

Decoding Budget 2018

- Indian Growth Story
- Corporate tax perspective

February 6, 2018



India's Growth Story

- ❑ India is now among the **global financial elite** – *PM said in Davos*
- ❑ GDP expected to grow by 4 times to reach US\$ 10 trillion by 2030 – *Mr. Arvind Panagariya, Vice Chairman, NITI Aayog*
- ❑ Indian Economy is now 2.5 trillion dollar economy- seventh largest in the world. It is expected to take over UK and France to become the fifth largest very soon.
- ❑ IMF in its latest update has forecast that India will grow 7.4 percent next year.
- ❑ Ranked as the sixth largest manufacturing country (up from the ninth position) after China, US, Japan, Germany and Korea - *United Nations Industrial Development Organization (UNIDO) report*
- ❑ India's ranking has gone up by 42 places in last three years in the World Bank's 'Ease of Doing Business' with India in top 100
- ❑ India to raise Non-Tax revenue – divestment in 24 PSU's
- ❑ Global tax rate cut has not been mirrored

India's Growth Story

- ❑ 41% more income tax returns were filed, more people have joined tax net
- ❑ Tax payer base has risen from 6.47 Cr in 2014-15 to 8.27 Cr in 2016-17
- ❑ Exports are expected to grow by 15% in financial year 2018
- ❑ FDI is expected to rise and India can attract FDI well above 70 billion \$ mark
- ❑ Foreign exchange reserve 450 billion \$ covering 9 months of import
- ❑ DT revenue likely to cross 10 lakh cr
- ❑ Tax arrears of 7.4 lakh cr, needs serious deliberation and dissection to the quality of these arrears and study that frivolous tax demands need not be raised and without forgetting that tax office has been an unsuccessful litigator
- ❑ Infra outlay up by 21% to 6 lakh crores
- ❑ **Will Budget 2018 re-boot India?**



The Compensation Plan

Taxing Compensation

Taxing Compensation

- ❑ Compensation received on termination of employment, compensation received on termination or modification of business contracts, and lump sum money received by trade partners after the contracts were scrapped fell through the crack and did not get taxed. This issue often ended up in litigation with the tax office over the taxability of such payments
- ❑ Matter of taxing these capital receipts went up to tribunal and higher courts
- ❑ **Now litigation on this matter has been put to an end**
- ❑ **Budget 2018 taxes compensation in connection to business or employment [Section 28 & 56]**
 - ❑ Any compensation, whether revenue or capital received in connection with termination or modification of terms and condition of any business contract or employment contract shall now be taxable as business income or other source income respectively

Taxing Compensation

- ❑ Judicial precedents holding that if the compensation is capital receipt the same shall not be taxable, stand **overruled**:
 - ❑ In the case of **HCL Infosystems Ltd, Delhi HC** held that *compensation received by assessee pursuant to termination of the JV agreement was a capital receipt, hence not taxable*
 - ❑ In **Elegant Chemicals Enterprises Private Limited**, HC held that *compensation received upon termination of contract for specialized machinery, was a capital receipt, not taxable*
 - ❑ In **Khanna and Anndhanam, SC** dismissed Revenue's SLP against Delhi HC decision in Khanna and Annadhanam (assessee CA firm), *holding termination amount under work referral agreement with to be a capital receipt, not taxable*
 - ❑ In **Pritam Das Narang**, Delhi HC held that *compensation received from prospective employer for non-commencement of employment, was a capital receipt, not taxable*



Taxing Dividend

Taxing Dividend

- ❑ Section 2(22) defines “dividend” to include distribution of accumulated profits (whether capitalized or not) to its shareholders by a company, whether it is in the nature of,—
 - a) release of all or any of its assets,
 - b) issue of debentures in any form (with or without interest) or distribution of bonus to its preference shareholders,
 - c) distribution of proceeds on liquidation,
 - d) on the reduction of capital, or**
 - e) in the case of an unlisted company, any loan or advance given to a shareholder having shareholding of 10% or above, or to a concern in which such shareholder holds substantial interest (exceeding 20% of shareholding or interest) or any payment by such company on behalf of or for the individual benefit of such shareholder.

- ❑ Explanation 2 to the said clause provides the definition of the term ‘accumulated profits’ for the purposes of the said clause, as all profits of the company up to the date of distribution or payment or liquidation, subject to certain conditions.

