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India's Union Budget 2024 Tax Reforms Will Attract Investors

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Anshu Khanna of Nangia Andersen discusses India's Union Budget 2024 proposal that would reform direct and indirect taxation in India as part of the government's goal to attract investors to India.

The Union Budget 2024, proposed by India's Finance Minister Ms. Nirmala Sitharaman on July 23, unveils an ambitious vision for a 'Viksit Bharat,' or 'Developed India.' The latest budget has ushered in significant reforms in both direct and indirect taxation, with notable changes affecting corporate and non-corporate tax rates alike. This article examines the proposal, highlighting the implications for international investors and businesses engaged with India and exploring the potential for sustained economic growth.

With a strong emphasis on reducing social inequalities, the budget prioritizes key areas such as employment, skilling, support for MSMEs (Micro, Small & Medium Enterprises), and the middle class, while targeting critical demographic groups, including farmers, the poor, women, and the youth.

Notable initiatives encompass enhancing agricultural productivity, driving inclusive human development, boosting manufacturing and urban development, and ensuring energy security. The budget has garnered positive feedback from various industry sectors, especially among investors, who view the abolition of the Angel Tax as a transformative reform expected to invigorate the startup ecosystem and drive innovation. The focus on the space economy, education, and a streamlined tax regime further positions India as a compelling destination for global investment.

Direct Taxation Reforms

Capital Gains Taxation. The proposed budget would change the taxation of capital gains holding periods, tax rates, and indexation benefit. From an international investor perspective, investors should reassess their investment strategies considering their assets, holding periods, etc.

One of the most notable adjustments in direct taxation would pertain to the proposal's taxation of capital gains. In India, capital gains are categorized into Long-Term Capital Gains (LTCG) and Short-Term Capital Gains (STCG). While the tax rates for these categories across different asset classes have remained consistent, the holding period has been the key differentiator.

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Below is a schedule outlining the pre-budget classification and taxation of capital assets:

Taxation of Capital Gains

Classificiation	Nature of Assets	Holding Period	10% (in excess of INR 1 lakhs)
	Unlisted shares and immovable property, such as land and buildings	>24 months	10% (in excess of INR 1 lakhs)
	Most other assets, including debt-oriented mutual funds, jewelry, and various other capital assets not covered under the 12 or 24-month criteria	>36 months	20% if benefit of indexation claimed, otherwise 10%
Short-Term Capital Assets	Listed equity shares, equity-oriented funds, and units of business trusts	<12 months	20% if benefit of indexation claimed, otherwise 10%
	Assets other than in the 12- month criteria	<24/36 months	Taxed at slab rate

Source: Nangia Andersen LLP | Bloomberg

Holding Period Proposed Change. The holding periods are crucial as they determine the tax treatment of the capital gains realized from the sale of these assets.

In this budget, the holding threshold of 36 months would be completely abolished. So, the Debt Oriented Mutual Funds and any other securities belonging to the 36-month threshold would move into the 12-month category. In other words, from a holding period perspective, debt oriented mutual funds and other securities would move to the same category as equity-oriented funds and would be considered a long-term asset after 12 months.

Tax Rate Proposed Change. LTCG exceeding INR 1,00,000 (~$1200) are currently taxed at a rate of 10%. The proposal would increase the LTCG tax rate to 12.5% and the exemption limit to INR 1,25,000

(~$1500). Similarly, STCGs realized from listed shares, which were taxed at 15%, are proposed to be taxed at a rate of 20%.

Indexation Benefit Proposed Removal. Indexation is a concept in the Indian tax system that adjusts the original purchase price of an asset or investment to neutralize the impact of inflation on the asset. The proposals are considered an effort by the government to streamline capital gains taxation, simplify compliance and administration, and encourage long-term investments.

Under the proposal, the benefit of indexation for LTCG with a holding period of over 24 months and 36 months would be completely withdrawn. Currently, a 20% tax rate is charged if the indexation benefit was claimed instead of the 10% levied on the other LTCG.

The government introduced an amendment to the Finance Bill (No. 2) 2024 on August 7, 2024 offering some relief. Under the revised provisions, for transfers of long-term capital assets—such as land or buildings—acquired before July 23, 2024, taxpayers can choose between the new tax scheme (12.5% without indexation) and the existing scheme (20% with indexation), paying the lower of the two tax amounts.

In other words, the proposed changes to the indexation benefit may or may not increase the effective tax burden; the analysis is very facts specific. Similarly, while the increase in the STCG tax rate might seem bold, it would check market volatility by discouraging short-term speculative trading. Shortening the holding period requirements might maintain interest in long-term holdings.

