Comprehensive Analysis of International Tax Proposals in Budget 2018

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ANALYSIS OF INTERNATIONAL TAX PROVISIONS IN BUDGET 2018

In our below analysis we have mainly covered the provisions proposed in the Finance Bill, 2018 that affect non-residents and cross border transactions. Our analysis covers the intent behind such proposals, applicability of the proposals and issues surrounding them. For ease of understanding, where required, we have provided illustrations to explain the proposed amendments while some provisions have been explained in an FAQ format.

1. New regime for taxation of long-term capital gains on sale of equity shares etc

Under the existing regime, long term capital gains ('LTCG') arising from transfer of long term capital assets, being equity shares of a company or an unit of equity oriented fund or an unit of business trusts , are exempt from income-tax under clause (38) of section 10 of the Act. However, transactions in such long term capital assets carried out on a recognized stock exchange are liable to securities transaction tax (STT). Consequently, this regime is inherently biased against manufacturing and has encouraged diversion of investment in financial assets. It has also led to significant erosion in the tax base resulting in revenue loss. The problem has been further compounded by abusive use of tax arbitrage opportunities created by these exemptions.

In order to minimize economic distortions and curb erosion of tax base, it is proposed to withdraw the exemption under clause (38) of section 10 and to introduce a new section 112A in the Act to provide that LTCG arising from **transfer of** a long term capital asset being an **equity share in a company** or a **unit of an equity oriented fund** or a **unit of a business trust** shall be *taxed at 10 per cent* of such capital gains exceeding one lakh rupees. This concessional rate of 10 per cent will be applicable to such long term capital gains, if—

i. in a case where long term capital asset is in the nature of an equity share in a company , securities transaction tax has been paid on both acquisition and transfer of such capital asset; and
ii. in a case where long term capital asset is in the nature of a unit of an equity oriented fund or a unit of a business trust, securities transaction tax has been paid on transfer of such capital asset.

Further, sub-section (4) of the new section 112A empowers the Central Government to specify by notification the nature of acquisitions in respect of which the requirement of payment of securities transaction tax shall not apply in the case of equity share in a company. Similarly, the requirement of payment of STT at the time of transfer of long term capital asset, being a unit of equity oriented fund or a unit of business trust, shall not apply if the transfer is undertaken on recognized stock exchange located in any International Financial Services Centre ('IFSC') and the consideration of such transfer is received or receivable in foreign currency.

The new provision of section 112A also proposes to provide the following:—

i. The long term capital gains will be computed without giving effect to the first and second provisos to section 48, i.e. *inflation indexation in respect of cost of acquisitions and cost of improvement, if any, and the benefit of computation of capital gains in foreign currency in the case of a non-resident, will not be allowed.*

ii. The cost of acquisitions in respect of the long term capital asset acquired by the assessee before the 1st day of February, 2018 , shall be deemed to be the higher of –
    a. the actual cost of acquisition of such asset; and
    b. the lower of –
        i. the fair market value of such asset; and
        ii. the full value of consideration received or accruing as a result of the transfer of the capital asset.

iii. "equity oriented fund" has been defined to mean a fund set up under a scheme of a mutual fund specified under clause (23D) of section 10 and,—
    a. In a case where the fund invests in the units of another fund which is traded on a recognized stock exchange,-
        i. A minimum of 90 per cent. of the total proceeds of such funds is invested in the units of such other fund ; and
        ii. Such other fund also invests a minimum of 90 per cent. of its total proceeds in the equity shares of domestic companies listed on recognized stock exchange; and
    b. in any other case, a minimum of 65 per cent. of the total proceeds of such fund is invested in the equity shares of domestic companies listed on recognized stock exchange.

iv. Fair market value has been defined to mean –
    a. in a case where the capital asset is listed on any recognized stock exchange, the highest price of the capital asset quoted on such exchange on the 31st day of January, 2018. However, where there is no trading in such asset on such exchange on the 31st day of January, 2018 , the highest price of such asset on such exchange on a date immediately preceding the 31st day of January, 2018 when such asset was traded on such exchange shall be the fair market value;
    and
    b. in a case where the capital asset is a unit and is not listed on recognized stock exchange, the net asset value of such asset as on the 31st day of January, 2018.

The benefit of deduction under chapter VIA shall be allowed from the gross total income as reduced by such capital gains. Similarly, the rebate under section 87A shall be allowed from the income tax on the total income as reduced by tax payable on such capital gains.

This amendment will take effect from 1st April, 2019 and will, accordingly, apply in relation to assessment year 2019-20 and subsequent years.

Our analysis:

LTCG on certain capital assets have been exempt u/s 10(38) as introduced in Finance (No.2) Act, 2004. This proposal to do away with such exemption has a vide impact on all taxpayers as well as the secondary equity markets. On taking away such exemption, the government also proposes to introduce a new section to provide for a regime for a concessional rate of taxation (subject to conditions) for LTCG on certain capital assets. Given the two fold effect of the proposed amendments and its importance, we have presented our analysis in the form of FAQs as below to ensure ease of understanding:

Q 1. The proposed section 112A is applicable to which long term capital assets?

