DECODING COMPLEXITIES OF INDIA BUDGET 2026-27

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INTRODUCTION

Nirmala Sitharaman, the Indian Finance Minister, presented Budget 2026-27 ("the Budget") on February 1, 2026. Her ninth consecutive Budget has arrived at a defining "Goldilocks moment" in the Indian economic odyssey. During the current Financial Year[1] ("F.Y."), the Indian economy has been navigating the shifting tides of global volatility, looming tariffs, surging bullion prices, cross border tensions, suspended treaties, regional security threats, and rapid technological disruption.

During F.Y. 2025 26, the Indian economy remained resilient, adaptive and robust, posting a strong Gross Domestic Product growth rate of 7.6%[2] despite global turbulence. As we move through the latter half of this decade, the discussion has evolved beyond resilience. Discussions now reflect a bold, accelerated drive toward achieving the vision of *Viksit Bharat* – a developed India by the centennial of Indian independence.

The reform "express train" that is embodied in the Budget moves full steam ahead to (i) sustain the momentum of structural reforms, (ii) strengthen a robust and resilient financial sector, and (iii) advance cutting-edge technologies, including artificial intelligence applications. Some of the noteworthy policy proposals announced in the Budget are as follows:

- Scaling up manufacturing, especially for semiconductors
- Creating champion small and medium enterprises and supporting micro enterprises
- Development of high-speed rail corridors
- Adapting emerging technologies, including artificial intelligence
- Promoting tourism in India and creating hubs for medical value tourism
- Comprehensive review of the banking sector
- Empowering women through education
- Upskilling and job creation

In essence, the Budget aims to provide a strategic masterplan designed to elevate India and transform it from a developing-country mindset to a leadership mindset, while ensuring that the benefits of progress reach the last mile.

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[1] The Financial Year in India runs from April 1 to March 31.

[2] India's Revised G.D.P. Estimates released on February 27, 2026.

NEW INCOME TAX LAW

As part of an effort to modernize and simplify India's six-decade-old tax law, a comprehensive review of the Income tax Act, 1961 ("Old Act") was initiated in 2024 and the Income-tax Act, 2025 ("New Act") was enacted in August 2025. The New Act will be effective from April 1, 2026.

The New Act is more concise than the Old Act and contains provisions that reflect current realities and the digital age, making the overall language simpler. While the intention has been to preserve the core principles of the earlier law, certain simplifications from a drafting perspective may unintentionally leave room for new interpretations, potentially leading to litigation.

Since the New Act was introduced only a few months earlier, it was widely expected that the Budget would contain limited additional changes. Contrary to the expectation, several amendments have been proposed – some welcome, others more stringent.

Several amendments seek to override adverse judicial interpretations through retrospective clarifications. Retrospective alterations of the law, particularly where courts have already interpreted the statutory framework in favor of taxpayers, dilute the principle of finality of judicial decisions and undermine legitimate expectations formed under the law as it previously stood.

Alongside the New Act, rules and forms under the New Act were recently notified. A preliminary review suggests that while certain proposals move towards stricter compliance and more granular reporting, others reflect a much needed simplification considering evolving business realities.

TAX HOLIDAYS FOR NONRESIDENTS

Units in I.F.S.C.'s and O.B.U.'s

India has made a clear, long-term plan to position itself as a competitive global hub for cross border finance and technology. A central element of this strategy is the International Financial Services Centre ("I.F.S.C.") at GIFT City, India's dedicated jurisdiction designed to host cross border financial services under a specialized regulatory regime. The I.F.S.C. offers a platform for banking, insurance, capital markets, fund management, global treasury operations, aircraft and ship leasing and other internationally focused financial activities, all within a ring-fenced environment intended to match the sophistication of established centers such as Singapore and Dubai.

