

BUDGET 2003-04 : INDIA

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From the Editors

Dear Reader,

In his first Budget speech delivered with much aplomb, the Finance Minister, Mr. Jaswant Singh, made it clear that though fiscal consolidation and removal of budgetary drags are essential to bolster the Indian economy, the reforms would be adopted in a graded manner. The Budget thus appears to be an odd patchwork of the recommendations of the Task Force sewn together with proposals to shore up popular support.

The Budget contains a mixed bag of direct and indirect tax provisions for various sectors like infrastructure, Telecom, IT, Healthcare, Housing and Business Processing Outsourcing and others. Nevertheless, analysis of the fine print depicts that the Budget is a balancing act of granting a relief on the one hand and taking it away on the other. The proposals of the BPO sector are a typical example of this. While continuing the tax holiday availed of by the BPO companies under section 10A/B of the Income Tax Act, a service tax of 8 per cent is likely to be levied on the 'business auxiliary services'.

The Budget has announced abolition of long term capital gains tax on listed securities and exempting dividends in the hands of shareholders. These provisions too are not without a sting in the tail. The long term capital gains tax exemption applies only to investments made after March 1, 2003 and thus excludes existing investments in listed securities as well as unlisted securities from its ambit. Further, dividends would attract dividend distribution tax incidence in the hands of the company at the rate of 12.8 per cent.

On the positive side, the Budget is not completely devoid of constructive and forward-looking proposals. Loss of tax holiday on change in beneficial ownership of the company owning the STP unit was looked upon as a disincentive to reorganization of the STP units. Doing away with this provision will give a fillip to M&A activities – on the domestic as well as international front. Introduction of VAT, electronic filing of income tax returns and simplification of tax administration procedures will bring India on par with the tax practices in other countries.

On the whole, the Budget seems to have been an effort to provide a little something for everyone. However, it has failed to address some pressing issues like reining in the mounting fiscal deficit and achieving the targeted GDP growth rate of 6-6.5%.

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DIRECT TAXES

RATES

Though the Finance Bill, 2003 ("Bill" or "Budget") has not made any changes in the basic rates of taxes in respect of individuals and corporates, the current applicable surcharge of 5% has been proposed to be reduced to 2.5% in the case of firms and corporates while it has been done away with in the case of individuals, Hindu Undivided Families ("HUFs") and Association of Persons ("AOPs") earning income upto INR 850,000. Individuals, HUFs and AOPs earning income above INR 850,000 would however be subject to surcharge of 10%.

The table below gives the proposed rates of tax (inclusive of surcharge) in relation to Individuals, HUFs and AOPs, etc:

Income (in INR)	Tax*
0-50,000	NIL
50,001-60,000	10.0%
60,001-150,000	20%
150,001 and above	30%

* In the case of income earned above INR 850,000, there will be a surcharge of 10% on the total tax liability.

Status	Tax
Partnership firms	35.875 %
Domestic Companies	35.875 %
Foreign Companies	41.000 %

CAPITAL MARKETS

Capital Gains Taxation: In order to provide a fillip to capital markets, and to restore the confidence of small investors, the Finance Minister has proposed to exempt from tax the long term capital gains arising from transfer of listed securities. Since this provision is likely to be reviewed next year, it is currently being made available only in respect of listed securities purchased between March 1, 2003 and March 1, 2004. The gains arising on sale or transfer of unlisted securities and short term capital gains would continue to be taxed at the applicable rates.

Capital gains arising out of transfer (after April 1, 2003) of membership rights held by a member of a recognised stock exchange on demutualisation or corporatisation of the stock exchanges in accordance with a scheme approved by the Securities and Exchange Board of India ("SEBI") shall be exempt

from tax. This is definitely a step in the right direction as it will increase the pace of demutualisation and corporatisation of the stock exchanges, which in turn would help ensure transparency and better corporate governance.

Taxation Of Dividends: The Bill proposes to exempt dividends/ income from units in the hands of shareholders/ unit holders. However, a Dividend Distribution Tax ("DDT") at the rate of 12.8% (12.5% tax plus 2.5% surcharge) would be levied on such company/mutual fund.

The Kelkar Committee was of the opinion that the classical system of taxing dividends in the hands of the shareholders leads to double taxation. Hence, it recommended that taxation on dividends by shareholders should be completely abolished.

