

Doing Business in India

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Introduction

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India has come a long way from the high tax rates and opaque administration days, more commonly known as "the Licence Raj". Millennial India is a package deal of a vibrant democracy, a large reservoir of skilled manpower, an economy at the cutting edge of new technology and above all a huge and growing domestic market. A healthy growth rate of approximately eight percent per annum, strong capital markets, implementation of second generation reforms, infrastructure advancements, exchange control relaxations and government's commitment to move towards more transparency and simplification of the regulatory and tax regime to bring it at par with the best international practices – all add up to make India an attractive investment destination. This paper focuses on the entry strategies available to a foreign investor and some of the issues that he would have to bear in mind with respect to the regulation of business.

I. Investment Climate

By and large, Foreign Direct Investment ("FDI") is now permitted in almost all sectors in India subject to prescribed sectoral guidelines. Sectors such as insurance and real estate, where FDI was highly restricted till a few years back, have now been liberalised. The only exceptions remaining are retail trading (which has also now been opened to single brand product retailing), atomic energy, lottery business, gambling and betting (collectively, referred to as the "negative list"), in which sectors FDI is still prohibited.

The FDI Policy issued by the Department for Industrial Policy and Promotion ("DIPP") provides sectoral guidelines, also prescribing whether investment in particular sectors would be under the automatic route or would require prior approval from the Foreign Investment Promotion board ("FIPB") under the Ministry of Finance.

A decision of the FIPB is normally conveyed within one month of submitting the application. The proposal for foreign investment is decided on a case-to-case basis depending upon the merits of the case and in accordance with the prescribed sectoral policy. Generally preference is given to projects in high priority industries, infrastructure sector, those having export potential, large-scale employment opportunities, linkages with agro sector, social relevance or relating to infusion of capital and induction of technology. Chart 1 sets out permitted FDI in a few sectors and specifies whether it is under automatic route or requires the approval of the FIPB.

The government is also promoting foreign investment in special economic zones, industrial parks and free trade warehousing, and up to 100 percent FDI is permitted in these sectors under the automatic route.

Chart 1

S. No.	Sector/activity	FDI Cap/Equity	Entry route
1	Airports (greenfield and existing projects)	100%	Automatic
2	Air transport services	49% FDI / 100% for non resident Indian ("NRI")	Automatic
3	Asset reconstruction companies	49%	FIPB
4	Atomic minerals	74%	FIPB
5	Banking – private sector	74%	FIPB
6	Real estate	100%	Automatic
7	Insurance	26%	Automatic
8	Investing companies in infrastructure / services sector	49%	FIPB
9	Non-banking financial company	100%	Automatic
10	Petroleum and natural gas (other than refining)	100%	Automatic
11	Petroleum and natural gas (refining)	26% in case of Public Sector Undertakings ("PSU")/ 100% in case of private companies	FIPB (in case of PSUs) Automatic (in case of private companies)
12	Publishing of periodicals (dealing with news)	26%	FIPB
13	Power	100%	Automatic
14	Single brand product retail	51%	FIPB

Direct Taxation

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The provisions of the Indian Income Tax Act, 1961 ("ITA") govern the income tax liability in India. The Finance Act, which is enacted annually by the Indian Parliament after presentation of the Finance Bill by the Finance Minister, periodically revises applicable rates of taxation and/or other provisions of the ITA. The article below attempts to highlight and discuss the main provisions of the ITA which may be kept in mind while considering investments into India.

I. Direct Taxes

India considers the financial year, that is, April 1 to the succeeding March 31, as its tax year. Taxability in India depends on residential status for the relevant tax year. Resident taxpayers are subject to tax in India with respect to their global income while non-residents are taxed in India on income received, accruing or arising in India, or deemed to have been received, accrued or arisen in India or from any source in India. Taxable income is generally computed after deduction of expenses in accordance with the provisions laid down in the ITA.

A company incorporated in India is a tax resident in India. A company that is incorporated outside India is generally regarded as a non-resident, unless it is wholly controlled and managed from India. Once a company is a tax resident of India, it is subject to tax in India on its global income. The ITA also provides that a non-resident person or a company may also be taxed in India if it earns income from a *business connection* in India. With respect to a non-resident who is a resident of a country with which India has signed a Double Tax Avoidance Agreement ("DTAA"), the provisions of the ITA apply only to the extent they are more beneficial. India has an extensive network of DTAA's with various countries, some of which, such as Mauritius and Cyprus, serve as favourable tax jurisdictions for investing into India.

A. Corporate Tax Rate

Domestic companies are currently taxed at the rate of 33.66 percent (30 percent basic tax rate plus surcharge of 10 percent and education cess of two percent on tax plus surcharge). Branches of foreign companies or foreign companies which are held to have a business connection or a Permanent Establishment ("PE") in India are subject to tax at the rate of 41.82 percent (40 percent basic tax rate plus surcharge of 2.5 percent and education cess of two percent).

