# ERGO

Budget 2023

DIRECT TAX PROPOSALS

UNION BUDGET

2023

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# 01

# Tax rates

## RATES FOR CORPORATES AND FIRMS

The Finance Bill, 2023 (Finance Bill) has not proposed any changes in the base tax rates for corporates and firms under the Income-tax Act, 1961 (IT Act). The rates are listed beside for ready reference:

- **Domestic companies:**
  15% / 22% / 25% / 30%, depending on factors such as nature of business, commencement of operations, turnover thresholds, optional concessional tax regime, etc
- **Foreign companies:**
  Corporate tax rate of 40% (special rates for specified income streams such as interest, fees for technical services, capital gains, and dividends)
- **Partnerships and LLPs:** 30%

Surcharge on base rates, too, remain unchanged for these entities.

## RATES AND OTHER KEY UPDATES FOR INDIVIDUALS AND CERTAIN OTHER NON-CORPORATE ENTITIES

Currently, all individuals (resident / non-resident) and Hindu Undivided Families (HUFs) are taxed as per progressive slab rates ranging between 0% and 30% (except special rates for specified incomes). In addition to the base tax, surcharge (in the range of 0% to 37%) is also applicable. Notably, there are two tax regimes, being 'old regime' 'new regime', having a specific manner of computing income and tax thereon (albeit the highest tax rate and surcharge are the same in both cases). Though the 'old regime' applies by default, a taxpayer can choose to adopt the 'new regime'.

**The Finance Bill proposes the following key changes:**

1. Alternate Investment Funds (AIFs), trusts, association of persons, body of individuals and artificial juridical persons are eligible for the 'new regime' (which was hitherto not available to them);
2. Rejig the progressive slab rates of 'new regime', though retaining the highest base rate at 30%;
3. No tax is payable for income up to INR 0.70 million under 'new regime' (as against INR 0.50 million under 'old regime');
4. Cap the maximum surcharge rate under 'new regime' to 25% (except in specified cases where it is capped at 15%), thereby resulting in the maximum effective tax rate of 39%;

5. Retain maximum surcharge rate of 37% under 'old regime' (except in specified cases where it is capped at 15%), thereby resulting in the maximum effective tax rate of 42.74%;
6. 'New regime' to be applicable by default instead of 'old regime' and any reversion to other regime is not straightforward.

The choice of regime hinges upon several factors such as nature and quantum of income (like salary, business income, house property, investment income), ability/intention to claim certain exemptions / deductions (such as house rent allowance, investment related deductions), and thus, would need case by case evaluation.

The 25% cap on surcharge should especially help investment vehicles (like AIFs) and individuals having substantially high short-term gains or ordinary income to lower their maximum effective tax rate.

## WITHHOLDING TAX RELIEF FOR NON-RESIDENTS ON INCOME FROM MUTUAL FUNDS

Currently, withholding tax at the rate of 20% applies to income of a non-resident from an Indian mutual fund. There is no provision to lower this rate for non-residents who otherwise enjoy a lower rate of tax under the applicable tax treaty. The Finance Bill proposes to obviate this hardship, as it proposes to allow application of the lower rate under the relevant tax treaty if the non-resident furnishes its tax residency certificate to this effect.

## FOREIGN TRAVEL, FOREIGN REMITTANCES TO ATTRACT HIGHER TAX COLLECTION AT SOURCE (TCS)

Under the IT Act, in certain specified cases, a payee is obligated to collect TCS (essentially an income-tax) at the applicable tax rate from the payer, in addition to the consideration amount. Payer is given a credit of TCS in its income-tax return.

Currently, TCS at the rate of 5% applies to (a) sale of overseas tour package, and (b) foreign remittance under Liberalised Remittance Scheme in excess of INR 0.70 million during a financial year.

The Finance Bill proposes to hike the TCS rate for (a) and (b) above to 20% from 5% without any de minimis threshold (except remittances for the purpose of education and medical treatment which will be subject to TCS at the rate of 5% over INR 0.70 million).

