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Indian Budget: 2006-07

For the International Business Community February 28, 2006

From the Editor

Dear Friends,

The cat (*a.k.a.* the Budget) is out of the bag. Private equity, foreign venture capitalists, Foreign Institutional Investors ("**FIIs**"), and other foreign investors can rejoice. The Indian economy has grown at the rate of 8.1% as compared to last year's 7.5%, while inflation has declined to 4.1% from 5.7% of the last year, signaling continued growth and increased trade, both domestic and international.

The other piece of good news is that the income tax rates remain unchanged. Our tax rates compare favourably with other countries. The maximum domestic tax rate is 33.66%, with no further state or city level income tax. Agricultural income is tax exempt. While it was feared that inheritance and gift taxes (earlier abolished), would return, this has not happened. On the flip side, much needed changes like introducing provisions for Advance Pricing Agreements, streamlining the cross border M&A regime and clearing ambiguities surrounding taxation of FIIs have been given a miss.

The Budget appears to have a special focus on turning India into a preferred destination for manufacturing semi conductors, other hi-technology products, textiles, petro-chemicals, leather, and automobiles. Food processing, health care, bio-tech and hospitality sectors have not been left out either. This should attract big ticket FDI and private equity investment into India in these sectors. It is also proposed to make India a hub for gem and jewelry, which should create new vistas for designers and retailers. Since micro finance has been very successful in India, a statute to regulate this sector is proposed to be introduced soon.

As a part of its e-governance initiative, the Government endeavors to make certain compliances electronic, thereby improving business ease and speed. Significantly, these include filing returns electronically, on-line applications under the Right to Information Act, and filing of police complaints. Housing records and copies of land records would also be maintained electronically, facilitating investments by recently floated Real Estate Investment Funds.

On the capital markets front, FIIs can now invest more in government securities and corporate debt. Further, the vistas for investments by Indian mutual funds in foreign securities have also increased, thereby integrating Indian capital markets with the global market. However, securities transaction tax on sale of listed Indian equity has been increased from 0.1% to 0.125%. Also, Minimum Alternate Tax ("**MAT**") has been increased from 7.5% to 10% (excluding surcharge and cess) of book profits and the exempt long term capital gains on listed securities have been brought within the MAT net. This move could adversely impact foreign companies (including those investing from Mauritius) having a permanent establishment in India.

The service sector contributes 54% of the GDP and continues to hold the government's attention. Service tax rate has not only been increased from 10% to 12%, but many new services have been brought into the tax net, including sale of space or time for advertisements, auctioneers services, ship management services, clinical testing services and internet telephony services. It is also proposed to introduce a national level Goods and Service Tax from April 1, 2010.

Changes in customs duties have been proposed, bringing the peak rate for non-agricultural products down from 15% to 12.5% increasing India's competitiveness in the East Asian markets.

On the whole, Budget 2006 aims to continue the ongoing reforms process in India, creating long term opportunities for industry and investors while retaining general stability in the tax and regulatory regime.

-**The International Tax Team**

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DISCLAIMER

DIRECT TAXES

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Rates

The Finance Bill, 2006 ("**Bill**" /"**Budget**") has proposed very minimal changes in the rates of direct taxes. There has been no change in rates of personal income tax or corporate income tax and no new taxes have been introduced.

- **Individual tax rates**

Since the personal tax remains unchanged, the rate of taxes in relation to Individuals, Hindu Undivided Families, Association of Persons etc. would be as follows.

Income (in INR)	Rate [1]
0 to 100,000 [2]	NIL
100,000 to 150,000	11.22%
150,000 to 250,000	22.44%
Above 250,000	33.66%

1. Inclusive of surcharge of 10% on income above INR 1,000,000 and education cess of 2%.
2. INR 125,000 for resident women and INR 150,000 for resident senior citizens.

While the rate of tax applicable to co-operative societies and local authorities remains unchanged, the applicable surcharge at the rate of 2.5% is proposed to be withdrawn.

