INDIA BUDGET 2017-18

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The Indian Finance Minister ("F.M.") presented the budget for financial year ("F.Y.") 2017 to 2018 ("Budget 2017-18") in parliament on February 1, 2017. Along with proposed amendments to the tax law, key economic numbers from the annual economic survey and additional policy proposals were announced.

Budget 2017-18 was presented in an economic environment fraught with the challenges of the recent demonetization exercise and weak investor sentiment, set amidst a V.U.C.A. world. This budget therefore posed a daunting task for the F.M., requiring him to achieve equilibrium between growth, job creation, and fiscal prudence on one hand and popular expectations on the other.

Budget 2017-18 is unique in three aspects. For the first time in Indian history, the Rail Budget has been folded into the country's fiscal plan, the bifurcation between plan and non-plan expenditures has been eliminated with a view towards focusing on capital and revenue expenditure, and the budget presentation to the parliament was advanced by a month.

Demonetization has caused short-term disruption in the Indian economy and has slowed down demand and consumption. The gross domestic product ("G.D.P.") growth forecast for F.Y. 2016-17 was reduced to 7.1% from the earlier estimate of 7.6%. The impact of demonetization on the G.D.P. is not, however, expected to spill over into the next year, and coupled with the roll out of the new goods and services tax ("G.S.T."), it is expected to spur G.D.P. growth in the long run. The wholesale price index ("W.P.I.") has reversed from -5.1% to 3.4%, while consumer price index ("C.P.I.") has declined from 6% in July 2016 to 3.4% in December 2016. The current account deficit has declined from 1% of G.D.P. in F.Y. 2015-16 to 0.3% of G.D.P. in the first half of F.Y. 2016-17.

Budget 2017-18 focuses on infrastructure, agriculture, rural development, and housing, in order to bolster growth through job creation and the elimination of black money. The F.M. outlined the Budget 2017-18 proposals under the "Transform, Energize and Clean India" agenda for the next year.

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KEY POLICY ANNOUNCEMENTS

Some of the important policy announcements from Budget 2017-18 are described below.

Foreign Investment Policy

- The Foreign Investment and Promotion Board ("F.I.P.B.") is to be abolished in F.Y. 2017-18, and the roadmap to this end will be announced in the next few months.

- Further liberalization of the Foreign Direct Investment ("F.D.I.") policy is under consideration and pertinent announcements will be made in due course.

Financial Sector

- To improve ease of doing business, the registration process for financial market intermediaries, such as mutual funds, brokers, and portfolio managers, will now be handled online.
- With a view towards enhancing the operational flexibility and ease of access to Indian capital markets, a common application form will be introduced for the registration and opening of bank accounts and Demat[1] accounts, and for the issuing of permanent account numbers ("P.A.N.'s") for foreign institutional investors ("F.I.I.'s") and foreign portfolio investors ("F.P.I.'s").
- The commodities and securities derivative markets will be unified further through the integration of the participant, broker, and operational frameworks.
- Systematically important non-banking finance companies ("N.B.F.C.'s") that are regulated by R.B.I. and are above a certain net worth will be categorized as qualified institutional buyers, thereby making them eligible for participation in initial public offerings ("I.P.O.'s") with specifically earmarked allocations. This will help to strengthen the I.P.O. market and channelize more investments.

Digital Economy

- Digital payment infrastructure and grievance handling mechanisms will be strengthened.
- A proposal to mandate that all government receipts exceeding a certain amount be handled through digital means is being considered.

Labor Law Reforms

- Legislative reforms are to be undertaken to simplify, rationalize, and amalgamate the existing labor laws into four codes: wages, industrial relations, social security and welfare, and safety and working conditions.

Railways and Infrastructure

- About 7,000 stations with solar power are to be created in the medium term.
- A new Metro Rail Policy will be introduced with a focus on innovative models of implementation and financing, as well as standardization and indigenization of hardware and software.
- A new Metro Rail Act will be introduced to increase private participation and investment in construction and operation.
- Airports in Tier 2 cities will be taken up for operation and maintenance using the public-private partnership ("P.P.P.") model. The Airport Authority of India

[1] The term "Demat" refers to dematerialization of investment accounts. Stock certificates for publicly traded companies are being phased out and replaced with electronic accounts.

Act will be amended to enable the effective monetization of land assets. The resources, so raised, will be utilized for airport upgrades.

- 2,000 kilometers of coastal connectivity roads are to be constructed.

Housing

- By 2019, 10 million new houses are to be constructed.
- To facilitate greater investment in affordable housing, housing projects will be afforded the status of infrastructure, subject to certain conditions, thereby enabling such projects to receive the associated benefits.

