2014

BUDGET 2014

DETAILED ANALYSIS OF BUDGET PROVISIONS AFFECTING NON-RESIDENTS

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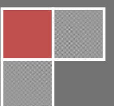
13-Jul-14



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FINANCE (NO. 2) BILL, 2014

1. Characterisation of Income in case of Foreign Institutional Investors (Sec. 2(14))

The Foreign Portfolio Investors (FPI) (referred as Foreign institutional Investors (FII) in the Act) currently face a difficulty in characterisation of their income arising from transaction in securities as to whether it is capital gain or business income.

In order to end this uncertainty, it is proposed to provide that any security held by FII which has invested in such security in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 would be treated as capital asset only so that any income arising from transfer of such security by a Foreign Portfolio Investor (FPI) would be in the nature of capital gain.

This amendment will take effect from 1st April, 2015 and will, accordingly, apply in relation to the assessment year 2015-16 and subsequent assessment years.

*(**PRB Analysis:** There have been conflicting judicial pronouncements in the case of FIIs in the past as to whether the income arising from transaction in securities is capital gain or business income. This amendment would put the controversy to rest as far as taxation under Indian Income Tax Act is concerned and would facilitate relocation of fund managers to India who until now have been operating out of India for want of clarity under domestic tax laws. | However, the proposed amendment does not mention anything about characterization of such income under respective DTAAs and therefore, there could arise ambiguity as to whether FIIs operating out of India could claim treaty benefits. Generally, FIIs investing from jurisdictions wherein capital gains is exempt under their DTAA with India, have been arguing that such income is in the nature of capital gains, whereas FIIs investing from jurisdictions other than the former, have been arguing that such income constitutes business income and in absence of Permanent Establishment in the source country, such income is exempt under relevant provisions of the DTAA. Additionally, the residence country could adopt a different characterization of such income in terms of interpretation of DTAA and therefore refuse to grant credit for taxes paid in India, if any. Uncertainty therefore still remains as far as taxability under respective DTAA is concerned. | This amendment would bring disparity between tax treatment in the case of FIIs vis-à-vis domestic taxpayers since such controversy would continue to exist in the case of domestic taxpayers notwithstanding that such characterization depends on facts of each case.)*

2. Long-term Capital Gains on debt oriented Mutual Fund and its qualification as Short-term capital asset (Sec 2(42A))

The existing provisions contained in Section 2(42A) of the Act provides that Short-term capital asset means a capital asset held by an assessee for not more than thirty six months immediately preceding the date of its transfer. However, in the case of a share held in a company or any other security listed in a recognised stock exchange in India or a unit of the Unit Trust of India or a unit of a Mutual Fund or a zero coupon bond, the period of holding for qualifying it as short-term capital asset is not more than 12 months.

It is proposed to provide that an unlisted security and a unit of a mutual fund (other than an equity oriented mutual fund) shall be a short-term capital asset if it is held for not more than 36 months.

These amendments will take effect from 1st April, 2015 and will accordingly apply, in relation to the assessment year 2015-16 and subsequent assessment years.

*(**PRB Analysis:** This amendment proposes to deprive unlisted securities as well as debt mutual funds of the benefit of shorter holding period in order to qualify as long term capital asset. This amendment would significantly affect current FDI investments in India since it plans to cover within its ambit any sale of such securities made after 1st April 2015.)*

3. Transfer of Government Security by one non-resident to another non-resident (Sec. 47)

The existing provision contained in Section 47 of the Act provides that certain transactions shall not be considered as transfer for the purpose of charging of capital gains.

It is proposed to insert clause(viib) to Sec. 47 so as to provide that any transfer of a capital asset, being a Government Security carrying a periodic payment of interest, made outside India through an intermediary dealing in settlement of securities, by a non-resident to another non-resident shall not be considered as transfer for the purpose of charging capital gains.

This amendment will take effect from 1st April, 2015 and will, accordingly, apply in relation to assessment year 2015-16 and subsequent assessment years.

*(**PRB Analysis:** As stated in Memorandum explaining the provisions in The Finance (No. 2) Bill, 2014, this amendment has been brought in to with a view to facilitate listing and trading of Government securities outside India.)*

4. Rationalisation of the Definition of International Transaction (Sec. 92B)

The existing provisions of Section 92B(2) of the Act extend the scope of the definition of 'International Transaction' by providing that a transaction entered into with an unrelated person shall be deemed to be a transaction with an associated enterprise, if there exists a prior agreement in relation to the transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between the other person and the associated enterprise.

