Tax Hotline

September 27, 2019

MAJOR TAX REFORMS ANNOUNCED– RUNWAY TO GROWTH?

- In an attempt to revive the spirit of the Indian economy amidst the continuing economic slowdown, the Indian Government introduces a slew of measures through the Ordinance.
- Slashes corporate tax rates for domestic companies to 22% (15% in case of new manufacturing companies). Provides for a uniform surcharge rate of 10%.
- Rolls back the enhanced surcharge on capital gains tax (i) payable by all classes of investors on transfer of listed equity shares (including listed units of an equity oriented fund and listed units of a business trust); and (ii) payable by FPIs on transfer of all securities, including derivatives.
- Lowers the threshold for the applicability of MAT and the rate of tax in case of MAT from 18 S % to 15%. Ousts the applicability of MAT in case of companies which opt for taxability under section 115BAA /BAB.
- Withdraws buy-back tax in respect of listed shares for which the announcement was made prior to July 5, 2019.

In an attempt to boost foreign investments and revive the spirit of the Indian economy amidst the continuing economic slowdown, the Indian Government recently introduced a slew of measures through the Taxation Laws (Amendment) Ordinance, 2019 (“**Ordinance**”).

The Ordinance comes as a follow up of all the direct tax related announcements that the Finance Minister (“**FM**”) has been making over the last few weeks. The biggest change that has been brought about by the Ordinance is the reduction in the corporate tax rate of domestic companies to 22% (15% for new manufacturing companies). The change has been welcomed and is in fact the need of the hour since an economic slowdown is currently gripping India[1]. There is a marked decrease in economic activity and employment resulting in decrease in consumption, decrease in investment, liquidity crunch etc. The reduction in corporate tax rate is likely to result in higher profits being distributed to individual stakeholders thereby increasing their disposable income followed by increase in demand and consumption. The reduction in the rate should provide an impetus to foreign investors to invest into India.

The other changes include the rollback of the enhanced surcharge which was introduced earlier this year by the budget, reduction in the Minimum Alternate Tax (“**MAT**”) rate from 18.5% to 15%, withdrawal of buy-back tax on certain listed shares. Each of the measures introduced under the Ordinance are discussed below:

1. REDUCTION IN CORPORATE TAX RATES

Under the current provisions of the (Indian) Income Tax Act, 1961 (“**ITA**”), the corporate tax rate for domestic companies in India is 30%. However, domestic companies are taxable at the beneficial tax rate of 25%[2] if (i) their total turnover or gross receipts does not exceed INR 4 billion (USD 56 million approx.) during the financial year (“**FY**”) 2017-18[3]; or (ii) a company (engaged in the business of manufacture / production of any article or thing and research / distribution of such article or thing (“**Manufacturing Company (ies)**”) that has been set up and registered on or after March 1, 2016 opts for being taxed at such lower rate provided all the prescribed conditions are satisfied[4].

The Ordinance has reduced the headline corporate tax rate for domestic companies to 22% (15% for Manufacturing Companies set up and registered after October 1, 2019). Details of the changes are discussed below:

Through the Ordinance, two new provisions have been introduced into the ITA i.e. section 115BAA and 115BAB. The taxpayer can choose to be taxed under any of these provisions, provided it meets the conditions that have been prescribed.

Under Section 115BAA, a company may choose to be taxed at the rate of 22% in the prescribed manner before the due date for filing returns as specified under section 139(1) of the ITA if the following conditions are satisfied:

- The total income is computed without claiming certain specified deductions and exemptions provided for under the ITA (“**Deductions**”).
- The company shall not be allowed to set off any carried forward losses from earlier assessment years if such loss is attributable to the Deductions.
- The company claims depreciation in the manner prescribed barring any depreciation in respect of plant and machinery installed after March 31, 2005.

Once exercised, the option to be taxed under this provision cannot be withdrawn and shall be applicable for subsequent years.

The same conditions currently exist for a Manufacturing Company opting for the 25% rate as stated above, if such company has been set up and registered on or after March 1, 2016. Similar to the new provisions, the existing provision provides that once the company has opted to be taxed at the 25% rate under the provisions, it cannot withdraw from the position and the provisions will be applicable for subsequent years.

