INDIA BUDGET 2016-17

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INTRODUCTION

The Indian Finance Minister presented the Union Budget for 2016-17 ("Budget 2016-17") and Finance Bill, 2016 in Parliament on February 29, 2016. Along with proposed amendments to the tax law, key economic figures (as per the annual economic survey) and policy proposals were also announced.

The proposals indicate that India is poised to experience sustainable growth, owing to favorable macro-economic factors and demographics, rising income, greater urbanization, and increasing focus on manufacturing activities. The positive domestic outlook is offset by turmoil in the global economic climate, characterized by uncertainty, low growth, and turbulent financial markets. For financial year ("F.Y.") 2016-17, the International Monetary Fund ("I.M.F.") projects 7.5% growth in India, while the estimates for global economic growth plummeted from 3.4% for 2014 to 3.1% for 2015. The negative Wholesale Price Index ("W.P.I.") of -2.8% and a reduction in the Consumer Price Index ("C.P.I.") from 5.9% in F.Y. 2014-15 to 4.95% in F.Y. 2015-16 highlight the stability of the Indian economy. Adherence to the fiscal deficit target of 3.5% is a sign of the Indian government's commitment to fiscal discipline.

Budget 2016-17 places an emphasis on infrastructure development, financial sector reforms, ease of doing business, education and skill development, and job creation.

This article focuses on key proposals of Finance Bill, 2016.

POLICY ANNOUNCEMENTS

Infrastructure and Investment

- Total outlay of I.N.R. 2.18 trillion (approximately $32.5 billion) is proposed for roads and railways.
- A bill is to be introduced regarding resolution of disputes in infrastructure-related construction contracts and Public Private Partnership ("P.P.P.") and public utility contracts. Guidelines will be issued for renegotiation of P.P.P. Concession Agreements.
- A dedicated fund is to be set up by the Life Insurance Corporation of India ("L.I.C.") to provide credit enhancement to infrastructure projects.
- A new credit rating system is to be set up for infrastructure projects.

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Fiscal Discipline

- The fiscal deficit will be set as a target range rather than a fixed number, by way of an amendment to the Fiscal Responsibility and Budget Management Act, 2003 ("F.R.B.M. Act").

Relaxation of Foreign Direct Investment ("F.D.I.") Policy

- 100% F.D.I. will be allowed in marketing of food products produced and manufactured in India under the Foreign Investment Promotion Board ("F.I.P.B.") approval route.
- Investment in insurance and pension sectors will be allowed up to 49% under the automatic route for government approval.
- 100% investment in asset reconstruction companies will be permitted under the automatic route for government approval.
- The investment limit by foreign entities in Indian financial exchanges will be increased from 5% to 15%, which is on par with domestic institutions.
- The investment limit for Foreign Portfolio Investors ("F.P.I.'s") investing in listed central public sector enterprises (other than banks) will be increased to 49%.
- F.D.I. will be allowed in additional activities beyond the 18 Non-Banking Financial Company activities specified under the automatic route for governmental approval.
- Hybrid instruments will be included among eligible F.D.I. instruments.

Financial Sector

- A comprehensive code on the resolution of bankruptcy situations of financial firms will be introduced.
- New derivative products are to be developed by the Securities and Exchange Board of India ("S.E.B.I.") in the commodity derivatives market.
- A proposed I.N.R. 2.50 billion (approximately $37.5 million) will be devoted to recapitalization of public sector banks.

Governance and Ease of Doing Business

- Amendments will be made to the Companies Act, 2013 to improve ease of doing business and to enable the registration of companies in a single day.

INCOME TAX PROPOSALS

Most direct tax proposals in Finance Bill, 2016 are effective from F.Y. 2016-17, *i.e.*, from April 1, 2016 unless otherwise specifically stated.

Tax Rates

The basic tax rates for domestic and foreign companies will remain unchanged, at

30% and 40%, respectively. Separately, for companies having turnover or gross receipts not exceeding I.N.R. 50 million (approximately $750,000) in F.Y. 2014-15, the basic rate of tax will be reduced to 29%.

Newly-established[1] domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%. Companies that exercise this option will not be eligible for deductions and reliefs that are otherwise allowable, except for the deduction for compensation paid to additional workmen employed.