Memorandum to Finance (No. 2) Bill, 2014 states that the existing definition creates doubt whether such unrelated person should also be a non-resident. Therefore, it is proposed to amend Section 92B of the Act to provide such transaction shall be deemed to be an international transaction entered into between two associated enterprises, whether or not such other person is a non-resident.

This amendment will take effect from 1st April, 2015 and will, accordingly, apply in relation to the assessment year 2015-16 and subsequent assessment years.

*(**PRB Analysis:** Section 92B(2) was enacted to cover those cases where two associated enterprises intend to have an international transaction but want to avoid transfer pricing provisions by interposing a third party as an intermediary. In such cases, the third party intermediary will generally not be the ultimate consumer of the services or goods. The intermediary would facilitate the transfer of services or goods from one enterprise to its associate enterprise with no value addition or insignificant value addition. The intermediary is used to break a transaction into two different parts, which parts when viewed in isolation would not satisfy the requirements of section 92A (Definition of Associated Enterprises). The legal form of the transaction in such circumstances is ignored. The substance of the transaction is given effect to, not by disregarding the existence of the intermediary but by deeming the transaction with the intermediary itself to be one with an associated enterprise. | This amendment has been brought in to overturn Hyderabad ITAT decision in IJM (India) Infrastructure Ltd. vs. ACIT [147 ITD 437] and similar decisions in the case of other associated companies. Under the facts of this case, taxpayer was a limited company promoted by a Malaysian Company. The taxpayer was engaged in the business of works contracts, construction and maintenance of roads, bridges, townships, residential and commercial buildings. It had transactions with a PE of the Malaysian Company in India as well as JVs (JV1 where taxpayer was a partner and JV2 where the Malaysian Company was a partner). After hearing contentions of the taxpayer and revenue department, ITAT eventually held that PE of the Malaysian Company and JVs (assessed as Association of Persons) should be treated as residents in India and therefore transactions between the taxpayer and PE/JVs would not be treated as international transactions for purpose of provisions of Sec. 92B(2) since there was no erosion of Indian tax base.)*

5. Roll back provision in Advance Pricing Agreement Scheme (Sec. 92CC)

Section 92CC of the Act provides for Advance Pricing Agreement (APA). It empowers the Central Board of Direct Taxes(CBDT), with the approval of the Central Government, to enter into an APA with any person for determining the Arm's Length Price (ALP) or specifying the manner in which ALP is to be determined in relation to an international transaction which is to be entered into by the person. The agreement entered into is valid for a period, not exceeding 5 previous years, as may be mentioned in the agreement. Once the agreement is entered into, the ALP of the international transaction, which is subject matter of the APA, would be determined in accordance with such an APA.

It is proposed to provide roll back mechanism in the APA scheme. The "roll back" provisions usually refer to the applicability of the methodology of determination of ALP, or the ALP to be applied to the international transactions which had already been entered into in a period prior to the period covered under an APA. Subject to prescribed conditions, procedure and manner, rollback provisions are proposed to be introduced for a period not exceeding four previous years preceding the first of the previous years for which the advance pricing agreement applies in respect of the international transaction to be undertaken in future.

This amendment will take effect from 1st October, 2014.

*(**PRB Analysis:** APA mechanism has been hugely popular with large taxpayers, some of whom have suffered humongous transfer pricing additions in recent assessment years and are currently litigating at different stages of the appellate machinery. As acknowledged in the Memorandum explaining the provisions in The Finance (No. 2) Bill, 2014, providing for such a mechanism under Indian legislation would lead to reduction in large scale litigation which is currently pending or may arise in future in respect of the transfer pricing matters.)*

6. Tax on long-term capital gains on units (Sec. 112)

Under the existing provisions of Section 112 of the Act, where tax payable on long-term capital gains arising on transfer of a capital asset, being listed securities or unit or zero coupon bond exceeds 10% of the amount of capital gains before allowing for indexation adjustment, then such excess shall be ignored. As long-term capital gains is not chargeable to tax in the case of transfer of a unit of an equity oriented fund which is liable to securities transaction tax, the benefit under Section 112 in respect of unit cover only the unit of a fund, other than an equity oriented fund.