Ans: There are three categories of capital assets proposed to be covered u/s 112A subject to further conditions which are as following:

i. Equity Shares in a company listed on a recognized stock exchange – asset is required to be held for more than 12 months; and STT should have been paid on transfer *as well as* acquisition of said equity shares.
ii. Unit of an equity oriented mutual fund – asset is required to be held for more than 12 months; and STT should have been paid on transfer of said equity shares.
iii. Unit of a business trust – asset is required to be held for more than 12 months; and STT should have been paid on transfer of said equity shares.

Q 2. Are there any exemptions available to the condition of payment of STT on acquisition and transfer of shares?

Ans: Previously, inorder to prevent abuse of the exemption provision in section 10(38) of the Act, proviso to section 10(38) was inserted vide Finance Act, 2017 to deny exemption in cases where shares were purchased after 1.10.2004 but STT on such acquisitions was not paid. Notification 43/2017 dated 5th June 2017 was later issued by CBDT to notify specific situations wherein such requirement of STT on acquisition would not apply. In proposed section 112A, a similar notification listing the situations exempt from STT requirement on acquisition, has not yet been notified however the same should be expected soon on enactment of this Finance Bill. This has also been clarified in the FAQs on taxation of LTCG proposed in the Finance Bill, 2018 released by CBDT on 4th February 2018. | Sub-section (3) of the proposed section 112A has clarified that the requirement of payment of STT on transfers undertaken on a recognized stock exchange located in an International Financial Services Centre ('IFSC') would not apply where the consideration is in foreign currency. This is in line with tax incentives provided to IFSCs vide amendments made by Finance Act, 2016. However, it should be noted that the sub-section merely absolves the requirement of STT, other conditions and taxability u/s 112A of the LTCG earned on a recognized stock exchange in IFSC would apply.

Q 3. Is the proposed amendment to tax LTCG retrospective in nature?

Ans: No. The proposed section is applicable to all transfers undertaken on or after 1.4.2018 therefore any LTCG in the months of February and March 2018 would still be able to avail exemption u/s 10(38) of the Act. | To ensure that there is no retrospective taxation of gains already accrued to a taxpayer as on date of budget and also to safeguard the secondary market, the proposed section has been suitably drafted to allow grandfathering of gains accrued till 31.01.2018.

Accordingly, a cost step-up is provided **for capital assets acquired by a taxpayer before 1.02.2018**. In such a case, the COA of such capital assets shall be:

Higher of:

- Actual cost of acquisition; and
- Lower of:
  - Fair market value ('FMV')(explained below); and
  - Sale consideration on transfer

FMV has been defined to mean the highest price quoted on the stock exchange in case of listed securities on 31.01.2018 or net asset value in case of a unit which

is unlisted as on 31.01.2018 or date on which it was last traded on the stock exchange.

Q 4. *Could you explain the above concept of grandfathering with illustrative examples?*

Ans: Certain scenarios have been explained below:

Scenario 1 : When FMV as on 31.01.2018 is higher than actual cost

Actual Cost of Acquisition (Say 01-01-2017)		100	higher of viz. 200
FMV as on 31-01-2018	200	lower of viz. 200	
Sale Consideration (On or after 01-04-2018)	250		

In this scenario, on applying the grandfathering mechanism provided in proposed 112A, the COA would arrive at 200 viz. the FMV as on 31.01.2018. This would ensure that all gains accrued until that date would not be taxed. Appreciation of the share after that date (i.e.31.01.2018) until transfer of capital asset is only taxed. LTCG : 250 (SC) less 200 (COA as arrived above) = 50

Scenario 2 - When FMV as on 31.01.2018 is higher than Sale Value

Actual Cost of Acquisition (Say 01-01-2017)		100	higher of viz. 150
FMV as on 31-01-2018	200	lower of viz. 150	
Sale Consideration (On or after 01-04-2018)	150		

In this scenario, on applying the grandfathering mechanism provided in proposed 112A, the COA would arrive at 150 viz. the Sale Consideration as on the sale date. The value of the capital asset has depcriated after 31.01.2018 and eventually sold at a lower value. The proposed computation will ensure that there is *no notional loss* due to an artificial step-up in cost. In this case, since the Sale Consideration itself is considered as the COA, it would ensure that there is situation of no loss or gain. LTCG : 150 (SC) less 150 (COA as arrived above) = NIL.

Scenario 3 - When FMV as on 31.01.2018 is lower than Actual Cost

Actual Cost of Acquisition (Say 01-01-2017)		100	higher of viz. 100
FMV as on 31-01-2018	50	lower of viz. 50	
Sale Consideration (On or after 01-04-2018)	150		

In this scenario, even after applying the grandfathering mechanism provided in proposed 112A, the COA would arrive at 100 viz. the Actual Cost of Acquistion and not the FMV as on 31.01.2018. This would ensure that the full value of cost is allowed to the taxpayer and is not restricted to the value of FMV as on 31.01.2018 and thereby deny a taxpayer of acutal costs incurred by him. LTCG : 150 (SC) less 100 (COA as arrived above) = 50.

