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FINANCE ACT HIGHLIGHTS

Finance Act 2020:

Stakeholder inputs reflected; Equalisation levy widened!

The Finance Bill, 2020 (“**Bill**”) was passed in the Lok Sabha with some amendments on March 23, 2020. The same has now received the assent of the President and been enacted as the Finance Act, 2020 (“**FA 2020/Act**”). We had discussed the provisions of the Finance Bill 2020 in our Budget Highlights dated February 3, 2020. In this Budget Highlights we discuss some of the key changes made to the Bill and their brief implications.

1. Changes to residency rules for citizens or PIOs:

The Income-tax Act, 1961 (“**IT Act**”) provides that an individual is considered a resident in India in a financial year (“**FY**”) if (i) he is in India for 182 days or more during the year; or (ii) he has been in India for 365 days or more during the 4 (four) immediately preceding years and for 60 days or more during the relevant FY. Prior to the FA, 2020, the IT Act provided a relaxed threshold of 182 days, instead of 60 days, in case of a citizen of India or a Person of Indian Origin (“**PIO**”).

The Bill had proposed to change the relaxation of 182 days and bring it down to a period of 120 days. Accordingly, as per the proposed provision if any citizen of India or a PIO stayed in India for 120 days or more, during a year **and** had been in India for a total of 365 days during 4 (four) years immediately preceding that year, then he would become an Indian tax resident in the year in which he exceeded his stay beyond 120 days in India and would be subject to tax in India as a resident, on his worldwide income if he was not resident but not ordinarily resident.

Now, the FA 2020, has amended this provision such that the reduced 120 days criteria for determining residence in India is applicable only to those Indian citizens or PIO’s, whose total income (excluding foreign source income) exceeds INR 1.5 million. For the purpose of this provision, income from foreign sources has been defined to mean income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India). As regards those Indian citizens or PIO’s, whose non-foreign source income does not cross the threshold of INR 1.5 million, they will continue to benefit from the higher number of days presence of 182 days in India for determining their residence.

This carve out provides the much-needed relief to various non-resident Indians, who do not earn income exceeding INR 1.5 million from non-foreign sources. However, it does complicate the administration of the provision and compliance requirement for the persons in this category. It would also restrict the ability of a no-resident and PIO to have large investments in India and spend time in India to manage such investments.

These amendments to the IT Act come into effect from April 1, 2020.

Tax residency test based on citizenship:

The Bill had also proposed to amend the IT Act to provide that an Indian citizen will be deemed to be tax resident of India if he is not liable to tax in any country or jurisdiction by reason of his domicile or residence or any other criteria of similar nature, regardless of whether such individual meets the residency test. Further, in order to lend additional clarification, the Central Board of Direct Taxation (“**CBDT**”) vide a press release dated February 2, 2020, had clarified that any person who qualifies as an Indian resident pursuant to the proposed provision would only be subject to tax in India on their income, which has been derived by them from an Indian business or profession.

The FA 2020 has amended the IT Act to provide for the deemed resident provision, where it has restricted its applicability only to those Indian citizens whose total income (excluding foreign source income) exceeds INR 1.5 million. Thus, providing a sigh of relief to various non-resident Indians, who do not earn income exceeding INR 1.5 million from India.

Once again, if such Indian citizens had large investments in India, the change in the provision does not help them and the change in law is not in line with the CBDT press release.

This amendment to the IT Act comes into effect from April 1, 2020.

<u>Tests for determining the status of Resident but Not-Ordinarily Resident in India:</u>

The IT Act provides that an individual or an HUF is deemed as 'not ordinarily resident in India' if (i) the individual or the karta of HUF has been a non-resident in India for at least 9 (nine) out of 10 years preceding the relevant fiscal year; or (ii) the individual or the karta of the HUF has not been physically present in India for less than 729 days during the period of 7 (seven) years preceding the relevant fiscal year.

The Bill had proposed to rationalise this provision and substitute the two conditions with the sole criteria that an individual/HUF shall be deemed to be not ordinarily resident in India, if he/karta of HUF has been a non-resident in any 7 (seven) out of the 10 immediately preceding relevant fiscal. However, the FA 2020, scrapped this proposed amendment entirely. Thus, reverting to the old position.

However, FA 2020, has amended the IT Act to provide two additional situations to ascertain if a resident would be deemed to be 'not ordinarily resident' in India. A resident would be deemed to be 'not ordinarily resident' in India if (i) he is an Indian citizen or a PIO whose total income (other than income from foreign sources) exceeds INR 1.5 million during the relevant year and who has been in India for a period of 120 days or more but less than 182 days; or (ii) he is an Indian Citizen and is deemed to be a resident because his non-foreign source income exceeds INR 1.5 million and he is not taxed anywhere else in the world on his income as explained in the first bullet of this section.

