

Impact of the Union Budget 2016 on the Financial Services Sector

05 March 2016

**Background**

The Union Budget for 2016-17 was presented by the Finance Minister in Parliament on 29 February 2016. This alert summarizes key tax proposals in the Finance Bill, 2016 ('Bill') impacting the Financial Services sector. The Bill will be discussed in Parliament before it is enacted and is subject to any amendments that may be made pursuant to these discussions. The direct tax proposals discussed in this alert will be effective from the tax year commencing on 1 April 2016 unless specified otherwise. Further, certain policy announcements are contained in the Budget speech which are likely to be implemented through legislative/administrative action in ensuing months.

Key Policy Announcements**Foreign Investments**

- Foreign investment limits in Insurance and Pension sector have been proposed to be enhanced to 49% under the automatic route from the earlier limit of 26%.
- Foreign investment limit in cases of Asset Reconstruction Companies ('ARC') is also proposed to be enhanced to 100% as against an earlier limit of 74%. Further, amendments to the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) have also been proposed to enable the sponsor of such ARCs to hold 100 percent stake in such ARCs.
- Existing investment limit of 5% in case of foreign companies in the Indian Stock exchanges will be enhanced to 15% on par with the limit of 15% applicable to domestic institutions.
- It has been proposed that Foreign Direct Investment ('FDI') will be allowed beyond the 18 specified NBFC activities in the automatic route i.e. in other activities which are regulated by financial sector regulators.
- Investment by Foreign portfolio investors ('FPI') in Central Public Sector Enterprises (other than

Banks) is proposed to be enhanced to 49% from the earlier limit of 24%.

- Investment options for FPIs are proposed to be increased by proposing to allow investment in unlisted debt securities and pass through securities issued by securitisation Special Purpose Vehicles ('SPV').
- Eligible FDI instruments are proposed to be expanded to include hybrid instruments.
- LIC of India will set up a dedicated fund to provide credit enhancement to infrastructure projects. The fund will help in raising the credit rating of bonds floated by infrastructure companies and facilitate investment from long term investors.

Financial sector and capital markets related proposals

- A comprehensive Code on Resolution of Financial Firms is intended to be introduced in Parliament. The Code will provide a specialized mechanism to deal with bankruptcy in case of banks, insurance companies and financial sector entities.
- Setting up of Financial Data Management Centre under Financial Stability Development Council to facilitate integrated data aggregation and analysis in financial sector.
- Bank Board Bureau to be operationalized and Roadmap for consolidation of public sector banks to be spelt out.
- The Reserve Bank of India ('RBI') Act, 1934 to be amended to provide a statutory basis for a Monetary Policy Framework and Monetary Policy Committee.
- RBI would facilitate retail participation in government securities in primary and secondary market through stock exchange.
- General Insurance Companies owned by the Government to be listed on the stock exchanges.
- New Derivative Products to be developed by the Securities and Exchange Board of India ('SEBI') in the commodity derivative market.

Direct Tax Proposals

• Corporate Tax Rates

General rate of corporate tax remains unchanged at the rate of 30% for domestic companies and 40% for foreign companies.

Rate of surcharge continues to remain unchanged in respect of domestic/ foreign companies. Education cess to remain at 3% on tax and surcharge, if any.

MAT at the rate of 9% proposed in respect of unit located in an International Financial Services Centre (IFSC) and deriving its income solely in foreign exchange subject to specified conditions.

No changes in the rate of Dividend Distribution Tax ('DDT') and Buy-Back Tax ('BBT').

• General Anti-Avoidance Rules ('GAAR')

The Finance Minister in his speech has reiterated the Government's commitment to implement GAAR from 1 April 2018.

• Residential status based on test of Place of Effective Management ('POEM')

The determination of residential status of companies based on its POEM was introduced by the Finance Act, 2015 and was to be effective from 1 April 2015. It is proposed that the POEM test for determination of residential status of companies be deferred to 1 April 2016. A transition mechanism for issues pertaining to computation of income unabsorbed depreciation, set off of losses, avoidance of tax etc. for a foreign company which has not been previously assessed, also proposed.

