NEERAJ BHAGAT & CO.
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Union Budget 2018-19 Analysis

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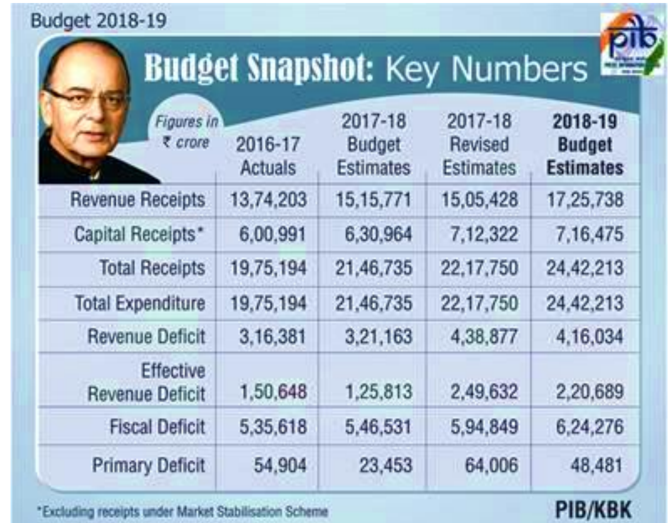
Insight

The Finance Minister ("**FM**") on Feb 1, 2018 announced the Budget for financial year ("**FY**") 2018-19 ("**Budget**"). This Budget is expected to be the last of this Government prior to elections which are expected to happen over the next twelve months, and the focus was around ensuring that the rural economy was adequately benefitted. Although the last twelve months have seen a significant increase in investments from Foreign Portfolio Investors ("**FPI**") and Foreign Direct Investment ("**FDI**"), the Budget largely focuses on the domestic audience. Reforms are proposed in the health and rural sector with emphasis on generating higher income for farmers. On the tax and regulatory front, the Budget proposals have been minimal, especially for the global investor community. The biggest blow has been for the Indian capital markets with introduction of a long term capital gains ("**LTCG**") tax at the rate of 10% on listed equities, which were earlier exempt.

The Budget proposes a **10% tax** on transfer of listed equity shares, units of an equity oriented mutual fund and units of a business trust, where such gains exceed INR 100,000 (approx. USD 1500), with effect from April 1, 2018. The Budget also proposes to introduce limited grandfathering in respect of protecting gains realized on a mark to market basis up to January 31, 2018; an increase in share value post this date would be brought within the tax net. This is in line with the Government's intent not to introduce taxes with retrospective effect and to protect any exodus from the Indian markets.

The most significant impact will be on foreign portfolio investments. The first blow to FPIs were the amendments to the Double Tax Avoidance Agreements ("**Tax Treaties**") 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 as the treaty benefits earlier available should also no longer be available.


Budget 2018-19

Budget Snapshot: Key Numbers

Figures in ₹ crore	2016-17 Actuals	2017-18 Budget Estimates	2017-18 Revised Estimates	2018-19 Budget Estimates
Revenue Receipts	13,74,203	15,15,771	15,05,428	17,25,738
Capital Receipts*	6,00,991	6,30,964	7,12,322	7,16,475
Total Receipts	19,75,194	21,46,735	22,17,750	24,42,213
Total Expenditure	19,75,194	21,46,735	22,17,750	24,42,213
Revenue Deficit	3,16,381	3,21,163	4,38,877	4,16,034
Effective Revenue Deficit	1,50,648	1,25,813	2,49,632	2,20,689
Fiscal Deficit	5,35,618	5,46,531	5,94,849	6,24,276
Primary Deficit	54,904	23,453	64,006	48,481

*Excluding receipts under Market Stabilisation Scheme

PIB/KBK

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 such as Singapore which offer better tax rates and sophisticated financial products.

On a more positive note, the Budget proposes to reduce corporate tax rates to 25% for Indian companies whose turnover is less than INR 2.5 billion (approx. USD 40 million). This is in line with the earlier proposals of the FM and should enhance competitiveness and encourage global investors to **'Make in India'**. The exemption is broad enough to cover 99% of all tax-paying companies. It is important that in an era of tax competition where countries have been lowering corporate tax rates, India does not get left behind. While the move to reduce corporate tax rates is welcome, it would have been ideal if the corporate tax rates for large companies were also reduced to make them more competitive in the global marketplace.

