DEMISTIFYING KEY COMPLEXITIES OF THE INDIA BUDGET 2024-25

Authors
Jairaj Purandare
Shibani Bakshi
Siddhita Desai

Tags
Budget 2024-25
India

INTRODUCTION

The Indian finance minister ("F.M.") presented Budget 2024-25 (the "Budget") on July 23, 2024, This was the current F.M.'s record-breaking seventh consecutive budget and the first budget after the Modi-led N.D.A. 3.0 government was back in power. Subsequently, on August 7, 2024, amendments were made to some of the direct tax proposals announced in the Budget.

BUDGET AT A GLANCE

During financial year ("F.Y.") 2023-24, the Indian economy emerged strong and resilient with a gross domestic product ("G.D.P.") growth rate of 8.2%. Surpassing the United Kingdom, India has sprinted to the position of the fifth largest economy in the world, and is not far from overtaking Japan and Germany to attain the third spot.

Budget 2024-25 continues to focus on four major categories: (i) the poor, (ii) women, (iii) youth, and (iv) farmers. Some of the noteworthy policy proposals announced in the Budget include the following areas of focus:

- Agriculture
- Five schemes for employment and skill upgrading
- The development of road connectivity projects
- Women-led development
- Irrigation and flood mitigation
- The promotion of tourism
- The simplification of foreign direct investment
- Opportunities to use the Indian Rupee for overseas investments

Overall, Budget 2024-25 is testimony to the fact that the Indian economy continues to grow. With a growth rate of over 7% for the third consecutive F.Y., the economy is on track to achieve its goal of "Viksit Bharat," or "Developed India," by 2047, which is the centennial anniversary of India's independence.

KEY AMENDMENTS IN THE DIRECT TAX SPACE

On the tax front, the Budget offered a blend of promising measures and some less favorable elements.

Jairaj Purandare is the Founder & Chairman of JMP Advisors Pvt Ltd, a leading advisory firm, based in Mumbai, India. He has over four decades of experience in tax and business advisory matters. He is an authority on tax and regulation in India.

Shibani Bakshi is an Associate Director with JMP Advisors Pvt. Ltd. She has more than 17 years of experience in advising clients on domestic and international tax matters, with a particular focus on the financial services sector.

Siddhita Desai is an Associate with JMP Advisors Pvt. Ltd in Mumbai, India with experience in international and domestic tax.

This article discusses some of the significant direct tax proposals announced in the Budget. The direct tax proposals discussed below are effective for F.Y. 2024-25, *i.e.*, from April 1, 2024, onwards, unless otherwise stated.

Corporate Tax Rate

Generally, Indian domestic tax law provides different base tax rates for domestic and foreign companies. Earlier, domestic companies were taxed at a base rate of 30% and smaller domestic companies with a turnover of up to INR 4 billion (~$50 million) were taxed at a base rate of 25%. In addition, domestic companies were required to pay a dividend distribution tax ("D.D.T.") at a base rate of 15% on profits distributed by way of dividends. The base rate of tax for foreign companies has been 40% since F.Y. 2002-03, with no additional taxes on the distribution of profits.

Both domestic and foreign companies are required to pay a surcharge, as applicable, on top of the base tax, as well as a health and education cess[1] of 4%, which is levied on the aggregate of the base tax and surcharge, if any. The surcharge is an additional tax that must be paid by taxpayers earning a higher level of income, determined based on their legal entity status and in accordance with the income thresholds specified in the tax law. The health and education cess is required to be paid by all taxpayers and is an additional tax collected to specifically fund the government's health and education initiatives.

Domestic as well as foreign companies were also subject to the provisions of the minimum alternate tax ("M.A.T."), which is computed at the base rate of 15% on book profits.

The applicability of the D.D.T. to domestic companies narrowed the gap between the headline tax rates for foreign companies and domestic companies.

In September 2019, a new optional tax regime was introduced for domestic companies. Under this optional regime, the rate of tax for domestic companies was reduced from 30% to 22%, subject to a taxpayer meeting certain conditions. This resulted in a maximum tax rate of 25.17% (including the surcharge and health and education cess) for domestic companies which opted for the new regime. Domestic companies which opted for this regime were also not subject to M.A.T. provisions.

Subsequently, from F.Y. 2020-21 onwards, the D.D.T. was abolished and the taxation of dividend was shifted to the recipients of the dividend.

The reduction in the corporate tax rate for domestic companies along with the elimination of the D.D.T. significantly widened the gap between the base tax rates applicable to foreign companies (40%) and domestic companies (22%). Globally, the general practice is to have a tax rate parity across all kinds of entities within the same industry.

The Indian government has reviewed various proposals to reduce the corporate tax rate applicable to foreign companies and address this disparity. The tax law was amended to lower the base corporate tax rate for foreign companies from 40% to 35% as of April 1, 2024. With this decrease in the base rate, the maximum effective tax rate for foreign companies is reduced from 43.68% to 38.22%. This long-awaited amendment brings considerable relief for foreign companies.