It is proposed to amend the provisions of Section 112 so as to allow the concessional rate of tax of 10% on long term capital gain to listed securities (other than unit) and zero coupon bonds.

This amendment will take effect from 1st April, 2015 and will accordingly apply, in relation to the assessment year 2015-16 and subsequent assessment years.

*(**PRB Analysis:** Non-resident tax payers would continue to be taxed @ 10% on unlisted mutual fund units which would create disparity vis-à-vis taxation on domestic taxpayers qua such units who would now be taxed @ 20% with indexation benefit in absence of concessional tax rate of 10% without indexation.)*

7. Reduction in tax rate on certain dividends received from foreign companies (Sec. 115BBD)

Section 115BBD of the Act was introduced as an incentive for attracting repatriation of income earned by Indian companies from investments made abroad. It provides for taxation of gross dividends received by an Indian company from a specified foreign company at the concessional rate of 15% if such dividend is included in the total income for the assessment year 2012-13 or 2013-14 or 2014-2015.

It is proposed to extend the benefit of lower rate of taxation without limiting it to a particular assessment year. Thus, such foreign dividends received in financial year 2014-15 and subsequent financial years would continue to be taxed at the lower rate of 15%.

*(**PRB Analysis:** This amendment has been brought in with a view to encourage Indian companies to repatriate foreign dividends into the country. It would be particularly beneficial for repatriations from overseas investment holding companies before Controlled Foreign Corporation (CFC) provisions kick in with introduction of Direct Tax Code (DTC) in near future.)*

8. Mutual Funds, Securitisation Trusts and Venture Capital Companies or Venture Capital Funds to file return of income (Sec. 139)

Clause (23D) of Section 10 exempts the income of a Mutual Fund, clause (23DA) of section 10 exempts the income of a securitisation trust from the activity of securitisation and clause (23FB) of section 10 exempts the income of a venture capital company (VCC) or venture capital fund (VCF) from investment in a venture capital undertaking. The Mutual Fund or securitization trust or VCC or VCF are not obligated to furnish their return of income under section 139 of the Act. Instead they are required to furnish a statement giving details of the nature of the income paid or credited during the previous year and such other relevant details as may be prescribed.

It is proposed to provide that Mutual Fund, Securitization Trust and Venture Capital Company or Venture Capital Fund shall, if the total income in respect of which such fund, trust or company is assessable, without giving effect to the provisions of section 10, exceeds the maximum amount which is not chargeable to income-tax, furnish a return of such income of the previous year in the prescribed forms and verified in the prescribed manner and setting forth such other particulars as may be prescribed and all the provisions of the Act, so far as may be, apply as if it were a return required to be furnished under sub-section (1) of section 139.

Further, in the case of the Mutual Funds and Securitisation Trusts, the requirement of filing of statements before an income-tax authority is proposed to be dispensed with by omitting sub-section (3A) of Section 115R and sub-section (3) of Section 115TA.

These amendments will take effect from 1st April, 2015.

9. Concessional rate of tax on overseas borrowing (Sec. 194LC, Sec. 206AA)

The existing provisions of Section 194LC of the Income Tax Act, 1961 (‘Act’) provide for lower withholding tax rate of 5% on interest paid by an Indian company to non-residents on monies borrowed by it in foreign currency from a source outside India under a loan agreement or through issue of long-term infrastructure bonds at any time on or after the 1st day of July, 2012 but before the 1st day of July, 2015 subject to certain conditions.

It is proposed to extend the benefit of this concessional rate of withholding tax to borrowings by way of issue of any long-term bond, and not limited to a long term infrastructure bond.

It is further proposed to extend by two years the period of borrowing for which the said benefit would be available. Therefore, the concessional rate of withholding tax would now be available in respect of borrowings made before 1st day of July, 2017.

Section 206AA of the Act provides for levy of higher rate of withholding tax in case the recipient of income does not provide permanent account number to the deductor. An exception from applicability of Section 206AA in respect of payment of interest on long-term infrastructure bonds eligible for benefit under section 194LC is currently provided in sub-section (7) of this section.

Consequential amendment is also proposed in Section 206AA to enable the benefit of this exemption to be extended to payment of interest on any long-term bond referred to in section 194LC.

These amendments will take effect from 1st October, 2014.

