

# Indian Budget 2004-05

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For the International Business Community

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## From the Editors

Dear Friend,

In the backdrop of rising fiscal deficit and the much-hyped Common Minimum Program, capital markets and industry were skeptically awaiting the budget proposals of this “dream team” consisting of eminent economists and fathers of first generation reforms in India. The announcements, *albeit* expected, have largely concentrated on agriculture, rural and infrastructure development, employment generation and an unprecedented focus on education. The Finance Minister (“FM”), Mr. P. Chidambaram, has reiterated that although fiscal responsibility is one of his key concerns, fiscal reforms would not be introduced in a hurried and piece-meal manner. In this ebulletin, we have culled out the key Budget proposals that impact the international business community.

By and large, the Budget seems to have done little and to a large extent has relegated itself to announcements of policy initiatives in response to populous demands. The FM seems to have counter balanced his fiscal dole outs very deftly to ensure that the tax base is not eroded. For example, tax exemption for gains on listed long term securities is tagged with securities transaction tax at the rate of 0.15% on transactional value across the board. Further, since the exemptions on long-term capital gains tax and reduction in short-term capital gains tax rate to 10% have been announced only in respect of listed securities, investing into India through tax favorable jurisdictions such as Mauritius may still lure private equity and other investors who may not stand to benefit from this concession. The proposal to levy service tax on sale of IP could lead to potential double taxation under service tax and income tax law. The withdrawal of tax exemption on deposits in NRE account and levy of income tax on receipt of gift by unrelated resident individuals may come as a disappointment to the non-resident Indian community.

Some of the items on the wish list of many have been given a complete go-by, such as change in tax rates, review of dividend distribution tax, controversies surrounding BPO taxation, transfer pricing, FDI in real estate and retailing *etc.* The positives include infrastructure exemptions to boost housing, agriculture, IT, telecom and power sectors together with increase in FDI ceilings for insurance, telecom and civil aviation. It has also been proposed to put many of the functions of the Foreign Investment Promotion Board under the automatic route and realign its role to serve as a one-stop service centre and facilitator. In order to provide a special thrust to education, the FM has levied an “education cess” of 2% on all taxes/duties across the board. Further, to encourage investments in health sector, the FM has announced tax holiday for hospitals set up in rural areas. The new tonnage tax scheme on shipping companies has been finally introduced.

Considering the fact that this government has just come to power and the track record of the “dream team”, one hopes that their best is yet to come! As prophesied by the FM, “**this century will be India’s century**”.

-[The International Tax Team](#)

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**DIRECT TAXES**

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The income tax rates for individuals and corporates have remained unchanged. However, the Finance Minister ("FM") has proposed an educational cess ("Education Cess") of 2% of the total income tax (inclusive of surcharge), excise duty, customs duty and service tax.

The FM had abolished the gift tax regime in India when he was the FM in 1997. However, he has attempted to partially reintroduce the same in the Finance (No.2) Bill, 2004 ("Bill"). With a view of check money laundering, certain "gifts" from persons other than relatives, are sought to be taxed as income.

As per the proposed amendment, any sum received by an Individual or a Hindu Undivided Family ("HUF") from any person in cash, cheque or in any other mode, other than for any consideration for goods or services, would be treated as income in the hands of such individual or HUF, unless the value of the same is less than INR 25,000. Thus, if an Indian resident receives a gift from his non-resident Indian friend, he will have to pay income tax on the amount of gift that will be construed as income in excess of INR 25,000 in the aggregate. However, gifts in kind may not be included.

The Bill proposes a 100% tax exemption to individuals earning income upto INR 100,000, though they are still required to file tax returns. The tax rates applicable to individuals earning income above this threshold are as follows:

Income (in INR)	Tax*
0-50,000	NIL
50,001-60,000	10%
60,001-150,000	20%
150,001 and above	30%

\*Income earned above INR 850,000 is subject to a surcharge of 10% on the total tax liability. A proposed Educational Cess of 2% would be levied on total income tax inclusive of surcharge.