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[1] A cess is a form of charge that is used to fund a specific purpose.

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TAXATION OF CAPITAL GAINS

In General

As per the domestic tax law, income is computed under five headings, one of which is capital gains. Income arises under this heading when a person transfers a capital asset as defined in the tax law.

Capital gains are further categorized as either long-term capital gains ("L.T.C.G.") or short-term capital gains ("S.T.C.G.") based on the holding period of the asset.

The taxation of capital gains in India is quite complex as compared to global markets, and requires the taxpayer to consider various aspects, including

- the type of asset;
- the holding period of the asset;
- differences in the rates of tax for different asset classes, including specific provisions for financial assets (equity and debt);
- differences in the rates of tax based on the residence status of the transferor; and
- the availability of an indexation benefit.

"Capital gains are further categorized as either long-term capital gains or short-term capital gains based on the holding period of the asset."

Further, the capital gains tax regime has undergone various revisions over the past few years. In order to attract foreign investments and create a vibrant Indian economy, simple and predictable tax treatment is of paramount importance.

With a view towards simplifying the capital gains tax regime, various amendments have been introduced in the Budget which will take effect from July 23, 2024. Some of the key amendments are discussed below.

Holding Period of Asset

Firstly, the tax law has been amended to provide for only two holding period rules to determine whether a capital gain is an S.T.C.G. or an L.T.C.G. The holding period for L.T.C.G. treatment is 12 months for listed securities. The term "listed securities" under Indian domestic tax law refers to securities which are listed on a recognized stock exchange in India. For all other assets, the holding period for L.T.C.G. is 24 months. The 24-month holding period applies to unlisted securities and to securities which are listed on foreign stock exchanges.

Base Rates of Tax

L.T.C.G.

Under the earlier tax law, L.T.C.G.'s were taxed at a base rate of either 10% or 20% depending on the asset class. The Budget has amended the base rates of tax on L.T.C.G.'s to create uniformity across all asset classes.

Under the amended provisions, the base rate of tax on an L.T.C.G. has been standardized at 12.5% for all asset classes. On one hand, this provision has resulted in a favorable change for certain assets, such as unlisted shares and real estate, which

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were generally taxed at 20% under prior law. However, for assets such as listed shares and units of equity-oriented mutual funds, the rate of tax was increased from 10% to 12.5%.

S.T.C.G.

Under the existing tax law, the base rate of tax on an S.T.C.G. was either 15% or the relevant tax rate applicable to the respective taxpayer (which could range from 5% to 40%, depending on legal entity status and income level). Now, the base rate of tax on S.T.C.G.'s will be 20% or the relevant tax rate applicable to the taxpayer. This amendment has resulted in an increase in the tax rates applicable to the transfer of certain short-term capital assets, such as equity shares, units of equity-oriented mutual funds, and units of a business trust, from 15% to 20%. Gains arising from the transfer of other short-term capital assets will continue to be taxed at the relevant rates applicable to the respective taxpayer.

Further, under the revised provisions, capital gains from the transfer, redemption, or maturity of certain classes of assets will be taxed as S.T.C.G.'s irrespective of the period of holding. Assets subject to S.T.C.G. treatment include

- unlisted bonds and debentures;
- market-linked debentures; and
- units of specified mutual funds that invest more than 65% in debt and money market instruments.

The rate of tax on these assets will be the relevant tax rate applicable to the taxpayer. For units of specified mutual funds, grandfathering provisions have been introduced for units purchased before April 1, 2023, and these units will continue to be taxed as either an S.T.C.G. or an L.T.C.G. based on the actual holding period.

Indexation of Cost

Under prior domestic tax law, taxpayers were permitted to reduce L.T.C.G. by applying the indexed cost of an asset instead of the original cost for certain assets. Indexation is essentially a mechanism to adjust the purchase price of assets for inflation.

In the initial Budget announcement, the F.M. announced the withdrawal of the indexation provisions. Thereafter, perhaps taking into consideration the backlash from taxpayers, the provisions relating to indexation were grandfathered for certain assets in the amendments to the Finance Bill.

As per the revised provisions, the benefit of indexation is now available only to resident individuals and certain other resident taxpayers ("Hindu Undivided Families") on the transfer of immovable property which was acquired before July 23, 2024. Accordingly, L.T.C.G. tax on the transfer of immovable property acquired before July 23, 2024 will be computed as the lower of either

- 12.5% on L.T.C.G.'s computed without indexation, or
- 20% on L.T.C.G.'s computed with indexation.

No benefit of indexation will be available in any other case.

