

MAKE IN INDIA AND DIRECT TAX: A CRITICAL ANALYSIS OF DIRECT TAX REFORMS 2015

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I. INTRODUCTION

India is one of the fastest growing economies in the world. It has been ranked number one attractive destination for foreign investment by the Baseline Profitability Index (hereinafter BPI), coined by Daniel Altman, an adjunct professor of New York University's Stern School of Business.¹ Almost two decades of economic liberalisation, alongside vigorous domestic demand, a developing middle class, a young population, and an exceptional return on investment have enticed multinational companies and investors to invest in India.² Today Indian markets have immense potential and offer prospects of high profitability and an effective regulatory framework which make India a credible investment destination. It is once again creating an interest and excitement in the global arena as hopes build for its reforms agenda to be carried forward. Industry anticipates tax reforms to be the prime concern in this agenda.³

In today's globalising world tax policies and reforms have become a major topic of discussion around the world. India's tax policy is no exception and is having tremendous reforms in comparison to global developments. The tax rates have been rationalised and tax laws have simplified resulting in better compliance, ease of tax payment and better enforcement.⁴ Still, India needs to strike a balance between checking tax avoidance

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¹Puja Mehra, 'India Ranked Best for Investment' (*The Hindu*, 27 June 2015) <<http://www.thehindu.com/business/Economy/india-ranked-best-for-investment/article7359257.ece>> accessed 23 October 2015.

²Stephanie Johnson, 'India: An Attractive Investment Destination - Market Realist' (*Marketrealist*, 2015) <<http://www.marketrealist.com/2014/10/india-can-attractive-investment-destination>> accessed 23 October 2015

³Ernst & Young, 'Make in India Through Effective Tax Reforms' (Ernst & Young, 2015) <[http://www.ey.com/Publication/vwLUAssets/EY-cii-whitepaper-17-dec/\\$FILE/EY-cii-whitepaper-17-dec.pdf](http://www.ey.com/Publication/vwLUAssets/EY-cii-whitepaper-17-dec/$FILE/EY-cii-whitepaper-17-dec.pdf)> accessed 23 October 2015.

⁴'Welcome to India in Business' (*Indianbusiness*, 2015) <http://indiainbusiness.nic.in/newdesign/index.php?param=investment_landing/293/6> accessed 23 October 2015.

and making the tax environment more efficacious and favourable compared to other countries competing for investment.⁵ With the agenda to make India a world-class global manufacturing sector, Government of India on 25 September 2014 launched “Make in India”, a major national program to promote and facilitate investment, enhance skill development, foster innovation, protecting intellectual property and build best-in-class manufacturing infrastructure.⁶ The key thrust of the program is to revive domestic investment and attract foreign investors. Secretaries across all the departments in cabinet presented a blueprint for the 25 identified sectors for the Make in India initiative to Prime Minister Narendra Modi. These sectors include automobiles, chemicals, Information Technology (hereinafter IT), pharmaceuticals, textiles, ports, aviation, leather, tourism and hospitality, wellness, railways, auto components, design manufacturing, renewable energy, mining, biotechnology, pharmaceuticals, and electronics among others. Some of the proposals include direct tax exemptions during the first three years for micro, small and medium enterprises, tax holiday for local manufacturing of defence and aerospace products, standard operating procedures for research and development, and tax benefits to attract electronics and telecom manufacturers among others.⁷

Finally, on 28th February 2015, Finance Minister, Arun Jaitley presented the Union Budget 2015-16. The Budget proposes a number of foreign investment and tax reforms with important consequences for investors including lower compliances costs, increased certainty in the tax regime, and an improved business environment.⁸ The main focus of the budget is “Make in India” concept followed by initiatives to tap the black money, ease of doing business and benefits to middle-class taxpayers. On the direct tax front, various positive changes have been made such as; General Anti Avoidance Rules (hereinafter GAAR) has been deferred by another two years admitting that it is not the best time to introduce it when the tax department (revenue) is yet to be fully equipped. To attract fund managers to operate from India it is being clarified that they will not be treated as a business connection or permanent establishment and that the offshore fund (hereinafter OFS) which is managed from India will also not be treated as an

⁵Ernst & Young (n 61).

⁶ ‘Make In India’ (Makeindia, 2015) <<http://www.makeinindia.com/about>> accessed 23 October 2015.

⁷ Partha Priya Dutta, ‘Make In India: An Academic Perspective-’ (*Indian Institute of Management, Calcutta, 2015*) <<https://www.iimcal.ac.in/make-india-academic-perspective-prof-partha-priya-dutta>> accessed 23 October 2015.

⁸ Chris Devonshire- Ellis, Tarun Manik and Nishant Dixit, ‘India’s FY 2015-16 Budget: Meaning and Implications For Foreign Investment - India Briefing News’ (*India Briefing News, 4 March 2015*) <<http://www.india-briefing.com/news/indias-fy-201516-budget-meaning-implications-foreign-investment-10182.html>> accessed 23 October 2015.

