India's 2017 budget will affect foreign investors and multinational enterprises

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In brief

The Indian Finance Minister on February 1, 2017, presented the 2017 union budget. The budget proposals continue the focus on development, improving the ability to conduct business in India, and attracting foreign investment.

This Tax Insight reviews key budget proposals affecting foreign investors and multinational enterprises doing business in India. Some of the key budget proposals include rationalization of capital gains taxation, benefits for cross-border debt, and initiatives based on the Organisation for Economic Co-Operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) action plan.

In a related development, the Indian government a week prior to budget announcement released clarifications on the applicability of the general anti-avoidance rule (GAAR) and guidelines to determine a foreign company's place of effective management.

The budget proposals would take effect after passing both houses of Parliament and obtaining presidential assent.

In detail

Reduction in domestic corporate tax rate

The government in the 2015 budget announced its intention to phase in a corporate tax rate reduction to 25%.

The 2016 budget reduced the corporate tax rate for certain types of domestic companies.

The new budget proposal would reduce the corporate tax rate for domestic companies with a total turnover not exceeding INR 500 million (approximately USD 7.5 million) to 25%.

The corporate tax rate for foreign companies, including branches and permanent establishments (PEs), would remain unchanged at 40%.

All rates would exclude applicable surcharges.

Indirect transfer taxation: Reduced applicability to foreign portfolio investors (FPI)

Indian tax law provides for indirect transfer taxation.

The Indian government had issued a circular providing clarification on the applicability of the indirect transfer taxation provisions to FPI. Due to certain concerns raised, the applicability of this circular is kept in abeyance.

The budget proposals clarify that the indirect transfer provisions will not be apply to investments held by non-residents, directly or indirectly, in Category I (government, sovereign funds, etc.) or Category II (broad-based funds, funds regulated in overseas jurisdictions, etc.) FPIs.

This amendment would take effect retroactive from April 1, 2012, granting relief to India-specific overseas funds and entities investing in Indian securities as FPIs.

The budget speech notes that the government will clarify that the indirect transfer provisions shall not apply to the redemption of shares or interests outside India as a result of, or arising out of, the redemption or sale of an investment in India, which is chargeable to tax in India.

Capital gains taxation

Long-term capital gains tax exemption on transfer of listed securities

Under current law, the transfer of a long-term capital asset being equity share of a company is exempt from capital gains tax if the transfer has been subject to Securities Transaction Tax (STT).

Finance Bill 2017 proposes that for equity shares acquired on or after October 1, 2004, an exemption from capital gains on transfer will be available only if STT was paid at the time of acquisition as well.

However, certain exceptions are expected, such as the acquisition of shares without payment of STT in Initial Public Offers, Fresh Public Offers, bonus or rights issue by a listed company or acquisition by non-residents in accordance with Foreign Direct Investment policy.

The proposed amendment would apply beginning April 1, 2017.

Fair market value to be substituted as full consideration when consideration is less than fair value

The budget proposes that in the case of transfers of shares other than quoted shares, the fair market value of such shares will be substituted as full value of consideration if the consideration received or accruing is less than the fair market value.

Rules to determine the fair market value of such shares will be prescribed.

Under current law, related-party transactions covered by Indian transfer pricing provisions must to be executed at fair market value to meet the arm's-length principle. This budget amendment would extend this principle to all transactions, including transactions with unrelated parties.

The proposed amendment would apply beginning April 1, 2017.

Cost of acquisition in a tax-neutral demerger of a foreign company

Under current provisions, the transfer of an Indian company's shares in a demerger of a foreign company to another foreign company is exempt from tax.

With a view to rationalize the provisions, the budget proposes that the acquisition cost of the Indian company's shares held by the demerged foreign company shall be considered as the cost in the hands of the resulting foreign company.

The proposed amendment would take effect beginning April 1, 2017.

Clarification of non-resident capital gains taxation on sale of Indian private limited companies

In 2013, the non-resident long-term capital gains tax rate on the sale of 'unlisted securities' was reduced to 10%, plus applicable surcharges. Because the provisions' wording was unclear, taxpayers were uncertain whether the beneficial rate would apply to the transfer of shares of Indian private limited companies. Last year's budget addressed this ambiguity by clarifying that the lower rate also would apply to shares of an Indian private limited company.

This year's budget further clarifies that the beneficial rate of 10% will apply retroactively from April 1, 2012.

Observation: This welcome clarification creates an opportunity for taxpayers to claim a refund if taxes were paid at a higher rate in earlier years.

Conversion of preferred shares into equity shares to be tax -exempt

Under current provisions, the conversion of a company's bond or debenture into equity shares is specifically exempt from capital gains tax, but a conversion of preference shares is not.

To maintain parity, a proposal would extend a similar benefit to the conversion of a company's preference shares into equity shares. The preferencee shares' acquisition cost and holding period would be taken into account when determining the acquisition cost and holding period of the equity shares acquired on such conversion.

The proposed amendment would apply beginning on April 1, 2017.

Cross-border debt

Extension of the eligible period for a concessional tax rate in case of foreign currency debt

Under current provisions, interest payable to a non-resident on borrowings made in foreign currency from sources outside India under a loan agreement or by way of issue of any long-term bond are eligible for a concessional tax rate of 5% for borrowings made before July 1, 2017. The budget would extend this period until June 30, 2020.

Extension of benefit to rupee-denominated bonds (including masala bonds)

As a result of various stakeholders' demands for granting the benefit of a lower tax rate to rupee-denominated bonds, a press release dated October 29, 2015, clarified that a 5% tax rate would apply to these bonds as it is applies to offshore dollar-denominated bonds.