Scenario 4 - When Sale Value is lower than the actual cost & FMV

Actual Cost of Acquisition (Say 01-01-2017)		100	higher of viz. 100
FMV as on 31-01-2018	200	lower of viz. 50	
Sale Consideration (On or after 01-04-2018)	50		

In this scenario, on applying the grandfathering mechanism provided in proposed 112A, the COA would arrive at 100 viz. the Actual Cost of Acquistion and not the FMV as on 31.01.2018. This would ensure that only ***real loss*** is carried forward or set-off by a taxpayer. By limiting the caluation mechanism to lower of sale consideration vs FMV, it ensures that notional loss of 100 that may have occured by grandfathering is ignored. LTC Loss : 50 (SC) less 100 (COA as arrived above) = 50.

Q 5. How would LTCG on the capital assets acquired on or after 1.2.2018 be calculated?

Ans: No benefit of cost step-up is available for capital assets acquired on or after the date of the budget. In such a case, LTCG would simply be calculated as illustrated below:

Sale Consideration	200	100
Less:		
Cost of Acquisition (capital assets acquired on or after **01-02-2018**)	100	150
Long Term Capital Gain / (Loss)	100	(50)

Q 6. What is the rate of tax on such LTCG? What would be the treatment of long term capital loss on such capital assets?

Ans: Rate of tax proposed in section 112A is 10% on gains exceeding Rs. 1,00,000/-. As explained in Q 4. above, no tax would be levied on gains accrued as on 31.01.2018 | Any long term capital ***loss*** can be set-off or carried forward under the provisions of the Act. As illustrated in Q 4. – scenario 2 vis-à-vis scenario 4 – ***no notional loss*** due to cost step-up available in the section can be claimed. It would be limited only to actual losses made on transfer of such capital assets at a price lower than its actual cost of acquisition.

Q 7. Is benefit of indexation and the option of computation of capital gains in foreign currency (i.e. benefit of first and second proviso to section 48 available? Can the cost be enhanced by cost of improvement?

Ans: Sub-section 5 to proposed section 112A denies the above mentioned benefit of indexation and foreign currency computation for the purpose of computation of tax @ 10% under this section. This has also been reiterated in FAQs on taxation of LTCG proposed in the Finance Bill, 2018 released by CBDT on 4th February 2018 | Contrastingly, on a strict interpretation of the language used in section 48 and proposed section 112A, it can be asserted that computation of capital gains is provided in section 48. Section 48 has not been suitably amended vide this Finance Bill 2018 to deny benefit to the first and second proviso to transfer of capital assets referred in proposed section 112A. Section 112A on the other hand merely provides the rate of taxability and method of calculation. Accordingly, it may be interpreted that in case of long term capital losses, the losses calculated as per the provisions of section 48 (i.e. giving effect to first and second proviso) would be carried forward. However this may not be the

intention of the legislature and could be subjected to litigation. Similar interpretation could also be applied w.r.t. to cost of improvement as is available u/s 48 but has not been appropriately included as part of COA in the proposed section 112A.

Q 8. *Is tax required to be deducted at source on such LTCG ?*

Ans: **Resident Taxpayer** → There is no requirement of TDS on such LTCG

Non Resident Taxpayer (other than FIIs) → TDS would be deductible on such LTCG u/s 195 of the Act at the rates prescribed in First Schedule to the Finance Bill viz. 10% on LTCG computed as per provisions of section 112A.

Q 9. *Explain the availability of minimum amount of Rs. 1,00,00/- and basic exemption limit on such LTCG. Is it different for residents* vis-à-vis *non-residents?*

Ans: The minimum benefit of Rs 1,00,000/- LTCG not chargeable to tax is available to all taxpayers irrespective of the type of person or its residential status. | In cases of Individuals and HUFs, resident in India, the proposed section permits use of any unutilized basic exemption limit in arriving at the gross total income of the taxpayer. This is in stark contrast to that available to Non-resident Individuals and HUFs. A comparative illustration has been provided below:

Resident		
Particulars		**Amount in Rs.**
Long Term Capital Gains		500,000
Incomes other than LTCG		190,000
Total Income		690,000
Taxable Income		
Incomes other than LTCG	190,000	
Less: Basic Exemption Limit	250,000	
Unutilised Basic Exemption Limit		(60,000)
LTCG u/s 112A	500,000	
Less : Basic Limit not taxable u/s 112A	100,000	
LTCG taxable u/s 112A		400,000
Total Taxable Income (after reducing the unutilised BEL as above)		340,000
Tax Payable		
LTCG @ 10%	(340000*10%)	34,000
On Balance Income		
(As per standard Rates)		-
Total Tax Payable		**34,000**

