Comprehensive Analysis of International Tax Proposals in Budget 2017

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Analysis of CBDT Circular on POEM

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ANALYSIS OF INTERNATIONAL TAX PROVISIONS IN BUDGET 2017

In our below analysis we have mainly covered the provisions proposed in the Finance Bill, 2017 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. Clarity relating to Indirect transfer provisions

Section 9 of the Income Tax Act, 1961 ('ITA') deals with cases of income which are deemed to accrue or arise in India. Sub-section (1) of the said section creates a legal fiction that certain incomes shall be deemed to accrue or arise in India. Clause (i) of said sub-section (1) provides a set of circumstances in which income accruing or arising, directly or indirectly, is taxable in India. The said clause provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India.

The Finance Act, 2012 had inserted certain amendments in the provisions of Section 9. The amendments, *inter alia*, included insertion of Explanation 5 in section 9(1)(i) w.r.e.f. 1st April, 1962. The Explanation 5 clarified that an asset or capital asset, being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

In response to various queries raised by stakeholders seeking clarification on the scope of indirect transfer provisions, the CBDT had issued Circular No 41 of 2016 dated 21st December 2016. However, concerns were raised by stakeholders that the provisions would result in multiple taxation.

In order to address these concerns, Finance Bill 2017 proposes to amend the aforesaid section so as to clarify that the Explanation 5 (viz. where share or interest in a foreign company is deemed to be situated in India) shall not apply to any asset or capital asset mentioned therein being investment held by non-resident, directly or indirectly, in a Foreign Institutional Investor, as defined under Clause (a) of the Explanation to Section 115AD, and registered as Category-I or Category II Foreign Portfolio Investor under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 made under the Securities and Exchange Board of India Act, 1992, as these entities are regulated and broad based. The proposed amendment is clarificatory in nature.

This amendment will take effect retrospectively from 1st April, 2012 and will, accordingly, apply in relation to assessment year 2012-13 and subsequent years.

Our analysis:

Enactment of Explanations 4, 5, 6 and 7 to Section 9(1)(i) of the ITA was a direct outcome of the decision of the Supreme Court in the case of Vodafone International Holdings B.V. [2012] 341 ITR 1 (SC) which the Government sought to overrule with their insertion. Thereafter, CBDT had constituted a Working Group on 15th June, 2016 to examine issues raised by stakeholders.

The conclusions of the Working Group were issued vide Circular No. 41 of 2016 dated 21st December 2016 in the form of FAQs. These FAQs exclusively dealt with taxation concerns raised by FPIs on redemption/sale or transfer otherwise of its units/shares. Due to various representations made thereafter on such circular, such Circular was kept in abeyance on 17th January 2017. | Vide the proposal under Finance Bill 2017, investors in Category - I and Category - II FPI would be exempt from the indirect transfer provisions. It may be noted that there is no cap on the number of layers between the investor and such FPI. In other words, it would apply to all investors above FPI level in a multi-layered structure. | *Category-I FPI* includes Government and Government related investors such as central banks, Governmental agencies, sovereign wealth funds and international or multilateral organizations or agencies. *Category-II FPI* includes broad based funds (such as mutual funds, investment trusts, insurance/reinsurance companies); regulated persons (such as banks, asset management companies, investment managers/ advisors, portfolio managers); university funds and pension funds and university related endowments. Whereas *Category-III FPI* includes Private Equity funds, Venture Capital funds, other endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices. Although the cases of indirect transfer could never arise under some classes of Category-III FPIs, most importantly, non-resident investors in Category-III FPI such as Private Equity and Venture Capital Funds have been left out from the exclusion to Explanation 5. | Depending upon the language of Article 13 (Capital Gains) of the DTAA between India and the state of residence of the investor in FPI, such investors could claim benefit under DTAA, if such DTAA gives sole taxing rights to the state of resident of the investor on alienation of share or interest in the Category-III FPI. In other cases, there could be possibility of double taxation for the investors in Category-III FPI.

2. Rationalization of taxation of income by way of dividend

Under the existing provisions of section 115BBDA (which was introduced through Finance Act, 2016), income by way of dividend in excess of Rs. 10 lakhs is chargeable to tax at the rate of 10% on gross basis in case of a resident individual, Hindu Undivided Family ('HUF') or firm.

Our Hon'ble Finance Minister wishes to ensure horizontal equity among all categories of tax payers deriving income from dividend and it is thereby proposed to amend section 115BBDA so as to provide that the provisions of said section shall be applicable to all resident assessees except domestic company and certain funds, trusts, institutions, etc.

This amendment is proposed to be effective from Assessment Year ('AY') 2018-19 (i.e. Financial Year ('FY') 2017-18) onwards.

Our analysis:

The insertion of section 115BBDA was introduced through Finance Act, 2016 which at the time was made applicable only to individual, HUF and firm resident in India. Through Finance Bill, 2017, it has now proposed to amend the section to broaden its applicability to all resident assessees except domestic company and certain funds, trusts, institutions, etc. | The benefit of non-applicability of this section has specifically been provided to a (i) domestic company, (ii) entities registered under section 10(23C) and (iii) registered charitable trust or institution. Accordingly, the applicability of this section has been widened to cover resident association of persons, body of individuals, local authority or artificial juridical persons that fall under the definition of “persons” under section 2(31). Since the exemption has been provided only to trusts and institutions that are registered under section 12AA (i.e. charitable trusts), other trusts such as discretionary trusts or family trusts would fall into the ambit of the proposed amendment. Also, it can be construed that a company whose place of effective management (‘POEM’) is in India would also be covered by this proposed amendment since it would be considered a foreign company resident in India and would not fall in the exemption provided only to *domestic companies*. Depending on type of entity through which a Mutual Fund has been set up, such mutual fund could also be covered by the proposed amendment thereby restricting the returns to investors due to multiple points of taxation of the same dividend. Under the erstwhile provisions (i.e. prior to Finance Act 2016), dividends which suffered dividend distribution tax (‘DDT’) under section 115-O were exempt under section 10(34) in the hands of the recipient. Vide Finance Act 2014, the Hon’ble Finance Minister had already required DDT to be calculated @ 15% by grossing up the dividend on the pretext that the effective rate of 15% is lower than the actual slab rate of taxation as applicable to respective shareholders. Vide Finance Bill 2016, in order to tax the “super rich”, the section required any income by way of dividend in excess of Rs. 10 lakh to be charged to tax at the rate of 10% (plus applicable surcharge and cess). This led to a concept of “triple taxation” in India – twice at the corporate level and once at the shareholder level. For our detailed analysis of section 115BBDA inserted through the Finance Act 2016, please refer to P.R. Bhuta & Co.’s previous year’s Budget analysis which can be viewed at http://eepurl.com/bUyQFv

3. Clarification with regard to interpretation of 'terms' used in an agreement entered into under section 90 and 90A

Under the existing provisions of Section 90 and 90A of the Act, it has been provided that any 'term' used but not defined under Income Tax Act, 1961 or in the Double Taxation Avoidance Agreement (‘DTAA’) shall have the meaning assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf, unless the context otherwise requires, provided the same is not inconsistent with the provisions of this Act or the agreement.

The Income-tax simplification committee in its final report has suggested to bring in more clarity in the Act in respect of interpretation of 'terms' used in an agreement entered under section 90 or 90A for the purposes of its application in order to reduce the avoidable litigation related to taxation of non- residents.

In light of the above discussion and to bring in clarity and avoid litigation, Finance Bill 2017 proposes to amend the Sections 90 and 90A of the Act, to provide that where any 'term' used in an agreement entered into under sub-section (1) of Section 90 and 90A of the Act, is defined under the said agreement, the said term shall be assigned the meaning as provided in the said agreement and where the term is not defined in the agreement, but is defined in the Act, it shall be assigned the meaning as defined in the Act or any explanation issued by the Central Government.

