OVERVIEW OF THE IMPACT OF FINANCE ACT, 2023 ON INVESTMENT AND CORPORATE DEALS IN INDIA

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ABSTRACT

Finance Act is an annual document released by the Government of India which forms the basis of the budget. This Act is the result of the Finance Bill which has undergone the scrutiny of the parliament and the necessary amendment proposed by the parliamentary standing committee has been incorporated in the document. The Finance Act, 2023 itself went through 64 amendments by the parliamentary standing committee. This Act has all the changes that the government wishes to make in the corporate framework of the country. The structuring of the Act can either make or break the economy. The Finance Act includes amendments and updates to the existing tax laws, such as corporate tax rates, capital gains tax, and other relevant provisions. These changes can have a direct impact on corporate transactions, influencing the cost structure and financial planning of businesses. The Act also incorporates modifications to regulatory frameworks that govern various sectors and industries. For instance, it may introduce new guidelines for mergers and acquisitions, foreign investments, anti-money laundering measures, or corporate governance requirements. Staying informed about such changes is crucial for businesses involved in corporate transactions to ensure compliance and mitigate legal risks. The Finance Act may also introduce new incentives, exemptions, or tax credits to promote specific sectors, encourage investments, or support economic growth. Companies engaged in corporate transactions should carefully analyse these provisions to leverage potential benefits that can positively impact their financial outcomes. Any changes proposed in the Finance Act may result in modifications to compliance and reporting obligations for businesses. This can include alterations to tax return filing procedures, disclosure requirements, or accounting standards. Being aware of these changes ensures that companies fulfill their obligations accurately and avoid any penalties or legal complications. This article is focused on how the Finance Act, 2023, highlights its potential impact on business and provides an insight into how the business can navigate through the new regulatory landscape of India.

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INTRODUCTION

India is the fastest Growing Major economy in the world with the IMF predicting a 5.9% growth for the year 2023[1]. This growth and potential of India could also be measured by the sheer number of M&A Transactions that happened in India.

The Year 2022 witnessed deals amounting to 152 Billion dollars[2]. Domestic deals dominated the Indian Market with a total of 355 deals executed while outbound deals only amounted to 61. It is pertinent to note that while the overall global market saw a 29% dip in the value of M&A deals, the Indian market remained stable. This only highlights the immense potential of the Indian Market waiting to be unlocked[3].

As India continues to strengthen its position, the government has been making significant strides in shaping the nation's financial landscape. At the heart of this endeavour lies the Finance Act Vis-a Vis the annual budget. The Act not only forms the bedrock of the government's budget but also encompasses proposed changes to tax laws, customs duties, and other financial regulations and this Act has a direct impact on the Investment trends. To understand how the Finance Act will impact the corporate trends of India, let's dive into the relevant amendments as recommended by the Act.

AMENDMENT TO SECTION 56(2)(VII)(B) OF THE INCOME TAX ACT, 1961

The Original concept of taxing the premium of investments was introduced in 2012 vide the Finance Act, 2012. This was made with the objective to prevent the circulation of black money and turning the Indian Business landscape into a money laundering machine. This Tax was infamously referred to as the angle tax. Previous to the 2023 amendment, this tax was applicable to the investments received from domestic investors only. The resident status was considered while computing this tax. The language of the section used to talk about taxing a closely held company (Private limited company) for the shares it issues to a "resident", the valuation of which is over the Fair Market Value of the Shares.

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[1]Ens Economic Bureau, "IMF cuts India GDP for FY24 to 5.9%" *Indian Express*, (New Delhi ,April 12, 2023) <https://indianexpress.com/article/business/economy/imf-cuts-india-gdp-for-fy24-to-5-9-8551283/>, accessed 06.05.2023

[2]Clarence Anthony et el ,"M&A Report, 2023: India" *IFLR,* (March 09, 2023) <https://www.iflr.com/article/2bdj3jm6k18dwd0xhxlhc/expert-analysis/mergers-acquisitions-report/m-a-report-2023-india>, accessed 06.05.2023

[3]Clarence Anthony et el ,"M&A Report, 2023: India" *IFLR,* (March 09, 2023) <https://www.iflr.com/article/2bdj3jm6k18dwd0xhxlhc/expert-analysis/mergers-acquisitions-report/m-a-report-2023-india>, accessed 06.05.2023

However, post the 2023 amendment, the scope of the tax has now been enlarged to include non-residents also. The tax is set at 30.9% above the amount received by any entity over the Fair Market Value (FMV). The method of calculating FMV is given in Rule 11(UA) of the Income Tax Rules.

