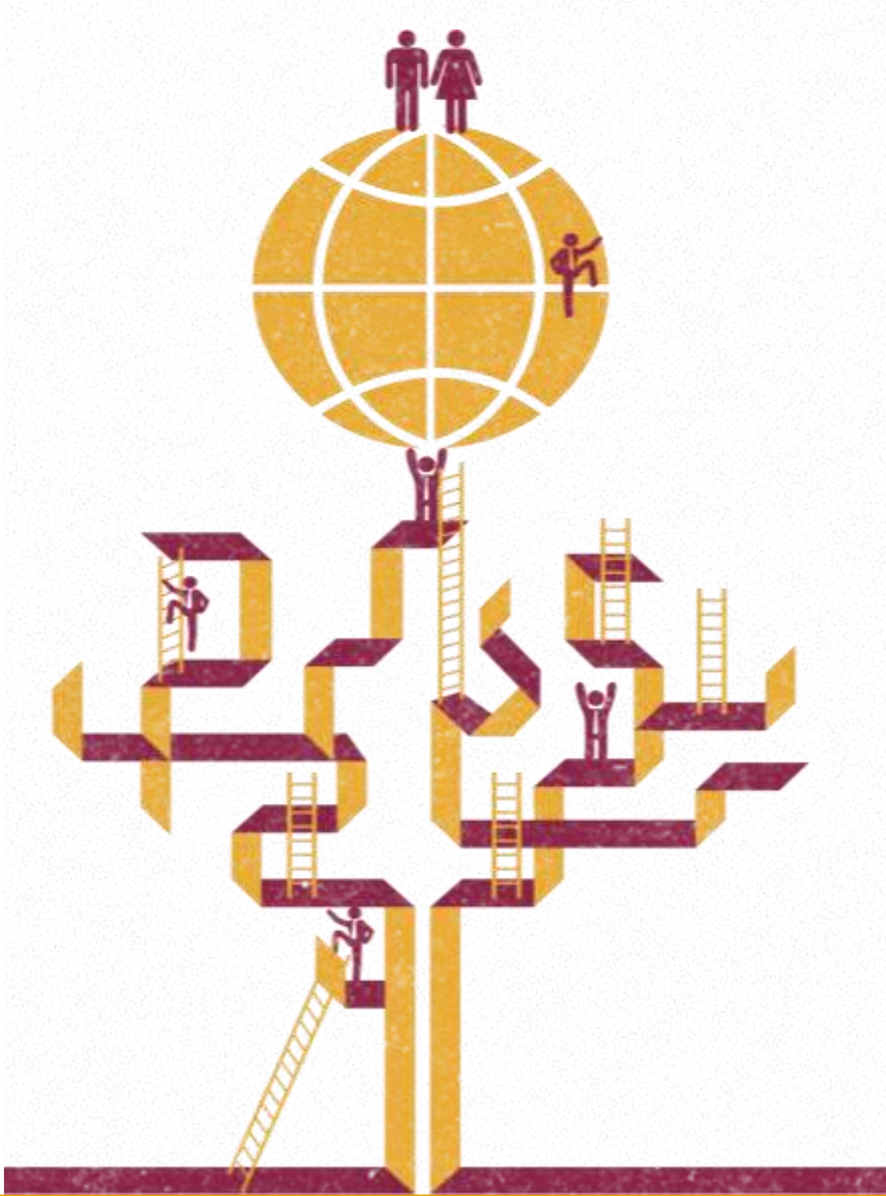
Union Budget 2014-15

Impact on the M&A & Private Equity investments in India

July 2014

Content



Overview

Two of the major asks of the PE fraternity have not been met. These mainly include the deferment of GAAR (General Anti Avoidance Rules) and clarity on taxation of indirect transfer of shares.

There was a clear expectation that GAAR would be deferred if not diluted. However, there has been no mention of GAAR at all by the Finance Minister which leads one to believe that these provisions will come into force from 1 April 2015, as they stand.

On indirect transfers, the Finance Minister has stated that a high powered committee under the aegis of CBDT will be set up to evaluate all such transactions but the existing litigation will have to take the legal recourse currently available. Time will tell how much teeth this committee has and how effective it proves to be to restore investor confidence.

At some level PE's thrive if there is a general buoyancy in the economy coupled with growth and hence general measures to boost the economy get a thumbs up from them too!

Special focus on MSME's by setting up a Rs. 10,000 crore fund to act as a catalyst in attracting private capital, introduction of REIT and Infrastructure Investment Trusts is a welcome move.

