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Dear Reader,

Being an election year, 2024 saw its second budget being presented before Parliament today. With the presentation of the Finance Bill (No. 2), 2024 ("**Finance Bill**") – her seventh consecutive budget – Mrs. Nirmala Sitharaman has earned the distinct honour of having presented the most consecutive budgets by any finance minister in the history of India. We congratulate her on this achievement.

The focus of the budget was to be progressive and to create a simple, certain, streamlined and friendly tax framework. And to some extent, it succeeds! For example, we had argued that the "diabolical" angel tax ought to go if India were to foster an environment for her entrepreneurs to flourish. That has happened, and Section 56(2)*(viib)* of the Income-tax Act, 1961 ("**ITA**") has been proposed to be abolished! Albeit partially, the most difficult aspects of the controversial Equalisation Levy have also been proposed to be rolled back. This is a step in the correct direction. A step also appears to have been taken towards reigning in the aggressive stance of the Indian tax authorities with the Vivaad se Vishwas Scheme.

However, a close look at the text of the Finance Bill reveals that not everything about the it is straightforward. Some of the provisions such as the change of scope and characterization of income from the buy-back of shares by a company from capital gains to dividends, the taxation of cruise ship operators is patently problematic.

Whatever may have been achieved or missed in this budget might be ephemeral after all. The finance minister has announced a "comprehensive review of the Income-Tax Act, 1961". This is intended to be done with the goal of making the ITA "concise, lucid, easy to read and understand." To achieve this, the minister has given herself and her team merely 6 months. We wish the finance minister all the best for this much needed endeavour.

We at Janssen-Sanghavi & Associates are laser-focussed on international taxation and have been pouring over the minutiae of the fine print relevant to cross-border taxation. And invariably, despite the best efforts of the powers that be, the devil always lies in the details. We are proud to present to you the very first edition of our Budget Analysis.

We hope you will find our thoughts on the final budget of 2024 enjoyable and valuable. Please feel free to contact us should you have any questions or feedback for of our work.

With best wishes,
Dr. Dhruv Janssen-Sanghavi

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1. Addio Diablo - Angel Tax Abolished!

Following the recommendations of the 2012 "White Paper on Black Money", the Finance Bill 2012 had introduced the "angel tax". This was a globally unprecedented tax on capital received from residents of India by a company for the issuance of shares to the extent it could be argued by the tax authorities that the consideration for the shares exceeded the fair market value of the shares. This was levied on the difference between the actual consideration received for the shares and the FMV as determined by one of the formulae prescribed by the Income Tax Rules. In 2023, the scope of the angel tax was extended to investments made by non-residents.

The tax was sought to be justified on the ground that the tax would prevent the introduction of "black money" (an Indian term for *tainted money*). In fact, the policy underlying the angel tax was diametrically opposed to India's foreign direct investment policy, which treated the same FMV threshold as a mere floor price. That policy had allowed Indian entrepreneurs to maximise the valuations of their companies. Unfortunately, the angel tax treated the FMV as the ceiling price for the issuance of shares of an Indian company.

This caused a great burden on investee companies, who were forced to dilute more equity and cede greater control than necessary to fund their capital requirements.

In line with the recommendations made by several experts including by Janssen-Sanghavi & Associates, the finance has finally abolished the angel tax, which was more diabolical than angelic.

This development must come as a welcome relief for Indian companies, although it comes into force with effect from 1 April 2025. The issue of whether the angel tax has been levied correctly, and whether it was tantamount to an unconstitutional expropriation of capital remain sub-judice before various High Courts in India.

2. A convoluted regime for the taxation of international cruise ship operators

The Finance Bill proposes certain amendments purportedly aimed at promoting the operation of cruise ships by foreign companies in India. The explanatory memorandum states these changes are aimed at making India attractive destination for international cruise ship operators and tourists, and to popularise the idea of cruise ships amongst Indians.

