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India Budget 2020: Key International Tax Proposals Impacting Non-Resident Taxpayers and MNCs

Mukesh Butani (BMR Legal) · Thursday, February 6th, 2020

On February 1, 2020 India's Finance Minister Nirmala Sitharaman presented the Government's Union Budget for the year 2020-21. With its continuing promise of making India a $5 trillion economy by 2025, the budget announcements contained a host of reforms to obliterate the seeping fears regarding prospects of the Indian economy with focus on agricultural, rural economy, infrastructure development and addressing credit update for businesses. On fiscal front, Budget 2020 has pronounced several key proposals in general on tax policy front and in general in the international tax law arena to address concerns of foreign investors and to make investment in India hassle free.

We have discussed few key proposals in this memorandum:

Aligning purpose of entering in Double Taxation Avoidance Agreements (DTAAs) with Multilateral Instrument (MLI)

In pursuance to India signing MLI in the June 2017 ceremony, it deposited its instrument of ratification along with its reservations, notifications and options on June 25, 2019. As a result, MLI has been in force in India since October 1, 2019. Its provisions will modify India's DTAA (from FY 2020-21 onwards) to address revenue loss through treaty abuse and profit shifting strategies by ensuring that profits are taxed in the jurisdiction where substantive economic activities are undertaken.

With trigger under Article 6 of the MLI, Preamble being minimum standard, India has signaled that its treaty obligation (with partners) is not limited to prevention of double taxation, but also to not create tax opportunities for non-taxation or reduced taxation. Although the ultimate purpose of tax treaties is to enhance international commerce by eliminating double taxation, the new preamble under Article 6 of MLI explicitly add a second operational purpose *i.e.* to prevent tax avoidance.[1]

To align the 'purpose of entering into DTAAs' under the domestic law, to that under Article 6 of MLI, section 90(1)(b) of the Income Tax Act, 1961 (ITA)[2] has been amended to provide that "the Central government may enter into any tax treaty with any other country for the avoidance of double taxation, without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of any other country or territory)". India's step to align Indian income tax laws with provisions of MLI (Article 6) reaffirms its goal to curb treaty abuse in cases of attempts to circumvent limitations provided by the treaty itself. The earlier legislation focused merely on 'avoidance of double taxation'. Though there has been some debate and concern on India using the (amended) domestic law provisions to question residents of countries (Singapore, Mauritius, Cyprus) with whom protocols provided for grandfathering of investments, in our view, such concerns are unfounded.

Modification of residence test

The Budget 2020 has proposed revision of the criteria and duration for determining residential status of an individual taxpayer. The proposals suggest following amendments to the ITA:

- An individual who is Indian citizen or a person of Indian origin would be considered resident in India if he/she resides in India for a period of 120 days in contrast to earlier duration of 182 days.
- An individual will be considered as 'Not Ordinarily Resident' if he/she has been a non-resident for seven out of ten previous years.[3]
- A third amendment creates a deeming fiction for an Indian citizen with stateless income.

The underlying intent of amendment is to plug loopholes for individuals who dodge the law by fulfilling the 183 days condition and in the process do not pay tax in any jurisdiction.

Further, the anti-abuse measure (third amendment) which has proposed 'deemed residency test' stipulates that individuals domiciled in India, who are not liable to tax in any other country shall be *deemed* to be resident of India. Though the amendment is a tax evasion measure for stateless persons having economic interests in India, its outcome has resulted in unintended consequence for genuine taxpayers, who now face an onerous stay day condition.

Owing to such situations, the Government via press release[4] clarified immediately after the budget that such 'deemed residency test' precludes income earned by bona fide individuals in other jurisdictions and do not pay tax on the same. By virtue of the new test, such individual will only be taxable in India only if he/she derives income from Indian business or profession.

With the incorporation of 'deemed residency test', claims of dual residency may arise. The government has clarified in such scenarios 'tie-breaker' rule as stipulated under Article 4 of DTAAs can be invoked. The rule contains several tests for determination of state of residence including state in which an individual has permanent home, his centre of vital interest i.e. state with which his personal and economic relations are closer, habitual abode and nationality of the individual. Rules of residency in India have historically been driven by domestic law, despite treaty provisions dealing with 'tie breaker' rules and dual residency situations. Though we anticipate that this part of amendment shall undergo change before the bill is passed as legislation, intent of the law makers is not clear. That besides dealing with stateless income situation, the domestic law will look at deeming fiction to bring global income to tax in situations where residency is established.