B. Minimum Alternate Tax

Under the provisions of the ITA, when the income tax payable on the total income as computed under the provisions of the ITA is less than 10 percent of the book profits of a company, the company is subject to the Minimum Alternate Tax ("MAT"). In such an instance, the book profit is deemed to be the total income of the company for the purpose of tax, and this book profit is subject to tax at the rate of 10 percent. The MAT

mechanism ensures that every company pays a tax of at least 10 percent of its book profits. The effective rate of tax with regard to Indian companies would be 11.22 percent and 10.455 percent in case of foreign companies. From the financial year 2005-06 onwards, a credit of such tax paid by a company is available for seven years following the year in which MAT has been paid.

Certain incomes, such as income from the export of software, are excluded from the purview of the MAT. Hence, MAT does not generally apply to software companies. MAT will also not apply to income accrued or arising on or after April 1, 2005 provided the business is carried on, or services are rendered by an entrepreneur in a Unit located in Special Economic Zone

C. Dividend Tax

Dividends are tax-exempt in the hands of the shareholders (residents as well as non-residents). However, the Indian company declaring the dividends is required to pay an additional corporate tax called a Dividend Distribution Tax ("DDT") at an effective tax rate of 14.025 percent. This DDT is not a withholding tax, and hence the benefit of lower withholding tax rates provided under the DTAA's entered into by India with other countries would not be available. Exemption from payment of DDT is however available to an SEZ developer.

D. Interest

Under the ITA, interest received by a non-resident is generally taxable at the rate of 20 percent, which can be reduced to 10 percent under some of the tax treaties entered into by India with other countries. Tax is required to be withheld at source by the resident payer at the time of making payments. Moreover, interest is a tax-deductible expense for the Indian resident (e.g., the wholly-owned subsidiary) only if the applicable tax has been withheld before making the payments to the non-resident.

E. Royalties / Fees for Technical Services ("FTS")

Royalties or FTS effectively connected to a PE in India, and paid in pursuance of an agreement entered into after April 1, 2003 are taxed on a net income basis at a rate of 41.82 percent.

Otherwise, payments towards Royalties and FTS currently attract tax at the rate of 10 percent, if the payments are made in pursuance of an agreement made on or after June 1, 2005, and at the rate of 20 percent in case of agreements made

before June 1 but after May 31, 1997. This earlier higher rate can often be reduced to 10 percent under the various tax treaties that India has entered into with other countries.

F. Capital Gains

Capital gains are classified into short-term capital gains and long-term capital gains. Shares of a company, securities listed on a recognised Indian stock exchange, and specified units of a mutual fund are treated as long-term capital assets if held for more than 12 months. In other cases, a long-term capital asset is one that is held for a period of more than 36 months. Gains realised from sale of long term capital asset are long term capital gains. Benefits of indexation are available to resident taxpayers while calculating costs of acquisition and improvement in case of sale of long term assets (excluding debentures). Non-residents would however be unable to take this benefit for sale of long term capital assets being shares and debentures acquired in foreign currency. Non-residents would however get the benefit of computing capital gains in foreign currency so as to have advantage of the exchange rate fluctuation.

G. Securities Transaction Tax

All transactions entered on a recognised stock exchange in India will be subject to Securities Transaction Tax ("STT") levied on the transaction value. In case of purchase / sale of listed equity shares which is settled by way of actual delivery or transfer of the equity share, STT will be levied at the rate of 0.125 percent on both the buyer and seller of the equity share. For sale of equity shares settled otherwise than by way actual delivery or transfer of the equity share, STT will be levied at the rate of 0.025 percent on the seller of the equity share. The STT can be setoff against business income tax calculated as per the provisions of the ITA.

Tax rates are shown in Table 1 below.

H. Tax Holiday

Currently, under the ITA, there are three major provisions regarding direct tax incentives. These are:

Deductions for profits derived by units established in any Free Trade Zone ("FTZ"), Electronic Hardware Technology Park ("EHTP"), Software Technology park ("STP")

Undertakings set up in FTZ, EHTP, STP are eligible for a deduction of 100 percent of profits and gains derived from the export of articles or things or computer software for a period of ten years. IT enabled units such as business process outsourcing units including call centres, medical transcriptions, data processing centres, software developers, etc are also eligible for these benefits provided they are registered under the aegis of an STP. A sunset clause has been introduced for this tax holiday and now the deduction for export profits is available only up to March 31, 2009.