Despite those stated objectives, it appears that the proposed regime puts cruise-ship operators at a distinct disadvantage in comparison with the existing regime under Section 44B of the ITA. Currently, non-resident shipping companies are taxed under Section 44B on presumptive profits calculated at 7.5 percent of:

- amounts paid or payable (whether in or out of India) to the taxpayer for the carriage of, *inter alia*, passengers at any port in India; and
- amounts received or deemed to be received in India for the carriage of, *inter alia*, passengers at any port outside India.

The Finance Bill proposes to exclude operators of cruise ships from the scope of Section 44B which addresses currently the shipping business generally. Instead, it proposes to bring them under the scope of the proposed Section 44BBC of the ITA. The mechanism under the proposed section may seem nearly identical to Section 44B at first glance. However, a closer examination reveals a radically different approach to determining the tax base on a presumptive basis on two counts. First, the presumptive profits are calculated at 20 per cent of the payments received by the cruise ship operator for the carriage of passengers. Secondly, language pertaining to the gross amount on which the rate of presumptive profits is to be applied appears to be much wider. Presumptive profits are calculated at 20 per cent of:

- the amount paid or payable to the taxpayer for the carriage of passengers; and
- the amount received or deemed be received on account of the carriage of passengers.

Unlike Section 44B, the proposed provision makes no reference to carriage of passengers “at any port in India”, or “received or deemed to be received in India”. There may be operators who operate only a segment, but not the whole, of their cruise in India, but the presumptive profits are calculated with reference to the revenue earned for the entirety of the international cruise.

None of these provisions should be of much import for cruise operators who are residents of a country with which India has concluded a tax treaty. However, a number of cruise ship operators are residents of countries like the Bahamas and Panama, which do not have an income tax treaty with India. The proposed Section 44BBC does not appear to achieve the ends it purports to achieve, but rather does quite the opposite. The finance minister may do well to reconsider its introduction.

The Finance Bill also proposes the insertion of section 10(15B) to exempt payments for lease rental contracts made by a company that opts to be taxed under section 44BBC. The exemption applies if the recipient company is a foreign entity and both the recipient company and the company opting for the presumptive regime are subsidiaries of the same holding company. This exemption should be available up to the assessment year 2030-31. One wonders if such an exemption might be necessary, at least insofar as the lessor entity is a resident of a state with which India has a tax treaty. Whilst such rental payments may qualify as royalties which are deemed to accrue or arise in India,[1] it is unlikely that such payments should qualify as royalties for treaty purposes, nor are the likely to be attributable to a lessor company's permanent establishment in India.

The Finance Minister may find it useful to reconsider the utility of her proposals in light of their stated motives. The two appear to be incompatible.

3. Abolition of the expanded scope of the equalisation levy

India introduced an equalisation levy of 6 per cent in the year 2016 under Chapter VIII of the Finance Act, 2016. The scope of this levy was limited to the consideration received for "online advertisement, any provision for digital advertising space, or any facility or service for the purpose of online advertisement" provided by non-residents in business-to-business transactions. The scope of the equalisation levy was expanded in 2020 to introduce a levy of 2 per cent on the consideration received or receivable for e-commerce supply of goods or services by an e-commerce operator. The Finance Bill proposes to disband the expanded scope of the 2 per cent equalisation levy which was applicable to e-commerce operators since 2020. Nonetheless, the roll back is only partial, and the original levy of 6 per cent on online advertising continues.

The explanatory memorandum to the Finance Bill justifies this partial roll back by citing stakeholder concerns over the ambiguous scope of the levy and the compliance burden it creates. Speaking at another occasion outside Parliament, however, the Finance Minister suggested that the partial roll back of the Equalisation Levy was an expression of India's commitment to achieving a global consensus on the two-pillar solution, albeit only as a package. This reflected India's well-known position that it does not want to subscribe only to pillar two, unless pillar one is also adopted.