Abolition of Dividend Distribution Tax (DDT)

One of the key rationalization measures in the Union Budget 2020 is abolition of dividend distribution tax, which was introduced in India back in 1997 (other than one isolated year of 2002 when DDT was abolished). Over the past few years, DDT regime has come under criticism as it does not follow the principle of progressive tax, proving detrimental to smaller shareholders who end paying a minimum of 20.57%. DDT was introduced at 7.5% flat rate as an effort towards efficient tax collection and it proved to be unfair with higher rates in subsequent years burdening

Indian companies having dividend payouts to its shareholders. From an investor's point DDT was a major bane due to non-availability of its credit in their host nations under the treaty. The withholding tax shall stand reduced to between 5-15% depending on the treaty.

Other key amendments

Deferment of applicability of SEP provisions

India legislated in its domestic law, concept of 'Significant Economic Presence' (SEP) by enlarging the scope of business connection under Section 9(1)(i) of ITA. The test was brought in, to bring within the tax net, digital platform businesses operated by non-residents in India, without any fixed place of business. Subsequent to this amendment, threshold for the aggregate amount of payments arising from specified transactions, number of users was awaited to be prescribed in the subordinate legislation. In anticipation of an ongoing discussion on profit attribution, the budget has clarified that the applicability of SEP will be deferred to fiscal year starting April 2021. This is in anticipation of the release of OECD G20- OECD Report in December, after which India shall notify rules to make it effective from April 2021.

Instead a new explanation has been added by way of clarification, to the definition of 'business connection'. The expanded definition tends to broaden the term 'operations in India' to include digital business operations that does not entail physical presence. It includes advertisements, data and sale of goods using data collected from resident Indians. Though the said amendments will not impact countries with whom India has a DTAA, it is viewed as changes in anticipation of PE attribution Such changes are likely to follow next year.

TDS levy of 1% on E-commerce transactions

Additionally, in order to widen and deepen the tax net for e-commerce giants, the budget proposals have introduced a withholding tax of one percent effective from April 1, 2020 to be levied by e-commerce operator on payments facilitated to e-commerce service providers. The ambit of such supply of goods and services is inclusive of digital products, supply of goods or services over digital network and fee for technical and professional services.

Amendment in taxation regime of offshore fund managers

Budget 2020 has taken a further step to revive exemption of offshore Indian fund managers. Section 9A of the ITA stipulates special regime for taxation of offshore fund managers by providing them exemption from creating a business connection or PE in India. Even after the Budget 2019 had proposed measures to revive 2016 regulations, there were anomalies in making them operational which prevented eligible fund managers to avail benefit of the exemption. Budget 2020 has further relaxed conditions stipulated earlier, by providing that the investment of eligible fund manager during first three years up to twenty-five crores (Rs 250 million) shall not be accounted for, while availing exemption. This is in contrast to pre-existing investment limit of 5% by eligible fund managers. It has also been clarified that the condition of monthly average asset value of fund of Rs 1 billion can be fulfilled within 12 months from last day of the month of incorporation of the fund.

Further category II Foreign Portfolio Investors (FPIs) who are not sovereign funds shall no longer employ exemption from indirect transfer tax for offshore transactions.

Key announcements in disputes settlement mechanism

One of the key highlights of Budget proposals has been government efforts to boost investor's confidence due to arbitrary and revenue biased tax assessments. Taking a step towards reducing direct tax litigation before various appellate forums, the government has proposed a dispute settlement scheme *Vivad se Vishwas* scheme. Under this scheme, the taxpayer would only be requisite to pay only the amount of the disputed taxes and in return can avail complete waiver of interest and penalty, provided the tax dues are deposited before March 31, 2020 extendable to June 30, 2020 (subject to incremental payment of 10%). Further, the scope of Dispute Resolution Panel has been expanded to include all non-residents besides foreign companies. The proposals of faceless appeal mechanism, and formalization of taxpayer rights by way of taxpayer charter reaffirms broader economic policy goal to uplift governance by imbibing efficiency, transparency and accountability in the process. The requirement for non-residents to comply with tax return filing requirement on passive income such as royalties or fee for technical services has been done away with in situations where no treaty benefit is claimed.