Section 115BAB provides that domestic companies may be taxed at the rate of 15%. For Manufacturing Companies to be eligible to be taxed under this provision, in addition to satisfying the conditions applicable for availing section 115BAA (discussed above), the following conditions shall be satisfied:

- The Manufacturing Company has been set up on or after October 1, 2019 and has commenced manufacturing on or before March 31, 2023.
- The Manufacturing Company is not formed by way of splitting up or re-construction of a business already in existence. However, this condition shall not be applicable in case of an undertaking which is formed as a result of re-establishment, re-construction or revival in the manner provided for under the ITA[5].
- The Manufacturing Company does not use any *'machinery or plant previously used for any purpose'*. However, plant or machinery used by any other person outside India shall not qualify as *'machinery of plant previously used for any purpose'* provided the following conditions are satisfied: (i) prior to installation, the machinery and plant were not used in India; and (ii) such machinery and plant is imported into India from any country outside India; and (iii) no depreciation is claimed / claimable on such machinery and plant in computing the total income of any person prior to installation. However, this condition shall be deemed to be satisfied if the value of the *'machinery and plant previously used for any purpose'* does not exceed 20% of the total value of machinery or plant used by the Manufacturing Company.
- The Manufacturing Company does not use any building which was previously used as a convention centre[6] or a hotel[7].

Section 115BAB also provides that any transaction between a new Manufacturing Company and an entity with which it has a close connection (as may be reasonable determined by the assessing officer) shall be considered to be a specified domestic transaction. Therefore, the profits for the purpose of taxation under Section 115BAB, in such cases, shall be computed on an arm's length basis. This provision has been introduced as a specific anti-avoidance measure where Manufacturing Companies may artificially hike their profits so as to pay a lower rate of tax.

The Ordinance attempts to provide the benefit of the new tax rate to existing Manufacturing Companies who had opted for the reduced rate of 25% under the existing provisions but have failed to do so. This is because the new Section 115BAB can be opted only by Manufacturing Companies set up and registered on or after October 1, 2019 and therefore for Manufacturing Companies set up on or before that, cannot take the benefit of the new provisions. It seems that the Government has made an inadvertent error where existing Manufacturing Companies which had opted for the existing provisions should have been allowed to opt for the new Section 115BAA as opposed to Section 115BAB.

Further, the Ordinance also seeks to reduce the surcharge applicable on domestic companies opting for taxability under section 115BAA and section 115BAB. Currently, the applicable rate of surcharge on domestic companies is (i) 7% where total income exceeds INR 1 crore but less than INR 10 crores; and (ii) 12% in respect of total income which exceeds INR 10 crores. The Ordinance seeks to provide for a uniform surcharge rate of 10% for domestic companies opting for taxability under the new Sections 115BAA or 115BAB resulting in the effective tax rate for such companies to be 25.17% or 17.16% respectively

To summarize,

- Companies which have total turnover or gross receipts not exceeding INR 400 crores during the financial year ("**FY**") 2017-18 shall be taxed at 25%.
- Manufacturing Companies set up and registered or after March 1, 2016 shall have the option to be taxed at 25%, provided the relevant conditions are fulfilled.
- Manufacturing Companies set up and registered on or after October 1, 2019 and commence manufacturing prior to March 31, 2023 shall have the option to be taxed at 15%, provided the relevant conditions are fulfilled;
- Domestic companies that satisfy the prescribed conditions shall have the option to be taxed at the rate of 22%.
- For all other domestic companies, the tax rate will be 30%.

Impact

- *Competitive rate for inbound investment:* Corporate tax rates plays a crucial role in any country's inbound investments. In the last few years, countries across the globe have reduced corporate tax rates with a view to boost investment, consumption and labour market participation. Resultantly, the average corporate tax rates amongst the Organization for Economic Co-operation and Development ("**OECD**") countries has reduced from 32.5% in 2000 to 23.19% in 2018.[8]
  Realizing the importance of having a balanced corporate tax rate, in the 2016 budget, the then FM had announced a roadmap for corporate tax reduction from 30% to 25% in four years. However, the current FM, with the intent to boost market sentiments and investments in the country, in a bold move has reduced this rate further to 22% making India not only an attractive jurisdiction from a tax perspective for making investments, but also a competitive one among the ASEAN countries.
  With the new corporate tax rate of 22%, India is competing with countries like Singapore (17%), Ireland (12.5%), UK (19%), US (21%), Vietnam (20%), Thailand (20%), Taiwan (20%) etc.,[9] some of whom have had low tax rates historically. The reduction of the corporate tax rate is in consonance with the global trend and a globally recognized method of boosting dying economies.
- *Increase in distribution of profits by companies:* Reduction of corporate tax rate has a direct impact on the amount of profits that can be distributed to the shareholders. In a country like India where dividends are subject to a dividend distribution tax ("**DDT**") at the effective rate of 20.55%[10] as a tax payable by the company, a higher corporate tax rate results in less profits available for distribution which is then further reduced by DDT. Therefore, if the corporate tax rate was effectively 35%, a further DDT on the profits after tax would result in approximately 48% of the gross profits being paid as taxes and only 52% reaching the shareholder. By reducing the corporate tax rate

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to 22%, the shareholder will be able to receive almost 60% of the profits of the company. Since, DDT is tax paid by the company, foreign shareholders are only rarely able to claim credit for the taxes paid, making this route quite inefficient. Therefore, any reduction in taxes will only go a long way for such shareholders.