This policy direction has been supported by broader tax reforms aimed at enhancing India's attractiveness:

- Reductions in corporate tax rates
- Lower withholding rates in select cases
- Simplified compliance for specified categories of taxpayers

As a result, the I.F.S.C. ecosystem has expanded rapidly, with over 1,000 registered entities including global banks, insurers, asset managers and fintech firms.

With the I.F.S.C. Act coming into effect in 2019, a new mechanism was introduced that permitted units to avail themselves of a 10 year tax holiday within a 15 year block. Subject to specified conditions, a unit in an I.F.S.C. earning specified income became eligible for a 100% income tax exemption for any 10 consecutive years out of a 15 year block, beginning from the year in which it received registration under the applicable regulatory statutes. This gave businesses greater flexibility by allowing them to align their tax exempt period with their operational growth and business cycles.

A parallel tax holiday exists for units of scheduled banks or Offshore Banking Units ("O.B.U.'s") of foreign banks operating from Special Economic Zones. These units are entitled to a 100% exemption for ten consecutive years, beginning from the tax year in which the requisite regulatory approval is obtained.

To significantly enhance the competitiveness of India's I.F.S.C. framework and provide certainty to global financial institutions, the Budget proposes a substantial expansion of the tax holiday regime. I.F.S.C. units will now be eligible for a profit linked deduction for 20 consecutive years within a block of 25 years, effectively doubling the incentive period. For O.B.U.'s, the law has been amended to grant exemption for 20 consecutive years, beginning from the tax year in which the requisite regulatory approval is obtained.

"A second aspect of the reform is the introduction of a concessional 15% tax rate on business income for the period other than the tax holiday."

A second aspect of the reform is the introduction of a concessional 15% tax rate on business income for the period other than the tax holiday. Compared with the regular corporate tax rate of 35%/22%, this provides entities with both an extended period of zero tax and a stable, low tax rate otherwise. Together, these amendments reflect India's broader policy vision of establishing a globally competitive financial center and signaling long term stability.

Data Centers

Data centers have become a major global investment destination. The data center industry in India is on the cusp of significant growth, with the cumulative installed capacity projected to rise from the current 1 GW to 14 GW by 2035. Estimated industry data suggests that this incremental growth is expected to require more than U.S. $555 million of capital expenditure by the end of the decade.[3]

Against this backdrop, India aims to strengthen long term digital infrastructure by offering greater tax certainty and a supportive policy framework aligned with its broader vision of *Viksit Bharat* by 2047.

A data center ecosystem includes several participants:

- Infrastructure or colocation providers
- Cloud service providers
- Managed service providers

[3] "India's Data Centre Capacity Set to Touch 14GW by 2035." India Brand Equity Foundation (IBEF), December 30, 2025.

- Application providers
- Resellers
- Network service providers
- Disaster recovery and backup service providers

These facilities require high upfront capital investment, long development timelines, and a stable policy environment. A.I. focused data centers require significant expenditure on specialized computing hardware, power and cooling systems, and skilled technical staff.

To attract and anchor this infrastructure, the Budget proposes an exemption for income of a foreign company that arises in (or is deemed to arise in) India from procuring services from a specified data center in India. The proposal is effective April 1, 2026, and remains through the tax year ending March 31, 2047.

Note, however, that this exemption comes with certain conditions, of which the most important are the following:

- The foreign company must be a company notified by the Indian Government.
- It must not own or operate any of the physical infrastructure or resources of the specified data center.
- All sales to customers located in India must be routed through Indian companies.

For the foreign company to be eligible for this exemption, the specified data center will also have to satisfy certain conditions:

- It must be set up under an approved scheme to be notified by the Government.
- It must be owned and operated by an Indian company.

The nature of operations that the Indian company should undertake must include data center services, which are defined to mean service delivery through physical infrastructure and information technology infrastructure, including servers, storage, operating systems, and related hardware and software.