- **Corporate tax rates**

The effective corporate tax rate for domestic companies remains at 33.66% while that for foreign companies continues at 41.82%. Dividends continue to be exempt in the hands of the shareholders and the domestic companies distributing dividends would continue paying a Dividend Distribution Tax ("**DDT**") of 14.025%.

- **Minimum Alternate Tax ("MAT")**

The Budget proposes to increase the scope and the rate of MAT applicable to companies. Currently, the companies paying corporate tax which is lower than 7.5% of the book profits, are liable to pay the MAT at the rate of 7.5% of the book profits. The Budget proposes to increase the MAT rate to 10%, leading to the effective rate of 11.22% in case of Indian companies and 10.455% in case of foreign companies with respect to any assessment year commencing on or after April 1, 2007.

The book profits subject to MAT will now include long term capital gains derived from the sale of securities on a recognized stock exchange, which are currently tax exempt. This effectively means that such long term capital gains would now be subject to MAT. MAT will also be applicable to depreciation on revaluation of assets that has been debited to Profit & Loss account or to an amount withdrawn from revaluation reserve that has been credited to Profit & Loss account.

- **Securities Transaction Tax ("STT")**

The STT rates have been increased by 25% across the board, on the existing rates.

Capital Markets

The Budget provided an impetus to the capital markets by introducing a single unified exchange traded market for corporate bonds in India. Further, the investment ceiling for Foreign Institutional Investors to invest in government securities and in corporate debt has been raised from $ 1.75 billion to $ 2 billion and from $ 0.5 billion to $1.5 billion respectively.

Further, a mutual fund set up in India can now invest upto $ 2 billion in foreign securities, which are listed on a stock exchange. Previously a mutual fund could invest only upto $ 1 billion. The requirement that the foreign company in which an investment is being made must hold at least 10% of an Indian listed company has been done away with. This will provide mutual funds with a wide spectrum of overseas investment opportunities. It is also proposed that a limited number of qualified Indian mutual funds will be permitted to invest upto $ 1 billion in the aggregate in overseas exchange traded funds.

One disturbing aspect to the Budget which could be detrimental for foreign investors is the amendment to the provisions of MAT. Foreign investors who realise long term capital gains from Indian listed securities and who claim an exemption under the ITA could be subjected to MAT thus effectively creating an illusion that long tem capital gains are exempt. However, it may not be detrimental for investors who take tax treaty shelter.

With a view to provide close ended equity oriented mutual funds a level playing field with open ended equity oriented mutual funds, the DDT of 12.5/20% (depending on the type of investor) levied on close ended equity oriented funds has been done away with.

Further, it has been proposed to align the definition of 'equity oriented fund', by defining an equity oriented fund as a fund where the investible funds are invested by way of equity shares in domestic companies to the extent of 65% (currently

50%) of the total proceeds of such fund. These amendments are to be effective from June 1, 2006.

- **Roll over of capital gains in certain cases**

Currently, capital gains arising from the transfer of a long term capital asset are exempt from tax if the capital gains are invested in certain specified bonds. This benefit is proposed to be restricted only to certain bonds of specified institutions. The roll-over benefit for the currently available capital gains tax exemption for transfer of long term capital asset, being listed securities or units of a mutual fund or of Unit Trust of India has been proposed to be withdrawn.

Special Economic Zones ("SEZs")

The SEZ regime came into effect from February 10, 2006. The SEZ regime provides significant tax benefits to a developer and an entrepreneur setting up a unit in an SEZ. With the tax holidays available to Software Technology Parks ("**STPs**") and Export Oriented Undertakings ("**EOUs**") due to expire by the year 2009, the SEZ regime is set to take momentum.

- **Developers of a SEZ**

The developers of a SEZ are entitled to a deduction of 100% of profits for a period of any 10 consecutive years out of 15 years, beginning from the year in which the SEZ is notified. Further, developers of an SEZ are also exempt from paying the MAT on any income arising from business carried on or services rendered in an SEZ and from the DDT payable on dividends distributed.