"Newly-established domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%."

The basic rate of tax for individuals will remain unchanged. However, the rate of surcharge that is levied on the amount of income tax will be increased to 15% for individuals earning income in excess of I.N.R. 10 million (approximately $150,000) in any financial year.

The basic rates of tax for Minimum Alternate Tax ("M.A.T.") and Dividend Distribution Tax ("D.D.T.") will remain unchanged, at 18.5% and 15%, respectively.

Taxation of Dividend Income Exceeding I.N.R. 1 Million

Under existing domestic tax law, where a dividend is paid by an Indian company, the Indian company is required to pay 15% D.D.T. on the amount of the dividend, plus a surcharge and education cess.[2] Once these amounts are paid, the dividend is exempt from further tax in the hands of the recipient, whether resident or nonresident ("N.R.").

It is now proposed that dividends received by resident individuals and firms in excess of I.N.R. 1 million (approximately $15,000) will be taxed at 10%, on a gross basis. If implemented, this proposal will have numerous adverse consequences. Most notably, it will amount to the same income being taxed three separate times:

- Corporate tax imposed on the corporation
- D.D.T. imposed on the corporation
- Proposed tax of 10% on the shareholder

This provision also has the effect of discriminating between residents and N.R.'s. Further, it will adversely affect promoters holding shares directly and may lead to disputes over the taxability of dividends in the case of taxable non-business trusts that receive dividends exceeding I.N.R. 1 million, even if the shares of individual beneficiaries are less than I.N.R. 1 million.

Provisions Relating to N.R.'s

Equalization Levy to Tax B2B E-commerce Transactions

It is proposed that a 6% "equalization levy" will be charged on the gross amount of consideration for specified services received or receivable by an N.R. that does not have a permanent establishment ("P.E.") in India when the consideration is received from residents carrying on a business or profession in India or N.R.'s having a P.E. in India.

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1 *I.e.*, incorporated on or after March 1, 2016.

2 A cess is a type of tax levied by the Indian Tax Authorities, which must be used for a particular purpose, here education.

No levy will be charged in any of the following fact patterns:

- The N.R. providing the specified service has a P.E. in India and the specified service is connected with the P.E.
- The total consideration received/receivable by the N.R. does not exceed I.N.R. 100,000 (approximately $1,500) in any F.Y.
- The services are not provided for the purpose of carrying on a business or profession.

Income on which the equalization levy is charged will be exempt from income tax.

The payer of a consideration that is subject to the equalization levy will be required to deduct the levy from the amount payable to an N.R. If no deduction is made by the payer, a deduction for the entire consideration will be disallowed in computing the income of the payer.

Procedures for collection of the levy, interest, penalties, and prosecution are in *pari materia* with withholding tax provisions under the domestic tax law.

This provision has been introduced to extend the scope of taxation to transactions relating to the digital economy and is based on the recommendations of the O.E.C.D. committee on base erosion and profit shifting ("B.E.P.S."). At present, income from digital economy transactions is not taxable in India, in accordance with India's Double Taxation Avoidance Agreements ("D.T.A.A.'s"), since the relevant foreign entities do not maintain a P.E. in India. However, these transactions are intended to be brought under the ambit of taxation by way of introduction of the equalization levy.

"It may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is per se not a 'tax' under the domestic tax law."

However, it may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is *per se* not a "tax" under the domestic tax law. For U.S. companies that provide services to Indian clients from locations in the U.S., the income is domestic-source income. Consequently, even if the tax is an income tax under U.S. concepts, it cannot be used to offset U.S. income tax on the consideration received.

The proposed amendment will be effective from a date to be stipulated by the Indian government.

Tax Incentives for International Financial Services Centers ("I.F.S.C.'s")

Various incentives are proposed with regard to entities set up in an I.F.S.C. to enable the I.F.S.C.'s to become international financial hubs.

Securities Transaction Tax ("S.T.T.") will not be payable on transactions in securities undertaken on a recognized stock exchange located in an I.F.S.C. In addition, the existing exemption from Long Term Capital Gains ("L.T.C.G.'s") will be extended to transactions undertaken in foreign currency on a recognized stock exchange by an entity located in an I.F.S.C., even if no S.T.T. is paid on such transactions.