ISSUE WITH THE PRICING METHOD

The amendment will directly impact the value of the shares of issuing companies. A grey area is still visible as to the method of calculating the value of those shares.

Rule 11(UA) of the Income Tax Rules, provides two broad methods of calculation:

NAV Method - This method relies on the book value of assets and liabilities of the last audited financial statements of the assessor. This can be done by a registered Chartered account or a Marchant Banker. The formula is described in Rule 11(UA)(1)(cb) of the Income Tax Rules.

Discounted cash-flow method - This method is described in Rule 11(UA) (2) of the Income Tax rules. This method tries to value the shares of the issuing company today based on its perceived future cash flow. This method however can only be used by a merchant banker.

Foreign Exchange Management Act (FEMA), 1999 on the other hand prescribes no such method for the valuation of the stocks. FEMA simply prescribes that the stock price will be determined by any internationally accepted valuation method. The stock price being the FMV for the purpose of calculation of the premium therefore can be calculated in various other methods like the Dividend discount model[4], Relative Valuation[5]model or as the case maybe Gorden Growth Model[6].

[4] Angle One, "How Stok Price is determined", Angle One, <https://www.angelone.in/knowledge-center/share-market/how-share-price-is-calculated>, accessed 08.05.2023

[5]Angle One, "How Stok Price is determined", Angle One, <https://www.angelone.in/knowledge-center/share-market/how-share-price-is-calculated>, accessed 08.05.2023

[6]Evan Travor et el, "How Is a Company's Share Price Determined With the Gordon Growth Model?", (March 03, 2022), <https://www.investopedia.com/ask/answers/061615/how-companys-share-price-determined.asp#:~:text=By%20determining%20a%20company's%20share,multiples%20on%20a%20relative%20basis. >, accessed 08.05.2023

EXEMPTIONS FROM THE ANGLE TAX AS IT STANDS TODAY

Exemption from the angle tax can be availed by the company if it is a registered and recognised start-up under the DPIIT. The Problem here is DPIIT only has 84,012 entities recognised as start-ups[7]. On the other hand, India recorded a whopping 1.48 million companies registered as in June 2022[8]. This will create a gap in funding and it will not be peculiar to see Indian startups based out of tax haven operating with a holding company in India.

SEBI AIF funds registered under category I and II of the SEBI (Alternative Investment Fund) Regulations, 2012are also exempted from angle tax. These funds have to pass the eligibility criteria as listed in section- 4 of the Alternative Investment Funds Regulation, 2012 to be registered under section – 3 of the regulations with SEBI.

The Finance Act, 2015 inserted pass-through taxation in the case of Category – I and II AIFs and that provision is still intact. There is no residence bar on the selection of investors while operating the investment pool for the purpose of angel tax.

Pertinent to note here that an AIF can raise investment from any investor and issue the shares of the AIF to that investor. The non-residence investors can take advantage of this rule and act as an investor in these funds and take decisions on investment. This investment must be raised through private placements and not public offerings.

IMPORTANCE GIVEN TO IFSC

In this Finance Act, huge importance has been given to International Financial Services Centre (IFSC). The IFSCs are a pet project of the Indian Government to give competition to the London and Singapore Financial Centres. The Government has given various incentives to promote businesses to relocate and operate from this sector. At present India only has 1 IFSC by the name of GIFT CITY in Gujrat. The incentives given to the IFSC are discussed below:

[7]Ministry of commerce and Industry, " Department for Promotion of Industry and Internal Trade (DPIIT) recognized startups create over 8.6 lakh direct jobs since the launch of Startup India" (16th December, 2022), <https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1884256#:~:text=84%2C012%20entities%20have%20been%20recognised,as%20on%2030th%20November%202022. >, accessed 08.05.2023

[8]ManyaRathor, "Number of registered active companies across India as of June 2022, by type", *Statista,*(September 12,2022), <https://www.statista.com/statistics/1008330/india-number-of-registered-active-companies-by-type/#:~:text=As%20of%20June%202022%2C%20there,by%20shares%20in%20the%20country. >, accessed 08.05.2023

Finance Act vide clause - 21 has proposed an amendment to Cause – b to the explanation to sub-section (viiab) to section 47 of the Income Tax Act, 1961 (The Act) and extended the time limit of March 2023 to March 2025.