These amendments will take effect from 1st April, 2018 and will, accordingly, apply in relation to the assessment year 2018-19 and subsequent years.

Our analysis:

Vide Finance Act, 2012, the Government inserted Explanation 4, 5 and 6 to Section 9(1)(vi) of Income Tax Act, 1961 to overcome various judicial decisions. These Explanations expanded the definition of 'Royalty' given in Explanation 1 itself. Vide the current proposal, it intends to apply these expanded meanings to the various DTAAs entered into by India with other countries. | It may be noted that the meaning of such terms under domestic law could be resorted to only if the context otherwise requires as mandated under Article 3(2) (Taxes Covered) of OECD / UN MTC. Further, Article 31 (General Rule of Interpretation) of Vienna Convention of Law of Treaties requires a treaty to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty *in their context* and in the light of its object and purpose. Therefore, Article 31 restricts the application of artificial meanings for interpreting the terms of the DTAA per se. | Also, the exercise of ascribing an artificial meaning to a term under a DTAA which may otherwise require to be interpreted merely by its general meaning may amount to unilateral treaty override. | This proposal would therefore need to withstand considerable judicial scrutiny once implemented.

4. Secondary adjustments in certain cases.

Primary transfer pricing adjustments change the allocation of taxable profits of a MNE group for tax purposes but they do not alter the books of accounts to reflect the modified allocation of taxable profits of an MNE group. In other words, the primary transfer pricing adjustment is purely effected to the tax profits and do not affect the book profits of both the entities of an MNE group. To bring in parity between tax profits and book profits as a consequence of the primary transfer pricing adjustment, some countries assert under their domestic legislation the subsistence of a constructive transaction to reflect this difference between tax profits and book profits.

The Finance Bill 2017 proposes to introduce this new concept - "Secondary adjustment" under the transfer pricing legislation in India vide insertion of a new Section 92CE. It defines 'Secondary Adjustment' as *an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee*.

It is proposed that an assessee would be required to carry out secondary adjustment where the primary adjustment to transfer price, has been made under the following circumstances:

i. suo moto by the assessee in his return of income; or
ii. made by the Assessing Officer has been accepted by the assessee; or
iii. is determined by an APA entered into by the assessee; or
iv. is made as per the safe harbour rules framed; or
v. is arising as a result of resolution of an assessment by way of MAP.

It is proposed to provide that where there is an increase in the total income or reduction in the loss of the assessee as a result of primary adjustment to the transfer price, the resultant excess money which is available with its associated enterprise should be repatriated to India within the time as may be prescribed later. And if such excess money is not repatriated to India, then it shall be deemed to be an advance made by the assessee to such associated enterprise and the interest on such advance, shall be computed as the income of the assessee, in the manner as may be prescribed later.

Further, it is also proposed to provide that such secondary adjustment shall not be carried out if the amount of primary adjustment made in the case of an assessee in any previous year does not exceed one crore rupees and where the primary adjustment is made in respect of an assessment year commencing on or before 1st April,2016.

This amendment will take effect from 1st April, 2018 and will, accordingly, apply in relation to the assessment year 2018-19 and subsequent years.

Our analysis:

Since this is again an important proposal, we have presented our analysis in the form of FAQs as below:

Q 1. Is this proposal in line with OECD Transfer Pricing Guidelines and international best practices?

Ans: The concept of secondary adjustment as proposed to be introduced under Indian transfer pricing legislation is equivalent to the notion of secondary transaction under OECD Transfer Pricing Guidelines ('OECD TP'). OECD TP further defines 'Secondary Adjustment' as adjustment that arises from imposing tax on such secondary transaction. OECD TP states that such secondary transactions can take the form of constructive dividends, constructive equity contributions, or constructive loans.

In our limited research on the domestic legislations of other countries that provide for secondary transaction as understood under OECD TP, it came to our notice that most of such countries (such as Canada, Spain, France, Netherlands, South Korea, South Africa) indeed follow the approach of either constructive dividends or constructive equity contributions since it is then easier to administer such secondary transactions. In fact, South Africa amended its secondary adjustment regulations from constructive loans to constructive dividends w.e.f. 1st January 2015 for the reasons it acknowledged that such constructive loans were never repaid in practice and no contractual obligation existed to repay such loans. Furthermore, their regulations caused uncertainty about the currency of the loans as well as exchange control and accounting problems. Even the 'Report on Secondary Adjustments' by European Joint Transfer Pricing Forum way back in 2012 recommended its Member States to adopt either constructive dividend or equity contribution approach in order to avoid issues of double taxation on account of secondary adjustment. United Kingdom had issued a consultative document in May 2016 proposing to adopt constructive loan as the approach to carry out secondary transaction but has not yet finalized the regulations.

Q 2. When could it be supposed that the primary adjustment has been accepted by the assessee?

Ans: When the assessee has exhausted all possible remedies for contesting the primary adjustment made by the Assessing Officer.

Q 3. When the primary adjustment itself arises out of MAP, could the taxpayer initiate MAP with regard to the secondary adjustment?

Ans: Commentary on Article 9(2) of the OECD Model Tax Convention notes that the Article does not deal with secondary adjustments, and thus, it neither forbids nor requires tax administrations to make secondary adjustments. It further notes that some countries might refuse to grant relief in respect of other countries' secondary adjustments and indeed they are not required to do so under Article 9.

Q 4. Interpretation of the terminology used in Proviso to proposed Sec. 92CE(1) results in the exclusion being applied only in those cases where the primary adjustment is below 1 crore rupees (viz. equivalent to USD 150,000/- approx.) in respect of assessments for assessment year 2016-17 and before. Does it mean that secondary adjustment would apply in all cases *where the primary adjustment is more than such amount in any assessment made for years referenced above?*

Ans: Notes on clauses forming part of the 'Statement of Objects and Reasons' explains that secondary adjustment would not apply where the amount of primary adjustment is below the threshold amount as well as in all cases where primary adjustment has been made in respect of assessment years 2016-17 and before. It is widely believed that the terminology employed in such Proviso would undergo a revision to reflect the intention before the Finance Act 2017 is passed.

Q 5. Whether secondary adjustment would also apply with regard to primary adjustments made to 'Deemed International Transactions'?

Ans: Secondary adjustment would not apply with regard to primary adjustments made to '*Deemed International Transactions*' since the meaning of Associated Enterprises is restricted to Sec. 92A(1) and (2). Perhaps since a third party is involved in such circumstances, such transactions would have been deliberately excluded from the scope of Sec. 92CE.

Q 6. What could the corresponding Rules possibly prescribe?

Ans: The expected Rules could possibly deal with the following aspects:

- Period within which the 'excess money' needs to be repatriated to India
- Date from which such deemed advance would come into existence. For e.g. from year when primary adjustment is determined <u>or</u> from the year to which such primary adjustments relates to;
- Manner of computation of interest. For e.g. if interest on such deemed advance remains unpaid, whether interest on such deemed advance would be required to be capitalized?

Q 7. Would secondary adjustment apply when primary adjustment is made to the transfer price adopted by an assessee, being a Foreign Company, which files return of income in India?

Ans: Recently, certain judicial decisions[1] have upheld the validity of transfer pricing additions made in assessment of Foreign Companies by disregarding the base erosion theory and instead adopting a strict interpretation of transfer pricing regulations under current law. However, the terminology used in Sec. 92CE(2) would restrict the scope of secondary adjustments in such cases since the assumed 'excess money' in such cases would apparently be existing with Indian AE and therefore no longer be required to be repatriated back to India. Even otherwise, assuming that secondary adjustment could have applied in such cases, it would have led to obnoxious situations due to denial of corresponding adjustment in the hands of Indian AE under the prevalent transfer pricing regulations.

