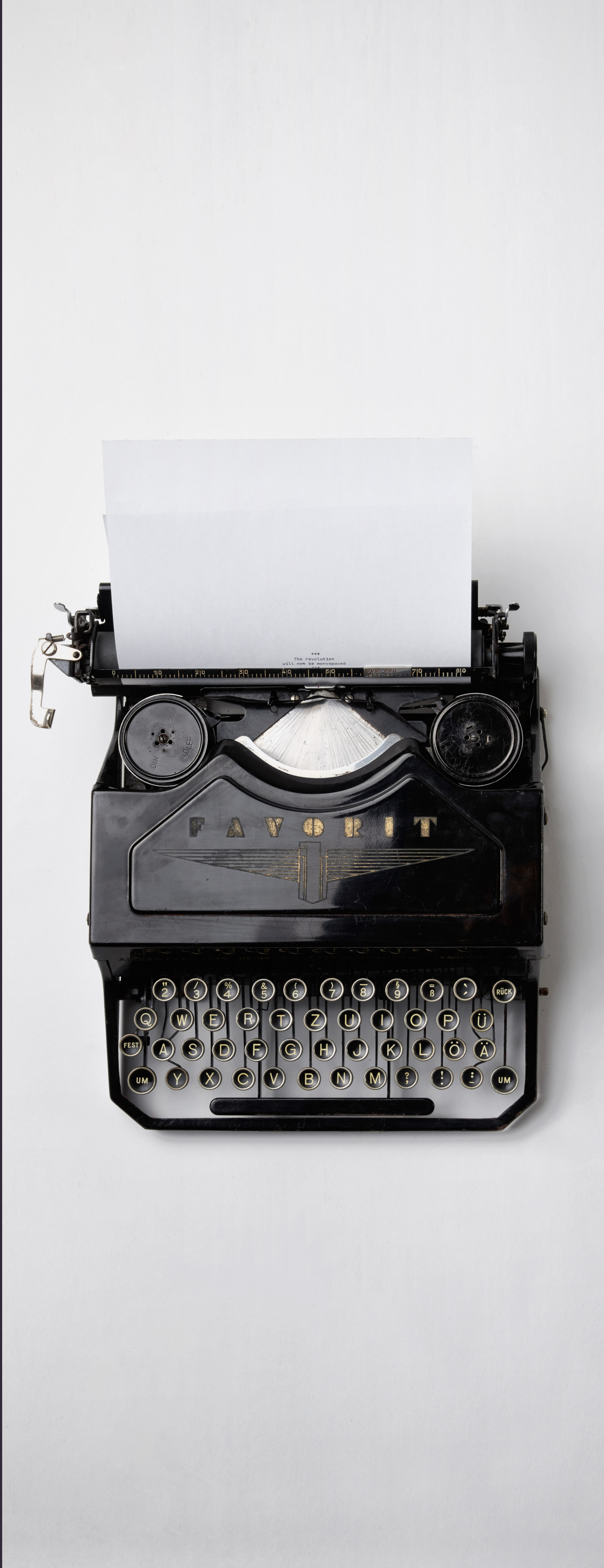

UNION BUDGET 2018

Key Highlights
Direct Tax

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Tax Insights

UNION BUDGET 2018 DIRECT TAX PROPOSALS

IN BRIEF

NDA government in its last full Union Budget, laid emphasis on rural & agricultural sector, micro, small & medium enterprises, senior citizens and health care, targeting the next general elections, due in 2019.

From tax proposals stand point, the budget disappoints, as no major benefit to the taxpayers are proposed. The budget does not provide for any change in the income tax slab rates for the individuals and only provides for standard deduction of Rs. 40,000 to salaried individuals, which is not good enough considering that it will be in lieu of two other tax benefits of transport and medical allowance, that are already available.

The tax proposals majorly focused on MSME sector and senior citizens. The MSME sector companies having turnover of less than Rs. 250 crores are gifted with the reduced tax rate of 25% and enhanced deduction of wages paid to new employees employed in certain specific industries. Further, certain tax concessions have been provided to the senior citizens in view of inflation and the increased medical expenses in the old age.

