Finance (No. 2) Bill 2014

Analysis of Important Income-tax Amendments

RASHMIN SANGHVI & ASSOCIATES

Notes

This is an analysis of only the main Income-tax provisions of the Finance (No. 2) Bill, 2014. Particularly, procedural amendments are not included. To that extent, this is not an exhaustive listing of amendments proposed by the Finance (No. 2) Bill, 2014. The note has considered the provisions of the Finance (No. 2) Bill, 2014 as announced on 10th July 2014; and changes made in the Bill as passed by the Lok Sabha on 25th July 2014.

It provides an academic guidance to the proposals and is for general information. This analysis is not a legal advice. Readers may not take any decision based on this note. This note does not substitute the need to refer to the original bill.

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Date: 29h July 2014.

Dear Sir / Madam,

Finance (No. 2) Bill 2014
Analysis of Important Income-tax Amendments

The first budget of the new NDA Government was announced on 10th July 2014. The refreshing aspect of the budget was that there were almost no retrospective amendments. Amendments were prospective.

At the same time, there were major issues which continue to be in suspense – Capital Gain on indirect transfer of Indian assets (Vodafone etc.), and General Anti-Avoidance Rules (GAAR). It was expected that there will be some relaxation or deferment. However there was no such announcement in the budget.

Details are given in the attached note.

Kindly see the note. If you have any queries, you may contact us.

Yours sincerely,

Rashmin Sanghvi and Associates

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Analysis of Important Income-tax Amendments

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Finance (No. 2) Bill 2014

Analysis of Important Income-tax Amendments

Finance No. 2 Bill of 2014 has made several changes in the Income-tax Act. There are however almost **no changes which have retrospective effect**. This is one of the main aspects compared to the previous budgets. Some amendments have plugged loopholes and have clarified various issues. Key amendments are discussed below.

CHAPTER I: PROVISIONS LEFT UNCHANGED

1. Indirect transfers (Section 9):

The tax case of **Vodafone** has caused major issues in India. Hutchison Ltd. of Hong Kong (Hutch) held shares in the Indian mobile phone company (Hutchison Essar) through a chain of intermediate companies. It sold a Cayman Island company with a capital of US$ 1 to Vodafone Netherlands. Through sale of Cayman Island company, Hutchison sold its Indian business (**indirect transfer)** and earned substantial capital gain (11 billion dollars). Hutchison did not pay tax in India. Vodafone did not deduct tax at source at the time of payment – despite an instruction by the Income-tax officer. Hence it was called upon to pay the tax.

The matter went up to Court twice. First time on whether the department had any jurisdiction with respect to this overseas indirect transfer - Bombay High Court & Supreme Court held in favour of the Department. Second time on whether any tax is payable by Vodafone on this transaction – Bombay High Court ruled in favour of the department. Finally, Supreme Court (SC) ruled in Vodafone's favour. However the Government amended the law in 2012 **retrospectively** making Vodafone liable to pay tax on Capital Gain. (Our detailed papers on the subject are available on our website.) This amendment has affected several past cases of indirect transfers.

Vodafone has commenced **arbitration** proceedings under India-Netherlands Investment Protection Agreement. However, this agreement specifically excludes tax disputes. Hence the arbitrator may not have any jurisdiction.

It was hoped by a section of people that the Government will reverse the retrospective provisions or come out with some clarification on the matter.

There is however no amendment on the subject of indirect transfers. The Finance Minister (FM) has re-iterated that the Government has an unquestionable right to make retrospective amendment. However the right has to be exercised judicially. All cases which come up before the department due to retrospective amendment of 2012 will be looked into by a High Level committee before taking any action. Cases already in courts or other legal forums will be decided by the courts or respective fora.

Thus indirect transfer provisions will continue to apply even for transactions which happened prior to 2012.

As far as right to retrospective taxation, the FM has in his post budget interviews highlighted the following:

The Government will not introduce retrospective legislation which will entail a fresh levy of tax. However, where the Government is taxing certain incomes / transactions and the courts take a divergent view based on interpretation; the Government may introduce retrospective legislation to maintain taxability of such incomes / transactions. This means: where an assessee does aggressive planning to avoid taxes; and the SC decides in favour of the assessee; Government reserves its right to amend the law retrospectively. The Government will however not bring in an altogether new tax through retrospective legislation.

While the indirect transfers remain taxable, there is quite a bit of ambiguity related to operation of these provisions. Clarity on the same would have helped tax payers to a large extent. However, the Finance Act is silent on the same.

2. General Anti-Avoidance Rules (GAAR) (Chapter X-A):

GAAR provisions were enacted in 2012. However as the provisions were drastic, the government delayed the implementation. It was expected that it will be delayed further. However, Finance Bill No. 2, 2014 has not announced any further delay.

These provisions will now be effective from Financial Year beginning 1st April 2015. Under these rules, any transaction which involves tax avoidance will be ignored. Tax will be levied considering the real purpose of transaction.

However, as per media reports following the budget, the FM and Revenue Secretary Shaktikanta Das have said that the government would shortly take a view on the GAAR provisions.

Please see our budget note of 2012 on our website which deals with indirect transfers and GAAR.

3. Expansion of definition of Royalties and International Transactions:

Apart from 'indirect transfers' provisions; the Finance Act of 2012 had also retrospectively amended the definitions of 'royalty' and 'international transaction' (for transfer pricing) under the Income-tax Act. The amendments expanded the scope of transactions covered under the 'royalty' definition and 'international transaction'. The amendments reversed the effect of certain judgements which were not in favour of the department.

The Finance Bill 2014 is silent on any reversal of these amendments. Further, unlike for 'indirect transfers', there is no provision for review by a CBDT Committee for additions made under these amendments.

CHAPTER II: SUBSTANTIVE PROVISIONS

4. Real Estate Investment Trusts and Infrastructure Investment Trusts (New Chapter XII-FA):

4.1 Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (Invits) have been proposed as a "modern vehicle / structure" of investment in real estate and infrastructure. It is expected that these structures will help mobilise public funds from India & abroad for various capital intensive projects.

The **SEBI** rules for these business structures have been **drafted**. However there was no certainty about tax implications. Now the budget has provided the clarifications.

Once SEBI finalises the rules, these structures can become effective.

