

Legislative and regulatory update

TAXATION

Payments to non-residents may not attract tax

The Supreme Court has stayed recovery proceedings ordered by Karnataka High Court in the case of *CIT v Samsung Electronics Co Ltd*, following the filing of a special leave petition before it. In a recent judgment that shook the software industry, the high court held that every person making a payment for the importation of shrink-wrapped software is obliged to deduct tax at source.

Though the case concerned the characterization of payments to foreign suppliers for the purchase of shrink-wrapped software, the high court did not focus on the specific questions surrounding software taxation. Instead, the court addressed a broader issue: withholding tax obligations arising out of payments made to non-residents by payers in India.

The high court held that every resident making such a payment to a non-resident was obliged to withhold tax under section 195(1) of the Income Tax Act (ITA), 1961. It further observed that section 195(1) of the ITA is not a charging provision, and the assessing officer cannot embark on an exercise to determine the actual nature of the income or the tax liability of the non-resident assessee.

The court concluded that the resident



payer's liability to withhold tax arises the moment there is a payment due to a non-resident, if such a payment is income in the hands of the recipient. The court held that the resident payer can be wholly or partly relieved of this obligation (obtaining a nil or lower rate of tax withholding) only by making an application to the assessing officer which demonstrates that the payment does not have, or only partially has, the character of income.

The principle laid down by the high court has significant implications; it could bring every payment which is in the nature of income within the purview of the ITA's

withholding tax provisions.

The law clearly states that withholding provisions are triggered only when an income is chargeable to tax. An application to the assessing officer under section 195(2) should only be required in a case where the entire payment, or part of it, is subject to withholding tax. However, where a payment is not chargeable to tax at all, no application to the assessing officer should be required.

It is hoped that the Supreme Court will now address this controversial issue, and provide certainty with respect to withholding obligations for payments to non-residents.

New valuation rules for taxation of perquisites

On 18 December 2009 the Central Board of Direct Taxes (CBDT) issued its long-awaited rules for the valuation of perquisites, which will take effect on 1 April 2010. In accordance with the amendment made by the Finance (No. 2) Act, 2009, to section 17(2) of the Income Tax Act, 1961, shares acquired by employees under employee stock ownership

plans (ESOPs) are now regarded as salary income for the employee. An employer is required to withhold tax on the difference between the fair market value of the shares (on the date of the employee's exercise of option) and the price paid by the employee. Until now the method for calculating the fair market value of shares for this purpose was uncertain. The government's valuation rules for perquisites are intended to remove this ambiguity.

The valuation rules for calculating the fair market value of shares allotted to employees is substantially comparable to those used under the

fringe benefit tax (FBT) regime. For example, in both cases employers have to obtain a valuation from a merchant banker to determine the fair market value of the shares for unlisted companies. This requirement may prove to be particularly cumbersome and expensive for smaller, unlisted companies, as they are more likely to be obliged to engage merchant bankers (depending on the exercise schedule under the ESOP). However, as under the FBT regime, listed foreign companies would also be required to obtain a valuation certificate from a merchant banker, despite the companies' stock prices

being readily available.

Notably, the valuation method to be used by the merchant bankers has not been specified in the rules, in effect allowing them to use any method they choose. Nor has the CBDT clarified whether FBT already paid by employers with respect to stock options exercised after 1 April 2009 will be adjusted in relation to future tax liabilities, or whether a refund will be available. Another issue which remains unclear is whether the government will provide a waiver of the interest levy on late payments of advance tax, given that the valuation rules for ESOPs were released only in December 2009.

Although the CBDT's circular does not provide comprehensive guidance on all issues, it does remove the previous ambiguity with respect to withholding taxes on the exercise of ESOPs. Employers will also be relieved that the circular holds no surprises, as the rules prescribed are essentially the same as those in the FBT regime.

Valuation rules for ESOPs

For shares of a company listed on a recognized stock exchange	Fair market value will be the average of the opening price and closing price of the shares on that date on the said stock exchange.
For shares of a company listed on more than one recognized stock exchange	Fair market value will be the average of the opening price and closing price of the shares on the recognized stock exchange which records the highest volume of trading in the shares.
If on the date of exercise, there is no trading on any recognized stock exchange	(i) Fair market value will be the closing price of the shares on a date closest to the date of exercise and immediately preceding this date; or (ii) the closing price of the shares on the recognized stock exchange which records the highest volume of trading in the shares, if the closing price (on the date closest to the date of exercise and immediately preceding this date) is recorded on more than one recognized stock exchange.
For unlisted companies	Fair market value shall be the value of the shares in the company as determined by a merchant banker registered with the Securities and Exchange Board of India on the specified date.

