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Union Budget 2018

Understanding the impact on Foreign Portfolio Investors

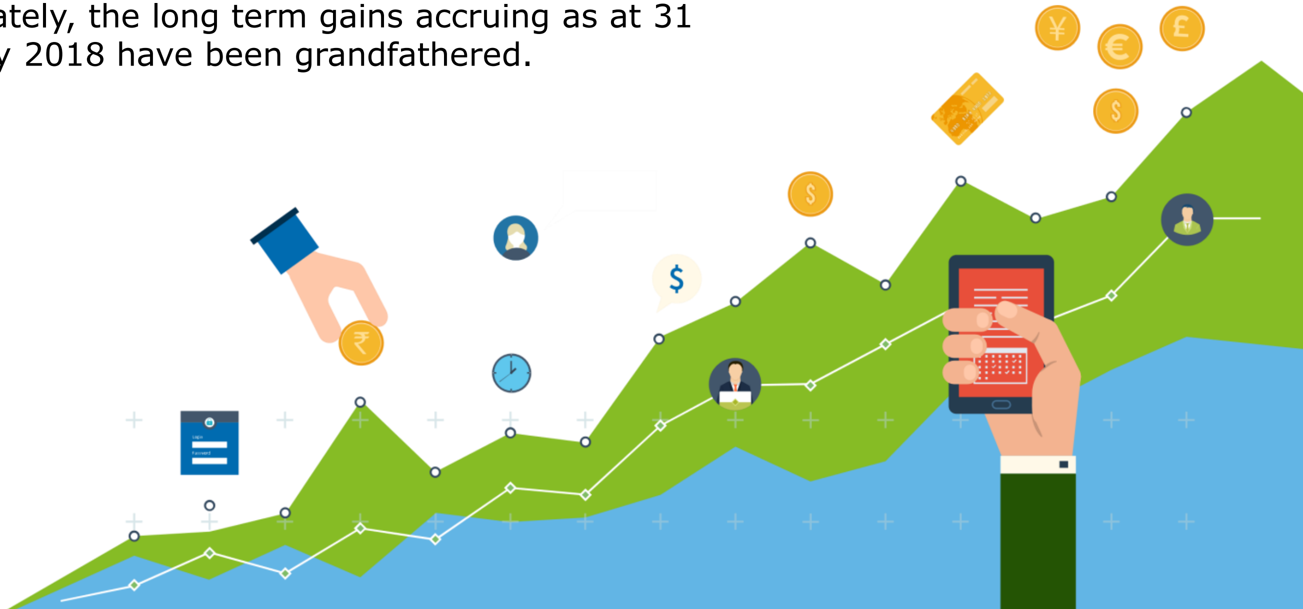
Forward

The Indian Finance Minister presented the Union Budget 2018 today. The budget was presented against the backdrop of slower economic growth, rising crude oil prices and growing protectionist tendencies in some countries. The GDP growth for the current fiscal year (April 2017 to March 2018) is estimated to be around 6.5% as compared to the growth rate of over 7% registered in last 3 financial years. The slower economic growth is generally attributed to the recent bold reforms undertaken by the government including implementation of Goods and Services Tax (GST) regime to replace the multiple indirect taxes and demonetization of higher currency notes aimed at removing black money from the economy. The other key reforms undertaken in the current financial year include introduction of new bankruptcy law, recapitalization of public sector banks and further liberalization of FDI norms. The government expects growth to pick up in the coming year supported by greater stability of GST regime, resolution of problems associated with non-performing assets of banks, moderate improvement in world growth and recovery in investment levels.

Please refer to Annexures for a quick review of the key economic indicators and the recent FPI and FDI flows.

Taking a cue from US tax reforms, there were widespread expectations that the budget would rationalize the corporate as well as individual tax rates. At the same time, there was significant discussion on bringing back the tax on long term capital gains arising from sale of shares on stock exchanges. With the Indian capital markets at their all time highs, this topic attracted huge media attention with many views for and against it.

Riding on the buoyancy of equity markets, the Finance Minister has proposed to bring the long term capital gains back into the tax net effective 1 April 2018. Fortunately, the long term gains accruing as at 31 January 2018 have been grandfathered.