For investment by non-residents, **FEMA** still has to be amended. Hence for non-residents to participate in these sectors, one will have to wait. It may be noted that present FDI policy does not permit non-residents to invest in completed projects to earn rental incomes. In the Business Trust scheme, non-residents will be indirectly investing in completed projects. Some modifications in the FDI policy will be necessary.

The structures are on the lines of mutual fund where investors can participate in the funds. The funds will have investments in either SPVs owning project; or directly in the real estate or infrastructure projects. The funds will earn income from the SPV/ projects and the income will be distributed to the investors.

The units of the trust will be listed on the stock exchange. Investors will be able to sell the units on the stock exchange also.

REIT is designed for "**completed**" real estate project. Thus those projects which can earn incomes post completion, can be considered for investment.

Invit is for infrastructure projects which are completed and also for those that are not yet completed.

While the objective of REIT and Invit are for different kinds of projects, the **tax rules are similar** as the income earning and distribution in both will be same. The details are discussed below. Since this is a new concept for India, we are trying to explain with illustrations & charts.

4.2 Illustration: GVK:

To understand the concept of Business Trust, we may take an **illustration**. GVK is a company having several very large infrastructure projects. It has already invested Rs. 20,000 crores in projects and has projects worth Rs. 30,000 crores (as per its website). It needs substantial finance. Some of the projects may be on **Public Private Partnership** (PPP) basis. In these cases, Government does not pay for the costs of the projects. GVK has to raise its own finances. Similarly, there will be some other large infrastructure companies that need to raise finances from within India and abroad. The Business Trust structure is for such large finance companies.

Extend the illustration further.

GVK may have ten completed projects – all together costing Rs. 20,000 crore. Projects are completed and revenue flows have started. However, GVK's capital is blocked in these projects. It needs funds to finance newer projects.

Hence GVK, as a **sponsor**, settles a **Business Trust**. It has one company – **SPV** – holding a few projects totaling investment of Rs. 1,500 crores. SPV has share capital of Rs. 750 crores and loans of Rs. 750 crores. GVK transfers the shares and loans to GVK Business Trust (GBT). In return, GBT issues units of Rs. 1500 crores to GVK. GVK will hold 25% of the units and sell the balance units in the stock exchange.

4.3 Parties in the structure:

Sponsor – The person who develops the projects and sets up the business trust. The sponsor can own the shares of the SPV which will own / operate the real estate / infrastructure project.

Business trust – The sponsor may settle a Business Trust in which investors will invest funds.

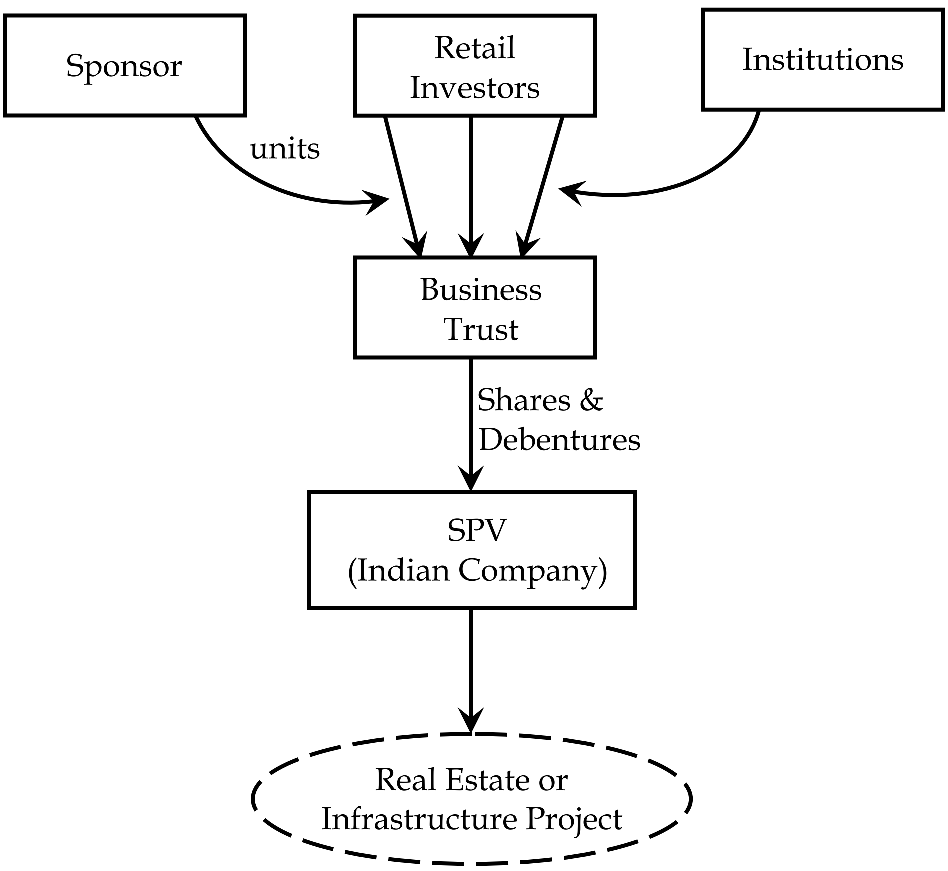
SPV – Indian company which will be the owner of / operate the real estate / infrastructure project.

Financial Institutions - They may buy/ subscribe units from the sponsor or the Business Trust.

Retail Investors – Resident and non-resident persons who will invest in the "Business Trust".

