

Tax Hotline

August 29, 2019

GOVERNMENT COMMITS TO REGULATORY CHANGES; PROPOSES REFORMS TO BOOST ECONOMIC GROWTH

- Press Conference held by Finance Minister announced a number of changes in line with industry asks, centered around six broad themes, in order to boost economic growth.
- Following tax law changes proposed:
 - Higher surcharge on capital gains removed for long-term and short-term capital gains tax on listed shares for both domestic and non-resident investors. Foreign Portfolio Investors have also been exempted from higher surcharge on derivative transactions.
 - Measures to rationalize 'angel tax': CBDT circulars to streamline tax assessment for startups seeking exemption from angel tax; and to extend exemption to startups assessed prior to February 19, 2019.
 - Press Conference statement by Finance Minister to make angel tax inapplicable to startups registered with DPIIT.
 - Changes to simplify tax administration, and to curb opportunities for harassment of taxpayers.
- Stated commitment of Ministry of Finance to ensure continued engagement with stakeholders for different sectors. Promise of more changes to come, and statements made in Press Conference being a part of ongoing reform.

In a rare move, the Union Finance Minister Smt. Nirmala Sitharaman ("**FM**") held a Press Conference on August 23, 2019 ("**Press Conference**"), announcing several legal and regulatory changes the Indian Government already has and further wants to introduce in an effort to boost the growth of the Indian economy. These changes range from tax related amendments addressing startup taxation to labour law amendments, and the announcements come in succession to many such piecemeal measures by the Government over the past few months.

Six broad themes were sought to be addressed in the changes:

- a. Simplification, reduction in harassment by authorities, and decriminalization of minor infringements to increase the ease of doing business in India;
- b. Measures to encourage investment and enterprise in India;
- c. Strengthening of the banking and credit system;
- d. Measures to aid liquidity for Non-Banking Finance Companies ("**NBFCs**") and Housing Finance Companies ("**HFCs**"), with focus on boost for Micro, Small and Medium Enterprises ("**MSMEs**");
- e. Increase of capital flow in Indian financial markets; and
- f. Addressing issues impeding the growth of the automotive sector.

To implement the theme of simplification and reduction in harassment, the Government has introduced measures to ease the process of tax compliance and interaction with tax authorities such as enabling pre-filled income tax returns and implementing faceless scrutiny proceedings. Much required measures to simplify labour laws have been brought in, including making inspection procedures web-based and setting a timeline for uploading of inspection report, ability to compound labour law offences, introduction of self-certification of startups, reduction of employees' state insurance contribution from 6.5% to 4%. Environmental clearances for MSMEs have been simplified via a single air and water clearance, and the requirement of single consent to set up a factory.

On the corporate side, introduction of one-day incorporation, simpler approvals for mergers and acquisitions, decriminalization of several offences, and a robust framework under the Insolvency and Bankruptcy Code, 2019 are some measures introduced to ease the compliance burden on companies in India.

To promote investment and enterprise in India, the Government has declared that the violation of the spending requirement of 2% of profits toward Corporate Social Responsibility will not be treated as a criminal offence, and that the Ministry of Corporate Affairs is reviewing relevant sections of the Companies Act, 2013 to implement this change. A faceless notification system is to be implemented by October 1, 2019 to curb harassment by income tax authorities. Higher surcharge brought in by Budget 2019 has been removed on long-term and short-term capital gains tax on listed shares for both domestic and non-resident investors. Foreign Portfolio Investors ("**FPIs**") have also been exempted from higher surcharge on derivative transactions. To address the angel tax concerns of the startup sector, it is stated that the angel tax under Section 56(2)(viib) will not be applicable to startups registered with the Department for Promotion of Industry and Internal Trade ("**DPIIT**"), and a dedicated cell will be set up by the Central Board of Direct Taxes ("**CBDT**") to address concerns of startups.

In order to strengthen the country's financial systems, the Government has committed to an upfront capital infusion of

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INR 700 billion to public sector banks. The FM also conveyed a commitment of banks passing on effects of interest rate cuts, to make housing, vehicle and retail loans cheaper. To aid NBFCs and HFCs, the FM declared that NBFCs will be able to use Aadhaar-authenticated KYC for easier customer onboarding, and necessary changes would be brought in to the Prevention of Money Laundering Act, 2002 and Aadhaar regulations. Similar enabling provisions are expected to allow Aadhaar-based KYC for opening demat accounts, and for investment in mutual funds. The one-time Partial Credit Guarantee scheme of INR 1 trillion for purchase of pooled assets of NBFCs and HFCs will be monitored closely by banks, as will be the issuing of prepayment notices to NBFCs. Co-origination of loans by NBFCs and public sector banks is to be fast-tracked.