Q 8. Would provisions of Non-discrimination under DTAA apply for secondary adjustments made?

Ans: Non-discrimination cannot be alleged under any of the clauses of Article 24 (Non-Discrimination) of OECD / UN Model Tax Convention.

5. Limitation of Interest deduction in certain cases

It is a wide belief among tax administrations across the world that MNEs tend to adopt debt financing as a method of capitalizing a group company over equity financing as countries typically allow a deduction for interest paid or payable in arriving at the profit for tax purposes while the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus the amount of interest it pays, the lower will be its taxable profit. For this reason, debt is

[1] Instrumentarium Corporattion Ltd. v. ADIT [2016] 160 ITD 1 (Kolkata –Trib) (SB); Shell Global Solutions International BV v. DDIT [2017] 162 ITD 193 (Ahmedabad Trib)

often a more tax efficient method of finance than equity. Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action plan 4. The OECD has recommended several measures in its final report to address this issue. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base.

The Finance Bill 2017 proposes to insert a new Section 94B, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest expenses claimed by an entity to its associated enterprises would be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) *or* interest paid or payable to associated enterprise, whichever is less.

The provision would be applicable to (1) an Indian company and (2) a permanent establishment of a foreign company, being the borrower which pays interest in respect of any form of debt issued by a non –resident, being an AE of the borrower. Further, the debt issued by a lender would be deemed to have been issued by an AE where an AE provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender.

The provisions would allow for carry forward of disallowed interest expense to eight assessment years immediately succeeding the assessment year for which the disallowance was first made and granting deduction of such carried forward interest against the income computed under the head "Profits and gains of business or profession to the extent of maximum allowable interest expenditure in the respective subsequent assessment year(s).

In order to target only large interest payments, it is proposed to provide for a threshold of interest expenditure of 1 crore rupees (viz. equivalent to USD 150,000/- approx.) exceeding which the provision would be applicable.

It is further proposed to exclude Banks and Insurance business from the ambit of the said provisions keeping in view of special nature of these businesses.

This amendment is will take effect from 1st April, 2018 and will, accordingly, apply in relation to the assessment year 2018-19 and subsequent years.

Our analysis:

Since this is an important proposal, we have presented our analysis in the form of FAQs as below:

Q 1. Is this proposal really in line with recommendations under BEPS Action Plan 4?

Ans: This proposal is broadly in line with the recommendations under BEPS Action Plan 4 albeit with two significant deviations. One being that it refers to limitation being applied on gross interest amount rather than net interest amount. Second deviation being the deeming provision whereby a debt issued by a lender is deemed to have been issued by an AE if such AE provides an implicit or explicit guarantee or places a corresponding deposit with the lender. Further, although given as an option under BEPS Action Plan 4 recommendation, proposal under FB 2017 does not provide for carry forward of unused EBITDA percentage out of the cap. Understandably, this proposal also does not incorporate recommendations given for adoption of a group ratio over and above fixed ratio on account of implementation challenges.

Q 2. EBIDTA has not been defined. Is there any guidance available for it?

Ans: Para 88 of updated BEPS Action Plan 4 Report states that calculation of EBITDA should be based on values that are determined under the tax rules of the country applying the rule.

Hence, it is certain that it would mean tax-EBITDA and not accounting-EBITDA. However, since it has not been defined, it is not known whether tax-EBITDA would correspond to gross total income or net total income as calculated under the provisions of Income Tax Act, 1961.

Q 3. Interest has not been defined. Is there any guidance available for it?

Ans: The definition of 'Interest' u/s 2(28A) of Income Tax Act, 1961 would apply in such case.

Q 4. Would 'debt' include CCDs too?

Ans: Yes, it would include CCDs too under the given definition. Therefore, it could substantially change the way startups are funded at seed funding round from CCD issuance to CCPS issuance.

Q 5. *Under the deeming provision, the debt issued by a lender would be deemed to have been issued by an AE where an AE provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender. Would Indian lender be also covered in such circumstance?*

Ans: Although the Memorandum to the Finance Bill 2017 states that these rules are designed to counter cross-border shifting of profit through excessive interest payments and to protect a country's tax base, going by the terminology employed under Proviso to Sec. 94B(1), even debt issued by an India lender could be deemed to have issued by an AE.

Q 6. What is the meaning of implicit guarantee?

Ans: Although it has not been defined, it would include situations of pledge of shares, etc.

Q 7. Could you provide an example of how to calculate interest disallowance?

Ans: There is an anomaly between the language used under Memorandum to the Finance Bill 2017 and the Finance Bill 2017 itself. The difference in language is also evident from the difference in the results as calculated below. We anticipate that the language employed in Finance Bill 2017 would undergo a revision to reflect the intention before the Finance Act 2017 is passed.

Calculation as per language of Memorandum and Chapter 6 of BEPS Action Plan 4 Report:

	Debt @10%	Interest paid
AE	300	30
Non AE	200	20
		50

Case 1 :

EBITDA	150	
30% of EBITDA	45	**Allowance:** Whichever is lower
or		
Int to AE	30	
Therefore 30 is allowed		

Case 2 :

EBITDA	50	
30% of EBITDA	15	**Allowance:** Whichever is lower
or		
Int to AE	30	
Therefore 15 is allowed		

Calculation as per Finance Bill provisions:

	Debt @10%	Interest paid
AE	300	30
Non AE	200	20
		50

Case 1 :		
EBITDA	150	
Total Interest	50	
Less: 30% of EBITDA	45	
	5	**Disallowance:** Whichever is lower
or		
Int to AE	30	
Therefore 5 is disallowed. Hence, 45 is allowed (50-5)		

Case 2 :		
EBITDA	50	
Total Interest	50	
Less: 30% of EBITDA	15	
	35	**Disallowance:** Whichever is lower
or		
Int to AE	30	
Therefore 30 is disallowed. Hence, 20 is alllowed (50-30)		

Q 8. *What would happen in a loss situation?*

Ans: It has been expressly stated under Para 77 to BEPS Action Plan 4 Report that an entity would be unable to deduct any expense paid to its AE if it has negative EBITDA.

Q 9. *How would the carry forward provisions work when there is interest disallowance in a particular year?*

Ans: The carried forward interest would be allowed as a deduction in the subsequent year(s) to the extent of positive difference between (a) 30% of EBITDA and (b) Interest paid to AE in the respective year(s) till 8 subsequent assessment years. In other words, carried forward interest would not be considered for calculation once again in subsequent year(s).

Q 10. *Would the provisions of Article 11(2) of DTAA apply post calculation under Sec. 94B or before such calculation?*

Ans: Article 11(2) of OECD /UN MTC DTAA deals with the WHT rate on interest income earned by the non-resident payee whereas Sec. 94B deals with the interest deduction limitation in the hands of the resident payer. Therefore, Article 11(2) would apply to the entire amount of interest income earned by the non-resident payee irrespective of any disallowance u/s 94B in the hands of the resident payer.

Q 11. *Whether the provisions of transfer pricing under Chapter X and interest deduction limitation u/s Sec. 94B would simultaneously apply?*

Ans: Theoretically, provisions of transfer pricing and interest deduction limitation could apply side by side since provisions of Sec. 94B do not result in absolute allowance in a particular assessment year (on account of enabling carry forward provisions) whereas the provisions of transfer pricing would result in absolute disallowance in that particular assessment year. Rationally, provisions of Sec. 94B should apply after the application of provisions of transfer pricing since any additions on account of primary adjustment would modify the amount of EBITDA to which the calculation under Sec. 94B is linked.

