COMPREHENSIVE ANALYSIS OF IMPORTANT INTERNATIONAL TAX PROPOSALS AND FDI REFORMS IN BUDGET 2016

P. R. BHUTA & Co.
CHARTERED ACCOUNTANTS

anb LEGAL
Advocates & Solicitors

Prepared By:

PANKAJ BHUTA
HARSHAL BHUTA
TANVI VORA

ASHISH BHAKTA
PAYAL BHAKTA
NAZNEEN ICHHAPORIA

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1. ADDITIONAL TAXATION OF DIVIDEND INCOME IN EXCESS OF RS. 10 LAKHS

Under the existing provisions of Section 10(34) of the Income Tax Act ('the Act'), dividends which suffer dividend distribution tax ('DDT') under section 115-O are exempt in the hands of the shareholder. At the time of paymentto the shareholders, such dividends are required to be grossed up at the rate of 15%. In the belief of the Hon'ble Finance Minister, this creates vertical inequity amongst the taxpayers as those taxpayers who have high dividend income are subjected to tax only at the rate of 15% whereas such income in their hands should have been chargeable to tax at the rate of 30%.

It has therefore been proposed to amend this section to provide that any income by way of dividend in excess of Rs. 10 lakh shall be chargeable to tax in the case of an individual, Hindu undivided family (HUF) or a firm who is resident in India, at the rate of 10% (plus applicable surcharge and cess). The taxation of dividend income in excess of ten lakh rupees shall be on gross basis.

This amendment is proposed to be effective from Assessment Year 2017-18 (i.e. Financial Year 2016-17) onwards.

*(**Analysis:**On the pretext that the effective rate of 15% is lower than the actual slab rate of taxation as applicable to respective shareholders, the Finance Act 2014 had introduced the concept of grossing up of dividends for the purpose of calculating dividend distribution tax. Vide Finance Bill 2016, the Hon'ble Finance Minister proposes to increase the tax rate yet again for Individuals/HUF / Firms (including LLPs) who earn annual dividend income in excess of Rs. 10 Lakh. | In an era where participation exemption is prevalent in tax systems of various countries across the world thereby alleviating (partially/fully) double taxation on dividend income, introduction of this tax would amount to bringing in the concept of "triple taxation" in India – twice at the corporate level and once at the shareholder level. | With the introduction of this additional tax, the effective tax rate for repatriation of foreign profits may increase in the hands of Indian Promoters of closely held companies who have made overseas investments in foreign subsidiaries through the closely held Indian companies.)*

2. TAXATION OF CROSS-BORDER E-COMMERCE PAYMENTS VIDE EQUALISATION LEVY

Currently in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. From a certain perspective, business in digital domain doesn't seem to occur in any physical location; rather the persons carrying business in digital domain could be located anywhere in the world. These new business models in the digital economy have created new tax challenges. The typical direct tax issues relating to e-commerce are the difficulties of characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction, the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes. The digital business fundamentally challenges physical presence-based permanent establishment rules.

The Organization for Economic Cooperation and Development ('OECD') had recommended, in Base Erosion and Profit Shifting ('BEPS') project under Action Plan 1, several options to tackle the direct tax challenges which include modifying the existing Permanent Establishment ('PE') rule to include that where an enterprise engaged in fully de-materialized digital activities would constitute a PE if it maintained a significant digital presence in another country's economy. It further recommended a virtual fixed place of business PE in the concept of PE i.e. creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website. It also recommended to impose of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or imposition of a equalisation levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having permanent establishment in other contracting state.

In order to address these challenges, it has been proposed to insert a **new Chapter titled "Equalisation Levy" in the Finance Bill**, to provide for an equalisation levy of 6 % of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment ('PE') in India, from – *(a)* a resident in India who carries out business or profession, or *(b)* a non-resident having permanent establishment in India. **Exemption** from such levy has been provided to – *(a)* resident persons who do not use such service in carrying on business or profession, and *(b)* aggregate amount of such consideration by persons resident in India carrying on business or profession does not exceed Rs. 1 lakh.

Terms and expressions used in this Chapter are defined in Clause 161 of Finance Bill 2016. **'Specified services'** ad interim has been defined to include online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement.

The procedural aspects of collection and recovery of equalisation levy and other compliances to be followed by the persons who are liable to pay equalization levy has been provided under Clauses 163 and 164 of Finance Bill 2016. The provisions dealing withproceedings for assessment of such levy has been given in Clauses 165 and 166. The provisions dealing with interest; penalty and prosecution in case of defaults are given under Clauses 167 to 170 and Clauses 173, 174 of Finance Bill 2016. Further, the provisions dealing with appeal for an order under this Chapter have been given in Clauses 170 and 172.

In order to avoid double taxation in India, the **corresponding income** from providing such specified services has also been proposed to be **exempted** under Section 10 of the Income Tax Act, 1961.

Further, it has been proposed to provide for **disallowance of the expenses** incurred by the assessee towards specified services in case of failure to deduct and deposit the equalisation levy to the credit of Central government.

This Chapter will take effect from the date appointed in the notification to be issued by the Central Government.