Overall, the amendment strengthens India's appeal to major cloud and A.I. providers by offering a stable tax environment and tax certainty for a period of two decades, which is required for high capex digital infrastructure. The exemption is poised to accelerate the next wave of developments while reducing the risk of Indian source taxation on eligible receipts.

Export Oriented Electronic Contract Manufacturing

Global manufacturers were hesitant to deploy high value equipment in India because foreign-owned machinery located in the country could be viewed as creating a permanent establishment ("P.E."). This potential P.E. exposure and the resulting risk of Indian taxation on attributable income in India discouraged investment in advanced manufacturing.

Income of foreign companies arising from the provision of capital goods, equipment, or tooling to a contract manufacturer in India is proposed to be exempt, subject to specified conditions. The exemption applies where the following conditions are met:

- The capital goods, equipment, or tooling are provided by a foreign company to a contract manufacturer resident in India.
- Ownership of the capital goods, equipment, or tooling remains with the foreign company even though they are under the control and direction of the contract manufacturer (including arrangements akin to rental or lease).
- The contract manufacturer is located in a customs bonded warehouse in India.
- The contract manufacturer produces electronic goods on behalf of the foreign company for consideration.

This exemption is made available for a period of four years up to F.Y. 2030-31.

Nonresident Individuals

In India, an individual becomes taxable on global income if the individual's residential status under the domestic tax law is that of a resident. In practice, nonresident professionals working in India often become residents after spending about three years in the country. To encourage global talent to visit India and provide specialized services, the Budget has introduced a favorable amendment offering a short tax holiday.

It is proposed that the overseas income of a nonresident individual for five consecutive tax years will be exempt from tax in India where the nonresident visits India for the first time to render services in India under an approved program that is yet to be announced.

TRANSFER PRICING

Safe Harbor Regime for Information Technology Services

A safe harbor is defined in the Indian transfer pricing rules as circumstances in which the Indian tax authorities accept the transfer price declared by the taxpayer if the conditions prescribed in the tax law are fulfilled.

Under the current safe harbor regime for transfer pricing, information technology services are divided into several distinct categories:

- Software development services
- I.T. enabled services("I.T.e.S.")
- Knowledge process outsourcing("K.P.O.")
- Contract R&D services relating to software development

Each category has separate revenue thresholds and differing rates, ranging from 17% to 24% safe harbor margins. However, given the highly interconnected nature of these service lines, this fragmented framework has often resulted in classification disputes that reduce certainty for taxpayers.

Recognizing India's position as a global leader in information technology services, a series of far reaching reforms have been proposed to simplify the safe harbor regime. The key change is the creation of a single, unified category for I.T. services by combining software development services, IT.e.S., K.P.O. and contract R&D services relating to software development. A common safe harbor margin of 15.5% will apply to this consolidated category.

In addition, the eligibility threshold for availing the safe harbor option will be significantly increased from I.N.R. 3,000 million (approximately U.S. $33 million) to I.N.R. 20 billion (approximately U.S. $2.2 billion). To enhance transparency, safe harbor applications for I.T. services will be processed through an automated, rule-driven process, without any requirement for tax officers to examine and accept the application. Once an eligible company chooses for the safe harbor regime, it will be allowed to continue using it for a continuous block of five years, unless the company opts out.

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This has been a long standing demand of the I.T./I.T.e.S. industry, and the proposed amendments are particularly significant. The consolidation of multiple service lines into a single unified category combined with a unified lower rate is a welcome reform that is expected to greatly enhance the ease of doing business. It should also help reduce litigation risk and provide much needed certainty to taxpayers operating in this sector.

Advance Pricing Agreements

Under the current Advance Pricing Agreement ("A.P.A.") rules, only the taxpayer that signs the A.P.A. with the tax authorities is allowed to file a modified return of income to give effect to the outcome of the A.P.A. However, an A.P.A. can result in changes in the income of an associated enterprise ("A.E.") of that taxpayer. The law does not allow A.E. to file a revised return or claim a refund of excess taxes paid. Only the taxpayer that filed the A.P.A. can submit a modified return reflecting the revisions necessitated by the A.P.A. To remove this gap, it is proposed to extend the facility of filing modified returns to the A.E.'s as well.