Key tax proposals
Highlights

- Long term capital gains arising from sale of equity shares would no longer be exempt.
- Likewise, long term capital gains from transfer of units of equity oriented mutual funds, units of real estate investment trusts and units of infrastructure investment trusts would also be taxable.
- Grandfathering of long term capital gains from investments held as on 31 January 2018 by allowing fair market value of the securities to be considered as cost of acquisition.
- Introduction of 10% dividend distribution tax on income distributed by an equity oriented fund.
- Capital gains arising from transfer of derivatives, GDRs, foreign currency bonds and masala bonds on an exchange located in IFSC to be exempt from tax for foreign investors
- Cess imposed on the sum of tax and surcharge increased from 3% to 4%
- Corporate Tax proposed to be reduced to 25% for domestic company whose total turnover or gross receipts does not exceed INR 2.5 billion during FY 2016-17

Long term capital gains

Removal of tax exemption

- **Change**: As expected in the run-up to the budget 2018, the Finance Minister has proposed to bring the long term capital gains to tax net. Accordingly, effective 1 April 2018, long term capital gains arising from transfer of following securities will be taxable at 10% (plus surcharge and cess):
  - Equity Shares
  - Units of equity oriented mutual funds
  - Units of Real Estate Investment Trusts (REITs)
  - Units of Infrastructure Investment Trusts (INVITs)
- **Grandfathering provisions**: To avoid retrospective impact of the amendment, it is proposed that the cost of acquisition of the security resulting in long term gains would be deemed to be either the actual cost or the fair market value on 31 January 2018, whichever is higher, capped to the actual sale price. This would ensure that the long term gains accruing on investments as at 31 January 2018 would continue to enjoy tax exemption. However, in the draft Finance Bill, there is no reference to grandfathering provisions in the relevant section which deals specifically with taxation of FPIs. This does not seem to be the intention of the government and a clarification in this regard would be welcome.
- **No change in holding period**: The holding period for long term capital gains continues to be 12 months for listed securities (including equity shares) and units of oriented mutual funds, 24 months for unlisted equity shares and 36 months for all other securities (including units of REITs and INVITs).

Long term capital gains tax amendment
Illustrations

Scenario 1	
Description	INR
Purchase of shares on 1 Jan' 2017	1,000,000
Sale of shares on 31 Mar' 2018	2,000,000
Actual gains	1,000,000
Market value of security on 31 Jan'18	1,500,000
Taxable gains	Nil
Tax	Nil
Remarks: Long term capital gains exempt from tax as the sale date is before 1 April 2018	

Scenario 2	
Description	INR
Purchase of shares on 1 Jan' 2017	1,000,000
Sale of shares on 1 Apr' 2018	2,000,000
Actual gains	1,000,000
Market value of security on 31 Jan'18	1,500,000
Taxable gains	500,000
Tax	50,000
Remarks: Market value of the security on 31 Jan to be the cost of acquisition as per grandfathering provision	

Long term capital gains tax amendment
Illustrations

Scenario 3	
Description	INR
Purchase of shares on 1 Jan' 2017	1,000,000
Sale of shares on 1 Apr' 2018	900,000
Actual gains / (loss)	(100,000)
Market value of security on 31 Jan'18	800,000
Taxable gains / (loss)	(100,000)
Tax	Nil
Remarks: Actual loss of INR 100,000 would be allowed to be set-off against other long term gains or to be carried forward	

Scenario 4	
Description	INR
Purchase of shares on 1 Jan' 2017	1,000,000
Sale of shares on 1 Apr' 2018	1,200,000
Actual gains	200,000
Market value of security on 31 Jan'18	1,500,000
Taxable gains	-
Tax	-
Remarks: Cost of acquisition cannot exceed the actual sale consideration, therefore no loss arbitrage	