Non-Resident		
Particulars		**Amount in Rs.**
Long Term Capital Gains		500,000
Incomes other than LTCG		190,000
Total Income		690,000
Taxable Income		
Incomes other than LTCG	190,000	
Basic Exemption Limit	250,000	
Unutilised Basic Exemption Limit	(60,000)	Not permitted to be utilised
LTCG u/s 112A	500,000	
Less : Basic Limit not taxable u/s 112A	100,000	
LTCG taxable u/s 112A		400,000
Total Taxable Income		400,000
Tax Payable		
LTCG @ 10%	(400000*10%)	40,000
On Balance Income		
(As per standard Rates)		-
Total Tax Payable		**40,000**

Q 10. Is DTAA benefit available to non-residents?

Ans: Yes. DTAA benefit will continue to be available to non-residents. This would depend on whether the taxing right of capital gains on sale of shares lies in the DTAA lies with India or the other contracting state. With the recent renegotiation of DTAAs with various jurisdictions such as Singapore and Mauritius, India has now been given the right to tax capital gains from sale of shares. The Netherlands - India DTAA has not yet been renegotiated and therefore Netherlands is currently considered a favorable jurisdiction to invest into India since on disposal of Indian company shares, neither is it taxed in India (based on the tax treaty), nor in the Netherlands (due to the participation exemption).

2. Taxation of long-term capital gains in the case of Foreign Institutional Investors

The existing provisions of section 115AD of the Act inter alia, provides that where the total income of a Foreign Institutional Investor ('FII') includes income by way of long-term capital gains arising from the transfer of certain securities, such capital gains shall be chargeable to tax at the rate of ten per cent. However, long term capital gains arising from transfer of long term capital asset being equity shares of a company or a unit of equity oriented fund or a unit of business trusts, is exempt from income-tax under clause (38) of section 10 of the Act.

Consequent to the proposal for withdrawal of exemption under clause (38) of section 10 of the Act, such long term capital gain will become taxable in the hands of FIIs also. As in the case of domestic investors, the FIIs will also be liable to tax on such long term capital gains only in respect of amount of such gains exceeding one lakh rupees. The provisions of section 115AD are proposed to be amended accordingly.

This amendment will take effect from 1st April, 2019 and will, accordingly, apply in relation to the AY 2019-20 and subsequent assessment years.

Our analysis:

On withdrawal of exemption of LTCG u/s 10(38) of the Act to all taxpayers and insertion of proposed section 112A, it was imperative to also amend section 115AD of the Act which provides a separate tax regime applicable to FIIs (now known as Foreign Portfolio Investors (FPIs) as per SEBI) | The proposed amendment to section 115AD provides for the taxability of such LTCG in excess of Rs.1,00,000/- on the capital assets listed in section 112A. However, there seems to be a lacuna in drafting the proposed amendment as there is no reference to availability of cost step-up as proposed in section 112A. The budget speech as well as the FAQs on taxation of LTCG proposed in the Finance Bill, 2018 released by CBDT on 4th February 2018 both indicate that grandfathering accrued LTCG as on 31.01.2018 by FIIs shall be available. The same should be included in the Finance Bill before the bill is passed into an Act.

3. Entities to apply for PAN in certain cases

Section 139A provides that every person specified therein and who has not been allotted a permanent account number shall apply to the Assessing Officer for allotment of a Permanent Account Number (PAN).

It is being proposed that in order to use PAN as Unique Entity Number (UEN) for non-individual entities, every person, not being an individual, which enters into a financial transaction of an amount aggregating to two lakh and fifty thousand rupees or more in a financial year shall be required to apply to the Assessing Officer for allotment of PAN.

In order to link the financial transactions with the natural persons, it is also proposed that the managing director, director, partner, trustee, author, founder, karta, chief executive officer, principal officer or office bearer or any person competent to act on behalf of such entities shall also apply to the Assessing Officer for allotment of PAN.

This amendment will take effect from lst April, 2018

Our analysis:

Currently, the existing section 139A r.w. rule 114B and 114C lists down persons who are required to apply for PAN and quote such PAN while undertaking a number of specific transactions. The above amendment has been proposed by our hon'ble Finance Minister with a view to link various ***financial transactions*** of an amount exceeding Rs.2,50,000/- in aggregate in a financial year by ***non-individual entities***. The section is also proposed to be amended to require **natural persons** to be linked to such financials transactions by non-individual entities and thereby requiring managing director, director, partner, trustee, author, founder, karta, chief executive officer, principal officer, etc. to apply for PAN. | Surprisingly, the term 'financial transaction' has not been

defined. This would cause hardship in interpreting the proposed amendment. For example: A payment to any foreign company (say royalty) of Rs. 5,00,000/- per annum may be construed as a financial transaction. Does that mean that the foreign company is required to compulsorily apply for PAN in India u/s 139A? Are the managing director, directors of that foreign company also required to apply for PAN in India? If such was the case, relief provided u/s 206AA(7) may become redundant in its application. The penalty of Rs. 10,000/- provided u/s 272B shall continue to apply. | Additionally, the government needs to clarify and provide a mechanism for PAN of specified natural persons mentioned above to be linked while undertaking 'financial transactions' by non-individual entities. | Due to the proposed amendment to section 276CC which deals with prosecution for non-filing of ITR, eventhough there may not be any outstanding liability tax, such entities may also be at risk of prosecution under the section.