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The removal of the indexation benefit will potentially increase the amount of taxable L.T.C.G.'s for assets purchased after July 23, 2024, especially for real estate, which typically are held for long periods of time. This amendment affects many taxpayers.

Basic Exemption Limit for L.T.C.G.

A small increase has been provided in the basic exemption limit on the taxation of L.T.C.G.'s, from INR 100,000 (~$1,200) to INR 125,000 (~$1,500). Accordingly, L.T.C.G.'s will be taxed only if they exceed INR 125,000 (~$1,500) in an F.Y. This exemption is applicable only to L.T.C.G.'s arising from the transfer of certain assets such as equity shares, units of equity-oriented mutual funds, and units of a business trust, which have been subject to payment of securities transaction tax ("S.T.T.")

Parity Between Residents and Nonresidents

In order to bring parity between the taxation of residents and nonresidents, there will be no difference in the rates of tax paid by residents and nonresidents on capital gains. With this amendment, the tax rate on L.T.C.G.'s arising on the transfer of certain classes of assets has been increased from 10% to 12.5%. Assets affected by this rule include:

- Units acquired by an offshore fund in a foreign currency, and
- Bonds of an Indian company or global depository receipts acquired by a non-resident in a foreign currency.

This revision may influence investment and tax planning strategies.

Overall Comment

It may be observed that sweeping amendments have been made to the capital gains tax regime in the Budget. While some of the above amendments, such as a uniform holding period, help in simplifying the capital gains tax regime, the result of certain other amendments may actually be an additional tax burden, such as the withdrawal of the indexation benefit in most cases, or the increase in base tax rates for certain assets. Therefore, there are mixed reactions among taxpayers to these amendments.

ABOLITION OF ANGEL TAX

Over the past few years, India has experienced an unprecedented surge in the creation and funding of start-up companies. However, the growth of the start-up ecosystem was somewhat hampered by the introduction of the "angel tax," starting from F.Y. 2012-13. This was part of various measures introduced to curb the generation and circulation of unaccounted money.

The term "angel tax" refers to the income tax levied on funds raised by unlisted domestic companies in excess of the fair market value ("F.M.V.") of equity shares issued by such companies. This tax generally impacts angel investment in start-ups. For that reason, it is popularly referred to as the "angel tax." The angel tax is required to be paid by unlisted domestic companies. Venture capital undertakings were kept outside the purview of the angel tax. Complex valuation rules were introduced for the determination of the F.M.V. of shares of such companies.

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The angel tax provisions were relaxed slightly in F.Y. 2018-19, to reduce the burden on smaller start-ups. Start-ups having an aggregate share capital and share premium up to INR 100 million (~$1.2 million) were outside the purview of the provisions of the angel tax. The relaxation was effective from April 11, 2018. This limit was further raised to INR 250 million (~$3 million) as of February 19, 2019. However, due to the low exemption threshold, a majority of businesses remained subject to angel taxation.

Initially, the scope of the angel tax was restricted to funds raised by unlisted companies from Indian residents. However, the scope of the angel tax was expanded to cover funds raised from nonresidents, effective from F.Y. 2023-24.

In nascent stages when start-up companies have their greatest need fort funds to build their businesses, start-up companies generally do not have significant value. Consequently, most start-up businesses would fall within the scope of the angel tax. Hence, over the years, angel taxation has continued to be a hindrance to the fundraising capacity of start-ups.

"To boost the start-up ecosystem further and to encourage innovation, the Budget abolishes the angel tax across all classes of investors."

To boost the start-up ecosystem further and to encourage innovation, the Budget abolishes the angel tax across all classes of investors. This amendment is effective for F.Y. 2024-25 onwards. The elimination of the angel tax is viewed as a significant reform that will simplify the funding process for start-ups in India and in turn boost job creation.

TAXATION OF BUYBACK OF SHARES

A buyback of shares or a share repurchase scheme is a corporate action under which a company buys back its own shares from existing shareholders. A buyback is usually undertaken to maintain a majority stake or to distribute surplus cash available within the company.

In general, a company that has distributable profits has two options in order to distribute them to its shareholders: a *pro rata* buyback of shares or a distribution of dividends. Earlier, both modes of distribution were subject to tax in the hands of the company. However, in the past few years, the tax law has been amended to subject the shareholders to tax in both cases.

Prior Law

Prior to its repeal, companies distributing dividends were required to pay a D.D.T. at 15% on the amount of the dividends. The dividends were exempt in the hands of the shareholders. Subsequently, the tax law was amended to abolish the D.D.T. with effect from F.Y. 2020-21. Hence, dividends are now taxed in the hands of the shareholders at their respective tax rates.

On the other hand, net buyback proceeds were taxable in the hands of the shareholders in the form of capital gains at lower tax rates. Since there was no D.D.T. under this mode of distribution, the buyback of shares was a favored mode for distribution of profits by companies.