- **Units for Export of Goods or Services**

An entrepreneur who has an unit in an SEZ is entitled to a phased exemption of 15 years on profits and gains derived from export of goods and services from the unit, which is 100% for the first five consecutive years, 50% for the next five consecutive years and 50% for the remaining five consecutive years, subject to the profits being debited to the Special Economic Zone Re-investment Reserve Account. The unit is further exempt from MAT but not from DDT. There is an exemption from capital gains arising on transfer of assets to an SEZ. The other significant tax benefits are service tax exemption to any service provider providing services to an SEZ, excise and customs duty exemptions on goods imported or exported from an SEZ, *etc*.

- **Offshore Banking Unit ("OBU") and International Financial Services Center ("IFSC")**

Income of OBUs and IFSCs from certain businesses is totally exempt for the first 5 years and to the extent of 50% for the next five years. No tax is payable on interest received by non-residents on deposits made with OBU on or after April 1, 2005.

With the fiscal incentives in place and the government providing a single window clearance for SEZ developers and units, the regime is geared to attract significant foreign exchange. At present approvals have been given for setting up 117 SEZs, of which 7 SEZs have become functional. During April-December, 2005, alone the exports from SEZs stood at about $ 3.5 bn.

Infrastructure

The tax exemption for long term capital gains and interest of an infrastructure capital fund or infrastructure capital company or a co-operative bank arising out of investments or long-term finance made in any infrastructure undertaking, including power generation projects, telecom services, housing projects, hotel and hospital projects has been withdrawn.

The Budget proposes to extend the 10-year tax holiday for profits from development, maintenance or operation of an industrial park to those notified till March 31, 2009. The tax holiday available for the power sector has been extended from March 31, 2006 to March 31, 2010.

Aircraft Leasing

The exemption available to a foreign enterprise deriving lease rental income from operation of aircraft is proposed to be extended by one more year till March 31, 2007.

Fringe Benefit Tax ("FBT")

Budget has made minor changes to the much-debated FBT regime introduced last year. This is the new tax which is levied on any benefit, service or facility provided by an employer to his employees. The constitutional validity of FBT has been challenged in the courts.

Benefits in the nature of provision of hospitality and the use of hotel, boarding and lodging facilities by employers engaged in the business of carriage of passengers or goods by aircraft or by ship will now be valued at 5% instead of 20%. Benefit arising from "tour and travel (including foreign travel)" will also be valued at 5% of the expenses now. Contributions to superannuation funds up to INR 100,000 will no longer be subject to FBT. It is proposed to exempt any expenditure incurred on distribution of free samples of medicines and medical equipment distributed to doctors, from the scope of FBT.

Charitable Institutions

In order to tax unaccounted money being contributed by way of anonymous donation to universities, hospitals, trusts or charitable or religious institutions, the Bill proposes to tax any income comprising of anonymous donation (with certain exceptions) received by such institutions at the maximum marginal rate of 33.66%.

Filing of Returns

The Budget proposes to withdraw the 1/6 scheme which required persons fulfilling certain criteria to furnish a return of income irrespective of whether they had income chargeable to tax in India. This will provide relief to many Non Resident Indians ("NRIs") who were compelled to file a tax return merely by virtue of owning a house in India or by subscribing to cell phone in India.

The Budget proposes to introduce new scheme under which, persons other than companies and other specified taxpayers may file their returns through 'tax return preparers' along the lines of the US. Officers of Scheduled Banks where the taxpayer holds a current account or where he has regular dealings, a legal practitioner or accountant are not eligible to be a 'tax return preparer'.

Permanent Account Number ("PAN")

In an endeavor to collect more information useful to the revenue, the Budget proposes that the Central Government will notify a class or classes of persons who must apply to the Assessing Officer for a PAN. The Budget also proposes to confer powers on Assessing Officer to suo motu issue PAN to persons, having regard to the nature of transactions undertaken by such person.

