Tax Snippets

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Introduction

1. Scope and application

Where income by way of an interest (*detailed in paragraph 2*) is payable to a Foreign Institutional Investor or a Qualified Foreign Investor by any person, the tax is required to be withheld at a concessional rate of 5% by the person responsible for making such payment.

2. Nature of interest

'Interest' referred to above shall be the interest payable on or after 1 June 2013 but before 1 July 2020 in respect of investment made by the payee in—

i) a rupee denominated bond of an Indian company; or

ii) a Government security.

<u>The rate of interest in respect of bond specified in (i) above shall not exceed the rate as may be notified by the Central Government in this behalf</u>.

Notified Rates

The Central government has notified the following rates of interest for rupee denominated bonds of an Indian Company in order to be eligible for concessional tax withholding rate:

- in case of bonds issued before the 1 July, 2010 - rate of interest shall not exceed 500 basis points (bps) over the Base Rate of State Bank of India as on the l July, 2010.
- in case of bonds issued on or after the 1 July, 2010 - rate of interest shall not exceed 500 basis points (bps) over the Base Rate of State Bank of India applicable on the date of issue of the said bonds.

Issues

While the government has prescribed the interest rate cap for eligibility to concessional tax withholding rate under section 194LD, ambiguity remains on how to compute such rate of interest. In the absence of any clarity under the statue, the following issues may arise:

1. Simple interest vs Compounded interest

- Section 194LD of the IT Act as well as the notification which prescribes the interest rate cap only refers to the headline interest rate. It may be possible that the bond carries an interest, which is compounded periodically rather than simple interest. There is no clarity on whether in such a scenario, compounded interest rate will be considered or simple interest rate will be considered for the purpose of ascertaining the compliance with prescribed interest rate cap.

2. Tax Gross-up

- In a scenario where the interest payment is required to be grossed up with the tax withholding component, there is lack of clarity on whether the grossed-up amount should be considered as 'interest' for the purpose of testing the interest rate cap.

3. Redemption Premium

- Divergent views exist on the treatment of redemption premium on whether such premium should be taxed as capital gains or is to be taxed as interest.
- Accordingly, there is lack of clarity on whether the redemption premium should be factored in or not while computing the interest rate cap.

4. Discount on Bonds

- It has been clarified by the Central Board of Direct Taxes **("CBDT")** that the difference between the issue price or the bid price, as the case may be, and the redemption price of Deep Discount Bonds will be treated as interest income (except when the Deep Discount Bond is transferred before maturity, in which case, capital gains may arise). Given the foregoing, analysis may have to be made whether such 'discount' can classified as 'interest' for the purpose of ascertaining the compliance with the interest rate cap.

Conclusion:

Currently divergent views exist in the market in so far as what qualifies as interest or how the interest rate is to be ascertained, for the purpose of evaluating the eligibility conditions under section 194LD of the IT Act, in cases enumerated above. Since most of these views are judicially untested, clarification from the government or legislative amendments in this regard will reduce the ambiguity and promote consistent tax treatment.

Incentives under Finance Act, 2019

1. Capital Gains

The IT Act provides the following tax incentives to IFSC:

- Long-term capital gains: Exemption from long-term capital gains tax arising from transaction undertaken in foreign currency on a recognized stock exchange located in an IFSC irrespective of payment of Securities transaction tax (**STT**) on the same;
- Short-term capital gains: Concessional short-term capital gains tax rate of 15% is available on transactions undertaken in foreign currency through a recognised stock exchange located in an IFSC, even where no STT is payable.
- Further, the transactions in foreign currency in the following assets by a non-resident on a recognized stock exchange located in any IFSC are also exempt from capital gains tax:
  - Bond or Global Depository Receipt,
  - Rupee Denominated Bonds of an Indian company;
  - Derivatives; and
  - Certain other notified securities

The Finance Act, 2019 **("FA 2019")** has introduced provisions to extend the benefit of the above tax-neutral transfers, which was hitherto available only to non-residents, to transfer of securities by a Category III AIF (all unit holders of which are non-residents).