Amid all the proposals, the markets radically reacted with the announcement of imposition of long-term capital gains tax on certain equity instruments. Long term capital gain on transfer of certain equity instrument, which is currently exempt is now proposed to be taxable at the rate of 10% on the gain of more than Rs. 1,00,000 per financial year.

DIRECT TAX PROPOSALS

KEY HIGHLIGHTS

- No change in personal income tax slab rates.
- Provisions are proposed to be amended for introduction of e-assessments.
- Deduction of Rs. 50,000 from interest income, in the hands of a senior citizen.
- Long term capital gain at the rate of 10% on sale of listed equity instruments.
- Provisions for taxability of conversion of stock in trade into capital asset proposed.
- Provisions of the Act are proposed to be amended to include the provisions of Income Computation and Disclosure Standards.
- Dividend distribution tax at the rate of 30% on deemed dividend.
- Definition of Business Connection amended in view of Action Plans of BEPS and Multi Lateral Instrument

01 INDIVIDUAL TAXATION

Although, it was expected that the tax slab rate for the individuals would be increased this year, the government has not proposed any change to the same.

However, the government, in view of the statistics, that the salaried individuals pay more tax on an average than the individuals earning income from business and professions, has proposed a standard deduction upto Rs. 40,000 or the amount of salary received, whichever is less, to the salaried assessee. Consequently, the present exemption in respect of transport allowance and reimbursement of medical expenses would not be allowed. Further, the Education Cess has been increased to 4%.

Changes have also been introduced to provide relief to the senior citizens keeping in view their personal circumstances like health and fixed source of income.

It is proposed to allow a deduction upto Rs. 50,000 in respect of interest income from deposits held by senior citizens. Further, it is also proposed to raise the threshold for witholding tax on interest income for senior citizens from Rs. 10,000 to Rs. 50,000.

It is also proposed to enhance the deduction in respect of payment towards annual premium on health insurance policy, or preventive health checkup, of a senior citizen from Rs. 30,000 to Rs. 50,000.

02 CORPORATE TAX RATE

In the case of domestic company, the rate of income-tax is proposed to be reduced to 25% for the domestic companies having turnover upto Rs. 250 crores and in all other cases the rate of tax would be 30%.

Further, an additional surcharge called the "Health and Education Cess on Income-tax" would be levied at the rate of 4% in all cases irrespective of any turnover or income threshold.

03 PERMANENT ACCOUNT NUMBER

Provisions pertaining to Permanent Account Number are proposed to be amended. It is proposed, that every person other than an individual, which enters into a financial transaction of an amount aggregating to Rs. 2,50,000 or more would be mandatorily required to apply for allotment of PAN. Further, such provisions are extended to the director, partner, trustee, author, karta, chief financial officer, principal officer or office bearer of such entities.

04 DIVIDEND DISTRIBUTION TAX

At present the dividend distribution tax is paid by the company on the dividend distributed by the company to the shareholders. However, such dividend distribution tax is not applicable on the deemed dividend provided under the provisions of Section 2(22)(e) of the Act. At present such dividend is taxable in the hands of the shareholder or the recipient as per the provisions of Section 2(22)(e) of the Act.

Now, it is proposed to amend the provisions of Section 115Q of the Act to bring such deemed dividend within the purview of dividend distribution tax in terms of the provisions of Section 115 O of the Act. Further, dividend distribution tax on such deemed dividend would be at the rate of 30 per cent (without grossing up).

05 LONG TERM CAPITAL GAIN ON CERTAIN EQUITY INSTRUMENTS

In the current regime, capital gain earned on transfer of long term capital asset being equity shares of a company or an unit of equity oriented fund or an unit of business trusts, is exempt from capital gains tax in terms of the provisions of Section 10(38) of the Act, subject to fulfillment of certain conditions.