These amendments throw spotlight on the intention of the government to scrutinise the non-resident Indians. Thus, it would be pertinent to ensure that the non-resident Indians undertake proper planning with regard to their Indian sourced incomes and the frequency and duration of their visits to India.

These amendments to the IT Act come into effect from April 1, 202010

2. Dividend income of unit holders from Business trusts: Partly exempt:

Upon abolition of the erstwhile tax regime on dividend, which was comprised in dividend distribution tax ("**DDT**") payable by a domestic company when distributing dividends, the Bill had changed the provisions pertaining to taxation of unitholders contained in Section 10(23FD) of the IT Act. The income of a business trust both in the nature of interest and dividend income received from special purpose vehicles ("**SPVs**") which are domestic companies in which the business trusts hold controlling interest or any specific level of equity holding as prescribed under the regulations applicable to the business trusts continues to be exempt under Section 10(23FC). The amendment to Section 10(23FD) of the IT Act under the Bill brought the dividend income which the business trusts received from the SPVs and distributed to unit holders was brought to tax in the hands of the unitholders with effect from April 1, 2020. It is to be noted that interest was already taxable in the hands of unit holders under Section 10(23FD).

This was seen as a negative measure of tax which would take away the attractiveness of business trusts as asset class to invest in. Several representations were made to the Finance Ministry to retain the tax-free status of dividends as was available under the erstwhile DDT regime for the unit holders of business trusts.

Partially heeding to the demands of the industry, the FA 2020 has amended the provision of Section 10(23FD) such that dividend distributed by the business trust shall be taxable in the hands of the unit holders, only if the SPV distributing the dividends has exercised the option to pay 22% corporate tax under Section 115BAA of the IT Act. The corresponding withholding tax provisions under Section 194LBA have also been amended.

Dividend income payable by business trusts to resident and non-resident unitholders shall be subject to withholding tax at the rate of 10% under Section 194LBA. However, in case of non-residents, who is eligible to the benefits of a Double Taxation Avoidance Agreement ("**DTAA**") between India and the country of its residence, if the DTAA provides for lower withholding rate for dividend, the same should be available.

This means that if the SPV is taxable under the 15% tax regime available to a company whose activities qualify as 'manufacturing' and was set up post October 2019, as well as companies which continue to pay tax under the 30% tax regime, the dividends paid by them to the business trust and in turn the business trust distributing the dividends to the unit holders will be exempt from tax in the hands of the unit holders. It is interesting to note that the companies under 30% tax regime may reduce over time, as they use up their accumulated minimum alternate tax credit and would start opting for the 22% tax regime. On the other hand, companies which qualify as manufacturing companies and start manufacturing before March 31, 2023, may increase in number. Thus, from tax efficiency perspective, the unit holder would look to assess the attractiveness of equity investment in business trusts based on the tax regime applicable to their investee SPVs.

These amendments to the IT Act come into effect from April 1, 2020.

3. Scope of exemption for sovereign funds widened:

The Bill proposed to exempt income in the nature of dividend, interest or long-term capital gains in the hands of 'specified investors' so long as the investment was made on or before March 31, 2024 and was locked in for 3 (three) years, in an Indian company which is in the business of developing or operating and maintaining any infrastructure facility as defined in Section 80-IA(4) of the IT Act ("**Infra Companies**"). Specified investors for this purpose was defined to be sovereign funds, falling within the meaning prescribed in the Bill.

The industry in general made representations that income of 'specified investors' should also be exempt from Indian income tax for their investments in asset classes including Alternative Investment Funds ("**AIFs**") and business trusts. The industry also sought to widen the definition of 'specified investors' to include pension funds.

Heeding to the representations, amendments have been made and the FA 2020 has now extended the exemption to specified investors from tax for income arising from investments made by specified investors in (a) AIFs which have in turn made all their investments in Infra Companies; and (b) business trusts.

Additionally, the Act has also expanded the definition of specified investor to include 'pension funds' which are created or established under the law of a foreign country, are not liable to tax in such foreign country and which fulfil other conditions as may be prescribed. The Government intends to notify such pension funds which will be eligible for this exemption.

This change is very welcome for investment flows from large sovereign funds as well as pension funds not only in infrastructure companies but also in InvITs and infrastructure specific AIFs. Some of the attractiveness taken away by the change in taxability of dividends in the hands of the unitholders of business trusts, may seem to be offset by this change.

These amendments to the IT Act come into effect from April 1, 2020.

4. Double tax on dividends avoided:

The Bill proposed to allow a corporate shareholder to claim deduction for dividends received from other domestic companies, to the extent of the dividends declared by such shareholder company prior to the prescribed date.