Companies located in an I.F.S.C. will be entitled to pay M.A.T. at a reduced rate of 9%, if the income of such companies is derived solely in foreign exchange.

Further, no tax will be levied on distributions of profits by a company located in an I.F.S.C. that derives income solely in foreign exchange, and such dividend income will also not be taxable in the hands of the recipient.

These are welcome measures to promote the growth of I.F.S.C.'s.

Application of M.A.T. to Foreign Companies for the Period Prior to April 1, 2015

The issue of the application of M.A.T. on foreign companies has been a matter of long-standing debate.

It has been now clarified that M.A.T. will not be applicable to foreign companies with effect from F.Y. 2000-01, if

- the foreign company is a resident of a country or specified territory with which India has a D.T.A.A. and such company does not have a P.E. in India, or
- the foreign company is a resident of a country with which India does not have a D.T.A.A. and such company is not required to seek registration under the Companies Act in India.

This clarification will be greatly appreciated by foreign companies.

Rationalization of Withholding Tax Provisions for Categories I and II Alternative Investment Funds ("A.I.F.'s")

Income of the fund that is not business income will be exempt in the hands of the fund. In addition, income received by the investor from the investment fund, other than specified income that is taxed at the fund level, will be taxable in the hands of investor in the same manner as if the investment were made directly by investor.

The person responsible for making the payment to the investor will be required to withhold tax at 10% where the payee is a tax resident. If the payee is an N.R., the rate will be specified and may change from time to time. A certificate for deduction of tax at a lower rate may also be obtained from a tax officer.

This proposed amendment will be effective from June 1, 2016.

Country-by-Country ("CbC") Reporting

It is proposed that a three-tier structure will be implemented for transfer pricing documentation and CbC reporting, in accordance with the recommendations of the O.E.C.D. committee on B.E.P.S. Specified information will be required to be reported in the prescribed formats, if the consolidated revenue of the multinational enterprise ("M.N.E.") group exceeds the specified threshold.

- CbC reporting would involve the following:
- Local file – containing material transactions of the local taxpayer
- Master file – containing standardized information relevant to all M.N.E.'s in the group
- CbC reporting – containing information about global allocation of the M.N.E. group's income and taxes along with the location of economic activity within the M.N.E. group

Exemption of Income of a Foreign Company Accruing from the Storage and Sale of Crude Oil

Income accruing or arising to a foreign company from the storage of crude oil in a facility in India and the sale of the stored crude oil to any person resident in India will be exempt, provided that such storage and sale by the foreign company is made pursuant to an agreement entered into and/or approved and notified by the Indian government.

The proposed amendment will be effective retrospectively from F.Y. 2015-16.

Relaxation of the Conditions of the Special Taxation Regime for Offshore Funds

The provision dealing with certain activities that are not considered to constitute a business connection in India has been relaxed to include funds established, incorporated, or registered in a country or a specified territory that is identified by the Indian government. Also, the existing requirement preventing funds from controlling and managing any business in or from India has been diluted so that only activities carried on in India are subject to the prohibition.

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Place of Effective Management ("P.O.E.M.") and the General Anti-Avoidance Rule ("G.A.A.R.")

Implementation of a P.O.E.M.-based residency test for foreign companies will be deferred to April 1, 2016. Under these rules, a foreign company is treated as being resident in India if its P.O.E.M. is in India; this means that key management and commercial decisions that are necessary for the conduct of its business, as a whole, are made in substance in India.

For G.A.A.R., the scheduled effective date of April 1, 2017, remains unchanged.

Exemption from the Requirement to Furnish a Permanent Account Number ("P.A.N.")

The higher rate of withholding tax in the absence of a P.A.N. will not apply to N.R. or foreign companies for payments of interest on long-term bonds or any other payments, subject to prescribed conditions.

Tax Incentives for Start-ups

Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups. A 100% deduction of profits will be available to an eligible, certified, start-up company that is

- incorporated after March 31, 2016 but before April 1, 2019, and
- engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property.