Apart from the above, a unit registered as an STP licensed unit is also eligible for the following benefits:

- 100 percent customs duty exemption on imports of capital equipments.
- Equipment can also be imported on loan or lease basis.
- All relevant equipment/goods including second hand equipment can be imported (except prohibited items).
- 100 percent excise duty exemption on indigenous items procurement.
- Central Sales Tax reimbursement on Indigenous items procurement.
- Green card enabling priority treatment for government clearances / other services.
- 100 percent foreign equity investment is permitted under the 'Automatic Route' of the foreign direct investment ("FDI") policy of the government of India.

Special Provisions with Regard to Newly Established 100 percent Export Oriented Undertakings

Entities set up in 100 percent EOUs are eligible for a deduction of 100 percent of profits arising from export of articles or things or computer software up to March 31, 2009.

Table 1

Particulars	Resident Corporations	Non-resident/ Foreign Corporations
Short term gains arising on sale of shares and units of equity oriented fund on a recognized Indian stock exchange	11.22%*	10.455%*
Other short term gains	33.66%	41.82 ¹
Long term capital gains arising on sale of shares and units of equity oriented fund on a recognized Indian stock exchange ²	0%*	0%*
Long term capital gains arising on sale of shares and units of equity oriented fund off a recognized Indian stock exchange	11.22%*	10.455%*
Other Long term capital gains	22.44%	20.91 ³

* Provided the applicable STT is paid.

- 1 30.365% in case of a company registered as a Foreign Institutional Investor ('FII')
- 2 The income by way of the long term capital gain shall be taken into account while calculating the book profits and income tax payable under the provisions applicable to Minimum Alternative Tax
- 3 10.455% in case of an FII

Special Economic Zone ("SEZ")

SEZs are duty free enclaves which are deemed to be outside the customs territory of India for the purposes of carrying out authorised activities. Units set up in a SEZ benefit from a package of direct and indirect tax incentives combined with an integrated infrastructure for export production and quick approval mechanisms.

For SEZ Units commencing production on or after April 1, 2006, a 100 percent income tax exemption will be available for the first five years, followed by a deduction of profits not exceeding 50 percent for the next five years, and up to 50 percent of the profits for another five years to the extent these profits are credited to Special Economic Zone Re-Investment Allowance Reserve Account.

Other benefits of operating in an SEZ are as follows:

- exemption from Minimum Alternative Tax
- exemption from customs duty
- exemption from excise duty
- exemption from service tax
- exemption from sales tax for units purchased from Domestic Tariff Area
- 100 percent foreign equity investment is permitted under the 'Automatic Route' of the FDI policy of the government of India.

I. Fringe Benefit Tax ("FBT")

FBT was introduced by the Central Government from Financial Year 2005-06 and aims to tax the prescribed fringe benefits deemed to have been provided by an employer to its employees. The value of fringe benefits calculated in accordance with the provisions of the ITA are taxed at the rate of 33.66 percent.

J. Banking Cash Transaction Tax ("BCTT")

BCTT is leviable at the rate of 0.1 percent on the amount of cash withdrawn/received from a scheduled bank from an account (excluding a savings account) exceeding Rs. 100,000 in a single day.

K. Wealth Tax

A company is liable to pay wealth tax at the rate of one percent on the amount of net wealth that exceeds INR. 150,000. Net wealth includes prescribed assets as reduced by corresponding debts and obligations. Assets have been defined to include *inter alia*, motor cars, yachts, boats, aircraft, urban land, etc. The definition of the term 'Assets' however excludes shares and certain securities. Also, commercial and business assets are exempt from wealth tax.

L. Transfer Pricing

Globalisation of business, technology advancements, growth in M&As/JVs and accelerating product life cycles have resulted in creating an increased network of transnational group of companies across the globe. More than 60 percent¹ of world trade takes place within multinational enterprises, resulting in transfer of tangibles and intangibles amongst the enterprises. This has led to aggressive transfer pricing regulations being adopted by various countries to arrest erosion of their tax base.

In 2001, the Government of India formally enacted the Transfer Pricing Regulations ("Indian TPRs") in the ITA and thus any

international transactions between two associated enterprises would have to be on an arm's length basis. Prior to the formal Indian TPRs, transfer-pricing provisions existed in rudimentary form under the earlier Income Tax Act of 1922 and section 92 of the ITA. To a large extent, the Indian TPRs are in line with international transfer pricing norms.

The ITA stipulates stringent penalties for non-compliance, namely, a penalty of up to 300 percent of the tax sought to be evaded by way of concealment of income or furnishing of inaccurate particulars, a penalty equal to two percent of the value of each international transaction for failure to maintain documents / furnish information and a penalty equal to INR 100,000 (approx. U.S.\$ 2,000) for failure to furnish chartered accountant's report as required under the Indian TPRs. Presently all enterprises having a turnover greater than INR150,000,000 (approx. U.S.\$ 3 million) fall within the ambit of compulsory audit by a special Transfer Pricing Officer. Thus, from the above, it is evident that the harsh penalties under the Indian TPRs are aimed at deterring non-compliance.