*(**Analysis:**Under the BEPS Action Plan 1 Final Report, the introduction of an equalisation levy has not been eventually recommended for the concern that it may alter the existing international standards for allocating taxing rights between source and residence countries. However, it has cautiously permitted its introduction with a stipulation that existing treaty obligations are to be respected. As far as the introduction of 'Equalisation Levy' in India is concerned, it has been proposed to be introduced under a Chapter of Finance Bill 2016 rather than by an amendment to the Income Tax Act, 1961. This has been presumably done in order to deny benefits under respective DTAA for payments made to non-residents. This supposition is based on certain judicial decisions (delivered in the context of the challenge made to the introduction of Explanation 1 to Section 90 under Article 24 of DTAA) wherein it has been held thatDTAA in general does not prevail over the Finance Act. Consequently, such opinion would preclude the application of Article 5 r.w. 7 (absence of permanent establishment in the source country) as well as Article 24 (Non-discrimination provision for disallowance of deduction) altogether. Nevertheless, one may challenge such supposition by contending that 'Equalisation Levy' may be covered within the ambit of 'Taxes Covered' under Article 2 of the respective DTAA since it could qualify as an 'identical / substantially similar tax' to income tax. It may be noted that BEPS Action Plan 1 Final Report also acknowledges that such 'Equalisation Levy' would be unlikely to be credited against the corporate tax paid by a foreign entity in the country of its residence. | The levy is imposed on the income of the non-resident person providing such specified service but the procedure for collection and recovery of such levy as well as other provisions dealing with assessment and appeal suggest that the onus and eventual liability for payment of such levy rests on the (resident / non-resident) payer. |The exemption limit of Rs. 1 lakh applies qua payer as well as qua payee. |Another issue which may arise pertains to the allowability of payment of 'equalisation levy' suo-moto by the payer. If it is considered as a 'tax' within the meaning of Section 40(a)(ii), then it may not be allowed to be claimed as a deduction by the payer. | At present, 'specified service' only includes service related to provision of online / digital advertising, but it is widely expected that the list of 'specified services' could be soon expanded to cover other types of online services.)*

3. INTRODUCTION OF 'PATENT REGIME'

In order to encourage indigenous research & development activities, the Hon'ble Finance Minister has proposed to**introduce a concessional taxation regime for income from patents**. The aim of the concessional taxation regime is to provide an additional incentive for companies to retain and commercialize existing patents and to develop new innovative patented products. This would encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India. The OECD has recommended, in BEPS project under Action Plan 5, the nexus approach which prescribes that income arising from exploitation of Intellectual property ('IP') should be attributed and taxed in the jurisdiction where substantial research & development ('R&D') activities are undertaken rather than the jurisdiction of legal ownership only.

Accordingly, it has been proposed to insert new Section 115BBF in Income Tax Act, 1961 to provide that where the total income of the eligible assessee income includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess) on the gross amount of royalty. No expenditure or allowance in respect of such royalty income shall be allowed under the Income Tax Act, 1961. Further, such royalty income has been proposed to be excluded from the purview of Minimum Alternate Tax too to preserve the intent of taxing such income purely @ 10% (plus applicable surcharge and cess).

For the purpose of this concessional tax regime, an eligible assessee would mean a person resident in India, who is the true and first inventor of the invention (including co-inventor) and whose name is entered on the patent register as the patentee in accordance with Patents Act, 1970.

Various other important definitions have been given under Clause 52 to Finance Bill 2016.

These amendments are proposed to be effective from Assessment Year 2017-18 (i.e. Financial Year 2016-17) onwards.

*(**Analysis:**The nexus approach allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer has itself incurred qualifying R&D expenditures that gave rise to the IP income. The reference to BEPS Action Plan 5Final Report in the memorandum to Finance Bill 2016 is misplaced since BEPS Action Plan 5 Final Report itself mentions that the Forum on Harmful Tax Practices (which has developed the nexus approach) does not make any recommendation on the introduction of IP regimes based on the nexus approach. Even more, the proposed provisions do not prescribe any nexus ratio for determining the extent of benefit which the royalty income may enjoy under the Patent Regime.* **|** *Unlike the BEPS Action Plan 5 Final Report, there is no clarity on which type of expenditures (capital / revenue) could be considered to have contributed towards 'development' of a patent. This may also call in doubt the qualification of expenditure incurred by the assessee through genuine arrangements such as Contract R&D.* **|** *Under the definition of 'royalty' income, consideration for sale of product manufactured with the use of patentedprocess or the patented article for commercial use has been expressly excluded. Contrasting this aspect of the aforesaid definition against the definition of 'royalty' as contained in Section 9(1)(vi) may unnecessarily influence the debate on the characterization of payments made for the purchase of shrink wrapped software.)*

4. EXEMPTION FROM DIVIDEND DISTRIBUTION TAX (DDT) ON DISTRIBUTION MADE BY AN SPV TO BUSINESS TRUST

A special tax regime was introduced in the Income Tax Act for taxation of Real Estate Investment Trust ('REITs') and Infrastructure Investment Trust ('Invits') regulated by SEBI. Under this regime, the multiple taxation due to interposition of business trust is avoided. AS per SEBI regulation, these business trusts can hold the income generating asset either directly or through a Special Purpose Vehicle (SPV). Under the SEBI Regulation, SPV is defined to mean any company or Limited Liability Partnership ('LLP') in which REIT holds or proposes to hold controlling interest which is not less than fifty percent of the equity share capital or interest. The SPV should hold at least 80% of the assets in properties and not invest in other SPV.