Previously Clause (b) of the Explanation to sub-section (viiab) to section 47 defined the term relocation as, the "transfer *of assets of the original fund, or of its wholly owned special purpose vehicle, to a resultant fund on or before the 31st day of March 2023, where consideration for such transfer is discharged in the form of share or unit or interest in the resulting fund in the manner specified therein*".

Further sub-section – (1) of Clause (b) of the explanation to clause (viiab) of section 47 of the Act, has been amended to give reference to International Financial Services Centres Authority (Fund Management) Regulations, 2022 in the definition of "resultant fund" of section 47 of the Act. This limit was extended to give stimulus to foreign investors to relocate their original funds or subsidiary funds to the IFSC. This in term will promote more commercial deals including M&As in India and promote competition in the market. This amendment will be operative from 1st April 2023 and accordingly will be applicable to the assessment year 2023-24 and so on.

Double taxation on the distribution of income to non-resident ODI holders has been omitted. Off-shore Derivative Instruments (ODI) are actually a vehicle by which non-residents get access to India Equity. ODIs operate through IBUs(IFSC banking units) which in turn invest in permissible start-ups and generate income. The income earned by the IBUs is taxed under section 115AD, as capital gains.

The resultant fund after tax is handed over to the IBUs and IBUs then distribute the profit to its members. Currently, this distribution is exempted from tax, and the funds when they reached the investors were again taxed as income under the relevant income slab of the Act.

To get rid of this double taxation an amendment has been preferred in section 10(4E) of the Act. This exemption has also been extended to ODIs being transferred by an offshore banking unit inside the IFSC as defined in section 80(LA)(1A) of the Act, which fulfills such conditions as may be prescribed, to further provide ease to the investors.

The ODI contracts have been given legal tender. The budget of 2023 vide an amendment to section 18A of the Security Contracts Act, 1956 has given legal recognition to the ODI

contracts issued by Foreign Portfolio Investor (FPIs) under the GIFT IFSC and regulated by the IFSCA. The expectation of the government is that this will incentivize the off-shore banking units (IBUs) to invest in permissible equities as underlying assets. The tax-saving bonds of the government is a big area of investment and with the FDI in infrastructure moved towards the automatic route (for development purpose only), this will give a big boost to foreign investment.

What remains to be seen is whether the government allows the FPIs to operate as AIFs and invest in the start-up arena. The advent of the angle tax for non-resident investors also, it will give a breather to the cash-starved start-up sector of our country.

Clause 48 of the Finance Act, 2023, seeks to amend section 48 of the Act, to the extent as to regulate and control the calculation of capital gains. At present the capital gains are calculated after deducting from the total value, the acquisition cost and the cost of the improvement. However, now a clause – II is inserted which says that the deduction benefits claimed under the amount of interest under clause (b) of section 24 or under the provisions of Chapter VIA of the Act shall not include the cost of acquisition or cost of improvement.

This reduces the scope to save tax on a transaction. The transaction of the future will be more complex. Alternative methods of funding will emerge. This amendment will come into force on 1st April 2024.

The regulatory web is somewhat clarified with the proposed transfer of authorisation power from SEZ authority under the Special Economic Zone (SEZ) Act, 2009 to the IFSCA. A single window clearance will go a long way in streamlining the licensing process.

The income tax holiday has also been extended to 10 years out of the first 15 years of the setup of a company.

AMENDMENT TO SECTION 115A OF THE INCOME TAX ACT

The tax payable by non-residents for royalty or fees for technical services is now charged at 20% under section 115A of the Act. Previously under the 2015 Finance Act, it was reduced from 25% to 10%. This benefit had given a breather to the foreign-based companies operating in India. Now with the increase in tax, it will directly affect the businesses like

Hindustan Unilever or Pepcico India, or Coca-Cola[9] as they will now be subjected to higher tax rates for their payment of royalties to the parent company.

India has been an importer of technology and high-end services from the US and UK. The Indian front of these companies, therefore, pays a significant amount of royalty to the foreign companies. The income generated by these companies in India is taxed using the source rule that is the Income is generated in India and therefore will be taxed in India. One point to be noted here is that the option of withholding tax while paying the royalties is in the hands of the Indian company. Previously section 115A of the Act, also exempted the non-residents from filing an income tax return provided that (i) such non-resident had only income from dividend/interest/royalty / FTS from India and (ii) tax has been withheld at source from such income at a rate which is not lower to the rate provided under section 115A.