However increase in the holding period of unlisted shares to 36 months to qualify as long-term capital asset and grossing up the method of computing dividend distribution tax will be a dampener in the short run as it directly affects tax outlay on extraction of profits from an SPV and transfer of shares.

We share herein some of the key policy initiatives for this sector in the Budget and the tax proposals.

Key policy initiatives

Creation of fund for start-ups

To create a conducive eco-system that would attract venture capital in the MSME sector, it is proposed to establish a Rs 10,000 crore fund to act as a catalyst to attract private capital by way of providing equity, quasi equity, soft loans and other risk capital for start-up companies

Retrospective amendments

A high level committee of the CBDT to scrutinise all fresh cases arising out of retrospective amendments through Finance Act, 2012 in respect of indirect transfer

Foreign Direct Investment (FDI)

- FDI in defence increased to 49% from present 26% with full Indian management under approval route
- FDI in insurance sector increased to 49% from present 26%
- The manufacturing units with FDI will be allowed to sell its products through retail including e-commerce platform without any additional approval
- To enhance development of smart cities, FDI conditions in the real estate sector are proposed to be relaxed for the first time since 2005, when the FDI was first allowed in the real estate sector. It is proposed that built-up area requirement be reduced from 50,000 sqm to 20,000 sqm and minimum capitalisation requirement in case of wholly-owned subsidiary is proposed to be reduced to US$ 5 million from US$ 10 million. Further, it is proposed to provide complete exemption from built up area and minimum capital requirement for the projects which commit at least 30% of the total project cost for low cost affordable housing with a minimum lock-in of 3 years

Key incentives to the capital markets

Measures towards liberalising the legislative framework and energising capital markets

- Elimination of the unnecessary restrictions on the corporate bond market and currency derivatives market as a move towards creating more depth and liquidity in these markets
- Extension of the lower withholding tax rate of 5% to all overseas bonds issues by Indian corporates, to be applicable for monies borrowed up to 30 June 2017 (as against the present limit of 30 June 2015)
- Liberalisation of the ADR/GDR regime to allow issuance of depository receipts on all permissible securities
- Revamping / introduction of the Indian Depository Receipt and the more liberal Bharat Depository Receipt

Measures towards strengthening and better governance of capital markets

- Ongoing process of consultations with all stakeholders on enactment of the Indian Financial Code and reports of the Financial Sector Legislative Reforms Commission to be completed
- Introduction of uniform Know Your Customer (KYC) norms and inter-usability of the KYC records across the entire financial sector
- Introduce one single operating demat account

Direct tax proposals

Introduction of a new taxation regime for REIT and InvTrust (Business trust)

- Budget has brought in the tax framework for REITs and InvTrusts, even though the regulations are yet to be notified by the SEBI
- Salient features of REITs / InvTrust:
  - Units of REIT and InvTrust to be listed on recognised stock exchanges in India
  - Income bearing assets to be held under Indian Special Purpose Vehicles (SPVs), which in turn would be held by REIT/ InvTrust
  - Units of REIT/ InvTrust to be granted same status as listed equity shares i.e. they will be liable to the same rates of Securities Transaction Tax (STT) as well capital gains tax
  - Swap of shares of SPV by Sponsors for units of REIT/ InvTrust would be exempt
- These provisions are proposed to take effect from 1 October 2014
- Budget proposes to provide a clear tax framework for REITs. This will pave way for the advent of REIT in India. The regulatory framework of REIT is still in a consultative stage. However, in the present form , REIT funds would substantially be available for the acquisition of completed and income bearing assets. The risk profile of the REIT assets can perhaps be increased, and a little more than a mere 10% can be made available for assets other than completed and income bearing assets

Though pass through status has been accorded to the REIT and InvTrust on their incomes, but they have not been absolved of their responsibility to withhold taxes on certain incomes to the unit holders

Direct tax proposals

Taxability of REITs / InvTrust:

Nature of income	REITs / Invtrust	Unit holders
Interest	Exempt (considered as pass through)	Taxable (on distribution) (Non-resident – 5%, Others – 10%)
Dividend	Exempt	Exempt
Capital Gains on exit by REIT / Invtrust	At the rates applicable to income under the head capital gains	Exempt (on distribution)
Capital gains on sale of units of REIT / Invtrust	NA	Long term – exempt Short term – 15% (in case of sponsors long term – 20%, short term – 30%, period of holding and cost of acquisition of shares of SPV considered)
Any other income	Maximum Marginal Rate	Exempt (on distribution)