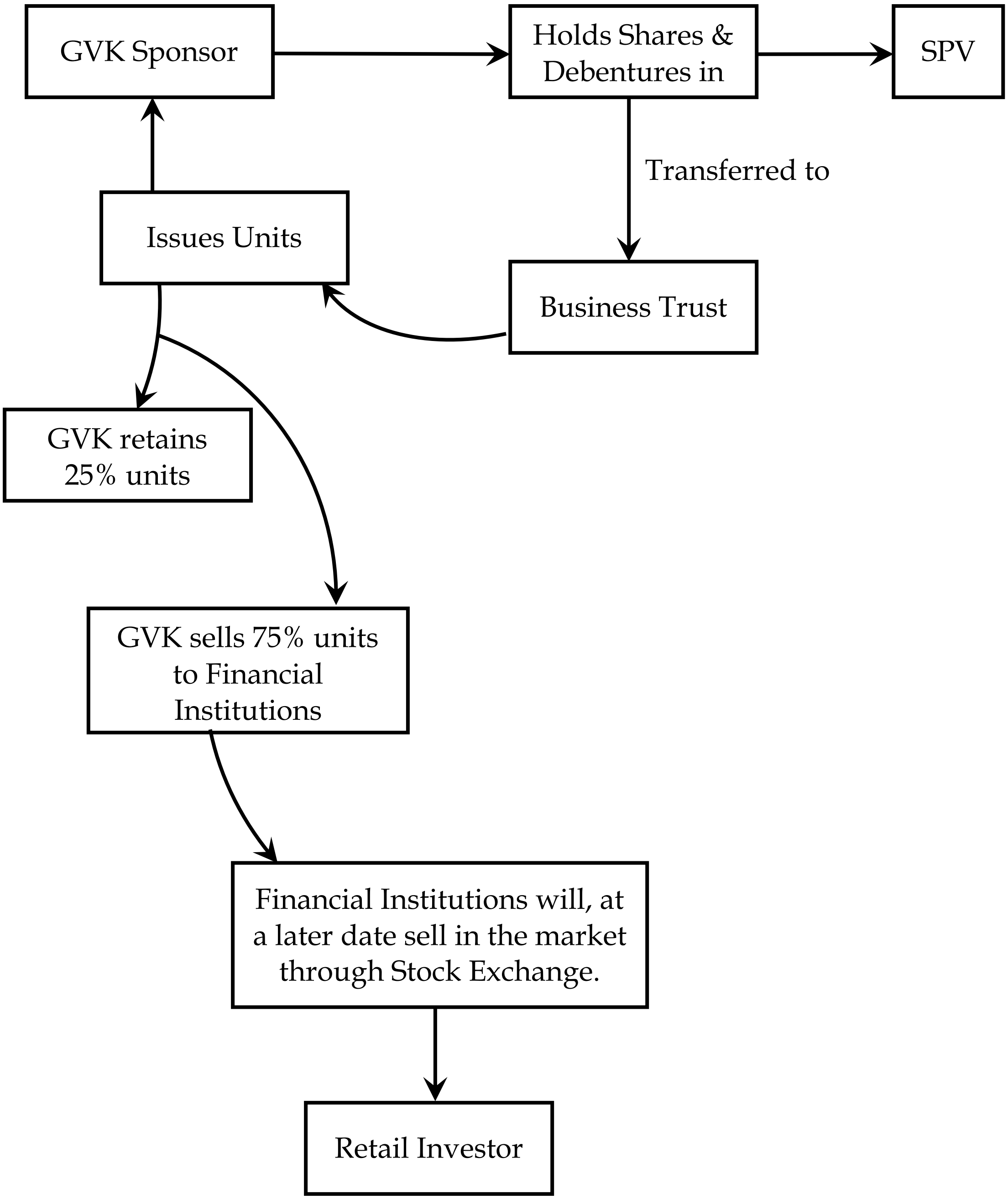
A chart is given below explaining the ownership structure.

4.4 **Ownership Structure**



4.5 **A** chart explaining the flows of securities is given below.

Flow of Securities



The Institutions or retail investors will be the unit holders in the Business Trust. The trust will be shareholder in the SPV.

GVK will get its finance.

4.6 Flows of Incomes:

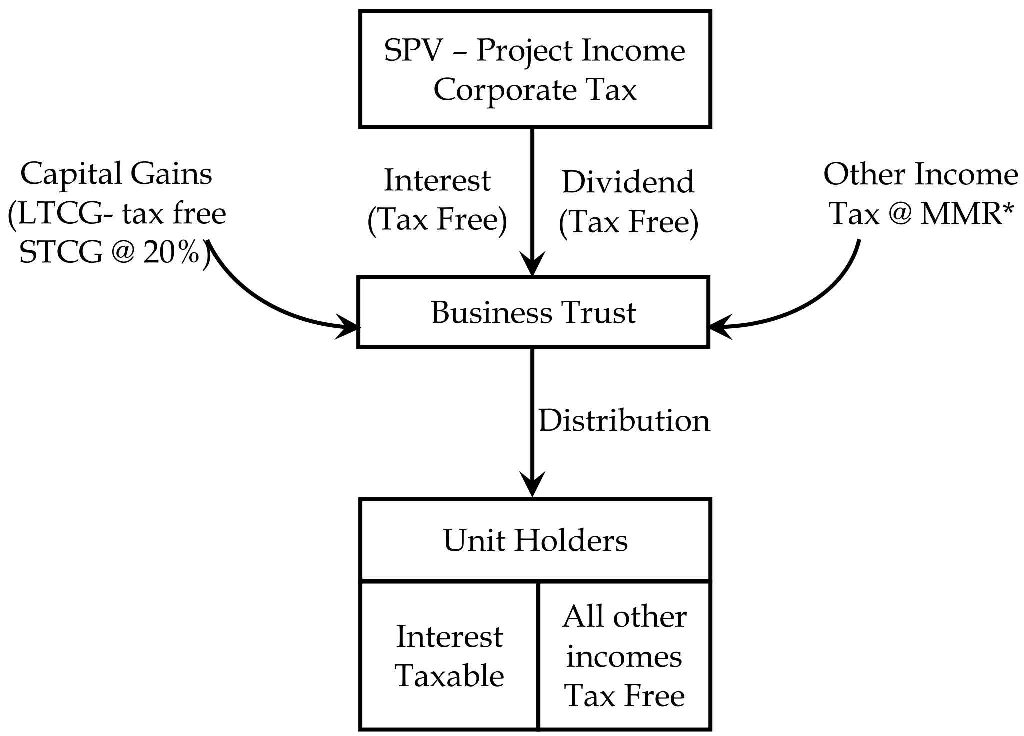
GVK Sponsor Conversion of SPV Shares & Debentures into Trust Units.
Sale of Units to Institutions or Market.

SPV Project Profits.
S.80 IA & other reliefs.
Payment of Interest.
Tax on net profit.
Distribution of dividends.