Indian fund through controlled from India to avoid Indian taxes. Further, benefits to the sponsors of real estate investment trust (hereinafter REITs) and Infrastructure Investment Trust (hereinafter InvITs) through concessional capital gains treatment, Reduction on withholding tax (hereinafter WHT) for royalty and fees for technical services (hereinafter FTS) payments abroad, steps to make Rules to provide Foreign Tax Credit (hereinafter FTC) and reduction in corporate income tax from 30% to 25% etc. are some of the major reforms major reforms which have an impact on nearly all segments of the economy.⁹ From the perspective of the International community, the measures taken by the government through the budget to present new tax incentives will play a major role to change India into a global manufacturing hub and attract huge scale investment.¹⁰ It also gives a bold roadmap for improving the ease of doing business in India.

II. NEED FOR TAX REFORMS IN INDIA

The Indian manufacturing sector contributed fifteen percent to the India's Gross Domestic Product (hereinafter GDP) in 2013-14 and involves a share of only two percent in the world's manufacturing output as per the economic survey of 2013-14. In order to boost the manufacturing sector, the government of India has set a target to increase manufacturing's share in the GDP to 25 percent and create about 100 million jobs by 2022. To accomplish this goal, the government introduced the "Make in India" program in September 2014 which underlines on cutting down delays in manufacturing projects clearance, introducing new labour reforms, developing infrastructure and taking India to new heights by not only encouraging domestic manufacturing but making India a manufacturing hub and an investment destination.¹¹

There are certain difficulties confronted by manufacturers, like inverted duty structure due to free trade agreements (hereinafter FTAs) that make Indian manufacturing uncompetitive for white goods such as washing machines, refrigerators, and air conditioners. There has been a rise in imports from low-cost regions such as China and South East Asia. Additionally, Modified Special Incentive Package Scheme (hereinafter

⁹ Karthik Ranganathan, 'Union Budget 2015 Direct Tax' (Mondaq, 2 March 2015) <<http://www.mondaq.com/india/x/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

¹⁰ Kamlesh Chainani, 'Opinion: Tax Support Needed to Turn 'Make In India' A Reality - NDTV' (NDTV Profit, 26 February 2015) <<http://profit.ndtv.com/budget/opinion-tax-support-needed-to-turn-make-in-india-a-reality-742501>> accessed 23 October 2015.

¹¹ 'Union Budget 2015 Inspiring Confidence, Empowering Change In India' (KPMG, 2015) <<https://www.kpmg.com/IN/en/services/Tax/unionbudget2015/Documents/KPMG-Union-Budget-Manufacturing-PoV-2015.pdf>> accessed 23 October 2015.

MSIPS) is not applicable to the aforementioned consumer durable products. Moreover, insufficient and immature local supplier base and the high cost of capital and other manufacturing costs due to frequently revised energy efficiency requirements do not provide the local manufacturers with a positive and favourable environment.¹² Disputes on indirect transfers and issues of shares have had gigantic proportions. Similarly, disputes on transfer pricing do not seem to wane away. Though the taxpayer has been granted relief at the higher appellate levels, it has created a negative adversarial image of the government.¹³

The primary question is the present scenario is that 'Why would somebody risk his big-ticket investment when such direct tax risks emanate in India?'. Foreign investors have been quite scared in terms of safety and stability in the direct tax policy of the government. In 2014 Budget, Government has stepped to changes tariff which has ameliorated some of the negative perceptions about the Indian taxation. Such steps include the introduction of roll back provision in the Advance Pricing Agreement (hereinafter APA) scheme, amendments in some litigation-related aspects of transfers pricing, tax holidays for power generating units and so on. However, this is not enough to make India an attractive destination for investment. From India's perspective, it would be a great accomplishment, but from a foreign investor's point of view it may not be sufficient; more so when other countries around the world are providing a host of tax impetuses to the global players for investment into their respective nations. Some of these are appropriately made to the requirement of the global companies and may vary based on the size of the investment and their contribution and commitment to the economic and financial development of the respective country. Hence, if India wants to accumulate a greater cut of interest in the manufacturing sector, it needs to make reforms to its existing direct tax laws.¹⁴

Keeping in mind the end goal to reverberate well with the 'Make in India' program, it is necessary that certain tax benefits are given to investors, which will go far in giving a quite required momentum to the manufacturing area and make India a viable and easier option for companies to engage in business with.¹⁵ The government's main concern

¹² Manish Sharma, 'Union Budget 2015-16: Government Should Undertake Next-Generation Tax Reforms' (*Businessstoday*, 27 February 2015) <<http://www.businessstoday.in/union-budget-2015-16/expectations/govt-should-undertake-next-generation-tax-reforms/story/216208.html>> accessed 23 October 2015.

¹³ Ajay Kumar, 'Make in India needs a tax boost' (*The Financial Express*, 17 December 2014) <<http://www.financialexpress.com/article/fe-columnist/make-in-india-needs-a-tax-boost/19992/>> accessed 23 October 2015.