Q 12. *Could the provisions of Sec. 94B and GAAR apply side by side?*

Ans: Sec. 94B and Sec. 95 (GAAR) both begin with a non-obstante clause. Answer to question 1 in CBDT Circular No. 7 of 2017 dated 27/01/2017 states that GAAR and SAAR can co-exist.

Therefore, even after application of Sec. 94B provisions, if an arrangement is classified as an impermissible avoidance arrangement, GAAR provisions could be subsequently invoked.

Q 13. *Would provisions of Non-discrimination under DTAA apply for interest deduction limitation pursuant to application of Sec. 94B?*

Ans: Non-discrimination could be alleged under Article 24(4) (Deduction based Non-Discrimination) of OECD / UN Model Tax Convention **only** for interest deductions limited by application of Sec. 94B(1). Moreover Article 24(4) could not even be applied for interest deduction limited under Proviso to Sec. 94B(1).

Q 14. What could be the foreseeable hardship that assessees would face under this Section?

Ans: Assessees in the infrastructure sector (including real estate) could face genuine hardship since long gestation periods are typically involved therein effectively pushing the debt cost even higher.

There is also a possibility of double taxation arising on account of application of Sec. 94B if carried forward interest lapses in succeeding assessment years.

Absence of group ratio rule would cause inconvenience to companies whose Interest/EBITDA ratio is lower than its group Interest/EBITDA ratio.

Proviso to Sec. 94B would cause great hardship to assessees although they would have borrowed from Indian lenders who would have lent the funds after application of prudential norms.

6. Extension of eligible period of concessional tax rate on interest in case of External Commercial Borrowing and Extension of benefit to Rupee Denominated Bonds

The existing provisions of section 194LC of the Act provide that the interest payable to a non-resident by a specified company on borrowings made by it in foreign currency from sources outside India under a loan agreement or by way of issue of any long-term bond including long-term infrastructure bond shall be eligible for concessional TDS of five per cent. It further provides that the borrowings shall be made, under a loan agreement at any time on or after the 1st July, 2012, but before the 1st July, 2017; or by way of any long-term bond including long-term infrastructure bond on or after the 1st October, 2014 but before the 1st July, 2017, respectively.

Various representations were made by taxpayers for extension of concessional rate of TDS under sections 194LC of the Act. Therefore, it is proposed to amend section 194LC to provide that the concessional rate of 5% TDS on interest payment under this section will now be available in respect of borrowings made before the 1st July, 2020.

This amendment is proposed to be effective from AY 2018-19 (i.e. FY 2017-18) onwards.

Further, consequent upon demand from various stakeholders for granting benefit of lower rate of TDS to rupee denominated bonds, a Press Release dated 29th October, 2015 was issued by CBDT clarifying that TDS at the rate of 5 per cent would be applicable to these bonds in the same way as it is applicable for off-shore dollar denominated bonds. In order to give effect to the above, it is further proposed to extend the benefit of section 194LC to rupee denominated bond issued outside India before the 1st July, 2020.

This amendment is proposed to be effective from AY 2017-18 (i.e. FY 2016-17) onwards. Therefore, it has retrospective effect from 1.4.2016.

Our analysis:

Section 194LC is applicable to interest paid by Indian Company on External Commercial Borrowings (ECB) and Foreign Currency Convertible Bonds & Foreign Currency Exchangeable Bond and certain infrastructure bonds. The benefit of lower deduction of TDS @ 5% has been extended time and again. The current government has continued to boost the economy in various ways through initiatives such as Make in India and various liberalizations to FDI regulations and has therefore proposed to extend this benefit upto 1st July 2020. Further, Rupee Denominated Bonds (popularly known as Masala Bonds) have been permitted to be issued by Reserve Bank of India ('RBI') following guidelines issued vide A.P. (DIR Series) Circular No. 17 dated 29th September 2015) and (A.P. (DIR Series) Circular No. 60 dated 13th April 2016 and (A.P. (DIR Series) Circular No. 31 dated 16th February 2017 which widens the eligibility of investors to any persons being resident outside India. Therefore, the benefit on lower deduction of TDS @ 5% has now been extended to such Masala Bonds too. Furthermore, this budget has also given fuel to further issuance of rupee denominated bonds by amending Section 47 of the ITA to provide that transfers of rupee denominated bonds of an Indian company by a non-resident to another non-resident from FY 2017-18 onwards shall not be considered to be a transfer under the ITA.

7. Extension of eligible period of concessional tax rate under section 194LD

The existing provisions of section 194LD of the Act, provides for lower TDS at the rate of five per cent. in the case of interest payable at any time on or after 1st June, 2013 due before the 1st July, 2017 to FIIs and QFIs on their investments in Government securities and rupee denominated corporate bonds, provided that the rate of interest does not exceed the rate notified by the Central Government in this behalf. It is proposed to amend section 194LD to provide that the concessional rate of five per cent. TDS on interest will now be available on interest payable before the 1st July, 2020.

This amendment will take effect from 1st April, 2018 and will, accordingly, apply in relation to the AY 2018-19 (FY 2017-18) onwards.

Our analysis:

In order to extend similar benefit of reduced TDS under section 194LC to interest paid to Foreign Institutional Investors (FIIs) and Qualified Foreign Investors (QFIs), it is proposed to extend the availability of benefit upto 1st July 2020. One of the most common mode of raising funds from FPIs is through issuance of NCDs by Indian corporates. The extension of benefit would encourage more foreign investment in the debt market by such FIIs and QFIs.

8. Rationalisation of Provisions relating to tax credit for Minimum Alternate Tax and Alternate Minimum Tax

Section 115JAA contains provisions regarding carrying forward and set off of tax credit in respect of Minimum Alternate Tax (MAT) paid by companies under section 115JB. Currently, the tax credit can be carried forward upto tenth assessment years.

In order to provide further relief to assessees paying MAT, it is proposed to amend section 115JAA to provide that the tax credit determined under this section can be carried forward up to fifteenth assessment years immediately succeeding the assessment years in which such tax credit becomes allowable.

Further, similar amendment is proposed in section 115JD so as to allow carry forward of Alternate Minimum Tax (AMT) paid under section 115JC upto fifteenth assessment years in case of non-corporate assessee.

In cases of foreign taxes paid by assessees, it is proposed to amend section 115JAA and 115JD so as to provide that the amount of tax credit in respect of MAT/ AMT shall not be allowed to be carried forward to subsequent year to the extent such credit relates to the difference between the amount of foreign tax credit (FTC) allowed against MAT/ AMT and FTC allowable against the tax computed under regular provisions of Act other than the provisions relating to MAT/AMT.

These amendments will be applicable for AY 2018-19 and subsequent years.