In the Bill, the Finance Minister partly accepted the Kelkar Committee recommendations by exempting from taxation, dividends and incomes from units. However, these recommendations have not been completely adopted, since the Bill envisages the shifting of the tax liability to the company/mutual funds distributing such income. However, the Bill specifies that no DDT would be levied on distributions made by open-ended equity oriented funds. Since the above income is not taxable in the hands of the shareholders as well, the same would be completely tax-exempt.

TAXATION OF NON-RESIDENTS

Resident but Not Ordinarily Resident ("RNOR"): Individuals returning to India after residing abroad for two years were accorded the special status of RNOR under the Income Tax Act, 1961 ("ITA") whereby their foreign income was exempt from tax in India for nine years after their return. This definition is now proposed to be amended in line with the interpretation given to it in the recent Gujarat High Court ruling.

Under the amended definition, foreign income would be exempt from Indian tax only if the individual has been a non-resident in nine out of previous ten years. As a result, foreign income of a person returning to India would now be exempt only for the first two years of his return. This amendment is proposed to be effective from April 1, 2003.

Business connection ("BC"): As per the ITA, a non-resident having a BC in India [business connection is analogous to the concept of permanent establishment ("PE") under tax treaties] is

taxed only in respect of income attributable to the operations of the BC. The Bill seeks to bring in clarity in relation to the situations under which an Indian agent would constitute a BC of such non-resident entity in India.

It has been provided that an Indian agent dependent on his non-resident principal will constitute a BC in India if he exercises an authority to conclude contracts on behalf of the non-resident; he habitually maintains in India stock of goods from which he makes regular delivery on behalf of the non-resident; or it habitually secures orders mainly for the non-resident and its related parties. Further, an agent will be deemed to be a dependent agent if he carries out work mainly for the non-resident or its related entities. Thus, it can be seen that the amendment aims at bringing within the ITA the concept of agency-business connection, along the lines of bilateral tax treaties.

Payments made to non-residents: Under the ITA, when a person makes any payment to a non-resident, he is required to withhold tax at appropriate rates. Further, according to section 40(a)(i) of the ITA, a deduction for payment made in the nature of salary, interest, royalty or fees for technical services payable outside India, is available to the payer only if tax has been withheld on such payments. The Budget proposes to extend the scope of this provision to the payments made to a non-resident in India as well. Thus, a deduction for such payments made by a resident to the branch of a non-resident in India would be allowed only if tax has been withheld on them.

Royalty and Fees for Technical Services (“FTS”): Currently, the payments for royalty and fees for technical services are subject to withholding tax in India at the rate of 20% on gross basis. The Bill proposes that income in the nature of royalty or FTS earned by a non-resident carrying on business activity in India through a PE would be computed under the head business income provided it is effectively connected with such PE. The Budget further proposes to restrict the applicability of section 44D of the ITA, which provides for taxation on gross basis, to agreements entered into prior to April 1, 2003. As a consequence, royalty and FTS connected with a PE would be subject to tax on net basis, after deduction of expenses.

India-Mauritius Taxation Treaty (“DTAA”): With dividends being made exempt from taxation in the hands of shareholders, and in view of the proposed tax exemption on long term capital gains on sale of listed securities, the Indian capital markets

would be brought on the same level playing field as those in most competing economies. However, investments into India, made by Foreign Institutional Investors and other private equity investors, may still be required to be structured through tax favourable jurisdictions, such as Mauritius.

The Circular No. 789 of 2000 issued by the Central Board of Direct Taxes, which contained a clarification with respect to the availing of the benefits under the DTAA, was challenged in two public interest litigations filed before the Delhi High Court. Pursuant to the Delhi High Court quashing the said Circular, the Supreme Court finally heard the matter in appeal earlier this week and the judgement is reserved. It is expected that the judgement will be delivered in around 4-8 weeks.

SECTOR SPECIFIC REFORMS

Telecom: Telecom is a promising sector for the Indian economy. Under section 80-IA (4) (ii) of the ITA, a deduction of 100 % of profits is available for a period of ten years to an undertaking, which provides telecommunication, domestic satellite services etc. This deduction was available only if the undertaking was set up before March 31, 2003. Realizing the importance of this sector to the Indian economy, this limit for the setting up of the undertaking has been extended to March 31, 2004 by the Bill.

