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BUDGET ANALYSIS

IMPACT ON FOREIGN PORTFOLIO INVESTORS

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Foreword

The Finance Minister presented Union Budget for fiscal year 2017-18 in the parliament today. The budget has been announced in the wake of several bold steps taken by the government in the recent past to curb black money and bring structural reforms to steer the country towards long term growth and development. Some of the recent steps taken by the government in this direction include withdrawal of high denomination currency notes of INR 1000 and INR 500, implementation of Goods and Service Tax regime, Income Disclosure Scheme 2016, etc.

In a historic development and with the intent to curb treaty abuse, India revised its tax treaties with Mauritius and Singapore to obtain a right to tax capital gains on sale of shares of Indian companies effective April 2017. These two countries account for a major portion of portfolio as well as strategic investments into India largely because of the capital gains tax exemption available in the treaties.

In the last few days, there have been heightened discussions about the government intending to either tax long term capital gains from equity shares or increase the threshold period. Press reports indicated that certain FPIs represented to the government to abolish capital gains tax and instead increase the securities transaction tax (STT).

In December 2016, the Central Board of Direct Taxes (CBDT) issued a circular clarifying that indirect transfer of shares provisions apply, in entirety, to FPIs. While the CBDT subsequently put the circular on hold, in absence of any exemption in the law, the exposure of indirect transfer provisions to FPIs continued to exist.

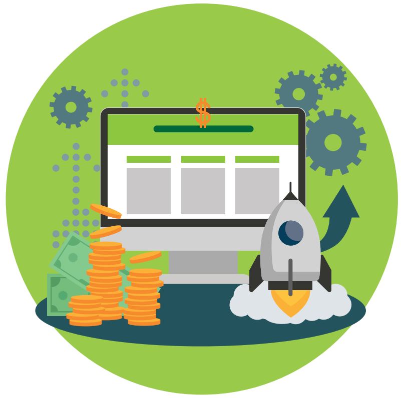
In the above backdrop, the Budget 2017 needed to provide sufficient stimulus to spur the economic growth in the country and at the same time provide clear and unambiguous tax policy changes to provide certainty and predictability to foreign investors.

Key tax highlights

- No change in capital gains tax rates and STT rates.
- Concessional tax rate of 5% on interest income from government bonds and qualifying corporate bonds extended from 30 June 2017 to 30 June 2020.
- Indirect transfer provisions not applicable to Category I and Category II FPIs.
- Exemption for long term capital gains tax on sale of equity shares available only if the corresponding purchases was chargeable to STT except as provided in law.

Policy Updates

- A common application form would be introduced for FPIs to obtain SEBI registration and Permanent Account Number as well as to open demat and bank accounts.
- Security receipts issued by Securitization company or a reconstruction company would be permitted to be listed and traded on stock exchanges.
- Since the Foreign Direct Investment (FDI) applications are now filed as well as processed online, the Foreign Investment Promotion Board (FIPB) would be abolished in the financial year 2017-18.
- Presently, more than 90% of the FDI inflows are under the automatic route. Further liberalization is underway and necessary amendments would be announced in due course.
- The commodities and securities derivatives markets will be further integrated by combining the participants, brokers and operational frameworks.
- Government would put in place a revised mechanism to ensure time bound listing of public sector enterprises including railway enterprises on stock exchanges.



Tax changes proposed in the budget impacting FPIs

- **Indirect transfer provisions not applicable to Category I and Category II FPIs:**
  Circular no. 41 issued by CBDT on 21 December 2016 created uncertainty for FPIs and their investors. As clarified in this circular, any transfer of shares or interest in a FPI which derived its value, substantially from assets located in India would be taxable in India under the indirect transfer provisions. Acceding to the representations made by various stakeholders, it has been proposed that indirect transfer provisions will not apply to investment made by non-residents, directly or indirectly in a FPI which is registered as a Category I or Category II FPI under SEBI (FPI) Regulations, 2014.

  The above amendment would certainly help to avoid unnecessary litigation and would be welcomed by the industry. However, since Category III FPIs have been kept outside the exemption, funds with less than 20 investors and non-institutional investors would still be exposed to the indirect transfer provisions. While the Finance Minister in his speech talked about exempting redemption of shares or interest outside India from indirect transfer provision, no corresponding amendment has been proposed on the same in the Finance Bill.

- **Concessional tax rate of 5% on interest income extended to 30 June 2020:**
  The sunset date for concessional tax rate of 5% on following interest income has been extended till 30 June 2020:
  - Interest income payable before 1 July 2020 to FPIs on government securities and qualifying corporate bonds.
  - Interest income in respect of monies borrowed before 1 July 2020 in foreign currency or by way of rupee denominated (masala) bonds or through long term foreign currency bonds.

- **Restrictions on Long term capital gains tax exemption on equity shares:**
  Currently, long term capital gains arising from sale of equity shares are exempt from tax provided the sale transaction is chargeable to STT. It has been proposed that this exemption would be available only if the corresponding purchase transaction was also chargeable to STT. Certain share acquisitions such as acquisition of equity shares prior to 01 October 2004, acquisition in a public offer or through bonus or rights issue etc. have been carved out from this restriction.

