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Union Budget 2020

I. The vision: "Ease of Living"

On February 1st, the Finance Minister of India presented the Union Budget 2020. The first in the new decade, it claims to be trend setting the years to come. Under the motto "ease of living", it strives to promote development around the following themes:

Aspirational India

Areas such as agriculture, irrigation, rural development, wellness, water, sanitation, education and skill setting are given priorities.

The **agricultural sector** is still the most important sector in the Indian economy contributing 18% of GDP and giving employment to around 50% of the population. The 16-points action plan envisages the building of efficient cold supply chains and warehousing, liberalizing the market and implementation of integrated farming solutions, availability of financing, adopting sustainable cropping patterns and usage of more technologies. The identified key priorities in the sector open up many opportunities for foreign investment.

One of the major promises and at the same time of the major challenges of both Modi Governments so far, has been to create more **employment** opportunities for the young Indian workforce joining the labour market every year. The current labour law reforms which are on top of the legislative agenda of the Government aim at easing the framework for manufacturing establishments in India.

So far, the restrictions on termination of employment of workers under the Industrial Disputes Act, 1947 has been seen as one of the main hurdles for the "Make in India" manufacturing revolution that was hoped for. Further challenges being the education system and the growing concern of employability. Educational reforms and education initiatives funded by the Government are expected to push for change in that area too.

Economic Development

Under the theme economic development, the focus is clearly on manufacturing sector and strengthening the hard infrastructure as well as the growing energy supply. The Government is proposing to spend USD 14 -13824 for infrastructure and build a National Infrastructure Pipeline.

Some of the projects in the coming years are building of around 15.000 km highways, economic corridors and other roads. In the railway sector – the electrification of 27.000 km railways, setting up a large solar power capacity alongside railways, re-development of 4 major stations and operation of 150 trains under Public Private Partnership mode, the development of the Mumbai-Ahmedabad high speed train and the building of 148 km metro line in Bangalore.

In addition, the air transportation sector is in the focus, with the Government planning to build 100 new airports in the following 4 years.

In the sea transportation sector, it is planned to privatize one seaport and to modernize other ports to achieve global competiveness.

Overall, the Government is pursuing ambitious plans and relying on foreign investment to support the infrastructure projects.

Caring Society

The third theme focuses on Women & Child, Social Welfare, Culture, Tourism, Environment and Climate Change.

II. Key Takeaways

After the landmark reform of the indirect taxes in 2017 during the first term of Prime Minister Modi and the introduction of Goods and Service Tax, the Government has started to reform the direct tax regime gradually in the second term.

The first step was initiated on September 20st 2019 when the Indian government announced the reduced Corporate Tax rates and other fiscal reliefs by notifying the Taxation Laws (Amendment) Ordinance, 2019 (“Ordinance”), which was later enacted and notified on December 11th 2019.

The abolition of Dividend Distribution Tax is the second important step in reducing effective corporate tax rate in India and a major takeaway for foreign companies.

1. Corporate Tax

Dividend Distribution Tax (DDT)

Currently if a foreign shareholder of an Indian company or units of a mutual fund receive dividends, the Indian Company is required to pay DDT. The non-resident shareholders often have to pay taxes in the home country and are exposed to double taxation without the option to set off the distribution tax from the taxable income.

With the abolishment of DDT, dividend income will be only taxable in the hands of the recipient (shareholder). Tax Deducted at Source (TDS) on such dividend incomes will be levied at the rate of 10 per cent if it exceeds INR 5, 000 in a financial year.

To avoid the cascading effect in case of holding structures, the Government suggests deducting the income received by a domestic company from dividends from another domestic company if the dividends are distributed at latest 1 month before the deadline for filing income tax return.

2. Corporate Tax – Power Generation

In September 2019 the corporate tax rate for all domestic companies (if they do not avail any specified exemption, incentive and not carry forward any loss from an earlier FY) was cut from previously 30% to 22%.

Additionally all manufacturing companies incorporated in India after October 1st, 2019 and which start manufacturing before March 23, 2023 can opt to be taxed at a reduced tax rate of 15 % if they fulfil certain conditions.

In both cases the applicability of minimum alternate tax (MAT) which was otherwise reduced from 18,5 to 15% was excluded completely. However those companies continue to be subject to an additional surcharge rate of 10 percent on income tax payable irrespective of their income making the effective tax rates 17% and 25,17% respectively.

The Government is now proposing to extend the definition of manufacturing to include the generation of **electricity**.

It also suggests a clarifying amendment so that a company can opt for the new concessional tax rates and still claim **depreciation on capital expenditure**.

It further proposes to extend the period for availing 100% deduction of profits derived from the business of developing or building affordable housing projects for one more year until 31st March 2021.