The rates of taxation for other entities remain as under:

Status	Tax**
Partnership firms	35%
Domestic Companies	35%
Foreign Companies	41 %

\*\* These rates are exclusive of the surcharge of 2.5% and the proposed Education Cess of 2% on the tax including the surcharge.

All rates mentioned herein are exclusive of surcharge and Education Cess.

**FOREIGN INVESTMENTS**

In a major step towards free-market reforms, the foreign direct investment ("FDI") limits in the fast-growing sectors of telecom, civil aviation and insurance have been raised. It is proposed to set up an investment commission, which will engage in, discuss with and invite domestic and foreign businesses to invest in India. Many of the functions of the Foreign Investment Promotion Board will be brought under the automatic route and its role will be recast as a one-stop service center and facilitator. In order to promote India as a major hub for manufacturing and exports, a bill for regulating Special Economic Zones is likely to be introduced.

**CAPITAL MARKETS**

In order to broaden and deepen the capital markets, the FM has announced a number of changes, which would provide the much-needed fillip to the capital markets. It is proposed to integrate the commodities markets and the securities markets.

Dividends continue to be exempt in the hands of the shareholders, and the dividend distribution tax is retained at 12.5%. It is proposed to expand the scope of anti-abuse provisions to cover dividend-stripping and bonus-stripping transactions in units of mutual funds.

With a view to revamp taxes on securities transactions, the FM has announced a withdrawal of the long-term capital gains tax on the sale of listed securities on the stock exchange, and a reduction of short-term capital gains tax rate on listed securities to 10%. However, he has proposed a securities transaction tax of 0.15% on the transaction value on all transactions on the stock exchange, which is to be borne by the purchaser of securities.

The concessions announced on capital gains tax rates do not apply to investments in unlisted securities. In light of that and considering the need of investors to have certainty in tax regime, many long-term investors may still prefer to invest through tax favourable jurisdictions such as Mauritius.

**FOREIGN INSTITUTIONAL INVESTORS ("FII")**

It is proposed to simplify the registration and operating processes for FIIs. The investment ceiling for FIIs in debt funds is proposed to be raised from USD 1 bn to USD 1.75 bn. This will

give a boost to the ailing debt market in India as the current limit of USD 1 bn has long been exhausted and SEBI has not been granting any fresh approvals for debt funds. The imposition of securities transaction tax, will increase the cost of transaction for the FIIs. Such a transaction tax, not being a tax on income, will not be creditable in the hands of FIIs in their home countries.

### **MUTUAL FUNDS**

Income distributed by an equity-oriented mutual fund continues to be exempt from tax. However, in the case of debt-oriented mutual funds a 12.5% tax is proposed to be continued for distributions made to individuals and HUF. Distributions made to other persons (including companies) are proposed to be taxed at the rate of 20% with effect from July 9, 2004. This could significantly impact the income schemes, which had found favour with many corporates as an attractive means to invest short-term cash surpluses.

### **VENTURE CAPITAL FUNDS (“VCFS”)**

Income of VCFs registered with SEBI set up to invest in Venture Capital Undertakings (“VCUs”) is tax exempt in India. An amendment has been proposed to align the definition of VCUs with the one in SEBI (VCF) Regulations. A VCU as defined in the SEBI (VCF) Regulations is an Indian unlisted company. While the recent amendment to SEBI (VCF) Regulations allows a VCF to invest up to 1/3rd of its corpus in securities of listed entities (including in debt instruments), there remains an ambiguity on taxability of income received from investee companies which do not fall within the definition of VCUs. Though the intent of the legislation seems to be to exempt all income of VCFs, the letter of law is unclear. Hence, it is expected that there may be a need for a clarification on the taxability of such income and timing thereof in the hands of VCFs and its investors.

### **SECTOR SPECIFIC REFORMS**

#### **IT / TELECOM**

Currently there exists a tax holiday for ten years for new undertakings set up to provide telecommunication services, basic and cellular, including satellite, broadband and internet services. The time period for setting up such new undertakings has been extended by one more year, upto March 31, 2005.

