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Dear readers,

Yesterday, the finance minister extended her record for the most consecutive finance budgets announced by anyone in Independent India. We congratulate her on this achievement. As participants in a democracy, however, we must review the contents of the budget critically.

Occasionally, the government appears to have the right intentions, but the manner in which it seeks to achieve those ends leaves something to be desired. For example, the budget seeks to introduce a tax holiday of a maximum of 20 years for foreign companies earning profits from the use of data centre services in India. On the face of it, this incentive appears to be aimed at augmenting India's standing as a global hub for information technology and information technology enabled services. However, the following concerns arise immediately.

First, exemption does not appear to be meaningfully impactful on digital companies' income-tax liabilities in India, which, in the absence of a permanent establishment, is already exempt from tax. Secondly, whether real or perceived, the lack of transparency has long been India's Achilles heel. The proposed tax holiday appears to be available only to those foreign companies which are notified by the central government. It is also not clear which data centres would qualify as "specified data centres", as that too requires government notification. It may be considered by the finance minister to articulate a clear statutory definition of these terms without discretionary qualifications to eschew any perception of a lack of transparency.

The budget also witnesses a reversal of the one-year-old policy of treating income from buy-back of shares as dividends, and reverts to characterising it as capital gains. However, it also makes a puzzling policy choice of taxing promoters (including promoter companies) at higher tax rates. The memorandum justifies the discrimination on the ground that promoters wield greater influence over the timing of buy-back of shares. However, there appears to be no nexus between the promoter's ability to influence corporate decisions and a discriminatory tax rate. Capital gains from shares, like dividends, represent a realisation of underlying corporate gains by the shareholder. These underlying corporate gains are already taxed in the form of a corporate income tax. Taxing these capital gains in the hands of shareholders, especially substantial shareholders participating in the economic life of the company, results in harmful economic double taxation. Globally, measures are undertaken to avoid the incidence of such double taxation through measures like underlying foreign tax credits, participation exemptions, split-rate taxation or imputation credits. The proposal to tax participating shareholders at higher rates appears to be ill advised, and defies logic. Apart from these policy issues, the higher tax rates for foreign promoter companies vis-à-vis Indian promoter companies are likely to violate the non-discrimination provisions in India's tax treaties. These proposals should be reconsidered by the finance minister on not only legal but also grounds of sound economic policy.

No other country experiences the volume and intensity of tax litigation as does India. There are some positive amendments to prevent excessive transfer pricing litigation. For example, the proposed introduction of expedited advance pricing arrangement procedures, and a safe harbour margin of 15.5 per cent for information technology, and allied services, should succeed in preventing a large number of transfer pricing disputes. However, the means adopted for resolving certain existing tax disputes quite exacerbate the issue in reality. For example, the finance bill proposes to resolve the controversy in *Shelf Drilling* and *Hexaware* by way of a retroactive clarification in favour of the revenue. Instead of resolving the dispute which is *sub judice* before the Supreme Court of India, the amendment might add an additional issue of whether it is tantamount to a retrospective negation of vested rights for taxpayers.

The government has also been keen to incentivise corporate taxpayers to migrate from the old tax regime to the new tax regime. The finance bill continues to do so by employing a negative tax incentive. It proposes to make MAT credits unusable for taxpayers choosing to remain within the old tax regime. This measure raises again the issue of whether such repudiation of vested statutory rights is constitutionally valid.

India has set the ambitious target of transforming itself into a developed society by 2047. A society develops through a commitment to the rule of law in which the means are as important as the ends. The transformation would be more likely to be realised if the economy is steered through a calibrated set of policy choices as opposed to reactionary U-turns, and opportunistic repudiations of vested rights which creates the perception of an inadequate rule of law.

With these thoughts, we are delighted to present “Budget 2026: Mind the Gap Between Policy and Law” – our critical appreciation of certain aspects of the direct tax amendments proposed by Finance Bill 2026.

