Janssen-Sanghavi & Associates
International Tax Counsel
Mumbai | Amsterdam

Saturday, 2 February 2025

Dear Readers,

The Indian Finance Minister, Mrs. Nirmala Sitharaman, presented the Finance Bill 2025 in the lower house of Parliament yesterday. The theme of her record extending eighth consecutive budget presentation may be summarised in her slogan "trust first, scrutinise later". Alas, we must scrutinise closely the amendments, sparse as they may be, first!

Albeit limited in number, the Finance Bill does introduce some interesting changes to the Income-tax Act, 1961, which are relevant for cross-border transactions. One of the more significant changes in India's approach to international taxation comes in the form of a quasi-safe harbour in India's transfer pricing rules. According to this rule, a taxpayer has the option to agree to an arm's length price with respect to similar transactions for a block period of 3 years. This should abate, at least partially, the volume transfer pricing litigation in India, which is unparalleled elsewhere.

Another interesting development is with respect to the introduction of a presumptive income mechanism for cross-border payments for services and technology in the electronics manufacturing sector. Whilst this could indeed reduce the profit-eroding impact of gross-basis withholding taxes on royalties and fees for technical services, the question remains: are these changes are fit for purpose?

The Finance Bill extends the sunset clauses on a number of exemptions and other benefits available to certain investment funds and their investors. A number of benefits have been extended for units operating in the International Financial Services Centre ("IFSC"). It also extends the definition of "virtual digital assets" to encompass all "crypto-assets". But the Bill also creates a rather confusing reporting requirement.

It is not surprising that the income-tax amendments were sparse, given that the ministry's efforts may have been focused on the drafting the new Income Tax Bill. The Finance Minister has promised to table the new law in Parliament as soon as next week. We have been informed by senior officials from the ministry that the new bill does not reflect any policy changes. It merely rewrites the existing law concisely, simply, and clearly. The Finance Minister has promised to reduce its volume to half.

Whilst we reserve comment on how effectively the law may have been rewritten, we congratulate the Finance Minister and her team on delivering the Bill, as promised, merely six months after its announcement! For perspective, the UK had announced a similar project to rewrite its direct tax laws in December 1996. It took nearly a decade and a half before its conclusion in April 2010.

We hope that you will enjoy reading our analysis of the international tax implications of the Finance Bill 2025. Please do not hesitate to contact us should you have any questions or feedback on our work.

With best wishes,
Dr. Dhruv Janssen-Sanghavi
Mumbai

Table of Contents

JS&A International Tax Counsel

1. A new presumptive tax for technology transfers and allied services

India has aspired, for some time now, to be a global hub for electric system design and manufacturing. The Ministry of Electronics and Information Technology has launched a number of schemes to attract state-of-the-art technology and know-how to achieve this. However, the transfer of technology and allied services have attracted burdensome withholding taxes. Royalties and fees for technical services, for example, attract a withholding tax of 20 per cent on the gross amount of the payment. In cases where a non-resident provides such technology or services through a permanent establishment, tax is levied on a net-basis. However, not only is the process of attribution of profits to a permanent establishment complicated, they are also taxable at a discriminatory rate of 35 per cent.

The Finance Bill proposes to introduce a presumptive income regime under Section 44BBD in the Income-tax Act 1961 for stimulating the transfer of technology and know-how. It presumes a non-resident's taxable income to be 25 per cent the gross payments it received for the provision of technology or services to a resident of India. This technology or services should be for setting up an electronics manufacturing facility or in connection with the manufacture or production of electronics in India. This translates to a tax rate of 8.75 per cent[1] on the gross payments received by a non-resident.

But does the presumptive income regime do enough to make India an attractive destination of the world's leading technology and know-how?

The effective tax rates may seem like a substantial reduction in comparison to the withholding tax rates prescribed under the Income-tax Act itself. It may also seem to be a useful reduction for taxpayers who are residents of countries like the Italy,[2] United States[3] or the United Kingdom.[4] However, they are barely different from India's tax treaty rate of 10 per cent with countries like the Netherlands, Germany, Switzerland, France and Japan.

The real problem with technology companies does not appear to be the fact that they have to pay taxes in India. The real issue appears to lie in the fact that these are capital intensive industries, requiring constant upgradation to meet the demands of fast-paced development. This can make technology companies' profitability cyclical. Both presumptive income taxation and withholding taxes are applied on gross payments regardless of whether the taxpayer actually earns a profit or loss. These taxes can erode a taxpayer's profits in low profit scenarios or even exacerbate its losses.

The presumptive income regime does not seem adequate to make India as attractive as the ministry seems to believe. A thorough review of the policy and the law in this regard ought to be undertaken in order to bridge the gap between the two.