Such exemption has been of much debate in last union budget, because of the ongoing litigation on such exemption termed as 'penny stock' by the revenue authority.

In the last union budget, the provisions were amended, post which, exemption under Section 10(38) was only allowed if securities transaction tax is paid on transfer as well as on purchase of such equity instruments.

However, now in view of the decisions of the courts in favour of the assessee's claiming the exemption, the government has proposed to amend the provisions and tax gain earned on transfer of such long term capital assets.

Now, it is proposed to tax gain earned on transfer of such long term capital assets at the rate of 10% over such gain of Rs. 1,00,000 in a financial year subject to condition that securities transaction tax have been paid on the acquisition as well as on sale of such capital asset. It is also proposed that the benefit of indexation and benefits of computing the capital gain in foreign currency by non-residents will not be available while computing such capital gains.

The said provisions would not be applicable for any gain earned on any transfer made before February 1, 2018.

However, any long term capital gain earned on or after February 1, 2018 on any instruments acquired prior to February 1, 2018 would be grand fathered. In such case the cost of acquisition for the purposes of computing capital gains would be higher of (a) cost of acquisition of such instrument and (b) the lower of (i) the fair market value (**FMV**) of such instrument and (ii) the full value of consideration received or accruing as a result of transfer.

In this regard, it is proposed that FMV for shares is to be taken at highest price quoted on stock exchange on January 31, 2018 while FMV for other assets is to be taken at NAV as on the same date.

06 TAX ON TRANSACTIONS IN IMMOVABLE PROPERTY

The current provisions of the Act, while computing capital gains, business profits or income from other sources from transactions pertaining to immovable property, consider the actual transaction value or the stamp duty value of the immovable property (whichever is higher), as sales consideration.

These provisions have witnessed lot of litigation, where, the assessee's have challenged the stamp duty value of the immovable property on basis of many factors such as location, size etc.

Now, the government in order to minimize hardship in case of immovable property transactions has proposed to provide that stamp duty value of the immovable property would not be deemed as the sale consideration, if variation between the actual sale consideration and stamp duty value is not more than five percent of the sale consideration.

This is a welcome move and would avoid unnecessary litigation.

07 TAX NEUTRAL TRANSFERS

In terms of the provisions of Section 47 of the Act, transfer of a capital asset by a company to its subsidiary and any transfer by a subsidiary to its holding company, is not regarded as transfer and hence exempt from capital gains tax. However, in terms of the provision of Section 56(2)(x) of the Act, such receipt of capital asset was taxable in the hands of the receiver company.

In order to ease out and facilitate the transaction of transfer of money or any property between a wholly owned subsidiary company and its holding company, it is now proposed to amend the provisions of Section 56 of the Act so as to exclude such transfer from taxability in the hands of the recipient company.

08 CONVERSION OF STOCK IN TRADE INTO CAPITAL ASSET

The provisions of the Act provides for taxability on conversion of capital asset into stock in trade, however, no provisions are provided pertaining to taxability of conversion of stock in trade into capital asset.

Now, in order to discourage the practice of deferring the tax payment by converting the inventory into capital asset, it is proposed, that profits and gains arising from conversion of inventory into capital asset would be taxable at the time of conversion, and fair market value of the inventory converted would be considered as the sale consideration.

Further, for the purposes of computation of capital gains at the time of transfer of capital asset, such fair market value of inventory would be considered as the cost of acquisition of the capital asset and period of holding of such capital asset shall be reckoned from the date of conversion .

09 TAX OF COMPENSATION IN CONNECTION TO BUSINESS OR EMPLOYMENT

Under the current regime, compensation receipts were taxable subject to conditions prescribed under Section 28(ii) of the Act. The provisions of Section 28(ii) of the Act is restrictive in its scope as far as taxation of compensation is concerned, hence a large segment of compensation receipts in connection with business and employment is out of the purview of taxation.

Thus, in order to curb the base erosion and revenue loss, it is proposed to amend the provisions of Section 28 and Section 56 of the Act to provide that any compensation received or receivable, whether in the nature of revenue or in the nature of capital would be taxable in the hands of the receiver.