Securities Transaction Tax: Effect on Trading Futures & Options. For international investors, high transaction costs could affect market liquidity, potentially influencing investors' strategies and overall experience in Indian markets. The proposed increase in the Securities Transaction Tax (STT) rate would help manage market volatility and promote more informed trading practices.

The STT is a tax levied on transactions as a percentage of transaction value in the stock market, including the purchase and sale of securities. While STT is not a direct income tax, it is crucial for international investors to understand its impact on their overall tax situation.

Currently, the STT rates are: 0.0625% on the option premium for selling an option, 0.0125% of the trading price for futures contracts, and 0.1% on both buying and selling of equity share delivery trades. When an option is exercised, the STT rate is 0.125% of the intrinsic value (the difference between the settlement price and the strike price), with the responsibility for this tax falling on the purchaser.

Given the significant growth in the derivatives market, where such instruments have become a major component of stock exchange activity, there are proposals to adjust these rates. The STT on the sale of an option in securities would increase from 0.0625% to 0.1% of the option premium. Similarly, the STT for futures contracts would rise from 0.0125% to 0.02% of the trading price.

For international investors, high transaction costs could affect market liquidity, potentially influencing international investors' strategies and overall experience in Indian markets. However, this adjustment is primarily aimed at addressing the rapid expansion of futures and options trading in India. Reports from brokerage firms indicate that more than 90% of trades in futures and options have resulted in losses for traders. Combined with the earlier recommendation by the Working Committee on Futures and Options

to raise the minimum lot sizes for such trades, this suggests that the government is targeting a reduction in speculative trading and discouraging casual retail investors from incurring undue losses in the derivatives market.

Angel Tax. The proposed abolition of the Angel Tax would solidify India's position as a global startup hub and give a huge fillip to the startup community.

The Angel Tax was introduced in 2012 to tax startups on the premium paid by investors for shares of a company that exceed the Fair Market Value (FMV) of a company. A 30% tax is imposed on an investor's purchase price for shares above the FMV. The Budget would abolish this tax. Consequently, various valuation methodologies previously required under this section would be rendered obsolete from an Indian tax perspective. The Angel Tax removal would not be retrospective which means it would be applicable for investments made before April 2024 and any pending litigations may continue.

This is an initiave to help Indian startups thrive. The Angel Tax was long standing concern by start-ups and incubators: it was placing undue financial and compliance burden on young ventures; and also in certain fast-growing industries, it is common to have investments valued at more than the FMV. The removal of the Angel Tax would be expected to stimulate increased investment, a better funding scenario for startups, and boost investor sentiment. Startups would have less of an administrative burden (including complying with valuation norms, etc.) and would have greater financial resources to support job creation and business growth.

Income from Buy-Back of Shares —**Taxability Change.** The Finance Act of 2013 introduced a special provision to tax income from the buy-back of shares at the company level, similar to the dividend distribution tax (DDT). Under this provision:

- Shareholders are exempt from tax on income received from buy-backs; and
- Buy-backs are excluded from being treated as 'deemed dividends' under the Income Tax Act.

To broaden the tax base and address tax avoidance, the Union Budget 2024 proposes significant changes. Starting October 1, 2024, the entire consideration from buy-backs would be taxed as dividends in the hands of shareholders, rather than at the company level. Unlike capital reduction, where only the company's accumulated profits are treated as dividends, this new rule would apply to the entire buy-back consideration.

This reclassification aligns buy-back payments with dividend tax treatment, facilitating the application of tax treaty benefits, including reduced rates on dividend income. Previously, buy-backs were seen as a tax-efficient alternative to dividends due to their lower effective tax rate. The proposed changes would standardize the tax treatment of distributed profits, close loopholes, and enhance tax compliance and fairness.

Key points of the new proposed policy are the following:

- Income from Buy-Backs: would l be taxed at the shareholder's applicable income tax slab rates, with no deductions allowed for expenses against this income.
- Capital Loss from Share Repurchases: the cost of acquisition of repurchased shares wouldl be treated as a capital loss for that period and could be used to offset capital gains or carried

forward.

Example:

- 100 shares are bought in 2020 at $10 per share (Total cost: $ 1,000).
- 20 shares are bought back in 2024 at $ 12 per share. Income taxable as deemed dividend: $ 240. Capital loss on buy-back: $200.
- 50 shares are sold in 2025 at $15 per share. Capital gains: $750. Chargeable capital gains after offset: $550.

Corporate Tax Rate for Foreign Companies. For foreign companies operating in India, the corporate tax rate would be reduced significantly from 40% to 35% and would incentive foreign investment. This reduction is intended to enhance India's attractiveness as an investment destination and is seen as a positive move to encourage foreign investments.