Business Trust Incomes from SPV – Interest & Dividends.
Capital gains on sale of shares.
Miscellaneous incomes.
Payment of interest & Dividends. } to Unit holders.

Unit Holders Incomes. Interest & Dividend } From Trust
Capital gains on sale of units.

4.7 **Flows of Incomes & taxability**



*MMR – Maximum Marginal Rate of tax

4.8 Now the tax treatments are discussed in some details:

Tax treatment is at four levels:

Sponsor – shareholder of SPV.
SPV – Operating Projects.
Business Trust – Investment Intermediary.
Unit Holders – Retail Investors + Sponsor + institutions.

4.9 Taxation of sponsor:

The sponsor will be taxed in the following manner: Income distribution will be taxed in similar manner as investors. **However capital gain will be taxed differently.**

To the extent of sponsor's investment in the SPV is concerned, there is no change in the taxation. However the sponsor is required to hold certain interest in the business trust. Therefore the sponsor may have to transfer the shares in the SPV, to the trust. Against that, the trust will issue units to the sponsor. (His direct holding in the SPV will become indirect holding in the SPV – through the business trust.)

When the sponsor transfers his shares to the trust, it will not be considered as transfer. Only when the units of the business trust are sold, there will be capital gains. It has also been provided that the period of holding of shares will be considered as period of holding of units also. The cost of shares in the SPV will be considered as the corresponding cost of the units. Thus in essence the sponsor does not lose the benefit of holding period of shares in the SPV.

Holding shares in SPV versus holding units in the business trust:

When the sponsor holds units of the trust, there is no difference in the taxation compared to his holding in the SPV. However in a situation where the SPV is unlisted, there could be a benefit by transferring the holding to the trust. If the SPV is unlisted, there is no relief in case of capital gain. However capital gain on listed units can give the benefit of lower / Nil taxes on capital gain.

4.10 SPV's income & tax:

The SPV earns its profits on its projects and pays normal corporate tax on the profits. It may get S.80 IA and other tax reliefs. When it declares dividends, it again pays Dividend Distribution Tax. The interest paid to the Business Trust is deductible expenditure for the SPV. In essence, there is no change in tax treatment of incomes earned by the SPV.

4.11 Taxation of business trust:

The business trust is mainly considered as a pass through vehicle for investment by the investors. Tax is levied only at one place – business trust or investor.

The **business trust** can invest in equity capital and debt of the SPV. It will normally have **dividend** income or **interest** income. Further it may sell the shares of the SPV and earn **capital gain**. Apart from the above, the trust may have **other miscellaneous income** like bank deposit interest, money market fund income, etc.

The investors will receive **distribution of income** (dividend) from the trust. They may also earn **capital gain** from sale of units of the business trust.

The tax treatment will be as under:

Dividend - Dividend declared by the SPV will be liable to Dividend Distribution Tax (DDT). DDT is payable by the SPV @ 15% (plus surcharge and education cess). The business trust will not pay any tax. This is the **normal provision.**

Capital Gain - On capital gain, the business trust will pay tax as per **normal** provisions. (e.g. On long term gain on shares of the SPV sold on the stock market, it will not pay any tax.)

Interest – On interest received (or interest accrued) from the SPV, there is no tax payable by the trust. The SPV is also not required to deduct tax at source. Interest is taxed in the investor's hands whenever the business trust distributes income to the investors.

Other miscellaneous income – Any other income of the Trust is taxed at maximum marginal rates. The maximum marginal rate is 30% (plus education cess and surcharge). If the trust has a foreign company as the investor, proportionate income will be taxed @ 40% (plus surcharge and education cess).

4.12 In the hands of investors:

Income distribution to investors – Income of the trust will comprise of various kinds of income (discussed above). At the time of distribution of income to the investors, a break-up of the different components will be given.

Interest component of the income distributed is taxable in the hands of the investor when the same is distributed by the trust. If the investor is a **non-resident**, interest component is taxable @ 5%. The trust will deduct tax at source. **Resident** investor is taxed normally. However when the trust declares the income, it will withhold tax @ 10%.

Other components of income distributed by Trust are not taxed in the hands of the investors.

Thus investors are not taxed on distribution except on interest component of income. Trust is taxed on capital gain and other income. On dividend from the SPV, DDT is paid by the SPV. (As far as Trust & Unit Holders are concerned, there is only one level of tax between the trust and investors.)

Capital gain on sale of units:

On sale of units of the business trust, normal capital gain provisions will apply. (e.g. if the units are sold on stock exchange, there is no tax on Long Term Capital Gain. Short term gain will be taxed @ 15%.)

Issue – The holding period for units of business trust to be considered as Long Term, will be 36 months. Whereas for equity oriented mutual fund, the period of holding is only 12 months for the same to be considered as Long Term. Hence an investor in a Business Trust is in a disadvantageous position to this extent.

4.13 Borrowing by the business trust:

The business trust may borrow from residents and non-resident (External Commercial Borrowing). Interest earned by non-residents will be taxed @ 5% which will be deducted at source by the business trust. Residents will be taxed normally.

4.14 Present assessment Procedure:

Under the present Income-tax Act, Sections 161 to 164, etc. determine taxability of a trustee and the beneficiaries. A trustee is taxable in his own name but in the like manner and to the same extent as the beneficiaries. While making new tax provisions for FIIs and Business Trusts, this well settled scheme of taxation has been forgotten. It can give rise to some complications.

4.15 Some Systemic Weaknesses in Business Trusts:

These Business Trusts will be settled under The Indian Trust Act, 1882. Is a 132 years old law suitable for modern investment instruments? Consider following issues:

4.15.1 Under the Indian Trust Act, a trust is **not a separate legal entity**. It is a "trust", a "confidence" placed by the settlor in the trustee. Securities and properties **cannot be registered** in the name of a trust. Normally in case of trusts in India, the securities are held in the name of a Trustee; not in the name of the Trust. SEBI draft guidelines provide for registration of shares and securities in the name of a trust. How can companies register securities in the name of a trust that does not exist as a person?

4.15.2 The Trust Act has **a scheme and a purpose**.

A settlor wants to give certain assets in favour of certain beneficiaries. He does not have faith in the competence of the beneficiaries to protect their own financial interest. Hence he finds some competent and trust worthy people to own and manage tax assets for the benefit of the beneficiaries. The beneficiaries get their beneficial interest purely as a gift. They don't purchase it.

