

FEBRUARY 2017

**UNION BUDGET 2017-2018: HIGHLIGHTS****1. INTRODUCTION**

India's Finance Minister presented the Union Budget 2017-2018 (the "**Budget**") before Parliament on February 1, 2017, with promises to boost rural spending and cut taxes for the lower middle classes and small to medium business enterprises.

On the whole, with elections looming in 5 (five) key battleground states and the unorganized sector of the economy still recovering from the impact of demonitisation, it was inevitable that the Budget was tailored towards increasing government expenditure for the masses, leaving corporate India somewhat in the shadows.

The key reforms introduced in the Budget are summarized below.

**2. FINANCE & TAX****2.1 Income tax**

The Finance Minister announced plans to halve the lowest personal tax rate from 10% (ten per cent) to 5% (five per cent) that applies to incomes between INR 250,000 (approximately USD 3,700) and INR 500,000 (approximately USD 7,400).

Taxpayers earning more than INR 5,000,000 (approximately USD 75,000) will be charged a surcharge of 10% (ten per cent).

According to the last set of available statistics, just 2 per cent of Indians filed income tax returns and just 1 per cent paid tax.<sup>1</sup>

**2.2 Reduction in income tax rate for MSMEs**

To stimulate micro, small and medium enterprises ("**MSMEs**"), income tax for companies with annual turnover of up to INR 50 crores (approximately USD 7.4 million), has been reduced to 25% (twenty five per cent), from the prevailing 30% (thirty per cent) rate.

It is noteworthy that only companies that fulfill this criterion can avail this benefit, not entities that are formed as sole proprietorships or partnership firms.

Statistics suggest that 94% (ninety four per cent) of Indian companies fall within the definition of MSMEs.<sup>2</sup>

<sup>1</sup> <http://indianexpress.com/article/india/india-news-india/data-shows-only-1-of-population-pays-income-tax-over-5000-pay-more-than-1-crore-2779065/>

<sup>2</sup> <http://www.livemint.com/Opinion/zyvNMqIAdbmVEW02DUU5BP/MSMEs-not-large-corporations-are-powering-Indias-growth.html>

However, a much speculated reduction in corporation tax from 30% (thirty per cent) to 25% (twenty five per cent) was not announced, leaving India's major corporates disappointed.

### 2.3 Funding political parties

The Budget tightens the rules on the funding of political parties, reducing the maximum cash donation to INR 2,000 (approximately USD 30) and further, requires parties to file income tax returns.

The reduction of cash contributions to finance political parties, while welcome, is likely to lead to cash slicing. An entirely *online* financing mechanism is perhaps the only way that full accountability and transparency can be brought into the system.

### 2.4 Funding social programs

The Budget allocated approximately INR 480 billion (approximately USD 7 billion) (the highest ever) to the national employment guarantee scheme, which is intended to stimulate consumption amongst the lower middle class households, impacted by the fallout from last year's note ban.

Government spending, however, should not be a substitute for private spending (which is less prone to leakage) and the universal roll out of bank accounts to all Indians is a necessary condition for the movement to direct electronic credits to individuals, bypassing the bureaucracy that administers it.

### 2.5 Long term capital gains on listed shares

The Budget proposes to restrict the current exemption provided for long term capital gains arising out of the sale of listed equity shares. It is now proposed that this exemption will not be available where the equity shares so transferred was acquired after 1 October 2004 and was not chargeable to securities transaction tax. It is hoped that the Government will notify certain exceptions in this regard.

### 2.6 Transfer of unlisted shares

The Budget proposes the introduction of a new Section 50CA to the Income-Tax Act, 1961, wherein in case of transfer of unlisted shares for less than fair market value ("FMV"), the transferor will be deemed to have received the FMV as full value of consideration for the shares.

### 2.7 Conversion of preference shares to equity

Earlier, the conversion of preference shares to equity shares was a taxable transfer and subject to capital gains tax. The Budget now proposes that the conversion of preference shares to equity will be a tax neutral transaction. Further, the period of holding of the converted equity shares will include the period of holding of the original preference shares and the cost of acquisition of the converted equity shares will be the cost of acquisition of the original preference shares.

### 2.8 Thin capitalization rules

The Budget proposes to introduce a new Section 94B to the Income-Tax Act, 1961, which seeks to cap deductions of interest payouts made to associated enterprises. Accordingly, where interest deductions sought are in excess of INR 1 crore (approximately USD 143,000), the same would be capped at 30% of the EBITDA of the company.

## 2.9 Clarification in case of demerger of foreign companies

Currently, the transfer of an Indian company's shares by a demerged foreign company to a resulting foreign company is exempt from tax in India. The Budget makes a clarificatory amendment in this regard and states that the cost of acquisition of the Indian company's shares in the hands of the resulting foreign company will be the same as it was in the hands of the demerged foreign company.

