Budget Implications on Non-Resident Taxation

Budget 2018 focuses on the less privileged sectors of society and is centred around the rural, agriculture, health and infrastructure sectors, quality of education and employment generation. The Government has gone one step further from 'Ease of doing business' and introduced various reforms to improve 'Ease of Living.' Another key proposal is the amendment to the definition of Business Connection in line with the OECD Base Erosion and Profit Shifting ('BEPS') recommendations. In this article, we are discussing the significant budget proposals affecting taxation of non-residents and Transfer Pricing regulations.

India broke into the top 100 in the World Bank's latest 'ease of doing business' rankings, notching up the biggest improvement among all countries on the back of big gains on a number of measures. The rise to the 100th position from 130th the previous year made India one of the top 10 best-improved countries, which the Government celebrated as an emphatic endorsement of its economic reforms. Buoyed by the impressive gains scored by India on the ease of doing business index for 2018, everyone was enthusiastic and looking for the populist Budget 2018-19. On the direct tax front, individuals as well as corporates may have been a tad disappointed at the slight increase in the effective tax rate. The Budget also does not seem to have taken cognizance of the recent reductions in tax rates in the U.S. However, at the same time, there were no surprises in the fine print. A big ticket announcement is the proposal to tax Long Term Capital Gains ('LTCG') exceeding INR 100,000 (~USD 1,500) on listed equities and equity mutual funds for all taxpayers, including Foreign Institutional Investors ('FIIs'). The levy of Securities Transaction Tax ('STT'), however, remains unchanged. While high net worth individuals would be disappointed with the levy of tax on LTCG, they would be relieved that Inheritance tax has not been introduced. Another key proposal is the amendment to the definition of Business Connection in line with the OECD Base Erosion and Profit Shifting ('BEPS') recommendations. Following is the discussion on significant budget proposals affecting taxation of non-residents and Transfer Pricing regulations.

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1. Tax Rates

There is no change proposed in the basic rate of income tax for non-residents. However, it is proposed that 'Education Cess on income-tax' and 'Secondary and Higher Education Cess on income-tax', which is at 3% at present, shall be discontinued and a new cess, by the name of 'Health and Education Cess' shall be levied at 4% of income tax including surcharge, wherever applicable. This would result into marginal increase in effective tax rate for non-resident taxpayers.

2. Widening the Ambit of 'Business Connection' [Section 9(1)(i)]

The term Business Connection used in the Income-tax Act ('IT Act') is defined on the lines of Dependent Agent Permanent Establishment ('DAPE') in the Double Tax Avoidance Agreements ('DTAAs'). The OECD BEPS Actions contain recommendations to revise the definition of Permanent Establishment ('PE') in the DTAAs. Pursuant to signing of the Multilateral Instrument ('MLI'), the DAPE provisions in the DTAAs will stand modified and will have a wider scope than that of Business Connection.

With a view to align the definition of Business Connection with that of PE in the DTAAs and to target commissionaire arrangements, it is proposed to amend the definition of Business Connection to include persons who habitually conclude contracts or play the principal role leading to conclusion of contracts by the non-resident, including for the transfer of ownership of, or granting the right to use, property owned by the non-resident or which the non-resident has the right to use or for provision of services by the non-resident.

A second amendment is proposed to the definition of Business Connection to capture increasing use of information technology and digital media in business models, which no longer require physical presence in India. BEPS Action 1 - 'Address the tax challenges of the Digital Economy' recommended introduction of Equalisation levy, which was introduced in the Indian tax law with effect from 1 June 2016. Equalisation levy is applicable to consideration received from the services like online advertisement, provision of digital advertising space and provision of facilities/services or space for online advertising. Due to advancement in information and communication technology and increase in the business through digital platform, it was expected that some additional services may be notified to be covered within the ambit of equalisation levy e.g. B2C transactions in specified digital services like online marketing, cloud computing, website design, digital platform for sale of goods and services online, use or download of software and applications, etc. It is, however, proposed to clarify that 'Significant Economic Presence' ('SEP') of a non-resident would constitute a 'Business Connection'. A SEP would mean transactions in respect of any goods, services or property carried out by a non-resident in India, including providing downloading of data or software in India, if the aggregate payments from such transactions exceed a specific threshold, which will be subsequently prescribed. Further, it would also include systematic and continuous soliciting of business activities or engaging in interaction with such number of users, as may be subsequently prescribed, in India through digital means. These will be applicable whether or not the agreement for such transactions or activities is entered in India or the non-resident has a place of business in India or renders services in India.