The amendment, now proposes to tax the compensation irrespective of the nature of such revenue, thereby putting an end to the litigation pertaining to the compensation received being of capital nature and hence not taxable.

10 INCENTIVE FOR EMPLOYMENT GENERATION

Provisions of Section 80JJA provides for an additional deduction of 30% in respect of emoluments paid to eligible new employees who have been employed for a minimum period of 240 days during the year. The minimum period of 240 days is reduced to 150 days for the apparel industry.

Now, in order to boos employment generation, it is proposed to extend the relaxation of 150 days to footwear and leather industry as well. Further, it is also proposed to provide such deduction even of the new employee is employed for less than the stipulated period during first year but is employed for the stipulated minimum period in the subsequent year.

11 INCOME COMPUTATION AND DISCLOSURE STANDARDS

Section 145 of the Act, empowers the Central Government to introduce Income Computation and Disclosure Standard. Pursuant to the said provision, 10 ICDS were introduced by the Central Government which were applicable for the financial year 2016-17. Amendments were also made in the tax audit report format, pertaining to disclosure requirements of ICDS.

However, in the midst of the ICDS being complied by the specified assessees, Hon'ble Delhi High Court has struck down certain provisions of ICDS.

Now, in order to provide certainty with respect to applicability of the ICDS, amendments have been proposed to made in the provisions of the Act itself. However, such amendments have been proposed to be retrospective, in view that such provisions were already complied by large number of tax payers for the financial year 2016-17.

The proposals provides as under:

- Amendment to Section 36 of the Act to provide for allowance of deduction of market to market loss or other expected loss.

- Insertion of new Section 43AA which provides for treatment of income or loss arising on account of effects of changes in foreign exchange rates in respect of specified foreign currency transaction. However, the same shall be subject to provisions of Section 43A of the Act, pertaining to capitalization of such gain/ loss.

- Introduction of percentage of completion method for the purpose of computing profits from construction contract or contract of service by inserting a new Section 43CB.

- Interest received on compensation or enhanced compensation to be taxable in the year of receipt.

- Amendment is proposed to Section 145A of the Act to provide for valuation of inventory, including inventory being listed or unlisted security.

12 BUSINESS CONNECTION

The government, in its endeavor to follow the best international tax practices and as a signatory to Organisation for Economic Development (OECD), Base Erosion and Profit Shifting (BEPS), has proposed to amend the definition of 'business connection' provided in Section 9 of the Act, to align the same with the definition of permanent establishment provided in Action Plan 7 of the BEPS project.

The OECD under Action Plan 7 of BEPS project has reviewed the definition of dependent agent permanent establishment in view of the avoidance of payment of tax by multi national enterprises by circumventing against the existing definition of permanent establishment by working upon commissionaire arrangements or fragmentation of business activities.

Action Plan 7 has proposed a new definition of dependent agent permanent establishment (DAPE) to provide that an agent would not only include who habitually concludes contract on behalf of non-resident but would also include a person who habitually plays a principal role leading to the conclusion of contracts. Further, Action Plan 7 also provides for introduction of anti-fragmentation rules so as to prevent the tax payer from resorting to fragmentation of functions which are otherwise a whole activity in order to avail benefit under the provisions of Article 5 of the double avoidance tax treaties.

The amended definition of permanent establishment, as proposed by Action Plan 7 was adopted in Multilateral Instrument (MLI) introduced vide BEPS, to which India is also a signatory. MLI proposes to amend the double taxation avoidance agreement (DTAA) between the signatory countries as per the amendments included in MLI suggested by various Action Plans of BEPS.

Now, in view of the fact that the provisions of DTAA are amended when read with MLI, it is necessary to realign the domestic provisions of the Act in view of the provisions of Section 90(2) of the Act. Section 90(2) of the Act provides that the provisions of domestic law would prevail over the provisions of DTAA, to the extent they are more beneficial to the taxpayer.

