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Union Budget 2021

Tax Alert – Key amendments impacting Financial Services sector

Policy and tax reforms impacting Financial Services Sector

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The Budget 2021, being the first paper less budget in India, presented by the Hon'ble Finance Minister, Ms Nirmala Sitharaman, has aimed at reviving the economy impacted by the shockwaves stemmed from the global pandemic. The FM has road mapped a six pillar Budget to strengthen the Government's vision of AatmaNirbharta (a self-reliant India) to aid faster recovery of the economy.

From a Financial Services perspective, the following key changes/ themes were introduced:

- Introduction of a new structure for taking over the existing stressed debts from the public sector banks including proposed privatisation of two public sector banks;
- Increase in permissible foreign direct investment limit in insurance sector from 49% to 74% subject to certain conditions;
- Introduction of further incentives for attracting investments in the IFSC; and
- Enabling FPI investments in debt financing of REITs/ InvITs and restricting tax withholding on dividend pay-outs at tax DTAA rates.

From a procedural perspective on direct taxes, the Budget proposes several changes including introduction of faceless Appellate Tribunal proceedings, reduction of time limits for completion of tax audits, etc.

From an indirect tax standpoint, the key amendments are with respect to the omission of requirement of certification of annual reconciliation, introduction of Agri Infra Development Cess and rationalisation of customs duty rates for creating level playing field for the benefit of farmers, MSME and domestic manufacturers.

How does the budget impact Financial Services sector?

Key Policy Proposals

- Allowing debt financing of REITs and InvITs by FPIs
- Consolidation of several securities related market laws into a rationalized single Securities Markets Code
- Development of a world class Fin-Tech hub at IFSC
- Creation of a permanent institutional framework for developing the bond market
- Introduction of an investor charter as a right of all financial investors towards investor protection
- Increase in the FDI limit in insurance sector from 49% to 74% with additional controls and safeguards
- Recapitalization of INR 20,000 crores to consolidate the financial capacity of PSBs
- Setting-up of an Asset Reconstruction Company and Asset Management Company to take over, manage and dispose the existing stressed debt of public sector banks to AIFs and other potential investors
- Minimum loan size for debt recovery reduced from INR 50 lakhs to INR 20 lakhs for NBFCs with minimum asset size of INR 100 crores.
- Privatization of two PSBs and one General Insurance company
- Divestment of Government's stake in LIC through IPO

Key amendments

- **Tax measures and incentives for IFSC**
  - Currently, the IT Act provides for a special tax regime for onshore management of eligible investment Funds (based outside India) by domestic Fund managers subject to compliance with certain conditions. It is proposed that one or more of the conditions shall not apply (or shall apply with modifications) in case the domestic Fund manager (proposing to manage an eligible investment Fund) is in IFSC and has commenced its operations on or before 31 March 2024. A notification will be issued by the CBDT to provide for the conditions which will not be applicable/ will be modified.
  - It is proposed to confer a comprehensive tax exemption for relocation of an offshore Fund to IFSC on or before 31 March 2023 (i.e. relocation of 'Original Fund' to 'Resultant Fund'). Key aspects to be noted in this regard are as under:
    - Capital gains arising or received by a non-resident on transfer of shares of an Indian company by the Resultant Fund to be exempt, if capital gains on such shares were not chargeable to tax had relocation not taken place;
    - Resultant Fund is defined to mean an AIF located in IFSC;
    - Cost of acquisition, period of holding as well as carry forward and set-off of losses are protected; and
    - Capital gains tax exemption also provided in the hands of the shareholder/ unitholder of the Original Fund.
  - Capital gains arising on transfer of specified capital assets (transacted on a stock exchange located in any IFSC) are proposed to be exempt in the hands of an investment division of offshore banking unit in the

Highlights

Increase in FDI limit in the insurance sector

49% → 74%

Development of world class Fin-Tech hub at IFSC

Permanent institutional framework for bond market

Conditions for tax exemption rationalized in case of foreign SWF and PF

Tax incentives for eligible funds located in IFSC

IFSC to the extent attributable to it and computed in the prescribed manner. It is also proposed to widen the definition of 'specified fund' to include investment division of an offshore banking unit of a non-resident located in IFSC (commencing operations on or before 31 March 2024) which has been granted a category III AIF registration and is in compliance with the prescribed conditions. Further, the special tax regime, as applicable to FPIs, would equally apply to the aforesaid income.