---

1 This rate increases to 9.28 per cent or 9.56 per cent if one factors in the applicable surcharge and cess.

2 India's tax treaty with Italy also provides for a maximum withholding tax rate of 20 per cent on royalties and fees for technical services.

3 India's tax treaty with the United States provides for a maximum withholding tax rate of 15 per cent on royalties and fees for included services.

4 India's tax treaty with the United States provides for a maximum withholding tax rate of 15 per cent on royalties and fees for technical services.

2. Optional quasi-safe harbours for transfer pricing

Transfer pricing has been the source of much international tax litigation in India. Given that income from international transactions (and specified domestic transactions) is computed annually having regard to the arm's length, taxpayers often face and litigate identical issues repeatedly. The Finance Bill 2025 proposes useful amendments to Section 92CA of the Income-tax Act, which prescribes the procedure of referring questions of determination of the arm's length to a "transfer pricing officer". These changes should help abate repetitive transfer pricing litigation.

The Finance Bill proposes to give taxpayers the option to apply the determination of an arm's length price to similar transactions for a block of three consecutive tax years. This is subject to the transfer pricing officer declaring that the taxpayer's assertion that the transfer pricing is at arm's length. Such a declaration should be made within one month, and in writing, by the transfer pricing officer. The form, manner and timelines of exercising such an option are yet to be prescribed.

The transfer pricing officer is also required to examine and determine the arm's length price in relation to such similar transactions for each of the tax years in question.

Interestingly, no procedure has been prescribed for how to implement the option for applying the arm's length price to a block of three years. To address this, sub-sections 11 and 12 to section 92CA of the Income-tax Act empower the Central Board of Direct Taxes to issue guidelines. Every guideline so issued must be tabled before both houses of Parliament for approval.

3. Virtual Digital Assets & Crypto-assets

The Finance Act 2022 had introduced a separate regime for the taxation on income derived from the transfer of "virtual digital assets". Such income has since been taxable at the rate of 30 per cent, and most deductions are disallowed. Payments for the transfer of these assets are subject to a withholding tax of 1 per cent.

The Finance Bill 2025 continues its tough stance against virtual digital assets, and seeks to ensure that no crypto-asset escapes from the definition of a "virtual digital asset".

A definition of a virtual digital asset in Section 2(47A) of the Income-tax Act is now proposed to be expanded to enumerate "any crypto-asset being a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology to validate and secure transactions", whether it is included in original definition.

The Finance Bill 2025 also introduces a new Section 285BAA in the Income-tax Act to impose a reporting requirement for transactions of "crypto-assets". The provision uses the term "a reporting entity", but the details of who this entity might be are yet to be prescribed. The form and manner of such reporting are also yet to be prescribed.

It is noteworthy that the reporting obligation is cast for transactions of "crypto-assets", and not all "virtual digital assets". It is nonetheless ambiguous whether there is a difference between the two concepts. It may be useful, apropos the Finance Minister's dedication to tax laws which are clear, direct, and *simple to understand*, to extend the reporting requirements to all virtual digital assets. This should prevent any controversy with respect to whether a virtual digital asset is a crypto-asset, especially because mis-reporting or non-reporting carries penal consequences.

4. Investment funds & Capital gains

4.1. Definition of a "capital asset"

Section 2(14) of the Income-tax Act defines a capital asset. This includes any property of any kind held by a taxpayer, but excludes assets such as stock in trade and personal assets. Specifically included are any securities held by a Foreign Portfolio Investor in accordance with the regulations of the Securities and Exchange Board of India. This is irrespective of whether these securities are held as investments or as stock-in-trade. This ensures that all trading and investment income of an FPI from the transfer of such securities is characterised as capital gains.

The Finance Bill 2025 proposes to expand this deeming fiction also to any securities held by a Category I or Category II Alternative Investment Fund. We shall refer to these simply as "investment funds".

It is relevant to note that Section 115UB of the Income-tax Act provides for the taxation on income of, and from, an investment fund. It states that any income earned by a person, who owns units in an investment fund, from the investments that the fund makes, will be taxed as if that person made the investments directly. Therefore, the investment fund acts as a pass-through entity for the unit holder.

The amendment to Section 2(14) clarifies that income from the sale of any securities held by an investment fund would result in capital gains, and not be characterised as business income of the investment fund. Therefore, income earned by a unit holder in an investment fund from the sale of an asset by such fund would result in capital gains in the hands of the unit holder.