Our analysis:

Two amendments have been proposed relating to MAT/AMT. MAT in simple terms is an obligation to pay a minimum tax @ 18.5% of book profit, if the tax payable under normal provisions of ITA (after giving effect to various deductions) is lesser than MAT. This ensured to fill the coffers of the Government in cases where exemptions were provided to various entities under ITA whereby incidence of taxation was postponed to future years. Thus, MAT acted as a presumptive tax and an anti-avoidance measure. | Over the years, there have been various representations for abolishing MAT, however, though the Government did not eliminate MAT altogether, it has proposed to reduce the burden by allowing carry forward of MAT credit upto 15 years as compared to the earlier 10 years. Such credit shall be carry forward for 15 years immediately succeeding the assessment years in which such tax credit becomes allowable. For example MAT credit which pertains to AY 2018-19 shall be allowed to be carried forward till AY 2033-34. | The second amendment proposed to MAT/AMT provisions is in connection to foreign income earned by assesses on which foreign tax credit ('FTC') is available. Currently under the erstwhile provisions, MAT credit is the difference between the MAT paid and the tax computed under the normal provisions of ITA that can be carried forward as credit for future years and be set off against tax payable under normal ITA provisions. However, as per the new provisions proposed in this budget, MAT credit will not be allowed to be carried forward to the extent that the amount of FTC that can be claimed against MAT exceeds the amount of FTC that is claimable against tax computed under the normal ITA provisions. To illustrate by way of some examples:

Particulars		Illustration 1	Illustration 2	Illustration 3
Normal Tax Liability	A	50	75	90
MAT Liability	B	75	100	100
FTC u/s 90/90A/91	C	75	55	95
Erstwhile Provisions:				
FTC allowed	C or B ↓	75	55	95
MAT / AMT carried forward	B-A	25	25	10
Effect of Amendment:				
FTC claimed in CY	C or B ↓	75	55	95
Excess MAT / AMT Credit*	D=C-A	25	NIL	5
MAT / AMT carried forward	B-A-D	NIL	25	5

* Excess MAT / AMT credit = FTC claimed against MAT/AMT liability (Less) FTC against normal provisions tax

As per the illustration above, it is evident that the carry forward of MAT is being restricted although providing a miniscule relief by allowing the carry forward for a period of 15 years instead of 10 years.

9. Modification in conditions of special taxation regime for off shore funds under section 9A

Section 9A of the ITA provides for a special regime for taxation of offshore funds. As per the section, for an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India merely because the eligible fund manager undertaking fund management activities on its behalf is located in India. The benefit under section 9A is available subject to various other conditions. Conditions for eligibility of the fund inter-alia, are related to residence of fund, corpus, size, investor broad basing, investment diversification and payment of remuneration to fund manager at arm's length.

In respect of corpus of the fund, the condition is that the monthly average of the corpus of the fund shall not be less than one hundred crore rupees except where the fund has been established or incorporated in the previous year. In such case, the corpus of fund is required to achieve the rupees 100 crore condition by the end of such previous year and the monthly requirement shall not apply.

Representations were made stating that in the year in which the fund is being wound up, it would not be possible to maintain the monthly average of the corpus of the fund of one hundred crore rupees as required. To rationalise the regime and to address the concerns of the stakeholders, it is proposed to provide that in the previous year in which the fund is being wound up, the condition that the monthly average of the corpus of the fund shall not be less than rupees 100 crore, shall not apply.

This amendment will take effect retrospectively from 1st April, 2016 and shall apply to the assessment year 2016-17 and subsequent years.

Our analysis:

Section 9A was introduced vide Finance Act 2015 and further modified vide Finance Act 2016 to facilitate location of fund manager in India and articulate conditions applicable to offshore funds for benefit of exemption. The tax regime and issues surrounding such funds have been elaborated in P.R. Bhuta & Co.'s previous years' Budget analysis. Please refer - http://eepurl.com/bhAT8n & http://eepurl.com/bUyQFv | Since its inception, section 9A has not been able to provide benefit as the conditions therein are practically difficult to adhere with. The government has time and again tried to amend the provision concerning offshore funds to facilitate fund management from India but have not been fruitful. | Finance Bill, 2017 has proposed to amend Section 9A to do away with the requirement for an offshore fund to maintain a corpus of at least rupees 100 crore in case of a fund that has been wound up during the previous year. This amendment along with earlier amendment by Finance Act 2016, has alleviated a few concerns surrounding offshore funds but it does not seem to have provided enough thrust to the regime. | Stringent conditions result in private equity and venture capital funds not opting into such a regime as they prefer not to be bound by conditions relating to minimum number of investor requirement, the requirement to not invest more than 20% of corpus in one entity, etc.

10. Scope of section 92BA of the Income-tax Act relating to Specified Domestic Transactions ('SDT')

The existing provisions of section 92BA of the Act, inter-alia provide that any expenditure in respect of which payment has been made by the assessee to certain "specified persons" under section 40A(2)(b) are covered within the ambit of specified domestic transactions. As a matter of compliance and reporting, taxpayers were required to obtain the chartered accountant's certificate in Form 3CEB providing the details such as list of related parties, nature and value of specified domestic transactions (SDTs), method used to determine the arm's length price for SDTs, positions taken with regard to certain transactions not considered as SDTs, etc. This considerably increased the compliance burden of the taxpayers.

In order to reduce the compliance burden of taxpayers, it is proposed to provide that expenditure in respect of which payment has been made by an assessee to a person referred to under section 40A(2)(b) are to be excluded from the scope of section 92BA of the Act. Accordingly, it is also proposed to make a consequential amendment in section 40(A)(2)(b) of the Act.

These amendments will apply from AY 2017- 18 and subsequent years.

Our analysis:

Applicability of transfer pricing compliance was brought to certain specified domestic transactions through Finance Act 2012. At the time of introduction, the section applied when the aggregate of transactions enumerated under the section exceeded rupees 5 crores. This threshold limit was enhanced to rupees 20 crores through Finance Act 2015 in order to reduce adversities faced by small businesses by way of compliance costs and burden. | Transactions between specified persons under section 40A(2)(b) was one of the six limbs of transactions covered by sections 92BA. Such transactions between related parties was perceived to create tax arbitrage thereby reducing the tax base of the government. | However, the compliance costs relating to such transactions was a impediment to the taxpayers as well as to the government as compliance of the section was to be ensured through the specialized wing of transfer pricing officers. | The erstwhile section 40A(2)(b) [before introductions of domestic transfer pricing] already had in place the concept of fair market value ('FMV') which was to be proved in case of transactions between such specified persons. Both provisions (i.e. before and after insertions of domestic transfer pricing) led to the same conclusion albeit through additional compliances. Accordingly, an extremely welcome proposal, such transactions between specified persons are now proposed to be excluded from requirement of transfer pricing compliance. | It must be noted that compliance with the erstwhile FMV shall once again be required for such transactions. | Domestic Transfer Pricing shall continue to apply to the rest of the transactions cited under sections 92BA where the aggregate amount of such transactions exceeds 20 crore rupees.

11. Tax neutral conversion of preference shares to equity shares

Under the existing provisions of the Act, conversion of security from one form to another is regarded as transfer for the purpose of levy of capital gains tax. However, tax neutrality to the conversion of bond or debenture of a company to share or debenture of that company is provided under the section 47. No similar tax neutrality to the conversion of preference share of a company into its equity share was provided till date. In order to provide tax neutrality to the conversion of preference share of a company into equity share of that company, it is proposed to amend section 47 to provide that the conversion of preference share of a company into its equity share shall not be regarded as transfer.

Consequential amendments are also proposed in section 49 and section 2(42A) in respect of cost of acquisition and period of holding. These amendments will take effect from 1st April, 2018 and apply in relation to the AY 2018-19 onwards.

Our analysis:

Finance Bill 2017 has proposed to bring on par the tax neutrality available to conversion of preference shares with that of bonds and debentures. Hitherto, due to various judicial precedents, conversion of preference shares into equity shares were typically charged to tax. | Due to ambiguity in law certain assesses preferred to pay tax at the time of sale of equity shares on the full difference between the sale consideration and the cost of acquisition of the preference shares, while some paid tax at two points i.e. *first* at the time of conversion of the preference shares, on the difference between the market value of the resulting equity shares and the cost of acquisition of the preference shares and *second* at the time of sale of the resulting equity shares, on the difference between the consideration received on the sale of the resulting equity shares and the market value of the equity shares at the time of conversion. | Litigation was afloat and therefore the Hon'ble FM has finally cleared the muddle through the proposed amendment. Corresponding amendment to section 2(42A) has ensured substitution of holding period of equity share to include the holding period of original preference share and amendment to section 49 substitutes the cost of preference share as the cost of acquisition of equity share.