In the proposed scheme, the unit holders (Beneficiaries) actually **pay for their units (benefits).** This is not in the spirit of the Indian Trust Act.

4.15.3 A **non-resident Trustee** can be removed by other trustees (Section 73). A **non-domiciled** person is not a "Proper Trustee". Are such restrictions appropriate in the modern world?

Ideally Parliament should legislate a modern law suitable for current investment instruments.

CHAPTER III: AMENDMENTS IMPACTING NON RESIDENTS

5. Transfer Pricing Amendments:

There are a few amendments proposed by the Government with respect to Transfer Pricing provisions which are intended mainly for reducing litigation and bringing in corrections.

5.1 Advanced Pricing Arrangements (APA) (Section 92CC):

The APA provisions enable the tax payer and the department to enter in to agreements whereby the ALP or the method to arrive at the ALP is determined and agreed upon for a fixed period of years. This results in much needed certainty and relief for tax payers by fixing the basis for transfer price for transactions which would have otherwise led to litigation. At present, the APA applies prospectively.

The Finance Act has proposed to bring in 'roll back' provisions for APAs. This will enable the APAs to be applied for the preceding 4 years in cases where the facts and circumstances permit.

The idea seems to be to reduce the huge litigation which is pending at present at various levels of the judiciary in transfer pricing cases for returns filed while APAs are still under negotiation.

5.2 Computation of Arm's Length Price (ALP) (Section 92C):

Presently, in the comparability analysis required for computing the ALP, the tax officer only allows the data for the **current assessment year** to be considered. This leads to incorrect ALP where the businesses are subject to multiple-year cycle and also gives a very narrow database on which comparability is based.

Further, the ALP generally falls within a range of prices and not one particular price. The law presently prescribes an **arithmetical mean** of such prices to arrive at the final ALP.

The Budget proposes to allow use of **multiple year data** for comparability analysis. It also proposes to bring in a '**range'** concept for determining ALP in cases where there are plentiful comparables available. Both these amendments are in line with the TP assessment practices in developed countries and should help in reducing unnecessary litigation surrounding these concepts.

It should be noted that these amendments were not mentioned in the Finance Bill as introduced in the Parliament on 10th July 2014. The Government has made a change in the Finance Bill before it was passed by the Lok Sabha, which mentions that where more than one ALP is determined; the ALP for the transaction shall be computed in such manner as prescribed. The present system of arithmetic mean and acceptable difference will not apply in such cases. Therefore, the range concept should now be brought about through the Rules. This concept will be applicable only to transactions entered in to after 1st April 2014.

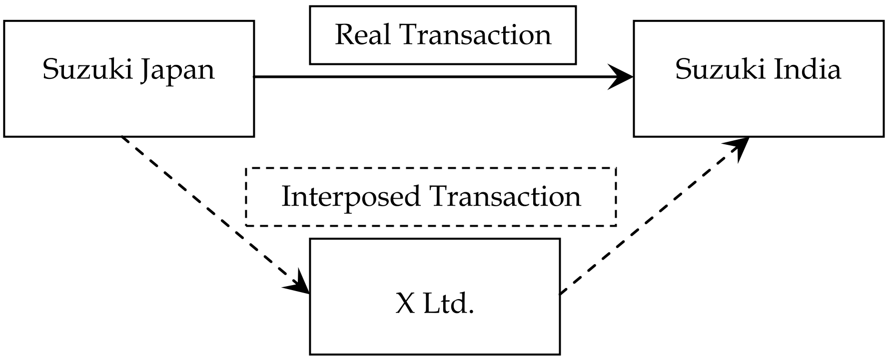
The provision for use of multiple-year data is also expected to come through the Rules.

5.3 Deemed 'international transaction' (Section 92B(2)):

An 'international' transaction between 'associated enterprises' (AEs) is presently covered under the TP provisions. To avoid application of TP provisions, the tax payer can enter in to a transaction with an unrelated party, where the terms & prices will be determined in advance between the AEs. In this manner, application of TP provisions can be avoided by interposing the unrelated party.

An example to explain this provision is provided on the next page.

Example 1



Suzuki India needs to import engines from Suzuki Japan. A direct transaction between them would be covered under the TP provisions. To avoid the TP provisions, Suzuki Japan can sell the engines to an unrelated party – X Ltd. X Ltd. can resell the engines to Suzuki India. The price at which engines are to be sold by X Ltd. to Suzuki India would be decided by Suzuki Japan. In this manner, as transactions are between unrelated parties, TP provisions can be avoided.

The Act provides that such an "**influenced**" transaction between the tax payer and the unrelated party will also be deemed to be a **transaction between AEs.**

Recently there have been cases where the influenced transaction between the tax payer and the unrelated party was within India, i.e., a **domestic transaction**. As this was not an 'international' transaction, it was argued that the Transfer Pricing provisions were not applicable.

The Budget now proposes that such influenced transactions between a tax payer and the unrelated party will be **deemed** to be an **international transaction** irrespective of the residential status of the unrelated party. In this manner, a wholly domestic transaction between the tax payer and the unrelated party where the terms or price are determined between the AEs will be covered by the TP provisions.

6. Taxation of FIIs (Section 115AD):

6.1 Tax rates for incomes earned by FIIs are separately provided for under the Income-tax Act. These provisions prescribe the rates for capital gains and other incomes received in respect of securities. There has been quite a bit of litigation on whether income earned by FIIs is in the nature of business income or capital gains.

FIIs have taken different stands depending whether they consider their incomes as business income or capital gain. If the income is business income, then under a double-tax avoidance agreement, income is not taxable in India in absence of a PE. If income is considered as capital gain, under certain agreements entered in to by India (like Mauritius and Singapore), capital gains earned by FIIs cannot be taxed in India. The department has been taking a stand that income of FIIs is capital gain. Therefore there was constant litigation on this aspect.

6.2 The Budget has now proposed that incomes earned by FIIs would hence forth be treated as capital gains. The intention is two-fold:

a. To provide clarity on characterisation of income earned by FIIs; and
b. To enable the Fund Managers of these funds to operate from India as their stay in India will not impact the characterisation of income.