- *Choice of entity in India*: From a choice of entity perspective that should be set-up in India, the Limited Liability Partnerships ("**LLP**") have been gaining popularity after foreign investment in an LLP has been permitted (in sectors where there are no conditionalities). The main reason for this is the fact that after payment of corporate tax of 30% on the total income, there is no further tax on distribution of the profits to the partners and close to 65% of the total income of the LLP can be received by the partners. Therefore, partners of an LLP tend to receive a higher amount of profit in their hands as opposed to a company where the profits suffer another level of DDT as discussed above. Even though the rate of tax for an LLP remains higher than a domestic company under the new regime, from a distribution of profits perspective a higher amount of distribution is made by an LLP to its partners. However, an LLP comes with its own draw backs such as it is not able to issue bonds or other types of securities. Therefore, whether an LLP or a company should be set up remains a question which can only be answered on the basis of facts of each situation, as with the new rate of tax the difference in what a shareholder will receive and what a partner will receive has been reduced to only 5%.
- *New Manufacturing units*: As discussed above, new Manufacturing Companies established after October 1, 2019 can avail a lower corporate tax rate of 15% under section 115BAB. However, this benefit should not be available to Manufacturing Companies formed by way of splitting up or re-construction of a business already in existence. The same condition exists even for units which are set up in a Special Economic Zone ("**SEZ**") for claiming tax exemption under the ITA wherein SEZ units formed by the 'splitting up', or 'reconstruction', of a business already in existence are not allowed to take benefit of the exemption. While no definition has been provided under the ITA for these terms, judicial precedents have given some direction. Essentially, the 'splitting up' / 'reconstruction' condition requires that the new unit (s) should not be a continuation of an already existing business. Instead, it should be a new entity capable of functioning independently. In other words, transfer of the plant/ machinery/ employees from an existing business should not form the basis on which the new unit is formed.[11]
  It is standard business practice for businesses having multiple verticals to be broken up in such a manner, whereby different verticals functioning under the business as a whole, start functioning as separate businesses. Such dis-integration is done primarily from a ring–fencing perspective to ensure that the liabilities of one vertical do no transgress onto others. The 'splitting up or re-construction' condition under section 115BAB will prevent Manufacturing Companies from carrying out such dis-integration if they wish to avail the low tax rate of 15%.

2. ROLLBACK OF ENHANCED SURCHARGE INTRODUCED THROUGH THE UNION BUDGET 2019

In the budget speech earlier this year, the FM had announced that a higher surcharge would be applicable 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. However, the fine print of the Finance Bill 2019 provided that the enhanced surcharge was made applicable not only to individuals, but also to Hindu Undivided Families, Association of Persons, Body of Individuals and every other artificial juridical person. This resulted in Foreign Portfolio Investors ("FPIs") set up as trusts and Category III Alternate Investment Funds also coming within the purview of the enhanced surcharge, which adversely impacted investments into Indian capital markets.

This had become a cause of concern for a large part of the funds industry and is considered one of the major factors behind the current economic slowdown. Several industry representations were made which finally resulted in the FM announcing that 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. The Ordinance, apart from making the above amendments, goes one step ahead to provide that the enhanced surcharge will not be applicable on tax payable by FPIs on long and short-term capital gains on transfer of any securities, including 'derivatives'.

The changes that were announced by the FM would have resulted in capital gains on transfer of bonds for FPIs which are set up in non-treaty jurisdictions as there was no exemption announced on the higher surcharge for such transfers. However, the Ordinance takes care of this issue by providing exemption on the higher surcharge to all securities which are transferred by FPIs. This is a welcome move and will help in reducing the disparity that exists between FPIs set up as trusts and corporates. However, interest income arising to FPIs from bonds, which can otherwise avail concessional tax rates under the ITA still remain to be an issue and no exemption has been provided for it.

