ERGO

THE FINANCE ACT 2021

THE FINANCE BILL 2021 ENACTED AFTER SIGNIFICANT AMENDMENTS

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INTRODUCTION

The Finance Bill 2021 was presented in the Indian Parliament on 1 February 2021 (Finance Bill) as part of the Budget proposals (see our Ergo on direct tax related budget proposals here). On 24 March 2021, it was passed by the Indian Parliament with certain amendments. Some of these amendments are significant, including the clarification on equalisation levy provisions and certain important changes from a mergers and acquisitions point of view, such as the deemed valuation provision for slump sale and rationalization of tax provisions related to dissolution or reconstitution of a partnership firm. After receiving the Presidential assent on 28 March, it is now in force (Finance Act).

Key amendments and effect thereof are summarized below:

Mergers and acquisitions related amendments –

- **Deemed sale consideration made applicable to slump sale**

  The existing provisions for computation of capital gains on slump sale (section 50B of the Income Tax Act 1961 (IT Act)) require capital gains/loss to be computed based on the difference between actual sale consideration and 'net worth' of such transferred undertaking. In computing such 'net worth', depreciable assets are taken at their written down value as per IT Act and other assets shall be taken as per their book value (except for assets for which deduction is fully availed under section 35AD are taken at NIL).

  The Finance Act has introduced a deeming fiction whereby the fair market value of the undertaking / division (computed in a prescribed manner) is deemed to be the value of consideration for computing capital gains in slump sale cases. Moreover, in computing the 'net worth' which is the deemed 'cost of acquisition' of such undertaking, the value of any goodwill of business or profession (other than goodwill acquired by purchase from a previous owner) would need to be taken as NIL.

  While we await notification of the rules for computing fair market value of the 'undertaking', it would be interesting to see the interplay of deemed valuation vis-à-vis the actual sales consideration, whether the valuation will be arrived at basis an itemized approach or lumpsum approach, and whether the value of liabilities would be considered in arriving at the deemed valuation.

  The amendment is effective from FY 2020-21 and is therefore applicable for slump sale deals undertaken during FY 2020-21. With the deemed valuation provisions in place for slump sale, it would be important to have a valuation report on record to demonstrate compliance with the provisions.

- **Rationalisation of provisions concerning tax on dissolution or reconstitution of specified entities**

  The Finance Bill had proposed to levy capital gains tax on a partnership firm, Association of Persons (AOP) or Body of Individuals (BOI), in case of distribution of assets to a partner or member, as the case may be, upon dissolution or reconstitution of the firm/AOP/BOI. However, a lot more clarity was desired as the proposals were quite ambiguous.

  The Finance Act has rationalised the proposed amendments and the provisions as enacted are summarised below:

  - Section 9B is inserted in the IT Act, whereby if a partner receives any capital asset and / or stock-in-trade from a firm upon dissolution or reconstitution of the firm, the firm shall be deemed to have transferred such capital asset and / or stock-in-trade to the partner in the year of receipt of such capital asset and / or stock-in-trade. The profits and gains arising from such deemed transfer shall be taxable in the hands of the firm as 'income from business or profession' or 'capital gain', in accordance with the provisions of the IT Act. It also provides that for computing profit and gains from such deemed transfer, the fair market value of the capital asset or stock on the date of its receipt by the partner shall be deemed to be the full value of consideration.

- Section 45(4) of the IT Act has been substituted to provide that if a partner receives any capital asset and / or money from a firm in connection with the reconstitution of the firm, then any profit or gains arising from such receipt by the partner shall be deemed to be capital gains in the hands of the firm, and a formula has been prescribed for computing the gains arising to the firm. In this regard, it is expressly provided that in computing the balance in the partner's capital in the books of the firm, any increase on account of revaluation of any asset or due to self-generated goodwill or self-generated asset shall not be taken into account.