¹⁴ *ibid.*

¹⁵ 'Make In India Through Effective Tax Reforms' (*Ernst & Young*, 2015) <[http://www.ey.com/Publication/vwLUAssets/EY-cii-whitepaper-17-dec/\\$FILE/EY-cii-whitepaper-17-dec.pdf](http://www.ey.com/Publication/vwLUAssets/EY-cii-whitepaper-17-dec/$FILE/EY-cii-whitepaper-17-dec.pdf)> accessed 23 October 2015.

has been the revival of growth in the Indian economy and crucially enough, it has chosen to give the industrial sector a structural push to achieve its goal.

III. CRITICAL ANALYSIS OF PROPOSED DIRECT TAX REFORMS

India's tax laws and policies have always been a major area of uncertainty for foreign investors. Every Indian citizen who is either directly or indirectly affected by union budget has a keen eye on the budget 2015-16. Apart from such citizens, global investors, venture capitalists, Small and Medium Size Enterprises (hereinafter SME's) across the globe, investment banks, etc., scrupulously observed the budget speech given by the Finance Minister of India. The major reason behind everyone's eagerness towards union budget of 2015-2016 was 'Make in India' campaign because tax reforms introduced by the government in the budget will play a crucial role to transform India into a manufacturing hub. Thus, it becomes pertinent to understand these reforms with utmost clarity because these reforms are key deciding factors in the success of the campaign. This Budget contains several announcements which should help bring clarity to the otherwise complicated tax regime. The tax reforms which are mainly targeting towards attracting investments and easing norms will also allow new ventures to flourish in India. The Major Direct tax reforms presented in Finance Bill, 2015 are followings:

I) DEFERENCE OF GAAR BY TWO YEARS

One of the key steps taken in the finance bill, 2015 was deference of GAAR by two years. The previous government had proposed the implementation of the GAAR from April 1, 2015. However, in the present budget, it was explicitly made clear that GAAR will be made applicable from 1st April 2017. Thus all the investments made in the next two years until 31 March 2017 are free from the ambit of GAAR. This move by the union government was a relief for Foreign Institutional Investors (hereinafter FII's) and other investors.¹⁶ In order to discuss implications of GAAR on the Indian market and various sectors, it becomes essential to discuss and understand GAAR. This concept was introduced after the Vodafone tax case in 2007. Finance Minister Mr. Pranab Mukherjee in his budget speech in 2012 proposed this concept with the ambition to check tax evasion and avoidance. Originally, when GAAR was first introduced in the year 2012, it was very controversial because it gave immense power to taxing authorities. It empowers officials to deny the tax benefits of transactions or arrangements which do not have any commercial substance or consideration other than achieving tax benefit. It contains a provision allowing the government to retroactively tax past overseas deals

¹⁶ Anshu Khanna, 'Finance Bill, 2015 & Taxation Of Foreign Investors' (2015) 12 Int Taxation Rev 193.

involving local assets. GAAR could also give powers to the tax department to deny double taxation treaty benefits to foreign funds based out of tax havens like Mauritius. India has a Double Taxation Avoidance Agreement with Mauritius. Overseas portfolio investors, routeing their investments via countries like Mauritius, currently do not pay any tax on short-term capital gains.¹⁷ So if any private equity and other investors invest in India through jurisdictions like Mauritius and Singapore to claim tax treaty benefits, then arrangements could potentially be questioned under the GAAR. Thus, it gave very wide discretionary powers to the already powerful revenue authorities to allow or disallow benefit of double tax avoidance agreements. However, an extension of implementation of the GAAR until April 1, 2017, provides some comfort to foreign investors, particularly those looking to invest through jurisdictions like Singapore and Mauritius. When implemented, GAAR will have no retrospective effect, i.e., it will apply only to investments made on or after April 1, 2017. It is also expected that the government will provide more clarity and guidance on the GAAR provisions before implementation.¹⁸

Having discussed the nature of GAAR, it becomes important to discuss the benefits to the business community by the deference of GAAR. It is argued that deference was done because of two major reasons first being the wide power given to authorities and the other being the participation of India in OECD's BEPS plans which will make it necessary to incorporate GAAR as an integrated part of legal framework dealing with tax avoidance.¹⁹ Thus deferring of GAAR is a sign of relief for all the investors and business companies who find their way through tax havens such as Singapore, Mauritius, etc.

The impact of deferring could be best understood from the analogy of 2007 market collapse. It is undoubted that most part of investments of FII's in India is handled by way of Participatory Notes (hereinafter P notes). In 2007, mere news that government is planning on prohibiting or restricting P notes led to the market crash.²⁰ With the

¹⁷ '5 Facts About The General Anti-Avoidance Rule (GAAR)' (NDTV Profit, 14 May 2012) <<http://profit.ndtv.com/news/corporates/article-5-facts-about-the-general-anti-avoidance-rule-gaar-300693>> accessed 23 October 2015.