As per the existing tax regime in case of REITs, the income by way of interest paid by SPV being a companyto REIT is given pass through treatment i.e. it is not taxed at the level of REIT but in the hands of respective investors of REIT. The rental income from directly held assets by REIT is also allowed a pass through treatment. In respect of assets held through an SPV, if SPV is a company then the company pays normal corporate tax and thereafter when the income is distributed to the REIT being a shareholder, it suffers DDT which is paid by the SPV and thereafter the income is exempt both in the hands of REIT and also its investors. In case of Invits, there is a similar regime with only exception being that there is no pass through for Invits holding income generating assets directly as normally such large infrastructure projects are not held directly in the trust but are held through an SPV. As an incentive in the case of sponsor (i.e. the person setting up trust), capital gain arising at time of swap of its shareholding in SPV for units of business trust is deferred both under normal provisions and from applicability of MAT. Such gains get taxed only after actual sale of units.

It has been represented by the stakeholders that levy of dividend distribution tax at the level of SPV when it distributes its current income to the business trust makes the business trust structure tax inefficient and adversely impacts the rate of return for the investor. The use of such a structure is further hindered, as under the SEBI regulations both the SPV and business trust are obligated to distribute 90% of their operating income to the investors, whereas in case of normal real estate company, there is no requirement of such annual distribution of dividends. It has been represented that because of the additional levy of DDT and associated tax inefficiency, these initiatives have not yet taken off.

Therefore, in order to further rationalize the taxation regime for business trusts (REITs and Invits) and their investors, it is proposed to provide a **special dispensation and exemption from levy of dividend distribution tax**. The salient features of the proposed dispensation are:

(a) exemption from levy of DDT in respect of distributions made by SPV to the business trust;
(b) such dividend received by the business trust and its investor shall not be taxable in the hands of trust or investors;
(c) the exemption from levy of DDT would only be in the cases where the business trust either holds 100% of the share capital of the SPV or holds all of the share capital other than that which is required to be held by any other entity as part of any direction of any Government or specific requirement of any law to this effect or which is held by Government or Government bodies; and
(d) the exemption from the levy of DDT would only be in respect of dividends paid out of current income after the date when the business trust acquires the shareholding referred in (c) above in the SPV. The dividends paid out of accumulated and current profits upto this date shall be liable for levy of DDT as and when any dividend out of these profits is distributed by the company either to the business trust or any other shareholder.

This amendment will take effect from 1st June, 2016.

*(**Analysis:**The REITs and Invits were introduced vide SEBI Regulations in 2014. The tax regimes surrounding such structure were brought in though the Finance Act 2014 and further liberalized through Finance Act 2015 [Please refer P.R. Bhuta & Co.'s previous years' Budget analysisfor*

evaluation of the special tax regimes - http://eepurl.com/bhAT8n]. Such tax regimes however continued to be less attractive due to the levy of DDT on the distributions by the SPV. The above exemptions now proposed to be provided by this budget is a welcome relaxation making such structures viable. The other exemptions already available under the Income Tax Act, 1961 in relation to a 'business trust', a 'special purpose vehicle' is defined as an Indian company in which the business trust holds a controlling stake, i.e. at least 50% of the nominal voting capital, the proposed amendment under this Budget for DDT has been provided only to companies in which the business trust holds the entire equity share capital. Therefore, this may restrict the grant of exemption to SPVs where the entire free shareholding is held by the business trust. The treatment of Interest income provided through the Finance Act 2014 shall continue to apply wherein the interest income received by thebusiness trust from SPV is accorded pass through treatment i.e., there is no taxation of suchinterest income in the hands of the trust and no withholding tax at the level of SPV. However,withholding tax at the rate of 5% in case of payment of interest component of income distributedto non-resident unit holders, at the rate of 10% in respect of payment of interest component ofdistributed income to a resident unit holder shall be effected by the trust.)

5. MODIFICATION IN CONDITIONS OF SPECIAL TAXATION REGIME FOR OFF SHORE FUNDS SECTION 9A

Section 9A of the Income Tax Act, 1961 provides for a special regime in respect of offshore funds. It provides that in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund. Further, an eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf is located in India. The benefit under section 9A is available subject to the conditions provided in sub-sections (3), (4) and (5) of this section.

The sub-section (3) of section 9A provides for the conditions for the eligibility of the fund. These conditions, inter-alia, are related to residence of fund, corpus size, investor base, investment diversification and payment of remuneration to fund manager at arm's length.

In respect of residence of the fund, the condition is that the fund has to be resident of a country or territory with which India has entered into a Double Taxation Avoidance Agreement ('DTAA') or Tax Information Exchange Agreement ('TIEA').

In respect of activities of fund, there is a restriction that the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India and shall neither engage in any activity which constitutes a business connection in India nor have any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf

The Government had received representations giving instances whereby a fund may not qualify as a tax resident of a country on account of domestic tax laws or legal framework of the country and thereby unable to benefit from the special regime under Section 9A although India could still be able to collect information regarding fund under the applicable DTAA or TIEA. It had also been further represented that the conditions relating to restriction on fund carrying on business or controlling fund managing business in India or from India restricts the flexibility of operation for funds and focus should be on nature of activities undertaken in India.