DISPUTE RESOLUTION

New bill aims to speed up dispute resolution

The Commercial Division of High Courts Bill, 2009, was recently passed by the lower house of the Indian parliament and has been referred to a select committee for further discussions by the upper house.

The bill is based on the 188th report of the Law Commission of India, 2003, and provides for the establishment of a specialist commercial division in each high court in India dedicated to dealing with certain commercial disputes.

These commercial divisions will work to achieve the speedy disposal of disputes which have a specified value of not less than Rs50 million (US\$1.08 million), or higher amounts as notified by the central government in consultation with the relevant state government.

Commercial disputes are defined in the bill to include those between tradesmen and relating to movable and immovable commercial property, including intangible property.

Commercial divisions will exercise jurisdiction in several categories of cases:

- suits relating to commercial disputes and any execution proceedings arising from them;
- suits, applications, proceedings and appeals – including appeals from a single judge of a high court – relating to commercial disputes pending in the high court (or in subordinate courts) and transferred to commercial divisions;
- appeals against interim orders passed in suits by subordinate courts to a high court; and
- applications under sections 34 and 36, and appeals under sections 37(1)(a) or 37(2) of the Arbitration and Conciliation Act, 1996, provided they are of at least the specified value of the dispute.

Section 8 of the bill outlines how the specified value of a suit, appeal or application must be calculated, and this overrides any conflicting provision for valuation under any law that is in force for the time being.

Section 9 of the bill specifies the documents to be filed along with the plaint, and fixes the timelines for filing written statements, counter claims and rejoinders. All parties must file a

written submission before commencing with oral submissions. A single judge of the commercial division is empowered to hold case management conferences, fix schedules to finalize various issues, cross-examine witnesses, file written statements and oral submissions, record evidence and appoint commissioners. (A commissioner can be appointed to conduct a cross-examination and re-examination of witnesses and parties.) The bill allows the service of summonses and the issue of judgment copies by email.

A commercial division should pronounce its judgment within 30 days of the conclusion of the argument. In the case of an application or appeal under the Arbitration and Conciliation Act, 1996, a commercial division should make efforts to dispose of the matter within one year of serving a notice to the other party. Appeals against orders of a commercial division must be decided by the Supreme Court.

The bill will facilitate the efficient adjudication of commercial disputes within two years of their filing, as proposed by the report. This should reduce the burden of the Indian courts, increase foreign investors' trust in the Indian judicial system and encourage further foreign investment in India.

BANKING & FINANCE

Reserve Bank amends ECB policy

The Reserve Bank of India (RBI) has brought in changes to the policy governing external commercial borrowings (ECBs), though its circular 19 of 9 December 2009. The previous policy permits eligible borrowers to raise funds in the form of ECBs from recognized lenders at a mutually agreed rate, under the approval route. The RBI has now decided to change this arrangement, fixing all-in-cost ceilings under the approval route for loan agreements entered into from 1 January, as shown in the table.

Where an eligible borrower seeks to use ECBs and has entered into a loan agreement on or before 31 December 2009, with the all-in-cost ceiling exceeding the newly specified limits, the borrower should provide a copy of the loan agreement to the RBI for the application to be considered under the approval route.

Under the new amendment, non-banking financial companies exclusively involved in financing the infrastructure sector can borrow from any eligible lender under the approval route, after complying with applicable prudential

standards and fully hedging the currency risk of the loan. Previously they were permitted to raise ECBs only from multilateral or regional financial institutions, or from developmental financial institutions owned by the government.

The RBI previously permitted the buy-back of foreign currency convertible bonds, but in a change to the policy, this facility was discontinued on 1 January.

Currently corporations may raise funds for the development of integrated townships, which is a permitted end-use of ECBs until 31 December 2010. The acquisition of 3G spectrum is another permitted end-use under the current ECB policy. It is unclear whether payments for broadband wireless access (BWA) spectrum is also a permitted end-use, although the Department of Telecommunications' information memorandum of 23 October 2009 suggests that it is. A definite answer to this question is needed.