¹⁸ 'India Budget 2015 – Key Takeaways for Foreign Investors' (Devoise & Plimpton, 2015) <<http://www.devoise.com/~media/files/insights/publications/2015/03/20150304indiabudget.pdf>> accessed 23 October 2015.

¹⁹ 'International Tax Update' (Deloitte, 2015) <<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-indiabudget2015-international-tax-alert-noexp.pdf>> accessed 23 October 2015.

²⁰ R Vaidyanathan, 'Why Participatory Notes Are Dangerous' (The Hindu Business Line, 24 October 2007) <<http://www.thehindubusinessline.com/todays-paper/why-participatory-notes-are-dangerous/article1672845.ece>> accessed 23 October 2015.

implementation of GAAR, it is still not clear that whether P notes will be in the scope of GAAR or not. Thus, if GAAR is passed it will be discouraging on the part of FIIs to invest in India. Thus, deferring GAAR and making it clear that all investments made till 31st March 2017 are outside the purview of GAAR will encourage investments and business functions in the Indian market because they will not have to prove any commercial interest in the transaction. However, most of the investor's request are that the GAAR should be modified to make it less of a broad spectrum anti-avoidance rule, instead of targeting only high abusive contrived and artificial arrangements.²¹

II) RATIONALISATION OF MINIMUM ALTERNATE TAX

In the Finance Bill 2015, application of Minimum Alternate Tax (hereinafter MAT) on FIIs in case of capital gains was rationalised. Income from transaction in securities (other than short-term capital gains arising on which securities transaction tax is not chargeable) arising to FII excluded from the ambit of MAT by excluding both, the income and corresponding expenses, in the computation.²² In order to understand this rationalisation one needs to understand situation prior to the passing of Finance Bill. In cases of security market, FII were asked to pay 15% tax on Short Term Capital Gain (hereinafter STCG) and nil tax in cases of long-term capital gain. However, the revenue was subjecting such FIIs to MAT as the gains made by them will be added to their book profits and therefore, were asked to pay MAT. The cornerstone benefit of tax exemption to FIIs was denied due to MAT levy.²³ Thus, in effect, no benefit was conferred on FII in case of long term capital asset.

In the Finance Bill 2015, it is proposed that MAT provisions will not be applicable to capital gains income of FII's. In order to give the requisite benefit, it was decided to amend section 115JB of the Income Tax Act which deals with MAT. It is provided company's share of income such as long terms capital gains (hereinafter LTCG) credited to its profit and loss account (on which no income tax is payable as per normal provisions) that shall not be included in the book profits for the purpose of MAT provisions and consequentially, the book profits shall be increased by the amount of expenditure

²¹ Matthew Gilleard, 'Indian Budget To Focus On 'Make In India' And FDI Incentives' (*International Tax Review*, 26 February 2015) <<http://www.internationaltaxreview.com/Article/3431841/Indian-Budget-to-focus-on-Make-in-India-and-FDI-incentives.html>> accessed 23 October 2015.

²² 'Union Budget 2015 Inspiring Confidence, Empowering Change In India' (KPMG, 2015) <<https://www.kpmg.com/IN/en/services/Tax/unionbudget2015/Documents/KPMG-Union-Budget-Manufacturing-PoV-2015.pdf>> accessed 23 October 2015.

²³ Karthik Ranganathan, 'Union Budget 2015 Direct Tax ' (Mondaq, 2 March2015) <<http://www.mondaq.com/india/x/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

relatable to that income.²⁴ Accordingly, FII's are not required to pay MAT on the capital gains which are exempted by the income tax act. However, the amendment continues to be prospective in nature and will not impact or benefit FPIs that have been receiving tax notices in the past couple of months on the basis of applicability of MAT to past gains on investments.²⁵

The main impact of this amendment is the benefit of exempting income on capital gains of FII and living up to the true spirit of not taxing income of FII's. It must be quite common notice that bidding for large Engineering Procurement Construction (hereinafter EPC) Contracts are undertaken by a consortium consisting of foreign and Indian contractors due to the varying skill sets, technology requirements, etc. One of the significant risks in such consortium arrangements is the taxation of Association of Persons (hereinafter AOP). Budget 2015-16 proposes to exclude the share of income earned by a member on AOP from the ambit of MAT liability. Any expenditure incurred in relation to the share of income of the member of the AOP would be added back in the MAT computation.²⁶ This is also favourable move because it is in line with the view that MAT cannot apply to foreign companies that do not prepare an account in accordance with Indian company laws, i.e., foreign companies not having a place of business in India. However, the applicability of MAT to FII's which do not have a presence in India, an issue which is pending adjudication by the Supreme Court of India has not been addressed. Similarly, the interplay of MAT provisions with the provisions of a treaty to a corporate entity has not been addressed by the amendments. But in light of positive factors of the reforms, it can be agreed that this amendment is clearly a welcome move and is also aligned to Government's intention to eliminate unnecessary litigation as well as provide an impetus to the infrastructure sector.

