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Building an economic superpower

Prin Shasiharan
Senior commercial editor
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India is home to one-sixth of humanity. With a young population and a grand consumer base – complete with ethnic and linguistic diversity – it is a country with unparalleled economic potential. In March, the OECD forecasted India's GDP to grow by 12.6% in 2021 – a figure that if realised, would return the country to being the world's fastest growing major economy.

The country's steady economic growth in the mid-2010s had slowed following ambitious fiscal policy – including the 2016 demonetisation and 2017's goods and services tax (GST) implementation – though appears to have quickly rebounded through reforms supporting increased economic liberation and extended support for overseas investors. Moreover, there has been political stability, welcome incentives targeting the manufacturing sector, and a liquidity boost handed to the country's busy micro, small and medium-sized enterprise sector.

With India's penchant for creativity and entrepreneurship, new capabilities will emerge to overcome obstacles. As businesses, investors and taxpayers strive for prosperity, the demand for tax advice remains high.

Associating with leading firms who are closest to the action, *ITR* brings you an exclusive insight into some of the most important developments from the Indian tax world. We are delighted to feature articles from experts at Aurtus Consulting, Dhruva Advisors, KNAV, Lakshmikumaran & Sridharan, and TMSL.

In addition to the chapters, practitioners and policymakers from the subcontinent provide their view on the most important career tools for the tax lawyers and chartered accountants of tomorrow. Alongside tax voices from Bangladesh, Bhutan and Nepal, Tata Consultancy Services' global head of taxation, Renu Narvekar, discusses the importance of keeping in-sync with the changing tax landscape.

As the investment climate bounces back, India's tax world will go from strength to strength in the coming year. We hope that you enjoy hearing from the tax experts leading the progression in our first India Special Focus.

India

A closer look at India's Union Budget 2021

Tax incentives set to attract global investors

Punit Shah, Shashidhar Upinkudru and Vishal Lohia of Dhruva Advisors look ahead at changes to India's direct tax landscape, led by encouraging policies aimed to support GIFT City, sovereign wealth and pension funds.

In the backdrop of an unprecedented contraction in the Indian economy caused by the lockdown imposed due to the COVID-19 pandemic, the Honourable Finance Minister, Nirmala Sitharaman, presented the Union Budget for financial year (FY) 2021-22 on February 1 2021.

The Union Budget largely focused on aspects of healthcare improvement, infrastructure, agriculture, support for small and medium enterprises, and skill development, among other areas. From a regulatory reform perspective, the Finance Minister mentioned the intention of the government to introduce a new securities law code to consolidate laws under the Securities and Exchange Board of India Act, 1992, the Depositories Act, 1996, the Securities Contracts Regulation Act, 1956 and the Government Securities Act, 2007. Also, there have been proposals to expand the foreign direct investment limit for insurance companies to 74% and permit foreign ownership and controls.

On the direct tax landscape, tax rates largely remain unchanged. However, the Union Budget sought to introduce a number of procedural changes for simplifying the tax administration, ease of compliance and reducing litigation such as introduction of faceless appeals before the appellate tribunals, reduction of time limits for reopening of assessment proceedings, and for the introduction of a dispute resolution committee for small and medium taxpayers.

Some key tax incentives have been proposed in the financial services sector, which include amendments for making Gujarat International Financial Tec-City (GIFT City) more attractive for foreign funds and aircraft leasing business, relief to foreign portfolio investors (FPI) by aligning the withholding tax rates applicable to FPIs with tax treaty rates, and on withholding tax on dividend income being received by infrastructure investment trusts/real estate investment trusts (InvITs/REITs). Moreover, there are also changes planned for the relaxation of certain conditions for sovereign wealth funds (SWFs) and pension funds (PFs) to ensure long-term stable capital participation. The key tax incentives as mentioned above, and as proposed by the Union Budget, are discussed in the article.