In addition, customs duty on a number of capital goods used by the telecom and IT sector for manufacture of components will be reduced from 25 % to 15 %. The customs duty for optical fibre cables, which are used widely for networking to provide bandwidth to the IT community, will be reduced from 25% to 20%.

IT, ITES/BPO, EOUs, etc.: The Budget has kept up with the commitment of the Government to the IT, ITES/BPO, and export sectors by not tampering with the tax holiday available under section 10A/B of the ITA. Section 10A/B of the ITA provides for a tax holiday to 100% Export Oriented Units (“EOU”), units set up in Software Technology Parks, Special Economic Zones, etc. for export of goods and computer software manufactured or produced in such units.

The Budget seeks to facilitate restructuring activities in these sectors by deleting sub-section 9 of section 10A/B. This sub-section provided that where there is a change in the ownership or beneficial interest of a unit enjoying this tax holiday or change in shareholding of a company, which owns such units in excess of 49%, then the tax holiday would be lost. In case of a merger or

demerger (i.e. spin-off) of a company that owns such units, the Budget proposes to introduce a new sub-section to provide for a tax holiday to the resultant company for the year in which such merger or demerger takes place.

Budget proposes to levy a service tax at the rate 8% on 'Business Auxiliary Services', which prima facie seeks to include services provided by a BPO company. The explanatory memorandum to the Budget states that the intention is not to cover computer enabled back office services. It is expected that once the Bill receives Presidential assent a clearer picture would emerge.

A welcome amendment for the IT sector has been introduced by way of a notification whereby value of pre-loaded software, with or without an accompanying media, would be excluded from the value of computer for excise duty purposes.

Biotechnology and Pharma sector: Specified pharmaceutical and biotechnology equipments for R&D have been exempted from customs duty subject only to their being registered with the Department of Scientific and Industrial Research. Condition relating to minimum turnover of INR 200 million and restriction on availability of exemption only upto 1 % of export value has been removed. Subject to certain conditions, specified pharmaceutical and biotech equipment have been exempted from custom duty.

Venture Capital: The Bill has not provided for any direct sops to Venture Capitalists ("VCs"). However, some other proposals introduced by the Finance Minister in the Budget could provide incentives to VCs. These are:

- Removal of the provision relating to loss of tax holiday in the event of change in beneficial shareholding under section 10A/B of the ITA, would not only encourage VCs to take significant stakes in such companies but would also provide an added flexibility to them to restructure their existing holdings in such companies. This relaxation could stimulate M&As in the IT and ITES sector which in turn will open up newer opportunities for VCs to invest in these sectors and also offer them exit opportunities;
- The proposed introduction of the Limited Partnership Act would enable structuring of Venture Capital Funds as limited partnerships, a structure generally adopted and preferred by foreign VCs; and
- Reforms in the banking sector would offer more investment opportunities to VCs in the banking sector.

Banking: The Budget proposes to increase the ceiling on foreign direct investment in banks from the current 49 % to 74 %. This would facilitate foreign banks to set up subsidiaries in India wherein they can hold shares upto 74 %.

Further, the current restriction of 10 % on voting rights to foreign investors, regardless of their shareholding, is proposed to be removed. Their voting rights would thus be proportionate to their shareholding. This is likely to increase the interest of the non-banking corporates into banking sector. It may also help the minority shareholders in takeover bids, as, open offers so far were not made due to restriction on voting rights.

It is proposed that in case of merger of a banking company with certain specified banks, the accumulated losses and unabsorbed depreciation of the merging company would be permitted to be carried forward for set off against future profits of the merged company provided, certain conditions are fulfilled. This should facilitate M&A activity in this sector and give private sector banks the opportunity to expand their reach by acquiring and merging into these specified banks that have strong network of branches.

Infrastructure: As a part of the concerted efforts to bolster infrastructure, the Finance Minister proposed a number of reforms with respect to roads, railways, airports, and seaports and highlighted the need to have innovative public-private funding mechanisms, to achieve these objectives.

Under section 80-IA (4) (iii) of the ITA a deduction of 100 per cent of the profits, is available for a period of ten years, to undertakings engaged in developing, operating or maintaining an industrial park or a special economic zone. The Bill proposes to extend this tax deduction to transferees of a special economic zone.