With best wishes,
Dr. Dhruv Janssen-Sanghavi
Mumbai

Budget 2026:
Mind the Gap Between Policy and Law

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Budget 2026: Mind the Gap Between Policy and Law

1. Buy-backs: not quite back to square one

One of the more controversial amendments introduced by Finance Act (No. 2) of 2024 was that the entire consideration received by the shareholder from the buy-back of shares was deemed to be a payment of dividends. Correspondingly, the cost of acquisition of the bought-back shares were characterised as a capital loss.

It is proposed to reverse this in Finance Bill 2026. The Finance Bill proposes to revert to characterising the difference between the consideration received on the buy-back of shares and their cost of acquisition as capital gains.

However, it is proposed to tax such capital gains received by a "promoter" of a company at higher tax rates. A "promoter", the case of unlisted companies, is defined as a person who holds, either directly or indirectly, more than 10 per cent of the shares in the company. It also includes a person considered a "promoter" under the definition within Companies Act 2013.[1] A person is considered to be a promoter of a listed company if they qualify as a promoter under the Securities and Exchange Board of India (Buy-Back of Securities) Regulations, 2018.[2]

The table below provides the tax rates applicable on buy-back of shares.

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1 In the case of unlisted companies, "promoter" means a person—
(a) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or
(b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or
(c) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act:
Provided that nothing in sub-clause (c) shall apply to a person who is acting merely in a professional capacity.

2 In the case of listed companies, promoter is defined to include:
i) who has been named as such in a draft offer document or offer document or is identified by the issuer in the annual return referred to in section 92 of the Companies Act, 2013; or
ii) who has control over the affair of the issuer, directly or indirectly whether as a shareholder, director or otherwise; or
iii) in accordance with whose advice, directions or instructions the board of directors of the issuer is accustomed to act;
Provided that nothing in sub-clause (iii) shall apply to a person who is acting merely in a professional capacity.

Item of income	Non-promoter shareholders	If the promoter is a domestic company	For all other promoters
Short term capital gains from listed equity shares	20%	22%	30%
Short term capital gains from unlisted equity shares	Marginal rates	Marginal rates + 2%	Marginal rates + 10%
Long term capital gains from all equity shares	12.5%	22%	30%

The memorandum to the Finance Bill attempts to justify this distinction by stating that promoters typically exercise significant control and influence over corporate decision-making, including whether, when, and on what terms a buy-back of shares is undertaken. Non-promoters, on the other hand, have a minimal role in the decision-making process and merely participate in a buy-back as passive recipients of an offer made by the company. On the face of it, it seems that this classification between promoters and non-promoters is based on a clear reason with a nexus to the object it seeks to achieve.

Whilst the memorandum has attempted to address the different rates applicable to promoters and non-promoters, a further classification can be seen between promoters which are domestic companies and promoters which are foreign companies. It may be useful to consider whether the different rates applicable to gains derived by a domestic company and a foreign company may be permitted under India's tax treaties.

Income earned by a non-resident of India may be chargeable to income-tax under the domestic law of India. However, the taxation of such income may be restricted by the provisions of a tax treaty entered into with India by the country of which the recipient of the income is a resident. Article 13 of most tax treaties deal with capital gains. Whilst providing for rules to determine the extent to which the gains may be restricted from tax in either contracting state, it does not provide for a restricted rate of tax on such gains. Instead, reference must be made to the domestic law of the country to determine the tax rate applicable to such gains. Tax treaties also provide for a non-discrimination clause. These clauses provide for certain scenarios in which a more burdensome taxation imposed on a foreign company would not be permitted. Section 159(5) of the 2025 Act provides that the charge of tax on a foreign company at a rate higher than the rate applicable to a domestic company shall not be regarded as a less favourable levy of tax. Therefore, it would be difficult to argue that the different rates of tax applicable on the gains from the buy-back of shares are discriminatory.