Whatever the reasons, the partial roll back of the Equalisation Levy should provide welcome relief to the e-commerce industry because it suffered from several demerits including:

a. A number of scholars have expressed the view that it is substantially similar to taxes covered under Indian tax treaties and therefore, should be within scope

[1] See: Section 9(1)*(vi)(c)* of the ITA read with clause *(iva)* of Explanaton 2 thereof.

of Article 7. Consequently, the question of whether the Equalisation levy could be imposed on e-commerce operators in the absence of a permanent establishment in India is controversial.

b. The equalisation levy has also been criticised for not defining the terms "goods" and "services". This meant that the taxpayer was left to borrow from other laws such as Sale of Goods Act or GST to check the scope of their activities and their liabilities.[2]

c. Section 165A(3)(b) of the Finance Act, 2016, was viewed as being unnecessarily complex. It included within its scope goods and services sold through an e-commerce operator, but only to the extent that the seller was not a resident of India, or that the sales were not effectively connected with a non-resident seller's permanent establishment in India. These complexities made the administration of the equalisation levy difficult for taxpayers.

d. The applicability of the equalisation levy is also contingent on the usage of an Indian IP address. This creates more problems than it solves as through the usage of services like VPN, the IP address can be shifted to other jurisdictions and the user created valuation is affected.

e. Under section 40(1)*(if)* of the Income Tax Act, 1961, a person failing to withhold the equalisation levy should be held liable to pay the amount to the government. E-commerce operators (who are all non-residents) are faced with the burden of collecting and depositing the levy before the due dates, furnishing statements, etc. creating administrative difficulties for taxpayers with no physical presence in India.

4. New scope and characterisation of income from buy-back of shares

Income from the buy-back of shares have been characterised consistently as capital gains in India. This was due to the fact that any profit or gains arising from the "transfer" of a capital asset is taxable as a capital gain. The term "transfer", in turn, is defined in section 2(47) of the ITA, "in relation to a capital asset" to include "the sale, exchange or relinquishment of the asset; or [...] the extinguishment of any rights therein".

The Finance Bill proposes to change this by characterising the entire consideration for the buy-back of shares as deemed dividends under the proposed clause (f) to Section 2(22) of the Income-tax Act, 1961. The allied proposal to Section 57 of the ITA is rather egregious inasmuch as it excludes the possibility to deduct any expenses including the cost of acquisition of the shares from the deemed dividends.

[2] Sanket Goel, *"Equalisation Levy 2.0- The Unresolved Saga"*, [2022] 134 taxmann.com 204 (Article).

The explanatory notes state that the cost of acquisition should contribute to the creation of a capital loss upon the extinguishment of the shareholder's assets. These capital losses could be set-off against other capital gains that the taxpayer may earn. However, this appears to be unfair on two counts: First, whilst dividends are likely to be taxed at the maximum marginal rate applicable to the taxpayer, capital gains are taxed at a lower tax rate. The disallowance of deduction of the cost of acquisition against the dividend income is not in equilibrium with allowing a capital loss to accrue. Secondly, it may be useful to recognise that capital losses can only be set-off against capital gains of a similar type (short-term or long-term),[3] and these losses can only be set off for a period of 8 years. There may be several instances in a cross-border setting in which an investor may not have any capital gains to set the capital losses off against within 8 years. In such a scenario a taxpayer may be forced to write-off its cost of acquisition.

The change of characterisation may also lead to some controversy regarding how such income may be characterised for tax treaty purposes, as the tax implications may be very different in the two scenarios. The standard definition of dividends as used in the equivalent of Article 10 of the OECD Model is:

> "3. The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as <u>income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident</u>" (emphasis supplied).

It appears that the income from the buy-back of shares should, also for tax treaty purposes, qualify as "dividends" under the last limb of Article 10(3). The question remains whether the income should continue to qualify, either exclusively or concurrently, as income from the "alienation" of movable property at least in some of the tax treaties.

Whilst these changes are likely to be controversial, there is positive news too. Companies were liable to an additional charge of tax at the rate of 20 per cent on their undistributed profits upon a pay-out due to the buy-back of shares. This was akin to the erstwhile dividend distribution tax under Section 115-O. Such a secondary tax has now been proposed to be abolished.

[3] Section 74 of the ITA.

There are two schools of thought in how tax treaties should interact with the domestic law. One school of thought believes that "good faith interpretation" the characterisation of income should remain static, in accordance with how it was at the time a tax treaty was concluded. Another school believes that the reference to domestic law of the state applying the tax treaty for the interpretation of undefined terms under Article 3(2) should be dynamic.