III) ELIGIBILITY PERIOD OF CONCESSIONAL TAX RATE EXTENDED

In 2013, a major step was taken by the UPA government towards foreign debt investment in India while presenting the budget. It was proposed that on the applicability of certain ceilings, tax on the income earned from interest at the hands of Qualified Foreign

²⁴ Anshu Khanna, 'Finance Bill, 2015 & Taxation Of Foreign Investors' (2015) 12 Int Taxation Rev193.

²⁵ Shipra Padhi, TP Janani and Rajesh Simhan, 'Nishith Desai Associates: Finance Act, 2015 Passed Into Law: Some Creases Ironed' (*Nishith Desai & Associates*, 18 May 2015) <http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article-a-c-t-2015-p-a-s-s-e-d-i-n-t-o-l-a-w-s-o-m-e-c-r-e-a-s-e-s-ironed.html?no_cache=1&cHash=2a4665bf6c388949a1208b2dff192ef2> accessed 23 October 2015.

²⁶ Rajesh H Gandhi and Anita Nair, 'Finance Bill 2015 & MAT Provisions' (2015).

Investors (hereinafter QFI) or FII was reduced to 5 % from 40%. This step taken by the government in 2013 was a major boost for QFI and FII. This new step was incorporated by way of amendment in section 194LD. It provides that interest payments made to QFIs and FIIs in form of rupee denominated bond of an Indian company or government security will be subject to tax at the rate of 5%.²⁷ This section was applicable to income generated from March 2013 to May 2015. However, in the present budget section 194LD is sought to be amended and interests earned till 30th June 2017 will be taxed at the rate of 5%. This is similar to the benefits extended in Finance act, 2014 for External Commercial Borrowings (hereinafter ECB) under section 194LC of Income Tax Act.

The step was taken by the government of extending the time limit period of concessional tax rate till 2017 is another positive move in inviting foreign investments. The impact of this provision can be imagined from the fact that the rate of interest is reduced to 5% from 40%. It clearly shows the benefit which will occur to both QFIs and FIIs. Both these class of investors will be highly benefited because one of the major sources of revenue for such class is from interest earned. Thus, reduction of the tax rate will give direct monetary benefit to the investors and will also encourage new investments and thus will foster the aim of Make in India.

IV) REDUCTION IN RATES OF TAX FOR ROYALTY AND FEE FOR TECHNICAL SERVICE

In order to allow free flow of transfer of technology, expertise and ease to small entities government introduced to bring down withholding tax (hereinafter WHT) rate for royalty and Fee for Technical Service (hereinafter FTS) on payments non-residents to 10%.²⁸ This reduction in the tax rate will take effect from 1st April 2016. Earlier in the case of a non-resident taxpayer having an income by way of royalty and fees for technical service received from government or Indian concern after 31.03.1976 shall be liable to a WHT rate of 25% on such gross income provided the non-resident has no permanent establishment in India.²⁹ The earlier higher rate of the tax created a lot of confusion, in the case of an existing Double Tax Avoidance Agreement (hereinafter DTAA) with the country of non-resident, as to which rate would be applicable to income tax and DTAA. However, in the case where the resident belongs to a country where there is no DTAA,

²⁷ Income Tax Act 1961, s 194 LD.

²⁸ Karthik Ranganathan, 'Union Budget 2015 Direct Tax' (*Mondaq*, 2 March 2015) <<http://www.mondaq.com/india/x/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

²⁹ Ankit Banka, 'Reduction In Rate Of Tax On Royalty & Fees For Technical Services In Case Of Non-Residents' (*Taxguru*, 4 March 2015) <<http://taxguru.in/income-tax/reduction-rate-tax-royalty-fees-technical-services-case-nonresidents.html>> accessed 23 October 2015

the non-resident suffers the loss and is taxed under the provisions of Income Tax Act. Reducing tax rate minimises the variance between the income tax provisions and the various DTAAs in terms of tax rate, resulting in reduced litigations and also quicker resolutions.³⁰ If recent trends of SMEs are any kind of indication, then it will be correct on our part to term this era as "start-up era". One of the key requirements of a start-up is a free flow of technology and technical know-how. Most start-ups have innovative ideas and these ideas and their success are mainly dependent on the transfer of technical knowledge and innovation. Before this budget, 25% was paid as a royalty due to which foreign companies were compelled to Treaty-shop to transfer technology into India via a jurisdiction which imposes fewer tax rates. By bringing it back to 10% not only will there be a free flow of transfer of technology but also treaty shopping vis-à-vis reduced WHT for royalty and FTS will be reduced.³¹ This can be best explained with the following example: As per terms of DTAAs between India and Mauritius, 15% will be paid as a tax of royalty. Thus, if the technology is transferred from Mauritius, 15% will be paid as a tax but if a person is a resident of a country with whom India has not signed a DTAAs, they will be taxed at 25%. However, with a reduction in rates of WTH, the presence or absence of DTAAs will not matter because effectively the rates under DTAAs and Income tax act are almost same and thus this move of the union government will be welcomed by small and medium scale enterprises. Thus, reduced rates of royalty and FTS will allow free flow of technology because more technology will be transferred owing to a reduction in tax rates. One of the key concerns of skill development and innovation is a lack of technical knowledge amongst the local developers. Thus, small ventures can now avail best services from the globe and this will lead to the successful transfer of technology which in turn facilitates "Make in India" project.