Safe Harbour Rules

Under the proposed Financial Bill, the determination of attribution of income in case of a non-resident person to the permanent establishment (PE) shall fall within the scope of Safe harbour rules (SHR) and Advance Pricing Agreements (APA).

SHR provides tax certainty for relatively smaller cases for future years on general terms, while APA provides tax certainty on case-to-case basis for up to five future and four earlier years (rollback).

This is a positive step and will reduce the risk for foreign companies with PE in India limiting the discretion of the Assessing Officer and curb litigation. The Rules are yet to be notified.

Exemption Income Tax Return

The Financial Bill includes an exemption for non-residents from filing Income tax return in case their total income consists of Royalty or Fees for Technical Services, provided TDS on such income has been deducted at the prescribed rates.

The Proposal will have positive impact on the operations of foreign companies providing technical services in India, which do not have a PE in India.

Tax Concession for Foreign Investments

It is proposed to incentivise investments by Sovereign Wealth Funds of foreign governments in the priority sectors, by granting 100% tax exemption to their interest, dividend and capital gains income in respect of investment made in infrastructure and other 36 notified sectors before 31st March 2024 and with a minimum locking period of 3 years.

Exemption – Sovereign Wealth Fund

In order to promote investment of sovereign wealth fund, including the wholly owned subsidiary of Abu Dhabi Investment Authority (ADIA), it is suggested to insert an exemption for income from dividends, interest or long-term capital gains arising from an investment in an Indian enterprise carrying on the business of developing, operating or maintaining any infrastructure facility if the investment is made before 31st March, 2024 and held for at least three years.

Concessional Rate – Extension

The Bill provides for an extension until 1st July, 2023 of the concessional rate of 5% applicable to interest payments to Foreign Institutional Investors (FII) and Qualified Foreign Investors (QFIs) on their investment in Government securities and Rupee Denominated Bond (RDB) of an Indian company (194LD).

The same rate and the same extended period shall be applicable also on interest paid to non-residents under an overseas loan agreement, long-term infrastructural bonds approved by the Central Government and by way of issue of rupee denominated bond. For long-term bond or Rupee Denominated Bond (RDB), which is listed only on a recognized stock exchange located in an International Financial Services Centre (IFSC) the rate shall be even 4%.

3. Personal Income Tax

Taxation of Expats – New Residency Provisions

A major change that affects foreign employees in India is the modification of the definition “not ordinarily resident”.

A person is treated as resident if she/he has spent 182 days or more in India in a year. There are two types of residents: ordinarily and not ordinarily. The former is taxed only on the income accrued or arisen in India whereas the latter is taxed on the global income.

Under the old provisions a “not ordinarily resident” was defined as an individual who has been a non-resident in India in 9 out of 10 previous years preceding that year, or has during the seven previous years preceding that year been in India for a period(s) of 729 days or less.

The proposed amendments simplify and relax the definition of a not-ordinarily resident to the condition of having been in India for less than 7 out of the previous 10 years. No accumulation of days will take place.

Boosting Consumption

In order to boost the consumption of the middle class in India (up to USD 21.000 annual salary) and to simplify the Income tax laws, the Government has proposed optional reduced slab rates if certain deductions are not availed.

Surcharge and educational cess rates remain the same.

4. Tax Litigation

Tax Amnesty

Pending litigation is slowing down the effectiveness of tax authorities in India. After the implementation of an amnesty scheme during the last budget related to indirect taxes, now the Government is planning an amnesty for direct taxes. Under the scheme, a taxpayer would be required to pay only the amount of the disputed taxes and will get complete waiver of interest and penalty provided he pays by 31st March 2020. After the deadline, taxpayers will have to pay some additional amount. The scheme will remain open until 30th June 2020.

E-Appeal Scheme

Eliminating human interface through digital technology has been in the focus of the Government in order to reduce corruption and improve the efficiency of the fiscal authorities. The recently introduced faceless assessment will be followed by faceless appellate proceedings through launching an e-appeal scheme.

From the perspective of foreign companies, disputes with tax authorities over formation of PE of foreign companies, profit attribution, TDS deductions, transfer pricing etc. have been a grey area and subject to substantial litigation in India. The new scheme a step forward to achieving greater efficiency, transparency and accountability.

Taxpayers’ Charter

Another move to improve relationship between tax authorities and taxpayers is the proposal to mandate the Central Board of Direct Taxes (CBDT) to adopt a Taxpayers’ Charter. The details and content of the charter shall be notified soon.

5. Tax Collection – Tax at Source

Contract Manufacturing – “Work”

Under the current regime, a person is obliged to deduct tax at source for payments to residents (1% to individuals and 2% in all other cases) for contract work, including supply of labour for carrying out any work. If the value of the material is separately stated on the invoice, only on the work and if not on the whole amount.