The outcome of either approach may be more or less beneficial to the taxpayer depending on the treaty being applied, and the quantum of the capital gain that would accrue if a deduction for the cost of acquisition were available. It appears that the proposal to alter the scope and characterisation of income from buy-back is likely to raise a number of interesting, but uncertain, issues of tax treaty interpretation.

5. Tax rates for capital gains

The Finance Minister, in her speech, stated that the regime for the taxation on capital gains ought to be simplified. To achieve this, she has attempted to streamline tax rates for long-term capital gains, and those applicable to short-term capital gains arising from listed securities. Further, the Finance Bill also proposes to streamline the holding periods for listed securities and other assets to determine whether they are long-term capital assets or short-term capital assets. Listed securities are proposed to be categorised as short-term capital assets if they are held for up to 12 months. Unlisted securities and other assets, on the other hand, are proposed to be categorised as short-term capital assets if they are held for a period up to 24 months.

Perhaps the most radical, and some may posit inequitable, changes to the regime on the taxation on capital gains is the abolition of indexation to correct for inflation for determining the cost of acquisition of capital assets.

The table below provides a comprehensive overview of the rates and holding periods for the computation of taxes on capital gains from various types of assets.

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Particulars	Long-term Rate	Short-term Rate	Holding Period[4]	Indexation Benefit
Specified Mutual Fund[5]/ Market Linked Debenture/ Unlisted bond or debenture[6]	Standard Rates		No Holding Period	NA
Listed Equity Shares	12.5%[7] (Exceeding Rs. 1,25,000)	20%[8]	12 Months	NA
Listed unit of business trust	12.5%[9](Exceeding Rs. 1,25,000)	20%[10]	12 Months	NA
Listed unit of an equity-oriented fund	12.5%[11](Exceeding Rs. 1,25,000)	20%[12]	12 Months	NA
Unlisted Equity Shares	12.50%[13]	Standard rates	24 Months	Removed[14]
Other Assets*	12.50%[15]	Standard rates	24 Months	Removed[16]
Listed bond or debenture	12.50%[17]	Standard rates	24 Months	Abolished[18]

* With the exception of slump sales, which are dealt with specifically in Section 50B of the ITA. Section 50B finds no mention in the Finance Bill, which might be an oversight given the intent to streamline definitions of long-term capital gains and short-term capital gains across different asset classes.

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[4] Section 2(42A) of the ITA.
[5] "Specified Mutual Fund" means: a mutual fund by whatever name called, which invests more than sixty-five per cent. of its total proceeds in debt and money market instruments, or a fund which invests sixty-five per cent. or more of its total proceeds in units of a fund referred to in sub-clause (a) of Section 50AA of the ITA.
[6] Section 50AA of the ITA.
[7] Section 112A of the ITA.
[8] Section 111A of the ITA.
[9] Section 50AA of the ITA.
[10] Section 111A of the ITA.
[11] Section 50AA of the ITA.
[12] Section 111A of the ITA.
[13] Section 112 of the ITA.
[14] 2nd proviso to Section 48 of the ITA.
[15] Section 112 of the ITA.
[16] 2nd proviso to Section 48 of the ITA.
[17] Section 112 of the ITA.
[18] 2nd proviso to Section 48 of the ITA.

Currently, long-term capital gains arising to a non-resident from the transfer of the shares of a company in which the public is not substantially interested (usually an unlisted company) are taxed at the rate of 10 per cent. This rate applies without giving the benefit of accounting for foreign exchange fluctuation.[19]

The Finance Bill proposes to end the reduced 10 per cent rate on such long-term capital gains on 23 July 2024. This implies that long-term capital gains arising from the transfer of shares of a private company should be taxable at the proposed rate of 12.5 per cent. Nonetheless, a non-resident taxpayer would be able to benefit from the 1st proviso to Section 48. This means that capital gains arising from the transfer shares in and debentures of an Indian company shall be computed by reference to the currency which was initially utilised for the acquisition of those assets.