KEY DIRECT TAX PROPOSALS

The direct tax proposals discussed below are effective for F.Y. 2017-18, *i.e.*, from April 1, 2017, unless otherwise specifically stated.

Rates of Tax

No change is proposed on the rates of tax, surcharges, and education cess for partnership firms, limited liability partnerships, and foreign companies for F.Y. 2017-18.

For domestic companies, the rate of tax is proposed to be reduced from 30% to 25% in cases where the company's total turnover or gross receipts for F.Y. 2015-16 did not exceed I.N.R. 500 million ($7.5 million).

"For individuals with a total income between I.N.R. 250,001 ($3,750) and I.N.R. 500,000 ($7,500), the rate of tax is proposed to be reduced from 10% to 5%."

For individuals with a total income between I.N.R. 250,001 ($3,750) and I.N.R. 500,000 ($7,500), the rate of tax is proposed to be reduced from 10% to 5%. It is further proposed to levy a surcharge at 10% where an individual's total income is between I.N.R. 5 million ($75,000) and I.N.R. 10 million ($150,000).

No change is proposed for the rate of Minimum Alternate Tax/Alternate Minimum Tax ("M.A.T./A.M.T."). However, the carryforward of M.A.T./A.M.T. credit is now proposed to be allowed for 15 years instead of the present limit of 10 years.

Indirect Transfer of Assets

Budget 2017-18 proposes to clarify that the provisions relating to the indirect transfer of assets will not apply to the transfer of an asset or a capital asset held by a nonresident, directly or indirectly, in an F.I.I. that has been notified by the government and has registered as a Category I or Category II F.P.I. with the Securities and Exchange Board of India ("S.E.B.I"). This clarification will help to alleviate the concerns of investors in F.I.I.'s and F.P.I.'s and is welcome. However, no similar relief is proposed to be provided to private equity funds or venture capital funds investing in Indian securities.

The proposed amendment is effective as of April 1, 2011, *i.e.*, from the year in which the provisions relating to indirect transfer of assets were introduced into domestic tax law.

Special Taxation Regime for Offshore Funds

Eligible offshore investment funds carrying out fund management activities in India through an eligible fund manager are neither considered to be resident in India nor

to be constituting a business connection in India, subject to the fulfilment of certain conditions. One of the specified conditions is a requirement to maintain the fund's monthly average of the corpus at a minimum of I.N.R. 1 billion ($15 million). It is proposed to do away with this requirement in the year in which the fund is wound up.

The proposed amendment is effective from April 1, 2015, *i.e.*, from the year in which the special taxation regime for offshore funds was introduced into domestic tax law. However, no relief is proposed in respect to several other onerous conditions that are required to be fulfilled by offshore funds.

Interpretation of Terms Used in Agreements Entered into with Different Countries

Budget 2017-18 proposes to clarify that any term used in a double taxation avoidance agreement ("D.T.A.A.") entered into between the government of India and the government of any other country will be assigned the meaning as provided in the D.T.A.A. In cases where a term is not defined in the D.T.A.A., the term will be assigned the meaning as defined in Indian domestic tax law or any other explanation issued by the government of India. This amendment seeks to reverse the decision of the High Court in a past judgment, wherein it was held that unless the context otherwise requires, it would be impermissible to interpret a particular expression that was not defined in a D.T.A.A. by ascribing to it the meaning drawn from the definition of a different term in the domestic law.

Provisions Relating to Transfer Pricing – Secondary Adjustments in Transfer Pricing Cases

In order to align India's transfer pricing provisions with the O.E.C.D.'s transfer pricing guidelines and international best practices, Budget 2017-18 proposes that a resident taxpayer entering into an international transaction will be required to carry out secondary adjustments in cases where the primary adjustment has been made in any of the following ways:

- *Suo moto* by the taxpayer in his return of income
- By the tax authority, and accepted by the taxpayer
- As determined by an advance pricing agreement
- As per safe harbor rules
- As a result of a mutual agreement procedure ("M.A.P.") under a D.T.A.A.

It is further proposed that where, due to a primary adjustment to the transfer price, there is an increase in total income or reduction in loss to the taxpayer and excess funds available to its associated enterprise ("A.E.") are not repatriated to India within the prescribed timeframe such excess will be deemed to be an advance made by the taxpayer to its A.E., the interest on which will be computed as income of the taxpayer.

However, the secondary adjustment would not be carried out if the following conditions were met:

- The amount of the primary adjustment made by the taxpayer in any F.Y. does not exceed I.N.R. 10 million ($150,000).