Taking into account these representations, it has been proposed to modify these conditions to provide that the eligible investment fund for purposes of section 9A, shall also mean a fund established or incorporated or registered outside India in a country or a specified territory notified by the Central Government in this behalf. It is also proposed to provide that the condition of fund not controlling and managing any business in India or from India shall be restricted only in the context of activities in India.

These amendments are proposed to be effective from Assessment Year 2017-18 (i.e. Financial Year 2016-17) onwards.

*(**Analysis:**This a welcome relaxation removing the hurdle for tax exempt entities (in the country of their establishment) for availing the benefit under this provision. However, it may be kept in mind that there are a host of other conditions to be satisfied in order to avail the benefit under this provision [Such other conditions can be referred to in P.R. Bhuta & Co.'s previous year's Budget analysis - http://eepurl.com/bhAT8n])*

6. ENABLING PROVISION FOR IMPLEMENTATION OF VARIOUS PROVISIONS OF THE ACT IN CASE OF A FOREIGN COMPANY HELD TO BE RESIDENT IN INDIA

The provisions of Section 6 of the Income Tax Act, 1961 provide for conditions in which residence in India is determined in case of different category of persons. Section 6(3) deals with conditions to be satisfied for a company to be treated as resident in India in any previous year. It provides that a company would be resident in India in any previous year if it is an Indian company or its Place of Effective Management ('POEM') in that year is in India.

During the course of assessment proceeding, company claiming to be a foreign company not resident in India may be alleged to have become a resident in India due to its POEM being in India. Consequentially many issues may arise which at present appear to be unresolved. In particular, the issues relate to applicability of specific provisions of the Act relating to Advance tax payment, applicability of TDS provisions, computation of total income, set off of losses and manner of application of transfer pricing regime. These provisions have compliance requirements which would not have been undertaken by the company at relevant time due to absence of any such requirement under tax laws of country of incorporation of such company. Similarly, issues of computation of depreciation also arise when in earlier years it has not been subject to computation under the Income Tax Act, 1961.

In order to provide clarity in respect of these issues, it has been proposed to: -

(a) Defer the applicability of POEM based residence test by one year i.e. from AY 2016-17 to AY 2017-18.

(b) Provide a transition mechanism for a company which is incorporated outside India and has not earlier been assessed to tax in India. The Central Government is proposed to be empowered to notify exception, modification and adaptation subject to which, the provisions of the Act relating to computation of income, treatment of unabsorbed depreciation, setoff or carry forward and setoff of losses, special provision relating to avoidance of tax and the collection and recovery of taxes shall apply in a case where a foreign company is said to be resident in India due to its POEM being in India for the first time and the said company has never been resident in India before.

(c) Provide that these transition provisions would also cover any subsequent previous year upto the date of determination of POEM in an assessment proceedings. However, once the transition is complete, then normal provisions of the Income Tax Act, 1961 would apply.

(d) Provide that in the notification, certain conditions including procedural conditions subject to which these adaptations shall apply can be provided for and in case of failure to comply with the conditions, the benefit of such notification would not be available to the foreign company.

These amendments are proposed to be effective from Assessment Year 2017-18 (i.e. Financial Year 2016-17) onwards.

*(**Analysis:**It may be noted that Section 6(3) of the Income Tax Act, 1961 was amended vide Finance Act 2015 bringing in the concept of POEM w.e.f. FY 2015-16. Thereafter, the Central Board of Direct Taxes ('CBDT') had issued Draft Guidance on POEM on 23rd December 2015 for public comments. [P.R. Bhuta & Co. had suggested improvements on the draft guidelines to the CBDT. They can be referred to in their International Tax alert on POEM - http://eepurl.com/bMR4kH]. However, since the final guidelines have not yet been notified by the CBDT, the applicability of provisions under Section 6(3) of the Income Tax Act, 1961 have been correspondingly deferred by one year. | It may be noted that although the transition mechanism is proposed to cover subsequent previous years upto the date of determination of POEM in an assessment proceedings, subsequent applicability of normal provisions of the Income Tax Act, 1961 thereafter may prove to be of great (avoidable) hardship for companies in whose case an appellate authority may eventually set aside the applicability of POEM altogether.)*

7. EXEMPTION FROM REQUIREMENT OF FURNISHING PAN UNDER SECTION 206AA TO CERTAIN NON-RESIDENTS

The existing provision of Section 206AA of Income Tax Act, 1961, provides for a rate of tax deduction on income chargeable to tax at 20% largely in all cases of payment to non-residents where the Permanent Account Number not quoted by the non-resident payee. The provisions of section 206AA also apply to non-residents with an exception in respect of payment of interest on long-term bonds as referred to in Section 194LC.

It has been proposed to amend the aforesaid Section 206AA so as to provide that its provisions shall also not apply to a non-resident in respect of any other payment, other than interest on bonds, subject to such conditions as may be prescribed.

This amendment is proposed to take effect from 1st June, 2016.