GIFT City

With a vision to make India a hub for international financial activities, the government had established GIFT City, a global financial and IT services hub, in the state of Gujarat as India's first international financial services centre (IFSC) in 2015. GIFT City caters to India's large financial services potential by offering global firms, world-class infrastructure and facilities. The GIFT City aims to bring back those financial services transactions that are currently carried on outside India by overseas financial institutions and overseas branches/subsidiaries of Indian financial institutions to the Indian shores.

The target business segments of GIFT City include offshore banking, aircraft leasing, capital markets, insurance, fund management, and offshore funds. In order to make GIFT City an attractive destination for financial players, the government has provided various tax incentives over the years for the units established in IFSC. The Union Budget 2021-22, with a view to further incentivise the units in IFSC, proposed various amendments to the Indian tax laws. The key direct tax incentives in relation to GIFT city are encapsulated below:

Relocation of offshore funds

As per the existing domestic tax laws, any relocation by an offshore fund to IFSC would be subject to tax in India. Also, if offshore funds relocate to India, such offshore funds would lose the tax exemption (i.e. grandfathering provisions) provided under the tax treaties for any incremental gains on subsequent sale.

The Union Budget 2021-22 proposes a tax neutral relocation of foreign funds to IFSC. The amendment proposes to make relocation from another country to IFSC tax neutral i.e. the transfer of capital asset by an 'original fund' (from a tax treaty jurisdiction) to a 'resultant fund' in IFSC in 'relocation' is proposed to be exempt from tax, subject to certain conditions.

A tax exemption has also been proposed for capital gains tax from transfer by a shareholder/unit holder, in a relocation, of capital asset being share/unit held by him in the original fund in consideration for shares/units in the resultant fund.

Further, and more importantly, it has been proposed that the resultant fund in IFSC will continue to get capital gains exemption, otherwise available under the respective tax treaty for the original fund in respect of subsequent transfer of shares of an Indian company.

The proposed amendment of exempting the subsequent transfer will motivate various private equity funds based in jurisdictions such as Mauritius or Singapore to relocate to India as there would not be any tax withholding on capital gains arising on such subsequent transfer.

Also, the proposed amendment would be attractive for offshore debt funds and derivative funds to relocate to IFSC as there would not be any capital gains tax post the relocation. Also, the resultant fund – which would be required to register as a Category III alternative investment fund (AIF) registered with the Securities Exchange Board of India – in IFSC would not be required to rely on a tax treaty for claiming tax exemption on capital gains (this would also assist in reducing the exposure relating to general anti-avoidance rule/multilateral convention).

Fund manager in IFSC not to constitute a business connection

Fund management activity from India in respect of offshore funds may result in certain tax consequences (such as the

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Punit has extensive experience in advising domestic organisations and multinational companies (MNCs) on international and transactional tax matters. In particular, he advises banks, insurance companies and non-banking financial companies. He has expertise in the fund space and extensively advises private equity funds, mutual funds, FPIs, infrastructure funds and real estate funds, on tax and regulatory aspects, including on fund structuring, cash repatriation, investments and exits.

Prior to joining the firm, Punit was the co-head of a Big Four tax practice and headed the firm in West India. He is also extensively involved in tax policy issues, and routinely represents clients and industry bodies in making representations and holding discussions with the government. He is a qualified chartered accountant.

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Shashi specialises in conceptualising and structuring inbound investments, effecting acquisitions and joint ventures, identifying optimum operating structures, restructuring existing investments, funding and cash repatriation strategies.

Prior to joining Dhruva Advisors, Shashi worked with a Big Four firm as a director. He is a qualified chartered accountant.

offshore fund may be considered to be resident in India, offshore fund's global income may be subject to tax in India). In order to encourage fund management activity from India in respect of offshore funds, certain exemptions are available in the Indian domestic laws.

In the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager located in India and acting on behalf of such a fund shall by itself not constitute a business connection in India of the said fund. Further, an eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf is located in India.

