India's 2003 Finance Bill Proposes Changes to Direct, Indirect Taxes

Author: Khan, Shagoofa;
Ajinkya, Bijal

In his 28 February budget speech for fiscal 2003-2004 (for prior coverage, see *2003 WTD 41-8* or *Doc 2003-5514 (1 original page)*), Indian Finance Minister Jaswant Singh outlined a number of proposed changes to direct and indirect taxes. There had been much anxiety during the run-up to the budget because of the radical recommendations of the Kelkar Committee, a task force set up by the Ministry of Finance and Company Affairs to rationalize and simplify India's direct and indirect taxes (encompassing issues such as the taxation of agricultural income, the withdrawal of tax exemptions and rebates, the revocation of the dividend tax, the withdrawal of the special tax rate on long-term capital gains, and so forth). (For prior coverage, see *Tax Notes Int'l*, 25 Nov. 2002, p. 759, *2002 WTD 222-3*, or *Doc 2002-25634 (7 original pages)*.) There was much speculation about which of those recommendations the finance minister would accept. The proposals in the 2003 Finance Bill include some of the Kelkar Committee's recommendations, while the decision to adopt others has been deferred.

This article focuses on some of the important proposals that would have an impact on cross-border transactions.

Direct Taxation

Tax Rates

The tax rates would remain unchanged, with the exception of the surcharge on income tax, which, for corporations, would be reduced from 5 percent to 2.5 percent. Accordingly, the corporate tax rate would be 35.875 percent for domestic companies and 41 percent for foreign companies. Foreign companies would continue to be subject to the surcharge.

Taxation of Dividends

The Kelkar Committee had recommended putting an end to the "economic double taxation" of dividends by making dividends tax-exempt in the hands of the shareholders and also exempting them from distribution tax. That recommendation has been partly accepted in the Finance Bill. Dividends have been made tax-exempt in the hands of the shareholders, but the companies would have to pay a dividend distribution tax of 12.81 percent (12.5 percent plus a 2.5 percent surcharge). This provision extends to the distribution of income on units of mutual funds. However, open-ended equity-oriented funds are not subject to the dividend distribution tax.

Taxation of Capital Gains

Currently, capital gains are classified as either short-term capital assets or long-term capital assets under India's Income Tax Act, 1961. Shares of a company, securities listed on a recognized Indian stock exchange, and specified units of a mutual fund, if held for more than 12 months, are treated as long-term capital assets. In other cases, a long-term capital asset is one that is held for a period of more than 36 months. Gains on sales of listed securities currently are subject to tax at a concessional rate of 21 percent in the hands of a resident company, or at whatever rate is prescribed in the relevant double tax treaty, in the case of a foreign company. Short-term capital gains are taxed at normal rates.

The Kelkar Committee had recommended the elimination of the concessional rate for long-term capital gains and a complete exemption from long-term capital gains tax on sales of equity.

The Finance Bill again includes that recommendation in part. While the concessional tax rate for long-term capital gains would continue, long-term capital gains arising from transfers of listed securities purchased between 1 March 2003 and 1 March 2004 would be exempt. That exemption would be reviewed in 2004, Singh said.

It has been said that this provision would stimulate the capital markets by attracting retail savings and foreign investments. However, this may not be entirely true. First, because the exemption is restricted to one year, retail investors would prefer to wait and watch before committing their savings to the capital markets. Second, the exemption is applicable only to prospective investments in listed securities, thus putting existing investments outside the purview of the exemption. And third, the exemption does not cover long-term capital gains on sales of unlisted securities, or short-term capital gains, which continue to be taxed at normal rates.

For those reasons, foreign investors still would prefer to make investments through a favorable tax jurisdiction, such as Mauritius, where all of their capital gains would be exempt from tax in India under the beneficial provisions of the double tax treaty.

Business Connection

The concept of business connection (BC) under the ITA is akin to the concept of permanent establishment under the double tax treaties. Under section 9 of the ITA, any income arising to a foreign company, either directly or indirectly, through or from a BC in India would be subject to tax in India. So far, the ITA does not contain a definition of BC, and consequently, the definition is based on the judicial precedents and principles laid down in Circular 23 of 1969, issued by the Central Board of Direct Taxes.

The Finance Bill would amend section 9 of the ITA to incorporate a definition of an agency BC, along the lines of an agency PE. Consequently, an agent would be deemed to be a dependent agent if he or she carries out work mainly or wholly for the nonresident, or for other nonresidents controlling, controlled by, or subject to the same common control as that nonresident. No mention is made of an "arm's-length basis" in this section.