The enhanced rate of TCS would impact a multitude of transactions including Indian investors desirous of investing in foreign securities. Despite credit of TCS available to the taxpayers, it would lead to a higher cash outflow at the outset

# 02

## Angel tax provisions applicable to shares issued to non-residents

Currently, a tax valuation provision applies to an Indian closely held company at the time of issuance of shares to a resident investor, as per which any premium received in excess of fair market value (computed as per prescribed rules) is taxable in the hands of such company as its ordinary income (sometimes colloquially referred to as 'angel tax'). An exemption is provided to certain eligible start-ups and in relation to shares issued to certain specified funds which fulfil prescribed conditions. As explained in the Memorandum to the Finance Bill, this provision was introduced in 2012 to "prevent generation and circulation of unaccounted money through share premium".

The Finance Bill proposes that such angel tax provisions would also apply in case of share issuances to non-resident investors. Accordingly, the Indian company would suffer adverse tax consequences if the price at which it issues shares to an investor, whether resident or non-resident, exceeds the "fair value" of such shares. Notably, the extant company law and exchange control regulations mandate the "fair value" as the floor price for issuance of shares to non-residents. Going forward, it will be critical to obtain robust valuation reports and the pricing of such issuance would need to conform with such requirements under company law, tax and exchange control regulations.

# 03

# Taxation of unitholders of REITs / InvITs

## SCOPE OF TAXATION WIDENED

Currently, the tax regime applicable to income earned by a Real Estate Investment Trust (REIT) / Infrastructure Investment Trust (InvIT) and its unitholders is as follows:

- **At REIT / InvIT level:** Income in the nature of: (a) dividend, (b) interest, and (c) rental income; is exempt and taxable directly in the hands of the unitholder on a pass through basis. Other streams of income (including any capital gains) are taxable in the hands of the REIT / InvIT as per general tax principles.
- **At unitholder level:** Income in the nature of: (a) dividend (where the underlying specific purpose vehicle (SPV) of the REIT / InvIT has opted to be taxed under the corporate tax regime providing for a 22% tax rate), (b) interest, and (c) rental income; is taxable in the hands of the unitholders. All other income streams are exempt from tax in the hands of the unitholders.

The Finance Bill proposes to introduce a new provision, as per which any sum received by a unitholder from the REIT / InvIT, shall be chargeable to tax in the hands of the unitholder as its ordinary income, except for the following income streams:

- Income in the nature of dividend, interest and rental income; and
- Income (including any capital gains) which is chargeable to tax in the hands of the REIT / InvIT.

The Finance Bill further provides that if such sum is received by the unitholder on redemption of any unit held by him in the REIT / InvIT, the cost basis of such unit shall be allowable as a deduction against the sum received (to the extent that the cost basis does not exceed the sum received).

The Government's stated intent for proposing this amendment is to ensure that any income received by the REIT / InvIT on repayment of debt (and which is distributed to investors) does not escape tax in the hands of both the REIT / InvIT and the unitholders.

However, the scope of this provision needs to be carefully examined to identify any other income streams which could fall within its purview, as in the case of a buyback undertaken by the SPV, wherein buyback distribution tax would be payable by the SPV and such income would therefore be exempt in the hands of the REIT / InvIT.

Further, as per this proposal, income arising to the unitholder on redemption of its units would be taxable as ordinary income (i.e., at a higher tax rate ranging from 22% to 40% exclusive of surcharge and cess, depending on the category of the investor), as compared to capital gains (where the applicable tax rate would be 10-20% exclusive of surcharge and cess where the gains are considered as long-term in nature). In case of non-residents, while several tax treaties provide an exemption for income in the nature of capital gains from sale of units, an exemption for "other income" is limited to very few treaties.

## MECHANISM FOR EXEMPT INVESTORS TO OBTAIN A NIL WITHHOLDING TAX CERTIFICATE INTRODUCED

Currently, income distributed by a REIT / InvIT to its non-resident unitholders is subject to withholding tax in India at prescribed rates.

To enable unitholders who are entitled to certain prescribed exemptions under the IT Act (such as pension funds and sovereign wealth funds having a tax exempt status in India) to receive distributions from the REIT / InvIT without any taxes being withheld, the Finance Bill proposes to provide such non-resident unitholders with the ability to apply to the Indian tax authority for a 'nil withholding' certificate.