The proposal provides that when income is modified because of an A.P.A., the taxpayer that entered the A.P.A. as well as the A.E. may file modified returns in line with the terms of the A.P.A. The modified returns must be filed within three months from the end of the month in which the A.P.A. is signed. This provision will apply to A.P.A.'s entered on or after April 1, 2026, and will cover the tax year beginning April 1, 2026, and subsequent years.

In addition, targeted fast-tracking of unilateral A.P.A.'s for the I.T. services sector has been proposed. It seeks to ensure that unilateral A.P.A. applications relating to I.T. services are processed and concluded within a period of two years from the date of application, with a one-time extension of up to six months available at the taxpayer's request.

MINIMUM ALTERNATE TAX

India's corporate tax system is built on the principles of source based and residence based taxation, supported by a wide network of income tax treaties designed to prevent double taxation for cross border investors. Residents are taxed on their worldwide income, while nonresidents and foreign companies are taxed only on income that arises from sources in India.

Foreign companies are taxed at the rate of 35% (plus applicable surcharge and cess[4]), whereas domestic companies are generally taxed at a 30% rate. Domestic companies with turnover up to I.N.R. 4,000 million (approximately U.S. $44 million) are taxed at a reduced rate of 25%. In 2019, a new optional regime was introduced, offering a 22% corporate tax rate for domestic companies that forgo specified exemptions and incentives, and a further reduced rate of 15% for new domestic manufacturing companies, subject to conditions (together referred to as the Concessional Tax Regime).

Within this framework, the Minimum Alternate Tax ("M.A.T.") serves as a safeguard for the Revenue. It ensures that companies showing substantial book profits but paying little or no tax under the regular provisions, often due to incentives or adjustments, still pay a minimum amount of tax. Introduced in 1987, the M.A.T. operates similarly to the U.S. alternative minimum tax. When the tax under normal provisions falls below a fixed percentage of book profits (as defined under the law), M.A.T. applies. The current M.A.T. rate is 15% (plus applicable surcharge and cess). M.A.T. provisions are not applicable to domestic companies that have already opted for the Concessional Tax Regime.

Under the M.A.T. regime, a company compares the income tax payable under the normal provisions with a specified percentage of its adjusted book profit (*i.e.*, the "M.A.T. liability"). If the normal tax is lower than the M.A.T. liability, the company must pay M.A.T., since it represents the higher amount.

When M.A.T. liability exceeds the normal tax, the difference is recorded as M.A.T. credit. Such M.A.T. credit can be carried forward and set off in a subsequent year in which the normal tax liability again exceeds the liability under M.A.T., thereby reducing the cash outflow in that later year. Under the existing provisions, M.A.T. credit could be carried forward for up to 15 tax years, underscoring that M.A.T. operates largely as a timing mechanism, an advance payment against future regular tax liability rather than a permanent tax burden.

The Budget introduced a shift in the corporate taxation landscape by overhauling the M.A.T. framework and treating M.A.T. as the final tax liability. The M.A.T. rate is proposed to be reduced from 15% to 14% for all companies, including foreign companies. M.A.T. credit accumulated up to March 31, 2026, can continue to be carried forward up to a maximum of 15 years, but no fresh credit can be accumulated.

For domestic companies that opt for the Concessional Tax Regime, with effect from April 1, 2026, onwards, the offset of existing M.A.T. credit accumulated up to March 31, 2026, is capped at 25% of the year's normal tax liability. For foreign companies,

[4] A cess tax in India is an additional levy imposed by the central government for specific purposes such as health, education, or infrastructure.

however, M.A.T. credit accumulated up to March 31, 2026, remains usable under the amended rule. It can be offset to the extent of normal tax payable in a later year exceeds the liability under M.A.T.