12. Cost of acquisition in Tax neutral demerger of a foreign company

Under the existing provision of section 47(vic), the transfer of shares of an Indian company by a demerged foreign company to a resulting foreign company is not regarded as transfer. It is proposed to amend section 49 so as to provide that cost of acquisition of the shares of Indian company referred to in section 47(vic) in the hands of the resulting foreign company shall be the same as it was in the hands of demerged foreign company.

This amendment is applicable from 1st April, 2018 and accordingly apply to the AY 2018-19 (FY 2017-18) and subsequent years.

Our analysis:

When shares of an Indian Company are transferred by a demerged foreign company to the resulting foreign company, such transfer has been exempted from tax subject to certain conditions. While the transfer was exempted from tax, there was no corresponding provision for calculation of cost of acquisition of the Indian company shares by the resulting company. | To rectify such an anomaly, this budget has proposed that cost of (Indian Co) shares which are transferred to the resulting foreign company shall be the same cost of acquisition as that of the demerged foreign company. This ensures the tax neutrality status of a foreign demerger.

13. Extension of capital gain exemption to Rupee Denominated Bonds

Indian corporates have been permitted by the Reserve Bank of India (the RBI) to issue rupee denominated bonds outside India as a measure to enable the Indian corporates to raise funds from a source outside India. Finance Act, 2016, inter-alia, amended section 48 of the Act with effect from the 1st April, 2017 so as to provide that the gains arising on account of appreciation of rupee against a foreign currency at the time of redemption of rupee denominated bond of an Indian company subscribed by him, shall be ignored for the purpose of computation of full value of consideration.

Various representations were made to allow exemption from capital gain arising to secondary holders. It was also represented to allow exemption in respect of transfer of Rupee Denominated Bonds from non-resident to non-resident for the purpose of increasing acceptability and transferability of such instrument in the foreign market. In order to further provide relief in respect of gains arising on account of appreciation of rupee against a foreign currency at the time of redemption of rupee denominated bond of an Indian company to secondary holders as well, it is proposed to amend section 48 providing that the said appreciation of rupee shall be ignored for the purposes of computation of full value of consideration.

Further, with a view to facilitate transfer of Rupee Denominated Bonds from non-resident to non-resident, it is proposed to amend section 47 so as to provide that any transfer of rupee denominated bond of Indian company issued outside India, by a non- resident to another non- resident shall not be regarded as transfer.

Amendments are applicable from AY 2018-19 i.e. FY 2017-18 onwards.

Our analysis:

The Rupee Denominate Bonds popularly known as Masala Bonds permitted by RBI have been a huge success and enabled Indian corporates to raise funds from abroad. One of the attractive features of this bond is that at the time of redemption such bonds shall be converted at the market rate of foreign currency prevalent then and therefore requires the Indian corporate to bear the risks of foreign exchange gain/loss. | In light of the same, Finance Act 2016 was amended to provide that the gains arising on account of appreciation of rupee against a foreign currency at the time of redemption of rupee denominated bond of an Indian company subscribed by a person, shall be ignored for the purpose of computation of full value of consideration. | These masala bonds are permitted to be listed on stock exchanges outside India and therefore allows free transferability of such bonds. However, the erstwhile section only applied to *subscribers* of masala bonds. It has now been proposed to also cover secondary holders of such bonds to assuage the transferability of the bonds by providing tax certainty. | Since the bonds are a debt instrument issued by an Indian corporate there was doubt about taxation in India when they were transferred from one NR to another NR outside India. To put an end to any speculation, it has been proposed to provide that any transfer of rupee denominated bond of Indian company issued outside India, by a non- resident to another non- resident shall not be regarded as transfer and thereby further push the success of issuance of Masala Bonds.

14. Enabling claim of credit for foreign tax paid in cases of dispute

The existing provisions of section 155 of the Act provide for procedure for amendment of assessment order in case of certain specified errors.

In view of rule 128 of the Income-tax Rules, 1962, which provides a mechanism for claim of foreign tax credit, it is proposed to insert sub-section (14A) in section 155 to provide that where credit for foreign taxes paid is not given for the relevant assessment year on the grounds that the payment of such foreign tax was in dispute, the Assessing Officer shall rectify the assessment order or an intimation under sub-section (1) of section 143, if the assessee, within six months from the end of the month in which the dispute is settled, furnishes proof of settlement of such dispute, submits evidence before the Assessing Officer that the foreign tax liability has been discharged and furnishes an undertaking that credit of such amount of foreign tax paid has not been directly or indirectly claimed or shall not be claimed for any other assessment year.

This amendment will take effect from AY 2018-19 (FY 2017-18) and subsequent years.

Our analysis:

In cases where foreign tax credit has been denied to an assessee on the ground that payment of such tax was in dispute in the foreign country, it is now provided to give credit of such tax on settlement of such dispute in the foreign country. To avail the credit, the assessee shall be required to make an application the Assessing Officer ('AO') within six months from the end of the month of settlement and also furnish proof of settlement and taxes paid and also provide an undertaking that the credit has and shall be availed only once. Such credit of foreign tax shall be allowed in the year in which foreign income (pertaining to the disputed FTC) was offered to tax in India. | Vide Notification No. 54/2016 dated 27th June 2016, CBDT had issued the final rules (Rule 128 of the Income Tax Rules, 1962

('ITR')) for the purpose of availing foreign tax credit after releasing a draft version open to public for providing comments in April 2016. P.R. Bhuta had made a representation to CBDT on such draft rules which can be referred at http://eepurl.com/boRAYT. Sub-rule 4 of the rule had already provided that credit for any foreign tax under dispute shall not be available for the purpose of computation of tax in India but shall be to be available only on settlement of dispute in foreign country after furnishing proofs and undertaking as mentioned above. Therefore, insertion of proposed sub-section 14A is only proposed to provide legal sanctity to an Assessing Officer to rectify an order of assessment/intimation / deemed intimation.

15. Fair Market Value to be full value of consideration in certain cases

Under the erstwhile provisions of ITA, income chargeable under the head "Capital gains" is computed by taking into account the amount of full value of consideration received or accrued on transfer of a capital asset. To ensure that the full value of consideration is not understated, the ITA also contains provisions for deeming of full value of consideration in certain cases such as deeming of stamp duty value as full value of consideration for transfer of immovable property in certain cases.

It is proposed to insert a new section 50CA to provide that where consideration for transfer of shares of a company (other than quoted shares) is less than the Fair Market Value (FMV) of such shares determined in accordance with the prescribed manner, the FMV shall be deemed to be the full value of consideration for the purposes of computing income under the head "Capital gains".

This amendment will take effect from 1st April, 2018 and will, accordingly, apply in relation to the assessment year 2018-19 and subsequent assessment years.