This decrease in the corporate tax rate coupled with other measures, such as the removal of the Angel Tax, collectively would aim to create a more favorable investment climate. The lower tax rate would reduce the overall tax burden on foreign companies, potentially increasing their profitability and incentivizing further investment. This is particularly beneficial for sectors like manufacturing, technology, and startups, which often require substantial foreign capital.

Tax Exemptions in GIFT City. The Union Budget 2024 introduces additional tax benefits for the GIFT (Gujarat International Finance Tec) International Financial Services Centre (IFSC), continuing the trend of enhancing the attractiveness of this financial hub.

Standardized Tax Treatment for IFSC Retail Funds:

- IFSC Retail Funds would receive standardized treatment by classifying them as "specified funds." These funds would be regulated under the International Financial Services Centres Authority (Fund Management) Regulations (2022). This change aligns their tax benefits with those available to Category III AIFs in GIFT City, regardless of whether they are structured as companies or trusts.

Key tax exemptions would include:

- Specified Securities: Income from the transfer of certain securities listed on an IFSC exchange—such as rupee-denominated bonds, derivatives, foreign currency bonds, and equity shares—would be tax-exempt.
- Non-Resident Securities: Transfers of securities issued by non-residents (not having a permanent establishment in India) would also enjoy tax exemptions, provided the income does not accrue or arise in India.
- Non-Resident Investors: Income received by non-resident investors from their investments in IFSC Retail Funds or from the transfer of units would be exempt from tax. Non-residents would not be required to obtain a PAN (permanent account number) or file income tax returns.

Benefits would be extended to the following:

- ETFs: Provided all units, except those held by managers or sponsors, are owned by non-residents.
- Interest Deductions: §94B restrictions on interest deductions would be relaxed for Non-Banking Financial Companies (NBFCs) located in the IFSC.
- Venture Capital Funds: Relaxation on proof of source under §68 would be extended to Venture Capital Funds (VCFs) registered with the IFSCA.
- Core Settlement Guarantee Funds: Tax benefits would apply to these funds established by IFSCA-registered clearing corporations.

The following challenges, however, would remain with the following items:

- Family Investment Funds (FIFs): The proposed amendments do not address the taxation of FIFs, which would continue to be taxed based on their structure.
- Dividends and Insurance Policies: Non-resident investors in the IFSC would remain subject to tax on income from insurance policies and dividends from listed securities that could deter investment. Aligning the tax treatment of dividends with existing exemptions could further boost investment in IFSC securities.

Equalization Levy (EL 2.0) Would Be Abolished. The removal of the EL could significantly strengthen India's e-commerce ecosystem that would benefit both businesses and consumers.

The Equalization Levy (EL) was introduced in India as part of a broader global trend to address taxation in the digital economy. In 2015, the OECD initially introduced a Two-Pillar solution as the BEPS Action Plan 1 and later in 2019 formalized the plan as the Two-Pillar solution addressing two key concerns within the international tax law framework:

- Pillar 1: Aims to redistribute taxing rights to market jurisdictions where significant value is created, even if companies don't have a physical presence there.
- Pillar 2: Proposes a global minimum tax rate to prevent harmful tax competition among countries.

Due to delays in reaching a global consensus on these proposals, several countries, including India, implemented their own digital services taxes (DST). India's version of this is known as the Equalization Levy (EL). These taxes aim to levy charges on revenues generated by overseas companies from market jurisdictions, even in the absence of a physical presence as required under the current treaty framework.

Evolution of the Equalization Levy in India. The EL 1.0 imposed a 6% tax on non-residents providing specified online advertising services (referred to as the "Advertisement EL" or "EL 1.0"). The Finance Act of 2020 expanded EL 1.0 by introducing a 2% levy on revenue generated by non-resident e-commerce operators from digital transactions. This includes revenue from online sales of goods or services facilitated by these operators and from the online sale of goods or the provision of services facilitated by e-commerce operators, including any combination of these activities.

Challenges and Efficacy. The 2% EL, however, faced significant challenges. Many companies passed the additional costs onto consumers that reduced the effectiveness of the levy. It became apparent that the measure did not achieve its intended impact on leveling the playing field between resident and non-resident businesses.

Proposed Changes. The changes would abolish EL 2.0 starting August 1, 2024, in order to align with global initiatives like Pillar 2 and reduce compliance burdens (There is no change proposed to Advertisement El or EL 1.0; and provide transitional provisions that would provide that income derived from e-commerce supply or services between April 1, 2020, and July 31, 2024, would continue to be exempt under §10(50) of the Income Tax Act, provided certain conditions are met.