Further, it is proposed to expand M.A.T. exemptions to nonresidents such as cruise ship operators and certain electronics manufacturing support services, if they opted for the presumptive taxation system. This fixes a long-standing issue for specified foreign businesses and aligns M.A.T. with the original intention of allowing presumptive schemes to simplify compliance burdens for these operators.

Overall, these proposals signal a deliberate move toward eventually phasing out M.A.T. as well to encourage domestic companies to transition to the Concessional Tax Regime. As more domestic companies opt for the Concessional Tax Regime, M.A.T. will naturally become less relevant. This is a positive development, given complexity under M.A.T. and history of disputes.

BUYBACK OF SHARES

The concept of companies repurchasing their own shares originated in the United Kingdom in the early 1980's. Companies generally undertake buybacks either to consolidate promoter or majority control or to distribute excess cash reserves that are not required for business operations.

In India, the Companies Act initially treated a buyback as the release of a company's assets, requiring mandatory approval from the Company Court. Subsequent amendments to the Act introduced a simplified, fast track mechanism that allowed companies to return capital through buybacks without seeking Court approval.

For companies with distributable profits, there are two primary methods of returning value to shareholders, namely, declaring dividends or undertaking share buybacks. The tax treatment of these distribution mechanisms has undergone significant evolution, shaped by various policy shifts. Historically, both dividends and buybacks were taxed at the company level. Whereas now, both dividends and buybacks are generally taxed in the hands of shareholders, reflecting a broader move toward shareholder level taxation of profit distributions.

The taxation of dividends and buyback of shares has undergone frequent amendments in recent years. Earlier, companies distributing dividends in India were required to pay Dividend Distribution Tax ("D.D.T.") at 15% on the amount of dividends declared. During this period, dividends were exempt for shareholders.

In contrast to the dividend regime, where dividends were subject to D.D.T., the net proceeds received by shareholders from a buyback were taxed as capital gains - often at lower rates. Since buybacks did not attract D.D.T., it emerged as a preferred mechanism for distributing surplus profits.

To remove this disparity, the tax law was amended to introduce a buyback tax. Under this regime, companies undertaking a buyback were required to pay tax at a flat rate of 20% on the distributed income, plus applicable surcharge and health and education cess. Correspondingly, income arising to shareholders from the buyback was exempt for the shareholders.

In 2020, the D.D.T. regime was abolished, and dividend income became taxable directly in the hands of shareholders at applicable rates. A similar shareholder-level tax treatment was proposed for buybacks. In 2024, further reforms were implemented to align buyback taxation with the dividend regime. Under the revised framework, buyback proceeds are treated as dividend income taxable in the hands of the shareholder, while the shareholder's original cost of acquisition of the repurchased shares is treated as a capital loss.

Budget Proposals

The Budget amends the tax law by providing that the consideration received by shareholders upon the repurchase of shares will be taxed as capital gains rather than as dividend income. This change seeks to restore the original characterization of buyback proceeds.

Further, recognizing the unique position and influence of promoters in corporate decision-making, particularly relating to buyback transactions, the amendment introduces an additional tax where the repurchased shares are held by promoters. Where a company undertakes the buyback in accordance with the Board/Shareholder approval route as per the Companies Act, 2013, promoters are subject to an additional layer of tax, over and above the rate of normal capital gains The rate of the additional tax varies, depending on whether the gains are short-term or long-term and whether the promoter is a domestic company or not. Under the proposal, the effective rate for domestic company promoters is 22%, whereas promoters that are not domestic companies will be subject to an effective rate of 30%.

The proposed amendment can be viewed as a course correction for non-promoter shareholders, restoring a more equitable tax framework for buyback transactions. The amendment has been broadly welcomed, as it is expected to ease the burden on smaller investors and shift the system toward taxing shareholders on their actual net gains rather than treating the gross receipts as dividends, while losses are recognized separately.