Our analysis:

In cases where the price at which a share of a company (other than "quoted" share) has been sold at an amount lower than FMV, the FMV shall be deemed to be the sale price of such a share and therefore levy tax on a notional income. | The definition of quoted share has been defined to only include shares that are quoted on a recognized stock exchange and are regularly traded. Thereby, the applicability of the proposed section has not been restricted to just unlisted shares but includes shares that are not regularly traded. However, there is no specific mention to the meaning and duration of the term *regularly*. Also, such section would apply not only to equity shares but also to preference shares, rights, warrants, etc. but not applicable to shares that are held as stock in trade by an assessee. | For shares that fall outside the definition of quoted shares, the FMV of such shares shall be required to be calculated as prescribed. The prescribed method would form part of the rules that would be issued after the Finance Bill, 2017 is passed as an Act. Therefore, the computation mechanism for calculation of FMV shall remain a question mark until such rules are notified. | The proposed amendment would apply irrespective of the residential status of the transferor. Eg. a non-resident / foreign company selling shares in India | Where shares were undervalued, the transferee was taxed on the difference between the consideration and FMV under sub-clauses of section 56. Accordingly, a single transaction would lead to **double taxation**, first, in the hands of the transferor, it would be taxed on a notional capital gains on the difference between the notional fair market value of the shares and the actual consideration received (section

50CA); and second in the hands of the transferee it would be taxed under Section 56(2)(x) (which is now further widened to cover all types of assesses – explained below in detail elucidating the proposed amendment to section 56) in respect of the difference between the notional fair market value of the shares and the consideration actually paid thereby creating artificial tax burden to both transferor and transferee.

16. Widening scope of Income from other sources

Under the existing provisions of section 56(2)(vii), any sum of money or any property which is received without consideration or for inadequate consideration (in excess of the specified limit of Rs. 50,000) by an individual or Hindu undivided family is chargeable to income-tax in the hands of the resident under the head "Income from other sources" subject to certain exceptions. Further, receipt of certain shares by a firm or a company in which the public are not substantially interested is also chargeable to income-tax in case such receipt is in excess of Rs. 50,000 and is received without consideration or for inadequate consideration.

The existing definition of property for the purpose of this section includes immovable property, jewellery, shares, paintings, etc. These anti-abuse provisions are currently applicable only in case of individual or HUF and firm or company in certain cases. Therefore, receipt of sum of money or property without consideration or for inadequate consideration does not attract these anti-abuse provisions in cases of other assesses.

In order to prevent the practice of receiving the sum of money or the property without consideration or for inadequate consideration, it is proposed to insert a new clause (x) in sub-section (2) of section 56 so as to provide that receipt of the sum of money or the property by any person without consideration or for inadequate consideration in excess of Rs. 50,000 shall be chargeable to tax in the hands of the recipient under the head "Income from other sources". It is also proposed to widen the scope of existing exceptions by including the receipt by certain trusts or institutions and receipt by way of certain transfers not regarded as transfer under section 47.

Consequential amendment is also proposed in section 49 for determination of cost of acquisition.

These amendments will take effect from 1st April, 2017 and the said receipt of sum of money or property on or after 1st April,2017 shall be chargeable to tax in accordance with the provisions of proposed clause (x) of sub-section (2) of section 56.

Our analysis:

Where property or money was received without consideration or below its fair market value, such transactions were subject to tax as income from other sources only to **Individuals and HUFs** [56(2)(vii)]. Separately, when a **firm or closely held company** received shares of a closely held company without consideration or below FMV, such transactions were also subjected to tax [56(2)(viia)]. Such transactions were applicable respectively to only Individuals, HUFs, firms or certain companies and hence many assessees where able to plan their affairs to avoid incidence of taxability. To bring applicability to all types of assesses, it has been proposed to repeal the erstwhile section 56(2)(vii) and 56(2)(viia) of the ITA and replace it with section 56(2)(x) for all receipts after 1.4.2017. Therefore, the proposed section shall be applicable to all assesses irrespective of residential status. It would therefore also bring under its ambit AOPs, BOIs, listed companies, trusts, and even foreign companies apart from the already covered individuals, HUFs, firms and closely held companies. In the case of companies or firms, where the section applied only to transactions that involved shares, the proposed section shall widen its applicability to include diverse properties. Exemptions have been allowed in the following situations:

- Receipts from relatives (definition of relative provided in section 56(2)(vii))
- Receipts on occasion of marriage
- Receipts under a will or by way of inheritance
- Receipts in contemplation of death of the payer or donor
- Receipts from local authority as defined in section 10(20) of the ITA
- Receipts from or by university, educational institution, hospital, trust or institution registered under some sub-clauses of section 10(23C) of ITA
- Receipts from or by charitable trusts or institutions (registered under section 12AA of ITA)
- In cases where certain transactions are not regarded as transfer – e.g. Partition of HUF, certain amalgamations / demergers.

It should be noted that conversion of preference shares or bonds or debentures has not be specifically excluded in the list mentioned above and would therefore open up a pandora's box and cause tax uncertainty to foreign investors who prefer to invest through convertible securities in India. In cross border transaction between associated enterprises there are some cases where foreign holding companies pay amounts by way of subvention to its Indian subsidiaries to cover the loses made by such subsidiaries. This is primarily to protect its own capital investment in the company. Supreme Court has held that such receipt is a capital receipt and not revenue in nature. However, in absence of any clarity, since such subvention is received without any consideration, these transactions could also be covered under this section. Also, issues relating to applicability in other cases such as receipt of subsidies, introduction of capital in kind into a partnership, applicability at the time of liquidation of companies or buyback of shares etc need to be addressed. Double taxation of the same notional income due to interplay between section 50C & 50CA and section 56(2)(x) exists. (explained in detail above) Beneficially, when such assessee sells the property, the FMV on which tax has been calculated for section 56 shall be considered as the cost of acquisition. Legitimate business transactions would certainly be affected by this amendment. The section being introduced as an anti-abuse provision, CBDT should ensure that assesses are not unduly harassed by application of this section due to its nature of taxing notional income.

17. Clarification regarding the applicability of section 112

Finance Act, 2012 with effect from 1st April, 2013 amended the provisions of section 112(1)(c) to provide concessional rate of taxation of ten per cent for long-term capital gains arising from the transfer of unlisted securities by non-resident. There was an uncertainty regarding the application of section 112(1)(c)(iii) to the transfer of share of a private company.

Finance Act, 2016 amended section 112(1)(c) to clarify that the share of company in which public are not substantially interested shall also be chargeable to tax at the rate of ten per cent with effect from 1st April, 2017. As the concessional rate was originally provided w.e.f. 1st April, 2013, there was uncertainty about the applicability of the amendment to the intervening period. To clarify that the amendment made by Finance Act, 2016 shall also apply to the period from 1st April, 2013 to 31st

March, 2017, it is proposed to amend section 50 of the Finance Act, 2016 so as to provide that the effective date of amendment made to section 112(1)(c)(iii) vide Finance Act,2016 shall be 01-04-2013 instead of 01-04-2017.

This amendment will take effect, retrospectively from 1st April, 2013 and will, accordingly, apply in relation to the assessment year 2013-14 and subsequent assessment years.

Our analysis:

This amendment it merely clarificatory in nature and puts to rest any uncertainty and litigation regarding availability of concessional rate of 10% in case of transfer by non-resident shares of a company in which public are not substantially interested by providing retrospective application of the amended section from FY 2012-13.

18. Definition of 'person responsible for paying' in case of payments covered under sub-section (6) of section 195

The existing provisions of section 204 of Act, has defined the meaning of 'person responsible for paying' to include employer, company or its principal officer or the payer. Further clause (iii) of section 204 of the Act, inter alia, provides that in the case of credit or payment of any sum chargeable under the provisions of this Act, the 'person responsible for paying' shall be the payer himself, or, if the payer is a company, the company itself including the principal officer thereof. However, the said section does not cover in respect of payment of any sum as per sub-section (6) of section 195, which mandates the 'person responsible for paying' to furnish information relating to payment of any sum, whether chargeable to tax or not.

Thus in order to bring clarity to the meaning of 'person responsible for paying' in case of payment by a resident to a non-resident in accordance with section 195(6) of the Act, it is proposed to amend the said section of the Act to provide that in the case of furnishing of information relating to payment to a non-resident, not being a company, or to a foreign company, of any sum, whether or not chargeable under the provisions of this Act, 'person responsible for paying' shall be the payer himself, or, if the payer is a company, the company itself including the principal officer thereof.