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Insight contd..

Over the last couple of years, the Government has enacted several provisions in line with the Base Erosion and Profit Shifting Action Plan ("**BEPS Action Plan**") by the Organization for Economic Cooperation and Development ("**OECD**"). This year, the Budget proposes to expand the scope of the 'business connection' test (the equivalent of permanent establishment) through two sets of changes. Firstly, the scope of 'dependent agent' 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 Permanent Establishment ("**PE**") under the Multilateral Instrument ("**MLI**"). Secondly, to tax new business models in the digital space, the Budget proposes to include a 'significant economic presence test' ("**SEP Test**"). Under the SEP Test, 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 enough, 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 extremely reluctant to undertake transactions with Indian entities other than through treaty countries, given the expanded scope of the provisions. The possibility of substantial litigation going forward also cannot be ruled out.

The justification of the Government to expand the scope of the provisions has been that going forward, these 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 digitization in India.

One area where the Government seems to have proactive has been in the context of bankruptcy and insolvency laws, which have always been a pain point for investors and creditors. While 2017 witnessed a large number of cases being referred to bankruptcy courts (NCLT), concerns have been raised on the fact that tax law has not yet caught up with the changes. The Budget proposes to promote the restructuring plans by introducing tax incentives such as the ability to carry forward losses despite change in ownership and Minimum Alternate Tax ("**MAT**") relief to the extent of unabsorbed depreciation and carried forward loss where a company has been admitted into the bankruptcy process. These proposals should further increase interest amongst investors in distressed assets.

In its continuous endeavour to build a robust financial services centre in the country, the Government has proposed incentives for financial services operating through International Financial Services Centers ("**IFSCs**"). Importantly, in addition to the tax reforms, the FM in his speech has proposed to establish a unified authority to regulate this space.

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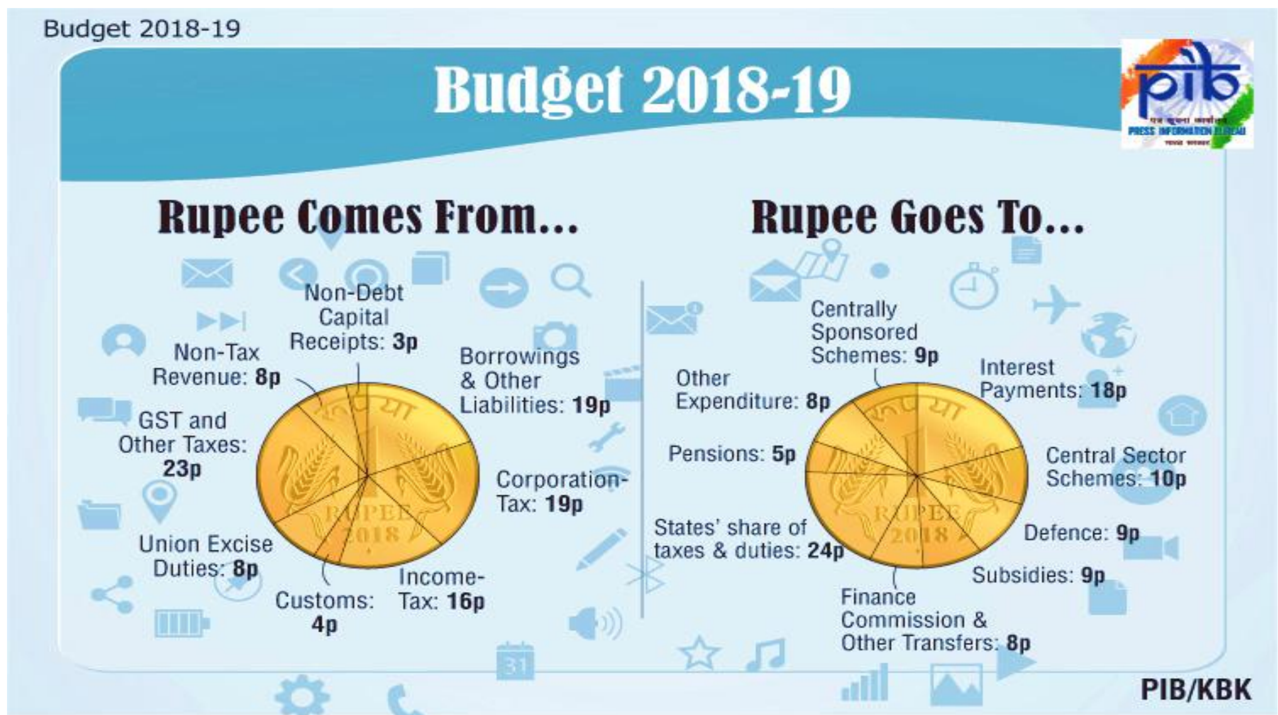
Another interesting takeaway from the FM's speech was the policy for hybrid instruments that will be put in place, especially for the start-up community and venture capitalists. A robust framework for investments through hybrid instruments will be vital in developing a sophisticated market to attract foreign investment. The Start Up Action Plan introduced by the Government has garnered an overwhelming response from the start-up community. A key cause of concern for the start-up community has been the inefficient tax incentives associated with the Action Plan. Over the years, the Government has rationalized these measures. In this Budget, the FM has proposed to bring the definition of start-up in line with that provided by the Department of Industrial Policy and Promotion ("**DIPP**"). Additionally, considering that the tax incentives were not fully being utilized, the FM has proposed to extend the tax exemption for another 2 years i.e. till March 31, 2021.