FPI Tax rates

Comparative chart – existing & proposed

Type of Income		Corporate FPIs^		Non-corporate FPIs (Trusts)*	
		Existing	Proposed	Existing	Proposed
Capital gains on transfer of listed equity shares/equity oriented mutual fund on market (STT is paid)	**Long-term**	**Nil**	**10.92%**	**Nil**	**11.96%**
	Short-term	16.223%	16.38%	17.768%	17.94%
Capital gains on transfer of debt securities (including debt mutual funds)	Long-term	10.815%	10.92%	11.845%	11.96%
	Short-term	32.445%	32.76%	35.535%	35.88%
Sale of listed derivatives (listed futures and options)	Short-term	32.445%	32.76%	35.535%	35.88%
Interest on securities**		5.408%	5.46%	5.923%	5.98%
Dividend#		Exempt	Exempt	Exempt	Exempt

^tax rate is inclusive of 5% surcharge assuming that the total income exceeds INR 100 million.

* tax rate is inclusive of 15% surcharge assuming that the total income exceeds INR 10 million.

**5% (plus surcharge and cess) is applicable on interest on government bonds and those corporate bonds whose coupon rate does not exceed 500 bps of base rate of State bank of India on date of issuance of bonds. Interest from other corporate bonds is taxable at 20% (plus surcharge and cess).

#. Subject to dividend distribution tax of 20.356% on equity shares. In Finance Bill 2018, it is proposed to introduce distribution tax at 10% (plus 12% surcharge and 4% cess) on dividends declared on equity-oriented mutual funds

Measures to promote IFSC
Tax incentives

Background : The Finance Minister in Budget 2015, unveiled the plan to set up the first IFSC in Gujarat which was named as Gujarat International Finance Tech-City i.e. GIFT City. The GIFT IFSC seeks to compete with major financial hubs such as Singapore and Dubai and the target business segments for IFSC are stock exchanges, offshore banking units, financial intermediaries, financial service back office, and information technology enables services, business process outsourcing, knowledge process outsourcing, etc.

Existing tax concessions: IFSC has been given a number of tax incentives to units set-up in IFSC (e.g. tax exemption for first 5 years, 50% tax holiday for next 5 years) as well as for trading in securities listed on stock exchanges in the IFSC (for e.g. no securities transaction tax and no commodity transaction tax).

Other benefits to FPIs : FPIs are permitted to invest in commodity derivatives in IFSC which is otherwise not permitted for them, there is no currency risk on transactions in IFSC (since the trading is in dollars), longer trading hours (22 hours), lower transaction costs, enhanced position limits and the freedom from the need to maintain bank / custody accounts

Budget 2018 proposals: Despite the incentives available currently, the participations of FPIs in the GIFT IFSC has been quite low and therefore in its attempt to attract FPIs to IFSC in a big way, the Finance Minister has proposed capital gains tax exemption to non-residents (which will include FPIs) on transfer of following securities on a stock exchange in IFSC:

- Derivatives
- Foreign Currency Bonds or Global Depository Receipts issued by Indian Companies
- Rupee Denominated bonds of Indian companies (popularly known as Masala bonds)

Also, it is proposed to reduce the Alternate Minimum tax rate from 18.5% to 9% for non-corporate units set-up in IFSC. This is on the lines of concessional Minimum Alternate Tax (MAT) rate of 9% application to companies set up in IFSC

This measure is attempted to bring GIFT IFSC at par with the Singapore Stock Exchange which recently introduced stock specific derivatives on 50 Indian stocks and which does not impose any tax on such transactions. Nonetheless, this measure may result in migration of derivative trading by FPIs from NSE and BSE to the stock exchanges in GIFT IFSC considering that the short term capital gains from derivative trading on NSE and BSE attracts tax at 30% plus surcharge and cess.

Other direct tax proposals
Key changes

Dividend Distribution Tax (DDT) on income distribution by equity oriented mutual fund

- Equity oriented mutual funds were not subject to distribution tax and were specifically exempted. With a view to provide a level playing field between growth oriented funds and dividend paying funds and due to the new capital gains tax regime for unit holders of equity oriented funds, it is now proposed that income distributed by an equity oriented mutual fund shall be liable to pay additional income-tax at the rate of 10% on income so distributed.
- DDT shall be paid by such mutual funds and the income will continue to be exempt in the hands of investors.