# 04

# Further impetus to GIFT city

The IT Act provides for several tax incentives to units and investors in an International Financial Services Centre (IFSC), and it has been a yearly tradition for the Government to introduce additional sops in the Budget. The key incentives proposed by the Finance Bill are as follows:

- **Extension of period for tax neutral relocation of offshore funds to IFSC:** The Finance Act, 2021 introduced provisions enabling the tax neutral relocation of offshore funds (fulfilling prescribed exemptions) to an alternative investment fund located in IFSC (IFSC Fund). Currently, such relocation is tax neutral provided the transfer of assets by the offshore fund (or its wholly owned subsidiary) to the IFSC Fund is completed on or before 31 March 2023. The Finance Bill proposes to extend such sunset date to 31 March 2025.

- **Exemption to non-residents on income from offshore derivative instruments entered into with an offshore banking unit of an IFSC (ODIs):** Currently, an exemption is provided to non-residents for income arising on transfer of ODIs. The Finance Bill proposes to extend the scope of this exemption to also cover distribution of income on such ODIs, to avoid a double level of taxation: i.e., first, in the hands of the offshore banking unit (when it receives income from underlying investments) and second, in the hands of the non-resident (at the time of distribution by the offshore banking unit). Such exemption shall be available so long as the distributed income has been subject to tax in the hands of the offshore banking unit.

# 05

# Debt funding

## GAINS ON MARKET LINKED DEBENTURES (MLDS) DEEMED AS 'SHORT TERM CAPITAL GAINS'

Currently, there is no specific mechanism provided for taxing the gains arising on transfer of MLDs. As per general provisions, any gain on MLDs should be taxable as capital gains if it is held as a capital asset by the investor or as business income, if held as a business asset.

The capital gains tax rate, as is currently applicable, varies depending upon the period for which the MLDs are held by the investor – generally it is 10% (exclusive of surcharge and cess) provided the MLDs are listed on the Indian stock exchange and held for more than 12 months, else at a higher rate (i.e., applicable tax rate, which ranges from 20% to 40% exclusive of surcharge and cess).

As per the proposal under the Finance Bill, any gains on exit, redemption or maturity of MLDs would be deemed as short terms capital gains (irrespective of the holding period). Accordingly, the Finance Bill seeks to remove the capital gains tax rate differential and tax any gains on transfer of MLDs, at higher rates (i.e., tax rate applicable to the relevant investor on short term gains). For non-resident investors / foreign portfolio investors, the short-term gains tax rate would be in the range of 30% to 40% (exclusive of surcharge and cess), subject to any relief provided under the relevant tax treaty with India.

Interestingly, courts in the context of another similarly worded section, have held that such deeming fiction in the context of computing capital gains income should be read strictly and a lower tax rate applicable to long term capital gains can still apply depending on the period of holding in the taxpayer's hands.

The Finance Bill has also defined MLDs to essentially mean any security having an underlying principal component in the form of a debt and whose returns are linked to market returns on underlying securities / indices. The definition also includes MLDs regulated by the Securities Exchange Board of India. It would be important to assess if any debt funding in the form of debentures is impacted by the above proposal.

## TAX DEDUCTION AT SOURCE (TDS) ON INTEREST ON SECURITY

The Finance Bill proposes a 10% TDS on interest on listed security payable to residents, which was specifically exempted under the IT Act. Accordingly, interest pay-outs on listed debentures and MLDs would suffer a 10% TDS.

## NON-BANKING FINANCIAL COMPANIES (NBFCS) TO BE EXEMPTED FROM THE APPLICABILITY OF THIN CAPITALISATION NORMS

Currently, the IT Act has thin capitalisation norms which essentially restrict interest deduction (computed in a specified manner) in the hands of certain borrowers (being an Indian company or permanent establishment of a foreign company) on debt borrowed from its offshore related party. Borrowers engaged in the business of banking or insurance are exempted from the applicability of this provision.

The Finance Bill proposes to extend this exemption to NBFCs, to be notified.