INDIRECT TAXES

The focus of indirect tax proposals is on:

- Introduction of Value Added Tax ("VAT") and consequent phasing out of sales tax;
- Rationalization of excise duty rates;
- Reduction of customs duties and;
- Broadening the service tax net.

VAT: Introduction of VAT has been on the anvil for sometime, with the Committees of States' Finance Ministers being set up

way back in 1995. 26 of the 28 Indian States will be shifting to VAT system from April 2003. However, the Central Sales Tax in respect of inter-state sales between registered dealers would continue to be leviable, though at the reduced rate of 2 %. To compensate the States for the potential revenue loss by adoption of VAT, the Central Government has agreed to compensate the States with a 100 % of the loss in the first year, 75 % of the loss in second year and 50 % of the loss in the third year of the introduction of VAT.

Many of the Indian states have already finalized the VAT bills. However the biggest challenge before the Central Government would be to ensure that VAT does not degenerate into the problem that it seeks to solve, i.e. multiplicity of rates and disjoint of administration of the VAT legislation between States.

VAT has been introduced in over 120 countries around the world and introduction of the same in India would not only harmonise the Indian tax system with the international best practices, but would also reduce the cascading effects of taxes; a characteristic feature of the historic sales tax regime.

Customs duty: A few of the reforms proposed are as follows:

- The peak customs duty rate has been reduced from 30 % to 25 %;
- Customs Act to be amended so as to provide for advance ruling mechanism, in respect of all notifications under the Customs Tariff Act and any other duty chargeable as customs duty. Non residents who have set up joint ventures in India and Indian WOS of foreign companies will now be eligible to seek advance rulings in relation to the above;
- Self-assessment scheme proposed to be introduced for importers and exporters which would facilitate faster clearance of goods at the ports;
- Cinematographic films (developed) are proposed to be assessed to customs duty on the cost of print, freight and insurance charges incurred in respect of the print; and
- Customs duty on gold reduced to enable India to emerge as the 'Gold Trading Capital' of the world.

Excise duty: The Bill proposes to continue with the three tier excise duty rates of 8,16 and 24 %. Household items, life saving drugs / equipments and medicinal and toilet preparations are

some of the various items that have been conferred with reduced excise duty rates.

Service tax: A few of the reforms proposed are as follows:

- In a surprise move, the Bill has hiked the service tax rate from 5 % to 8 % and added ten new services within the service tax net, which are as follows:
 - Commissioning and installation services;
 - Technical testing and analysis (excluding health and diagnostic testing);
 - Technical inspection and certification services;
 - Maintenance and repair services namely, annual maintenance contracts and authorized service station in relation to any service or repair of any maxicab;
 - Business auxiliary services;
 - Services by a foreign exchange broker other than brokers in relation to banking and other financial services;
 - Internet café;
 - Commercial vocational institutes, coaching centers and private tutorials;
 - Franchise services; and
 - Port services to minor ports.

The date from which these services will attract service tax will be notified by the Government.

- So far, payments received in convertible foreign exchange were not subject to service tax. This exemption has now been withdrawn;
- The Bill has introduced the advance ruling mechanism, for *inter alia*, classification of services, valuation of services, etc. Non-residents who have set up joint ventures in India and Indian WOS of foreign companies would be eligible to seek advance rulings in relation to the above; and
- Credit for service tax paid on services consumed or duties paid or deemed to be have been paid on goods used for providing taxable services, will now be available across the board i.e. inter head service tax credit will now be available.

EXCHANGE CONTROL

To enable Indian companies to globalize and capture the opportunities in diversified fields, the Budget proposes to allow

Indian companies with proven track record to make overseas investments, on an automatic basis, in companies which may not be engaged in the core activities of the investing company. Further, the Indian company would now be permitted to invest upto 100% instead of the earlier 50% of its net worth in the overseas company without prior approval of the Reserve Bank of India. Indian companies would now be permitted to prepay their foreign exchange borrowings upto USD 100 million without prior approval of the Reserve Bank of India.

With a view to leverage and promote India's strategic economic interests abroad, and promote India as production centre and an investment destination, an "India Development Initiative", is proposed to be established in the Ministry of Finance with an allocation of INR 2 billion.