*(**PRB Analysis:** Sec. 194LC pertains to lower withholding tax rates on External Commercial Borrowings (ECB) and Foreign Currency Convertible Bonds & Foreign Currency Exchangeable Bonds. It is a welcome amendment wherein the scope has been extended to cover issuance of bonds for end use in any sector rather than restricting it to infrastructure sector. It may be noted that while period of borrowing has been extended under Sec. 194LC, the same benefit has not been granted to borrowing by way of rupee denominated bonds under Sec. 194LD. | Further, while Sec. 206AA contains an exception in respect of payment of interest on FCCB/FCEB, there is no such exception for payment of interest on ECB.)*

10. Levy of Penalty by Transfer Pricing Officers (Sec. 271G)

The existing provisions of Section 271G of the Act provide that if any person who has entered into an international transaction or specified domestic transaction fails to furnish any such document or information as required by sub-section (3) of Section 92D, then such person shall be liable to a penalty which may be levied by the Assessing Officer or the Commissioner (Appeals).

It is proposed to amend Section 271G of the Act to include TPO, as referred to in Section 92CA, as an authority competent to levy the penalty under Section 271G in addition to the Assessing Officer and the Commissioner (Appeals).

This amendment will take effect from 1st October, 2014.

*(**PRB Analysis:** Bombay High Court in Vodafone India Service (P.) Ltd vs. Union of India [359 ITR 133] has held that AO is bound to pass an order in conformity with the TPO's order and so he is bound by the TPO's determination and cannot sit in judgment over the same in any respect. Therefore, the present amendment would merely expedite conclusion of transfer pricing assessments due to improved cooperation from taxpayers during such transfer pricing assessments. | It may be noted that similar amendment has not been brought in under Sec. 271AA which prescribes similar quantum of penalty of 2% of value of each International Transaction / Specified Domestic Transaction albeit that Sec. 271AA levies penalty for failure to keep and maintain documentation.)*

11. Taxation Regime for Real Estate Investment Trust (REIT) and Infrastructure Investment Trust (Invit)

The Securities and Exchange Board of India (SEBI) had proposed draft regulations relating to two new categories of investment vehicles namely, the Real Estate Investment Trust (REIT) & Infrastructure Investment Trust (Invit). These regulations were placed in public domain for comments. The final Regulations are yet to be notified.

Real Estate Investment Trusts (REITs) have been used as instruments for pooling of investment in several countries. Infrastructure Investment Trusts (InvITs) is a modified REITS type structure for PPP and other infrastructure projects. The income-investment model of such REITs and Invits (referred to as business trusts) has the following distinctive elements:

(i) the trust would raise capital by way of issue of units (to be listed on a recognised stock exchange) and can also raise debts directly both from resident as well as non-resident investors;

(ii) the income bearing assets would be held by the trust by acquiring controlling or other specific interest in an Indian company (SPV) from the sponsor.

It is proposed to put in place a specific taxation regime for providing the way the income in the hands of such trusts is to be taxed and the taxability of the income distributed by such business trusts in the hands of the unit holders of such trusts. Such regime has the following main features:–

(i) Treatment of Income in nature of Capital Gains in hands of Unitholders other than Sponsor: The listed units of a business trust, when traded on a recognised stock exchange, would attract same levy of securities transaction tax (STT), and would be given the same tax benefits in respect of taxability of capital gains as equity shares of a company i.e., long term capital gains, would be exempt and short term capital gains would be taxable at the rate of 15%.

(ii) Treatment of Income in nature of Capital Gains in hands of Sponsor: In case of capital gains arising to the sponsor at the time of exchange of shares in SPVs with units of the business trust, the taxation of gains shall be deferred and taxed at the time of disposal of units by the sponsor. However, the preferential capital gains regime (consequential to levy of STT) available in respect of units of business trust will not be available to the sponsor in respect of these units at the time of disposal. Further, for the purpose of computing capital gain, the cost of these units shall be considered as cost of the shares to the sponsor. The holding period of shares shall also be included in the holding period of such units.

(iii) Treatment of Income in nature of Interest: The income by way of interest received by the business trust from SPV is accorded pass through treatment i.e., there is no taxation of such interest income in the hands of the trust and no withholding tax at the level of SPV. However, withholding tax at the rate of 5% in case of payment of interest component of income distributed to non-resident unit holders, at the rate of 10% in respect of payment of interest component of distributed income to a resident unit holder shall be effected by the trust.