2. Data centres – the tax holiday that isn't

It has been India's stated policy to become a hub for data centres globally. This is a key element of India's aspiration to become a developed economy by the year 2047.[3] In line with these goals, the Finance Bill proposes a tax holiday of a maximum of 20 years for foreign companies on income from the use of "data centre services" located in India. The exemption is available only until 31 March 2047. In other words,

[3] https://www.nitiforstates.gov.in/public-assets/Policy/policy_files/PNC510C000384.pdf.

foreign companies commencing the use of Indian data centres after 01 April 2026 will not be entitled to a full twenty-year period of the tax holiday, unless the exemption is extended by future amendment.

This appears potentially to be a significant fillip for Indian data centres, and tax holiday may incentivise companies to engage them. Two questions arise in this respect. Is the tax exemption really meaningful? And what are the caveats for entitlement to the exemption.

First, the impact of this exemption seems to be limited. It is most likely that the income earned by a qualifying foreign entity from the use of data centre services would be characterised as business profits. In the absence of a permanent establishment, these profits are already exempt in India, which is unlikely in the case of such digital businesses. It is unlikely that receiving data centre services in itself should constitute a permanent establishment, as the data centre would not be at the service recipient's disposal. The exemption is likely to be meaningful only in rare instances in which the income can be characterised as fees for technical services or royalties arising in India for treaty purposes. Therefore, it seems unlikely that this tax holiday would make material difference to the intended beneficiaries' tax bills in India.

Even in scenarios in which the tax holiday might potentially be meaningful, it is subject to significant caveats, and uncertainties.[4]

- The Finance Bill states that the exemption is available only to those foreign company that are notified by the Central Government.
- The tax holiday is available only in respect of services rendered by "specified data centres". Specified data centres are those which are:
  (a) set up under an approved scheme and is notified in this regard by the Central Government in the Ministry of Electronics and Information Technology; and
  (b) owned and operated by an Indian company.
- Any sales made to Indian users must be routed through an Indian company acting as a reseller.
- The foreign company must maintain and furnish information as may be prescribed.
- The foreign company must not own or operate any of the physical infrastructure or any resources of a data centre.

Secondly, the operation of these data centres is fraught with uncertainties. First, the requirement that all sales by foreign companies to users located in India must be made through a reseller which is an Indian company, raises familiar challenges for digital enterprises to determine the locus of users, especially when users are able to mask their locations. Secondly, whilst data centres should yield economic returns, the costs to be incurred are not only economic, but also environmental. The two should not be decoupled. The budget does not appear to make commensurate provisions for offsetting the environmental costs associated with data centres.

Finally, apart from the practical difficulties outlined above, the caveat that any sales to Indian users should be made through Indian resellers appears to be a surreptitious attempt to reclaim taxing rights

[4] Clause 109 of the Finance Bill, 2026.

over digital services, which accrued to India under the erstwhile equalisation levy. Digital service providers must now be expected to create captive resellers, who must pay corporate income-tax on their commissions, whilst the foreign company is exempt on its own income.

3. Minimum Alternate Tax

3.1. Rationalisation of Minimum Alternate Tax Provisions

The Finance Bill proposes to amend the Minimum Alternate Tax ("MAT") regime under section 206 of the Income-tax Act, 2025. Prior to the proposed amendments, MAT operated as a minimum tax, computed at the rate of 15 per cent of a company's "book profits", and was payable only where such amount exceeded the tax liability computed under the general provisions of the Act. In such cases, MAT functioned as a substitute levy, designed to ensure a floor on corporate taxation. The Finance Bill proposes to reduce the MAT rate to 14 per cent of book profits, while simultaneously altering the structural logic on which the levy operates.

The 1961 Act also provided for a MAT credit[5] for the difference between MAT paid and the taxpayer's nominal tax liability for a period of fifteen tax years. The MAT was, however, not applicable to the so-called new regime.[6]

The Taxation Laws (Amendment) Act 2019 had introduced the so-called "new tax regime" for domestic companies. Under this regime, a domestic company could choose to be taxed at the rate of 22 per cent, but would be required to forgo most tax exemptions and some beneficial deductions, including accelerated or incentive-linked depreciation.[7] MAT does not apply to companies opting for this new tax regime. The choice of this option was irrevocable.