The tax exemption for export of goods and services has been left untouched. Much needed clarification on taxation of outsourcing

industry is conspicuous by its absence. The following indirect tax concessions have been offered:

- ?? Customs duty exemption to mobile switching centers currently available to cellular mobile telephone service providers is now extended to imports by universal access service providers
- ?? Customs duty exemption presently available to specified goods for manufacture of telecom grade optical fibers and cables has been extended to additional inputs items
- ?? Computers, including central processing units cleared on a stand alone basis but excluding input or output devices/accessories cleared separately, have been excluded from excise duty.

#### **BANKING AND SECURITISATION**

The Supreme Court of India has recently upheld the constitutional validity of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. However, the Court observed that certain provisions granting unbridled powers to the lenders could be constitutionally challenged. It is now proposed that necessary amendments shall be carried out to the above provisions so as to give a fair deal to borrowers and at the same time ensuring effective and timely recovery by the lenders.

It is proposed to increase banks' exposure to capital markets. The rate of interest on small savings instruments has been left untouched at 8%.

It would also be pertinent to note here that just prior to the Budget, the Reserve Bank of India has proposed certain guidelines for diversification of shareholding in private sector banks under which it has been proposed to cap the investment from any single shareholder (including the group) to 10% and also cap inter-bank cross-holding to 5%.

#### **AUTOMOBILE**

In order to laud an already well-performing automobile industry, the FM has announced a 150% deduction for research and development expenses incurred by automobile companies on in-house research.

### HOSPITALS

New hospitals with 100 beds or more set up in rural areas to be eligible for tax holiday equal to 100% of profits for a period of five years.

### INFRASTRUCTURE

The FM has emphasized that a sustainable growth of the economy depends upon the availability of efficient infrastructure and has promised to remove the inadequacies in infrastructure facilities through a mix of policy measures.

Income by way of dividends (other than dividends distributed by domestic companies on which tax has already been paid), interest and long-term capital gains of an infrastructure capital company engaged in investing in or providing long-term finance to infrastructure projects is currently tax exempt. It has now been proposed that such income will be includible in the book profits of such company, for computing Minimum Alternate Tax of 7.5%.

The tax benefits available to a new enterprise engaged in generation, transmission or distribution of power have now been extended even to the existing enterprises, which undertake substantial renovation and modernization of the existing transmission or distribution lines up to the year ending on March 31, 2006. Further, in view of the ongoing reforms of the state electricity laws, it is proposed to remove the restrictions imposed on the transfer of old plant and machinery previously used by the State Electricity Boards.

### SHIPPING: TONNAGE TAX

The long standing demand of the Indian shipping industry has been acceded to by introducing the much debated tonnage tax scheme. The proposed scheme is along the lines of the Tonnage Tax system in the UK. It is sought to be an optional tax scheme, which would be applicable to "qualifying companies" engaged in the business of operating "qualifying ships". A qualifying company has to make an election for being taxed under this scheme on presumptive income at normal corporate tax rate. Once elected, it would be valid for 10 years. The Bill describes the type of income covered, the conditions to be fulfilled on an ongoing basis, etc. These are briefly discussed below:

A qualifying company is a company, which is incorporated in India, has its place of effective management in India, owns at least one qualifying ship and its main object is to carry on the business of operating qualifying ships. For this purpose, a

qualifying ship would mean a sea going ship or vessel registered under the Merchant Shipping Act, 1958 of at least 15 net tonnage capacity, with a valid certificate indicating its net tonnage. However, vessels such as fishing vessels, factory ships, pleasure crafts, dredgers, etc. are not covered within the purview of qualifying ships. A company is regarded as operating a ship, if it operates any ship, whether owned or chartered by it, either in full or under a slot charter, space charter, joint charter arrangement.

Further, the Bill describes "relevant shipping income" to include income from core shipping activities, such as profits from operation of qualifying ships, from pooling arrangements, from contracts of affreightments and from activities, incidental to such core activities provided that they do not exceed 0.25% of turnover from core activities. The tonnage income is proposed to be computed with reference to daily tonnage income of each qualifying ship multiplied by the number of days in a year for which the company operates the ship.