Average maturity period	All-in-cost ceilings over six month Libor*
Three years and up to five years	300 basis points
More than five years	500 basis points

*For the currency of borrowing or applicable benchmark.

INTELLECTUAL PROPERTY

Restrictions on royalty payments removed

On 16 December the Indian government issued press note 8 of 2009, which concerns the liberalization of remittances made for technology collaborations.

The press note removes restrictions on outbound remittances for royalties and lump sum fees that are paid for technology transfers and the use of trademarks and brand names. Indian companies seeking to make payments to foreign technical collaborators can now directly approach their authorized banks to make the necessary remittances.

Under the earlier regulatory norms, various payments made by Indian residents to non-residents for technology transfers – including lump sum fees of up to US\$2 million, and royalty payments of 5% on domestic sales and 8% on exports – could be made without any prior approvals. In addition, royalty payments of up to 2% on exports for the use of trademarks and 1% on domestic sales were permitted (although, under the rules of the Foreign Exchange Management Act, 1999, these were considered to be current account transactions). Any payments in excess of the specified caps required prior government approval.

Some of these remittance limits dated back to 2001 without revision, and may have deterred many potential investors and owners from bringing their technology and trademarks to India.

The relaxation of foreign exchange restrictions on technology collaborations has been warmly welcomed. It is expected to provide considerable relief to foreign investors who can now expect a fair return on their intellectual property.

The relaxation will also provide an additional incentive for foreign companies to enter Indian markets and undertake collaborations with Indian companies. Such increased business is likely to strengthen India as a manufacturing hub, thereby creating a mutually beneficial environment for foreign investors and the Indian economy.



PHARMACEUTICALS

Probiotic foods market to be regulated

Probiotic foods, which are currently classified as general foods and are subject to little regulation, are soon likely to begin being governed by a set of stringent guidelines. The Indian Council of Medical Research (ICMR) and the Ministry of Science and Technology's department of biotechnology have released their draft "Guidelines for Evaluation of

Probiotics in Food in India", proposing how probiotics should be governed by law. The ICMR has invited comments on the draft guidelines.

Probiotics are live, non-pathogenic micro-organisms that benefit the consumer's digestive system by boosting the naturally existing gastrointestinal microflora. This prevents the colonization of the intestine by pathogens and so improves the immune system. Probiotics are available in the marketplace in the form of health foods and dietary supplements.

The Indian probiotic market is currently regulated by the laws that govern general food items. These laws include the Prevention of Food Adulteration (PFA) Act, 1952, and

corresponding PFA rules of 1955; certain food product-specific orders under the Essential Commodities Act, 1955; and the Standards of Weights and Measures Act, 1976, and Standards of Weights and Measures Rules of 1977. The PFA rules specify minimum standards for the quality, content, labelling and packaging of food products.

Probiotic food products are sold as food, but the intention or claim that they have a therapeutic effect takes such products beyond the ambit of ordinary food articles as envisaged under existing legislation. In addition, it is a cause for concern that the probiotic cultures being used in currently available food products are of foreign origin, and hence untested on the gut microflora of the Indian population. The lack of appropriate legislation has prompted regulators to initiate the development of what is intended to become a thorough set of guidelines to govern the use of probiotics in food.

The conditions prescribed for probiotic foods and their manufacturers in the guidelines include:

- *in vitro* tests, including tests mimicking the hostile gut environment;
- *in vivo* tests in appropriate validated animal models;
- *in vivo* tests on humans in four phases, to determine safety and efficacy;
- certain labelling requirements in addition to those prescribed by existing food laws; and
- the requirement for Good Manufacturing Practices (GMP) and the Codex General Principles of Food Hygiene and Guidelines for Application of Hazard Analysis and Critical Control Point (HACCP) to be applied in the manufacture of probiotic food products.

The market is currently awaiting the final set of guidelines, which will lay down the precise clinical study requirements that would have to be conducted to substantiate the health claims of probiotic foods.

The legislative and regulatory update is compiled by Nishith Desai Associates, a Mumbai-based law firm. The authors can be contacted at nishith@nishithdesai.com. Readers should not act on the basis of this information without seeking professional legal advice.