Although a marginally higher tax rate of 12.5 per cent should now apply, the proposed change should protect against the foreign exchange risks. At worst, these risks could have yielded a capital loss in the foreign currency utilised for concluding the acquisition and yet incur a tax liability in India. The proposed change, if adopted, should come as a relief for foreign private equity / venture capital investors who make long-term investments in Indian companies.

6. Securities Transaction Tax on derivatives transaction revised

The recent increase of trading in derivatives has led to volatility and instability in the stock markets. Derivatives trading accounts for a large chunk of the capital markets in India.

In order to stabilise the volatility, and to disincentivise speculative trades, the Finance Bill proposes to increase Securities Transaction Tax rates on the sale of an option in securities from 0.0625% to 0.1% of the option premium, and on sale of a futures contracts for securities from 0.0125% to 0.02% of the price at which such futures contracts are traded.

The amendment should take effect from the 1 October 2024.

7. Tax rates for foreign companies – reduced, but still discriminatory

India is one of the few, if not the only, major economies which taxes foreign companies at a higher tax rate than it does domestic companies. This continues to be the case, but

[19] Section 112(1)(c)(iii) read with first proviso to Section 48 of the ITA.

the Finance Bill does propose to reduce the disparity by reducing the corporate income tax rate applicable to foreign companies from 40 per cent to 35 per cent.

This discriminatory rate of tax has been challenged as being discriminatory in a manner that is prohibited by the equivalent of Article 24(1) and Article 24(3) of the OECD Model. However, Explanation 1 to Section 90 of the ITA states that "the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company". With the exception of some tax treaties, which acknowledge this phenomenon explicitly, the issue remains whether the Explanation 1 is relevant in all scenarios for the interpretation of treaty non-discrimination rules. This should be particularly important for banks who operate traditionally in India through branches.

8. Grossing up of withholding taxes mandatory

It was observed that some residents of India whose income was subjected to withholding taxes in other countries were, despite claiming a credit for the withholding taxes, did not gross up the amount of taxes paid abroad. This amounted to claiming a dual benefit of deducting taxes paid in a foreign company as a deduction as well as claiming a credit for those taxes in India. It has now been clarified abundantly in Section 198 that foreign taxes paid must be grossed up as income before a credit may be claimed in India.

9. International Financial Services Centre

In line with recent budgets, the government has continued its trend of providing substantial benefits to International Financial Services Centre (IFSC) with the aim of easing their operations and further incentivising them as a lucrative investment opportunity. The following changes have been proposed.

a. Expansion of the ambit of specified funds

Section 10(4D) of the Income Tax Act, 1961, exempts any income received by a specified fund for the transfer of a capital asset, on a recognised stock exchange located in the IFSC. The definition of specified funds has been enlarged to encompass within the section- retail schemes (a scheme offered to investors for subscription with no ceiling as to number of investors in the scheme)[20] and

[20] Regulation 2(hh), International Financial Services Centres Authority (Fund Management) Regulations.

exchange traded funds regulated under the regulated under the International Financial Services Centres Authority (Fund Management) Regulations.[21]

b. Expansion of the definition of "recognised clearing corporation"

Section 10(23EE) of the Income Tax Act, 1961, exempts any income of a Core Settlement Guarantee Fund, set up by a recognised clearing corporation. The government has now included a recognised clearing corporation (i.e., IFSCA recognised entities established to undertake the activity of clearing and settlement of trades in securities that are dealt traded on a recognised stock exchange and includes a clearing house)[22]. The intention clearly being to further enhance benefits offered to entities within the IFSC.

c. Relaxation on cash credits

Section 68 of the Income Tax Act, 1961, provides that when a sum credited in the books of a taxpayer, and the explanation offered (if any) for its source is found untenable by the Assessing Officer, the sum may be charged to income-tax as income. However, an exception is carved into Section 68 by way of the third proviso, wherein if a Venture Capital Funds[23] (VCFs) which is regulated by SEBI has such a sum credited to it, the burden of explaining its source or its addition to their income would not take place. The additional onus of proof of explaining the source in the hands of the creditor has thus been done away with. The relaxation which was previously only accorded to VCFs regulated by SEBI has now also been extended to those governed by the IFSCA.[24]

d. Relaxation of interest limitation rules

Section 94B of the ITA reflects India's adoption of the interest limitation rules prescribed by BEPS Action 4. It limits, generally, the deduction of interest payments made by Indian companies or those that are attributable to a non-resident company's permanent establishment in India to 30% of EBITDA.