The scheme is also envisaged to be applicable to ships registered outside India provided certain requirements are complied with. It is proposed that the scheme would continue to apply post merger or a demerger, provided the company had already made election for being taxed under the scheme.

### AGRICULTURE

Boosting agricultural growth through diversification and development of agro-processing was one of the objectives of the National Common Minimum Programme. Accordingly, it is proposed to offer a tax holiday to undertakings engaged in the business of processing, preservation and packaging of the fruits and vegetables.

## **MISCELLANEOUS PROVISIONS**

### NON-RESIDENT INDIANS

Last year the definition of resident but ordinarily resident individual had been changed in a manner that if an individual has been a tax resident in India for a continuous period of 2 years, then he would become ordinarily resident in India and his worldwide income would be subject to tax in India. It was expected that the FM would provide some relief in this provision. This expectation has been belied.

Additionally, the Bill seeks to remove the tax exemption, which was granted to non-residents on interest income from Non-resident External ("NRE") Account.

#### AIRCRAFT LEASING

The exemption from tax on payments to a foreign company for lease of aircraft or aircraft engine is sought to be withdrawn for any agreement entered on or after September 1, 2004.

#### TAX TREATIES - NON-DISCRIMINATION

Currently, foreign companies are taxed at the rate of 40% in respect of their India branch/permanent establishment profits compared to an Indian company being taxed at the rate of 35%. Thus, the Indian tax laws enables the Government to levy higher rate of tax on foreign companies without attracting the non-discrimination article in the tax treaties, if the foreign company did not make prescribed arrangement for declaration of dividend in India. Recently a tax tribunal ruled that since the Government had not prescribed any rules for foreign company to declare dividends in India, this provision could not be made applicable and the Government could not take shelter under this provision for charging higher rate of tax to foreign companies. By deleting the provision regarding prescribed arrangement for declaration of dividends by foreign company in India, which had become redundant, the Bill seeks to overturn this decision.

## INDIRECT TAXES

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#### VALUE ADDED TAX (VAT)

The central and state governments have once again committed to introduce VAT from April 1, 2005. Many state governments have already passed the respective VAT bills in the respective state parliaments, the rest of the states have been requested to do so by end of December 2004. In order to compensate the states for the potential revenue loss by adoption of VAT, the Central Government has agreed to work out a suitable compensation formula.

#### CUSTOMS DUTY AND EDUCATION CESS

?? No change in peak customs duty rate of 20%

?? An Education Cess levied on aggregate customs duty (excluding safeguard duty, countervailing duty and anti dumping duty); aggregate excise duties and service tax at

the rate of 2%. Education Cess paid on inputs and capital goods will be creditable against payment of cess on final products and services.

#### SERVICE TAX

?? Service tax rate to be hiked from 8% to 10%

?? Following new services to be brought within the service tax net:

- o Airport services
- o Business exhibition services
- o Construction services in respect of commercial or industrial buildings or civil structures
- o Forward contract services
- o Intellectual property services, other than copyright
- o Opinion poll services
- o Outdoor catering / Pandal or shamiana services
- o Survey and exploration of minerals
- o Transport of goods by air / road
- o TV or Radio programme production
- o Travel agents (other than air/rail travel agents)

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

?? Definitions of certain taxable services have been amended as under:

- o Business auxiliary services to now include: (a) procurement of goods or services which are inputs for the clients; (b) production of goods on behalf of clients (c) provision of service on behalf of the client and (d) incidental / auxiliary services such as collection or recovery of payments, maintenance of accounts, inventory management, development of prospective vendors and management or supervision;
- o Commissioning and installation of plant, machinery and equipment to now include "erection";
- o Consulting engineer to exclude computer hardware or software engineering;
- o Financial services to include other financial services such as lending, issue of pay orders, demand drafts, cheques, letter of credit and bill of exchange, providing bank guarantees, overdraft facility, bill discounting

facility, safe deposit lockers, safe vaults, operation of bank accounts;

- o Stock brokers to include "sub-brokers"

?? Following exemptions have been rescinded:

- o maintenance or repair of computers, computer systems or computer peripherals under a maintenance contract or by the manufacturer has been removed;
- o broadcasting services by a cable television operator