Other budget proposals include introduction of a new scheme for assessments. The proposed scheme eliminates interactions between the tax officer and the taxpayer through an e-assessment model which will result in greater transparency and efficiency. The effort seems to be in line with the dual aim of 'ease of doing business' and promoting the digital economy.

We have provided below a more comprehensive analysis and further insights on the 2018 Budget proposals.



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Fiscal and economic review

Economic indicators

- Fiscal deficit for FY 2017-2018 is expected to be expanded to the target of 3.5% of GDP. The road map for fiscal deficit is 3.3% in FY 2018-19. Govt. intends to use fiscal deficit target as key operational parameter for fiscal consolidation
- GDP growth is expected to be between 6.5% and 6.75% in FY 2017-18. GDP growth is projected to be between 7.0%- 7.75% in FY 2018-19.
- Current account deficit has declined to reach about 1.8% of the GDP in the first half of FY 2017-18
- The wholesale price index (WPI) settled at 2.90% in FY 2017-18 (April-December).
- Forex reserves: USD 411 Bn. at its highest ever
- Index of Industrial Production (IIP) grew 3.2 per cent, while registering a growth rate of 8.4 per cent in November 2017, the highest in 25 months.
- Service sector growth: Projected to grow at 8.3% in FY 2017-18, as against 7.7 % in FY 2016-17.

Measures to boost MSME segment

- Provision of INR 38 billion to MSME Sector for giving credit support, capital and interest subsidy and innovations.
- Online loan sanctioning for MSMEs to commence
- Policy and institutional development measures are being examined for creating right environment for Fintech companies to grow in India.
- Measures will be announced soon for effectively addressing non-performing and stressed accounts of MSMEs.

Ease of Doing Business in India

- Various reforms taken by the Government of India have led to increase in India's ranking in the World Bank's Ease of Doing Business Index from 130 in 2017 to 100 in 2018.
- India's ranking in the taxation and insolvency parameters improved by 53 and 33 spots, respectively, on the back of administrative reforms undertaken by the Government in the areas of taxation and passage of Insolvency and Bankruptcy Code (IBC), 2016.
- To improve the ease of doing business in the country, the government has taken various initiatives to improve contract enforcement. Over 1,000 redundant legislations have been scrapped.

India Economy – 7th largest

- India aims to occupy the 5th largest position at the soonest
- India is already the third largest economy on Purchasing Power Parity (PPP) basis
- Indian economy is now a 2.5 trillion dollar economy

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RATIONALIZATION OF CORPORATE TAX RATES

The Finance Bill, 2018 ("**Finance Bill**") provides that the income of companies whose turnover in FY 2016-17 does not exceed INR 2.5 billion (approx. USD 40 million) is to be taxed at the rate of 25% from FY 2017-18. Earlier, only companies with a turnover less than INR 500 million (approx. USD 7.8 million) in FY 2015-16 could avail of the 25% rate. This reduction marks the latest step in the Government's drive to gradually reduce the **corporate income tax rate to 25%** across the board. The reduction in the corporate tax rate is also in line with a similar trend across the globe. It is hoped that the reduction will provide a fillip to the small and medium enterprises.