The Budget has enabled this provision by proposing an amendment to the definition of 'capital asset'; whereby all securities traded by FIIs will now onwards be considered as 'capital assets'. Therefore, income earned on transfer would be capital gains and not business income.

6.3 However, there are certain issues related to this amendment:

a. The change has been proposed by amending the definition of capital assets; and not by deeming the incomes earned by FIIs as capital gains. Therefore, an issue remains as to what would be the characterisation of income earned by the FIIs under a DTA. It is a settled position that income-tax act or the DTA, whichever is more beneficial applies. Is it possible that FIIs can still claim the profits earned by them as 'profits' covered under the 'Business Profits' Article of the applicable DTA? In such a case, as they would not have a PE in India, incomes earned by them should not be liable to tax.

   The general stand has been that income would be treated as capital gains under a DTA too. In such a case, there is another issue as mentioned below.

b. The amendment has been made for all securities traded by FIIs. This even covers derivatives traded by FIIs. Speculation income which was earned on trade of such derivatives was earlier taxed as business income and not liable to tax in India in absence of a PE. However, these incomes will now be taxable as capital gains and subject to tax even in absence of a PE.

c. This amendment is applicable from 1st April 2014. There is an issue regarding income earned during the period between 1st April 2014 and the date the Finance Bill becomes law. Suitable clarifications should ideally be provided.

7. Sale of government securities from non-resident to non-resident:

On sale of Indian Government securities, capital gain if any will be taxable in India. It does not matter whether the transactions are between two non-residents. Now the budget proposes that capital gain earned on sale of government securities by one non-resident to another non-resident through specified dealers, will not be liable to tax in India.

This is perhaps the first step to export our capital market and externalize our rupee.

CHAPTER IV: MEASURES AFFECTING BUSINESS INCOME

8. Investment allowance (Section 32AC(1A)):

A manufacturing company gets a deduction from income @ 15% of cost of new machinery purchased for manufacturing. This deduction is known as investment allowance. The deduction is available if investment is made to the extent of Rs. 100 crores (Rs. 1000 Million) or more during the two financial years 2013-14 and 2014-15.

The budget proposes to reduce the amount of investment in machinery to Rs. 25 crores (Rs. 250 million) per year. Thus lower investments will also be able to get the benefit.

The benefit has been extended up to financial year 2016-17.

It has also been provided that those who will not be able to invest up to Rs. 100 crores by 31st March 2015, will get the benefit if investment in FY 2014-15 is at least Rs. 25 crores.

9. Investment based deduction (Section 35AD):

9.1 For some sectors, investment based deduction is permitted instead of income-based relief under Section 35AD. Any capital expenditure on machines, equipment, etc. can be entirely deducted from the profit in case of some industries. (Normally only depreciation can be claimed.) The full deduction would normally result in a loss which can be carried forward. Taxable profits could be earned after a few years. This results in savings of tax outflow for the initial years.

Thus instead of depreciation where only 15% of the cost of plant and machinery can be claimed every year on written down value; deduction gives full relief of the cost in one year itself. These industries include cold chain facility, warehousing for agricultural products, etc. (There are 11 industries for which the deduction is permitted.)

The budget has proposed 2 more industries – laying and operating slurry pipeline for transportation of iron ore; and setting up and operating a semiconductor wafer operating manufacturing unit.

9.2 There was no time limit prescribed for use of assets in those industries. People would buy assets for use in the specified industries to claim full deduction of cost. Subsequently they would transfer the asset to a different business.

The budget now provides that the asset should be used for **at least 8 years**. If the asset is sold or discarded within 8 years, then the relief claimed will be added as income.

9.3 For business like **semiconductor wafer units**, relief under section **10AA** can be claimed by setting up the unit in SEZ. Entire profits are exempt for first 5 years; 50% of the profits are exempt for the next 5 years; and 50% of the profits for the next 5 years are exempt subject to fulfillment conditions.

It is possible for a person to claim deduction under section **35AD**. This may result in a loss for few years. Subsequently when the business starts to generate profits, relief under section 10AA can be claimed.

It is proposed to plug this possibility. It is provided that only one tax relief will be available. Whichever relief is claimed first, will be allowed. The other relief will not be allowed.

9.4 Alternative Minimum Tax is payable by persons other than companies under section 115JC. (Companies pay similar tax under section 115JB.) Due to tax reliefs, taxable income and tax payable by persons can reduce substantially. If tax payable is less than 18.5% of the income (before claiming any relief), then 18.5% of such income is payable as minimum tax.

Minimum tax applies only if specified reliefs are claimed. In the specified reliefs, investment based deduction is not included. Thus if person claims investment based deduction under section 35AD, the tax may be less than 18.5% of income before the deduction.

It has been proposed that deduction under section 35AD will not be taken into account to work out minimum tax payable. Instead only normal depreciation on assets will be considered. After adding back the deduction under section 35AD, and reducing normal depreciation, if the tax is less than 18.5% of that amount, then 18.5% will payable as minimum tax.

10. Credit for Alternate Minimum Tax (AMT) (Section 115JEE):

Tax payers are required to pay a minimum alternate tax as stated above. Such AMT is available as a credit in the subsequent year against normal tax (if normal tax exceeds AMT).

It may so happen that in the subsequent year, the person does not fall within the AMT regime. Then technically credit will not be available. It has now been provided that even if the person does not fall within the AMT regime, credit for AMT will be available.

11. Corporate Social Responsibility expenditure:

Under The Companies Act, 2013, certain companies are required to incur expenses towards Corporate Social Responsibility (CSR). These expenses are towards charitable activity (which should be different from the activity which it is undertaking).

There was an issue as to whether such CSR expenses will be allowed as a deduction for income-tax. It has been provided that such CSR expenditure will not be available as a deduction. Only those expenses which are specifically available under the Income-tax Act (e.g. contribution towards specified research and development) will be available.

SC has decided in some cases as under: (i) Purely gratuitous expenses are not available as deduction against taxable income. (ii) If a charitable expenditure simultaneously helps the business of the assessee, the whole of, or an appropriate portion of the expenditure is available as deduction.

Companies Act provides that CSR expenditure will be purely for charity. Any expenditure in the course of the business of the company will not be considered for CSR obligation. Hence the budget provision is in line with the existing settled law.