(iv) Concessional rate of tax on overseas borrowing: In case of external commercial borrowings by the business trust, the benefit of reduced rate of 5% tax on interest payments to non-resident lenders shall be available on similar conditions, for such period as is provided in Section 194LC of the Act.

(v) Treatment of Income in nature of Dividend: The dividend received by the trust shall be subject to dividend distribution tax at the level of SPV but will be exempt in the hands of the trust, and the dividend component of the income distributed by the trust to unit holders will also be exempt.

(vi) Income in nature of Capital Gains in hands of Business Trust: The income by way of capital gains on disposal of assets by the trust shall be taxable in the hands of the trust at the applicable rate. However, if such capital gains are distributed, then the component of distributed income attributable to capital gains would be exempt in the hands of the unit holder. Any other income of the trust shall be taxable at the maximum marginal rate.

(vii) The business trust is required to furnish its return of income.

(viii) The necessary forms to be filed and other reporting requirements to be met by the trust shall be prescribed to implement the above scheme.

This amendment will take effect from 1st October, 2014.

*(**PRB Analysis:** This amendment has brought in certainty in taxation aspects of REIT/InvITs model and would facilitate exits by promoters as well as raising capital for stressed assets.)*

BUDGET SPEECH

12. Retrospective amendments

Finance Minister (FM) in his Budget Speech affirmed the Government's right to introduce retrospective legislation. Further, he stated that Government was committed to provide a stable and predictable taxation regime and announced that all fresh cases arising out of the retrospective amendments of 2012 in respect of indirect transfers and coming to the notice of the Assessing Officers will be scrutinized by a High Level Committee to be constituted by the CBDT before any action is initiated in such cases.

*(**PRB Analysis:** Although FM stated that committed to provide a stable and predictable taxation regime to the investor community, he stopped short of doing away with the retrospective amendments to the Income Tax Act 1961 undertaken through the Finance Act 2012. Further, although he acknowledged that few cases of dispute arising out of retrospective amendment have come up in various courts and other legal for a, no measures were announced for an amicable solution to them.)*

13. High Level Committee for regular interaction with trade and industry

FM announced that a High Level Committee would be set up for regular interaction with trade and industry and to ascertain areas where clarity in tax laws is required. Based on the recommendations of the Committee, the Central Board of Direct Taxes (CBDT) and the Central Board of Excise and Customs (CBEC) shall issue appropriate clarifications, wherever considered necessary, on the tax issues within a period of two months.

*(**PRB Analysis:** Since the current Government was elected to power recently, it seems that due to inadequate time for consultation with trade and industry and deliberation thereafter, it could not deal with all representations made before it. This is a welcome move which would enable issuance of clarifications through circulars and/or notifications for bring in clarity in tax laws rather than introducing them at the time of annual Budget.)*

14. Introduction of range concept for determination of arm's length price

FM has proposed to introduce range concept for determination of arm's length price. However, the arithmetic mean concept would continue to apply where number of comparable is inadequate. The relevant data is under analysis and appropriate rules would be prescribed subsequently.

*(**PRB Analysis:** Inter-quartile range is an accepted criterion in many countries when calculating arms length price. One of its key advantages over arithmetic mean is that it would ignore the outliers among comparables (i.e. potential comparables with extreme results). Incidentally, absence of range concept has been listed as one of the emerging Transfer Pricing challenges in India in the United Nations Practical Manual on Transfer Pricing. | Necessary legislative amendments to give effect to the above proposals would be moved by the Government in the current session of the Parliament.)*

15. Use of Multiple year data

The Indian transfer pricing regulations stipulate that data to be used in analyzing the comparability of uncontrolled transaction with an international transaction should be the data relating to the financial year in which international transactions have been entered into. However, the rule also provides exception and permits the use of data for the preceding two years if and only if, it is proved that such data reveals a fact which could have an influence on the determination of the arm's length price. Therefore, the exception comes into play only when a proof that earlier year data could have an influence on determination of the arm's length price is provided.

FM has proposed to amend the regulations to allow use of multiple year data.

*(**PRB Analysis:** Use of multiple year data has been a bone of contention between taxpayers and revenue department leading to huge scale litigation especially since OECD Transfer Pricing Guidelines prescribes use of multiple year data for its usefulness in providing information about the relevant business and product life cycles of the comparables.)*