Expansion of scope of Safe Harbor Rules and Advance Pricing Agreements

To provide certainty to the non-resident taxpayers on attribution of profits to business connections/PEs, Budget 2020 has proposed Safe Harbour Rules and Advance Pricing Agreements from April 1, 2020. The Rules are yet to be announced.

The author is Managing Partner at BMR Legal and was assisted by Riya Gupta, Associate at the firm.

[1] B?a?ej Ku?niacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application". World Tax Journal, May 2018, Page 252.

[2] Section 90 of the ITA empowers the Central Government to enter into DTAA with other jurisdiction for:

(a) granting relief in respect of (i) income on which tax has been paid both, in India and that foreign country or territory, or (ii) income-tax chargeable under the laws of both jurisdictions, to promote mutual economic relations, trade and investment;

(b) avoidance of double taxation of income under the laws of both jurisdictions;

(c) exchange of information; or

(d) recovery of income-tax under the laws of both the jurisdictions.

[3] This is in contrast to earlier condition of 9 out of 10 year or overall stay period of 729 days for seven previous years preceding that year.

[4] Press Information Bureau, "Clarification regarding proposal in the Finance Bill 2020". Ministry of Finance, 2 February 2020. Accessed at: < https://pib.gov.in/PressReleasePage.aspx?PRID=1601641>

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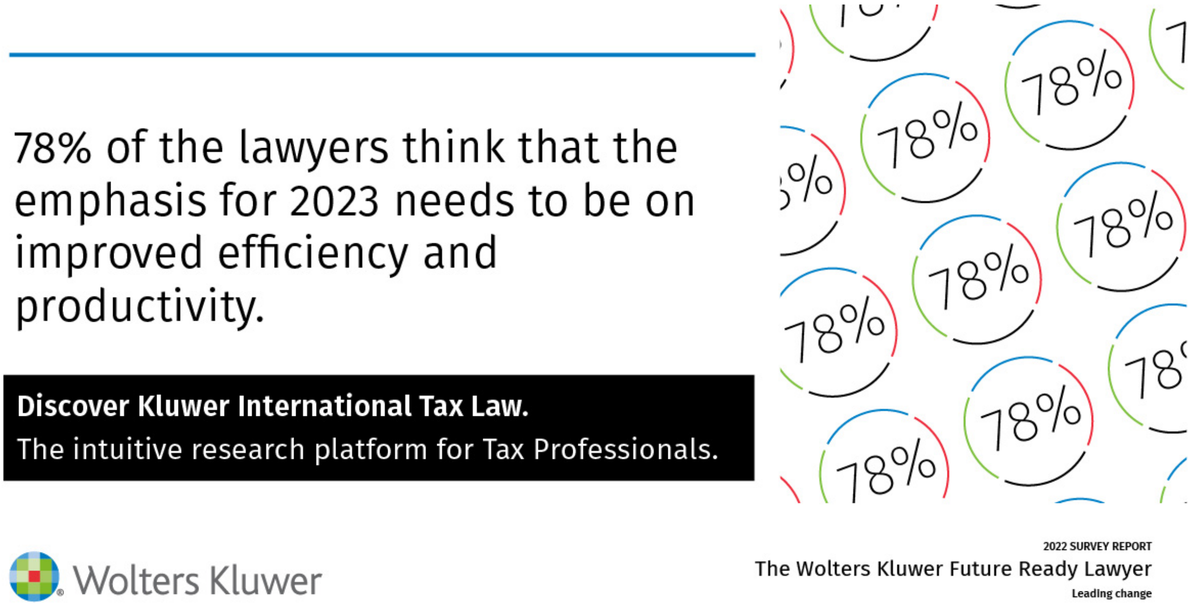

This entry was posted on Thursday, February 6th, 2020 at 3:11 pm and is filed under Dividends, India, MLI, Residence, Tax Policy, Tax Treaties
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