Royalties and Fees for Technical Services

Payments of royalties and fees for technical services (FTS) currently are subject to a withholding tax of 20 percent, on a gross basis. Under the various double tax treaties that India has entered into with other countries, that rate generally is reduced to 10 percent. Further, most of India's double tax treaties contain a provision that states that if royalty and FTS payments are effectively connected to a PE in India, those payments will be taxed as business profits in accordance with the provisions of domestic law. However, under section 44D of the ITA, which contains a *non obstante* clause, those payments are taxed on a gross basis. This has resulted in a great hardship for taxpayers.

The Finance Bill would remedy that anomaly by inserting a new section 44D(A), which provides that if royalty and FTS payments are effectively connected to a PE in India, those payments will be taxed as business profits on a "net income" basis. Further, the scope of section 44D would be curtailed only to agreements entered up to 1 April 2003.

Power to Enter Into Double Tax Treaties

The government's power to enter into double tax treaties under section 90 of the ITA would be widened. The government would be able to enter into a double tax treaty to grant relief on income tax chargeable under the ITA, or under the corresponding law of another country, to promote economic relations, trade, and investment. Further, terms not defined in the double tax treaties and the ITA could be defined by way of notifications issued by the government in India's official gazette.

Advance Rulings

Finance Act 2000 permitted residents to obtain advance rulings from the Authority for Advance Rulings (AAR) for transactions (undertaken or proposed) with nonresidents. The new Finance Bill clarifies that an advance ruling can apply only to the nonresident's tax liability arising from the transaction, not to the tax liability of a resident. As proposed, that clarification would be effective retroactively from 1 June 2000, but rulings delivered since then by the AAR would continue to be binding.

Mergers and Acquisitions and Reorganizations

The Kelkar Committee had suggested either the complete withdrawal or the phasing out of the tax holiday under section 10A/B of the ITA. However, the implementation of that recommendation would violate the government's commitment to give tax concessions to the information technology (IT), ITES/BPO (IT-enabled services/business process outsourcing), and export sectors. The Finance Bill restores the tax holiday under section 10A/B of the ITA to 100 percent (from the 90 percent rate implemented last year) and provides that the tax holiday will continue as originally envisaged (that is, up to 31 March 2009). Further, the exemption will not be lost due to any change in the ownership/shareholding pattern of the company.

The Finance Bill also provides that in the case of an amalgamation/demerger, the amalgamated/resulting company to which the unit enjoying the tax holiday is transferred will enjoy the tax holiday for the balance of the period to which the amalgamating/transferor company was entitled. However, the amalgamating/transferor company will not be entitled to claim the tax holiday for the fiscal year in which the reorganization takes place.

Resident But Not Ordinarily Resident

Individuals returning to India currently are accorded the special status of "resident but not ordinarily resident" under the ITA, and their foreign income is exempt from tax in India for nine years after their return. Under the amended definition, that exemption would be available for only two years if the individual has been a nonresident for 9 of the previous 10 years. This amendment is in line with a controversial ruling given recently by the Gujarat High Court. It would become effective from 1 April.

Indirect Taxation

VAT

The state governments have agreed to shift to the VAT system, starting in April. However, the central sales tax on interstate sales between registered dealers will continue to apply at a reduced rate of 2 percent. The central government has agreed to compensate the states for revenue lost as a result of the adoption of the VAT system.

Many Indian states already have finalized their VAT bills. The biggest challenge before the central government is to ensure that VAT does not degenerate into the problems that it seeks to solve (namely, multiple rates, mismatched classifications, and so on), leading to problems in VAT administration among the states.

Service Tax

The service tax rate would be increased from 5 percent to 8 percent. The Finance Bill also adds seven new services and expands the scope of three existing services. The exemption from service tax for payments received in convertible foreign exchange has been withdrawn. Credit for the service tax paid on services used, and for duties paid or deemed to have been paid on goods used for providing taxable services, would be available across the board. Further, the Finance Bill introduces an advance ruling mechanism for, among other things, the classification and valuation of services. Nonresidents who have set up joint ventures in India and Indian wholly owned subsidiaries of foreign companies could apply for the advance ruling.

Expenditure Tax

To boost the tourism sector and reduce the tax burden on the hotel industry, the expenditure tax would be abolished, with effect from 1 June. Currently, a 10 percent expenditure tax is levied for room charges that exceed INR 3,000 per day.

Conclusion

The amendments to section 10A/B, the introduction of VAT, the relaxations in exchange control regulations, coupled with policy announcements relating to infrastructure and the power sector, and the enactment of important laws such as the Competition Act and the

Securitization and Reconstruction of Financial Assets Act indicate that India is committed to reform and is poised to be a competitive global market player.

Shagoofa Khan and Bijal Ajinkya, Nishith Desai Associates