4.2. Parity of tax rates for long-term capital gains

The Finance Act (No. 2) of 2024 had introduced a tax rate of 12.5 per cent on long-term capital gains for both residents and non-residents. Correspondingly, the special provision for Foreign Portfolio Investors was also amended to increase the tax rate on long-term gains from 10 per cent to 12.5 per cent. That amendment was made specifically for gains covered under Section 112A (primarily related to listed securities) of the Income-tax Act. However, the 10 per cent rate continued to apply to Foreign Portfolio Investors on long-term gains earned from other securities. The Finance Bill 2025 proposes to homogenise the tax rate for all long-term capital gains also for Foreign Portfolio Investors to 12.5 per cent.

5. Significant economic presence

Business profits are deemed to be *accrue or arise* in India if they are earned directly or indirectly through or from any *business connection* in India. The Finance Act, 2018 had inserted an explanation that the significant economic presence of a non-resident in India shall constitute *business connection*.

This explanation raised concerns that the mere functions of purchasing goods in India may result in a significant economic presence in India. The Finance Bill 2025 excludes expressly activities confined to the purchase of goods in India for the purpose of export from the scope of a “significant economic presence”.

6. IFSC related amendments

6.1. Fund Managers in IFSC

Section 9A of the Income-tax Act provides for scenarios which are excluded from the scope of a “business connection”. Subject to certain conditions, one such exclusion is fund management activities carried out through an eligible fund manager acting on behalf of an eligible investment fund. One such condition is that the aggregate participation or investment in the fund by persons who are residents of India does not exceed five per cent of the corpus of the fund.

The Finance Bill 2025 proposes to test whether the 5 per cent participation threshold semi-annually, instead of annually. This would occur on 1 April and 1 October of every tax year. However, even if the 5 per cent threshold is found to have been breached on either date, the fund may nonetheless bring the participation within the 5 per cent threshold within four months thereafter. This would enable it to retain its exclusion from the scope of having a business connection in India.

6.2. Constructive dividends & Treasury Functions

As is the case with many jurisdictions, the Indian Income-tax Act also contains a provision for constructive dividends in relation to loans between related parties. Unlike most jurisdictions, however, it treats the entire loan given by a company to its shareholder as a dividend. This is limited to a shareholder who is the beneficial owner of at least 10 per cent of the voting power in the creditor company, and as long as the company extending the loan has accumulated profits.

This deeming fiction has now been proposed to be relaxed in certain cases. Loans and advances between group entities are excluded from the scope of the deemed dividends if the following conditions are fulfilled. One of the parties to the loan transaction or advance is a “parent entity” or “principle entity” outside India, and the other is a “group entity” which is a “finance company” or a “finance unit” established in an IFSC. The finance company or unit should be set up as a global or regional corporate treasury centre for undertaking treasury activities or treasury services.

The Finance Bill does not define the terms “group entity”, “parent entity” and “principal entity”. The conditions to qualify as such are yet to be prescribed.

6.3. Exemptions for FPI’s

Section 10(4E) of the Income-tax Act exempts non-residents on income from the transfer of non-deliverable forward contracts or offshore derivative instruments or over the-counter derivatives, or the distribution of income on offshore derivative instruments entered into with those offshore banking units of an IFSC which is referred to in section 80LA (1A) of the Income-tax Act.

The Finance Bill 2025 proposes to extend the exemption to the contracts entered into with Foreign Portfolio Investors being units subject to fulfilment of certain conditions. This amendment will be applicable from 1 April 2026.

6.4. Capital gains exemptions for shipping and aircraft leasing companies

Section 10(4H) of the Income-tax Act exempts non-residents and IFSC units engaged in aircraft leasing on tax on capital gains on transfer of equity shares of domestic companies being IFSC Units which have commenced their operations on or before the 31 March 2026. The Finance Bill proposes to extend this deadline to 31 March 2030.

Further, the Finance Bill also proposes to extend this exemption from tax on capital gains to non-residents and IFSC units from the transfer of equity shares of IFSC units which are engaged in ship leasing. Further, "ships" have been defined to mean a ship or an ocean vessel, engine of a ship or ocean vessel, or any part thereof.

6.5. Relocations to IFSC

Section 47 of the Income-tax Act excludes certain transactions from resulting in capital gains. Section 47 *(viiad)* provides currently that the transfer of shares, units, or interests pursuant the relocation of an "original fund" to an IFSC based Category I, Category II or a Category III AIF does not result in capital gains. The exclusion applies also to relocations to certain IFSC-based Banking Units mentioned in Section 80LA(1A). This exclusion is available currently to transfers occurring before 31 March 2025.

The Finance Bill proposes two extensions in this provision. First, it extends the benefits to a relocation of an original fund to a retail scheme or exchange traded funds located in an IFSC. Secondly, it extends the timeline for such extension to 31 March 2030.