Client Update
India Budget 2015 – Key Takeaways for Foreign Investors

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The Narendra Modi-led government in India presented its first full-year finance budget for 2015-16 on February 28, 2015 (the "**Budget**"). This Budget was one of the most keenly awaited in recent years, partly because private equity and other foreign investors were expecting a series of policy announcements and regulatory and other measures to support some of the pre-electoral promises made by the new government, and also because the previous five years saw some disappointing growth figures and a discouraging investment climate in India.

Though there has been some criticism of the Budget for its lack of any big-bang reforms, it does lay down several pragmatic policy announcements for India to achieve the targeted growth rate of 8.5% for 2015-16. In addition, the government announced several measures that should ease the challenges of doing business in India – an area in which India has consistently lagged behind on the world stage.

Some of the highlights of the Budget from a foreign investor's perspective include:

TAXATION

India's tax laws and policies have always been a major area of uncertainty for foreign investors. This Budget contains several announcements which should help bring clarity to the otherwise complicated tax regime.

- Retrospective Tax – The retrospective tax on overseas transactions with underlying Indian assets, announced in the 2012 budget after the *Vodafone* case, has been limited to transactions where the underlying assets in India exceed INR 10 crore (~US$ 1.6 million) and constitute at least 50% of the global enterprise value. Further, sellers that do not control the overseas target and hold less than 5% in it or its holding company will not be subject

to this tax. It was widely hoped that such retrospective taxation would be abolished entirely as it received much criticism from the global investment community. Investors that have utilized a holding company whose only asset is shares of an Indian company will not take much comfort.

- GAAR – The previous government had proposed the implementation of the "general anti-avoidance rules" (GAAR) from April 1, 2015. The GAAR would empower the revenue authorities to deny the tax benefits of transactions or arrangements which do not have any commercial substance or are structured purely for tax avoidance purposes. The GAAR was feared since it would provide discretionary powers to the already powerful revenue authority to question even legitimate tax planning. Further, many private equity and other investors invest in India through jurisdictions like Mauritius and Singapore to claim tax treaty benefits, which arrangements could potentially be questioned under the GAAR. The Budget has deferred the implementation of the GAAR until April 1, 2017 providing 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.

- Corporate Tax Rate – The Budget proposes to reduce the corporate tax rate from the current 30% to 25% over a period of four years from 2016, with a view to simplifying the corporate tax regime and providing incentives to foreign investors.

- GST – The government has announced that a unified goods and services tax (GST) will be rolled out by 2016. GST is a comprehensive tax levy on the manufacture, sale and consumption of goods and services at a national level, replacing the complicated system of federal and state indirect taxes (e.g. sales taxes, excise taxes or service taxes) that is currently in force. Through a tax credit mechanism, this tax will be collected on value-added goods and services at each stage of sale or purchase in the supply chain.

- Pass-through Status for AIFs – The Budget proposes pass-through status for Category I and Category II alternative investment funds, i.e. onshore venture capital, infrastructure, private equity and debt funds. While investment income earned by the fund would be taxed at the level of the investor or unit holder, other business income will be taxed at the maximum marginal rate at the fund level. However, in what could be viewed as a regressive measure, the Budget has imposed a withholding tax of 10% in respect of distributions of non-business income by funds to their investors. This will also apply to exempt income such as dividends/capital gains on listed shares. Despite this,

overseas investors can continue to claim tax treaty benefits for investments routed through Mauritius, Singapore or the Netherlands.

- Permanent Establishment test for Fund Managers – With a view to facilitate relocation of fund managers of offshore funds to India, the permanent establishment test has been modified so that the mere presence of a fund manager in India would not constitute a permanent establishment of the offshore fund in India, resulting in adverse tax consequences. However, to claim this relief, extensive conditions need to be fulfilled which could be a concern. These conditions include that the fund should at least have 25 limited partners who are not related to one another, and that no single investor can own more than 10% in the fund. It is also not entirely clear if this measure is applicable to all types of funds, including private equity funds.

REGULATION AND ENFORCEMENT

With a view to improving the investment environment, the government has announced several measures to simplify and improve various regulations, each of which requires separate implementation:

- Foreign Investments – The distinction between different types of foreign investments, especially between foreign portfolio investments and foreign direct investments, will be done away with. These will be replaced with composite foreign investment caps in a move to make it simpler for foreign investors to understand the foreign investment regime in India.
- New Bankruptcy Code – A comprehensive new bankruptcy code, along the lines of the regime in the United States, will be introduced in India in 2015-16 to make it easier for stakeholders to restructure or exit unviable ventures and help creditors recover value in the case of defaults.
- Commercial Courts – One of the biggest concerns for foreign investors in India is the notoriously slow and expensive court system. With a view to resolving commercial disputes expeditiously and addressing the vast backlog of cases, the government has accepted the recommendations of the Law Commission of India in its 253rd Report to set up exclusive commercial divisions in the various courts in India.
- Black Money – In what is being viewed as a strong signal of the government’s intent to improve India's image on the anti-corruption/compliance front, the Budget announced a comprehensive new law tackling the issue of black or unaccounted for money (often considered a parallel economy in India) to be introduced in parliament in 2015. The proposed law is likely to prescribe prison terms of up to 10 years and fines of

up to 300% on the tax due, bringing it in line with similar laws prevalent globally. However, this law is being seen as draconian by many since it will give almost unbridled power to the already powerful revenue authority, resulting in fears that this could in fact lead to more issues of corruption and graft.

CONCLUSION

While the Budget did not contain any headline-grabbing policy announcements, it does indicate a strong focus on growth and improving the general business environment in the country. For example, the infrastructure sector should see funding to the tune of nearly US$ 11 billion to develop roads, railways, ports and other projects. Five new ultra-mega power projects, each of 4,000 MW, have been announced. These measures, along with the simplification of the tax system and various regulatory issues, should go a long way in cementing the new government's position as pro-business and enhancing India's position as an attractive destination for international investment.

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Please note that this firm is not qualified to advise on Indian law. This update is based on information that has been published in the press and from other sources in the public domain.

Please do not hesitate to contact us with any questions.