Impact of Abolition. The abolition would (1) attract investment in India (the removal of EL 2.0 is expected to make India a more attractive market for global e-commerce giants and potentially lead to increased investment); (2) reduce costs and prices (lower operational costs for companies could result in reduced prices for consumers and enhanced market competition); and (3) expand the market (the abolition may encourage more foreign e-commerce players to enter the Indian market that would drive innovation and growth in the sector).

Reduction in Withholding Rate on E-Commerce Participants. A significant reduction in the tax rate imposed by §194-O of the Income Tax Act is proposed in the budget that is anticipated would stimulate growth in the e-commerce sector and contribute to a more dynamic and competitive marketplace.

Currently, §194-O requires that any person facilitating the sale of goods or the provision of services through an electronic commerce platform must withhold tax at the rate of 1% from the gross amount of such transactions. This deduction is made at the time of crediting the amount or making the payment to the participant, whichever occurs first.

The government proposes to reduce the tax deduction rate from 1% to 0.1%. This adjustment aims to streamline the tax process and reduce the administrative burden on e-commerce platforms and sellers.

The government's goal is to simplify compliance for e-commerce platforms and sellers, thereby enhancing operational efficiency. This adjustment is likely to encourage more small and medium-sized businesses to join e-commerce platforms, as the reduced tax burden could expand their market reach and increase potential revenue. Additionally, the decreased withholding tax may lead to lower operational costs for sellers, which could translate into reduced prices for consumers and a wider variety of products available online.

Indirect Taxation Reforms

The Union Budget introduces significant reforms in indirect taxation, specifically targeting the Goods and Services Tax (GST) framework and customs duties. While these changes are primarily aimed at domestic businesses, they also hold implications for international companies and investors engaged with the Indian market.

Reforms in the GST Framework. The budget proposes a rationalization of GST rates, with some goods and services experiencing a reduction in rates while others see an increase. These adjustments are designed to enhance fairness and simplicity within the domestic tax system. For international businesses operating in India, these changes could impact the cost structure of their operations and supply chains.

Additionally, the enhancement of the input tax credit (ITC) mechanism, which aims to simplify tax credit claims and reduce compliance burdens, could lead to a more efficient tax environment for foreign companies.

The budget also introduces stricter anti-evasion measures, including advanced data analytics and technology for better tracking and compliance. These measures aim to enhance the overall efficiency of tax administration, potentially affecting how international businesses report and manage their tax obligations in India.

Customs Duties. In customs duties, the budget outlines reforms intended to foster a competitive trade environment. Key changes include a reduction in customs duties on specific raw materials and inputs, which could benefit international firms by lowering the costs of importing these materials into India. This is expected to support domestic manufacturing and attract foreign investment.

Conversely, there is an increase in customs duties on certain finished goods to protect domestic industries. For international businesses importing such goods into India, this could result in higher costs and necessitate adjustments in pricing and market strategies.

The budget also emphasizes streamlining customs procedures and leveraging technology to improve efficiency. These reforms aim to facilitate smoother cross-border transactions, which could positively impact international companies engaged in trade with India by reducing delays and improving the predictability of customs processes.

In summary, while the indirect tax reforms are primarily domestic in focus, they carry implications for international businesses and investors. The adjustments in GST rates, the improved ITC mechanism, and the changes in customs duties could influence operational costs, tax compliance, and trade efficiency for companies operating within or engaging with the Indian market. These reforms are part of a broader effort to create a more business-friendly environment, which may enhance the attractiveness of India as an investment destination.

Conclusion

In conclusion, the Union Budget 2024 articulates a transformative vision for India’s economic future through its strategic tax and regulatory reforms.

The budget’s focus on simplifying tax processes, refining GIFT IFSC regulations, and implementing stricter anti-evasion measures underscores a commitment to enhancing transparency and efficiency in the business environment. The abolition of the Angel Tax stands out as a significant reform, poised to energize the Indian startup ecosystem and stimulate innovation. Additionally, the budget’s attention to the space economy, education, and skilling reflects a broader strategy to foster economic growth.

These progressive reforms signal India’s continued evolution into a global economic powerhouse. As these measures take effect, they are set to create substantial opportunities for international businesses and investors, reinforcing India’s status as a dynamic and attractive market. The Indian government’s proactive approach to fostering a conducive investment climate not only positions India as a prime destination for global capital but also underscores its role as a key player in the global economic arena. Through these comprehensive efforts, India is making significant strides towards becoming a Viksit Bharat, paving the way for sustained economic advancement and greater international engagement.

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