The aforesaid benefit is available subject to fulfilment of certain conditions provided under the domestic tax laws. Practically, the fund management industry has not been able to take advantage of these provisions due to the requirements being too onerous or impractical for investment funds.

The Union Budget 2021-22 proposes that a fund manager (who has commenced operations on or before March 31 2024) in IFSC managing offshore fund may not be required to satisfy all the conditions (which will be notified by the government of India in due course) currently laid down in the Indian domestic law. One will have to wait for the government notifications to see which of these conditions are specifically waived for fund managers in IFSC, and the relaxations would determine the impact and extent of benefit.

The proposed change will attract the India-focused funds to be managed entirely from India, thereby doing away with the need to have a dual structure of an offshore manager with an Indian advisory company.

Investment division of a banking unit

The Union Budget 2021-22 proposes to incentivise the investment division of a banking unit of a non-resident located in IFSC. An investment division of a banking unit in IFSC set-up by a non-resident and which has been granted a Category III AIF license and fulfils such other conditions as may be specified will be eligible to claim tax exemption on any income accrued or arisen to, or received to such investment division, subject to certain conditions.

The proposed amendment should encourage the investment division of foreign banks to be set up in IFSC as the same will provide tax exemption on income arising from certain securities, subject to conditions.

Aircraft leasing in IFSC

The Finance Minister, in her budget speech for the financial year 2019-20, had showcased the government's desire to develop a self-reliant aviation industry and to enter into aircraft financing and leasing activities from Indian shores.

Under the existing provisions of the Indian domestic laws, income earned by units in IFSC is eligible for claiming a tax holiday in respect of income earned by such a unit. In order to further incentivise the aircraft leasing business, the Union Budget 2021-22 proposes to provide tax exemption to offshore lessors.

Currently, aircraft leasing is being undertaken by original equipment manufacturers (OEM)/aircraft lessors from jurisdictions such as Ireland. Income earned by such OEM/aircraft lessors from Indian lessees are not being subject to tax by placing reliance on tax treaties.

The amendment proposes to exempt aircraft lease income of non-resident paid by a unit in IFSC (subject to certain conditions). Additionally, it is proposed to provide a deduction in respect of gains arising on the transfer of an aircraft or aircraft engine by an IFSC unit engaged in aircraft leasing to a domestic company engaged in business of operation of aircraft (provided such aircraft/aircraft engine was leased to the company prior to transfer). The proposed amendment will motivate non-resident lessors to lease aircrafts to domestic companies through IFSC, thereby reducing reliance on tax treaty and reducing tax litigation.

Also, recently, aircraft leasing (which is defined to include operating and financial lease and any hybrid of operating and financial lease of aircraft or helicopter and engines of aircraft or helicopter or any part thereof) was notified as a financial product by the IFSC authority thereby paving way for setting up units in IFSC for undertaking aircraft leasing business.

Exemption on transfer of non-deliverable forward contract

A non-deliverable forward contract (NDF) is a foreign exchange derivative contract, which allows investors to trade in non-convertible currencies, with contract settlement in a convertible currency (mostly US dollars). NDF trades are carried out over the counter and are bilaterally settled.

In a recent notification, the Reserve Bank of India allowed Indian banks operating in IFSC to offer NDF involving Indian rupees, to persons not resident in India.

It is now proposed by the Union Budget 2021-22, to exempt any income accrued or arisen to, or received by a non-resident as a result of transfer of NDF entered into with an offshore banking unit located in IFSC.

ADIA, sovereign wealth and pension funds

Under the existing Indian domestic laws, income earned by Abu Dhabi Investment Authority (ADIA) or SWFs or PFs on investment made by them, were subject to tax exemption on fulfilment of certain conditions.

One of the conditions are that investment should be made in a company or enterprise carrying on the business of developing, or operating and maintaining, or developing, operating and maintaining any infrastructure facility. The benefit of the exemption is also allowed if ADIA/SWFs/PFs made investment through InvITs/REITs and AIFs. In the case of AIFs, the exemption is allowed to ADIA/SWFs/PFs if their investment has been made through Category I/II AIFs that have 100% investment into entities engaged in ‘infrastructure facility’ as defined under the Indian domestic laws.