This amendment will take effect from 1st April, 2017.

Our analysis:

Under section 195 of the ITA, where any payment is to be made to a non resident (excluding certain payments to non-residents covered under a specific section of ITA), the person making such payment is required to furnish details of the payment in Form 15CA and/or 15CB. | The “person responsible for paying” in cases of payments to non-residents was not specifically defined under the ITA. This led to procedural difficulty to penalize the persons who did not comply with section 195(6) of the ITA and Rule 37BB of the ITR (recently amended – Please refer P.R. Bhuta & Co’s analysis of the amended rule at http://eepurl.com/bKtDPT). | This amendment is therefore proposed to provide legal responsibility to such persons making payment to a non-resident.

ANALYSIS OF CBDT CIRCULAR ON PLACE OF EFFECTIVE MANAGEMENT ('POEM')

In order to determine the residential status of a company, section 6(3) of the ITA was amended vide Finance Act, 2015 to provide that *a company is said to be resident in India in any previous year, if-*

(i) *it is an Indian company; or*
(ii) *its place of effective management in that year is in India .*

"Place of effective management" is defined in the Act to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made.

Draft guidance for determination of place of effective management were issued on 23rd December 2015 with public invitation to send comments and suggestions on the same. PR Bhuta & Co's representation to the CBDT on such draft guidelines can be referred at http://eepurl.com/bMR4kH. However, the final guidelines were not released till the end of the fiscal year and therefore, Finance Act, 2016 postponed the applicability of the section to be effective from 1st April 2017 and will apply to Assessment Year 2017-18 (Financial Year 2016-17) and subsequent assessment years.

The much awaited final guidelines were eventually issued by CBDT on 24th January, 2017 vide Circular No. 6 of 2017 (i.e. almost 11 months after the applicability of the section has already commenced). The circular can be viewed at https://goo.gl/CDyg4v. Circular No. 8 issued by CBDT on 23rd February 2017, clarifies that the POEM guidelines shall not apply to companies having turnover or gross receipts of Rs. Fifty crore or less in a financial year.

It has time and again been made clear in the guidelines that determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management. Principles for determining POEM provided in the circular are for guidance only. No single principle will be decisive in itself. The above principles are not to be seen with reference to any particular moment in time but rather activities performed over a period of time, during the previous year. In other words a "snapshot" approach for determination of POEM is not to be adopted. In other words, the determination of POEM is to be based on substance over form. The POEM of a company is to be undertaken each year.

Adequate administrative safeguards have been incorporated in the guidelines by mandating that the Assessing officer ('AO') is required to seek approval from Principal Commissioner of Income Tax/ Commissioner of Income-tax before initiating inquiry for POEM in a case of an assessee. The AO shall also obtain approval from Collegium of Principal Commissioners of Income-tax before holding that POEM of a non-resident company is in India. The collegium so constituted shall also be required to provide an opportunity of being heard to the company before issuing any directions determining POEM.

In order to understand guidelines issued for determination of POEM, we have prepared below a simplified flowchart providing a snapshot of the same:

Company engaged in Active Business outside India

<u>Conditions:</u>

(i) Passive Income is not more than 50% of its total income; and
(ii) Less than 50% of its total assets are situated in India; and
(iii) Less than 50% of total number of employees are situated in India or are resident in India; and
(iv) The payroll expenses incurred on such employees is less than 50% of its total payroll expenditure;

Yes

Majority Board Meetings <u>outside</u> India

Yes

POEM <u>outside</u> India

No

POEM <u>in</u> India

<u>Points to be noted:</u>

i. If on facts and circumstances it is established that Board of Directors ('BOD') are standing aside and not exercising their powers of management and such powers are being exercised by either the holding company or any other person (s) resident in India → **POEM in India**

No

<u>Stage 1</u> - Identification or ascertaining the person(s) who actually make the key management and commercial decision for conduct of the company's business as a whole

<u>Stage 2</u> - Determination of place where these decisions are in fact being made

Place where management decisions are <u>*taken*</u> more important than place where decisions are <u>*implemented*</u>

<u>Guiding Principles for determining POEM:</u>

i. **Location where board regularly meets and make decisions → POEM**. <u>*Points to be noted:*</u> BOD retains and exercises its authority to govern | BOD in substance makes key management and commercial decisions necessary for the conduct of the business as a whole | Mere formal holding of BOD meetings at a place not conclusive for determination of POEM | If key decisions by directors are in fact being taken in a place other than place of formal meetings then such other place relevant for POEM | Incase of de facto delegation, place of meeting of delegated authority to be POEM

ii. **Delegation of Authority to executive committee or key members.** <u>*Points to be noted:*</u> Location where members of the executive committee are based and where committee develops and formulates the key strategies and policies for mere formal approval by the full board, often considered as POEM | Delegation of authority may

ii. Merely because BOD follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of Pay roll functions, Accounting, Human resource (HR) functions, IT infrastructure and network platforms, Supply chain functions, Routine banking operational procedures, and not being specific to any entity or group of entities per se; not to constitute BOD of companies standing aside.

iii. For determining if company is engaged in ABOI, the average of the data of the previous year and two years prior to be considered. In case company in existence for a shorter period, then data of such period to be considered.

iv. Where accounting year for tax purposes, in accordance with laws of country of incorporation of the company, is different from the PY in India, then, data of the accounting year that ends during the relevant PY and two accounting years preceding it to be considered.

Definitions of passive income, head office and senior management and computation mechanism of ABOI has been provided in the circular.

be de jure (by means of a formal resolution or Shareholder Agreement) or de facto (based upon the actual conduct of BOD and the executive committee)

iii. **Location of Head Office.** <u>*Points to be noted:*</u> Single location of senior management and their support staff and location publically known as principal place of business or HQ → POEM | If decentralized senior management, then head office is where these senior managers- (i) are primarily or predominantly based or (ii) normally return to following travel to other locations or (iii) meet when formulating or deciding key strategies and policies for the company as a whole | If senior management participate in meetings using technology, head office is normally place of highest level of management and their direct support staff | In situations where the senior management is so decentralised that it is not possible to determine the head office with a reasonable degree of certainty, the location of head office would not be of much relevance in determining POEM

iv. **Use of Technology.** <u>*Points to be noted:*</u> No longer necessary for the persons taking decision to be physically present at a particular location, therefore physical location of BOD meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made | Place where the directors or the persons taking the decisions or majority of them *usually reside* may be relevant factor

v. **Circular Resolution or Round Robin Voting.** <u>*Points to be noted:*</u> Frequency of use, type of decisions made and location of parties involved are to be considered for POEM | Location of proposer of decision alone not to be relevant but based on past practices and general conduct to be used for determination of POEM | Location of person who has the authority and who exercises the authority to take decisions considered more important than location of proposer

vi. **Decisions by Shareholders.** <u>*Points to be noted:*</u> Decisions made by SH on matters reserved for SH decision under company laws not relevant for determination of POEM eg. dissolution, liquidation, issue of shares, etc | SH involvement could through a formal arrangement by way of shareholder agreement etc. or by way of actual conduct turn into effective management | Whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only

vii. **Routine operational decisions.** <u>*Points to be noted:*</u> Day to day routine operational decisions undertaken by junior and middle management not relevant for POEM | The operational decisions relate to oversight of day-to-day business operations and activities of a company whereas key management and commercial decision are concerned with broader strategic and policy decision | Where person responsible for operational decision is also responsible for the key management and commercial decision to distinguish the two type of decisions and assess POEM

All the above factors are not to be seen in isolation but to be seen as a whole in order to determine effective management.