The non-resident had the option to be taxed under the Indian Tax regime or under DTAA which generally stood at 10 %(not for all cases). The DTAA is an agreement entered into by India and the country of origin of the non-resident entity to avoid paying double taxes on the same income. It is important to note here that although previously the rate of tax for royalties and FTSs was 10%, the domestic tax also included cess and surcharge, therefore increasing the tax burden and hence, the DTAA rules were preferred by the non-residents for the purpose of taxation.

Now, however, if the non-residents' source country doesn't have any DTAA with India, it will have to pay the higher tax as notified. Additionally, the non-residents now have to provide a TRC form that will be issued by the country of their origin to prove their residency, submit a Form 10F, as provided under the Income Tax Rules, electronically with the concerned department, obtain an electronic signature to put in the said Form 10F, Obtain a Permanent account number (PAN) from the Income Tax Department of India, file an Income tax return in India and also submit a declaration of the no-permanent establishment to the Indian paying entity which they will, in turn, submit to the proper department for calculation of tax, to avail the favourable conditions tax regime under the DTAA.

[9] Anuradha Shukla &DeepSikhaSilwalkar, ' No more royal treatment for Indian arms of MNCs as govt doubles tax on royalty, fee for technical services' *Economic Times*, (New Delhi, March 2023)<https://economictimes.indiatimes.com/news/economy/policy/no-more-royal-treatment-for-indian-arms-of-mncs-as-govt-doubles-tax-on-royalty-fee-for-technical-services/articleshow/98982426.cms> accessed 06.05.2023

This amendment is enforced from 1st April 2023. This increased tax is likely to impact the way royalties are obtained by those non-resident entities. The Indian companies also while utilising form 15CB or 15CF, have to take due care to see whether the benefits of DTAA can be claimed.

CONCLUSION

The Finance Act has given effect to a slew of changes, most focused on the regulation of money flow within and without the border of India. The M&A market will both benefit and somewhat be hurt by the changes brought in by the Finance Act.

Firstly, the angle tax which should have been abolished is now extended to non-residents. Although the relief granted to the AIFs are open, the AIFs are generally set up by institutional investors and HVIs, which is counterproductive to the aim of engaging more Investors, big or small, in the markets and promoting start-up culture. The registration of the AIFs is a tedious process and it can be assumed that investors testing new waters will be hesitant to give the commitment to form and invest in a proper company or trust in India. Keeping in mind that a huge chunk of investment in start-ups comes from FDIs, it can be suggested that the government may make a simple in-and-out system for foreign investors coming into India.

Secondly, There needs to be a guideline on the basis of which pricing may be calculated. The words of FEMA are very wide and therefore the pricing methodology can extend beyond the NAV and DCF methods as discussed in the Act. The Finance Act and the subsequent Budget session did not clear the stand of the authority on this issue. There is also no bar flowing from the original statute with regard to the process of calculation of the value of shares. This area can be exploited by start-ups to ease their tax burden. It remains to be seen how the legislature addresses this issue.

Thirdly, the promotion of the IFSC is a good step, however, the IFSC should not be situated in only one state. The government should endeavour to set up more IFSCs across the states in India and specifically in the lower-income states or at least at the adjacent states of the lower-income state and make the slipover effect work for those states. The IFSCs also should be made self-governing bodies to promote healthy commercial competition amongst them and ultimately promote the business acumen of the country.

Fourthly, the proposals for attracting investment in IFSC made in Finance Act, 2023, are not yet met with a road map of execution. Proposals are good if they are met with a strong and articulated execution plan.

Fifthly, The IBUs being set up in IFSC should be encouraged to invest in other potential pockets in India by extending the tax exemption given to Category – I and II of the SEBI AIF funds inasmuch as the recognition of the IBUs as AIFs will go a good distance to promote industry and investment in India.

Sixthly, the government should actively endeavour to sign more Tax agreements with major economies. At present, the GOI only has DTAA with 85 countries. The government should promote DTAA with potential African and South American nations as these will play a key role in firmly placing India as a geopolitical powerhouse. Further, India should also endeavour to include investment as a special category for tax treatment. Investments should be made a priority and tax exemptions may be given based on job creation.

Finally, this Finance Act will have a profound influence on M&A, Investment and Deal activity. Its provisions impact deal structuring, valuation, taxation, transparency and compliance. As legal professionals, it is crucial to remain vigilant, adaptive and well-informed about the evolving landscapes of the Finance world and to navigate the complexities and seize opportunities in the ever-changing opportunities in the world of investments and Deals.

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