- It is proposed to grant an exemption on income arising to or received by a non-resident on transfer of non-deliverable forward contracts entered into with an offshore banking unit of IFSC which has commenced operations on or before the 31 March 2024 subject to prescribed conditions.
- It is proposed to exempt royalty income of a non-resident arising on account of leasing of an aircraft by a unit in the IFSC (where unit in the IFSC claims a deduction under the IT Act and commences operations on or before 31 March 2024). Further, 100% deduction is proposed in respect of income on transfer of an asset, being an aircraft or aircraft engine, which is leased by a unit in IFSC (commencing operations on or before the 31st March 2024) to a domestic company engaged in the business of operation of aircraft.

- **Proceeds from specific high premium ULIPs to be taxable as capital gains; death proceeds continue to be exempt**
  - Presently, any sum received (except on death of the person) under a life insurance policy, issued on or after 1 April 2012, is taxable if premium payable for any of the years during the policy term exceeds 10 percent of the actual capital sum assured.
  - In addition to the percentage cap, it is now proposed that any sum received under any ULIPs, issued on or after 1 February 2021, shall be taxable if the amount of premium payable for any of the years during the policy term exceeds INR 2,50,000.
  - It is further proposed that if the premium is payable by a taxpayer for more than one ULIPs, issued on or after 1 February 2021, exemption shall be available only with respect to those ULIPs where the aggregate amount of premium payable for any of the years during the policy term does not exceed INR 250,000.
  - Death proceeds from aforesaid ULIPs to be exempt from tax.
  - Such ULIPs, for which no exemption is available, is to be considered as a 'capital asset' and is also proposed to be included in the definition of "unit of an equity-oriented fund". Accordingly, redemption of such ULIPs is proposed to be taxed as capital gains and the manner of computation of such capital gains shall be prescribed.
- **Clarifications on EL**
  - It is proposed to be clarified that the consideration which is in the nature of royalty and FTS [under the provisions of the IT Act read with the relevant DTAA] shall not be subject to EL.
  - Further, it has been clarified that the scope of terms 'online sale of goods' and 'online provision of services' will cover any one or more of the following activities where the same has been undertaken online:
    - Acceptance of offer for sale;
    - Placing the purchase order;
    - Acceptance of the purchase order;
    - Payment of consideration;
    - Supply of goods or provision of services, partly or wholly.
  - E-commerce operators are currently liable to 2% EL on the amount of consideration "received or receivable". In this regard, it is proposed to be clarified that such consideration will include:
    - consideration for sale of goods irrespective of whether the e-commerce operator owns the goods; and
    - consideration for provision of services irrespective of whether service is provided or facilitated by the e-commerce operator.
  - Income arising from transactions chargeable to EL was exempt with effect from 1 April 2021. Thus, for FY 2020-21, there was a mismatch between the effective date of EL and the corresponding income-tax exemption. It has now been proposed to remove this anomaly in order to grant income-tax exemption with retrospective effect from 1 April 2020.