- **Conversion of preference shares into equity shares not to be regarded as a taxable transfer:**
  A specific exemption has been brought in the law to clarify that conversion of preference shares into equity shares will not be regarded as a taxable transfer. Also, it has been clarified that in case of conversion of preference shares into equity shares, the cost of acquisition of equity shares shall be the original cost of purchase of preference shares and the holding period of equity shares shall be recognized from the date of original purchase of preference shares.

- **Capital gains from sale of masala bonds outside India not taxable in India:**
  A specific exemption has been introduced to clarify that transfer of rupee denominated bonds outside India between two non-residents would not be considered as a taxable transfer in India. This is in line with similar exemption available for transfer of Depository Receipts (ADRs / GDRs) outside India. It has also been proposed that gains arising to any secondary holder of such bonds, due to appreciation of INR against foreign currency, at the time of redemption shall not be taxable.

- **Terms not defined in a tax treaty:**
  A provision has been introduced to clarify that if a term is not defined in a tax treaty, it shall have the same meaning as assigned to it in the Indian tax law and any explanation given to it by the government

- **Reduction in time limit for completion of tax audit:**
  Currently, the time limit available to tax officer to complete a scrutiny assessment (tax audit) is 21 months from the end of the relevant financial year. This time limit has been reduced to 18 months for assessment year 2018-19 which means that the tax audit for returns filed for financial year 2017-18 would need to be completed by 30 September 2020. Starting from assessment year 2019-20, this timeline will be further reduced to 12 months.
- **Revision in timeline for filing revised tax return:**
  Currently, the time limit to file revised tax return is 24 months from the end of financial year in which the income is earned. This time limit has been compressed to 12 months from the end of the financial year.
- **Fees for delayed filing of return:**
  The following nominal penalties have been proposed for delay in filing of tax return:
  - INR 5,000 if the return is filed after the due date but filed by 31 December of the assessment year.
  - INR 10,000 if the return is filed after 31 December of the assessment year.
- **Processing of tax refund even if the return is selected for tax audit:**
  Currently, if a particular tax return is picked up for scrutiny assessment (tax audit), any refund claimed as per the tax return is not granted till the completion of the tax audit. It has been proposed that where the tax return is selected for audit, the refunds shall still be granted unless the tax officer obtains the permission of the Commissioner for holding the same.

Annexure

Domestic Tax Rates applicable for FPIs from 1 April 2017

Capital Gains					
	Corporate Taxpayer			**Non-Corporate Taxpayer**	
	Total Income (upto INR 10 mn)	Total Income (Exceeding INR 10mn but up to INR 100 mn)	Total Income (Exceeding INR 100 mn)	Total Income (upto INR 10mm)	Total Income (Exceeding INR 10 mm for a firm
Transfer of equity shares, units of equity oriented fund chargeable to Securities Transaction Tax (STT)					
Short-term capital gains	15.45%	15.759%	16.2225%	15.45%	17.7675%
Long-term capital gains	Exempt	Exempt	Exempt	Exempt	Exempt
Transfer of securities not chargeable to STT					
Short-term capital gains	30.90%	31.518%	32.445%	30.90%	35.535%
Long-term capital gains	10.30%	10.506%	10.815%	10.30%	11.845%

Dividend / Interest Income

	Corporate Taxpayer			**Non-Corporate Taxpayer**	
	Total Income (upto INR 10mn)	Total Income (Exceeding INR 10mn but up to INR 100 mn)	Total Income (Exceeding INR 100 mn)	Total Income (upto INR 10mm)	Total Income (Exceeding INR 10 mm)
Dividend from Indian Companies	Exempt	Exempt	Exempt	Exempt	Exempt
Interest on Govt. bonds and certain corporate bonds* upto 30 June 2020	5.15%	5.253%	5.4075%	5.15%	5.9225%
Income from Securities (excluding above)	20.6%	21.012%	21.63%	20.6%	23.69%

*Rate of Interest on corporate bonds should be within 500 bps of the applicable base rate of State Bank of India

Notes:

a: Tax rates for Corporate taxpayers are inclusive of surcharge on tax amount @ 2% exceeding INR 10mn but upto INR 100 mn, above 100 mn the rate of surcharge will be 5% and cess @ 3% on tax + surcharge

b: Tax rates for Non-Corporate tax payers are inclusive of surcharge @ 15% on tax amount only where the income exceeds INR 10mm and cess @ 3% on tax + surcharge

c: The beneficial rate of 5% was available upto 30 June 2017, this is now extended to 30 June 2020 vide an amendment in Finance Act, 2017.

Securities Transaction tax (STT)

Taxable transaction	Rate	Payable by
Purchase / sale of equity shares on stock exchanges	0.1%	Purchaser / Seller
Sale of equity oriented mutual fund units on stock exchanges / Redemption of equity oriented mutual fund units	0.001%	Seller
Sale of options	0.05%	Seller
Exercise of options	0.125%	Purchaser
Sale of futures	0.01%	Seller
Sale of unlisted equity shares under an offer for sale to the public included in an initial public offer and such shares are subsequently listed on a stock exchange	0.2%	Seller

Note:

a: Securities transaction tax is levied by the stock exchanges and is included in the settlement price of the transaction.