In order to bring parity to the taxation of the distribution of profits, the tax law was amended with effect from June 1, 2013, to introduce a tax on the buyback proceeds paid to shareholders. Companies were required to pay tax at a flat rate of 20% plus

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the applicable surcharge and health and education cess on such buyback proceeds. Consequently, the income arising from the buyback was exempt in the hands of the shareholders.

Budget Amendment

The Budget has now amended the tax law to align the taxation of buyback proceeds with the dividend regime. Effective October 1, 2024, the flat tax rate of 20% on buy-back proceeds has been eliminated, and buyback proceeds are now treated akin to "deemed dividend income" in the shareholders' hands. No deduction for expenses will be allowed against this deemed dividend and hence, the gross receipts will be subject to taxation at the respective tax rates applicable to the recipient. The domestic company is required to withhold tax at applicable rates on the amount paid to shareholders on the buyback of shares.

Further, under the amended provisions, when a company undertakes a buyback, it will result in the transfer of a capital asset for the shareholder. For the purposes of computing the capital gains on such a transfer, the value of consideration received by the shareholders on a buyback of shares will be deemed to be nil, resulting in a capital loss for the shareholders equivalent to the cost of the shares.

Shareholders will be eligible to set off the above loss against other eligible capital gains earned, in accordance with the provisions of the tax law. This new provision may be less tax efficient for many shareholders. For instance, a shareholder may pay tax on buyback proceeds at the applicable tax rates which could go up to 30% for residents, depending on legal entity status and income level, and 20% for non-residents, including foreign companies subject to tax treaty benefits. However, if this is a long-term asset for the taxpayer, the capital loss on buyback will be permitted to be set off only against L.T.C.G.'s which would have been otherwise taxed at a rate of 12.5%.

The intention of this amendment appears to be to ensure that both methods of distribution of accumulated reserves are taxed similarly. However, frequent amendments in the taxation of buybacks and dividends over the past few years have not gone down well with taxpayers, leading to a sense of uncertainty.

EQUALIZATION LEVY

With the advent of the digital economy in the last decade or so, new business models have given rise to fresh tax challenges globally. The Organization for Economic Co-operation and Development ("O.E.C.D.") issued Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan 1 to address the tax challenges of the digital economy, and set up various task forces to help resolve this issue.

One of the recommendations of the O.E.C.D. was the introduction of the "equalization levy." This levy was intended to tax the significant economic presence of a nonresident enterprise in another country.

India introduced an equalization levy ("E.L.") of 6% on certain online advertising and related services effective from F.Y. 2015-16. Subsequently, India expanded the scope of the equalization levy to include the e-commerce supply of certain goods

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or services by a nonresident e-commerce operator. An E.L. of 2% ("E.L. 2.0") was introduced on consideration received or receivable by e-commerce operators from the e-commerce supply of goods or services. The expansion took effect from F.Y. 2020-21.

E.L. 2.0 is payable by an e-commerce operator who does not have a permanent establishment in India if its turnover from e-commerce operations during the relevant F.Y. exceeds INR 20 million (~$240,000).

Income of nonresidents which has been subject to E.L. and E.L. 2.0 is exempt from other provisions of domestic income tax of India. However, since E.L. as well as E.L. 2.0 were not introduced in the domestic tax law but under a separate Finance Act, taxpayers face a challenge in claiming a foreign tax credit for these levies in accordance with the provisions of double taxation avoidance agreements, causing undue hardship to nonresident taxpayers.

Due to the broad definitions of the terms "e-commerce operator" and "e-commerce supply or services," and a low monetary threshold for applicability of the E.L., many business transactions were covered under the scope of the levy.

In order to address the above issues, E.L. 2.0, *i.e.*, the 2% levy on e-commerce transactions, has been withdrawn with effect from August 1, 2024. However, the E.L. of 6% on specified online advertising services will continue to apply.

The withdrawal of E.L. 2.0 is indicative of the Indian government's intention to ease compliance requirements, encourage the expansion of digital commerce, and guarantee fair tax treatment across various transaction channels. The withdrawal of E.L. 2.0 is expected to provide a major relief to global e-commerce operators.

ANTICIPATED DEVELOPMENTS

Based on the current global developments and the move towards a global minimum tax, the Budget was expected to lay down the roadmap for the implementation of Pillar Two provisions. Contrary to expectations, the Budget is silent on this issue. Equally, the absence of tax reforms for the electric vehicles sector is notable.

In addition, it was expected that the time limit for the concessional tax regime of 15% allowed to certain new manufacturing companies would be extended with a view to spur employment generation. However, the Budget did not address this provision.

The F.M. has announced in her Budget speech that a comprehensive review and complete overhaul of the income tax law will be undertaken within a period of six months. Accordingly, we may see more simplification and rationalization of the tax law in the next Budget, which will be announced in February 2025.

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