Taxing Dividend

- ❑ With a view to prevent abusive arrangements whereby companies with large accumulated profits adopt amalgamation route to circumvent DDT levy on capital reduction, the scope of 'accumulated profits' for the purposes of DDT levy in case of an amalgamated company enhanced by adding Explanation 2A to widen the scope of "accumulated profits"
- ❑ Accumulated profits of amalgamated companies will be increased by the accumulated profits of the amalgamating company as on the date of the amalgamation
- ❑ This amendment has overruled the Judicial precedents in this regard

Taxing Dividend

- ❑ Indian Courts have accepted the proposition that ***“accumulated profits of amalgamated companies, if any, cannot be treated as accumulated profits of amalgamating company. Hence any surplus arising out of amalgamation is not regarded as accumulated profits of the amalgamated company.”***
- ❑ Gujrat HC in Wood Polymer held that ***“after such amalgamations have been sanctioned as made in conformity with the requirements under the Companies Act, no such allegation of tax planning or tax evasion can be levelled by the revenue against the assessee”***
- ❑ Delhi HC in CIT v. Bharat Development fully supports the proposition that ***“any surplus taken to the amalgamation account consequent to amalgamation of companies would not liable to be treated as revenue receipt”***
- ❑ In ***Gautam Sarabhai Trust***, ITAT held that ***“Since amalgamating company is a separate entity, profits in its balance sheet, after amalgamation cannot be treated as accumulated profits of the amalgamated company”***
- ❑ This amendment has **plugged the loophole** by expanding the definition of accumulated profits
- ❑ Now the companies misusing this route to circumvent levy of DDT shall be liable to pay DDT even after amalgamation

Taxing Dividend

- ❑ **Application of Dividend Distribution Tax to Deemed Dividend [S. 2(22)(e)] to be taxed at the rate of 30 per cent**
 - ❑ At present dividend distributed by a domestic company is subject to dividend distribution tax payable by such company.
 - ❑ However, deemed dividend under sub-clause (e) of clause (22) of section of 2 the Act is taxed in the hands of the recipient at the applicable marginal rate.
 - ❑ **The taxability of deemed dividend in the hands of recipient has posed serious problem of the collection of the tax liability and has also been the subject matter of extensive litigation**
 - ❑ Loans and advances granted by companies which qualify as deemed dividend will be subject to DDT in the hands of the company (instead of the shareholder/concern) at the rate of 30% (without grossing up).
 - ❑ **The higher rate of 30% is to prevent camouflaging dividend in various ways such as loans and advances**



Prosecution

Prosecution

❑ Prosecution in India on a rise

- ❑ From April to November 2017, the income tax department filed prosecution complaints for various offences in 2,225 cases compared to 784 in the last year
- ❑ 48 persons were convicted for various offences during the said period as compared to 13 convictions for the corresponding eight months of 2016, marking an increase of 269%
- ❑ The number of complaints compounded by the department during April-November stands at 1,052 as against 575 in the corresponding period of the immediately preceding year, registering a rise of 83%
- ❑ In Bengaluru, the MD of a company engaged in infrastructure projects, found guilty of non-deposit of TDS of over Rs60 lakh, sentenced to imprisonment of 3 months
- ❑ A Mohali resident held guilty of non- deposit of TDS sentenced to 1 year jail

