Key tax changes expected in the Budget 2016-17

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Background

With just 18 days to go before the Finance Minister presents the third budget of the NDA government, there is widespread excitement in policy as well as business circles. Unlike in past years, where any discussion on budget expectations was highly speculative, this year is different. Throughout the year, the government put forward various tax proposals as also engaged with stakeholders on various aspects of tax reform. Based on these, it is possible to identify several key areas where changes are likely in the forthcoming Budget. These are briefly discussed below:

Reduction in corporate tax rates

With a view to bring stability in the tax regime, the Finance Minister in his last budget speech, announced the intention of the government to reduce the corporate tax rate from 30 per cent to 25 per cent in a phased manner over the next four years. The first phase of this reduction is expected to be announced in the upcoming budget. It will also be interesting to see whether the reduction in the tax rate is extended to non-corporate entities such as partnership firms and LLPs, especially considering that the proposed phase out of incentives (discussed below) is proposed to be applied to non-corporate entities as well.

Phase out of tax incentives

The reduction of rates is to be accompanied by a corresponding phase-out of tax exemptions and deductions. A roadmap for the phase out of incentives was released for public comments in November 2015. While the phase-out itself is proposed to be made on a gradual basis, the withdrawal of key incentives such as the weighted deduction for R&D activities and the introduction of a sunset clause for units in Special Economic Zones (SEZ) has been the subject matter of intense debate. Several representations have also been made to the Government to re-consider its approach to such incentives. It will be interesting to see whether these representations will be considered while finalising the incentive phase out.

Minimum Alternative Tax (MAT) on Foreign Companies

The Finance Act, 2015 excluded foreign companies from the ambit of MAT on a prospective basis in respect of specified streams of income. The prospective applicability of this law, led to uncertainty as to the applicability of MAT to prior years. However, the government responded to investor concerns and based on the recommendations of the Justice A.P. Shah Committee, clarified MAT will not apply to foreign companies in following cases:

a) *In the case of a foreign company which is a resident of a country with which India has a Double Tax Avoidance Agreement ('DTAA')*: If such foreign company does not have a permanent establishment within the definition of the term in the relevant DTAA; or

b) *In the case of a foreign company which is a resident of a country which does not have a DTAA with India*: If such foreign company is not required to seek registration under Section 592 of the Companies Act 1956 or Section 380 of the Companies Act 2013[1].

This clarification is expected to be included in the Finance Bill, 2016 with retrospective effect from 1st April 2001.

Taxation of income from off-shore rupee denominated bonds

The framework for external commercial borrowings underwent a significant change in 2015. An Indian company is now permitted to raise overseas debt through issue of offshore rupee denominated bonds. By a press release dated 29th October 2015, the Central Board of Direct Taxes announced that interest on such bonds will be taxable at the rate of five per cent and capital gains arising on their redemption would be exempt from tax. The Finance Bill, 2016 is likely to include amendments to this effect.

Promoting employment and Start-ups

As part of the government's 'Start-up India' campaign, start-ups are proposed to be exempted from income tax on their profits for three years. A capital gains tax exemption is also being contemplated. Changes to the law to incorporate tax benefits to start-ups are likely to form part of the Finance Bill, 2016.

Reports also indicate that with a view to promote employment generation, a plan to offer incentives to companies that create additional jobs and increase their headcount by two per cent is on the anvil. Further, a weighted rebate of 125 per cent is also being considered for employers' contribution to provident funds. Whether these plans will see the light of day now remains to be seen.

Base Erosion and Profit Shifting (BEPS) related amendments

Certain aspects of the OECD BEPS Action Plan could also find place in the forthcoming Budget. It has been reported that many of the recommendations made as part of the BEPs project are under active consideration of the government. Regulations relating to country-by-country reporting (which is part of the minimum standards that Governments are expected to adopt by 2017 as part of BEPS) are likely to be a part of this Budget. Amendments based on other Action plans such as interest deductibility or Controlled Foreign Corporation could also potentially be introduced.

[1] Foreign companies which have established a place of business within India

Recommendations of the Income-tax Simplification Committee (Easwar committee)

Emphasizing the need to simplify existing the income-tax law, the Government had set up a Committee last year to identify provisions that lead to litigation and to suggest modifications to bring about predictability and certainty in tax laws. This Committee recently submitted a preliminary report which addresses certain simpler issues requiring immediate attention (more complex issues are likely to form part of subsequent reports). The recommendations in this report that require legislative changes could form part of the Budget. These include:

- Providing clarity regarding the characterisation of income arising on the sale of shares and securities;
- Rationalising the provisions of section 14A of the Income-tax Act, 1961 (Act), including specifically excluding its applicability to income that is taxed in the hands of the company (e.g. dividend);
- Exempting non-residents having Tax Identification Number in foreign jurisdictions from applicability of withholding at a higher rate under section 206AA of the Act;
- Raising of threshold limits for withholding tax and rationalizing rates for tax deduction;
- Deferment of applicability of Income Computation and Disclosure Standards.

Alignment with the Goods and Services Tax (GST) framework

The Budget could also see government taking some determinative steps to move closer to the GST regime. It is possible that there would be a further revision in the service tax rate to the recommended GST rate of 16 per cent to 18 per cent. Additionally, the government may look at broadening the tax base with fewer exemptions and at the same time, provide relief to industry by liberalizing the availability of CENVAT credit on all inputs and input services. It is also contemplated that the threshold for applicability of service tax may be increased to INR 25 lakhs from the present INR 10 lakhs.

Wish-list of amendments

In addition to the above, there are several other expectations from the Finance Minister relating to key provisions of the Act. However, there is little clarity on whether the same are being considered. These are briefly discussed below:

- Deferral of the place of effective management (POEM) test for corporate residency;
- Amending the definition of income to exclude/restrict the taxation of subsidies, grants etc.;
- Providing more clarity on aspects related to taxation of indirect transfers such as method of determining tax basis of shares, availability of tax cost basis for future divestments, etc.;
- Extension of tax exemption to indirect transfers arising pursuant to transfer of shares of listed company and transfer by shareholders pursuant to intra group restructuring;
- Eliminating requirement of amalgamating company qualifying as an 'industrial undertaking' to benefit from the provision in relation to carry forward of losses in cases of merger;
- Exempting SEZ units from MAT levy;
- Rationalization of tax exemption provisions for conversion of company into limited liability partnership.

Summing up

On the anvil of the falling crude oil prices and global economic slowdown, the Indian capital markets have taken a hit. The Rupee too continues to weaken. However, the government's ambitious 'Make in India', 'Start-up India' and other campaigns are steps in the right direction and have the potential to contribute immensely to India's economy. The onus is now on the Finance Minister to deliver big ticket reforms that will pave the way for exponential growth.

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