V) CHANGE IN BUSINESS CONNECTION OF OFFSHORE FUNDS

Section 9 of the Income Tax Act provides for income which is deemed to accrue or arises in India. One of the main conditions to tax non-resident is the existence of business connection in India. Once such a connection is established, all the activities arising out of such connection are taxable in India. According to the previous position, the presence of an independent fund manager in India for an OFS will constitute a business connection. In a situation where fund manager is situated in India and he manages investments related to an OFS or investments which are made outside India, such profits were taxable in India because of the presence of the fund manager is in India. Thus mere presence of fund manager in India will constitute business connection and

³⁰ Anshu Khanna, 'Finance Bill, 2015 & Taxation Of Foreign Investors' (2015) 12 Int Taxation Rev193.

³¹ Karthik Ranganathan, 'Union Budget 2015 Direct Tax' (*Mondaq*, 2 March 2015) <<http://www.mondaq.com/india/x/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

may induce taxability for an OFS. Hence not only fund manager's fee is taxable, the mere fact that the fund is controlled in India will also make it taxable.³² This has been a long-standing irritant for foreign institutional investors and even private equity (hereinafter PE) funds.

In order to change the pre-existing norms of taxability, a new regime on the basis of international standards is suggested in the 2015 Budget. It has been suggested to add section 9A, which provides that income from investments made outside India will not be taxable solely on the ground that such investments are handled by a fund manager located in India.³³ In simpler terms, a fund manager acting on behalf of anyone and maintaining the fund will not constitute a business connection in India. Thus, this would reduce taxability of the profits made through such investments. However, this benefit is only available to a select offshore and fund managers who fulfil certain conditions. These conditions are:

The OSF (Officers' Superannuation Fund) has to fulfil:³⁴

- The OSF should not be an Indian resident and it should be located in a jurisdiction which has comprehensive or limited DTAA
- Participation in such OSF by Indian residents (directly or indirectly) should not be more than 5% and that such fund has at least 25 unrelated members who directly or indirectly are not connected
- No member of the fund along with other members should have controlling interest more than 10%
- No more than 50% participation interest should devolve upon 10 or fewer members of the fund
- The fund shall not invest more than 20% of its corpus in an entity and the fund should have a monthly average of INR 10 million including at the time of its creation
- The fund shall not function any business in India and should not have business connection in India other than fund manager who acts on behalf of the OSF

³² Anshu Khanna, 'Finance Bill, 2015 & Taxation Of Foreign Investors' (2015) 12 Int Taxation Rev 193.

³³ Debevoise & Plimpton (n 76).

³⁴ 'Make In India' Through Effective Tax Reforms' (*Ernst & Young*, 2015). <[http://www.ey.com/Publication/vwLUAssets/EY-cii-whitepaper-17-dec/\\$FILE/EY-cii-whitepaper-17-dec.pdf](http://www.ey.com/Publication/vwLUAssets/EY-cii-whitepaper-17-dec/$FILE/EY-cii-whitepaper-17-dec.pdf)> accessed 23 October 2015.

- The remuneration paid to the fund manager by the OSF for his services should be at arm's length.

To qualify as eligible Fund Manager (hereinafter FM) the following conditions have to be fulfilled:

- The person should not be an employee of the fund or its connected person
- The person should be registered with concerned regulators or should be registered as investment advisor in accordance with specified regulation
- The person should be acting in the ordinary course of his/her business as fund manager
- The person along with his connected persons shall not be entitled more than 20% of the OSF profits as remuneration.³⁵

Further, it has also provided in the amendment that an eligible investment fund shall furnish a statement containing information in connection with the fulfilment of conditions in a prescribed manner failing which will attract a penalty of INR 500,000.³⁶

Before insertion of this section, any OFS being managed by a fund manager in India was considered to have a business connection and was taxable in cases of profit. Section 9A was added to attract global fund managers to come and operate from India. This section was passed with the ambition that dispersed fund managers should be attracted to India in order to manage from India. However, while section 9A may be well intentioned, it employs a number of rigid criteria that would be impossible for PE funds and difficult for FPIs to satisfy.

VI) PASS THROUGH STATUS FOR CATEGORY-I AND CATEGORY-II ALTERNATIVE INVESTMENTS FUNDS (AIF)

Securities Exchange Board of India (hereinafter SEBI), by virtue of AIF regulations 2012 has divided AIF into three categories. Based on certain fulfilling criteria these funds are classified into three categories of funds. In this year's budget pass through status for Category -I and Category-II funds are provided. It must be noted that Category-I funds are those funds which invest in early ventures and are also known as angel investments.