Additionally, in order to claim the tax exemption, SWFs and PFs are currently not allowed to undertake any commercial activity whether within or outside India.

The Union Budget 2021-22 has rationalised certain conditions for such funds to make further investments in India. The proposed key amendments are as follows:

- Tax exemption for ADIA/SWFs/PFs extended to:
  - Investments made into a domestic holding company set up and registered after April 1 2021 which in turn will have a minimum 75% investment in infrastructure entities;
  - Investments in NBFC-Infrastructure Debt Fund/infrastructure finance company provided it should have minimum 90% lending to infrastructure entities; and
  - Investment in Category I/II AIF with minimum 50% (earlier 100%) investment in specified infrastructure entities or InvIT;
- Condition for not undertaking commercial activity replaced by non-participation in day to day operations of investee entities;
- Exemption not available if investments in India are made out of direct or indirect loans and borrowings. Loans and borrowings specifically defined; and
- Under the existing Indian domestic provisions, PFs can take benefit of the tax exemption, *inter alia*, if it is not liable to tax in its home jurisdiction. The Union Budget 2021-22 clarifies this position and proposes that PFs who may be ‘liable to tax’ but entitled to exemption in their home country are also eligible for tax exemption on qualifying investments.

The proposed rationalisation of the existing domestic tax provisions will assist in promoting the requisite investment by

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Prior to joining Dhruva Advisors, Vishal worked with a Big Four firm as a manager. He is a qualified chartered accountant.

SWFs and PFs in the infrastructure space in India. Also, the proposed amendments will provide the desired certainty on the tax implications in the hands of ADIA/SWFs/PFs.

Rationalisation of withholding tax on payments to FPIs

Currently, FPIs are subject to withholding tax at the rate of 20% on all income other than capital gains. Therefore, despite a lower withholding tax rate under the relevant tax treaty, tax are being withheld at 20% as per the Indian domestic laws.

In order to incentivise the FPIs, it is proposed to align the withholding tax rate applicable on payments to FPI with the tax rate prevailing in the relevant tax treaty if the FPI furnishing tax residency certificate. This welcome change would help avoid situations wherein the FPI would have to request tax refunds in case tax at higher rates would have been withheld.

The proposed amendment will provide the necessary relief to offshore debt funds receiving interest income.

Rationalisation of withholding tax on dividend payment to InvITs and REITs

Currently, InvITs/REITs are not subject to tax and the income is directly chargeable to tax in the hands of the unit holders. However, InvITs/REITs are subject to withholding tax at a rate of 20% on dividend income received by them. It is proposed, with effect from April 1 2020, that dividend income received by REIT/InvIT from specified special purpose vehicles will not be subject to tax withholding.

The existing withholding at the rate of 20% in the hands of InvITs/REITs results in an immediate cash flow issue for the InvITs/REITs. The proposed relaxation should address such a cash flow issue.

Strengthening the economy

More specifically, the proposed amendments provide a boost to the government's intention of making GIFT City more lucrative and an attractive destination for foreign funds and aircraft leasing activity. Also, the rationalisation of the tax provisions relating to investments by SWFs/PFs should encourage these funds to make investment in the infrastructure space in India.

On an overall basis, the government's bid to revive the economy and build a strong foundation through infrastructure spending, investment in sectors in distress clearly indicate a holistic approach to address the gaps in the economy. Strengthening the financial sector to build an ecosystem by boosting manufacturing through the institutionalisation of debt financing, increasing foreign direct investment in insurance to encourage more foreign institutional investors, monetising assets through divestments and focusing on accelerating foreign investments are commendable measures.

The measures announced by the Finance Minister will prove to be a stepping stone to make India an *Atmanirbhar Bharat* (i.e. self-reliant India) and realise the dream of building a $5 trillion economy.