Further, the Finance Bill has replaced the Education Cess (2%) and Secondary and Higher Education Cess (1%), with a **'Health and Education Cess' at the rate of 4%.** It will be applicable on the sum of income tax and surcharge payable by a taxpayer.

TAXATION OF STARTUPS

The Finance Bill extends the benefit of section 80-IAC to start-ups incorporated on or after April 1, 2019 but before April 1, 2021. Under section 80-IAC, a startup engaged in an eligible business can elect to exempt its income from income tax for any three successive years within a block of seven years commencing from the date of its incorporation. The Finance Bill has also replaced the existing definition of 'eligible business' ("*a business which involves innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property*") with the following: "*a business carried out by an eligible start up engaged in innovation, development or improvement of products or processes or services or a scalable business mode with a high potential of employment generation or wealth creation*".

The new definition is now closer to the definition of a start-up as notified by the DIPP[1] and should allow start-ups which are neither engaged in the development of a new product or process, nor in a business not driven by intellectual property or technology, but nevertheless engaged in a business with high wealth creation and employment generation potential, to claim the benefit of section 80-IAC. However, the start-up will still need to hold a certificate of eligible business from the Inter-Ministerial Board of Certification and have a turnover not exceeding **INR 250 million** (approx. USD 4 million). While the expansion of the benefit is to be commended, it is also unclear what would constitute high potential of employment generation or wealth creation.

Start-ups continue to remain subject to the MAT, which makes it difficult for them to avail the benefit of losses carried forward in a meaningful manner.

DIGITAL INDIA

- Doubling the budget of Digital India to INR 30 billion in FY 2018-19 shows the Government's vision and commitment towards digital economy.
- The task of connecting 0.1 million gram panchayats with high speed optic fibre network has been completed under Phase 1 of Bharat Net program. This has enabled broadband access to cover rural Indians in about 2.5 lakh villages.
- Aim to establish India as a knowledge and digital society by promoting Digital India, Start Up India and Make in India initiatives
- The Government will explore use of block chain technology; a very encouraging sign, for proactively ushering in digital economy
- The Government also proposes to setup five lakh wi-fi hotspots which will provide broadband access to five crore rural citizens.

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SCOPE OF DIVIDENDS WIDENED

(a) Introduction of anti-avoidance measure

The Government has introduced certain anti-avoidance provisions to capture transactions whereby companies were avoiding the payment of Dividend Distribution Tax ("**DDT**") by way of undertaking schemes of amalgamation along with a reduction of capital to make distributions to shareholders. This could then be viewed as distribution of capital as compared to a distribution of accumulated profits. In order to plug this loophole, the Government has introduced provisions to deem that in case of an amalgamation, the accumulated profits of the amalgamated company shall stand increased by the accumulated profits of the amalgamating company as on the date of amalgamation.

(b) Increase in scope of DDT

The issue of taxation of such "deemed dividends" has been the subject of substantial litigation. To bring clarity and increase the ease of tax collection, the Budget proposes to bring deemed dividends in the nature of loans or advances to shareholders under the scope of the DDT from April 1, 2018. Such deemed dividends are proposed to be subjected to a higher rate of tax at 30% (without grossing up) as opposed to regular dividends. The challenge as pointed out earlier is that the scope of deemed dividend has itself been a subject matter of substantial litigation. The impact of this provision will be to shift all such litigation to the hands of the company that is providing the loans and advances as compared to the recipient.

Another increase in the scope of DDT has come in the form of the proposal in the Budget to levy a DDT at 10% on any income distributed by equity oriented mutual funds to its unit holders/ investors. This proposal will impact investors in the dividend plans of equity oriented funds and has been made with a view of bringing them on the same level as investors who favour the growth plans of equity oriented funds, the redemption of units of which is also proposed to be subject to a 10% tax.