# 06

# Tax litigation & administrative proposals

## TIMELINE FOR SCRUTINY ASSESSMENTS TWEAKED, AGAIN!

Currently, scrutiny assessments are to be completed within 9 months from the end of the relevant assessment year. This timeline is proposed to be amended, and increased to 12 months, from the end of the relevant assessment year. Similarly, where an 'updated tax return' is filed by a taxpayer, the tax officer would have 12 months, instead of current 9 months, from the end of the financial year in which 'updated tax return' is filed, to complete the assessment.

Further, in certain cases, including where an income tax search is initiated, the tax authorities would have 12 months, in addition to the generally available timeline, to complete the ongoing assessment / reassessment.

The proposals are premised on providing adequate time to tax authorities to complete assessment proceedings, which would consequently also provide adequate opportunity to taxpayers to present their case.

## TDS CREDIT FOR HISTORIC INCOME RIGHTFULLY ALLOWED!

Currently, taxpayers are unable to claim credit of TDS (TDS Credit) where income has been offered to tax in an earlier financial year, on accrual basis, and tax is deducted in a subsequent financial year.

To ensure that TDS Credit is made available in such cases, it is proposed to provide the taxpayer with an option to make an application to the tax officer to claim such TDS Credit. Such application is to be submitted within 2 years from the end of the financial year in which tax was deducted at source. The tax officer would then have 4 years, from the end of the financial year in which tax has been deducted, to provide such TDS Credit to the taxpayer. Further, it is proposed that interest on such tax refund would also be allowed from the date of application to the date of grant of refund.

## DECRIMINALISATION OF LIQUIDATOR LIABILITY!

Currently, the liquidator of a company may be subject to rigorous imprisonment up to 2 years for: (a) failure to give notice of its appointment to the jurisdictional tax officer, or (b) failure to set aside the tax amount as required by the tax officer, or (c) disposal of assets of the company without the tax officer's prior approval.

In order to decriminalise minor offences as a step towards improving ease of doing business, it is proposed that the aforesaid prosecution provision would not be applicable to liquidators from 1 April 2023.

## INTRODUCTION OF JOINT COMMISSIONER (APPEALS)

Currently, Commissioner of Income-tax (Appeals) (CIT(A)) is the first appellate authority for a taxpayer aggrieved by an order of a tax officer.

In order to reduce the workload of the CIT(A), the Finance Bill proposes to introduce a parallel first appellate authority i.e., Joint Commissioner (Appeals) to handle certain class of cases involving small amounts of disputed demand. Taxpayers aggrieved by orders passed by a tax officer (below the rank of Joint Commissioner of Income-tax) can file appeal before the Joint Commissioner (Appeals) instead of filing appeal before CIT(A). Joint Commissioner (Appeals) will have all powers, responsibilities and accountability similar to that of CIT(A). Such appeals would also be faceless, similar to the existing mechanism before CIT(A). Also, orders passed by the Joint Commissioner (Appeals) will be appealable before the Income Tax Appellate Tribunal (Tax Tribunal) akin to orders passed by CIT(A).

This is a welcome move whereby the Government has taken note of the huge pendency of appeals before the CIT(A) and has proposed to appoint 100 Joint Commissioner (Appeals) to provide speedy remedy to taxpayers.

## CROSS OBJECTIONS CAN BE FILED IN ALL APPEALS BEFORE TAX TRIBUNAL

While appeal is filed by an aggrieved party, the respondent can also file cross objections. However, the cross objections are allowed in proceedings before the Tax Tribunal only where the appeal is filed against the order of CIT(A). The Finance Bill proposes to allow filing of cross objections before Tax Tribunal in all appeals i.e., even where appeal lies against the order passed by authorities other than CIT(A) such as Dispute Resolution Panel (DRP) etc.

The purpose of introducing DRP was to reduce litigation since DRP directs tax officer to pass consequential order and such directions of the DRP are binding on the tax officer. Where the tax officer is allowed to file cross objections against the directions of the DRP, it would effectively impact the binding nature of DRP's directions on the tax officer thereby potentially starting new series of tax litigation.

07

# Timelimits linked to start-up exemptions rationalised

## 100% PROFIT LINKED DEDUCTION EXTENDED TO START-UPS SET UP BY 31 MARCH 2024

Currently, a start-up incorporated between 1 April 2016 and 31 March 2023 and which fulfils certain prescribed conditions, is eligible to claim a deduction of 100% of profits derived from an 'eligible business' for 3 consecutive financial years out of the first 10 financial years from its incorporation.