To make this clarification effective, the budget would extend the 5% tax rate to rupee-denominated bonds issued outside India before July 1, 2020.

Transfer of rupee-denominated bonds issued outside India by a non-resident to another non-resident exempt from capital gains

In addition to the applicability of the lower tax rate for interest payable on rupee-denominated bonds, the budget proposes that the transfer of rupee-denominated bonds that are issued by an Indian company outside India and held by a non-resident to another non-resident shall be exempt from capital gains.

The budget further proposes that the Finance Act 2016's exclusion of the forex appreciation of rupee-denominated bonds from the capital gains computation at the time of redemption shall be extended to secondary holders of such bonds.

The proposed amendment would apply beginning April 1, 2017.

BEPS initiatives and transfer pricing provisions

Introduction of thin capitalization norms

Under current provisions, interest paid by an Indian company to any non-resident associated enterprise is allowable as a deduction without limit, provided the interest satisfies the arm's length test under the Indian transfer pricing regulations. Currently, there are no thin capitalization provisions.

To incorporate the OECD's BEPS Action Plan 4 recommendations, a new provision would introduce the following key features:

- The provisions would apply to taxpayers that are Indian companies or PEs of foreign companies in India. Taxpayers engaged in banking or insurance would be excluded.
- The provisions would apply to interest or similar expenses paid, including those paid on existing debt, to overseas associated enterprises or third-party lenders for whom the underlying debt is backed by an implicit or explicit guarantee or equivalent deposit from overseas associated enterprises.
- Any interest paid for the year under consideration in excess of 30% of the taxpayer's earnings before interest, taxes, depreciation and amortization (EBITDA) would be treated as excess interest.
- Excess interest disallowed in a year could be carried forward up to eight years, subject to the aforementioned limits.
- The provisions would not apply to interest paid or payable up to INR 10 million (approximately USD 153,000).
- The terms associated enterprise, debt, and permanent establishment have been defined for the purposes of this provision.

The proposed amendment would apply beginning April 1, 2017.

Introduction of secondary adjustments

Secondary adjustments seek to give an economic effect to the primary transfer pricing adjustment as if the underlying transaction had actually taken place at arm's length.

Many jurisdictions, including the US, Germany, France, and Netherlands, provide for secondary adjustments that may take the form of a deemed dividend, equity contribution, or loan.

The provisions define a secondary adjustment as an adjustment in the taxpayer's books of account and the associated enterprise. Further, there is a requirement to repatriate the excess amount available with the associated enterprise to India. If the excess amount is not repatriated within the prescribed time limit, it would be considered as an advance made by the taxpayer to the associated enterprise, and interest will be computed on the amount.

The variables used for computing interest, such as the rates, duration, etc., will be prescribed in due course.

Secondary adjustments would be required for the following primary adjustments:

- suo-moto, or 'on its own motion,' adjustments offered by the taxpayer
- adjustments made by the Assessing Officer and accepted by the taxpayer

- adjustments determined by an Advance Pricing Agreement (APA)
- adjustments made pursuant to safe harbor rules
- adjustments arising as a result of a Mutual Agreement Procedures (MAP) resolution

The provisions indicate that secondary adjustments would not apply for tax year 2015–16 or prior years and only if the primary adjustment does not exceed INR 10 million (approximately USD $153,000). In all other cases, they would appear to apply.

The provisions would require further clarifications, including how they would apply to periods prior to April 1, 2017, how an adjustment would be recorded in the financial books, and how to prevent double taxation if the associated enterprise does not agree to the adjustment.

Rationalization of domestic transfer pricing provisions

With a focus on reducing transfer pricing compliance and improving the ease of doing business, payments to specified persons, such as directors, parent and sister companies, etc., would be excluded from the domestic transfer pricing provisions effective in tax year 2016–17.

Going forward, domestic transfer pricing provisions would apply to intercompany transactions only if one or both parties are involved in activities eligible for tax holidays.

Other amendments

Implementation of general anti-avoidance rules (GAAR)

The budget proposes no changes to the GAAR provisions, which therefore will take effect April 1, 2017.

The Indian Central Board of Direct Taxes recently issued clarifications for implementing the GAAR provisions (Circular No. 7 of 2017, dated January 27, 2017). While the clarifications address many areas, preferably the government would present illustrative cases for providing guidance on the overall applicability of GAAR provisions, as was suggested in the 2012 Expert Committee Report.

Proposed amendment to Minimum Alternate Tax (MAT)

Under current provisions, a company is eligible for MAT credit to the extent there is excess MAT liability over tax liability.

The budget proposals provide an increase in the time limit for carryforward and utilization of MAT credit from 10 to 15 years.

The proposed amendment would apply beginning April 1, 2017.

The budget also includes other provisions and clarifications regarding MAT.

Update on Goods and Services Tax (GST)

The Indian government has reiterated its timely commitment to implementing GST by announcing that trade and industry initiatives will commence on April 1, 2017.

The GST council will finalize the legislation by February 18, 2017.

There are certain issues which will be resolved prior to implementation by July 1, 2017.

Timeframe for completion of tax audits

In a phased approach, tax audit timelines would be reduced to 24 months from the end of the relevant tax year, with an additional 12 months available in the case of transfer pricing audits.

The takeaway

The proposed budget reiterates the Indian government's pro-growth agenda through economic liberalization and initiatives for improving the ease of doing business in India.

The government continues to take various steps to attract foreign investors and multinational enterprises.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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