It is our view that Section 94B violates the non-discrimination rule contained in Article 24(4) of the OECD Model, to the extent it has been adopted in Indian tax treaties. Whilst this issue has not yet been addressed by Indian courts the Finance Bill, excludes the application of Section 94B to finance companies

[21] Clause 4(a) of the Finance Bill.
[22] Regulation 2(1)(n), IFSCA (Market Infrastructure Institutions) Regulations, 2021.
[23] Section 10 (23FB) of the ITA.
[24] Clause 4(c)(ii) of the Finance Bill.

located in the IFSC.[25] This exclusion was already available to Indian companies or permanent establishments of foreign companies which are engaged in the business of banking or insurance, or such class of non-banking financial companies as notified by the Central Government.[26] This was done given the special nature of these businesses.[27] It has now been extended to all finance companies operating in IFSC.

10. Rationalisation of assessment and reassessment timelines

The Indian tax administration suffers from the infamy of often adopting an unreasonably aggressive stance against taxpayers as a norm. The difficulty posed by such a stance was exacerbated by the long timelines granted to the tax authorities towards scrutinizing and reassessing the taxpayer's tax liabilities in India. For instance, the Income tax authorities could reopen tax returns for up to 10 years subsequent to the assessment year in which the tax returns are to be filed. The finance minister has proposed to rationalise these timelines such that tax returns may not be reassessed upon the expiry of 5 years and 3 months beyond the assessment year in which the tax returns were filed. The amendment should take effect from September 1, 2024.

11. Reduced timelines for treating a person failing to withhold taxes as a taxpayer in default

Section 201 of the ITA provides for consequences of failure to withhold taxes by the appropriate person. It provides that the person failing to withhold taxes shall be treated as a taxpayer in default, attracting the same liabilities and penalties as the recipient of income itself.

The law or Section 201(3) provided that a person could be treated as a taxpayer in default for up to 7 years after its failure to withhold taxes from payments made to resident of India. However, it did not prescribe any time limits for such a consequence to arise if the recipient of income were a non-resident.

The Finance Bill proposes to now treat both cases equally. It prescribes a time limit of 6 years for treating the person responsible to withhold taxes as a taxpayer in default.

[25] Clause 28 of the Finance Bill.
[26] Section 94(3) of the ITA.
[27] Ministry of Finance, *Memorandum to the Finance Act, 2017*, p. 25.

This is in consonance with the decisions of the Income-tax Appellate Tribunal in the cases of *Wipro Limited v. ACIT*[28] and *Google India Private Ltd v. ACIT*.[29]

12. Transfers of capital assets by way of gifts, wills, or irrevocable trusts

Section 47 of the ITA excludes certain transfers of capital assets from the scope of Section 45, which provides for a tax on capital gains. As it is worded currently, Section 47(iii) excluded any transfer of a capital under a gift, will or irrevocable trust from the scope of Section 45. The only scenario in which Section 47(iii) contemplated for capital gains to be taxable was for the transfer under any gift or irrevocable trust of the shares, debentures or warrants by a company under the Specified Employees' Stock Option Plans (ESOPs) or Scheme.

It is proposed that only the operation of Section of 47(iii) should be limited only in cases of natural love and affection lest it should result in the avoidance of tax on capital gains. To this end, the Finance Bill proposes to limit the scope of the provision to cover only transfers made by an Individual or a Hindu Undivided Family (HUF). Consequently, companies and other legal entities should be liable to tax of capital gains should they gift shares, debentures or any other capital assets away.

[28] ITA Nos.1215 to 1220/Bang/2014), dated 21 June 2019.
[29] IT(TP)A Nos. 1511 to 1518/Bang/2013), dated 23 October 2017.