The Finance Bill proposes to extend the outer date for incorporation of such start-up from 31 March 2023 to 31 March 2024.

## RELIEF TO START-UPS WITH RESPECT TO ABILITY TO CLAIM CARRY FORWARD OF BUSINESS LOSSES ON CHANGE IN SHAREHOLDING EXTENDED

In case of closely held companies, generally, unabsorbed business losses lapse on a change in 51% of beneficial voting power.

However, a relief is provided to 'eligible start-ups' as per Section 80-IAC of the IT Act, enabling such start-ups to carry-forward such losses irrespective of change in voting power beyond 51%, provided that all the shareholders in the year in which the loss is incurred continue to be shareholders in the start-up in the year in which such loss is sought to set off (i.e., they should continue to have some stake even if less than 51%).

This beneficial provision is currently available to eligible start-ups for the losses which are incurred during the period of first 7 years from the year of incorporation.

The Finance Bill proposes to extend this period by 3 more years (i.e., to the first 10 years from the date of incorporation) with the objective of aligning the beneficial provisions pertaining to carry forward and set off of losses available to start-ups with the time period available to start-ups for claiming profit linked deductions.

# 08

## Exemption on investment of long-term capital gains in residential houses capped at INR 100 million

Currently, an individual (resident or non-resident) or an HUF can claim an exemption from tax on long term capital gains arising on the transfer of any asset (including a residential house), if such capital gains or net sales consideration (as provided under the relevant provision) is reinvested, within the specified period, in the construction or purchase of a new residential house.

The exemption is available subject to satisfaction of certain conditions, however there is no monetary cap on the quantum of exemption (except where gains on transfer of a residential house are reinvested in two residential houses, in which case the gain amount cannot exceed INR 20 million).

The Finance Bill proposes to limit such exemption to a sum of INR 100 million. Consequently, any long-term capital gains in excess of INR 100 million shall be taxable in the hands of the individual / HUF.

The aforesaid existing cap of INR 20 million remains unchanged.

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# 09

# Monetary perquisites proposed to be taxed as business income

Currently, any benefit or perquisite (whether convertible into money or not) received by a taxpayer is taxed as business income, if the same arises from business or profession.

In the past, the courts in India have held that only benefits or perquisites of non-monetary nature (i.e., in kind) would be covered and monetary benefits / perquisites would be excluded from the purview of the above taxability.

Further, from 1 July 2022, an obligation had been imposed on the provider of such a benefit or perquisite to deduct tax at source at the rate of 10% on the value of such benefit or perquisite, including the monetary component (additional guidelines have been provided to ensure compliance in cases where the benefit or perquisite is partly in kind and also to exempt certain transactions from its ambit).

The Finance Bill proposes to expand the scope of this provision to cover monetary benefits or perquisites also.

Consequently, any existing business incentive arrangements which are monetary in nature, including debt restructuring involving write back of debt, may also need to be tested from 'monetary' benefit / perquisite perspective while also examining whether any capital receipt of this nature can be said to be arising from business/ profession.