REMOVAL OF LONG TERM CAPITAL GAINS EXEMPTION

The Finance Bill has proposed a removal of the existing exemption on LTCG arising out of sale of listed equity shares of an Indian company on a stock exchange. The Finance Bill has introduced a new provision (section 112A) to levy a 10% tax on LTCG arising from the transfer listed equity shares, units of an equity oriented mutual fund, or units of a business trust where such gains exceed INR 100,000 (approx. USD 1500). This tax shall be applicable on LTCG arising on or after April 1, 2018.

As a pre-condition for claiming the beneficial tax rate of 10%, the proposal makes it mandatory for STT to have been paid at the time of sale of units, while in respect of LTCG on listed shares, it makes it mandatory for STT to have been paid at the time of acquisition and sale of the share.

EXPANSION OF BUSINESS CONNECTION (PE TEST): ALIGNMENT WITH MLI

Based on the recommendations under BEPS Action Plan 7, the scope of dependent agent PE under DTAA is widened by MLI, to which India is also a signatory.

It is proposed to amend the term 'business connection' to align it with the provisions in the DTAA.

Business connection shall also include any business activities carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident and the contracts are:

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

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MEASURES TO FACILITATE INSOLVENCY RESOLUTION

(a) Benefit of carry forward and set off of losses

As a measure of promoting effective restructuring and rehabilitation of such companies, with effect from April 1, 2018, the Budget proposes to exclude the applicability of section 79 of the ITA in the case of companies where a change in shareholding takes place pursuant to a resolution plan being approved under the IBC, after affording a reasonable opportunity of being heard to the jurisdictional Principal Commissioner, or Commissioner, of Income Tax.

This is a welcome change and will go a long way in ensuring that companies undergoing insolvency are able to turn around their fortunes and chart a path to future profitability without the burden of additional tax hurdles to be overcome.

(b) Relief from MAT liability

The Budget now proposes to operationalize this relaxation by inserting clause (iig) in Explanation 1 to Section 115JB, which allows the aggregate amount of unabsorbed depreciation and loss brought forward to be reduced from the company's book profit in computing its MAT liability, in situations where an application for insolvency resolution under the Sections 7, 9, or 10 of the IBC has been admitted against it by the NCLT. By inserting a specific provision in this regard, the Budget also clarifies that the relaxation should be available irrespective of whether the amount of brought forward losses, or unabsorbed depreciation is nil.

It should be also noted that the proposed relaxation only applies to companies undergoing insolvency resolution, and not to companies opting for voluntary liquidation under the IBC. The relaxation also does not apply to companies undergoing insolvency resolution through alternative methods of resolution such as the Strategic Debt Restructuring scheme or the Scheme for Sustainable Structuring of Stressed Assets.

INCENTIVES FOR INTERNATIONAL FINANCIAL SERVICE CENTERS (IFSC)

In keeping with the Government's intention to give an impetus to IFSCs (which includes GIFT City), the Budget has provided certain incentives this time around as well. The Budget Speech recognised the need for a coherent and integrated regulatory framework for IFSCs to be able to compete with offshore financial centres. In the Budget Speech, the FM has declared that the Government will establish a unified authority for regulating all financial services in IFSCs. This is a welcome move.

Further, currently, in case of a corporate person, a unit located in IFSC and deriving income solely in convertible foreign exchange is subject to minimum alternate tax at a concessional rate of 9%.

In case of a non-corporate person also it is proposed to charge the alternate minimum tax at the rate of 9% to a unit located in IFSC and deriving income solely in convertible foreign exchange.

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COUNTRY BY COUNTRY REPORTING – MOVING TOWARDS GLOBAL HARMONISATION

BEPS Action Plan 13 recognised the need to develop robust rules for country-by-country reporting ("**CbCR**") by Multinational Enterprises ("**MNE**") to enhance transparency for tax administrations. As part of aligning Indian tax laws with the BEPS Action Plans, Finance Act, 2016 introduced section 286 in the ITA to provide for CbCR by Indian entities belonging to international groups.