*(**Analysis:**There has been a raging controversy as to whether Section 206AA (being a compliance provision) overrides the respective DTAA. There are even a few judicial decisions which have ruled that the relevant article of respective DTAA (prescribing the rate of tax) would prevail over Section 206AA. The Hon'ble Finance Minister has indicated in his Budget speech that*

alternative documents would be prescribed for furnishing whereby the higher rate under this section would become inapplicable. This amendment would help reign in the hardship caused to the non-residents who do not possess a Permanent Account Number but *receive income from Indian residents.)*

8. APPLICABILITY OF MINIMUM ALTERNATE TAX (MAT) ON FOREIGN COMPANIES FOR THE PERIOD PRIOR TO 01.04.2015

Under the existing provisions of Section 115JB, a company has to pay tax @ 18.5%, if the tax payable on the total income under the normal provisions of the Income-tax Act is lesser than that. Pursuant to the ruling of Advance Authority Ruling in the case of Castleton Investment Ltd. [348 ITR 537], issues were raised regarding the applicability of this provision to foreign companies who do not have a permanent establishment (PE) in India. Vide Finance Act, 2015, the provisions of Section 115JB were amended to provide for exemption from MAT for capital gains earned by foreign companies.

Thereafter, a Committee on Direct Tax matters headed by Justice A.P. Shah was set up by the Government to look into the matter. This Committee recommended for making Section 155JB inapplicable to Foreign Institutional Investors/ Foreign Portfolio Investors (FIIs/FPIs).

In view of the recommendations of this Committee, it has been proposed to amend the Income-tax Act so as to provide that **with effect from 01.04.2001, the provisions of section 115JB shall not be applicable to a foreign company if** -

(i) the assessee is a resident of a country or a specified territory with which India has a DTAA <u>and</u> the assesse does not have a permanent establishment in India; or
(ii) the assessee is a resident of a country with which India does not have a DTAA <u>and</u> the assessee is not required to seek registration under any law for the time being in force relating to companies.

This amendment is proposed to be made effective retrospectively from the 1st day of April, 2001 and shall accordingly apply in relation to Assessment Year 2001-02 and subsequent years.

*(**Analysis:**With this amendment, the controversy of applicability of MAT in India to foreign companies will be put to rest.)*

9. RATIONALIZATION OF TAX DEDUCTION AT SOURCE PROVISIONS RELATING TO PAYMENTS BY CATEGORY-I AND CATEGORY-II ALTERNATE INVESTMENT FUNDS TO ITS INVESTORS

The Finance Act, 2015 had inserted a special taxation regime in respect of Category-I and II Alternative Investment Funds ('AIFs') registered with SEBI. The special taxation regime was intended to ensure tax pass through status in respect of these AIFs which are collective investment vehicles. The special regime is contained in sections 10(23FBA), 10 (23FBB), 115UB and 194LBB of theIncome Tax Act, 1961.

Detailed analysis of this regime has been elucidated in P.R. Bhuta & Co.'s previous year's Budget analysis- http://eepurl.com/bhAT8n. As per these provisions, the income of the investment fund (not being in the nature of business income) is exempt in the hands of investment fund but income received by the investor from the investment fund (other than income which is taxed at the level of investment fund) is taxable in the hands of investor. The existing provisions of section 194LBB provides that in respect of any income credited or paid by the investment fund to its investor, a tax deduction at source ('TDS') shall be made by the investment fund @ 10% of the income. Under section 197 of the Act, facility for certificate for deduction of tax at lower rate or no deduction is available in respect of sections enumerated therein, if the Assessing Officer is satisfied that total income of the recipient justifies issue of such certificate, section 194LBB is currently not included in this provision.

Therefore, several hardships were faced by non-resident investors as they were not able to claim benefit of lower or NIL rate of taxation which is available to him under relevant Double Taxation Avoidance Agreement (DTAA), and deduction of tax @10% was to be undertaken mandatorily even if under DTAA, the income is not taxable in India.

In order to rationalise the TDS regime in respect of payments made by the investment funds to its investors, it is proposed to amend section 194LBB to provide that the person responsible for making the payment to the investor shall deduct income-tax under section 194LBB at the rate of ten per cent where the payee is a resident and at the rates in force where the payee is a non-resident (not being a company) or a foreign company. Further, it is proposed to amend section 197 to include section 194LBB in the list of sections for which a certificate for deduction of tax at lower rate or no deduction of tax can be obtained. Consequential changes are also proposed to be made to the definition of "rates in force" so as to include section 194LBB in it.

These amendments will take effect from 1stJune, 2016.

*(**Analysis:**With this amendment, the hardships faced by non-resident investors has been remedied. Rates in force is defined under section 2(37A) of the Income Tax Act. This means that the withholding rate would be the rates that are applicable under the ITA or those in accordance with the applicable DTAA, whichever is more favorable. In continuation of the existing provisions, distributions to residents shall require a tax deduction @ 10%.)*

10. NEW TAXATION REGIME FOR SECURITISATION TRUST AND ITS INVESTORS

The Finance Act, 2013 introduced a special tax regime for securitization trusts. Under this regime, the existing provisions of Chapter-XII-EA of the Income Tax Act consisting of sections 115TA, 115TB and 115TC, provide for the taxation of income of the securitisation trusts and the investors of such trusts.

The regime provides that income distributed by the securitisation trust to its investors shall be subject to a levy of additional tax to be paid by the securitisation trust within 14 days of distribution of income. The distribution tax shall be paid @ 25% if the distribution is made to an individual or a Hindu undivided family (HUF) and @ 30% if the distribution is to others. Further, no distribution tax is to be levied if the distribution is made to an exempt entity. Consequent to the levy of distribution tax, the income of the investor, received from the securitisation trust, is exempt under section 10(35A) of the Act and the income of securitisation trust itself is exempt under section 10(23DA) of the Act.