3. REDUCTION IN RATE OF MINIMUM ALTERNATE TAX

Section 115JB of the ITA provides that in case the income tax payable by a company on the total income computed as per the provisions of the ITA is less than 18 S % of its book profit, such book profit shall be deemed to be the total income and shall be taxed as Minimum Alternate Tax ("**MAT**") at the rate of 18 S %. It was introduced to prevent domestic companies which claim large deductions / concessions available under the ITA from paying zero / negligible amount of taxes.

The Ordinance seeks to (i) amend the threshold for applicability of MAT and provides that MAT will be payable if the total income computed as per the provisions of the ITA is less than 15% of its book profits; and (ii) reduce the rate of MAT from 18S % to 15%. This measure is likely to boost foreign investments, particularly for investments into companies that enjoy several deductions / exemptions under the ITA.

Further, the Ordinance provides that MAT will not be applicable in case of companies opting for taxability under the new Sections 115BAA / 115BAB.

It is quite common for companies undergoing the resolution process under the Insolvency and Bankruptcy Code ("**IBC**"), to write back loans as they are not able to service these loans. When this happens, the loans are recorded as income in the Profit and Loss account of the debtor company, resulting in them having to pay taxes even in situations where they are bankrupt, as these form a part of their book profits. Hence, MAT becomes payable even when the company actually does not have any money to pay. This is an added burden for already stressed companies undergoing insolvency. This conundrum may be avoided by companies opting for taxability under Section 115BAA / Section BAB, which ousts the applicability of MAT. Accordingly, this may become one of the factors that companies take into consideration while choosing the provision under which they are taxed. Having said that, it must be noted that once the company opts to be taxed under the new Section 115BAA / Section 115BAB it cannot change its stance and has to continue paying the 22% / 15% tax as the case may be.

However, it is not clear whether companies which were paying MAT and choose to be taxed at the lower rate under the new provisions, can take credit of the MAT that was paid earlier. Clarification in this regard is sought and if not provided for, all of the credit would be lost.

4. WITHDRAWAL OF BUY- BACK TAXES IN CASE OF LISTED SHARES

Section 115QA of the ITA provides that any amount of distributed income by a domestic company on buy-back of shares from a shareholder shall be taxed at the rate of 20% in the hands of the company. Distributed income in this context is defined as the difference between the consideration paid by the company on buy-back of shares and the price paid by the shareholders for acquiring the shares. The provision was first introduced by the Finance Act, 2013 as an anti-abuse provision to curb the practice of unlisted domestic companies resorting to buyback of shares instead of payment of dividends as the capitals gains tax rate applicable at the time was lower than the rate applicable to dividend distribution. The Finance Act, 2019 extended the purview of Section 115QA to listed companies as well. Thus, any buyback of shares from a shareholder by a company listed on recognized stock exchange, on or after July 5, 2019, would also be subject to a 20% buyback tax. The Ordinance seeks to amend section 115QA to provide that it shall not be applicable on buy-back of shares of listed companies provided that the public announcement in respect such buy-back has been made prior to July 5, 2019 in accordance with the provisions of the Securities and Exchange Board of India (Buy-back of Securities) Regulations, 2018. While the move is welcomed, since listed companies which had announced buy-back prior to budget 2019 would not have accounted for the taxes to be paid on such buy-back, the provision extending buy back tax on listed companies needs to be entirely dispensed with as it is unwarranted and seems impractical. Considering how often publicly listed shares are traded, it is not very likely that the shareholder from whom a listed company buys back its shares, is the same as the one who originally subscribed to such shares. Accordingly, it seems unreasonable, and even absurd to refer to the original subscription amount received by the company when computing such tax.

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You can direct your queries or comments to the authors

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[1] https://economictimes.indiatimes.com/news/economy/indicators/the-dynamics-of-indias-growth-recession/articleshow/71020942.cms?from=mdr.

[2] Unless otherwise specified, all tax rates mentioned herein are exclusive of applicable surcharge and cess

[3] First Schedule, Finance Act 2019

[4] Section 115BA of the ITA.

[5] Section 33B of the ITA

[6] Section 80-ID (6)(a), Income Tax Act, 1961

[7] Section 80 –ID (6)(b), Income Tax Act, 1961

[8] https://www.oecd.org/tax/tax-reforms-accelerating-with-push-to-lower-corporate-tax-rates.htm

[9] https://www.businesstoday.in/current/corporate/indian-corporate-tax-rates-among-the-lowest-in-asia/story/380780.html

[10] Section 115- O, Income Tax Act, 1961

[11] *CIT v. Hindustan General Industries Ltd.,* (1982) 137 ITR 851; Textile Machinery v. CIT, (1977) 107 ITR 195 (SC);