The Finance Bill proposes to make MAT the final tax for a taxpayer choosing to remain within the old tax regime. Further, the existing MAT credit may be utilised by a taxpayer opting for the new tax regime, albeit only to the maximum extent of 25 per cent of the tax payable by that taxpayer in a tax year.

In contrast, the Finance Bill preserves a distinct treatment for foreign companies, under which accumulated MAT credit may be carried forward. Such credit may be set-off only in tax years where the tax payable under the provisions of 2025 Act exceeds the MAT liability. The setoff of the MAT credit is further restricted to the extent of such excess.

Effectively, the Finance Bill coaxes a domestic company to migrate to the new tax regime lest the MAT credits become redundant. Although this is different from a straight-forward denial of a vested right, it is indeed tantamount to a coercive inducement for such migration. This choice could be exceptionally egregious for a capital intensive enterprise, which has made vast capital expenditure, which must be amortised by way of depreciation, and also has substantial amounts of MAT credits. The Finance Bill's proposal to re-engineer the MAT regime is likely to put such companies between a rock and a hard place.

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[5] Section 115JAA of the 1961 Act / Section 206(2)(g) of the 2025 Act.

[6] Section 115JB(5A) of the 1961 Act / Section 206(1)(q) of the 2025 Act.

[7] Section 115BAA of the 1961 Act / Section 200(5) of the 2025 Act.

Should the government persist by enacting the proposed law, it may expect a constitutional challenge on grounds of indirect discrimination and denial of vested statutory rights.[8]

3.2. Exclusion from Minimum Alternate Tax

The Finance Bill amends the 2025 Act so that MAT would not apply to specified non-resident businesses that are taxed under the presumptive taxation regime in Section 61 of the 2025 Act. The amendment is relevant in particular for non-residents engaged in shipping and international transport, as well as those providing services or technology for the setting up of electronics manufacturing facilities in India.

These enterprises are taxed on profits computed on a presumptive basis. For example, non-residents engaged in shipping are presumed to earn profits at the rate of 7.5 per cent on gross receipts for the carriages to or from India. For cruise ships, this presumption is at the rate of 20 per cent, and for the operation of aircraft, 5 per cent.

In the absence of an express exclusion, the concern was whether MAT could also be levied on such non-residents, notwithstanding their inclusion in the presumptive regime. Albeit only prospectively, the amendment removes this ambiguity by expressly excluding these specified businesses from the scope of MAT.

The amendment therefore restores coherence to the presumptive taxation framework and provides certainty to non-resident taxpayers in the shipping and electronics sectors. The change will apply from tax year 2026–27 onwards.

4. Amendments to providing effect to APAs

The law for Advance Pricing Agreements ("APA") previously only allowed the person who had signed an APA, to subsequently modify their returns under Section 169 of the 2025 Act.[9] Thus, there was no mechanism whereby, an Associated Enterprise ("AE") whose income had been affected as a result of the APA could modify its returns and claiming refund of any additional taxes paid by it or withheld from its income.

The proposed amendment in Clause 45 of the Finance Bill changes this and appears to provide for such corresponding adjustments. These adjustments allow an AE to file a modified return and seek refunds for additional taxes paid. This amendment is salient especially for jurisdictions which –

(a) do not have tax treaties with India; or
(b) treaties which do not contain a provision for corresponding adjustments on the lines of Article 9(2) of the OECD Model.

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8 See: *Eicher Motors Ltd. v. Union of India*, (1999) 2 SCC 361.

9 Section 92CC of the 1961 Act.

The amendment comes into effect from 01 April 2026, and as such, only applies to APAs entered into post 1st April 2026, for all subsequent tax years beginning from 2026.

The Annual APA Reports demonstrate the popularity of APAs.[10] Whilst unilateral APA numbers have stagnated, the number of applications for bilateral APAs with India have nearly tripled over the last decade.[11] However, it is important to note that the 2025 Act does not provide for bilateral APAs. Bilateral APAs, are therefore, usually initiated in the other contracting state, under the treaty mechanism for Mutual Agreement Procedures. Perhaps, it is time for the Government to provide for a predictable and standardised mechanism for initiating bilateral APAs in India.