India could take the lead globally in outlining a feasible structure for taxing digital entities that have a large user base or business in a country but don't have a significant physical presence there. Union Budget 2018 has, for the first time,

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mentioned India's intent to tax digital businesses by amending Section 9 of the IT Act. This proposed amendment is the outcome of the OECD and G20 BEPS and India is the first country to have taken concrete steps in this direction. This proposal is enacted despite the fact that work under BEPS Action 1 is still under way, and is meant to be in the nature of an enabler to facilitate negotiation for further DTAA amendments. The justification of the Government to expand the scope of the provisions has been that going forward, SEP tests would be included in tax treaties resulting in the domestic law becoming favourable to the taxpayer. However, it is relevant to note that even the MLI provisions today do not provide for the SEP Test that India has introduced. In an era of technology and digital access, this move of the Government runs contrary to their stance of increasing digitisation in India.

In the Explanatory Memorandum to the Finance Bill, 2018, a reference is also made to anti-fragmentation rules so as to prevent the taxpayer from resorting to fragmentation of functions which are otherwise a cohesive activity, in order to avail the benefit of exemption under Article 5(4) of DTAAs. However, these provisions are not found in the Finance Bill, 2018.

3. Measures to Promote IFSC [Sections 47 and 115JC]

In order to develop an international financial services hub in India and to encourage investment in International Financial Services Centre ('IFSC'), it is proposed to exempt the transfer of the following capital assets by a non-resident, from the scope of capital gains, if these are undertaken on a recognised stock exchange located in any IFSC and if the consideration for such transactions is paid/payable in convertible foreign currency:

a. Bonds or Global Depository Receipts ('GDR')
b. Rupee denominated bonds of an Indian company
c. Derivatives

Corporate entities which have units in an IFSC are subject to a reduced rate of Minimum Alternate Tax ('MAT') at 9% instead of 18.5%. This benefit is proposed to be extended to Alternate Minimum Tax ('AMT') in respect of non-corporate entities located in an IFSC.

4. Applicability of MAT to Foreign Companies [Section 115JB]

It is proposed that the MAT provisions will not be applicable in case of a foreign company whose income is computed on presumptive basis under the provisions of Sections 44B (shipping business) or 44BB (business of exploration etc. of mineral oils) or 44BBA (business of operation of aircraft) or 44BBB (business of civil construction etc. in certain turnkey power projects). The proposed amendment will be effective from 1st April 2000.

5. Taxation of LTCG [Sections 10(38)]

It is proposed to withdraw the tax exemption of LTCG arising on transfer of equity shares in a listed company or a unit of an equity oriented mutual fund or a unit of a business trust. Notwithstanding the provisions of Section 112, a new Section 112A, applicable from 1st April 2018 is proposed to be inserted to tax such capital gains exceeding INR 100,000 (~ USD 1,500) at 10%. No deductions will be available to offset such LTCG. The concessional tax rate of 10% is available if-

a. STT has been paid on acquisition and transfer of equity shares in a company; or
b. STT has been paid on transfer of a unit of an equity oriented mutual fund or a unit of a business trust

The Government shall notify the transactions of acquisition of equity shares for which the aforesaid condition of payment of STT shall not be applicable. In case of a capital asset acquired before 1st February 2018, the cost of acquisition ('COA') shall be deemed to be higher of –

a. Actual COA of the asset; and
b. Lower of Fair Market Value ('FMV') and full value of consideration received or accruing as a result of the transfer.