• Equalisation levy

Equalisation levy at the rate of 6% on the amount of consideration towards specified services (online advertisement/ or provision for digital advertising space) received/ receivable by a non-resident not having a permanent establishment in India is proposed to be introduced.

The equalisation levy is introduced by way of a separate chapter in the Bill, which shall come into force from a notified date.

- **Indirect transfer**

The Finance Minister had earlier announced constitution of a high level committee to oversee the applicability of indirect transfer provisions. The Finance Minister, in his speech has mentioned that the high level committee will now be chaired by the Revenue Secretary and will include chairman, Central Board of Direct Taxes and a third party expert.

- **Disallowance of expenditure to earn exempt income**

The Finance Minister, in his Budget speech has proposed that Rule 8D of the Income-tax Rules, 1962 providing the mechanism for computation of disallowance of expenditure incurred to earn exempt income be amended to provide that the disallowance of indirect expenditure will be limited to 1% of the average monthly value of investments yielding exempt income but not exceeding the actual expenditure claimed.

- **Applicability of MAT to foreign companies:**

Currently, the provisions of MAT are not applicable to a foreign company in respect of specified incomes for assessment years beginning 1 April 2015. To give effect to the clarification issued by the Central Board of Direct Tax ('CBDT'), it is proposed that MAT shall not be applicable to a foreign company retrospectively with effect from 1 April 2000 where:

- The foreign company is a resident of a country/ specified territory with which India has entered in to a Double Taxation Avoidance Agreement ('DTAA') and it does not have a Permanent Establishment in India in accordance with the provisions of such DTAA; or
- The foreign company is a resident of a country with which India does not have a DTAA as referred above and it is not required to seek registration under any law for the time being in force relating to companies.

- **Buy-back tax**

Currently, 'distributed income' on buy-back of unlisted companies' shares carried out under section 77A of the Companies Act, 1956/ section

68 of the Companies Act, 2013 is subject to BBT. Buy-back of shares carried out pursuant to a court approved scheme are not specifically covered. It is proposed that BBT on buy-back of such unlisted companies' shares shall apply to any buy-back under the Companies Act.

Further, currently, the manner of determination of consideration received by the company on issue of shares lacks clarity for e.g., there is no prescribed methodology prescribed for such determination to address situations where the shares may have been issued by the company in tranches, at different points in time or may have issued in lieu of existing shares of another company under amalgamation, merger or demerger. Accordingly, it is proposed that the manner of determination of such amount received by the company will be prescribed in the due course.

The aforesaid amendment is slated to be effective from 1 June 2016.

- **Deduction for provision for bad and doubtful debts ('PDD') in case of Non-Banking Financial Companies ('NBFC')**

Currently, Banks, State Financial Institutions, Public Financial Institutions and a State Industrial Investment Corporation are eligible for a deduction in respect of PDD, subject to prescribed ceilings. NBFCs who carry on similar business are subject to similar prudential norms of RBI, are not eligible to such deduction.

It is now proposed that NBFCs shall be allowed as a deduction in respect of PDD subject to a limit of 5% of the total income of the NBFC (computed before making any deduction).

- **Merger/consolidation of plans within a mutual fund scheme**

Current tax provisions provide for tax neutrality of consolidation of mutual fund schemes in the hands of unit holders.

It is proposed to extend such tax exemption available to unit holders on merger or consolidation of different plans in a mutual fund scheme.

However, the manner of determination of cost of acquisition and period of holding of units in the consolidated plan has not been clarified.

- **Taxability of rupee denominated bonds issued to a non-resident**

The RBI has recently permitted Indian corporates to issue rupee denominated bonds and raise funds from outside India.

It is proposed that in case of non-resident taxpayers, any gains arising on account of appreciation of rupee at the time of redemption of rupee denominated bonds of an Indian company shall be ignored in computing the full value of consideration for the purpose of computing the capital gains.

The aforesaid amendment is following a press release dated 29 October 2015 issued by the CBDT providing for exclusion of gains arising from rupee appreciation from the computation of capital gains and applicability of concessional tax rate of 5% on interest from such rupee denominated bonds. However, the Budget has not clarified on the applicability of concessional tax rate of 5% on interest from rupee denominated bonds.