The deduction will be available for any consecutive three-out-of-five F.Y.'s after the date of incorporation of the start-up.

L.T.C.G. will be exempt if it is invested after March 31, 2016 in units of a fund that is identified by the Indian government as a qualified fund. The exemption is capped at

I.N.R. 5 million (approximately $75,000). Further, exemption will be provided if the L.T.C.G. is invested in the subscription of shares of a company that qualifies as an eligible start-up, subject to certain conditions.

Taxation of Income from Patents

A new section will be introduced to tax gross royalty income, at a concessional rate of 10%, arising from a patent developed and registered in India. However, M.A.T. provisions will be applicable to such companies. This provision will apply to a person resident in India, who is the true and first inventor.

D.D.T. on Distributions Made by a Special Purpose Vehicle ("S.P.V.") to a Business Trust

D.D.T. will not be imposed on distributions made by an S.P.V. to Real Estate Investment Trusts ("R.E.I.T.'s") or Infrastructure Investment Trusts ("Inv.I.T.'s") holding prescribed shareholdings. In addition, dividends received by R.E.I.T.'s or Inv.I.T.'s and their investors will be exempt from tax. The exemption is allowed only in respect of dividends paid out of current income generated after the date of purchase of shares of the S.P.V. by a R.E.I.T. or Inv.I.T. This proposal is expected to have a positive impact on the establishment of R.E.I.T.'s and Inv.I.T.'s. These collective investment vehicles have not been widely utilized by investors since their enactment.

Amortization of Spectrum Fees

A new provision is announced to provide for amortization of the amount actually paid to acquire rights to use radio frequency spectrum for telecommunication services. The amortization will be allowed in equal installments over the license period.

Disallowance of Expenditures Incurred in Connection with Exempt Income

Currently, under the domestic tax law, no deduction is allowed for expenses incurred in connection with earning income that is exempt from tax. In the absence of a one-to-one correlation between exempt income and the expenditure specifically incurred to earn such income, tax officers generally disallow a part of the total expenses claimed as a deduction by the taxpayer based upon a formula for computing the disallowance. In certain fact patterns, the amount of the disallowance can be greater than the actual expenditure incurred. This has been a long standing topic of dispute between taxpayers and tax examiners in India.

The budget announces provisions redressing the problem. The disallowance will be computed at 1% of average monthly value of investments yielding exempt income and will be capped at the amount of the actual expenditure. Implementation rules will be announced in coming months.

Phasing out of Deductions and Incentives

Certain profit-linked deductions and exemptions, included weighted deductions, will be phased out under the budget. In addition, the highest rate of depreciation will be restricted to 40% with effect from April 1, 2017.

Tax Dispute Resolution Scheme

In order to reduce the huge backlog of pending appeal matters, a new scheme for resolution of disputes will be introduced. The scheme relates to "tax arrears" in respect of matters pending before the first level appellate authority and "specified taxes" in respect of pending matters relating to retrospective amendments, as of February 29, 2016, and provides as follows:

Tax Arrears

- If the declarant pays the entire disputed tax demand plus interest up to the date of the scrutiny order, it will be deemed that the appeal has been withdrawn, and the taxpayer will be granted immunity from penalty and prosecution, subject to exceptions in the following paragraphs.
- If the disputed tax liability exceeds I.N.R. 1 million (approximately $15,000), a 25% minimum penalty will be due in addition to tax and interest.
- In the case of pending appeals against a penalty order, a 25% minimum penalty will be due in addition to tax and interest payable.

Specified Taxes

- The taxpayer will be required to pay the amount of disputed tax and will be granted immunity from interest, penalty, and prosecution.
- The taxpayer will be required to withdraw the relevant appeals, notices, or claims filed with an authority.

The proposed dispute resolution scheme will be effective from June 1, 2016.

Income Declaration Scheme, 2016

A new scheme will be introduced to provide an opportunity for taxpayers to disclose previously undisclosed domestic income, pertaining to the period up to F.Y. 2015-16. Tax will be payable at 30% on such income along with a 7.5% surcharge and a 7.5% penalty, resulting in an effective tax rate of 45%.

The proposed amendment will be effective from June 1, 2016, and the scheme will remain open till a date that will be notified subsequently.