12. Consequences of not deducting tax at source (TDS) (Section 40(a)(ia)):

At the time of making payments of expenses, tax has to be deducted at source for several kinds of payments. If tax is not deducted at source, there are several penal consequences. One of the consequences is that the expenses will not allowed as a deduction. The budget has proposed a few changes.

12.1 In case of **payments to residents**, the expenses are disallowed in case of **certain** items of payments like royalty, contractor payments, etc. It is now proposed that in case of **any** payment of expenditure on which tax is deductible; if tax is not deducted at source, expenses will not be allowed.

12.2 The disallowance of expenses is to the extent of 100% of expenses. The budget proposes that in case of payment of expenses to **residents**, only **30% of the expenses will be disallowed**. However in case of payment of expenses to non-residents, 100% of disallowance of expenses continues.

12.3 Presently, there is a provision that allows deduction of expense in the year in which the above tax is deducted and paid to the government. Therefore, in effect, there is a timing delay in deduction of expenses on which tax is not deducted.

The Finance Bill has proposed an amendment in this provision too, corresponding to the above amendment restricting disallowance to 30%. Therefore, allowance in a later year is also now restricted to 30% of the expense.

There is an issue regarding expenses which had been disallowed in earlier years at 100% of the amount due to non-deduction of tax at source. Now if the tax is deducted and paid, only 30% of the expense disallowed earlier will be allowed as a deduction. This does not seem to be the intention of the Government; and an appropriate correction is required in the Finance Bill before it is passed into law.

12.4 Further, there is no clarification if there is a **shortfall of deduction of tax**. For example, if there is an expense of Rs. 1,000 on which tax has to be deducted @ 10% (Rs. 100). Assume that the payer has deducted only Rs. 90. In this situation will the entire amount of Rs. 1,000 will be disallowed; proportionate amount of only Rs. 100 be disallowed; or there will be no disallowance as the relevant section does not provide for such a scenario? Most of the court decisions have held that there should be no disallowance.. A clarification on this matter would have helped.

CHAPTER V: PROVISIONS AFFECTING INVESTMENT INCOMES

13. Dividend Distribution Tax (DDT) (Section 115O):

13.1 Companies pay tax on dividends at the time of distribution to the shareholders at a rate of 15% (plus surcharge and cess). Dividend income earned in the hands of shareholders is exempt from tax.

Presently, companies allocate funds aside for distribution of dividends and tax thereon. Tax is paid on the actual dividend amount and not the total amount allocated towards distribution of dividend and tax. For example, a company sets aside Rs. 100 towards dividend and DDT. As tax is to be paid on dividend distributed, it will do a reverse working to pay tax. It will hence pay a dividend of Rs. 87 and DDT on the same of Rs. 13. Therefore, the effective tax rate on the allocated funds is lower than 15%, i.e., 13%. However, the shareholder would have borne a tax of 15% on the dividend received by him.

13.2 The Budget now proposes to amend the provisions whereby the tax is paid on the total amount allocated towards dividend distribution (Rs. 100); and not just the actual amount of dividend distributed. This will result in effective tax rate on the total funds being restored to 15%. Therefore, now when a company allocates Rs. 100, it will pay a DDT of Rs. 15 and a dividend of Rs. 85. On the amount of dividend received, the shareholder would bear a tax rate of 17.647%.

In effect, companies will now pay tax at a higher rate on dividends than they used to pay earlier.

14. Lower rate of tax on Foreign Dividends (Section 115BBD):

The Income-tax Act has provisions whereby dividend received by an Indian company from investments made in a company outside India wherein it holds more than 26% would be taxed at a lower rate of 15% instead of 30%. This provision was introduced in FY 2011-12 and was being extended every year.

The Budget now proposes to make this provision permanent. Therefore, any dividends earned by an Indian company from a foreign associate would be levied a tax of 15% and not 30%. Our detailed article on this topic is available on our website.

15. Holding period for Long Term Capital Gain (LTCG) in case of Debt funds and shares of private limited company (Section 2(42A)):

Debt funds have the benefit of being considered as long term capital gain if the same are held for more than one year. There were several schemes wherein the person could invest in a debt fund which would be for a period of 370 days.

Just before the redemption, the fund would pay dividend which would be exempt in the investor's hands. On redemption of funds, there would generally not be any accounting gain or loss as debt funds would not change much in value. However, as these would be long-term in nature, there would be a taxable loss on account of inflation adjustment. The loss could be set off against other long-term gains; or carried forward.

This gave unintended benefit to investors due to tax computation even though there would be no intrinsic loss suffered by the investor.

Now the budget proposes that for units in debt funds, the period of holding will be 3 years instead of 1 year. Similarly the period of holding in case of shares of private companies has also been increased from one year to three years. This can impact everyone (including Private Equity Funds, HNIs, etc.) who have made investments in unlisted companies and want to exit before the three year holding period. Gains on such exits would be taxable as short-term gains.

Now only in case of listed securities, and equity oriented mutual funds, the period of holding will be one year for the purposes of LTCG. LTCG on such investments traded on a stock exchange would in any case be exempt. Therefore, the benefit of one year holding is now useful only for listed securities and units which are sold off-market (i.e., privately and not on stock exchange).

The difficulty:

The budget proposes to make this amendment from Financial Year 2014-15. This would mean that people who have sold units of Fixed Maturity Plans (FMPs) from 1st April 2014 will also not get the benefit of Long Term Capital Gain tax as generally they are for a period of less than 3 years. For such capital gain, it amounts to a retrospective tax.

The Budget as passed by the Lok Sabha has corrected this. It has been provided that transfer of such units and shares shall be continue to be long-term in nature if they have been held for more than a year; and are transferred during the period between 1st April 2014 and 10th July 2014.

This change in the Finance Bill makes it clear that there may be no relaxation for investments which have been made before 10th July 2014 but will be redeemed in the future. Therefore, to that extent, this provision will apply to investments made in the past.

16. Tax on long-term capital gains for units (Section 112):

Tax on long-term capital gains earned on transfer of units is payable by resident tax payers at 20% of the gains earned after inflation adjustment. Presently, this tax amount is capped at 10% of the gains computed without inflation adjustment.