2. Minimum Alternate Tax ("MAT"):

A unit located in IFSC and deriving its income solely in convertible foreign exchange, is chargeable to MAT at the rate of 9% (plus applicable surcharge and cess) as against 18.5% (plus applicable surcharge and cess) applicable to other assessees. On similar lines, FA 2019 also provides for alternative minimum tax (which is applicable to firms, LLPs, AOPs etc.), at a lower rate of 9 % to bring parity with MAT.

3. Dividend Distribution Tax ("DDT"):

Currently no DDT is applicable on dividend distributed (out of current year profits), in case of a company being a unit located in an IFSC, deriving income

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solely in convertible foreign exchange. The FA 2019 extends the exemption from DDT on distributions paid out of accumulated profits as well.

4. **Tax exemption on interest receipts from IFSC units:**
   In order to facilitate external commercial borrowings by units located in IFSC, FA 2019 provides that interest paid by units located in IFSC on deposits/ borrowings made on or after September 1, 2019 to a non-resident is tax exempt in the hands of such non-resident.

5. **Profit Linked Tax Holiday:**
   Currently, IFSC units can avail an exemption of 100% of the income for its approved business for the first five consecutive assessment years commencing from the year in which permission from RBI, SEBI or IRDAI, as the case may be is obtained, and 50% of such income for the next five consecutive assessment years.

   FA 2019 now provides a 100% deduction from income for any ten consecutive assessment years out of a block of fifteen assessment years (at the option of the taxpayer), beginning with the year in which permission/ registration to operate the unit is received from RBI or SEBI or IRDAI, as the case may be.

6. **Incentivising Mutual Funds relocation in IFSC's:**
   To incentivize relocation of mutual funds in IFSCs, no additional income-tax shall be chargeable in respect of distributions made on or after September 1, 2019, by such mutual fund (all unit holders of which are non-residents) out of income derived from transactions undertaken on a recognized stock exchange located in an IFSC.

Treatment of Secondary Discounts Under GST Laws

The statutory provisions under the Goods and Services Tax ("**GST**") laws allow claiming a GST adjustment on account of secondary discounts subject to (a) such discounts being pre-agreed and captured in an agreement (b) issuance of a tax credit note and (b) the recipient of goods or services reverses the input tax credit pertaining to such discounted value. On the basis of such provision, secondary discounts were being passed on to customers and tax adjustment was also being claimed to avoid excess payment of GST.

However, recently, Central Board of Indirect Taxes and Customs *vide* Circular bearing number 105/24/2019-GST dated 28 June 2019 ("**Circular**") has clarified as follows, in context of secondary discounts:

- If the additional discount given by the supplier of goods to the dealer is a post-sale incentive requiring the dealer to do some act like undertaking special sales drive, advertisement campaign, exhibition *etc.*, then such transaction would be treated as a service transaction. Such transaction would be separate from the transaction of supply of goods.
- Such additional discount would be treated to be the consideration received by the distributor/dealer for undertaking such marketing, advertisement activity and attract GST in the hands of the distributor/dealer.
- Any additional discount passed by the supplier to the dealer/distributor, on account of the dealer/distributor offering reduced prices to the final customers, would be treated as a part of the consideration payable by the final customer to the dealer/distributor and attract GST in the hands of the dealer/distributor. The final customer, would be eligible to claim input tax credit of such additional tax liability in case the final customer reimburses the additional GST payable.

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In light of the Circular, dealer/ distributor agreements (especially in pharmaceuticals, automobiles FMCG sectors) must be revisited so as identify any additional veiled GST liabilities in the supply chain.

The Circular further clarifies that in cases where the secondary discounts passed by way of a financial credit note and not a GST credit note, the recipient would be eligible to avail full credit of GST paid on the original invoice. The credit would be available subject to the condition that the recipient has reimbursed such GST liability to the supplier.

This clarification has provided a much needed relief to the Industry by negating the ruling given by the Authority of Advance Ruling ("**AAR**"), Tamil Nadu in the case of *In Re: MRF Ltd. 2019 (3) TMI 928* where it was held that the post-sales discount granted by a supplier to the dealer/distributor by way of financial/commercial credit notes would require proportionate reversal of ITC by the dealer/distributor.

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