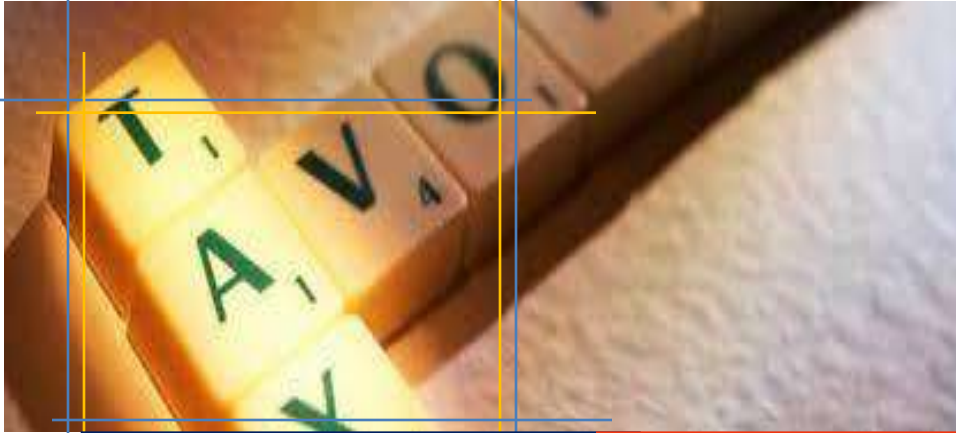
Prosecution

❑ Prosecution on failure to furnish returns in case of companies

- ❑ Section 276CC of the Act provides that if a person will-fully fails to furnish return of income, he shall be punishable with imprisonment and fine
- ❑ However Section 276CC shall not apply if the tax payable does not exceed INR 3000
- ❑ In order to prevent abuse of the above relaxation by shell companies or companies holding Benami properties, scope of Section 276CC has been widened
- ❑ Relaxation provided from prosecution on failure to furnish return if the tax payable is less than INR 3,000 (after reducing advance tax and TDS), shall not be applicable **in case of companies** with effect from 1 April 2018
- ❑ Though the memorandum states that this amendment is to prevent abuse by Shell Companies / Benami Properties, checks similar to GAAR should be in place to avoid genuine hardship

Prosecution

- ❑ Threat of prosecution should not be misused
- ❑ Prosecution provisions should be triggered in serious tax fraudulent matters
- ❑ In most developing countries, prosecution for tax matters is applied only in cases of serious tax frauds and not in general compliance matters
- ❑ Though the taxman may be driven by compulsions to ensure proper tax compliance, care must be taken while taking such action



Scope of Business
Connection Widened

Background - Permanent Establishment concepts

❑ Article 7

“Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment (PE) situated therein.”

❑ Article 5(1)

“... the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

❑ Article 5(3)

“A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.”

❑ Article 5(4)

Exemption for specific activities (e.g., storage, display or delivery of goods) and activities that are preparatory or auxiliary in nature.

❑ Article 5(5)

“Where a person, other than an independent agent, has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, the enterprise is deemed to have a permanent establishment in that State.”

Action 7 of BEPS – Concern and Aim

- ❑ Organization for economic cooperation and development (OECD) was concerned about potential for companies to engage in Base erosion and profit shifting (BEPS) activity by entering into **“arrangements that artificially avoid the occurrence of Permanent Establishments (PE’s)”**
- ❑ Aim of Action 7 of BEPS report

“Develop changes to the PE definition to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and specific activity exemptions. Work on these issues will also address related profit attribution issues.”

Aligning “business connection” with “PE” as per MLI

A. Fragmentation of business activities

- ❑ There have been incidences of enterprises avoiding a PE status by fragmenting or splitting up their activities between their different places of business, closely related enterprises or by entities operating cohesive business operations
- ❑ Some of India’s tax treaties with countries such as Finland, France, Germany, Korea, Luxembourg, the Netherlands, Switzerland and the UK provide that if a fixed place of business is maintained to conduct a combination of activities, the overall activity resulting from this combination should be of a preparatory or auxiliary nature

Aligning “business connection” with “PE” as per MLI

A. Fragmentation of business activities – Addressed by MLI

- ❑ Under the clause (a) of Explanation 2 to section 9(1)(i), "business connection" excludes business activities carried on by NR through dependent agents **which are limited to the purchase of goods or merchandise for the NR**
- ❑ Under Article 5(4) of the DTAA's, a PE is deemed not to exist when a place of business is engaged solely in certain activities such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing of goods or merchandise, collection of information. But this exclusion applies only when these activities are preparatory or auxiliary in relation to the business as a whole.
- ❑ In the case of “fragmentation of activities”, the OECD’s commentary on Article 5(4) states that an enterprise cannot fragment a cohesive operating business into several small operations to argue that each is merely engaged in a preparatory or auxiliary activity
- ❑ Under MLI, **anti-fragmentation** provision covers situations where combined activities of connected persons at the same place or different places in the same country exceed what is considered to be preparatory or auxiliary. India has not placed a reservation on this provision, hence this provision will apply to all tax treaties covered by MLI, except if a treaty partner signatory has placed a reservation.