The Budget proposes a change whereby LTCG earned on transfer of units would hence forth be taxable at 20% on gains computed after inflation adjustment. The cap of 10% is no longer available.

The amendment extending the holding period for units of a debt fund to be considered as long-term assets from 1 year to 3 years; and the amendment removing the cap on tax payable on transfer of such units, will bring debt fund units largely in par with other fixed term instruments like fixed deposits.

The benefit of inflation adjustment still continues for debt fund units. The tax would hence be payable only if there is a gain after inflation adjustment; and if so, only on the amount of reduced gain after such adjustment.

The difficulty:

There was an issue for transfers made during the period between 1st April 2014 and 10th July 2014. The Finance Bill as passed by the Lok Sabha has taken care of this aspect by extending the present cap of 10% to transfers made during this transition period.

CHAPTER VI: MEASURES TO PLUG LOOPHOLES

17. Forfeiture of advance (Section 56):

In situations of negotiation of sale of property, the seller may receive certain advances. Subsequently due to any reason (e.g. non-fulfillment of conditions by buyer), the advance is forfeited by the seller. So far such amount has to be reduced from the cost of the property. No tax will be paid on forfeiture of advances.

It is reported that owners of property who have black money would make arrangements with some people whereby they would transfer their black money and obtain cheque payments for sale of property. Subsequently ostensibly, the seller would "forfeit" the money. Thus his money would become converted into white money. At the same time there would be no tax. If and when he sells the house, he will pay capital gain tax on a higher amount (as cost would reduce). However that may take place after several years.

The budget now proposes that such amounts which are forfeited will become taxable income of the proposed seller.

18. Capital gain relief:

18.1 Relief on sale of house (Section 54):

On sale of a house, relief from tax on capital gain is available if capital gain is reinvested in another house. Can the assessee acquire a house outside India and still claim relief against Indian Income-tax? Clear language of law permits this. There have been decisions in the favour of the tax payer.

The budget now proposes that the acquisition of a house should only be in India. No relief will be available if the house is outside India.

Further, at present the relief is available even if more than one house is acquired. For example, one old house is sold, and with the sale proceeds, 2 new houses are acquired to accommodate a large family. Relief is available as per the language of the present law. The cases have gone in the courts.

Now the budget clearly provides that the relief will be available only against **one new house**.

It should however be noted that "one house" has been explained by courts. A person may buy 2 adjacent flats, and combine them into one house. There would be only one kitchen, one dining room, etc. This will still be considered as "one house". It is only if 2 houses are acquired (say on different floors or in a manner that these cannot be combined into one house), that the relief will be denied against second house.

18.2 Relief on sale of capital asset (other than a house) (Section 54F):

There is a similar relief available where any capital asset (other than a house) is sold. Relief is available if sale consideration is invested in a house. Here also the restriction regarding investment in **one** house **in India** has been proposed.

18.3 Relief by investing in bonds (Section 54EC):

Tax on Capital gain on sale of assets (other than a house) could be saved by investing in specified bonds. The maximum amount permitted was Rs. 50 lakhs. Due to technical loophole, it was possible that where the property was sold after September, investment could be made up to 31st March up to Rs. 50 lakhs. Another Rs. 50 lakhs could be invested after 31st March. Thus a total of Rs, 1 crore could be invested.

The budget has now proposed to plug this loophole. Now only Rs. 50 lakhs invested in bonds will be considered for tax relief.

Does this limit of Rs. 50 lakhs apply to capital gain on each asset, or is it a limit for the entire year? Based on the language of the law, it appears that investment of Rs. 50 lakhs is available for capital gain on "each" capital asset. Thus if a person sells shares in a company and also sells his house, he can invest Rs. 50 lakhs to claim relief for each of the asset. One cannot take this relief to extreme cases. E.g. Each share of a company is a separate capital asset. If a person sells 100 shares in a company, it will be incorrect to claim that for saving capital gain tax on each share, Rs. 50 lakhs can be invested.

However say a person has shares in two private limited companies for two different businesses. He sells the shares of both the companies. These shares represent two distinct assets. Can he invest Rs. 50 lakhs for saving capital gain tax on each company's shares?

The memorandum explaining the Finance Bill of 2007 provides that – "It is also proposed to amend the said section so as to provide for a ceiling on investment by an assessee in such long-term specified assets. Investments in such specified assets to avail exemption under section 54EC, on or after 1st day of April, 2007 **will not exceed fifty lakh rupees in a financial year.**" Thus the intention clearly is to limit the investment for the entire year and not for each asset.

CHAPTER VII: RELIEFS FOR INDIVIDUALS

19. Minimum Exemption Limit (Part III of First Schedule to Finance Act):

The Budget does not propose to change any tax rates. However, the minimum exemption limit for individuals up to the age of 80 has been raised by Rs. 50,000.

Therefore, the minimum exemption limit for individuals below the age of 60 is now raised to Rs. 2,50,000; while for those between the age of 60 and 79 is raised to Rs. 3,00,000.

20. Interest on housing loan (Section 24):

Interest on housing loans can be reduced from house property income. For homes which are self-occupied, the limit of deduction was up to Rs. 1,50,000 of interest. The amount has been increased to Rs. 2,00,000/-.

21. Relief for payment of LIC premium, PPF etc. (Section 80C):

For payment of LIC premium, etc. a deduction of up to Rs. 1,00,000 is permitted. The permitted deduction now is proposed to be raised to Rs. 1,50,000.

CHAPTER VIII: MEASURES TO STREAMLINE LITIGATION

22. Authority for Advance Rulings (AAR) Mechanism (Section 245N):

The AAR mechanism provides the tax payer an opportunity to determine taxability of its income before it enters in to a transaction. This mechanism is presently only available to non-residents and resident public sector companies. Further, the present capacity of the AAR is falling short of the applications being made.

During his Budget speech, the FM mentioned that the AAR mechanism would also be extended to specified residents. He also mentioned that provisions will be brought in to strengthen the AAR capacity. No mention of such amendments was found in the Finance Bill.

The Government, while passing the Finance Bill through the Lok Sabha has incorporated the amendments announced by the FM in his Budget Speech. The AAR mechanism will be available for such class or category of persons as the Government specifies by way of a notification.

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