Further, in keeping with theme of aiding the IT sector, the government has fast-tracked the procedure for obtaining Unilateral APAs for the IT sector. The procedure will now be completed within a period of two years, with an option to increase the time by six months at the behest of the taxpayer.[12]

5. Exemption to foreign company on provision of capital equipment

The budget continues the government's commitment to making India a global hub for electric system design and electronics manufacturing. To this end, the Finance Bill proposes to exempt income arising to a foreign company "on account of providing capital goods, equipment or tooling to a contract manufacturer for use in electronics manufacturing in India".

The scope of this exemption is defined narrowly. Contract manufacturers may take on hire equipment, tools, capital goods from the party on whose behalf they manufacture electronics. Captive contract manufacturers may lease such items from an associated enterprise.

In both cases, the arm's length rents may qualify as royalty payments under section $9(6)(b)(v)$ of the 2025 Act as being consideration for the use of industrial, commercial or scientific equipment. Any training provided for how to use these may constitute technical services, and arm's length fees may be sought to be imputed, and taxed on a gross basis. Such payments are proposed to be exempted if they are made by contract manufacturers located in a "custom bonded area".

It is important to note that the exemption is not available for payments made to third-party lessors, but only for payments made to persons on whose behalf electronics goods are manufactured.

The exemption is available only up to the tax year 2030–31.

6. Litigation in *Shelf Drilling*

The risk of protracted litigation is one of the greater challenges faced by taxpayers in India. These can be on substantive and on procedural issues. One of the most important procedural issues currently pending

[10] CBDT, Annual Report (2024-25), Advance Pricing Agreement (APA) Programme of India, 2025.

[11] CBDT, Annual Report (2024-25), Advance Pricing Agreement (APA) Programme of India, 2025.

[12] Para. 128, Budget Speech of the Finance Minister.

before the Supreme Court of India was in relation to limitation periods applicable in cases before the Dispute Resolution Panel ("DRP").

Generally, an assessment officer is obliged to complete assessment proceedings within 21 months of the end of the assessment year in which the income was assessable.[13] However, the assessment procedure is modified for certain taxpayers, including for non-residents.[14] In these cases, the assessment officer is required to provide the taxpayer with a draft assessment order if such order is prejudicial to the taxpayer. The taxpayer has the option to either accept the order, or object to the draft order before the DRP. The following timelines are applicable if the taxpayer chooses to object.

- The taxpayer may object within thirty days upon the receipt of the draft order;
- If an objection is made, the DRP is required to issue directions within 9 months from the end of the month in which the draft order was forwarded to the taxpayer;
- The assessing officer has one month to render a final order in accordance with the directions from the end of the month in which the officer receives the directions.

Indian courts have been faced with the issue whether the time allocated for proceedings before the DRP is in addition to, or if it is a part of the general limitation of twenty-one months to complete assessment proceedings. On 8 August 2025, the Supreme Court of India, in the case of *Shelf Drilling*[15] rendered a split verdict on this issue. Nagarathna J. held that the time available to conduct the DRP proceedings should be subsumed within the overall time available to finish an assessment proceeding. However, Sharma J. differed, and decided that the time allocated to the DRP was in addition to the general limitation period applicable to the assessing officer. The case has since been referred to the Chief Justice of India to constitute a larger bench of judges to consider the issue afresh. The issue is, therefore, *sub judice*.

The Finance Bill proposes to resolve this controversy by way of a retroactive legislative amendment in favour of the Revenue. It "clarifies" that the timelines prescribed for DRP proceedings were always intended to be in addition to the general limitation period applicable for the completion of an assessment.