³⁵ The Income Tax Act 1961, s 9A.

³⁶ Karthik Ranganathan, 'Union Budget 2015 Direct Tax' (*Mondaq*, 2 March 2015) <<http://www.mondaq.com/india/x/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

Category-II funds are like private equities which invest in more developed ventures.³⁷ A new chapter, XII FB has been introduced in the act to deal with pass through the status of AIF. The succinct new reforms are:

- Taxability in the hands of AIF will only be done for PGBP. Income from other sources and capital gains will be exempt.
- Taxability in the hands of the unit holder will be exempt in case of PGBP provided it is received from AIF. Income from other sources and capital gains will be taxed at normal rates.
- Income received by AIF will be free from TDS requirements.
- Losses shall be allowed to carry forward or set off to AIF but same shall be disallowed in the case of Unit holder.
- Business income on which tax is paid by AIF when repatriated to Unit Holders no tax will be paid on the same by unit holders. This is allowed to avoid double taxation.
- Buy back distribution of tax and division distribution of tax shall not be applicable in cases of distribution of income from AIF to UH.
- The fund, however, will have to file its return of income and other documents as required.
- WHT at the rate of 10% will be applicable in the case of income from other sources where no tax is paid at the fund level.³⁸

This is one of the key changes brought in the budget of the year 2015. This step by the government clearly gives an indicative that government is also encouraging innovative ideas and start-ups. One of the key objectives of Make in India campaign is to foster investments in India.³⁹ Thus by giving pass through status to AIF, it is sought by the government to achieve a good investment in the Indian sector.

If we talk about startups like Flipkart, Snapdeal, Ola, Grofers, Paytm, Jabong, etc. All these start-ups require a good amount of investment to excel. Fundraising in any start-

³⁷ 'International Tax Update' (Deloitte, 2015) <<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-indiabudget2015-international-tax-alert-noexp.pdf>> accessed 23 October 2015.

³⁸ 'Achieving Together India - Budget 2015 Analysis Of Tax Changes On Business' (Roedl & Partner, 2015) <http://www.roedl.com/fileadmin/user_upload/Roedl_India/Roedl-Partner-India-Budget_-2015pdf> accessed 23 October 2015.

³⁹ Anshu Khanna, 'Finance Bill, 2015 & Taxation of foreign Investors', (2015) 12 Int Taxation Rev 193.

up is divided into many stages. The first stage of funding is known as Angel Investments. Angel investment is an essential funding because it helps the new ventures which are at conceptual or developing stage. Other rounds of funding include State-II funding which includes Venture capitalists funding. Then higher levels of funding come into the picture. In the new regime suggested in the budget both angel investors and the State-II funding companies will be benefited. This will broaden the horizons of Indian start-ups because new companies who are interested in funding will enter the market and will help start-ups excel.⁴⁰ The main aim of this status is to protect the fund and with the onset of the new regime, it is expected that new investment funds are incorporated to fund Indian start-ups.

VII) REDUCTION IN CORPORATE INCOME TAX

Another major step taken by the government is by reducing Corporate Income Tax from 30% to 25%. This move was welcomed by everyone because it will decrease the taxability of the company. In the budget speech, FM pressed the fact that India is looked as Tax jurisdiction. Thus, reduction in the tax rate will in effect help the company because cess and surcharges are based on the tax levied and thus a reduction in tax will benefit the company. However, this reduction is only levied on domestic companies. Thus, this is a major benefit to domestic companies incorporated according to domestic laws.

VIII) OTHER ANCILLARY CHANGES

Apart from major changes suggested in the new regime, there are certainly other changes which are adopted in order to foster investment and skill development. These changes are:

- The proviso to section 32(1) provides that in order to claim 100% depreciation benefit machinery has to be used for at least 180 days. However, by way of the amendment, it is suggested that even if the machinery are used for less than 180 days depreciation benefit can be claimed.⁴¹ This will help the machinery used in electricity and manufacturing sectors.

⁴⁰ M Govinda Rao, 'The Tyranny Of The Status Quo: The Challenge Of Reforming India's Tax System' (*National Council of Applied Economic Research*, 2015) <<http://www.ncaer.org/uploads/photogallery/11erry/figile/1436711357IPF%202015%20Govinda%20Rao%20Conference%20Version%20Draft.pdf>> accessed 23 October 2015.

