Client Update
India Budget 2017—A Step in the Right Direction

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In a departure from previous practice, the Narendra Modi-led government in India presented its draft finance budget for 2017-18 on February 1, 2017 (the "Budget"), a month ahead of schedule. This Budget has been keenly awaited due to the fairly volatile economic and political environment prevalent in India since the government's decision late last year to demonetise certain high-value currency notes. In addition, the proposed changes to some of India's key international tax treaties (particularly with Mauritius, Singapore and Cyprus) and the impending implementation of the General Anti-Avoidance Rules ("GAAR") and the unified goods and services tax ("GST") from April 1, 2017 have also added to the general anxiety. This Budget was seen as an opportunity for the government to ease tensions, both among domestic and foreign investors, and to clarify its position and provide a future roadmap on a number of these critical issues.

Foreign direct investment ("FDI") in India increased by 36% in the first half of 2016-17, despite a 5% reduction in global foreign investment inflows. The Budget proposals seek to propel that growth further by easing investment restrictions and reducing regulatory compliance burdens. Although there has been some criticism of the Budget for its failure to effectively tackle the volatility created by demonetisation, the government has sought to placate stakeholders with the promise of stability, transparency and growth.

This update addresses significant developments in FDI and taxation from a foreign investor's perspective.

EASE OF DOING BUSINESS

With a view to improving the investment environment and to improve the ease of doing business in India, the government has announced several measures to simplify and improve various regulations:

- Abolition of the FIPB. Under the existing FDI regime in India, the Foreign Investment Promotion Board (the "FIPB") has been entrusted with reviewing FDI applications which fall under the government approval route. Recognising that more than 90% of India's total FDI currently flows in through the automatic route, *i.e.*, where no prior government approval is required, the government has proposed to phase out the FIPB and abolish it altogether with effect from 2017-18. The abolition is expected to reduce the existing bureaucracy and regulatory burden for foreign investors, and decrease transaction timelines for investments in India. However, since the government is yet to come out with details of what the alternate regime will look like or a timeline for its proposed implementation, the impact of this reform remains to be seen. It is therefore likely that there will be some level of uncertainty during the transition phase, especially with respect to applications currently pending before the FIPB and investment transactions sought to be entered into within the next few months. Adding to the expectations surrounding the proposed new FDI regime, the government has stated that a further liberalized FDI policy will be announced soon.

- Foreign investment in the debt market. In a move to incentivise foreign investors focused on the debt market, last year's budget reduced the withholding tax rate on interest payments made to them on Rupee denominated debt instruments from 20% to 5%. The concession period, which was to expire in July 2017, has now been proposed to be extended until 2020 and will include "*masala*" bonds as well. The government has also exempted from taxation transfers of Rupee denominated bonds from one non-resident to another. These are largely seen as measures by the government to attract foreign debt capital to India with a view to strengthening India's debt market in general.

- Consolidated labour laws. The government proposed to consolidate and simplify India's immensely complicated labour law regime into four codes which will deal with wages, industrial relations, social security and welfare, and safety and working conditions.

- Listing and trading of security receipts. The Budget has proposed that the listing and trading of security receipts issued by securitisation or reconstruction companies under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 will be permitted in stock exchanges registered with the Securities and Exchange Board of India. It is hoped that this will propel the flow of additional capital into the securitisation industry.

- Encouragement of foreign investment in the pharma sector. The Budget proposes the formulation of new rules for the regulation of medical devices.

In addition to reducing the cost of these devices, this move is expected to align India's regulations with international standards and attract investment into the sector.

TAXATION

India's tax laws and policies have always been a major area of uncertainty for foreign investors. While significantly larger changes are expected once the new tax regimes take effect on April 1, 2017, this Budget contains a few announcements which should help bring some amount of clarity to the otherwise complicated tax regime. Some of the key Budget announcements with respect to taxation are as follows:

- Goods and services tax regime from April 1, 2017. The government has announced that GST will be rolled out by April 1, 2017, ending uncertainty on its final implementation date. 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. The implementation of GST is expected to widen the existing tax net.
- Reduction in corporate tax rates for small and medium enterprises. The Budget has kept overall tax rates fairly stable. The focus, however, appears to be on small and medium sized companies, which have not reaped the benefits of tax exemptions and concessions to the extent available to other corporate entities. The Budget has therefore proposed to reduce the corporate tax rate for these entities to 25% from the existing 30%.
- Tax neutrality for conversion of securities. The Budget has sought to treat the conversion of preference shares into equity shares as tax-neutral transactions. This move is likely to help allay foreign investors' concerns, particularly private equity players, regarding the implications of converting their securities in Indian companies into equity.
- Tax exemptions for foreign portfolio investors. Taxation of indirect transfer of shares in a foreign entity by Indian tax authorities, whose value is derived substantially (usually 50% or more) from assets located in India, has been a controversial topic ever since the infamous 2012 budget announcement after the *Vodafone*[1] decision. Further, an announcement by the Indian tax

[1] *Vodafone International Holdings BV v. Union of India* 341 ITR 1.

authorities late last year sought to extend these indirect tax provisions to foreign portfolio investors as well. This had an unintended consequence of adversely impacting India-focused offshore funds. The Budget attempts to clarify this and provides that Category I and II foreign portfolio investors (which includes a class of offshore funds) will be exempt from these indirect transfer provisions. Category III foreign portfolio investors (such as corporate bodies, trusts and family offices), however, will continue to be subject to the indirect tax provision. The government has further clarified that this provision will not apply to the offshore redemption of shares or interests resulting from the redemption or sale of an investment which is taxable in India.

CONCLUSION

The Budget did not contain the significant headline-grabbing policy announcements that foreign investors and other stakeholders may have expected. This restrained approach may be attributable, in part, to the upcoming assembly-level elections in five Indian states in 2017 and the enforcement of the model code of conduct in connection with these elections which restricts the government from making certain announcements to maintain the neutrality of elections. That said, the Budget proposals do indicate a strong focus on growth and improving the general business environment in the country and more announcements could be expected to follow once the elections are over. The World Bank has pegged India's projected GDP growth rate at 7.6% and 7.8% respectively for the next two years, and the Budget seems to have taken some useful steps to move in that direction. These measures, along with the radical tax reforms to be implemented later this year, should go a long way in cementing the current government's pro-business stance 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.