4. Aligning the scope of "business connection" with modified PE Rule as per Multilateral Instrument ('MLI')

Under the existing provisions of Explanation 2 to clause (i) of sub-section (1) of section 9, "business connection" includes business activities carried on by non-resident through dependent agents. The scope of "business connection" under the Act is similar to the provisions relating to Dependent Agent Permanent Establishment ('DAPE') in India's Double Taxation Avoidance Agreements ('DTAAs'). In terms of the DAPE rules in tax treaties, if any person acting on behalf of the non-resident is habitually authorised to conclude contracts for the non-resident, then such agent would constitute a PE in the source country. However, in many cases, with a view to avoid establishing a permanent establishment ('PE') under Article 5(5) of the DTAA, the person acting on the behalf of the non-resident, negotiates the contract but does not conclude the contract. Further, under paragraph 4 of Article 5 of the DTAAs, a PE is deemed not to exist when a place of business is engaged solely in certain activities such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing of goods or merchandise, collection of information. This exclusion applies only when these activities are preparatory or auxiliary in relation to the business as a whole.

The OECD under BEPS Action Plan 7 reviewed the definition of 'PE' with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities. In order to tackle such tax avoidance scheme, the BEPS Action plan 7 recommended modifications to paragraph (5) of Article 5 to provide that an agent would include not only a person who habitually concludes contracts on behalf of the non-resident, but also a person who habitually plays a principal role leading to the conclusion of contracts. Similarly Action Plan 7 also recommends the introduction of an anti-fragmentation rule as per paragraph 4.1 of Article 5 of OECD Model Tax Convention, 2017 so as to prevent the tax payer from resorting to fragmentation of functions which are otherwise constitute a whole activity in order to avail the benefit of exemption under paragraph 4 of Article 5 of DTAAs.

Further, with a view to preventing base erosion and profit shifting, the recommendations under BEPS Action Plan 7 have now been included in Article 12 of Multilateral Convention to Implement Tax Treaty Related Measures (herein referred to as 'MLI'), to which India is also a signatory. Consequently, these provisions will automatically modify India's bilateral tax treaties covered by MLI, where treaty partner has also opted for Article 12. As a result , the DAPE provisions in Article 5(5) of India's tax treaties, as modified by MLI, shall become wider in scope than the current provisions in Explanation 2 to section 9(1)(i). Similarly, the

anti-fragmentation rule introduced as per paragraph 4.1 of Article 5 of the OECD Model Tax Convention, 2017 has narrowed the scope of the exception under Article 5(4), thereby expanding the scope of PE in DTAA vis-a-vis domestic provisions contained in Explanation 2 to section 9(1)(i). In effect, the relevant provisions in the DTAAs are wider in scope than the domestic law. However, sub-section (2) of section 90 of the Act provides that the provisions of the domestic law would prevail over corresponding provisions in the DTAAs, to the extent they are beneficial. Since under the instant situations, the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAAs, as modified by MLI, such wider provisions in the DTAAs are ineffective.

In view of the above, it is proposed to amend the provision of section 9 of the Act so as to align them with the provisions in the DTAA as modified by MLI so as to make the provisions in the treaty effective. Accordingly, clause (i) of sub-section (1) of section 9 is being proposed to be amended to provide that "business connection" shall also include any business activities carried through a person who, acting on behalf of the non-resident:

A) habitually concludes contracts or
B) habitually plays the principal role leading to conclusion of contracts by the non-resident.

And it is further proposed that the contracts should be-

i. in the name of the non-resident; or
ii. for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or
iii. for the provision of services by that non-resident.

This amendment will take effect from 1st April, 2019 and will, accordingly, apply in relation to assessment year 2019-20 and subsequent assessment years.