In an attempt to further standardize the format for the Indian leg of CbCR and to bring it in line with BEPS Action Plans, the Finance Bill proposes certain amendments to section 286, which are retrospectively effective from AY 2017-18 onwards, are a welcome move as they intend to achieve global uniformity in terms of CbCR. From a compliance standpoint, the extension of timelines is likely to bring about much needed relief for reporting Indian constituent entities. Further, the introduction of mandatory reporting requirements on Indian constituent entities not being parent/alternate reporting entity in cases where the non-resident parent entity has no obligation to do CbCR in its home jurisdiction would be viewed as a welcome step by the global community, as it tries to fill in gaps in such reporting due to inadequate laws in other jurisdictions.

TAX RELIEF FOR PARENT - SUBSIDIARY TRANSFERS

This amendment would provide much needed relief to entities which, due to the nature of their relationship, transact by transferring property at less than FMV. Further, internal restructurings involving a sale of shares within the group, will now be exempted from tax under the head income from other sources. This has effectively brought the position of such transfers at par with the exemptions provided for amalgamations and demergers under section 56.

OTHER REFORMS

Universal Healthcare

- World's Largest Government funded programme proposes health coverage of INR 0.5 million per annum to 100 million poor and vulnerable families under the National Health Protection Scheme
- Move to bring health insurance to almost 40 percent of the population

Changing face of Science, Research and Technology in India

- NITI Aayog will initiate a national program for enhancing efforts in areas of **machine learning, artificial intelligence, internet of things, 3D printing and the likes.**
- Proposed to invest INR 1 trillion for this project
- Launched the initiative "Revitalising Infrastructure and Systems in Education (RISE) by 2022" to set up investments in research and infrastructure for education

Rural economy

- Government continues to introduce measures to uplift agriculture based population.
- MSP at 1.5 times for kharif crops
- Operation Greens: to address price volatility of perishable commodities like potatoes, tomatoes and onions.
- Bamboo is Green Gold: An outlay of INR 13 billion has been allocated to promote bamboo sector in a holistic manner
- New policies that will address procurement, demand and forecast targeted at doubling farmers' incomes FY 2021-22.

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Deduction in respect of income of Farm Producer Companies

It is proposed to extend the benefit of section 80P of the Act to provide 100% deduction in respect of profits to Farm Producer Companies (FPC) having total turnover upto INR 100 crore, whose gross total income includes any income from:

- marketing of agricultural produce grown by its members, or
- the purchase of agricultural implements, seeds, livestock or other articles intended for agriculture for the purpose of supplying them to its members, or
- the processing of the agricultural produce of its members The benefit shall be available for a period of five years from the FY 2018-19. The amendment will take effect from 1 April 2018 and apply to AY 2019-20 and subsequent AYs.

Defence industry

- Private investment in defence production opened up including liberalizing foreign direct investment
- Measures being undertaken to develop two defence industrial production corridors in the country
- Industry friendly Defence Production Policy 2018 to be brought out to promote domestic production by public sector, private sector, and MSMEs

Service Tax

Retrospective exemptions

- Services provided or agreed to be provided by the Naval Group Insurance Fund by way of life insurance to personnel of Coast Guard, under Group Insurance Schemes of the Central Government, are proposed to be exempted from service tax for the period commencing from 10 September 2004 and ending with 30 June 2017.
- Services provided or agreed to be provided by the Goods and Services Tax Network (GSTN) to the Central Government or State Governments or Union territories administration, are proposed to be exempted from service tax for the period commencing from 28 March 2013 to 30 June 2017.
- Consideration paid to the Government in the form of Government's share of profit petroleum in respect of services provided or agreed to be provided by the Government by way of grant of license or lease to explore or mine petroleum, crude or natural gas or both, is proposed to be exempted from service tax for the period commencing from 1 April 2016 to 30 June 2017

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Neeraj Bhagat is a member of the Institute of Chartered Accountants of India (ICAI) since 1997. He is also an Associate member of Association of International Accountants, United Kingdom. He is founder of Neeraj Bhagat & Co, an Indian Chartered Accountancy firm serving various MNC'S from across the globe. Neeraj Bhagat & Co. has its offices at New Delhi, Gurgaon and Mumbai. They are part of Allinial Global Accounting Association which is one of the World's Top 10 in accounting associations.

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