DDT on Deemed dividend

- DDT at 30% (plus 12% surcharge and 4% cess) to be levied on a loan or an advance given by a closely-held company out of its accumulated profits to its shareholder holding at least 10% of the voting power or to any other entity in which such shareholder is beneficially entitled to at least 20% of the income.

Need to obtain Permanent Account Number

A new provision has been introduced in the tax law whereby following persons are required to obtain a Permanent Account Number (PAN) in India:

- Every entity that enters into financial transactions exceeding INR 0.25 million in a fiscal year
- Every person who is the managing director, director, partner, trustee, author, founder, karta, chief executive offaicer, principal officer or office bearer of the aforesaid entity
- Any person competent to act on behalf of the aforesaid entity.

A plain reading of the above may lead to an interpretation that every director, fund manager, authorized signatory etc. of an entity that executes financial transactions in excess of INR 0.25 million in a fiscal year needs to obtain a PAN in India. However, this amendment does not seem to be intended for FPIs or other foreign entities who in any case obtain PAN and file tax returns in the normal course. A clarification on this aspect by the government would be welcome.

Other direct tax proposals
Key changes

Corporate tax rate

- Corporate tax rate proposed to be reduced to 25% for domestic company whose total turnover or gross receipts does not exceed INR 2.5 billion (approx. US$ 40 mn.) during financial year 2016-17.

Health and Education cess

- Currently, a cess of 3% is levied on the sum of tax and surcharge to be borne by the taxpayer. It is proposed to increase the cess to 4%.

Rationalization of prima-facie adjustments during processing of income-tax return

- Currently, the tax law provides for income appearing in Annual Tax Statement (Form 26AS) to be added to the income of taxpayer if it has not been included in the tax return filed by such taxpayer.
- It is proposed to remove the above provision with effect from 1 April 2018.

New scheme of scrutiny assessment

- The Central Board of Direct Taxes (CBDT) has been running a pilot project of electronic assessments in few major cities in India and has been testing the feasibility of implementing this new regime of tax assessment for last few years.
- It is proposed to prescribe a new scheme to make assessments more transparent and accountable by eliminating interface between the tax authorities and the assesse, making optimum use of resources and introducing team-based assessment.