Our analysis:

The proposed amendment to clause (a) of Explanation 2 to section 9(1)(i) attempts to bring the Indian income tax provisions in line with DTAAs (as amended by MLI) to ensure effectiveness of the changes brought in through the MLI and the work completed under Action Plan 7 of the OECD / G20 BEPS project. As explained above, DTAAs amended by MLI would fail to apply if the Indian income tax provisions continue to remain more beneficial in light of section 90(2) of the Act which gives the option to the taxpayer to apply the provisions of the domestic law if they are more beneficial than the corresponding provisions in the DTAAs. | The proposed amendment would cover *activities that lead to conclusion* of a contract within the meaning of business connection. Under the extant provision, business connection could have arisen in India only upon actual conclusion of contract. | It may be noted however that the changes introduced vide MLI are not entirely an alien concept. They were in fact already forming part of the OECD 2014 Commentary to Article 5. *Para 32.1*[1] and *Para 33*[2] of the Commentary on OECD Model Convention (2014) already implied such situations to result

[1] *"Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions."*

[2] *"A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation"*

in creation of a PE. The MLI now brings the same into the text of the Article itself. | Under India's position on OECD 2014 Commentary to Article 5 (also retained in OECD 2017 Commentary to Article 5), India has expressed its view that a person, who is authorized to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts. This shows a consistent stand taken by the Indian Government and a justified thought process behind adoption of the new text in the proposed amendment. Accordingly, now, even absent eventual conclusion of contract by an agent, a foreign enterprise could have business connection in India merely on account of the agent playing principal role in the conclusion of such contracts. | A point of concern arises upon comparison of Article 12 of MLI with the proposed amendment in the Indian Income Tax Act. The words *"that are routinely concluded without material modification by the enterprise"* that form part of the Article 12 of the MLI which amends Article 5 of the OECD MC are absent in this proposed amendment to Section 9(1). The phrase "without material modification" essentially indicates conclusion of contracts with standard terms. To elaborate further, under peculiar circumstances, it may so happen that the agent plays the principal role in negotiation and subsequently finalizes key terms of the contract leading to its conclusion. However, post negotiations, the foreign enterprise modifies some of the essential terms which are then accepted by the third party. Under such circumstances, the difference between MLI (BEPS AP 7) and amendment proposed vide Finance Bill 2018 may play out. For e.g. an agent may be authorized to provide only upto 5% as bulk discount on a sales order whereas he would direct the Indian customer to his foreign principal if the Indian customer seeks additional discount as a condition for conclusion of the contract. Hereunder, percentage of discount constitutes a key term in conclusion of the contract which may be negotiated eventually and finalized only by the foreign principal. This may lead to a divergence between the concepts of "business connection" under Indian Income Tax Act and "permanent establishment" as understood under the treaties even after the proposed amendment may come into effect. | In this context, it may be noted that India's position on Article 5 to OECD 2017 Model Convention states that it reserves the right not to include the word "routinely" in paragraph 5 of Article 5. The intention of such a position is not altogether clear. | Explanation 2 to section 9(1)(i) presently excludes from the meaning of the business connection - *"activities limited to the purchase of goods or merchandise for the non-resident"*. These words are not retained under the proposed amendment. On the other hand, Article 5(4) of the 2017 OECD Model Convention continues to provide for an exception to such activities for constitution of PE if they are preparatory and auxiliary in nature. The 2017 OECD Commentary on Article 5 further clarifies that such activities should not be a core function of the business (for e.g. the business of a distributor) in order to set the interpretation right. It is unclear why the exclusion for activities limited to the purchase of goods or merchandise for the non-resident has been removed.

5. "Business connection" to include "Significant Economic presence"

Ordinarily, as per the allocation of taxing rules under Article 7 of DTAAs, business profit of an enterprise is taxable in the country in which the taxpayer is a resident. If an enterprise carries on its business in another country through a 'Permanent Establishment' situated therein, such other country may also tax the business profits attributable to the 'Permanent Establishment'. For this purpose, 'Permanent Establishment' means a 'fixed place of business' through which the business of an enterprise is wholly or partly carried out provided

that the business activities are not of preparatory or auxiliary in nature and such business activities are not carried out by a dependent agent.

With the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged. Under these new business models, the non-resident enterprises may interact with customers in another country without having any physical presence in that country resulting in avoidance of taxation in the source country. The existing nexus rule based on physical presence presents challenges to the source country to tax profits of such non-resident enterprises.

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on "significant economic presence". As per the Action Plan 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a significance economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools. It further recommended that revenue factor may be used in combination with the aforesaid factors to determine 'significance economic presence'.

The scope of existing provisions of clause (i) of sub-section (1) of section 9 is restrictive as it essentially provides for physical presence based nexus rule for taxation of business income of the non-resident in India. *Explanation 2 to the said section which defines 'business connection' is also narrow in its scope since it limits the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent.*

In view of the above, it is proposed to amend clause (i) of sub-section (1) of section 9 of the Act by insertion of Explanation 2A, to provide that significant economic presence' in India shall also constitute 'business connection'.

Further, "significant economic presence" for this purpose, shall mean-

(i) any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed; or

(ii) systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

It is further proposed to provide that only so much of income as is attributable to such transactions or activities shall be deemed to accrue or arise in India. It is further proposed to provide that the transactions or activities shall constitute significant economic presence in India, whether or not the non-resident has a residence or place of business in India or renders services in India. The threshold of "revenue" and the "users" in India will be decided after consultation with the stakeholders.