The FMV of a listed capital asset is to be taken at the highest price quoted on the stock exchange on 31st January 2018. However, in case there is no trading in such listed capital asset on such exchange as on 31st January 2018, the highest price of such asset on such exchange on a date immediately preceding 31st January 2018 when such asset was traded on such exchange shall be the FMV. In a case where unlisted capital asset is an unit, FMV is to be taken at the net asset value of such unit as on 31st January 2018. The FMV in case of unlisted equity shares as on 31st January 2018, which are listed on the date of transfer or listed on stock exchange at the time of transfer, but acquired in consideration of shares which were unlisted as on 31st January 2018 by way of transaction not regarded as transfer under Section 47 (which deals with certain situations, where transactions are not regarded as transfer for the purpose of capital gains) shall be the amount which bears to the cost of acquisition the same proportion as Cost Inflation Index ('CII') for the financial year 2017-18 bears to the CII for the first in which the asset was held by the taxpayer or for the year prior to FY 2001-02, whichever is later. That means in such cases indexation benefit would be available to the COA.

In other words, gains realised till 31st January 2018 will be grandfathered. The benefit of indexation on the COA and improvement in the case of a resident and the benefit of foreign currency variation in the case of a non-resident will not be considered in computing such capital gains.

For the purpose of Section 112A, the equity oriented mutual fund may include a fund of funds which invests a minimum of 90% of its total proceeds in the units of another fund traded on a recognised stock exchange, which in turn invests a minimum of 90% of its total proceeds in equity shares of listed domestic companies or units of such other fund.

The benefit of deduction under chapter VIA shall be allowed from the gross total income as reduced by such capital gains. Similarly, the rebate under Section 87A shall be allowed from the income tax on the total income as reduced by tax payable on such capital gains. Further, the benefit of the basic tax exemption limit would be available to such LTCG.

The Government has said that it has proposed to impose LTCG on stocks and equity-oriented mutual funds (MFs) from 1st April 2018, as the current regime was "inherently biased against manufacturing and encouraged diversion of investment to financial assets". "It has also led to significant erosion in the tax base resulting in revenue loss. The problem has been further compounded by abusive tax arbitrage opportunities created by these exemptions," the finance ministry said in a set of Frequently Asked Questions (FAQs), released on 4th February 2018. The requirement of payment of STT is not applicable on transfer of a capital asset undertaken on a recognised stock exchange located in any IFSC and where the consideration for such transfer is received/receivable in foreign currency.

6. LTCG in Case of FIIs [Section 115AD]

At present, Financial Institution Investors ('FIIs') also enjoy tax exemption of LTCG arising on transfer of equity shares in a listed company or a unit of an equity oriented mutual fund or a unit of a business trust. Consequent to insertion of the proposed Section 112A, it is proposed by way of new proviso to Section 115AD that in case of income arising from the transfer of a long-term capital asset referred to in Section 112A, income-tax at 10% shall be calculated on such income exceeding INR 100,000 (~USD 1,500). As the provision relating to FIIs does not specifically provide for grandfathering of gains realised till 31st January 2018, an apprehension was raised by FIIs on the computation of gains. In order to clarify this controversy, the CBDT through its FAQs on LTCG dated 4th February 2018 has clarified that the LTCG in case of FIIs will be determined in the same manner as in the case of resident tax payers. In case of FIIs also, there will be no tax on gains accrued up to 31st January 2018. It has been further clarified that the transfer made between 1st February 2018 and 31st March 2018 will be eligible for exemption under clause (38) of Section 10 of the IT Act in the hands of FIIs.