Since, the current definition of 'business connection' is beneficial to the tax payer vis-a-vis the amended definition of PE under Article 5 of DTAA read with MLI, it is proposed to amend the provisions of Section 9 and to provide that "business connection" shall also include any business activity carried through a person who , acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident. It is further proposed that the contracts should be

(i) in the name of the name of the non-resident; or
(ii) for the transfer of the ownership or, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or
(iii) for the provision of services by that non-resident

13 SIGNIFICANT ECONOMIC PRESENCE

The current definition of 'business connection' and the aforesaid proposed new definition of 'business connection' and the current definition of permanent establishment as provided in DTAA provides for taxability on the basis of physical presence. Both such rules, provides for taxability of the non-resident in the source country on the basis of non-residents physical presence.

However, in today's digital world, where the national borders does not impact the free flow of information, resources and capital, and entities are earning revenue from different countries without any physical presence in those countries, taxing only on the basis of physical presence would erode the tax base of the source countries.

OECD under its BEPS Action Plan 1 has addressed the tax challenges in digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital economy. One such option was adopted by India two years back by introduction of "Equalization Levy" which is applicable on payment to non-resident companies for online/ digital advertising/ promotion.

Further, the Action Plan 1 also provides for another option, a new nexus rule based on "**Significant Economic Presence**". As per the BEPS Action Plan 1 report, a non-resident enterprise would create a taxable presence in a country if it has a significance economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools.

In order to enlarge the scope of the domestic law, it is proposed to amend the provisions of Section 9 of the Act to include the definition of "Significant Economic Presence" to also constitute "Business Connection". However, it is proposed that only so much of income would be taxable in India which would be attributable to activities in India. Further, it is proposed that transaction or activities shall constitute "Significant Economic Presence" irrespective of the fact whether non-resident has a residence or place of business in India or renders services in India.

"Significant Economic Presence" is proposed to mean (i) any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed; or (ii) systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

Although, the government has proposed to amend the meaning of "business connection" and has proposed to also include the recommendation of BEPS Action Plan 1 pertaining to "Significant Economic Presence", however, the same would not be practically applicable in view of the absence of any such clause in the definition of permanent establishment in DTAA.

Section 90(2) of the Act provides that the provisions of domestic law would prevail over the provisions of DTAA, to the extent they are more beneficial to the taxpayer. In such a scenario, since the provisions of DTAA would be more favourable to the non-resident, the provisions of the Act would be otiose and would not provide the intended result. This fact has also been clarified by the government in their memorandum to finance bill and have provided that unless corresponding modifications are not made to permanent establishment rules in DTAAs, the cross border business profits will continue to be taxes as per the existing treaty rules.

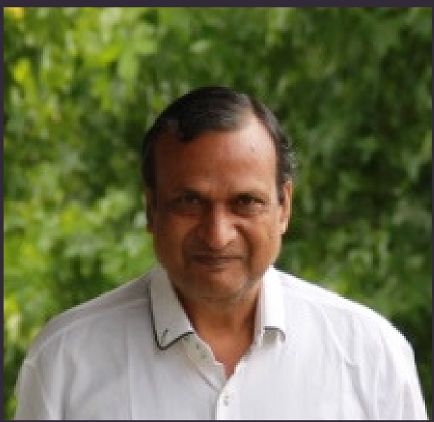
14 E-Assessments

The government has launched a pilot project of e-assessments, proposing for undertaking the scrutiny assessments online over the portal and emails and eliminating the interface between the tax payer and the tax officer.

It is now proposed to amend the provisions of Section 143 pertaining to scrutiny assessments and to provide for e-assessments for imparting greater transparency, optimal utilization of the resources and introduction of the team based assessment. it is also proposed to prescribe the said scheme by way of a notification to be passed by both the houses of parliament.

Although, this is a welcome move and would address the hardships faced by assessee's, however, this may also lead to excessive additions on account of lack of proper explanation and documentation, thereby leading to excessive appeals.

Meet the Team



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