- The primary adjustment is made in respect to F.Y.'s prior to F.Y. 2016-17.

Thin Capitalization Rules

A new provision is proposed to be introduced to curb companies from enjoying excessive interest deductions. This provision will be in line with the recommendations of O.E.C.D. B.E.P.S. Action 4.

The new provision seeks to restrict the deduction for interest expenses paid or payable by an entity to its A.E.'s to 30% of its earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). This provision will be applicable to an Indian company or the permanent establishment ("P.E.") of a foreign company that pays interest exceeding I.N.R. 10 million ($150,000) on any form of debt issued to a nonresident or the P.E. of a nonresident and which is an A.E. of the borrower. Such excess interest will not be deductible in the hands of the Indian company or P.E.

Further, the debt will be deemed to be issued by an A.E. where it provides an implicit or explicit guarantee to the lender, or where it deposits a corresponding and matching amount of funds with the lender. Such disallowed interest expenses will be allowed to be carried forward for eight F.Y.'s immediately succeeding the F.Y. for which the disallowance was first made, and deduction against income computed under the heading of "profits and gains of business or profession," to the extent of the maximum allowable interest expenditure, will be permitted.

Banking and insurance businesses would be excluded from the scope of the thin capitalization provisions.

Minimum Alternate Tax ("M.A.T.")

Currently, companies are required to pay M.A.T. at 18.5% of their book profits (computation of which is specified by law) if the tax payable as per the regular provisions of the domestic tax law after considering all other allowable deductions is less than 18.5% of the book profits. The time limit for the carryforward of the difference between the M.A.T. paid and the tax payable under the normal tax provisions, referred to as M.A.T. credit, is now proposed to be increased to 15 years from the present limit of 10 years. No M.A.T./A.M.T. credit will be allowed if the credit relates to the difference between a foreign tax credit ("F.T.C.") allowed against the M.A.T./A.M.T. and an F.T.C. allowed against the tax computed under the regular tax provisions.

As the adoption of Indian Accounting Standards ("Ind. A.S.") is a mandatory requirement for certain companies as of F.Y. 2016-17, it is proposed to introduce a framework for the computation of book profits for such companies in the first year of their adoption of Ind. A.S. and thereafter.

Extending the Period to Claim Tax Deductions and Carry Forward Loss for Start-Ups

A 100% deduction of profits is available to eligible start-ups that were incorporated after March 31, 2016, and before April 1, 2019, and are engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property. The deduction is available for any three consecutive F.Y.'s out of a block of five years after the date of incorporation of the start-up.

In view of the fact that start-ups may take time to derive profit from their business, it is now proposed to increase the period of the block from five years to seven years. It is also proposed that in the case of a change in the shareholding structure of an eligible start-up company during an F.Y., the loss incurred during the period of seven years beginning from the year in which such company is incorporated will be carried forward and set off against the income of that F.Y. if 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 F.Y. in which the loss is set off.

Capital Gains

Definition of Long-Term Capital Asset

To make the real estate sector more attractive to investors, it is proposed to reduce the holding period required to qualify as a long-term capital asset for land or buildings from 36 months to 24 months.

Shifting of Base Year for Computation of Capital Gains

The base year for calculating the indexed cost of acquisition for the purposes of computing capital gains has been proposed to be changed from the year beginning April 1, 1981, to the year beginning April 1, 2001. The cost of acquisition in relation to any capital asset acquired before April 1, 2001, will be the cost of the acquisition of the asset to the taxpayer or the fair market value ("F.M.V.") of such asset as of April 1, 2001, at the option of the taxpayer. Thereafter, the actual cost of improvement incurred after April 1, 2001 will only be considered when calculating the indexed cost of acquisition.

Conversion of Preference Shares to Equity Shares

To provide tax neutrality on the conversion of preference shares of a company into equity shares of that company, it is proposed that such conversion will not be regarded as a "transfer" for the purposes of capital gains. The cost of acquisition and the holding period of such preference shares will be considered to be part of the cost and the total holding period of the converted equity shares. Therefore, the conversion of preference shares into equity shares will not be considered a taxable event.

Fair Market Value to be Full Value of Consideration in Certain Cases

In cases were the full value of consideration for a transfer of shares of a company (other than quoted shares) is less than the F.M.V., the F.M.V. will be deemed to be the full value of consideration. This may impact private equity investors who are thought to sell stocks of closely held companies to other financial investors at prices that are lower than the F.M.V.

Tax on Certain Long-Term Equity Shares or Units

At present, any income arising from the transfer of specific long-term capital assets, *i.e.*, an equity share in a company, a unit of an equity-oriented fund, or a unit of a business trust, is exempt from tax provided that such transaction is subject to securities transaction tax ("S.T.T.").