India currently does not have an advance pricing arrangement mechanism.

M. Advance Ruling

The Finance Act 1993 introduced an advance tax ruling mechanism by amending the ITA. Under this mechanism an application can be made by non-residents (and residents in certain circumstances) to the Authority for Advance Ruling ("AAR") for a determination of the tax liability in India of the non-resident. The AAR is comprised of three members and is headed by a retired Supreme Court judge. An advance tax ruling can be sought on any question of law or fact specified in the application in relation to an existing/proposed transaction. However, an advance ruling cannot be sought where the question:

- is already pending before any income tax authority, the appellate tribunal or any court, or
- involves determination of fair market value of any property, or
- relates to a transaction which is designed prima facie for avoidance of income-tax.

Statutorily, the AAR is required to dispose of an application within six months of filing the same. Advance rulings are private in nature and are binding only as regards the parties to the ruling, that is, the applicant and the income tax authorities, and in respect of the specific transaction for which the ruling is sought. They are effective unless there is a change in law or fact on the basis of which the ruling was pronounced.

The tax litigation process in India can be fairly long-drawn and time-consuming. The advance ruling mechanism has proved to be constructive in avoiding long drawn and expensive litigations, removing uncertainty and imbalance in tax administration (on account of high-pitched tax assessments sought to be made by lower income tax authorities) and instilling confidence in non-residents to plan their Indian operations by having a precise knowledge of their Indian tax liability.

II. Structuring Issues

Investing in an Indian company through an intermediate holding company in a tax-favourable jurisdiction offers various

advantages. It helps in pooling offshore investments and also helps in the globalisation or restructuring of a company at a later stage. India has entered into favourable DTAA's with quite a few countries including Mauritius, Cyprus and the Netherlands. Mauritius is a favoured route for inbound investments into India, as the India-Mauritius DTAA offers a lot of tax benefits such as, the dividend withholding tax is reduced to five percent if the Mauritius company holds more than 10 percent of the shareholding of the Indian company and is 15 percent in all other cases. Capital gains earned by a Mauritius resident on sale of shares of an Indian company would not be taxed in India if the Mauritius resident does not have a permanent establishment ("PE") in India. Fees for technical services form part of other income, which would only be taxed in India if the Mauritius resident had a PE in India.

Mauritius provides an underlying tax credit² under its domestic law as well as under the India-Mauritius DTAA. The India-Mauritius DTAA also provides for a tax-sparing clause under which taxes spared in India are also creditable at the Mauritius level. However, setting up an intermediate holding company in Mauritius needs to be backed by sound commercial justifications. Care also needs to be taken to ensure that the control and management of the Mauritius holding company is not *wholly* situated in India.

The India-Singapore DTAA also offers substantial tax benefits. Dividends are taxed at the rate of 10 percent if the beneficial owner is a company which owns at least 25 per cent of the shares of the company paying the dividends; and 15 per cent of the gross amount of the dividends in all other cases. Further, capital gain income is exempt from tax provided however that the company organised in Singapore is not a shell or a conduit company, and the affairs of the company have not been so arranged so as to avoid tax.

III. Service Tax

Taking into account the growing contribution of the services sector to the Indian gross domestic product, service tax regime was introduced in India for the first time in 1994. The service

tax regime was introduced via Chapter V to the Finance Act, 1994. Subsequent Finance Acts, (1996 to 2003) have widened the service tax net by way of amendments to Finance Act, 1994. India is in the process of enacting an independent comprehensive legislation on service tax to consolidate the law and to ease administration of the same.

Service tax is levied on specified taxable services and responsibility of payment of the tax into the government exchequer is cast on the service provider. Currently, 100 services have been notified as 'taxable services'. Service Tax leviable on taxable services under section 66 of the Finance Act, 1994 has been increased from 10 percent to 12 percent. In addition to 12 percent, education cess at the rate of two percent of 12 percent, that is, 0.24 percent, is also leviable. The total tax leviable on taxable services is thus 12.24 percent of the value of taxable services.

Developer and SEZ Units are exempt from Service Tax when carrying on authorised operations in the SEZ. Service tax exemption is granted only to Units in the DTA providing services to a Developer or to a Unit. Export of services without payment of service tax has been made with effect from September 10, 2004.

The Finance Act 2006 has also introduced service tax on services received from outside India, from the recipients of services within India, under the reverse charge method.

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1 *Transfer pricing: Keeping it an arm's length*, John Neighbour, OECD Observer – April 2002.

2 "Underlying tax credit" refers to a tax credit for corporate taxes paid by the overseas subsidiary on the profits from which dividends are declared. This credit is in addition to the tax credit for taxes withheld when the dividends are paid.