- To mitigate any double taxation at the firm's level due to simultaneous application of section 9B and substituted section 45(4), section 48 of the IT Act has been amended to allow reduction of gains attributable to the capital asset transferred by the firm in computing income under section 45(4). The manner of computing such gains attributable to capital asset shall be prescribed by the Government.

- The aforesaid provisions also apply on reconstitution or dissolution of AOP/ BOI vis-à-vis their members.

The amendments are effective from FY 2020-21.

- **Clarification regarding depreciation on goodwill forming part of existing block of assets**

  The Finance Bill had proposed that goodwill shall not be considered as a depreciable asset. However, the Finance Bill did not specify what would happen to the amount of goodwill which formed part of an existing block of assets.

  The Finance Act has made amendments in section 43(6) of the IT Act to provide that written down value (WDV) of block of assets shall be reduced by the difference between actual cost of goodwill falling within such block of assets and the depreciation allowed / allowable on such goodwill up to 31 March 2020.

It is also specified that the amount of such reduction shall not exceed the WDV of the block of assets.

The amendment is effective from FY 2020-21.

Amendments specific to non-residents –

- **Concerns regarding applicability of equalisation levy partly addressed**

  Effective 1 April 2020, a new 2% levy was made applicable to the consideration receivable by a non-resident "e-commerce operator" for "e-commerce supply or services" provided or facilitated by it to Indian residents, persons using Indian IP address and non-residents in certain cases (subject to satisfaction of certain conditions).

  The Finance Act clarifies that equalisation levy would not apply to the following:

  (i) Consideration received / receivable for goods owned by a person resident in India or by permanent establishment in India of a person non-resident in India, if such sale is effectively connected with such permanent establishment;

(ii) Consideration for provision of services by a person resident in India or by permanent establishment in India of a person non-resident in India if such provision of services is effectively connected with such permanent establishment.

Depending on the business model, non-resident e-commerce operators would need to evaluate applicability of the above amendments.

The amendment is effective from FY 2020-21.

- **Definition of 'liable to tax' rationalized**

The Finance Bill had proposed to define the expression 'liable to tax', whereby 'liable to tax' in relation to a person means that there is a liability of tax on that person under the applicable law of any country and includes a case where after the imposition of such tax liability, an exemption has been provided.

The definition proposed by the Finance Bill did not specify the nature of tax to be considered for this purpose, and the scope was wide enough to include payment of any tax in any country.

The Finance Act defines 'liable to tax' with reference to a country and the income-tax liability in such country.

The amendment is effective from FY 2020-21.

IFSC-related amendments –

- **Clarifications regarding exemptions / reliefs to investment divisions of offshore banking units**

  - The Finance Bill had proposed to extend the capital gains tax exemption on transfer of certain specified securities on a recognized stock exchange set up in an IFSC, to investment divisions of offshore banking units which located in an IFSC and registered as a Category-III Alternative Investment Fund (AIF) (subject to conditions).

    The Finance Act replaces such requirement of the investment divisions of offshore banking unit being registered as a Category III AIF with a requirement of being registered as a Category-I Foreign Portfolio Investor (FPI).

The amendments are effective from FY 2021-22.

- **Clarifications regarding exemption in relation to aircraft leasing business**

  - The Finance Bill had proposed to insert a new sub-section 10(4F) to exempt royalty income earned by a non-resident, on lease of an aircraft to an IFSC unit subject to conditions, including that the IFSC unit is eligible to claim deduction under section 80LA of the IT Act for such year. The Finance Act has extended the benefit of this exemption to interest income arising from lease of an aircraft to such IFSC unit, while also omitting the requirement relating to the IFSC unit being eligible to claim the deduction under section 80LA of the IT Act.

  - Additionally, the Finance Bill had proposed to amend section 80LA of the IT Act to provide that any income arising from the transfer of an aircraft or aircraft engine, which was leased by an IFSC unit to a domestic company engaged in the business of operation of aircraft would be eligible for 100% deduction. The Finance Act has removed the condition of transferring the aircraft / aircraft engine to a 'domestic company engaged in the business of operation of aircraft'.

The amendments are effective from FY 2021-22.