One of the main concern under the current regime was that the trusts set up by reconstruction companies or the securitisation companies are not covered although such trusts are also engaged in securitisation activity. These companies were established for the purposes of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and their activities are regulated by the Reserve Bank of India (RBI). Another issue surrounding the existingregime was providing for final levy in the form of distribution tax is tax inefficient for the investors specially the banks and financial institutions. Further, the non-resident and resident investors are unable to take benefits of their specific tax status.

In order to rationalize the tax regime for securitisation trust and its investors, and to provide tax pass through treatment, it is proposed to amend the provisions of the Act to substitute the existing special regime for securitisation trusts by a new regime having the following elements:

(i) The new regime shall apply to securitisation trust being an SPV defined under SEBI (Public Offer and Listing of Securitised Debt Instrument) Regulations, 2008 or SPV as defined in the guidelines on securitisation of standard assets issued by RBI or being setup by a securitisation company or a reconstruction company in accordance with the SARFAESI Act;

(ii) The income of securitisation trust shall continue to be exempt. However, exemption in respect of income of investor from securitisation trust would not be available and any income from securitisation trust would be taxable in the hands of investors;

(iii) The income accrued or received from the securitisation trust shall be taxable in the hands of investor in the same manner and to the same extent as it would have happened had investor made investment directly in the underlying assets and not through the trust;

(iv) Tax deduction at source shall be effected by the securitisation trust at the rate of 25% in case of payment to resident investors which are individual or HUF and @ 30% in case of others. In case of payments to non-resident investors, the deduction shall be at rates in force;

(v) The facility for the investors to obtain low or nil deduction of tax certificate would be available;

(vi) The trust shall provide breakup regarding nature and proportion of its income to the investors and also to the prescribed income-tax authority. Further, it is proposed to provide that the current regime of distribution tax shall cease to apply in case of distribution made by securitisation trusts with effect from 01.06.2016.

These amendments will take effect from 1stJune, 2016.

*(**Analysis:**The entire tax regime applicable to securitisation trust has been given an entire face lift. By this proposed amendment, a pass through status has been accorded on such securitisation trusts. The income of an investor of a securitization trust will also be deemed to be of the same nature and shall be in the same proportion as in the hands of the securitization trust. Such break up of nature of income is to be provided by the trust to all the investors. However, in the Finance Bill, 2016 it is provided that if the income of a securitization trust in a given year, is not paid or credited to investors, it shall be deemed to have been credited to the account of the investors on the last day of such year in the same proportion in which the investors would have been entitled to receive the income had it been paid in such year. This would entail tax deduction in a situation even where the income is not actually paid nor is it credited to the investor.)*

11. BEPS ACTION PLAN - COUNTRY-BY-COUNTRY REPORT AND MASTER FILE

Currently, Sections 92 to 92F of the Act stipulate the Transfer Pricing Regulations in India. Specifically, Section 92D of the Act requires the maintenance of prescribed information and document (enumerated in Rule 10D of the Income Tax Rules) relating to the international transaction and specified domestic transaction.

The OECD report on Action 13 of BEPS Action plan provides for revised standards for transfer pricing documentation and a template for country-by-country reporting. India has been one of the active members of the BEPS initiative and part of international consensus. BEPS in its report has recommended that the countries should adopt a standardized approach to transfer pricing documentation. Accordingly, a three-tiered structure has been mandated consisting of:

- **a master file** containing standardised information relevant for all multinational enterprises (MNE) group members
- **a local file** referring specifically to material transactions of the local taxpayer; and
- **a country-by-country report** containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group

The above three-tiered approach, taken together (i.e. country-by-country report, master file and local file) will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks. It will facilitate tax administrations to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

The **master file** is intended to provide an overview of the MNE groups business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk. In general, the master file is intended to provide a**high-level overview** in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context. The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country. In that aspect, information in master file would be more comprehensive than the existing regular transfer pricing documentation. The master file shall be furnished by each entity to the tax authority of the country in which it operates.

Therefore, in order to implement the above international consensus of Action 13 of the BEPS Action Plan, this budget has proposed to insert a specific reporting regime in respect of the country-by-country reporting and master file. The essential elements w.r.t. to country-by-country reporting have been proposed by insertion of section 286 and detailed Rules shall be notified soon. The elements relating to country-by-country reporting requirement and matters related to it proposed to be included through amendment of the Act have been explained in detail in our analysis.

The Finance Bill, 2016 has proposed that the requirement of maintenance and filing of the country-by-country report shall be applicable to those international groups whose consolidated revenues in the preceding year exceeds a prescribed threshold. The Memorandum to the Bill has applied the limit set in the OECD BEPS Action 13 report of Euro 750 Million. Therefore, by way of example, CbC Report shall be required to be filed for an international group having Indian parent for the previous year 2016-17 (FY 2016-17) if the consolidated revenues of the group exceeded Rs. 5395 crores for the previous year 2015-16 (FY 2015-16) although the monetary limit would be dependent upon the equivalent exchange rate prevailing at the year end.