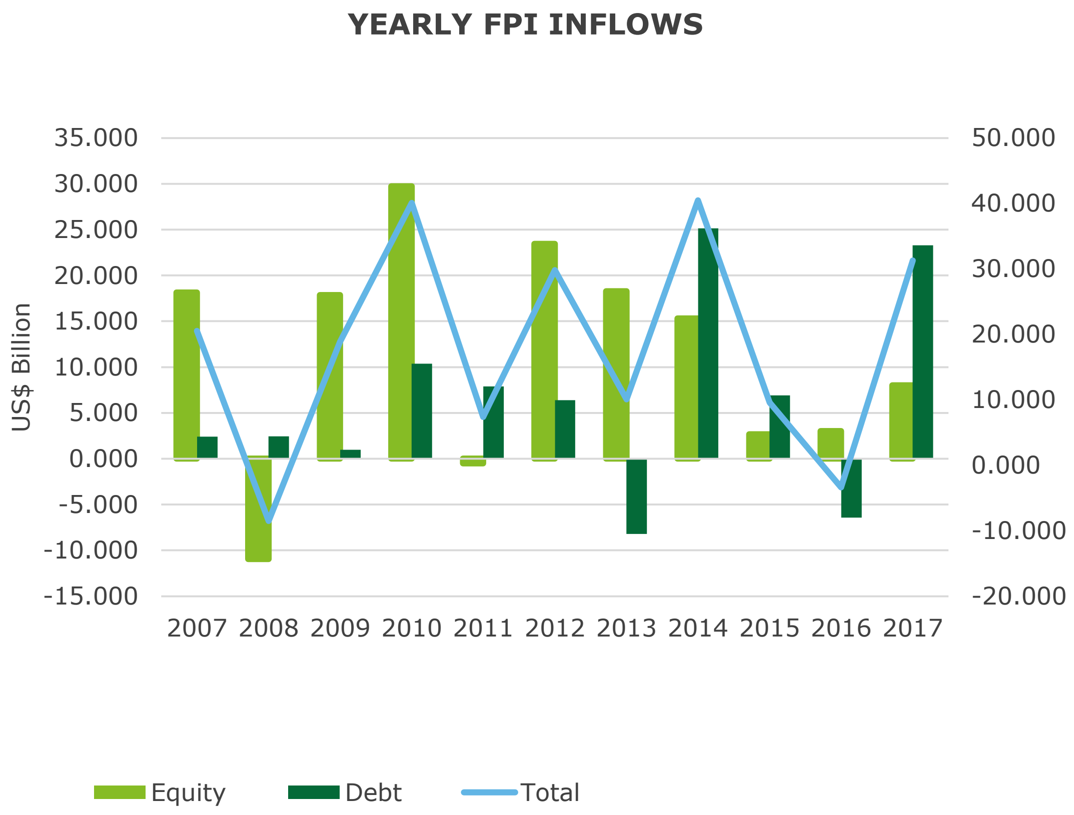
Annexure 1

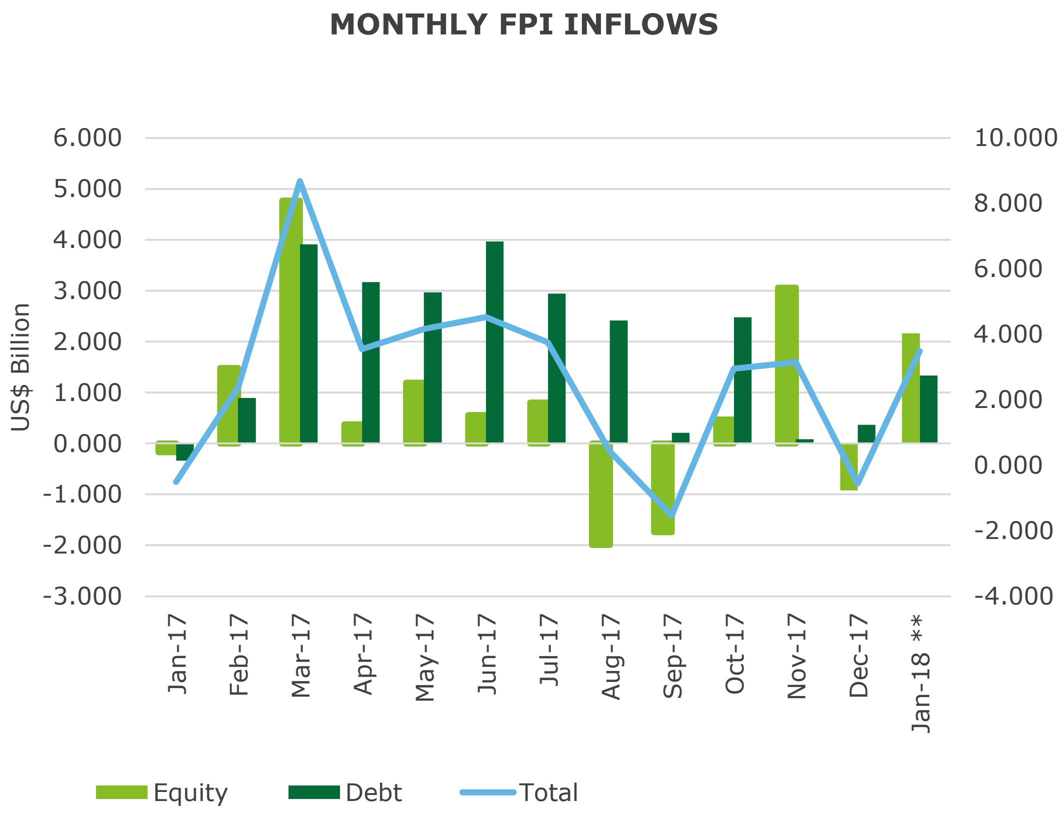
Key Economic Indicators

Data categories	Unit	2014-15	2015-16	2016-17	^2017-18
GDP and Related Indicators					
GDP Growth Rate	%	7.5	8	7.1	6.5
Gross Value Addition (GVA) Growth Rate	%	7.2	7.9	6.6	6.1
Prices					
Inflation Wholesale Price Index (WPI) (average)	% change	1.2	-3.7	1.7	2.9
Inflation Consumer price Index (CPI) (Combined average)	% change	5.9	4.9	4.5	3.3
External Sector					
Current Account Balance (CAB)/GDP	%	-1.3	-1.1	-0.7	-1.8
Foreign Exchange Reserves	US$ Billion	341.6	360.2	370	409.4
Average Exchange Rate	INR/US$	61.14	65.46	67.07	64.49
Money and Credit					
Broad Money (M3) (annual)	% change	10.9	10.1	10.1	10.5
Scheduled Commercial Bank Credit (growth)	% change	9	10.9	8.2	9.3
Fiscal Indicators (Centre)					
Gross Fiscal Deficit	% of GDP	4.1	3.9	3.5	3.2
Revenue Deficit	% of GDP	2.9	2.5	2.1	1.9
Primary Deficit	% of GDP	0.9	0.7	0.4	0.1