It is proposed that the above exemption will not be granted to the transfer of equity

shares in a company if the transaction to acquire such equity shares was entered into on or after October 1, 2004, without payment of S.T.T. However, to preserve the exemption for genuine cases where the S.T.T. could not have been paid (such as for the acquisition of shares in an I.P.O.; follow on public offering ("F.P.O."), bonus, or rights issue by a listed company; or an acquisition by nonresidents in accordance with the F.D.I. policy) it is proposed to eliminate the condition of chargeability to S.T.T. upon acquisition of shares in specific cases of transfer, which will be notified by the government.

Computation of Capital Gains in Case of Joint Development Agreement

For individuals and Hindu Undivided Families ("H.U.F.'s") entering into a specific agreement for the development of a project, capital gains arising from the transfer of a capital asset (whether land or building or both) will be taxable in the year in which a certificate of completion for the whole or a part of the project is issued by the competent authority.

The full value of consideration for the purposes of computing such capital gains will be the total of the stamp duty value of the taxpayer's share in the project on the date of issuance of the certificate of completion and the monetary consideration received, if any. The benefit of the proposed regime will not apply to a taxpayer if he or she transfers his or her share in the project to any other person on or before the date of issue of the certificate of completion, in which case the taxpayer will be liable for capital gains in the year in which the transfer takes place. The cost of acquisition of the share in the developed project in the hands of such taxpayer will be the amount that is deemed to be the full value of consideration. Tax at the rate of 10% will be withheld from the monetary consideration payable under the specific agreement.

This amendment has been proposed with the intent to minimize the ambiguity in the interpretation of the meaning of "transfer," which has long been the subject of litigation.

Extension of Capital Gains Exemption to Rupee-Denominated Bonds

The transfer of rupee-denominated bonds (issued by an Indian company outside India) held by a nonresident to another nonresident will be exempt from capital gains tax. Any gains arising due to forex appreciation of the rupee-denominated bonds in the computation of capital gains at the time of redemption will also be extended to secondary holders of such bonds.

Tax on Income from a Transfer of Carbon Credits

The taxation of carbon credits has been litigated in many cases, and various courts and tribunals have taken the view that such a credit is a capital receipt. However, one court held a sale of carbon credits to be revenue in nature, and this matter is pending before the Apex Court. Budget 2017-8 proposes to provide that the gross income from the transfer of carbon credits will be taxed at a concessional rate of 10% (plus surcharge and education cess). No expenditure or allowance in respect to such income will be allowable as a deduction.

Cost of Acquisition in a Tax Neutral Demerger of a Foreign Company

The transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company is not regarded as a transfer under the domestic tax law.

It is proposed to clarify that the cost of acquisition of such shares in the hands of the resulting foreign company will be the same as it was in the hands of the demerged foreign company.

Widening the Scope of "Income from Other Sources"

Budget 2017-18 proposes to extend to all taxpayers the taxation of the receipt of any sum of money exceeding I.N.R. 50,000 ($750) or any movable or immovable property without consideration or with inadequate consideration (as defined). Currently, this provision is applicable only to individuals and H.U.F.'s, and to firms and companies only with respect to shares of unlisted companies.

Tax on Dividends

Budget 2017-18 proposes to expand the scope of the tax on dividends inserted by Finance Act 2016 that was applicable only to resident individuals, H.U.F.'s, and firms (including L.L.P.'s). Accordingly, the proposal will tax dividends exceeding I.N.R. 1 million ($15,000) in the aggregate in the hands of all resident taxpayers except the following:

- Domestic companies
- Certain approved trusts, funds, or institutions established for charitable or religious purposes

Nonresident taxpayers continue to remain outside the scope of this provision.

The proposed amendment eliminates any opportunity for tax planning by corporations and their promoters by setting up an intermediary trust or Association of Persons ("A.O.P.").

Transparency in Electoral Funding

Budget 2017-18 proposes that income received by political parties should be exempt, subject to the following conditions:

- No donations exceeding I.N.R. 2,000 ($30) are to be received in cash.
- All political parties are required to file a return of income on or before the prescribed due date.

An amendment is proposed to the Reserve Bank of India Act, 1934, to provide for the issuance of electoral bonds to facilitate the funding of political parties via banking channels. Political parties will not be required to furnish the name and address of the donors who contribute by way of electoral bond.