The Act has extended this deduction to dividends received from foreign companies and business trusts.

This is a welcome change which will restore the position of taxability of dividends from foreign companies, to some extent. Including business trust in this makes investments by companies in business trusts more attractive from tax perspective.

These amendments to the IT Act come into effect from April 1, 2020.

5. TDS rationalised for some royalty payments:

Income tax at the rate of 10% is required to be deducted, inter alia, on the following payments under Section 194J of the IT Act: (i) fees for professional services; (ii) fees for technical services; and (iii) royalty.

The Bill proposed to amend Section 194J to reduce the withholding tax rate on payments in the nature of fee for technical services (excluding professional services) to 2% from the existing 10%, in order to reduce disputes and litigation. The Bill further proposed to amend the definition of royalty to include consideration for the sale, distribution or exhibition of cinematographic films within its ambit.

The FA 2020 has now extended the benefit of the reduced withholding tax rate of 2% to royalty when the payment is made as consideration for the sale, distribution or exhibition of cinematographic films.

This is a welcome change for India's large film industry.

These amendments to the IT Act come into effect from April 1, 2020.

6. Mutual funds: No withholding on capital gains:

The Bill had proposed to introduce a new provision for a withholding tax at the rate of 10% on payment made to a resident, inter alia, in relation to units of a mutual fund above the threshold of INR 5,000.

Since the withholding provisions merely suggested that tax shall be withheld by the mutual funds at the rate of 10%, there was a lot of anxiety regarding whether the mutual fund shall also be required to withhold tax on payment made by the mutual fund which is in the nature of capital gains.

The Act has amended the provision to clarify that the withholding tax under the newly introduced Section 194K would not apply when the income is in the nature of capital gains.

These amendments to the IT Act come into effect from April 1, 2020.

7. Equalisation levy broadened:

The Finance Act, 2016 had introduced Equalisation Levy ("**EL**") at the rate of 6% on certain payments if it exceeded INR 100,000 in a FY. The EL was made applicable on payments by a resident or a non-resident having a permanent establishment in India for online advertisements, i.e. on B to B transaction. It is interesting to note that the Bill as presented on February 1, 2020 had not proposed any changes in this respect.

As the taxation, based on significant economic presence ("**SEP**") test is pushed away further, there appears to be a concern to plug the hole in perceived erosion of base through the expansion of EL and hence we find that the FA 2020 has, without any deliberations, expanded the scope of EL. It now includes e-commerce supply or services provided or facilitated from April 1, 2020 onwards. EL would be applicable at the rate of 2% on the consideration received or receivable by an 'e-commerce operator' from 'e-commerce supply or services' made or provided or facilitated by or through it if the receipt in a year exceeds INR 20 million:

(i) to a person resident in India; or

(ii) to a non-resident where:

- It is sale of advertisement, which targets Indian resident customers or customers who access the advertisement through an IP address located in India; and
- sale of data, collected from an Indian resident or from a person who uses an IP address located in India; or

(iii) to a person who buys goods or services, or both supplied by the 'e-commerce operator' using an IP address located in India.

For this purpose, 'e-commerce supply or services' has been defined to mean, online sale of goods owned by the e-commerce operator; or (ii) online provision of services provided by the e-commerce operator; or (iii) facilitation of such goods or services or (iv) any combination of activities in (i) to (iii).

Further, 'e-commerce operator' has been defined as a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both.

The EL under these provisions would not be payable if the non-resident e-commerce operator has a permanent establishment ("**PE**") in India and the e-commerce supply of goods or services is connected with the PE. It will also not be payable if the operator is subjected to the EL under the provision applicable to online advertising which was introduced in 2016.

Interestingly, compliance to make the payment of EL has shifted to the non-resident e-commerce operator or facilitator. There is no burden on the resident payer of goods or services. The EL is levied not only on dealing with Indian residents but even when the revenue is earned using an Indian IP address. The government seems to have taken a leaf out of GST, which taxes certain forms of digital services under online information database access and retrieval services. Enforcement could be challenging, however, since the payments will go through banking channels, the RBI's payment system operation could be tapped to trace these e-commerce operators for compliance. With this phenomenal expansion in the scope of the EL, the e-commerce transactions would again be in the limelight in the times to come.

These amendments come into effect from April 1, 2020.