## 2.10 Withholding rates on interest

The concessional withholding rate of 5% (five per cent) charged on interest earned by foreign entities in external commercial borrowings, Rupee-denominated bonds, or in bonds and Government of India securities, has been extended to June 30, 2020. Further, transfer of rupee denominated bonds between non-residents is also proposed to be a tax neutral transfer.

## 2.11 Carry forward and set-off of losses

Section 79 of the Income-Tax Act, 1961 allows carry forward of losses of certain companies and then set-off against profit of future years. However, the carry forward and set-off was not allowed if 51% (fifty one percent) shareholding did not remain intact in the year of loss and in the year of set-off. This proved to be a hindrance for start-up companies, which see a series of investments, with frequent changes to shareholding.

The Government has relaxed this restriction, and now allowed carry forward and setting-off of losses even if majority shareholding has changed hands. This is subject to the condition that the holding of the original promoters continues.

## 2.12 Exemptions for start-ups

The profit-linked deduction exemption available to start-up companies for 3 (three) years out of 5 (five) years<sup>3</sup> has been revised to 3 (three) years out of 7 (seven) years. Extending the window for availing this tax exemption will provide some relief to start-up companies, since many do not turn profitable in the first few years of operation.

However, it is noteworthy that this exemption continues to be allowed only to start-up companies that are covered under the definition of 'start-up companies' under the notification issued by the Department of Industrial Policy and Promotion,<sup>4</sup> and are recognized by the relevant authorities. Further, such start-up companies must have been incorporated between April 1, 2016 and April 1, 2019.

## 2.13 Extension for claiming MAT

Minimum alternate tax ("MAT") is a minimum tax targeted towards those companies that, despite making profits, do not actually pay tax, by taking advantage of various provisions of income tax law.

A company is entitled to claim MAT credit (that is, excess of MAT paid over the normal tax liability). A company may carry forward MAT credit in the subsequent years. Under the Budget, the period for availing MAT credit has been extended to 15 (fifteen) years, from the previous 10 (ten) years.

<sup>3</sup> Section 80-IAC, Income-Tax Act, 1961, accessible at: <http://www.incometaxindia.gov.in/Acts/Income-tax%20Act,%201961/2016/Others/section80iac.htm>

<sup>4</sup> Notification No. GSR 180(E) dated February 17, 2016, Department of Industrial Policy and Promotion, accessible at - [http://dipp.nic.in/English/Investor/startupindia/Definition\\_Startup\\_GazetteNotification.pdf](http://dipp.nic.in/English/Investor/startupindia/Definition_Startup_GazetteNotification.pdf)

## 2.14 Asset Reconstruction Companies

The Budget anticipates that the SARFAESI Act, 2002, will be amended in order to permit the sponsor of an asset reconstruction company to hold up to 100% (one hundred per cent) of its equity

## 2.15 Agricultural markets

An expert committee will be constituted to study and promote creation of an operational and legal framework to integrate spot market and derivatives market in the agricultural sector, for commodities trading. The e-NAM<sup>5</sup> will be an integral part of the framework. This will be done to bring further reforms for the benefit of farmers.

## 3. REAL ESTATE

### 3.1 Expanding Infrastructure status

'Affordable housing' will be given 'infrastructure' status. It is expected that this measure will extend many benefits available to the infrastructure sector, to affordable housing projects.

### 3.2 Tax on notional rental incomes deferred

At present, houses that are unoccupied after completion certificates are issued are subjected to tax on notional rental income. This tax will now be applied only after a year of receiving the completion certificate, for builders for whom constructed buildings are stock-in-trade.

### 3.3 Capital gains to be calculated from completion

For Joint Development Agreements signed for development of property, the liability to pay capital gain tax will arise in the year the project is completed. Deferring this payment of tax is likely to provide clarity, and reduce cash flows into the project.

### 3.4 Calculation of capital gains

The holding period for computing long-term capital gains from transfer of immovable property will be reduced from 3 (three) years to 2 (two) years. It is proposed to move the base year for indexation from April 1, 1981 to April 1, 2001 for all classes of assets, including immovable property.

This means that any gains on the sale of immovable property held by a person for a period of more than two years, will be treated as long-term capital gains, and therefore, be taxed only at 20% (twenty per cent) after indexation. Moving the base year for indexation means that the taxpayer will receive increased benefit.

### 3.5 Affordable housing

The conditions relating to affordable housing projects have been revised. The relaxed conditions are:

- (a) A limit of 30 (thirty) square meters will apply only in case of the municipal limits of the four metropolitan cities, while for other areas, the limit of 60 (sixty) square meters will apply.

---

<sup>5</sup> E-National Agricultural Market. For details, please see - [http://www.enam.gov.in/NAM/home/about\\_nam.html#](http://www.enam.gov.in/NAM/home/about_nam.html#)

- (b) Under the scheme for profit-linked income tax deduction for promotion of affordable housing, carpet area, instead of built-up area, of 30 (thirty) and 60 (sixty) square meters will be counted.