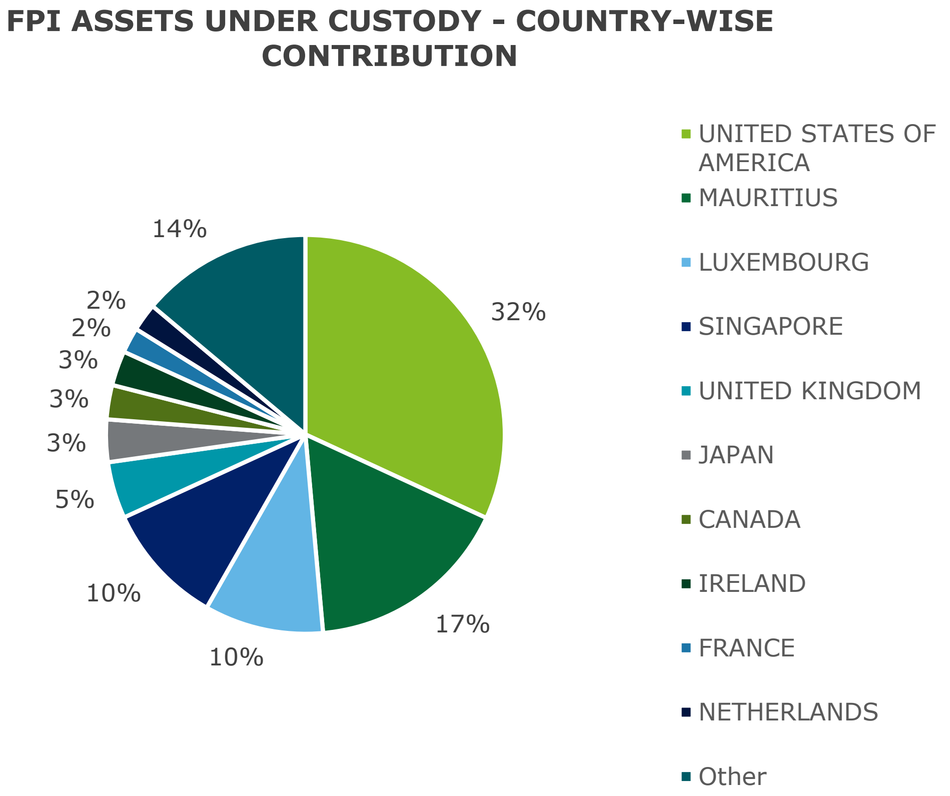
^Budgeted estimates

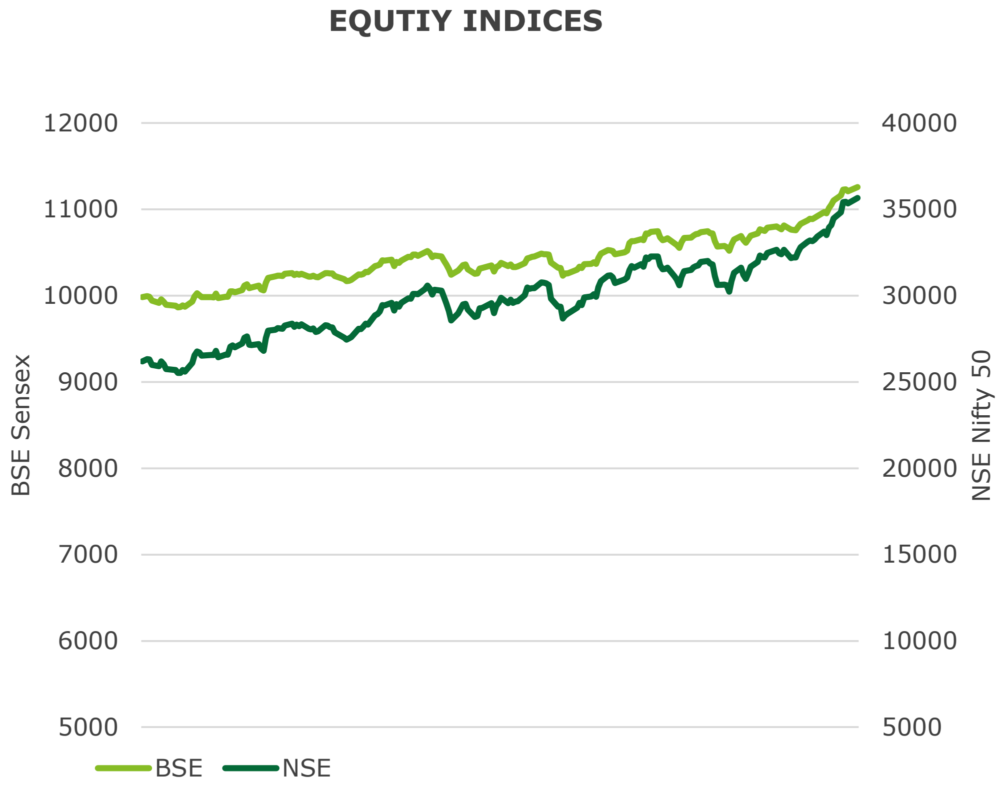
Annexure 2
FPI flows