- **Taxability of Sovereign Gold Bonds (SGB)**

It is proposed that any gains arising from redemption of SGBs to an individual shall be exempt from tax.

It is also proposed that indexation benefits shall be available to all assessee's earning long-term capital gains on transfer of SGBs.

- **Tax Treatment of Gold Monetisation Scheme, 2015**

It has been proposed that capital gains on deposit certificates and interest on such deposit certificates shall be exempt from tax with retrospective effect from 1 April 2015.

- **Modification of condition of special taxation regime for off-shore funds**

The Finance Act, 2015 provided for following safe harbours in respect of certain offshore funds:

- The fund management activity carried out through an eligible fund manager acting on behalf of such funds shall not constitute business connection in India of the said fund
- Eligible investment fund shall not be said as resident in India merely because the eligible fund manager, undertaking fund management activities is situated in India

Further, one of the condition for such safe harbours to apply is that the fund should be a resident of a country/ specified territory with which India has entered into a tax treaty.

The Bill proposes to amend the aforesaid condition to include a fund established/ incorporated/ registered outside India in a country or a specified territory notified by the Central Government. Thus, the safe harbours are proposed to be extended even to funds which do not qualify as a resident under the relevant tax treaty (say for instance a SICAV fund of Luxembourg).

Further, there was also a restriction on the fund to carry on or control and manage directly or indirectly, any business in India or from India. Since the said condition restricted the flexibility of operation for funds, it is proposed to omit the words 'or from India'.

- **Exemption from Dividend Distribution Tax on distribution made by a SPV to Business Trust**

In the case of Business Trusts [viz. Real Estate Investment Trusts (REITS) and Infrastructure Investments Trust (Invits)]; the Finance Act, 2015 rationalized the taxation regime to provide a tax pass through status to REITS and Invits. However, in the case of REITS; where income generating assets are held through an SPV; dividend distributions by such SPVs to the Business Trust were subject to DDT.

The DDT on dividend distributions by SPVs to the Business Trust rendered the REIT/ Invits structure tax inefficient and accordingly, the same did not take off.

To address this concern, the Bill proposes to exempt from the levy of DDT, dividends declared, distributed and paid by SPVs to its

shareholder, being a Business Trust subject to such SPV being wholly owned by the Business Trust (except where shares are mandatorily required to be held by any other person in accordance with any other regulation).

The exemption from levy of DDT is applicable only in respect of distribution of current income and income earned by such SPV after its acquisition by the Business Trust.

This provision is proposed to be effective from 1 June 2016.

- **Taxation regime for securitisation trust, Asset Reconstruction Companies (ARC) and its investors**

Under the current provisions, the income of the securitisation trust is exempt income. Further, the income distributed by a securitization trust is subject to an additional income-tax at 25%/30 %. Further, the said provisions are currently not applicable to a securitization trust set up under the SARFAESI. In order to rationalise the tax regime for securitization trust and its investors and to provide a tax pass through treatment, with effect from 1 June 2016, the following is proposed:

- The new regime shall apply to securitization trust being an SPV defined under SEBI (Public Offer and Listing of Securitized Debt Instrument) Regulations, 2008 or SPV as defined in the guidelines on securitization of standard assets issued by Reserve Bank of India ('RBI) or being setup by a securitization company or a reconstruction company in accordance with the SARFAESI Act.
- The income of securitization trust [which includes an Asset Reconstruction Company ('ARC')] will be exempt.
- However, income distributed or deemed to be distributed shall be taxable in the hands of the investors. The income accrued or received from the securitisation trust shall be taxable in the hands of investor in the same manner and to the same extent as it would have been taxable had the investor made investment directly in the underlying assets and not through the trust.

- Tax shall be withheld on such distributions at the rate of 25% in case of payment to resident investors which are individual or HUF and at the rate of 30% in case of others residents. In case of payments to non-resident investors, the tax shall be withheld at the rates in force.

The investors can now obtain low or nil deduction of tax certificate in respect of receipts from the securitization trust.