## **4. EASE OF DOING BUSINESS**

### **4.1 Foreign Investment Promotion Board**

As the Foreign Investment Promotion Board (the “FIPB”) has successfully implemented e-filing and online processing of foreign direct investment (“FDI”) applications, the FIPB will be abolished in 2017-18.

This move is aimed at achieving greater fund flows into India by easing the regulatory requirements involved in investment.

Also, further liberalization of the FDI policy is under consideration by the Government and 100% (one hundred per cent) FDI is anticipated in the marketing of food products produced or manufactured in India.

### **4.2 Infrastructure related dispute resolution**

To streamline institutional arrangements for resolution of disputes in infrastructure-related construction contracts, public-private partnership and public utility contracts, suitable mechanisms will be introduced as an amendment to the Arbitration and Conciliation Act, 1996 and an amendment law will be introduced in this regard.

This proposal is in furtherance to the Government's approval of the new arbitration guidelines issued on August 31, 2016, which were introduced for revival of the infrastructure sector by various measures, including speedy resolution of claims pending in arbitration.

### **4.3 Time bound listing**

The Government will put in place a revised mechanism and procedure to ensure time bound listing of identified Central Public Sector Enterprises (“CPSEs”) on stock exchanges. It was also announced that a new exchange trading fund with diversified CPSE stocks and other Government holdings will be launched in 2017-18.

### **4.4 Domestic transfer pricing**

The scope of domestic transfer pricing is restricted to situations where one of the entities involved in related party transaction enjoys specified profit-linked deductions.

Hence, the computation of income under Section 92BA and 92C of the Income-Tax Act, 1961, shall include any income from a specified domestic transaction, only if one of the entities enjoys specified profit-linked deduction under Section 80-A (6) or 80-IA (8) of the Income-Tax Act, 1961.

This has been done to reduce the compliance burden for domestic companies.

### **4.5 Indirect transfer provisions for FPIs**

Indirect transfer provisions under Section 9(1)(i) of the Income-Tax Act, 1961 shall not apply to Foreign Portfolio Investor (“FPI”) Categories I & II in case of redemption of shares or interests outside India as a result of or arising out of, redemption or sale of investment in India, which is chargeable to tax in India.

Any such income derived from the above shall not be taxable as income deemed to accrue in India.

## **5. DEMONITISATION**

The Budget announced that no transaction above INR 300,000 (approximately USD 4,500) will be permitted in cash.

**IndusLaw View:**

Choppy geo-political waters, an ongoing reform in indirect taxation (perhaps the biggest in history) and the unprecedented act of abolishing 86 per cent of currency notes in a country of 1.2 billion people are perhaps the defining structural contours for the Budget, limiting the Finance Minister's room for manoeuvre.

With the IMF recently cutting India's growth prospects from 7.6% to 6.6%, reflecting a short term blip caused by demonitisation, the Finance Minister's job of balancing fiscal prudence on the one hand, and priming the consumption pump on the other, is made much more difficult. However, tax cuts to the lower middle classes should help stimulate discretionary spending, badly needed following the recent cash ban.

As expected, with voters going to the polls in 5 (five) state elections shortly, the Budget has focused on the lower middle classes, anti-poverty programs and the agricultural sector, in an attempt to ameliorate the short term impact of demonitisation.

Apart from tax reductions to MSMEs, there's little in the Budget for India's corporate sector, though the announcement to phase out the FIPB should make the process of FDI less cumbersome.

Tellingly however, it's interesting to pick up on a quote from the Finance Minister during his speech to Parliament: *"The signs of retreat from globalization have the potential to affect exports from many emerging economies, including India,"* he prudently acknowledged.

With the looming amendment to the H1B visa scheme in the United States, potentially raising the salary threshold to USD 160,000 a year, India's corporate outsourcing industry will need to brace for the fall-out.<sup>6</sup>

Of a greater concern, it further remains to be seen how the Government's flagship program of *Make in India* will be hit by the retreat from globalization and how the Government plans to create the necessary 1 (one) million jobs a month to satisfy India's ever-growing skilled labour surplus.

**Authors:** Ran Chakrabarti, Ray Vikram Nath, Sowmya Agarwal, Chaitanya Shashank and Stuti Agarwal

February 10, 2017

**DISCLAIMER**

This alert is for information purposes only. Nothing contained herein is, purports to be, or is intended as legal advice and you should seek legal advice before you act on any information or view expressed herein.

Although we have endeavored to accurately reflect the subject matter of this alert, we make no representation or warranty, express or implied, in any manner whatsoever in connection with the contents of this alert.

No recipient of this alert should construe this alert as an attempt to solicit business in any manner whatsoever.

---

<sup>6</sup> <http://www.livemint.com/Industry/TuehxE1ZpalYexm5jKJCvO/What-H1B-visa-reforms-mean-for-Indian-IT-companies.html>