# 10

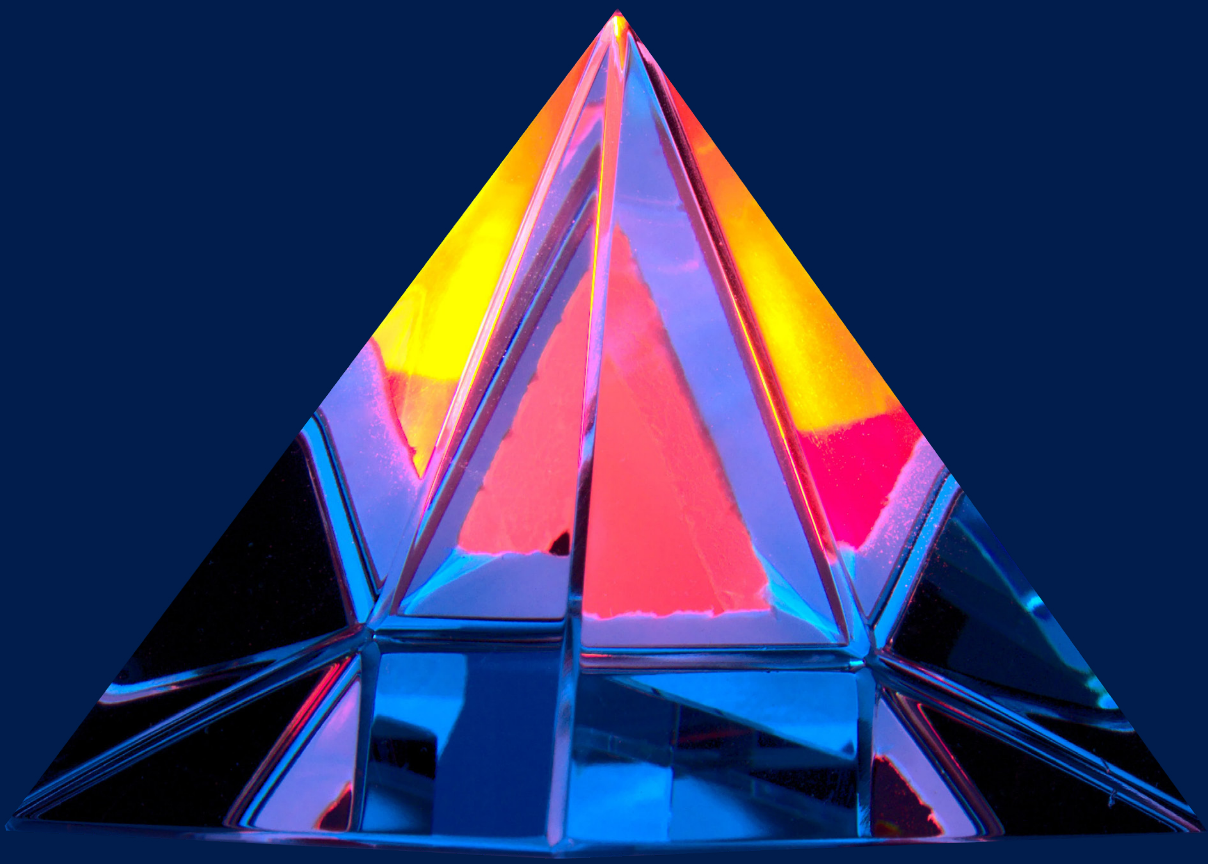
# Other key rationalization measures

**The Finance Bill proposes the following rationalisation measures:**

- **Cost basis for intangible assets:** Specifying the manner of determining cost base for computing capital gains arising on transfer of intangible assets, which under the extant law was subject to an interpretational debate on the ground of being indeterminable.
- **Charitable institutions:** Tightening the noose in relation to successive inter charitable institution donations to ensure effective application of the income-tax exemption, which is provided to charitable institutions.
- **Oil & gas and infrastructure:** Plug the loophole in the application of presumptive taxation schemes for non-residents engaged in certain specified businesses in relation to exploration of mineral oils and

the engineering, procurement and construction sector, so that set off of unabsorbed depreciation and brought forward loss shall not be allowed for the financial year for which such presumptive taxation scheme is opted.

- **Business reorganizations:** Codify the procedural aspects to be followed by Indian tax authorities after a modified income-tax return is filed by a successor entity in relation to assessment / reassessment proceedings in case of mergers / demergers etc.
- **Gift tax:** Extend the anti-abuse deeming fiction (which taxes receipt of monetary gifts by residents to non-residents) to also include monetary gifts from residents to 'not ordinarily resident' individuals.
- **Online gaming sector:** Introduce a separate tax regime (and corresponding withholding tax obligation) for taxing the winnings from online gaming (to be computed in a prescribed manner) at the rate of 30%.
- **Payments to micro and small enterprises:** Allow business deduction for expenses towards micro or small enterprises as defined under the Micro Small and Medium Enterprises Development Act, 2006 (MSME Act), only in the year of their actual payment (except where expenses have been paid within the time limit set out under section 15 of the MSME Act).



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