INDIRECT TAXES

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Customs and Excise

- Peak customs duty on non agricultural products has been reduced to 12.5% from the existing 15%;
- Customs duty has been reduced to 5% on vital and life saving drugs, 10% in case of manmade fibers reduced and 5% in case of packaging machines;
- Transfer of goods from EOUs to DTA units to be subject to 25% basic customs duty and full countervailing duty;
- Packaged software sold over the counter will attract excise duty at of 8%. However customized software or software downloads will be exempted from such levy;
- Excise duty of 12% imposed on computers. However, should not be any impact on prices as the manufacturers shall be eligible for full input tax credit. DVD Drives, Flash Drives and Combo Drives to be exempted from excise duty.
- Special countervailing duty of 4% levied on all imports. However full credit of this duty available to manufacturers against excise duty. Articles of jewellery to attract lower special countervailing duty stands of 1%. Further, goods exempt from Value Added Tax ("**VAT**"), passenger baggage and DTA clearances to EOUS/STPs/SEZ/EHTP units otherwise exempt from VAT/sales tax not to attract this duty.
- Customs duty on Set Top Boxes, whether or not covered under ITA (Information Technology Agreement), has been unified at Nil customs duty plus 16% CV duty plus 4% special additional duty of customs.
- Excise duty on aerated drinks and small cars reduced to 16% from the existing 24%. Small cars is defined to mean cars not exceeding 1200 cc (petrol cars) / 1500 cc (diesel cars).

Service tax

- Service tax rate is proposed to be increased to 12% from existing 10%; effective rate inclusive of education cess would be 12.24%;
- Following 15 new services are proposed to be inserted: Services provided by registrar to an issue, services provided by a share transfer agent, services in relation to Automated Teller Machine operations, maintenance or management, services provided by recovery agents, sale of space or time for advertisement service (excluding sale of space for advertisement in print media and sale of time slots by a broadcasting agency or organization), sponsorship service (excluding sponsorship in relation to sports events), scheduled or non-scheduled air transport service of any passenger embarking in India for international journey, in any class other than economy class, transport of goods in containers by rail provided by any person, other than Government railway (Indian Railways), business support services, Auctioneers' service, public relations service, ship management service, Internet telephony service, transport by cruise ship, and credit card, debit card, charge card or other payment cards related services.
- Following existing services are proposed to be amended: banking and other financial services, management consultancy services, maintenance or repair services, erection, commissioning or installation services, consulting engineer services, business auxiliary services (so as to

include computerized data processing). In several of the existing services, the words "commercial concern" are proposed to be substituted with "any other person". This seemingly unassuming change will have a big impact on all those entities, such as trusts, which currently may fall outside the service tax net.

- The definition of “technical testing and analysis” is proposed to be expanded to include clinical testing of drugs and formulations; but to exclude testing or analysis for the purpose of determination of the nature of diseased condition, identification of a disease, prevention of any disease or any disorder in human beings or animals.
- In continuation to the consumption based tax principle for service tax, the finance minister proposes to introduce the 'reverse charge' concept in the service tax regime whereby foreign offices of Indian entities that provide services to the Indian offices of foreign entities would become subject to service tax in India.
- Another important amendment proposed to be introduced by the finance bill relates to services provided by an unincorporated association or body of persons to its members for cash, deferred payment or any other valuable consideration. Such services shall be treated as services provided by any person to any other person and shall now fall within the ambit of service tax.
- The provisions relating to obtaining advance rulings are proposed to be amended to permit the Authority for Advance Rulings to adjudicate on a question relating to determination of the liability to pay service tax on a taxable service.
- Following amendments to become effective from March 1, 2006:
    - For purposes of computing value of taxable service in case of financial leasing services including equipment leasing and hire-purchase, 90% of the amount representing interest shall be ignored for levy of service tax. This exemption shall not apply to other charges such as lease management fee, processing fee, documentation charges and administration fee.
    - Exemptions in relation to general insurance where (i) premium is received from re-insurance both domestic and overseas; (ii) all business for which premium is booked outside India, have been rescinded.
    - Exemption to call centers / medical transcriptions centers from the ambit of “business auxiliary services” has been withdrawn.

VAT

- Comprehensive Goods and Services Tax (“GST”) regime to be introduced from April 1, 2010;
- Union government to issue formal proposal for phasing out of Central Sales Tax and compensation to state governments for loss in revenues on account of shift to the VAT regime.