KPMG

Union Budget 2018-19

Our Point of View

Private Equity

No big surprises - Union Budget along the expected lines

Budget analysis and impact

The Union Budget exercise involved a tight rope walk – on one hand to ensure that economic growth is sustained and encouraged and on the other, respond to the current socio-economic environment and the need for rural and agricultural spending.

At a macro level, this year's Budget chose to significantly appeal to the latter, healthcare benefits up to INR500,000 per family per annum for the economically backward strata, calling for increased rural outlays and a slew of measures on the agricultural side and increased focus on the Micro, Small & Medium Enterprises (MSME) and self-help sectors. This increased expenditure naturally meant that the tax benefits that corporates expected as a response to global developments in United States and United Kingdon could not come through and the much speculated Long Term Capital Gains on listed stocks made a comeback. This ensured that the fiscal slippage was more or less contained. From a Private Equity (PE) stand point, the increased rural and healthcare focus may perhaps improve the economics of companies engaged in consumption led and healthcare sectors.

On the policy side, in so far as the PE/Venture Capital (VC)/investing community is concerned, the Finance Minister (FM) clearly recognised the stellar contribution of this community and made two significant statements.

A. **Clear indication on hybrid instruments**: In what is perhaps the first such clear enunciation, the FM stated the need for the economy to further Foreign Direct Investment (FDI) flows and acknowledged the role of hybrid capital instruments – we expect to see a policy enunciation during the coming weeks, where the current restrictive pure equity or pure debt structures are significantly liberalised. We expect this to have an immediate and fundamental impact on the manner in which cross border PE investments are structured.

B. **Role of VC/angel investors**: The FM also acknowledged that to encourage start-ups, the investors namely VCs/angel investors need a more certain and supportive framework and promised a policy review in this regard.

Key announcements

Key tax proposals

- **New regime for taxation of long-term capital gains on sale of listed capital asset**
  - The Finance Bill proposes to abolish the long standing tax exemption in respect of capital gains arising on sale of listed shares and units of equity oriented mutual funds and business trusts (REITs / InvITs) held for more than 12 months. This exemption was available where the purchase (excluding certain exceptions) and sale of such shares and in case of equity oriented mutual funds, the sale of such units was subject to Securities Transaction Tax (STT). The Finance Bill proposes that such capital gains (exceeding INR1lakh) on sale of such assets consummated on or after 1 April 2018 will be liable to tax at the rate of 10 per cent.

— The Finance Bill proposes to provide grandfathering benefits in respect of gains accrued till 31 January 2018 on assets acquired before 1 February 2018. However, appropriate safeguards are built to ensure that no loss is allowed as a result of this grandfathering benefit. Separately, for Foreign Portfolio Investors (FPI) the computation mechanism as proposed does not offer any grandfathering benefit.

Following is the key impact:

— Minimum Alternate Tax (MAT) for corporate tax payers will continue to apply. In addition, the non-corporate tax payers will become liable to alternate minimum tax on such long-term capital gains

— The PE funds/promoters looking for an exist through Initial Public Offer (IPO) will now have to factor in tax cost at applicable rates, unless Government of India provides any exemption on such transaction through a circular.

- **Relief for companies under Insolvency and Bankruptcy Code, 2016 (IBC)**
  The following tax amendments are proposed to provide relief to the companies seeking insolvency resolution under the IBC:

  — The entire amount of brought forward loss (including unabsorbed depreciation) (as per books of account) will be allowed to be reduced from the book profit for the purposes of levy of MAT, in case of a company whose application for corporate insolvency resolution process has been admitted by the Adjudicating Authority under the specified provisions of the IBC

  — Carry forward of business losses are proposed to be protected despite change in beneficial owners of shares in case of closely held company whose resolution plan has been approved under the IBC.

- **Expansion of definition of 'business connection'**
  — The scope of 'business connection'" is proposed to be widened to align with internationally accepted tax provisions. The term will also include any business activity carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident.

  — It is further proposed that the contracts should be -

  (i) in the name of the non-resident or

  (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use or

  (iii) for the provision of services by that non-resident.

- **Permanent Account Number (PAN):**
  — Every person (other than individuals), which enters into a financial transaction of an amount aggregating to INR250,000 or more in a financial year will be required to obtain PAN. Further, with a view to link the financial transactions to the natural persons, the managing director, director, partner, trustee, author, founder, karta, chief executive officer, principal officer or office bearer or any person competent to act on behalf of such entities will also be required to obtain PAN.

- **Concessions for units located in International Financial Services Centre (IFSC):**
  — In case of non-corporate units located in IFSC, the Alternate Minimum Tax rate will be nine per cent (as against 18.5 per cent for others)
  — Transactions in global depository receipts, rupee denominated bonds or derivatives by a non-resident on a recognised stock exchange located in IFSC will not be taxable provided the consideration is paid or payable in foreign currency.