⁴¹ Karthik Ranganathan, 'Union Budget 2015 Direct Tax' (*Mondaq*, 2 March 2015) <<http://www.mondaq.com/india/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

- Section 86 of the Income-tax provides that in the case of an AOP if the income is distributed to its member companies no tax will be levied on the company. However, such income is calculated in the books of account as per section 115JB and MAT is levied. Thus, in order to avoid double taxation, an amendment is sought by which this income by companies will not be included in the calculation and thus not MAT will be levied.
- An amendment in section 32D is sought by way of which an investment made in the region of Andhra Pradesh and Telangana additional investment deduction by 15% is allowed and additional depreciation by 35% is sought in order to foster investment in Andhra Pradesh and Telangana.⁴²
- Initially, preferential tax treatment was not allowed to the sponsors of REITs at the time of selling of such units which were acquired by way of exchange against shares in unlisted SPV. On the other hand, the tax benefit was given to sponsors who hold share in SPV instead of exchanging them for REIT. Due to such denial, they were forced to pay tax. However, by way of an amendment, it is provided that sponsors of REIT (which have acquired bonds by way of exchange against shares in SPV) should be given tax benefit at the time of selling of REITs.⁴³ This amendment is invited by the real estate players and it is expected that it will encourage people in participating in real estate market as well. Another major change which is suggested is no taxing of income earned by REITs by way of rent or least. Initially, income received by SPV's as rent was not taxed while distributing it to REITs. However, similar income earned by REITs was taxed if it was not with the help of SPV. However, by way of an amendment a change is proposed which allows to not tax income received by way of rent or lease. Thus, before the amendment, if any rent income or lease income was earned by SPV, it was not subject to tax when it was distributed to REIT.⁴⁴ However, after the proposed amendment it is sought that even if REIT receives any income by way of rent or lease without any participation of SPV, such income will be given tax benefit.

⁴² Meghna Kapoor, 'Budget 2015-16 For The Corporates - Government, Public Sector - India' (*Mondaq*, 2 April 2015) <<http://www.mondaq.com/india/x/387462/Fiscal+Monetary+Policy/Budget+201516+For+The+Corporates>> accessed 23 October 2015.

⁴³ Karthik Ranganathan, 'Union Budget 2015 Direct Tax' (*Mondaq*, 2 March 2015) <<http://www.mondaq.com/india/x/378478/Capital+Gains+Tax/Knowledge+Sharing+Alert+Union+Budget+2015+Direct+Tax>> accessed 23 October 2015.

⁴⁴ Prosenjit Datta and Shweta Punj, 'What Mr Jaitley Should Do' (*Businessinsider*, 1 March 2015) <<http://www.businesstoday.in/magazine/cover-story/arun-jaitley-union-budget-panel-discussion-investment-jobs/story/215483.html>> accessed 23 October 2015.

IV. CONCLUSION

It has been aptly said that the Growth has to come from domestic factors and you can't rely on consumption growth as much as investment growth.⁴⁵ The direct tax was one of the most important obstacles to India's growth in manufacturing and inviting foreign investment. The BJP government has appropriately provided a new direction of tax reforms in India and restored the hopes of Indian economy resuming its journey on the high growth direction.

There are several amendments which are positives from foreign investor's standpoint. Thus direct tax proposals introduced are a welcome step and should attract foreign direct investment and create a hassle free business environment. Going forward, these reforms are the fundamental base for achieving "Make in India" vision.⁴⁶ Some financial specialist thinks that this budget does not provide the big bang that many investors wanted. However, the majority of the business analysts think that the budget marks a continuity of India's progress and competitiveness through these reforms.

Some of the proposals announced in the budget would bring clarity, increase predictability, and in turn rejuvenate the investment outlook of the world towards India. There are high expectations that tax revenue of India and stimulate investment into the Indian manufacturing sector might be increased as result of the tax reforms. Coupled with a reduction in profits tax rates, these tax reforms may be considered a long overdue structural change that marks a shift in India's position and development as a foreign investment-friendly destination.⁴⁷ While it is the commendable effort of government's tax reforms that has led government's "Make in India" program, however, a lot more reforms are expected from "Modi Sarkar" in order to make India a global player in manufacturing and investment sector. It is also important to study the reforms from the point of view of indirect taxation. The total benefits which investment and manufacturing sector will receive are a combination of both direct and indirect tax reforms. There were many substantial changes in the indirect taxes which mainly were concerned with Basic Customs Duty, Export Obligation for certain products under Foreign Trade Policy, excise regulations and other such regulations. Owing to the limitation of the topic only direct tax reforms were discussed. However, with the content of reforms and the pace at which India is developing the scheme of "Make in India" will be a big success.

⁴⁵ Satya Poddar, 'Tax System Reforms to Put Economy On Growth Path- Business News' (*BusinessToday*, 4 January 2015) <<http://www.businesstoday.in/magazine/cover-story/satya-poddar-ey-on-indian-tax-system-reforms-gst-for-economy/story/213485.html>> accessed 23 October 2015.

⁴⁶ Chris Devonshire- Ellis, Tarun Manik & Nishant Dixit, 'India's FY 2015-16 Budget: Meaning and Implications for Foreign Investment - India Briefing News' (*India Briefing News*, 4 March 2015) <<http://www.india-briefing.com/news/indias-fy-201516-budget-meaning-implications-foreign-investment-10182.html>> accessed 23 October 2015.