8. TDS on e-commerce:

The Bill had proposed to insert a new Section 194-O in the IT Act to require an e-commerce operator to withhold tax at the rate of 1% of the gross amount of sales/service fees paid to a resident e-commerce participant who sells goods or provides services through the digital or electronic facility or platform provided by the e-commerce operator. For the purposes of this withholding, the Bill had proposed to define e-commerce operator as any person who owns, operates or manages digital or electronic facility or platform for the purposes of electronic commerce and is responsible for paying to the e-commerce participant. The FA 2020 has revised the definition of e-commerce operator to include a person responsible to make payment to an e-commerce participant. The FA 2020 has included a deeming fiction that an e-commerce operator would be deemed to be responsible to pay to an e-commerce participant even when the e-commerce participant receives the payment for providing goods or services directly from the customer, as long as the transaction is done through the platform of the e-commerce operator or the payment is made by a person who falls within the definition of e-commerce operator. The FA 2020 has further introduced provisions to enable the Central Government to issue guidelines for removing difficulty in implementing Section 194-O of the IT Act, after having laid down such guideline before Parliament.

These amendments to the IT Act will now be effective from October 1, 2020 in place of April1, 2020 as originally provided in the Bill.

9. TDS on payments in cash:

Section 194N of the IT Act requires a banking company or cooperative society engaged in banking activities or a post office to deduct tax at the rate of 2%, on sum or aggregate of sums paid in cash to any person, exceeding INR 10 million in a FY. The FA 2020 has substituted the exiting provisions of Section 194N with a modified application to a recipient who has not filed return of income for 3 (three) years prior to the FY in which the sum is payable. For such recipient, up to payment of INR 2.5 million, no tax would be deducted. For amount paid between INR 2.5 million and 10 million, 2% will be deducted and the rate of 5% where such aggregate exceeds INR 10 million.

These amendments to the IT Act come into effect from July 1, 2020.

10. Clarifications in relation to wider scope of TCS:

The Bill proposed to introduce tax collection at source ("**TCS**") on certain transactions such as remittances made in foreign currency under the Liberalised Remittance Scheme ("**LRS**") through authorised dealers or to seller of an overseas tour programme package in order to expand the tax base. Under the Bill, TCS was to be applicable from April 1, 2020. However, the FA 2020 has deferred its applicability to October 1, 2020 and made some amendments to the provisions. We have discussed some of the key amendments to the TCS provisions.

The Bill had exempted from application of TCS, if payments were made through an authorised dealer under the LRS and the payment was less than INR 0.7 million. The FA 2020 has made certain amendments and the new provisions are summarized as follows:

(i) TCS at 5% would be applicable if the payment under the LRS exceeds INR 0.7 million. However, the TCS at 5% would apply for payment to overseas tour programme package, even if the amount being remitted is less than INR 0.7 million.

(ii) In case of remittance above INR 0.7 million, if the remittance is out of loan obtained from a financial institution for pursuing education, the TCS is to be deducted at the rate of 0.5%.

(iii) No TCS on remittance of foreign exchange to a resident, which pertains export of goods.

(iv) No TCS if the buyer of goods who is making payments has deducted tax from the payment to the seller of goods being income tax payable by the seller.

(v) No TCS on import of goods for business.

These amendments aim to provide more clarity on the expansion of TCS to certain foreign transactions and thereby provides more certainty for taxpayers.

These amendments to the IT Act come into effect from October 1, 2020.

11. Approval of Charitable Organisations more organised:

In addition to the tax exempt status available to charitable organisations under Section 12AA of the IT Act, Section 10(23C) of the IT Act exempts receipt of any income, on behalf of inter alia a fund or institution or trust established for charitable purposes or wholly for public religious purposes upon specific approval by prescribed tax authority. This approval is based on the satisfaction of authority about the genuineness of activities and compliance with such requirement under the laws as may be material for the purpose of achieving the objectives. The Bill had provided in detail the procedure for application with specific timelines for application and renewals and that such approval would be granted for a period of 5 (five) years. However, the Bill had not provided any specific date for entry into force for the detailed application procedure and timelines.

The FA, 2020 has included this procedure and timelines which were proposed under the Bill and has specified that these amendments would be effective from June 1, 2020.

This amendment to the IT Act comes into effect from June 1, 2020.

Section 10(23C) also requires such charitable organisation to apply or accumulate its income wholly and exclusively to the objects for which it is established. Where the accumulation exceeds 15% of the income of the organisation, the maximum period of accumulation allowed is 5 (five) years. To dispel the doubts on what constitutes income of such organisation and avoid litigation, the Act has clarified that voluntary contribution that is directed to form part of the corpus of the organisation, would not be included as income of the organisation for meeting this condition. The FA 2020 has also correspondingly provided that such contribution when made by one charitable organisation either under Section 10(23C) or Section 12AA of the IT Act to another charitable organisation, would not be considered as application of income by the organisation making such contribution.

These amendments to the IT Act come into effect from April 1, 2020.

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