Various other measures are proposed with a view to rationalize and simplify the taxation system and to transition toward a non-adversarial tax regime.

INDIRECT TAX PROPOSALS

Service Tax

- The 0.5% *Krishi Kalyan* cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the *Swachh Bharat* cess of 0.5%, which was introduced from November 15, 2015.
- Service tax exemptions in respect of the following services are withdrawn:
  - Construction services in respect of monorail and metro projects, to be taxed at a basic rate of 5.6% after abatement

- Air conditioned stage carriages, to be taxed at a basic rate of 5.6% (in line with service tax on contract carriages)
- Transport by cable car, ropeway, and tramway, to be taxed at 14%[3]

- Exemptions are given to the following services:
  - Housing projects under affordable housing schemes (*i.e.*, 30m^2 in four metropolitan areas and 60m^2 in other areas) are exempt as of March 1, 2016.
  - Services rendered by Pension Fund Regulatory and Development Authority/Employees Provident Fund Organization/Insurance Regulatory and Development Authority of India and S.E.B.I. are exempt as of April 1, 2016.[4]
  - Government-sponsored cold chain, biotechnology, and vocational training and cultural projects are exempt as of April 1, 2016.

"The 0.5% Krishi Kalyan cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the Swachh Bharat cess of 0.5%."

- A single premium insurance policy will attract service tax at 1.4%, rather than the existing 3.5% rate, from April 1, 2016.
- Service tax is levied on Indian shipping lines along with the full input tax credit ("I.T.C.") available, so as to ensure parity with foreign shipping lines.
- Service tax is levied on a receipt basis and payment of service tax is made on a quarterly basis for One Person Companies ("O.P.C.'s") and Hindu Undivided Families ("H.U.F.'s").
- The C.E.N.V.A.T. credit rules have been amended to give an option to banks and financial institutions to either reverse 50% of I.T.C. or reverse only part of the credit in proportion to exempt service turnover *vis a vis* total turnover.
- A clarification had been made that the allocation of radio frequency spectrum by the Indian government will be a taxable service and not a sale of intangible goods.
- Further clarifications include mutual exclusivity of application of service tax and excise duty on one taxable event.
- Interest rates and abatements have been rationalized in line with those applicable to customs duty and excise duty payments, except when the taxpayer has collected and not paid the service tax, in which case the rate of interest is increased to 24% per annum.
- The limit for prosecution for wrongful withholding of service tax has been increased to I.N.R. 20 million (approximately $300,000), from I.N.R. 10 million (approximately $150,000) under prior law.
- The limitation period for under-collection or underpayment of service tax has been extended from 18 months to 30 months when not attributable to fraud, collusion, or misrepresentation.

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[3] This will increase costs for tourists and hence may be a retrograde step, in so far as promoting India as a tourism destination is concerned.

[4] Previously only services rendered by the R.B.I. were exempt.

Excise Duty

- An infrastructure cess in the range of 1% to 4% will be levied on all motor vehicles, depending on the length of the motor vehicle, engine capacity, etc.
- The clean environment cess will be increased from I.N.R. 200 (approximately $3) per ton to I.N.R. 400 (approximately $6) per ton.

SUMMARY

Budget 2016-17 demonstrates the government's intent to promote balanced, long-term growth in India through fiscal discipline, infrastructure development, job creation, and tax and financial sector reforms. In particular, the focus on infrastructure projects has been praised by IMF chief Christine Lagarde.[5] Although Budget 2016-17 does not contain broad provisions aimed at attracting large multinational enterprises, it offers a number of more modest proposals, such as tax incentives to encourage investment through R.E.I.T.'s and Inv.I.T.'s, easing of restrictions on foreign direct investment, and benefits for start-ups and manufacturing businesses, which will strengthen the private sector and position India for sustainable, high growth rates on par with major global economies such as the U.S. and China.

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[5] "India's Fiscal Stance Sensible: IMF's Christine Lagarde," NDTV, March 13, 2016, where Ms. Lagarde is quoted as saying:

> We consider that the fiscal stance adopted by India is exactly appropriate and a very sensible objective that has been set. It's just the right one that has been set under the given circumstances.