- **Tax deduction on payments by Alternate Investment funds**

The existing provisions of the Act provides that in respect of any income credited or paid by the Category I and II Alternative Investment Fund ('AIF') to its investor, tax shall be deducted at source by the investment fund at 10% of the income (irrespective of residential status of the payee).

It is proposed that the person responsible for making the payment to the investor shall deduct income-tax at the rate of 10% where the payee is a resident and at the rates in force where the payee is a non-resident (not being a company) or a foreign company. Consequential changes are also proposed to be made to the definition of "rates in force" thus enabling the foreign investors to claim tax treaty benefits,

Further, it is proposed that a certificate for deduction of tax at lower rate or no deduction of tax can be obtained in relation to the aforesaid payments.

These amendments will take effect from 1 June 2016.

- **Tax Incentives to IFSC**

With a view to incentivise the growth of IFSC into a world class financial services hub and to provide a competitive tax regime to such IFSC, the Bill proposes to provide following tax incentives to IFSC:

- No levy of Security Transaction Tax ('STT') to taxable securities transactions entered into by any person on a recognized stock exchange located in IFSC where the

consideration for such transaction is paid or payable in foreign currency.

- No levy of Commodity Transaction Tax ('CTT') to taxable commodities transactions entered into by any person on a recognized association located in IFSC where the consideration for such transaction is paid or payable in foreign currency.
- Exemption from capital gains tax to the income arising from transaction undertaken in foreign currency on a recognised stock exchange located in an IFSC (even when no STT is paid in respect of such transactions).
- In case of a company, being a unit located in IFSC and deriving its income solely in convertible foreign exchange, MAT shall be chargeable at the concessional rate of 9% (as against 18.5%) plus applicable surcharge and cess.
- No tax on distribution of profits by a company, being a unit located in IFSC, deriving income solely in convertible foreign exchange, on any amount declared, distributed or paid by such company, by way of dividends (whether interim or otherwise) on or after the 1 April 2017 out of its current income, either in the hands of the company or the person receiving such dividend.

The provisions relating to STT and CTT are proposed to be effective from 1 June 2016.

- **Long-term capital gains on 'unlisted securities'**

Existing provisions provide for a tax rate of 10% on long-term capital gain to non-residents on transfer of 'unlisted securities'. Presently, there is an ambiguity whether the term 'unlisted securities' will include shares of a private limited company.

It is proposed to extend the concessional tax rate of 10% to long-term capital gains arising to non-residents from transfer of shares of a company not being a company in which public is substantially interested.

- **Period of holding in respect of unlisted shares**

The Finance Minister, in his speech has announced that the minimum period of holding for unlisted shares for qualifying as a long-term capital asset is to be reduced to 2 years from 3 years. However, the Bill contains no provision to this effect.

- **Securities Transaction Tax (STT)**

STT on sale of an option in securities where option is not exercised is proposed to be increased from 0.017% to 0.05%. The same would be effective from 1 June 2016.

Indirect Tax Proposals

- The Bill proposes to insert Chapter VI for levy of Krishi Kalyan Cess ('KKC') on taxable services at the rate of 0.5% of the value of such services with the objective of financing and promoting initiatives to improve agriculture. This Cess will be levied from 1 June 2016. The Budget speech indicates that CENVAT credit will be available for KKC.
- Mega Exemption Notification has been amended to exempt services provided by SEBI to protect the interest of investors and promote, develop and regulate securities market.
- Reverse charge mechanism in respect of services provided or agreed to be provided by a mutual fund agent or distributor to a mutual fund or asset management company has been eliminated. Therefore, going forward, the service providers i.e. mutual fund agent / distributor shall be the person responsible for discharging service tax liability.
- Cenvat Credit Rules has been amended wherein a banking company and financial institution including NBFC, for the purpose of reversal of credit pertaining to exempt services, has been given the flexibility to choose any of the option available under rule 6(3) or reverse every month 50% of the credit availed on inputs and input services.

Our Comments

The financial services sector has been granted its fair share of focus in this Budget in terms of both, policy reforms and taxation. Relaxations in foreign investment limits is a welcome move. The Budget has addressed several tax representations made by the financial services industry thus giving it a thumbs up by the industry.

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