Clarity relating to indirect transfer provisions

Under the provisions of the Income-tax Act, 1961 (the "**IT Act**") the income of a non-resident will be deemed to accrue or arise in India if it arises directly or indirectly, through or from any business connection, property, asset or source of income, or transfer of a capital asset situated in India. The indirect transfer of shares provision was introduced in the Finance Act, 2012, by way of Explanation 5 to Section 9(1)(i) of the IT Act, clarifying that an offshore capital asset will be considered to be situated in India if it substantially derived its value (directly or indirectly) from assets located in India. The indirect transfer provisions are applicable only if the value of the assets located in India exceeds INR 100 million and the assets in India represent at least fifty per cent (50%) of the value of all the assets owned by the offshore transferor company. The Central Board of Direct Taxes issued Circular No 41 of 2016 which raised apprehensions of the foreign investor community; as such circular extended the applicability of the indirect transfer provisions to foreign portfolio investors as well. The Finance Bill has now proposed that the indirect transfer tax provisions will not apply to Category I and Category II foreign portfolio investors registered under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014. The proposed amendment will take effect retrospectively from April 1, 2012, and this amendment will provide much needed relief to foreign portfolio investors.

Thin capitalization rules

A company is typically financed or capitalized through a mixture of debt and equity. The way a company is capitalized often has a significant impact on the amount of profit it reports for tax purposes since tax legislations of countries typically allow a deduction for interest paid. Therefore, the higher the level of debt in a company and considering the amount of interest it pays the lower will be its taxable profit. For this reason, debt often works as a tax efficient method of finance than equity. For this reason, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base. Following the OECD BEPs initiative, the Finance Bill provides that interest expenses paid to an associated enterprise and claimed by an entity shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization or to the actual amount of interest paid to an associated enterprise, whichever is less. The provision shall be applicable to an Indian company, or a permanent establishment of a foreign company being the borrower who pays interest in respect of any form of debt issued to a non-resident or to a

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permanent establishment of a non-resident and who is an "associated enterprise" of the borrower. Further, in order to target only large interest payments, the Finance Bill has proposed to provide for a threshold of interest expenditure of Rupees ten (10) million per financial year exceeding which this rule will become applicable. This rule will not be applicable to banks and insurance companies. This amendment will take effect from April 1, 2017.

Shifting the base year from 1981 to 2001 for computation of capital gains

The existing provisions of the IT Act provide that for the purposes of computing capital gains, a taxpayer is allowed a deduction of the cost of acquisition of the asset from the sale price. In respect of an asset that is acquired before April 1, 1981, the taxpayer had the option to consider the fair market value ("**FMV**") of the asset as on April 1, 1981 or the actual cost of the asset as the cost of acquisition for the purpose of computing capital gains. Given that the base year of 1981 is more than three decades old, taxpayers were facing difficulties due to the non-availability of information for computing the FMV of such an asset. The Finance Bill has revised the base year from 1981 to 2001 to provide that the cost of acquisition of an asset acquired prior to April 1, 2001 could be the FMV as on April 1, 2001 by virtue of which such cost of acquisition is likely to increase, thereby reducing the incidence of capital gains. This amendment will take effect from April 1, 2017.

Long term bonds for capital gains exemption

The existing provisions of the IT Act provides that capital gains arising from the transfer of a long-term capital asset will be tax exempt if the taxpayer invests the whole or any part of the capital gains up to an allowable limit in certain specified bonds within a specified period. Currently, investment in bonds issued by the National Highways Authority of India or by the Rural Electrification Corporation Limited is eligible for exemption under this section. The Finance Bill has widened the scope to include eligibility of this exemption being applicable to investment in bonds of other public sector undertaking which would be notified by the Central Government. This amendment will take effect from April 1, 2017.

Extension of eligible period of concessional tax rate on interest in case of External Commercial Borrowing and Extension of benefit to Rupee Denominated Bonds

The existing provisions of the IT Act provides that the interest payable to a non-resident by an Indian company on foreign currency borrowings from sources outside India under a loan agreement or by way of issue of any long-term bond including long-term infrastructure bond will be eligible for a concessional withholding tax of 5%. To be eligible for the reduced rate of withholding tax the borrowing had to be made before the July 1, 2017. The Finance Bill has extended such date of borrowing to July 1, 2020 thereby allowing the beneficial reduced rate of withholding tax to apply on such borrowings. This amendment will take effect from April 1, 2017.

Extending the period for claiming deduction by start-ups

The existing provisions of the IT Act provides that an eligible start-up will be allowed a 100% deduction of the profits and gains derived from eligible business for three (3) consecutive assessment years out of five (5) years beginning from the year in which such eligible start-up is incorporated. Given that start-ups usually take time to derive profit out of their business, the Finance Bill allows a 100% deduction for any three (3) consecutive assessment years out of seven (7) years beginning from the year in which such eligible start-up is incorporated, which is likely to give relief to start-ups. This amendment will take effect from April 1, 2017.

Our Comments

Overall, the Budget seems to be positive as it allays the fears of foreign portfolio investors due to non-applicability of the indirect transfer provisions. Further, in course of the budget speech the Finance Minister has indicated that the Foreign Investment Promotion Board i.e., the nodal authority governing foreign investors into India will be phased out and abolished in 2018 signaling further liberalization of the foreign investment regime, which is a positive step. The budget also seeks to give a much needed impetus to rural growth while balancing the fiscal deficit.