Effect on Promoters

The definition of a promoter is proposed to include anyone who holds, directly or indirectly, more than 10% in an unlisted company. No guidance is provided on whether the 10% threshold would include only direct shareholding or whether indirect and beneficial interests must also be considered. Further, there are complexities in interpreting the definition of the term "promoter" when a direct holding is by an entity with a tax-transparent status such as certain alternative investment funds ("A.I.F."), especially given that the statutory language uses the terms "directly" or "indirectly." A private equity fund set up as an A.I.F. pools capital from multiple unitholders and typically deploys such funds into unlisted companies. Given that the A.I.F. exercises control over its underlying investments rather than the unitholders, a view may be taken that an A.I.F. may be regarded as a promoter. However, since an A.I.F. is a tax transparent entity for the purpose of capital gains and the gains are chargeable to tax in the hands of its unitholders, the question of who should bear the additional tax liability becomes an important point for consideration.

Effect on Nonresident Shareholders

Under the current regime, treaty eligible shareholders faced challenges because domestic law treated buyback proceeds as dividend income while separately allowing the cost of acquisition as a capital loss, an inconsistency that opened the door to potential disputes. Thus, the current regime may still offer a limited but meaningful advantage for certain nonresident shareholders.

The proposed amendment to treat buyback of shares will simplify the taxability of nonresidents benefitting from an income tax treaty. Capital gains under the O.E.C.D. Model Convention includes alienation of any property, including shares. The phrase "alienation of property" is used to cover an extinguishment of any rights in a capital asset. Accordingly, buyback of shares should constitute an alienation of property, which could be subject to tax as capital gains under the Tax Treaty.

Further, many of India's Tax Treaties state that capital gains should be computed according to the domestic tax laws of the country where the income arises. Consequently, the classification of income will primarily follow the treatment under domestic law. Since domestic law is now being aligned with an income tax treaty, it will be easier to justify that such gains are capital gains.

For nonresident shareholders who made the investment before April 2017, the benefit of grandfathering should apply wherever allowed under a relevant income tax treaty. However, this benefit will remain subject to General Anti Avoidance Rule scrutiny. One is yet to see if the benefit of grandfathering will be extended to the additional tax payable by the promoters.

Despite this step in a positive direction, one underlying concern remains unchanged: after years of frequent shifts in the taxation of buybacks, what stakeholders continue to seek most is clarity and long term certainty.

OTHER AMENDMENTS

It is proposed to rationalize and decriminalize several penalty and prosecution provisions. As part of this shift, certain delays in filing prescribed statements or documents will now attract a fee instead of a penalty, raising an important question as to whether such fees can be litigated or whether they will be payable mandatorily by taxpayers.

In addition, the Budget proposes to advance the timing for the imposition of a penalty in cases of under reporting that are identified during scrutiny. Under the amendment, the penalty for under reported income will be imposed along with the scrutiny order itself. However, where the scrutiny is disputed, interest on the penalty amount will be levied only after disposal of the appeal by the Appellate Authorities.

In addition, the Budget seeks to rationalize prosecution provisions for specified offences including failure to deposit withholding tax, willful attempt to evade tax, and failure to furnish a return of income. A system of staggered prosecution thresholds has been introduced to align consequences with the severity of the offence, with the broader objective of reducing unnecessary criminal exposure for procedural lapses while retaining deterrence for willful violations.

FINAL THOUGHTS

In recent Budgets, the capital gains tax regime has seen frequent adjustments; however, this year the Government has chosen to retain the simplified and rationalized rate structure, signaling a period of stability after multiple rounds of change. Given global momentum around the O.E.C.D.'s Pillar Two initiative and the broader move towards a global minimum tax, there were expectations that the Budget would outline India's implementation roadmap. However, the Budget has continued to remain silent on Pillar Two.

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