Withholding Tax Provisions

Interest Payable to a Nonresident Taxpayer on Borrowings in Foreign Currency

The concessional rate of 5% withholding tax on interest on borrowing made under a loan agreement or by way of any long-term bond, including a long-term infrastructure bond, which is applicable until July 1, 2017, is proposed to be extended to July 1, 2020. Further, the benefit of the lower rate of withholding tax of 5% is also proposed to be extended to rupee-denominated bonds issued outside India before July 1, 2020. The proposed amendment will be effective as of April 1, 2015.

Interest Payable to Qualified Foreign Investors

The concessional rate of 5% withholding tax, which is applicable to interest payments to F.I.I.'s and qualified foreign investors ("Q.F.I.'s") in respect to investments in government securities and rupee-denominated corporate bonds made before July 1, 2017, is now proposed to be extended to July 1, 2020.

Disincentives for Cash Transactions

"To promote digital transactions with a view towards transitioning to a 'less cash' economy and tackling the issue of growing black money, several amendments are proposed."

In order to promote digital transactions with a view towards transitioning to a "less cash" economy and tackling the issue of growing black money, several amendments are proposed to reduce the limit of permissible cash transactions. Specifically, no cash transactions will be permitted for amounts exceeding I.N.R. 300,000 ($4,500). Further, penalties are proposed to be introduced for contravention of the restrictions on to cash transactions.

KEY INDIRECT TAX PROPOSALS

Given the impending introduction of the G.S.T. by July 1, 2017 or thereabout, there are few noteworthy amendments and proposals regarding the indirect tax laws in Budget 2017-18. Nevertheless, the F.M. has tried to address issues such as inverted duty structure in the chemicals sector, de-incentivizing the drain of vital mineral resources from India, and boosting the renewable (solar and biogas) energy sector.

The F.M. asserted in his budget speech that the G.S.T., by far the biggest tax reform since India's independence, is on schedule and that preparation of the information technology ("I.T.") system for G.S.T. is progressing well. He assured the business community at large that extensive outreach efforts to trade and industry for G.S.T. will start from April 1, 2017.

The key indirect tax proposals are briefly discussed below.

Service Tax

- The effective service tax rate remains unchanged at 15% (service tax at 14%, *Swachh Bharat* cess at 0.5%, and *Krishi Kalyan* cess at 0.5%).
- Services provided by select airline operators to the government, including the transportation of passengers by air either embarking from or terminating at Regional Connectivity Scheme ("R.C.S.") Airport, weighed against consideration in the form of viability gap funding ("V.G.F."), have been exempted from service tax with effect from February 2, 2017. This exemption will not be available more than one year from the date of the commencement of operations at R.C.S. Airport, as advised by the Ministry of Civil Aviation.
- A one-time, upfront amount collected by the State Government Industrial Development Corporation Undertaking from industrial units for the grant of the long-term lease of industrial plots (for 30 years or more) is proposed to be exempted from service tax retrospectively from June 1, 2007, *i.e.*, when the service of the "renting of immovable property" was made exigible to service tax.
- For the purposes of the reversal of the central value added tax ("CENVAT") credit on common input services under Rule 6(3) or 6(3A) of the CENVAT

Credit Rules, 2004 ("C.C.R. 2004") by banks and financial institutions, including N.B.F.C.'s, the value of services provided by way of extending deposits, loans, or advances – insofar as the consideration is represented by interest or a discount – will form part of the value of the exempted services (with effect from February 2, 2017).

Customs Duty

- The standard ad valorem rate of basic customs duty ("B.C.D.") remains unchanged at 10%. The education cess and secondary and higher education cess will also continue to apply to B.C.D.
- The following proposals will be effective as of the date of assent on Finance Bill, 2017:
  - It is proposed that the provisions relating to unjust enrichment will not apply to cases where the refund is given in relation to excess duty paid by the importer prior to the order permitting the clearance of goods for home consumption and the same is evident from the bill of exchange filed.
  - Facilities for the storage of imported goods in public warehouses for up to 30 days has been extended to imported goods that cannot be removed for warehousing within a reasonable time.

Excise Duty

- The standard ad valorem rate of excise duty remains unchanged at 12.5%.
- In the case of a transfer of business undertakings or a change in ownership, a timeframe of three months has been prescribed for permission to be granted for the transfer of accumulated CENVAT credit under Rule 10 of C.C.R. 2004. This period could be further extended by six months by the Principal Commissioner/Commissioner of Central Excise (with effect from February 2, 2017).

CONCLUSION

The provisions in Budget 2017-18 that relate to infrastructure, the financial sector, accountability, prudent fiscal management, and tax administration reflect a view that times are changing in India. The government appears to remain steadfast in bringing the tax and regulatory environment up to global standards.

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