- **Reduction in corporate tax rate of MSMEs**
  — Corporate tax rate in case of domestic companies having a total turnover/gross receipts in financial year 2016-2017 not exceeding INR250 crore is proposed to be reduced to 25 per cent

- ***Other key points:***
  — **Scope of 'accumulated profits' widened for the purposes of dividend:**

  Dividend under the current tax provisions has been defined to include distribution of 'accumulated profits'. The scope of the term 'accumulated profits' is proposed to be widened so as to provide that in the case of an amalgamated company, accumulated profits, whether capitalised or not, or losses as the case may be, will be increased by the accumulated profits, whether capitalised or not, of the amalgamating company on the date of amalgamation

— **Dividend Distribution Tax (DDT) proposed to be applicable on deemed dividend on loans and advances to shareholder:**

Presently, deemed dividend i.e. loan/advance by a closely held company to its substantial shareholder or to any concern in which such shareholder holds substantial interest is not subject to DDT but is taxable in the hands of such shareholder

DDT will now be applicable on such deemed dividend at the rate of 30 per cent (without grossing up) and will be exempt from tax in the hands of such shareholder like any other dividend.

— **Tax on distribution by equity oriented mutual fund:**

Currently, distributions by equity oriented mutual funds to their respective unit holders are exempt from levy of additional income-tax. The equity oriented mutual funds will now be liable to pay tax at the rate of 10 per cent on distributions to their respective unitholders. This would bring the dividend paying funds on level playing field with growth oriented funds which are proposed to be covered under the long term capital gains tax regime.

— **Rationalisation of tax impact due to imputed value in case of real estate transactions**

At present, in case of transactions of immovable property, the actual consideration or stamp duty value, whichever is higher is adopted for the purpose of computing capital gains/business income in the hands of the seller and difference between the stamp duty value and actual consideration is also taxable as income from other sources in the hands of the purchaser

It is proposed that where the stamp duty value does not exceed by five per cent of the sale consideration, stamp duty value will be substituted for computing the income as above.

— **Taxability on conversion of stock in trade to capital assets**

Conversion of stock-in-trade into capital assets is proposed to be chargeable to tax as business income on the date of conversion itself. The fair market value on the date of conversion will be deemed to be the full value of consideration for the purpose of business income and cost of acquisition for computing capital gains at the time of subsequent sale. Further, period of holding would be considered from the date of conversion. As per the current provisions, the taxability on conversion was deferred till the sale of capital asset.

— **Tax neutral transfers excluded from deemed income provision**

While transfer of assets between a company and its wholly owned subsidiary is not regarded as a taxable transfer, currently, such receipt of asset below its fair market value is taxable in the hands of the recipient company

It is now proposed to exclude such transactions between a holding company and its wholly owned subsidiary from the deemed income provisions and as such not taxable in the hands of the recipient company.

— **Health and Education Cess**

Education Cess and Secondary and Higher Education Cess on income-tax is proposed to be discontinued and replaced by a 'Health and Education Cess' of 4 per cent. This will entail into higher effective tax rate.

— **Failure to furnish return of income:**

Presently, failure to willfully furnish the return of income within due date attracts imprisonment and fine. However, where the tax unpaid (i.e. tax amount assessed less tax paid or withheld) is less than INR3,000, no such proceeding can be initiated.

It is now proposed that such exemption from proceedings will not be applicable for a company (including a foreign company).

Key regulatory proposals announced in Budget speech

- Additional measures to be introduced to strengthen the environment for growth and successful operation of Indian Alternative Investment Funds (AIFs) – currently, no specific measures announced
- Securities and Exchange Board of India (SEBI) to consider mandating large corporates to meet 1/4th of their financing needs from the Bond market
- With a view to attract foreign investments in several niche areas especially start-ups and venture capital, Government to evolve a separate policy for hybrid instruments – currently, no specific policy announced
- Government to come with more Exchange Traded Funds (ETF) offers including debt ETFs

- Government to review existing outbound investment guidelines and come up with a revised policy
- SEBI provided with more powers – SEBI Act, 1992, Securities Contracts (Regulation) Act, 1956 (SCRA) and Depositories Act, 1996 proposed to be amended to streamline adjudication procedures and provide for penalties for certain contraventions
  - *Penal provisions proposed to be introduced for non-compliances of respective regulations by AIFs, Real Estate Investment Trusts (REITs), Infrastructure Investment Trusts (InvITs), Investment Advisers and Research Analysts*
  - *Also, penal provisions proposed for failure to comply with listing/delisting norms by AIFs, REITs and InvITs.*
- Appropriate amendment to be made in relevant stamp acts after consultation with states with respect to Stamp Duty regime on financial securities
- Establish single authority for regulating all financial services in IFSC in India.

Unfinished agenda

While the proposals as presented by the Finance Minister in respect of companies where resolutions plans are admitted under IBC are in the right direction, removal of capital gain tax exemption could hurt the Private Equity Funds. There are certain other key expectations that remain unaddressed:

- Relaxation of conditions for non-applicability of Place of Effective Management (POEM) to offshore private equity funds which are managed by Indian managers
- Extending the indirect transfer tax benefit to distributions made by offshore PE Funds
- Tax pass through status for Category III AIFs
- Pass through status for losses by Category I and II AIFs
- Removal of Angel tax
- Removal of deemed gift tax on purchase of stressed assets shares
- Relief to AIFs from withholding taxes when distributing exempt income to resident investors.

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