Aligning “business connection” with “PE” as per MLI

A. Fragmentation of business activities – Indian Perspective

- ❑ Indian Courts have dealt with the issue relating to ‘preparatory or auxiliary’ activities and are broadly of the same view as expressed in BEPS report
- ❑ A significant number of foreign companies have set up liaison offices in India – the argument taken in such cases is that the activities of the liaison office are preparatory or auxiliary in nature, and accordingly, no PE is created
- ❑ With the proposed tightening of the conditions relating to preparatory or auxiliary activities, coupled with the anti-fragmentation rule for specific activity exemptions, the revenue authorities are likely to look at such liaison offices in greater detail
- ❑ The other important area where this proposal could impact is, of course, the digital economy. Given the tremendous growth of e-commerce in India, functions such as warehousing, display, delivery, and its impact on the entire supply chain model may have to be analyzed in the context of preparatory or auxiliary activities

Aligning “business connection” with “PE” as per MLI

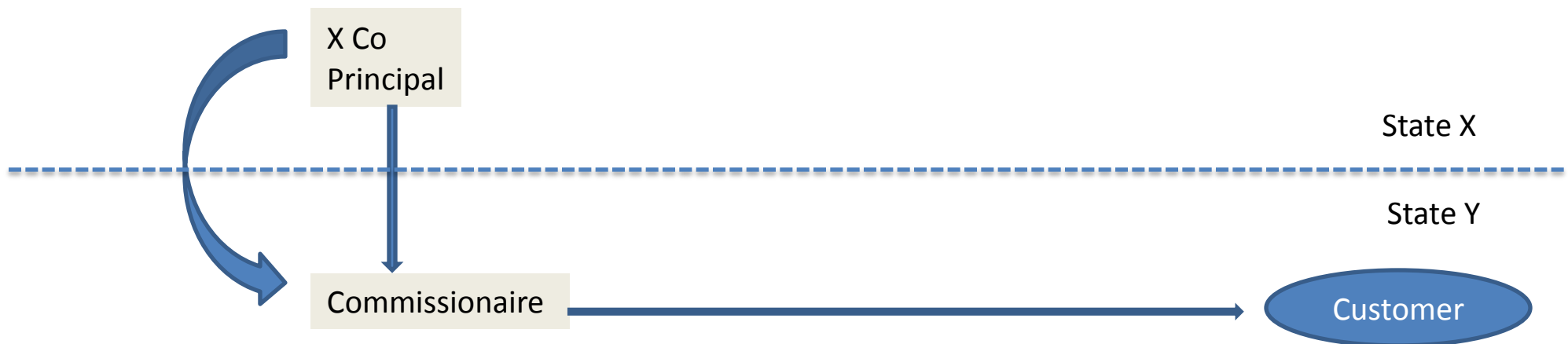
A. Fragmentation of business activities – Indian Judicial Precedents

- ❑ LO is not a PE - Liaison Office did not carry out any business for the foreign enterprise and performed **preliminary and preparatory activities**. Moreover as per RBI rules a LO is not permitted to carry on any business activity – **Motorola Inc. & Others Vs DCIT (2005) 95 ITD 269 (Del)(SB)**
- ❑ LO is a PE – LO in India rendered marketing support, including soliciting requests for customers for quotation and undertaking promotional activities which converted quotation requests into orders for foreign enterprise – **Rolls Royce Plc Vs DDIT (2008) 113 TTJ 446 (Del) [Affirmed in Rolls Royce Plc. Vs DIT (2011) 339 ITR 147 (Del)]**

Aligning “business connection” with “PE” as per MLI

B. Commissionaire Arrangement

- ❑ **Commissionaire** is a commercial structure, which acts in “its own name,” but on behalf of the principal
- ❑ OECD’s concern was the base erosion and profit shifting owing to the commissionaire arrangement
- ❑ Lack of a PE of the NR meant that the commissionaire is taxed only the difference between the commission fee received and its expenses in State Y



Aligning “business connection” with “PE” as per MLI

B. Commissionaire Arrangement – Addressed by MLI

- ❑ Under the existing provisions of Explanation 2 to section 9(1)(i), "business connection" includes business activities carried on by NR through dependent agents
- ❑ The scope of "business connection" under the Act is similar to the provisions relating to Dependent Agent Permanent Establishment (DAPE) in DTAA's under Article 5(5)
- ❑ To avoid establishing a PE under Article 5(5) of the DTAA, the person acting on the behalf of the non-resident, negotiates the contract but does not conclude the contract
- ❑ The MLI expands the scope of a DAPE and includes the phrase ***“if the agent habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise....”***