To increase capital flows in India, creation of an organization has been proposed to provide credit enhancement for housing and infrastructure projects. Action is expected to be taken on development of credit default swap markets, in consultation with the Reserve Bank of India ("RBI") and the Securities and Exchange Board of India ("SEBI"). The RBI will work with the Ministry of Finance for measures to improve the market for bonds in India. The SEBI is expected to soon operationalize the Depository Receipt Scheme, 2014, which will potentially increase access of foreign funds to Indian debt markets through American or Global Depository Receipts. It is expected that recent simplification of KYC norms by the SEBI for foreign investors, including FPIs, will increase market access. The FM also stated that the Ministry of Finance and the RBI are working to introduce measures for bringing the offshore rupee market to domestic stock exchanges, and to permit USD-INR derivatives trading in GIFT City IFSC in Gujarat (India's first International Financial Services Centre).

To address infrastructural issues, the FM mentioned a few measures which will be taken, such as monitoring of delayed payments by the Government and performance review by the Cabinet Secretariat. 75% of arbitration awards in contractual disputes with the Government are to be paid, which will be implemented and monitored by the Cabinet Secretariat. An Inter-Ministerial Task Force by the Department of Economic Affairs will be set up to finalize pipeline of infrastructure projects which will be monitored actively, and which is expected to increase investment and create jobs.

Below we have looked at the tax law changes the government seeks to bring in.

HIGH SURCHARGE ON SPECIAL RATES OF CAPITAL GAINS REMOVED

The Budget 2019 introduced a higher surcharge on tax for high income earning groups. While the FM in her budget speech indicated that there would be an enhanced surcharge on individuals having taxable income from INR 20 million to INR 50 million, and INR 50 million and above so that effective tax rates for these two categories will increase by around 3% and 7% respectively, the fine print of the Finance Bill had a different story to tell. The higher surcharge became applicable not only to individuals but also to Hindu Undivided Families, Association of Persons, Body of Individuals and every artificial juridical person. This meant that trusts earning such income became subject to the higher tax which resulted in increase of effective tax rates for the FPIs set up as trusts and the Category III Alternate Investment Funds ("Cat III AIFs") to as high as 42.7%. In contrast there has been no change in tax rates for FPIs set up as corporate vehicles. This had become a cause of concern for a large part of the funds industry and resulted in being one of the major factors behind investors losing more than INR 5 trillion in market wealth recently¹.

Acknowledging the higher tax rate's impact on investment in Indian capital markets, the FM in her Press Conference stated the government would withdraw the higher surcharge to the extent applicable to long term and short-term capital gains tax on listed (i) equity shares; (ii) unit of an equity-oriented fund; and (iii) unit of a business trust. Additionally, in respect of FPIs the tax payable on gains arising from the transfer of derivatives (futures & options) would also be exempted from the levy of the enhanced surcharge.

This was followed by a Press Release from the CBDT issued on August 24, 2019 ("Press Release"). To summarize, the Press Release provides that the enhanced surcharge shall be withdrawn on tax payable by both domestic as well as foreign investors on long-term and short-term capital gains arising from the transfer of equity shares in a company or unit of an equity-oriented fund/business trust which are liable for Securities Transaction Tax, and also on tax payable by FPIs on the capital gains arising from the transfer of derivatives. However, the tax payable at normal rates on the business income arising from the transfer of derivatives to a person other than FPI shall be liable for the enhanced surcharge. This would mean CAT III AIFs set up as trusts would still be subject to the higher rate of surcharge as there is no pass-through available to CAT III AIFs and income earned by them from sources other than capital gains is considered as business income.

Several representations by stakeholders were made to relevant authorities in order to resolve this issue, and hence this was much awaited and as such comes as much-needed relief. However, it will be interesting to see how these changes will be brought about in the Income Tax Act, 1961 ("ITA"). The ITA is amended by way of a Finance Bill which is passed by both houses of the Indian Parliament, post which the President gives his assent which is then gazetted. Notably, the Finance Bill is introduced during the budget session of the Parliament. Considering that the amendments that will need to be brought about are substantive in nature, the question arises whether these can be brought about by way of a circular issued by the CBDT under Section 119 of the ITA, i.e. through an executive order; or whether legislation by way of an amendment bill would need to be passed in Parliament followed by the President giving his assent. Section 119 of the ITA provides for 'instructions to subordinate authorities' and states that the CBDT may issue directions or instructions 'for the purpose of proper and efficient management of assessment and collection of revenue' or if it is of the 'opinion that it is necessary in the public interest' and is therefore wide enough to carry out such changes. In the past, the CBDT has provided relaxations under various provisions of the ITA by way of a circular followed by changes made in the ITA in the next budget. The Cabinet chaired by the Prime Minister is reported to also be considering introducing an ordinance to effectuate the change.² The coming days will tell us how the Government is going to bring about the changes.

Further, the scope of the relaxations currently proposed are narrow. They do not cover interest income arising to FPIs from bonds, which can otherwise avail concessional tax rates under the ITA. Additionally, capital gains on transfer of bonds for FPIs which are set up in non-treaty jurisdictions continue to be affected as there is no exemption on the higher surcharge for such transfers. Therefore, FPIs set up as trusts and Cat III AIFs will still be subject to a disproportionately higher effective tax rate owing to the higher surcharge, as compared to their counterparts set up as corporates.