- **Expanding the scope of exemption on relocation of foreign investment fund to an IFSC**

  - The Finance Bill had proposed several exemptions in relation to the relocation of investments held by a foreign investment fund (Offshore Fund) to an Alternative Investment Fund (AIF) located in an IFSC (IFSC Fund), subject to conditions. One such incentive was an exemption to a non-resident for capital gains arising on account of transfer of shares of an Indian company received pursuant to a relocation, by the IFSC Fund, if such capital gains would have not been subject to tax in India, had such relocation not taken place. Notably, an IFSC Fund registered as Category-III AIF is taxed on the capital gains in own hands itself as it does not enjoy a pass-through status.

  - The Finance Act has extended the benefit of such capital gains exemption to Category-III AIFs located in an IFSC in respect of such proportion of income which is attributable to units held by non-resident (except where the non-resident has a permanent establishment in India), to be computed in a manner to be prescribed by the Government.

  - Further, the Finance Act allows capital gains exemption even in relation to shares of an Indian company which are transferred by a wholly owned special purpose vehicle of the Offshore Fund on relocation.

  The amendments are effective from FY 2021-22.

Amendments related to assessment and procedural provisions –

- **Reassessment provisions further amended**

  The Finance Bill had proposed a new scheme of reassessment of income, under which the Assessing Officer (AO) can initiate proceedings if the AO has information which suggests that income chargeable to tax has escaped assessment.

  In this regard, the Finance Act has modified the proposals given in the Finance Bill to the extent that –

  - The AO cannot initiate re-assessment proceedings merely based on the following categories of survey conducted on or after 1 April 2021 –

    (a) Survey for verifying that tax has been deducted or collected at source in accordance with provisions of the IT Act;

    (b) Survey related to expenditure incurred by an asssessee in connection with any function, ceremony or event.

  - As against a plain 'requisition' as proposed in the Finance Bill, it shall be deemed that the Assessing Officer has the information which suggests that some income has escaped the assessment, only in cases relating to requisition of books of accounts, documents or jewellery, bullion or other valuable article or thing under section 132 or section 133A the IT Act.

- **Increase in threshold limit for applicability of tax audit**

  Earlier, a taxpayer carrying on a business was required obtain a tax audit report only if total sales / turnover / gross receipts from such business exceeds INR 50 million provided the total receipts / payments in cash do not exceed 5 per cent of the total receipts / payments of the business. The Finance Bill 2021 had proposed to increase this limit of INR 50 million to 100 million.

The Finance Act also provides that receipt / payment by way of non-account payee cheque / bank draft shall be deemed to be receipt / payment in cash. Accordingly, receipt / payments by way of non-account payee cheque / bank draft would be included while computing the limit of 5 per cent for applicability of higher threshold for tax audit.

COMMENTS:

Most of the Finance Act amendments clarify or rationalize the proposals of the Finance Bill. Through amendments introduced at the enactment stage, the Government has taken cognizance of suggestions of various stakeholders. Several amendments on tax regime concerning IFSC, in the Finance Bill as well as enactment stage, demonstrate the Government's steadfast intent to make IFSCs more attractive than ever before. Further, the Finance Act has inserted certain additional conditions for re-computation of book profits (MAT) pursuant to an APA or secondary adjustment and accordingly, a taxpayer would have to evaluate its eligibility by weighing in such additional conditions at the time of making application for any book profits adjustments.

The introduction of the concept of deemed fair value as sale consideration in slump sale cases is a surprise insertion though – this provision would certainly change the rules of the game for several ongoing business transfer deals.

Having said that, the Finance Act contains several substantive amendments with a retroactive effect from 1 April 2020, for example, widening the slump sale construct to include slump exchange, deemed fair market value as sale consideration for slump sale, expansion of equalisation levy provisions, tax on dissolution/reconstitution of firms. A prospective application of such provisions was certainly desirable. Alternatively, taxpayers should have been granted specific relief from delay in deposit of advance tax on account of the same.

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