This amendment will take effect from 1st April, 2019 and will, accordingly, apply in relation to assessment year 2019-20 and subsequent assessment years.

Our analysis:

DTAAs (by its PE definition) as well as the Indian Income Tax (extant definition of business connection) generally requires some sort of physical presence in India for transactions to be taxable. Due to such requirement, various transactions circumvented the physical place PE rule and therefore went untaxed. The proposed amendment intends to

accordingly expand the scope of business connection to include non-residents within its ambit that do not have physical presence in India but however directly or indirectly have a significant nexus with India. This is especially important in the ever expanding digital world. | The concept of "significant economic presence" ('SEP') was one of suggestions forming part of BEPS Action Plan 1 of OECD on Digital Economy. None of the suggestions of Action Plan 1 including the concept of SEP formed part of the MLI as further work on this action plan is underway. This concept has its own flaws in its implementation as digital business models are ever changing and complex. Basic intrinsic issues such as identification of and marking of online business solicitation transactions, determining when services are carried out in India vis-à-vis from outside India would need to be addressed as soon as possible. | It is interesting to note that Equalization Levy ('EL') was introduced vide Finance Act 2016 on specified services to cover digital transactions. Concept of EL was also one of the suggestions forming part of BEPS Action Plan 1 of OECD on Digital Economy. Presently EL applies to online advertisement and any provision for digital advertising space or facilities / service for the purpose of online advertisement. Since there is no exemption for services to which EL is applicable from being covered within the scope of SEP, there could be a likely overlap between EL and SEP. | As explained above, there are two types of transactions qualifying as SEP. One pertain to any transaction in respect of **any goods, services or property carried** out by a non-resident in India where the quantum of transaction exceeds an amount as will be prescribed. The second being **systematic and continuous soliciting of** its business activities or **engaging in interaction** exceeding prescribed number of users in India through digital means. It is clear from the budget memorandum that SEP has been introduced with the intention to tax non-residents who have a digital presence but do not have a physical presence in India; however in the absence of the phrase "through digital means" under the first leg of SEP, it may apply to ***any transaction in goods, service or property*** carried out by the non-resident in India whether or not carried out digitally. | **Another** significant **impact of the introduction of SEP would be on the** services provided by the non-residents which do not qualify as "technical services" under Explanation 2 to Sec. 9(1)(vii). For e.g. a foreign enterprise providing accounting services to Indian consumers through digital means may now have business connection in India on account of SEP although such services may not qualify as "technical services" under Explanation 2 to Sec. 9(1)(vii). | Proposed changes under the Indian Income Tax Act have neither formed part of MLI nor has there been any instance of renegotiated DTAAs to include the widened PE definition in the regard. Consequently, relevance of such amendment may be restricted till the time treaty benefit continues to be available.

6. Rationalisation of provisions relating to Country-by-Country Report

Section 286 of the Act contains provisions relating to specific reporting regime in the form of Country-by-Country Report ('CbCR') in respect of an international group. Based on model legislation of Action Plan 13 of Base Erosion and Profit Shifting ('BEPS') of the OECD and others, following amendments are proposed to be made so as to improve the effectiveness and reduce the compliance burden of such reporting:—

(i) the time allowed for furnishing the CbCR, in the case of parent entity or Alternative Reporting Entity ('ARE'), resident in India, is proposed to be extended to twelve months from the end of reporting accounting year;

(ii) constituent entity resident in India, having a non-resident parent, shall also furnish CbCR in case its parent entity outside India has no obligation to file the report of the nature referred to in sub-section (2) in the latter's country or territory;
(iii) the time allowed for furnishing the CbCR, in the case of constituent entity resident in India, having a non-resident parent, shall be twelve months from the end of reporting accounting year;
(iv) the due date for furnishing of CbCR by the ARE of an international group, the parent entity of which is outside India, with the tax authority of the country or territory of which it is resident, will be the due date specified by that country or territory;
(v) Agreement would mean an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A, and also an agreement for exchange of the report referred to in sub-section (2) and sub-section (4) as may be notified by the Central Government;
(vi) "reporting accounting year" has been defined to mean the accounting year in respect of which the financial and operational results are required to be reflected in the report referred to in sub-section (2) and sub-section (4).

These amendments are clarificatory in nature.

These amendments will take effect retrospectively from the 1st April, 2017 and will, accordingly, apply in relation to the assessment year 2017-18 and subsequent years.