In view of the above, LTCG exceeding INR 100,000 (~ USD 1,500) in the hands of FIIs on transfer of listed equity shares in a company or a unit of equity oriented mutual fund or a unit of business trust will be taxable at 10% (without availing the benefit of foreign currency variation). In case the provisions of the DTAA are more beneficial than the aforesaid provisions of the proposed Section 112A, the provisions of

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the DTAA will prevail. Therefore, the DTAAs entered into by India with France, Netherlands, Switzerland, Belgium, etc. will continue to enjoy capital gains tax exemption. However, the India's DTAA with Mauritius and Singapore will enjoy capital gains tax exemption only in respect of transfer of shares which are purchased prior to 1st April 2017 whereas the shares purchased and sold between 1st April 2017 to 31st March 2019 will be taxed at 50% of the domestic tax rate on LTCG.

7. Country by Country Report [Section 286]

In the world of globalisation, multinational enterprises carry out tax planning by transferring the profits of the group from high tax jurisdiction to low or nil tax jurisdiction through robust transfer pricing which may result into base erosion and profit shifting. Therefore, the OECD introduced BEPS Action 13 to enhance transparency for tax administration amongst various countries. These rules would provide all relevant Governments with needed information on their global allocation of income, economic activities and taxes paid in each jurisdiction accordingly to a common template and ensure profits are taxed where economic activities take place and value is created. BEPS Action 13 has laid down a three-tiered standardised approach to transfer pricing documentation, viz, Country-by- Country Report ('CbC'), Master File ('MF') and Local File ('LF'). India introduced the CbC reporting requirement and MF in the IT Act with effect from Assessment Year 2017-18. The CBDT released the final rules on CbC reporting and MF requirements on 31st October 2017.

In this budget, the due date for filing CbC reporting in respect of an accounting year commencing from 1st April 2016 and onwards is proposed to be prescribed in place of the due date of filing the return of income for the relevant accounting year. The constituent entity/alternate reporting entity having a non-resident parent shall be also required to furnish CbC reporting if the parent entity outside India does not have an obligation to file the report in its country. The time allowed for furnishing of CbC reporting to such constituent entity/alternate report entity resident in India will be prescribed. Reporting accounting year has been defined to mean the accounting year in respect of which the financial and operational results are required to be reflected in the report. The proposed amendment is in consonance with BEPS Action 13 and will be effective from 1st April 2016 (i.e. Assessment Year 2017-18).

In this budget, the due date for filing CbC reporting in respect of an accounting year commencing from 1st April 2016 and onwards is proposed to be extended from the due date of filing the return of income for the relevant accounting year to 12 months from the end of the reporting accounting year.

Conclusion

The most significant impact of this Budget would be on FIIs. The first blow to FIIs were the amendments to the DTAAs with Mauritius and Singapore, last year, which gave India the right to tax capital gains from sale of shares. The introduction of a tax on LTCG is the second blow which will result in higher tax costs for FPIs/FIIs as the treaty benefits earlier available should also no longer be available. This will be a deterrent for foreign investors and could potentially result in a movement of trading activity away from India to other offshore jurisdictions, which offer better tax rates and sophisticated financial products. Over the last couple of years, the Government has enacted several provisions in line with the BEPS Action Plan by the OECD. This year, the Budget proposes to expand the scope of the 'business connection' test through two sets of changes. Firstly, the scope of DAPE has been widened to include persons who habitually play the principal role leading to conclusion of contracts by non-residents. This is in line with the expansion of the concept of PE under the MLI. Secondly, to tax new business models in the digital space, the Budget proposes to include a SEP Test, under which download of data or software, or solicitation of business activities through digital means in India could lead to non-residents coming within the tax net. Interestingly, the OECD in the BEPS Action Plan has not yet endorsed such an approach on the basis of economic presence. The result of these changes would effectively mean that companies would be hesitant in undertaking transactions with Indian entities other than through treaty countries, given the expanded scope of the provisions. The possibility of protracted litigation also cannot be ruled out. ■

Always bear in mind that your own resolution to succeed is more important than any other. - Abraham Lincoln