The definition of “work” explicitly excludes manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from a person, other than such customer.

In the past many contract manufacturer have procured the raw materials from related parties and were not obliged to deduct TDS under the exception.

The Government is proposing to amend the provision and include “*such customer* ***or its associate***”, so that associated companies will be obliged also to deduct TDS.

TDS – Fees for Technical Services

Currently the tax deduction at source (TDS) rate on fees for technical or professional services, remuneration, commission or royalty is 10% on all payments to a resident.

The TDS rate on payments for carrying out any work is 1% to individuals and Hindu-undivided families and 2% to all other entities.

Because of increased litigation and the difficulties to distinguish between contract work and technical services in many cases, it is suggested to reduce the TDS rate on fees for technical services (other than professional services) to 2%. In all other cases, TDS would remain 10%.

The TDS rate of 10%, which is applied on payments to non-residents and the respective DTAA, will remain unchanged.

TDS on E-Commerce Transactions

E-commerce operator would be required to deduct 1% on the gross amount of sales or services (if turnover > 5 Lakh INR) to the account of E-commerce participants.

TCS – Section 206C

Currently less than 5% of the Indian population pay taxes. Only around 60 Mio out of 1,3 billion people have filed income tax return in the previous year. Although there has been steady increase in the number of filings, still the overwhelming majority of the population is not paying any taxes.

In order to widen and deepen the tax net, it is proposed impose a levy of 5%-10% TCS on overseas remittance under the Liberalized Remittance Scheme and on the sale of overseas tour packages unless the buyer is liable to deduct tax at source under any other provision of the Act.

Further, TCS of 0.1% or 0.2% (if no PAN or Adhaar) shall now be levied on all sales of goods worth more than 5.000.000 INR if the total turnover from the business is > 10 crore INR. Currently TCS was only compulsory in trading with alcohol, liquor, forest produce, scrap etc.

6. International Taxation

OECD Convention

On 1st October 2019, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (commonly referred to as MLI) has entered into force in India and will be applicable on India’s DTAAs from FY 2020-21 onwards.

In order to empower the Government to modify the existing DTAAs and adopt the provisions of MLI, the Financial bill proposes changes to the existing ITA.

Significant Economic Presence

The Bill recommends to defer the applicability of the provisions relating to significant economic presence of non-residents in India to AY 2022-23, as the discussion on this issue is still going on in G20-OECD BEPS project and the “numbers of users” and “aggregate amount of payments” threshold relating to determination of significant economic presence have not been notified yet.

7. Indirect Taxes

Goods and Service Tax – GST

The Fifteenth Finance Commission (FFC) estimates GST evasion at 2, 4% of the GDP in India and 40% of the GST collection target according to a recent report.

In order to improve compliance and collection efficiency of GST the Government is suggesting inserting penalty provisions for the supply of goods and services without issuing of an invoice or for issuing of an invoice without the actual supply of such goods or services. The recipient who utilizes or distributes input tax credit in contravention of the provisions or a person trading with fake invoices shall be also punishable.

Free Trade Agreements – Supervision

Increased imports under FTA and undue claims to benefits are seen as a contributing factor to the rise of the trade deficit. The Bill suggests stricter control and proposes a new section 28DA “Administration of Rules of Origin under Trade Agreement” for defining the procedure to claim a preferential rate of duty. The Government is also planning to review the Rules of Origin requirements in the coming months.

Make in India – Protectionist Measures

In order to promote Make in India and support the domestic manufacturers of **medical devices**, it is proposed to impose an additional 5% “Health Cess” on the estimated import value of such goods. Only inputs used in manufacturing medical devices or medical devices, which are exempted from Basic Custom Duty, shall be also exempted from Health Cess.

Basic Customs Duty

Basic Customs Duty Rates have also been increased for other commodities such as completely built units of commercial electric vehicles, parts for mobile phones, refrigerators, air conditioners etc.

On the other hand, with an aim to boost domestic manufacturing in mobile phones, electronic equipment and semi-conductor packaging, and to attract investments, the Government is proposing a new scheme, details of which will be provided later.

Conclusion

While there have been some positive proposals to reduce effective tax burden on companies in India (especially newly established manufacturing companies), to increase predictability in tax related disputes and reduce the compliance burden on non-resident companies without PE, the proposed Bill is at the same time imposing protectionist barriers on some imports and thus tightening the opportunities for foreign companies.

Given the low tax compliance and collection efficiency in India, the focus of the Government is on taking measures to improve performance. The proposed Taxpayer’s Charter and further eliminating the human interface on the other hand is aiming increase the fairness and decrease corruption opportunities in interactions with the tax administration.

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