- **Applicability of DTAA rate for withholding of taxes on income earned by FPIs**
  - Currently, based on the provisions of the IT Act and a judicial precedent rendered by the Hon'ble SC of India, taxes are withheld at the rate of 20% (plus applicable surcharge and cess) on dividend income earned by FPIs.
  - With a view to enable FPIs to avail the beneficial rates under the relevant DTAA, it has been proposed to amend the existing provisions to provide for the withholding of taxes at the rate of 20%/ 5% (in case of interest income on certain specified securities) or the rates provided in the relevant DTAA, whichever is lower on dividend/ interest pay-outs to FPIs.
  - The availability of the beneficial tax DTAA rate shall be subject to furnishing of a valid tax residency certificate by the FPIs and availability of benefits under the relevant DTAA.
- **Exclusion of dividend income from the applicability of interest on short payment of advance tax instalment**
  - Currently, interest at the rate 1% per month is levied for delay/ deferment in payment of advance tax instalment on or before the specified due dates in respect of income earned/ estimated to be earned during the course of the year.
  - The current provisions of the IT Act provide a relief from the interest levy on failure to estimate certain types of income (for instance, capital gains) where taxes are discharged appropriately by the taxpayer in advance tax installments falling due in the period subsequent to earning of the specified income.
  - It has now been proposed to include dividend income (subject to a minor exception) in the categories of income where the failure to estimate does not result in an interest levy so as long as taxes on such dividend income are discharged vide subsequent advance tax instalments in a timely manner.
  - The amendment is proposed to be retrospectively applicable from FY 2020-21.
- **Rationalisation of provisions related to SWFs/ PFs**
  - Currently, an exemption is provided to SWFs and PFs in respect of dividend, interest and LTCG earned in respect of specified investments: (a) in the units of business trust; (b) in the securities issued by a company or an enterprise carrying on eligible infrastructure activities; and (c) units of Category I/ II AIF whose 100% investment is in one or more company or enterprise referred to in point (b).

    It is now proposed to expand/ relax the list of qualifying investments to include the following:
    - Units of Category I/ II AIFs having not less than 50% (as against 100% current) investment in eligible companies undertaking eligible infrastructure activities;
    - Units of Category I/ II AIFs having investment in InvITs;
    - Investment permitted through domestic holding companies set-up and registered after 1 April 2021, having minimum 75% investment in infrastructure companies, entities or entity carrying on the business of developing, operating, maintaining any infrastructure facility;
    - Investment permitted in Non-Banking Finance Company - Infrastructure Debt Fund/ Infrastructure finance company, having minimum 90% lending to one or more infrastructure entities;

    The Central Government shall prescribe the method for calculation of 50% or 75% or 90% as referred to above.
  - *Relaxation of certain conditions for SWF/ PF to avail exemptions:*
    - One of the qualifying conditions prescribed for a PF was that it should not be liable to tax in the foreign country where it was established/ incorporated. It is now proposed to amend the eligibility criteria to include PFs which are liable to tax but may be exempt from taxation with respect to all or any of its income.
    - Presently, a SWF/ PF is not allowed to undertake any commercial activity. This condition is proposed to be removed and replaced with a condition that the SWF/PF shall not participate in the day to day operation of the eligible investment entity. However, the monitoring mechanism to protect the investment, including the right to appoint directors or executive director shall not be considered as participation in the day to day operations of the eligible investment entity.
    - Presently, SWF/ PFs are not allowed to have loans or borrowings or deposit or investments as there is a condition that no benefit should accrue to a private person. It is now proposed to provide that there should not be any loan or borrowing for the purpose of making investment in India. It is also proposed that the condition regarding no benefit to a private person and assets vesting with the foreign government on dissolution, shall not apply to any payment made to a creditor or depositor for loan taken or borrowing other than for the purpose of making investment in India.