Additionally, these changes are going to result in logistical and administrative difficulties for taxpayers while paying

taxes and filing tax returns. This is because surcharge is agnostic to head of income and is generally applicable on the total tax payable by the taxpayer. However, with these changes, the surcharge will have to be separately calculated for sub-heads of income and then added to the total income on which also the surcharge will have to be calculated separately. This may cause confusion for domestic investors who earn capital gains from various sources and not just through listed equity.

ANGEL TAX EXEMPTION

Section 56 of the ITA seeks to tax 'income from other sources' of a taxpayer, being income that is chargeable under the ITA but is not taxed under other heads of income. While sub-section (1) articulates the general provision, sub-section (2) enlists specific types of income which would be chargeable under Section 56. Section 56(2)(viib) is a tax on a private company on issuance of shares if such shares are issued at a price higher than their fair market value. The provision exempts situations where the consideration is received by: (a) non-resident; (b) a venture capital undertaking from a venture capital company or fund; or (c) by a company from a class or class of persons notified by the Central Government.

The provision proved particularly egregious to startups and early stage companies with limited capital, that would be required to part with a significant portion of funds obtained by them from investors in lieu of equity – hence the phrase 'angel tax'. The Government has, in recognition of this hardship, issued various notifications time and again under exemption (c) mentioned above to provide thrust to the start-up eco-system. The CBDT has provided an exemption from levy of angel tax to 'startup' companies that receive consideration from an Indian resident, and that fulfil conditions prescribed under the current DPIIT Notification,³ and files the declaration required under the DPIIT Notification. Additionally, in case additions are made by the Assessing Officer ("AO") after modification or rejection of valuation of the shares based on Rule 11UA(2) of the Income Tax Rules, 1962, no coercive measures are to be undertaken to recover outstanding tax demand, and cases pending before the first appellate authority were to be expeditiously disposed of by March 31, 2018.

Pursuant to the above, with an aim to streamline the assessment process for startups seeking exemption from applicability of Section 56(2)(viib) of the ITA and with a view to ease the process of assessment for these startups, the CBDT has prescribed the following procedure:⁴

- Where the startup has been recognized by the DPIIT, but the case is selected for 'limited scrutiny' only to determine applicability of Section 56(2)(viib) – the contentions of startups are to be summarily accepted without any inquiry or verification by the AO.
- Where the startup has been recognized by the DPIIT, but the case is selected under 'limited scrutiny' with multiple issues for determination or 'complete scrutiny', including determination of applicability of Section 56(2)(viib) – applicability of 56(2)(viib) will not be pursued during assessment, and inquiry or verification on other issues shall be carried out by the AO as per due procedure under the ITA, but after obtaining approval of the supervisory officer.
- Where the startup has not been recognized by the DPIIT, and the case is selected for scrutiny *inter alia* on grounds of applicability of Section 56(2)(viib)– inquiry or verification on all issues shall be carried out by the AO as per due procedure under the ITA, but after obtaining approval of the supervisory officer.

The CBDT also clarified⁵ that the exemption from Section 56(2)(viib) which only applied to startups for which assessment order were passed after the date of DPIIT Notification (i.e. after February 19, 2019), would also extend to for cases where assessment order was passed before the DPIIT Notification.

In the Press Conference on August 23, 2019, the FM also declared that startups recognized by the DPIIT will be exempt from application of the angel tax altogether. Application for startup recognition can be made [here](#). However, it remains to be seen how this change will be implemented, and whether further amendments or notifications will be brought in to ease the process of availing the exemption.

The streamlining for startups for claiming angel tax exemption, in particular, signifies that the Government is hearing the stakeholders and is trying to work with the industry to create a beneficial regulatory environment. The FM in the Press Conference specifically stated the commitment of the Ministry of Finance to engage with the industry, and that many other changes are in the pipeline to ease the process of doing business in India.

SIMPLIFICATION OF TAX ADMINISTRATION

The FM during the budget for the year had indicated various measures to ease tax administration and make it more accessible for the common man. In the Press Conference, the FM asserted this intention of the government which are going to be executed in the coming days. Some measures that were mentioned are:

- Introduction of pre-filled Income Tax returns;
- Faceless tax scrutiny process to commence from October 1, 2019 to preclude instances of harassment by tax authorities:
 - All notices, summons or orders issued after October 1, 2019 are to be issued through a centralized computer system, which will contain a unique document identification number;
 - Communication without the document identification number are to be regarded as *non est* in law;
 - Older notices are to be decided before October 1, 2019; or to be re-issued through the new system;
 - Notice from October 1, 2019 to be disposed of within 3 months from reply.
- Returns to be filed under Goods and Services Tax ("GST") regime to be simplified;
- Process to obtain refund of GST to be simplified.

– Varsha Bhattacharya & Ashish Sodhani

You can direct your queries or comments to the authors

¹ <https://www.businesstoday.in/markets/stocks/sensex-nifty-investor-lose-market-wealth-post-union-budget/story/362630.html>

² <https://www.indiatoday.in/business/story/cabinet-may-relax-fdi-in-retail-okay-ordinance-to-roll-back-fpi-surcharge-1592348-2019-08-28>

³ DPIIT Notification No. G.S.R. 127 (E) dated February 19, 2019

⁴ CBDT Circular No. 16 of 2019 dated August 7, 2019

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