Our analysis:

BEPS Action Plan 13 of the OECD recommended a 3-tiered approach to transfer pricing documentation viz. the Master File, the Local File and Country-by-Country Report. Vide Finance Act, 2016 the government introduced the Master File and Country-by-Country Report. P. R. Bhuta & Co's analysis on such amendment can be referred in our previous year's budget analysis at this link – https://goo.gl/JyWsKv. Rule 10DA and 10DB were also subsequently notified by the CBDT vide Notification No. 92/2017 dated 31.10.2017 after receipt of comments from stakeholders on draft rules. P. R. Bhuta & Co had represented to the CBDT in this regard. The representation and an analysis of said rules can be referred at - https://goo.gl/MifDjy. | As mentioned above, in the memorandum to Finance Bill, the proposed amendments have been said to be clarificatory in nature. However, some of the changes do have a material effect on the reporting mechanism. The important changes are explained below:

Timeline:

Currently, the CbCR is to be filed in Form 3CEAD on or before due date of furnishing ROI. For the FY 16-17 such time limit was extended upto 31st March 2018. As per the proposed amendment, the time limit are now extended upto 12 months from the end of reporting account year. Which would apply for different cases as follows–

- Incase of Indian Parent or where ARE is resident in India→ in typical cases where the year end is 31st March, due date would be 31st March of subsequent year (i.e. 12 months from year end).
- Incase where a constituent entity ('CE') has a non-resident parent but is required to file CbCR in India due to provisions of section 286(4) → 12 months from the year end of the NR parent.
- In case the ARE is not resident in India → due date specified by the country or territory of which it is resident.

Broadening applicability of CbCR filing:

- The proposed amendment also extends the obligation to file CbCR in India by CEs resident in India in cases where the parent entity has no obligation in its country to file CbCR. This would apply in cases where no ARE has been appointed.

Definition of "agreement":

The current definition of agreement includes agreements referred in section 90(1) or section 90A(1). This definition is proposed to be amended to include agreements entered into for the exchange of CbCR viz. Multilateral Competent Authority Agreement on the Exchange of Country-By-Country Reports or any subsequent similar agreements signed by India.

7. Tax neutral transfers

Section 47 provides for certain tax neutral transfers. Section 56 also excludes income arising out of certain tax neutral transfers from its ambit. However, the transfers referred to in clause (iv) and clause (v) of section 47 have not been excluded from the scope of section 56.

In order to further facilitate the transaction of money or property between a wholly owned subsidiary company and its holding company, it is proposed to amend the section 56 so as to exclude such transfer from its scope.

This amendment will take effect, from 1st April, 2018 and shall accordingly, apply in relation to the transaction made on or after 1st April, 2018.

Our analysis:

Section 47(iv) and 47(v) dealt with transfer by a holding company to its *Indian* WOS or transfer by a WOS to its *Indian* holding company. Such transfer by the **transferor** were not subjected to capital gains taxation. However, these transactions were being subjected to tax in the hands of the **transferee** u/s 56(2)(x) where the transfer was not at fair market value as defined in the said section. By specifically including these transactions to the list of transactions exempted from section 56(2)(x), it provide relief to taxpayers and allows such transactions to completely be tax free and any ambiguity regarding its taxation is put to rest.

8. Measures to promote International Financial Services Centre (IFSC)

Amendment 1:

Section 47 of the Act provides for tax neutrality relating to certain transfer.

In order to promote the development of world class financial infrastructure in India, it is proposed to amend the section 47 of the Act so as to provide that transactions in the following assets, by a non-resident on a recognized stock exchange located in any International Financial Services Centre shall not be regarded as transfer, if the consideration is paid or payable in foreign currency:—

(i) bond or Global Depository Receipt('GDR'), as referred to in sub-section (1) of section 115AC; or

(ii) rupee denominated bond of an Indian company; or
(iii) derivative.

This amendment will take effect, from 1st April, 2019 and will, accordingly, apply in relation to the assessment year 2019-20 and subsequent assessment years.

Amendment 2:

Section 115JC of the Act provides for alternate minimum tax ('AMT') at the rate of 18.50 percent. of adjusted total income in the case of a non-corporate person.

In order to promote the development of world class financial infrastructure in India, it is further proposed to amend the section 115JC so as to provide that in case of a unit located in an International Financial Service Center, the alternate minimum tax under section 115JC shall be charged at the rate of 9 percent.

Consequential amendment in section 115JF is also proposed to be made.

This amendment will take effect, from 1st April, 2019 and will, accordingly, apply in relation to the assessment year 2019-20 and subsequent assessment years.

Our analysis:

Transactions in specified capital assets undertaken by **non-residents** on a recognized stock exchange in the **IFSC** would not be regarded as transfer and capital gains would not be taxable. This exemption is only applicable to bonds or GDRs; or rupee denominated bond of an Indian company; or derivatives. However it must be noted that the proposed amendment is only applicable if the sale consideration is paid in foreign currency. As the capital assets covered in this the proposed amendment differ from proposed section 112A, exemption is *only* limited to above mentioned capital assets.

Vide Finance Act 2016, the Minimum Alternate Tax ('MAT') rate u/s 115JB applicable to units located in an IFSC was reduced to 9% from 18.5% as is applicable to other companies. To bring other persons also on par, the proposed amendment also reduces the AMT from the existing 18.5% to 9% to units located in an IFSC. Accordingly, even Limited Liability Partnerships as well as other non-corporates in an IFSC would be able to take advantage of such reduced rate.