No roll back in retrospective amendments

- No specific amendment has been proposed for retrospective taxation of indirect transfers which was introduced by the Finance Act, 2012
- The FM has assured the investor community that the government will not ordinarily bring about any change retrospectively, which creates a fresh liability
- Also, assurance has been given to the investor community that all fresh cases arising out of the retrospective amendments in respect of indirect transfers will be scrutinised by a high level committee to be constituted by the Central Board of Direct Taxes before any action is initiated in such cases

No respite for pending cases; Possibility of re-opening cases under retrospective amendment cannot be ruled out

Direct tax proposals

Tax withholding on interest income earned by non-resident

- Tax withholding at the rate of 5% on interest payment to non residents in respect of foreign currency borrowings is proposed to be extended to business trusts, as well
- Such concessional treatment is proposed to be applicable for monies borrowed before 1 July 2017 (as against the present time limit of 1 July 2015)
- Under existing provisions, apart from foreign currency loan, this reduced withholding tax rate of 5% applies only to interest on long term infrastructure bonds. It is now proposed that this benefit will extend to all long term bonds (i.e. whether infrastructure bonds or not)
- This provision will be effective from 1 October 2014

Calculation of Dividend Distribution Tax (DDT) on the grossed up amounts

- Under the existing provisions, a domestic company is liable for payment of DDT at the rate of 15% on any amount declared, distributed or paid by way of dividends to the shareholders under Section 115-O
- Budget proposes to amend this section to provide that DDT shall be levied on grossed up distributable amount i.e. the amount distributed and the DDT amount
- This amendment will take effect from 1 October 2014

Direct tax proposals

Tax on dividends received from foreign companies

- Under the current provisions of the Act, dividends received by an Indian company from its foreign subsidiaries were taxable at a concessional rate of 15%
- This window was available for dividends received up to 31 March 2013
- With a view to encourage repatriation of foreign dividends into the country, the Finance Bill, 2014 now proposes to increase the beneficial rate of 15% to FY 2014-15 and subsequent financial years without any sunset clause

Long term capital gains on transfer of units - withdrawal of concessional rate

- In case of listed securities, mutual fund units and zero coupon bonds tax on long term capital gains is restricted to 10% of capital gains without providing the benefit of Indexation
- It has been proposed to restrict the benefit of 10% taxation only to listed securities (other than units) and zero coupon bonds, as long term capital gains is exempt in case of transfer of an equity oriented fund which are subject to securities transaction tax
- This provision will take effect from FY 2014-15

Period of holding of unlisted securities and units of non-equity oriented mutual funds revisited for the purpose of capital gains

- Currently, the period of holding for qualifying as short term capital asset is 'not more than 12 months' in the following cases (as against 36 months in other cases):
  - shares held in a company
  - any other security listed on a recognised stock exchange
  - units of the Unit Trust of India or a Mutual Fund
  - Zero coupon bonds
- The shorter period of 12 months above was introduced with a view to boost investment in the stock markets as long term capital gains are taxed at beneficial rate
- It is proposed to increase the period of holding for qualifying as short term capital assets to 'not more than 36 months' in the following cases:
  - unlisted securities
  - units of a mutual fund (other than equity oriented mutual fund)
- This provision will take effect from FY 2014-15

Direct tax proposals

Mandatory filing of return of income

Following entities are mandated to file a return of income if their income exceeds maximum amount not chargeable to tax without giving effect to exemption provisions prescribed under Section 10 of the Act

1. Mutual Funds covered under Section 10 (23D) of the Act
2. Securitisation Trusts covered under Section 10(23DA) of the Act
3. Venture Capital Company or Venture Capital Funds covered under 10(23FB)

Infrastructure Investment Trust and Real Estate Investment Trusts are also mandated to file a return of income

This provision will take effect from FY 2014-15

Other tax proposals

General update

- No amendments have been proposed regarding general tax rate structure for direct and Indirect taxes for corporates
- Tax rates (Customs and Excise) have been changed for certain specific goods in certain specified sectors/ industries
- No concrete announcement on GST implementation timeline and roadmap
- Government hopes to find a solution during this fiscal and approve the legislative scheme in discussion with States after giving due consideration to their apprehensions

Focus to reduce litigation

- Advance Ruling scheme extended to 'resident private limited companies' to seek tax clarity on proposed business transactions
- Scope of Settlement Commission increased to cover additional dispute areas

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