This amendment is likely to be particularly controversial for bridging the separation of prerogative powers between Parliament and the judiciary. Indeed, Parliament is empowered to legislate retrospectively. However, the Supreme Court has held consistently that this power does not extend to impair vested statutory rights.[16] The controversy before the Supreme Court in *Shelf Drilling* acquires an additional layer of whether the extant law could be viewed as vesting a statutory right in taxpayers to an overall period of limitation of twenty-one months, and if the retrospectivity of the 2026 "clarification" is constitutionally valid.

7. Non-allowance of interest as a deduction against dividend income

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13 Section 286 of the 2025 Act / Section 153 of the 1961 Act.

14 Section 275 of the 2025 Act / Section 144C of the 1961 Act.

15 *ACIT v. Shelf Drilling*, 2025 INSC 946.

16 *Govinddas v. ITO*, [1976] 103 ITR 123 (SC).

Income from dividends and from mutual fund units, generally tend to fall under the head income from other sources.[17] Although, the facts of a case may require their characterisation as business profits.

Historically, expenses incurred for the purposes of earning dividends or income from mutual funds, is deductible in the computation of taxable income irrespective of their categorisation as other income or business profits. Insofar as such income qualified as other income, such deductions were limited by Finance Act, 2020 to only interest expenses, with a maximum ceiling of 20% of the gross dividend received.[18] It is now proposed to abolish the deduction of all expenses against dividends and income from mutual funds, so long as, they qualify as other income.

By removing the investors' ability to offset interest costs, this proposal erodes the returns of investors who borrow capital to fund their investments. Given that the interest income itself would be taxable in the hands of the lender, this amendment increases the incidence of economic double taxation under Indian income-tax law.

8. IFSC exemptions expanded

The Finance Bill continues to incentivise the International Financial Services Centre ("IFSC") by extended and introducing additional benefits to its tax regime.

8.1. Deductions for income from offshore banking units ("OBUs") and units in IFSC

Section 147 of the 2025 Act provides for a 100 per cent deduction of the income of scheduled banks or banks incorporated outside India that have Offshore Banking Units in Special Economic Zones, as well as income of units in IFSC. For units in IFSC, this deduction is available for 10 consecutive years out of 15 years. For banks, the deduction is available for 10 consecutive years.

The Finance Bill proposes to extend the period of this deduction to 20 consecutive years out of 25 years for units in IFSC and to 20 consecutive years for banks. In the case of banks, this deduction is available on income from OBUs in Special Economic Zones. For units in IFSC, the deduction is available on income from approved business activities of the unit.

8.2. Tax on business income of OBUs and units in IFSC

The Finance Bill proposes to introduce a new section 218, which imposes a tax rate of 15% on the income of banks and units in IFSC referred to in section 147 of the 2025 Act. The memorandum clarifies that this tax would be applicable to income on which the deduction is currently available and would apply after the expiry of the available deduction period.

8.3. Rationalising definitions of certain terms with respect to IFSC

[17] Section 56 of the 1961 Act / Section 92 of the 2025 Act.

[18] First proviso to Section 57 of the 1961 Act / Section 93(2)(b) of the 2025 Act.

Section 2(40)(v) of the 2025 Act defines the term “dividend” and provides that the term shall not include any advance or loan between two group entities, where one of such entities is a “finance company” or a “finance unit”. Further, the parent or principal entity of the group is required to be listed on a stock exchange in a country or territory outside India, other than such country or territory as may be specified by the Board in this behalf.

The Finance Bill proposes to amend this provision to require that the other group entity involved in the transaction must also be located in a country or territory outside India that is a notified jurisdiction. The FAQs to the Finance Bill 2026 state that the existing provision does not provide for any requirement for the location of the other entity in the loan transaction, leading to a possible misuse of the provision and requiring this proposal to be brought forth.

The Bill also proposes to introduce a new definition of the term “group entity”. Consistent with the other terms in this provision, the proposed definition is aligned with the International Financial Services Authority (Payment Services) Regulations, 2024 made under the International Financial Services Centres Authority Act, 2019. The Bill further proposes to define “parent entity” as an entity that, either alone or together with one or more of its subsidiaries, exercises or controls more than half of the total voting power, or that controls the composition of the board of directors.