- **Conversion of Primary Co-operative Bank into a Banking Company**
  - Currently, the IT Act contains special provisions for computing certain tax deductions and granting tax neutral status in case of business reorganization of co-operative banks.
  - The RBI permits voluntary conversion of a primary co-operative bank [commonly known as an UCBs] into a banking company.
  - Accordingly, it is proposed to expand the scope of business reorganizations to include conversion of a UCB into a banking company so as to enable the UCBs to claim the specified tax deductions and tax neutral status as provided in the IT Act.
  - The amendment is proposed to be retrospectively applicable from FY 2020-21.
- **Revamped procedure for conducting reassessment and search assessment proceedings**
  - Due to advancement of technology, IRA receives relevant information on almost real time basis from various entities and other governmental agencies. IRA uses this information to verify the details declared by the taxpayers in their tax returns as well as to detect non-filers or those who have not disclosed the correct amount of income. Largely, the process is information driven. Therefore, there is a need for complete reform of system of reassessment of income.
  - Under the new scheme, reassessment proceedings can be initiated by the tax officer only where he has information which suggests that the income chargeable to tax has escaped assessment for relevant FY. New scheme provides specific circumstances defining source of information viz (a) information flagged in accordance with risk management strategy formulated by CBDT and largely driven by computer based system (b) final objections raised by CAG that assessment of taxpayer has not been made in accordance with provisions of the IT Act (c) Survey or search action on taxpayer on or after 1 April 2021 (d) money, bullion, jewellery or other valuable article or thing, books of account or documents seized or requisitioned in case of any other person on or after 1 April 2021 which belongs to or pertains to the taxpayer.
  - Prior approval of specified senior Tax Authority is to be obtained before issuance of notice for reassessment.
  - A new procedure is also prescribed for Tax Authority to conduct enquiries, if required and granting an opportunity to taxpayer before issuance of notice for reassessment except in cases of search or requisition.
  - Revised time limit for conducting reassessment proceedings:
    - In normal case – 3 years from the end of relevant assessment year;
    - In cases where tax authority is in possession of evidence which reveals that income escaped assessment is more than INR 50 lacs – 10 years from the end of relevant assessment year.
  - Reopening of past years as per existing provisions is grandfathered. Likewise, cases of search or requisitioned initiated before 31 March 2021 are excluded from the scope of new procedure.

Impact analysis

The Budget 2021 has been presented in the backdrop of various challenges being faced by the Indian economy in light of the COVID-19 pandemic. From a financial services standpoint, several measures have been introduced to promote the financial markets, addressing of the concerns around asset quality, credit losses, liquidity stress, supporting the development of the IFSC, infrastructure financing and overall fiscal management of the economy.

The demand of the FPIs enabling tax withholding at the DTAA rates on dividend pay-outs has been accepted by the Government. The Government has also provided for aspects related to reduction in the time limit with respect to re-opening of assessments, tax neutrality for re-organization of primary co-operative banks into banking companies under the prescribed regulatory framework and rationalization for conditions related to investments by SWFs and PFs in the infrastructure sector. Moreover, the Government has also proposed several measures for furthering its objective of promoting the IFSC which will surely go a long way in achieving the stated objective of making India a global hub with world class financial products.

On the tax administration front, the Government has acknowledged the need for reduction in income-tax litigation and has constantly made efforts over the last one year to achieve a more robust and transparent form of direct tax assessments through introduction of various faceless schemes and Vivad se Vishwas scheme. It is now proposed to introduce a new scheme under the IT Act for preventing new disputes and settling the issues at an initial stage itself for small and medium taxpayers. Furthermore, a faceless scheme for proceedings before the ITAT (i.e. the second appellate authority) is also proposed to be introduced.

From a sector point of view, while the Government has introduced transforming measures, several asks of the financial services players such as non-withholding of taxes on interest payments to NBFCs (which are operating on thin margins specifically owing the pandemic), clarity on EL provisions for financial services companies, alignment of IndAS provisions with the taxation laws on aspects related to interest on stressed assets, abolition of long-term capital gains tax, clarity on taxation of Category III AIFs, etc. still need to be dealt with.

Glossary

AIFs - Alternate Investment Funds

CAG - Comptroller and Auditor General of India

CBDT - Central Board of Direct Taxes

DTAA - Double Tax Avoidance Agreement

EL - Equalisation levy

FPIs - Foreign Portfolio Investors

FTS - Fees for Technical Services

FY - Financial Year

IFSC - International Financial Services Centre

IndAS - Indian Accounting Standards

InvIT - Infrastructure Investment Trust

IPO - Initial Public Offering

IRA - Indian Revenue Authorities

IT Act - The Income-tax Act, 1961

ITAT - Income Tax Appellate Tribunal

LIC - Life Insurance Corporation of India

LTCG - Long-term capital gains

NBFC - Non-Banking Financial Company

PF - Pension Funds

RBI - Reserve Bank of India

REIT - Real Estate Investment Trusts

SWF - Sovereign Wealth Fund

UCB - Urban Co-operative Bank

ULIPs - Unit Linked Insurance Policy

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