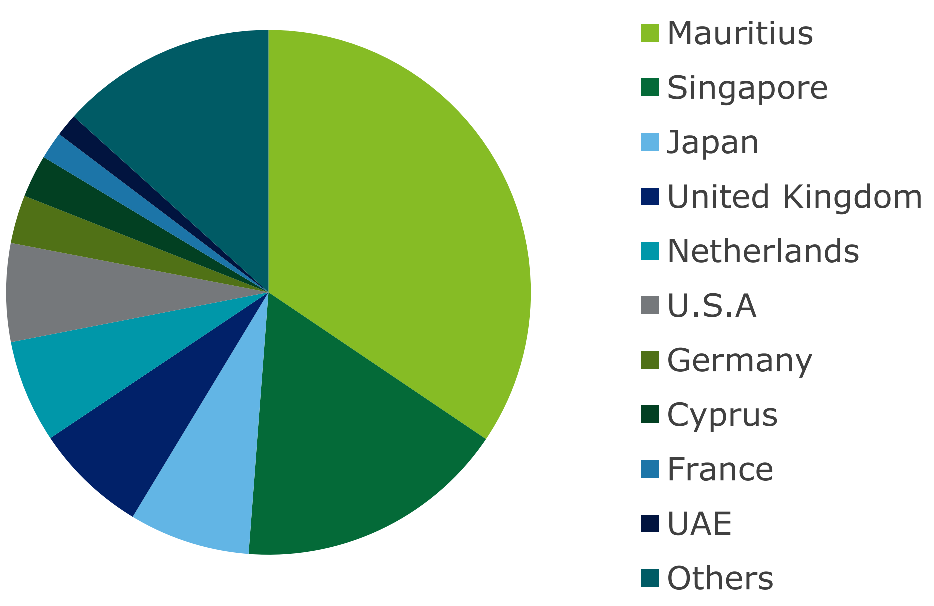
Annexure 3
FPI flows





Annexure 4
Foreign Direct Investment (FDI) flows

COUNTRY-WISE FDI INFLOWS



YEAR WISE FDI INFLOWS