A proposed amendment with respect to maintenance and furnishing of master file has also been made. In respect of the master file, a constituent entity of an international group shall be required to maintain such information and details as shall be prescribed in the rules. Period of furnishing of such master file to the prescribed authority and manner of furnishing shall also be prescribed in the rules. For Non furnishing of the information and documents to the prescribed authority, a penalty of Rs. 5,00,00/- could be levied.

*(**Analysis:**The three tiered approach to transfer pricing documentation of Master file, Local file and country-by-country reporting recommended by BEPS Action 13 was required to be implemented in the local legislations of the participating countries. This amendment in the Finance Bill has therefore largely followed the OECD BEPS report on Action 13.*

The requirement of filing the country-by-country report to the tax administration is expounded as follows:

Particulars	***Who to file CbC Report***	***Due date***
If the parent entity is resident in India	*CbCR is to be filed with Indian tax authorities by the parent entity*	*CbCR to be filed by due date of filing Return of Income u/s 139(1)*
• *Constituent entity whose parent entity is not a resident in India; or* • *The group has designated an alternate reporting entity of the international group who is not resident in India*	• *Constituent entity is required to inform the Indian authorities the country/territory of residence of the parent / alternate reporting entity of the international group to which is belongs* • *CbCR is to be filed with the tax authorities by the parent / alternate reporting entity in the country in which it is resident*	*Such authority to whom and date by which such information has to be furnished is to be prescribed*
Constituent entity whose parent / alternate reporting entity is not a resident in India and • *Such entity is a resident in a country with which India does not have an agreement of for Exchange of Information of the CbC*	*CbCR is to be filed with Indian tax authorities by the Indian constituent entity*	*CbCR to be filed by due date of filing Return of Income u/s 139(1)*

Report; or • *There has been a systemic failure [1] of the country or territory and the said failure has been intimated by the prescribed authority to such constituent entity*		
If there are more than 1 entities of the same group in India	*The group can designate (under intimation in writing to the prescribed authority) the entity that shall furnish the report on behalf of the group.*	

A parent entity has been defined to be an entity which is required or would have been required to prepare consolidated financial statements under the applicable laws. The format of the country-by-country report and the manner of furnishing the report shall be prescribed and shall be based on the template provided in the OECD BEPS report on Action Plan 13. The report would contain (a) the aggregate information in respect of the amount of revenue, profit or loss before income-tax, amount of income-tax paid, amount of income-tax accrued, stated capital, accumulated earnings, number of employees and tangible assets not being cash or cash equivalents, with regard to each country or territory in which the group operates;(b) the details of each constituent entity of the group including the country or territory in which such constituent entity is incorporated or organised or established and the country or territory where it is resident; (c) the nature and details of the main business activity or activities of each constituent entity; and (d) any other information as may be prescribed. The tax authorities may call for documents and information from the entity furnishing the CbC Report for verifying the accuracy of the report by notice in writing. Such details are required to be produced within 30 days of receipt of the notice (may be extended by a period of 30 days). Penalty provisions applicable to country-by-country reporting is as under:

i. *For non-furnishing of the report by an entity which is obligated to furnish it, a graded penalty structure would apply:-*
   a. *if default is not more than a month, penalty of Rs. 5000/- per day applies;*
   b. *if default is beyond one month, penalty of Rs. 15000/- per day for the period exceeding one month applies;*
   c. *for any default that continues even after service of order levying penalty either under (a) or under (b), then the penalty for any continuing default beyond the date of service of order shall be @ Rs 50,000/- per day;*

ii. *In case of timely non-submission of information before prescribed authority when called for, a penalty of Rs. 5000/- per day applies. Similar to the above, if default continues even after service of penalty order, then penalty of Rs.50,000/- per day applies for default beyond date of service of penalty order;*

[1] "systemic failure" has been defined where a country or territory has an agreement with India providing for exchange of the report, but—
(i) in violation of the said agreement, it has suspended automatic exchange; or
(ii) has persistently failed to automatically provide to India the report in its possession in respect of any international group having a constituent entity resident in India.'.

iii. *If the entity has provided any inaccurate information in the report and,-*

   a. *the entity knows of the inaccuracy at the time of furnishing the report but does not inform the prescribed authority; or*
   b. *the entity discovers the inaccuracy after the report is furnished and fails to inform the prescribed authority and furnish correct report within a period of fifteen days of such discovery; or*
   c. *the entity furnishes inaccurate information or document in response to notice of the prescribed authority, then penalty of Rs.500,000/- applies;*

The entity can offer reasonable cause defence for non-levy of penalties mentioned above.)

FDI Reforms in Budget 2016

Our Hon'ble Finance Minister announced significant changes in the existing Foreign Direct Investment Regulations ('FDI Regulations') in the Union Budget 2016 thereby proposing significant relaxations in foreign investment limits in some of the few key sectors, including insurance, pension and asset reconstruction companies, to accelerate the foreign investments and facilitate ease of doing business in India. Some of the key amendments proposed in the Budget with respect to FDI Regulations are as under:

1. INSURANCE & PENSION SECTOR

Provisions under FDI Regulations: Foreign Direct Investments (FDI) in the insurance and pension sectors upto 26% is allowed under the automatic route, however, approval from Foreign Investment Promotion Board (FIPB) would be required for FDI beyond 26%, but up to the cap of 49%.