Aligning “business connection” with “PE” as per MLI

B. Commissionaire Arrangement – Indian Perspective

- ❑ Many multinational enterprises operate in India through a subsidiary to ‘market’ the products of the group – typically the Indian subsidiary receives a fee that is taxable in India, whereas the overseas group entity is not taxable in India on the profit of the sales, in the absence of a PE in India.
- ❑ The proposed expansion of the definition of agency PE under MLI in the context of conclusion of contracts discussed above and the inability of the Indian subsidiary to be regarded as an ‘independent agent’ could expose a part of the overseas group entity’s profit on sale of products to be taxed in India, depending on the facts of the case.
- ❑ Interestingly, the Indian tax authorities have interpreted the term ‘conclude contracts’ widely to include various activities which facilitate conclusion of contracts – the proposed modification of the agency PE under MLI definition will support the case of the revenue authorities.
- ❑ Indian tax authorities, in cases involving distributors of services have asserted that such distributors conduct business in India on behalf of their foreign affiliates, and therefore, create a DAPE of the foreign affiliates in India. Even if such a DAPE arises, Indian judicial position is that an arm’s length compensation in the hands of the DAPE extinguishes the need for any further attribution.

Aligning “business connection” with “PE” as per MLI

B. Commissionaire Arrangement – Indian Judicial Precedents

- ❑ The phrase “authority to conclude a contract” is widely interpreted by Indian courts
- ❑ Only persons having and exercising an “authority to conclude contracts in the name of the enterprise” can lead to a PE – **CIT Vs. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)**
- ❑ An agent may be considered to possess such actual authority when he solicits and receives the orders which are sent directly to a warehouse from where goods are delivered by the principal and when the principal routinely approves the transactions – **TVM Ltd. Vs CIT (1999) 237 ITR 230 (AAR) and Motorola Inc & Others Vs DCIT (2005) 95 ITD 269 (Del)(SB)**

Aligning “business connection” with “PE” as per MLI

Why change in ‘Business Connection’ was required?

- ❑ DTAA read with MLI becomes wider in scope than the domestic law
- ❑ Section 90(2) – DTAA or domestic law, whichever is more beneficial applies
- ❑ Domestic law being narrower in scope applies over DTAA, hence DTAA read with MLI becomes ineffective and to ensure that beneficial provisions of Domestic law are not misused

How is ‘Commissionaire arrangement’ and ‘Fragmentation of Business Activities’ addressed by Domestic Law now?

- ❑ Existing clause (a) of Explanation 2 to Section 9(1)(i)

"business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident-

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident;

Aligning “business connection” with “PE” as per MLI

How is ‘Commissionaire arrangement’ and ‘Fragmentation of Business Activities’ addressed by Domestic Law now?

- ❑ Clause (a) of Explanation 2 to Section 9(1)(i) has now been amended
- ❑ Now “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 should be
 - (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

Aligning “business connection” with “PE” as per MLI

Changes to ‘business connection’ will lower the threshold for having business connection in India

Explanation 2
to S. 9(1)(i)

Person acting on
behalf of the NR
habitually concludes
contracts, or
habitually plays the
principal role leading
to conclusion of
contracts by the NR

In the name of the NR

For the transfer of ownership
of or granting of right to use
property owned by the NR, or
that the NR has right to use

For the provision of services by
that NR

BEFORE

Actual conclusion of
contracts required to have
business connection

AFTER

NR has business connection when a person acting on
behalf of the NR habitually concludes contracts or
habitually plays the principal role leading to conclusion of
contracts by the NR



Decoding the fine print

Decoding the fine print

- ❑ There is an amendment u/s 80AC that for claiming deduction u/s 80JJA, 80JJAA, 80LA, 80O, 80P, 80Q, 80QQA, 80QQB, 80R, 80RR, 80RRA, 80RRB, filling return of Income u/s 139(1) is now mandatory
- ❑ When a startup raises angel funding at a valuation higher than its fair market value, it is counted as income to the company and 30% of it is charged as Angel tax. **While the FM spoke of rolling out an alternative taxation regime for the benefit of VC and the angel investors, no mention of Angel Tax**
- ❑ Aimed at plugging a loophole that was being exploited by issuing cheques to charities and claiming tax exemption, cash expense by Charitable Trusts exceeding INR 20K shall be disallowed [**S. 40A(3)**]. Further 30% of expense shall be disallowed in case of TDS default [**S. 40(a)(ia)**]
- ❑ Widened powers to investigating officers of deputy director level probing foreign tax evasion under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015



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