Proposed Amendment: The Budget proposes that FDI be permitted in the insurance and pension sectors up to 49 per cent under the automatic route, subject to the guidelines on Indian management and control, to be verified by the regulators.

*(**Analysis:**This change should be a welcome move for both industry players and investors, and is intended to benefit the society at large.)*

2. ASSET RECONSTRUCTION COMPANIES ('ARCS')

Provisions under FDI Regulations: Under the present FDI Regulations, no government approval is required for any foreign investments up to 49% in an ARC and the same will be permitted under the automatic route. Approval from FIPB would be required for any FDI beyond 49%.

Proposed Amendment: FDI up to 100% be allowed in an ARC, without obtaining any government approval. Foreign Portfolio Investors (FPIs) will be allowed to invest up to 100% (74% presently under the FDI Regulations) of each tranche in securities receipts issued by ARCs, subject to sectoral caps.

*(**Analysis:**ARCs play a crucial role in resolution of non-performing assets by acquiring them from banks and financial institutions. Recognizing this, the above proposal is intended to help banks and financial institutions address the problem of huge NPAs, and to help improve credit ratings of ARCs, which will bring down the cost at which they borrow money and consequently ease the capital requirements of the ARC; however, the same may only be expected in the long term.)*

3. MARKETING OF FOOD PRODUCTS PRODUCED AND MANUFACTURED IN INDIA

Provisions under FDI Regulations: Under the present FDI Regulations, there are no specific provisions for retailing and marketing of food products. However, government approval is required to bring FDI upto 51% in multi-brand retailing section (including for food products).

Proposed Amendment: 100% FDI to be permitted in the entities engaged in business of marketing of food products, subject to a clearance from the FIPB, the only condition being that such products are produced and manufactured in India.

*(**Analysis:**This proposal is expected to benefit farmers, create more employment opportunities in the concerned sector, and allow foreign companies buy products from Indian farmers, process it and sell it in the domestic or international markets. However, the definition of 'marketing' shall play an important role in deciding what shall be allowed under this proposal and whether the same aims at retail marketing or wholesale marketing. Also, concerns have been expressed by various trade bodies, who are of the view that this move would amount to partially opening up foreign investment in multi-brand retail trade and allow multi-nationals in the sector through the backdoor.)*

4. STOCK EXCHANGES

Provisions under FDI Regulations: Foreign investors are permitted to invest only up to 5% in recognized stock exchanges in India, subject to the applicable SEBI guidelines/regulations.

Proposed Amendment: The Budget proposes for an increase in the investment limit for foreign investors in stock exchanges upto 15% instead of the existing 5%.

*(**Analysis:**This change is suggested to make the investment limit of the foreign investors at par with the investment cap of the domestic institutions who are permitted to hold up to 15%. This move seems to be aimed at enhancing global competitiveness of Indian stock exchanges and accelerating adoption of global market practices.)*

5. NON-BANKING FINANCIAL COMPANIES ('NBFCS')

Provisions under FDI Regulations: FDI in NBFCs are permitted under the automatic route however, the same is restricted to only18 (eighteen) identified activities as specifically enlisted in the FDI Regulations.

Proposed Amendment: The scope of FDI in NBFCs to be widened to include other regulated financial activities, in addition to the presently covered 18 specified NBFC activities, and the same shall be allowed under automatic route.

(**Analysis:** *Widening the scope of the foreign investments in NBFC activities would facilitate and ease the infusion and raising of capital by NBFCs.*)

6. OTHER KEY REFORMS PROPOSED IN THE BUDGET WITH RESPECT TO THE FDI REGULATIONS

- The range of eligible instruments for the purposes of FDI may be expanded to include 'hybrid instruments', subject to certain conditions as may be prescribed by the concerned regulators. The proposed list of these hybrid instruments is yet to be finalized.
  Analysis: *This proposal would encourage investors to come up and experiment with more innovative investment structures;*

- FPI's permissible investment limit in Central Public Sector Enterprises, other than banks, listed in stock exchanges, to be increased from 24% to 49%;

- Investment by FPIs to be permitted in unlisted debt securities issued by corporates, and pass through securities issued by securitization SPVs.
  Analysis: *This proposal will help in increasing the depth of the bond market, however the guidelines issued by the Reserve Bank of India in this regard, will play a key role;*

- Foreign investors to be accorded 'Residency Status', subject to certain conditions, instead of existing norm of being granted business visa of 5 years at a time, in order to promote 'Make in India'.
  Analysis: *This is in tandem with the practice followed today in many other countries.*

- Introduction of Centre-State Investment Agreements, whereby states which opt to execute such agreements will ensure fulfillment of their obligations under the Bilateral Investment Treaties.
  Analysis: *This will go a long way in making such states more favorable and attractive destinations to foreign investors.*

Contact Details:

P. R. Bhuta & Co.,
Chartered Accountants
2-I, Jeevan Sahakar, 2nd Floor,
Sir P.M. Road,Fort,
Mumbai – 400 001, India.
Phone: +91 22 22660010,
+91 22 22663427
www.bhutaco.com

ANB Legal,
Advocates & Solicitors
Jai-Hind Building, Unit Nos. 2&3,
3rd Floor, 106, N.M. Road, Fort,
Mumbai – 400 023, India.
Phone: +91 22 22626549,
+91 22 65501112
www.anblegal.in