

Indian Budget: 2007 - 08

For the International Business Community

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From the Editor

Dear Friends,

India's Finance Minister, Mr. P. Chidambaram ("FM"), attempted in vain to disguise the punch in the Budget this year. While the corporate tax rates have apparently been maintained at the same rate as last year, the effective corporate tax rate has gone up from approximately 42% to 44%. The rate of education cess has increased to 3% from 2%.

Dividend Distribution Tax ("DDT") has increased from 14.025% to 16.995%. DDT is a tax on the company distributing the dividend and not on the shareholder. The increase in this distribution tax may do more damage to foreign investors than apparent at first glance, because credit for the distribution tax is often not granted in the home jurisdiction.

Apart from increased corporate taxes and DDT, Indian companies will also be subject to Fringe Benefit Taxes ("FBT") in respect of Employee Stock Options exercised by employees, on the difference between the fair market value and the exercise price on the date of the exercise. Further, FBT is not a deductible expense. More importantly, the taxable value is uncertain given that the fair market value of the shares at the time of exercise is not determinable before hand, thus causing hiccups in the cash flows of companies.

The woes of Indian companies apart, investors in Venture Capital Funds ("VCF") may not have much to cheer about either. The tax pass-through status that has so far been accorded to the Securities and Exchange Board of India ("SEBI") registered VCFs will no longer be available except to funds investing in nine sectors, such as bio technology, pharmaceutical research etc., to name a few. The tax neutrality afforded to the investors investing through such VCFs may be lost, especially where the VCFs are structured as companies. With the proposed amendments, the advantages of registering with the SEBI needs re-consideration; many funds will need redesigning and re-structuring.

Tax exempt software technology park and export oriented units, which are still coming to terms with the phasing out of tax holidays will now also have to deal with the imposition of a Minimum Alternate Tax ("MAT") of 10%. Given that the tax holiday itself will be phased out by 2009, one would imagine that there would be little to be gained from this amendment.

Apart from bringing in the unexpected, the Budget failed to bring in some of what was expected. The prevailing confusion on the taxation of Foreign Institutional Investors ("FII") was expected to be sorted out by the Budget. The issue remains untouched, and foreign investors remain uncertain of their tax treatment.

The negative reaction to the Budget announced today is evidenced by the significant dip in the Indian stock markets. A new comprehensive tax code is expected to be announced later this year. The Limited Liability Partnership Act is expected to come into force soon. One hopes that going forward the Indian Government will work towards the much needed resolution of some uncertainties and that the ever resilient Indian economy will continue to boom irrespective of the tax dampener, surprising the world with its spirit.

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WEBINAR

[Webinar on Indian Budget – 2007](#)
Insights for the International Business Community

On Friday, March 2, 2007: India 0800 / Singapore 1030;

On Thursday, March 1, 2007: PST 1830 / EST 2130.

For registering please send an email to monica@nishithdesai.com

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DIRECT TAXES

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Rates

The Finance Bill, 2007 (“Budget”) has proposed a few changes in the rates of direct taxes. The surcharge of 10% on income tax levied on partnership firms and companies with a taxable income of INR 10 million or less has been removed. An Additional secondary and higher education cess of 1% has been introduced. There has been no increase in capital gains tax or Securities Transaction Tax (“STT”).

• **Personal Tax Rates**

For the fiscal year 2007-08, the effective rates of taxes on Individuals, Hindu Undivided Families (“HUF”), Association of Persons, etc. would be as follows:

Income (in INR)	Rate ¹
0 to 110,000 ²	NIL
110,000 to 150,000	11.33%
150,000 to 250,000	22.66%
Above 250,000	33.99%

1. Inclusive of surcharge of 10% on income above INR 1,000,000 and education cess of 3% (on tax and surcharge).
2. INR 145,000 for resident women and INR 195,000 for resident senior citizens.

• **Corporate Tax Rates**

The basic corporate rate of tax on domestic companies continues to be 30%. The surcharge on tax at the rate of 10% and the education cess at the rate of 3% (on tax and surcharge) would result in an effective corporate tax rate of 33.99% as against 33.66% in the last fiscal year. The rate of tax on foreign companies continues to be 40% with a surcharge of 2.5% and education cess of 3% (on tax and surcharge) resulting in an effective corporate tax rate of 42.23%. The effective MAT rate for domestic companies and foreign companies will be 11.33% and 10.557% respectively.

The DDT has been increased from 12.5% to 15%. Along with the surcharge and education cess, the effective rate for DDT will be 16.995%. Thus an Indian company would in the aggregate be subjected to an effective rate of tax at 44% (inclusive of the corporate tax and the DDT).

• **Withholding Tax**

There have been several changes in the withholding tax rates applicable to payments made to Indian residents:

- Rent for the use of any machinery or plant or equipment will now be subject to a lower withholding tax of 10% from the existing rate of 15/20%.
- Interest upto INR 10,000 paid by banks or co-operative societies will not be subject to withholding tax.
- Individuals and HUFs, whose total sales, gross receipts or turnover from business or profession exceed INR 20,000 will be required to withhold tax from payments made to contractors at the rate of 2%.
- Fees for professional services or fees for technical services will now be subject to a higher withholding tax of 10% as compared to the current rate of 5%.

Though the Budget has not changed the rates of capital gains tax, it has broadened the tax base for capital gains tax by amending the definition of “capital assets”. Accordingly, transfer of personal assets such as archaeological collections and works of art will attract capital gains tax.

• **Transfer Pricing**

While many ambiguities continue to prevail in the transfer pricing regulations, an amendment in the tax laws is sought to be introduced to prescribe the time limit for the Transfer Pricing Officer (“TPO”) to pass his order determining the arm's length price. Further, currently, the Assessing Officer (“AO”) is required to proceed with the computation of income of the taxpayer having regard to the arm's length price determined by the TPO. This discretion seems to be withdrawn and the AO is now required to compute income of the taxpayer in conformity with the arm's length price determined by the TPO. This will bring relief to many companies, which are currently in litigation against the arbitrary assessments made by the AO.

Capital Markets

In a welcome move, the Budget has announced that financial institutions would now be permitted to short sell securities, provided the transactions are settled by delivery. Securities lending and borrowing to facilitate delivery would be permitted. This is expected to provide the much needed stability to the capital markets. However, FIIs would still need to wait to be able to short sell in the Indian markets. Currently, FIIs are permitted to short sell only in derivatives.

Indian companies will be allowed to unlock a part of their holdings in group companies to meet their financing requirements by issue of Exchangeable Bonds. Further, the Budget has provided simplicity to participants in the securities market by making Permanent Account Number¹ ("PAN") the sole identification number for all operations on the capital market. This is definitely a step in the right direction, as currently there is a lot of confusion regarding the different identification numbers required for participants in the capital market, such as MAPIN (for intermediaries), MIN (for investors in mutual funds).

- **Venture Capital Funds**

While recognizing that venture capital funds provide a useful source of risk capital to start up ventures, the Budget has sent out shock waves to the venture capital community by restricting the current pass through status accorded to SEBI registered VCFs set up in India. Currently, any income of a VCF set up to raise funds for investments in Venture Capital Undertakings ("VCUs") is exempt from taxation. A VCU is defined as an Indian company, which is not listed on any stock exchange. With a view to restrict this tax exemption only to certain truly deserving sectors, the exemption shall now be available only to income from Indian unlisted companies engaged in the business of nano-technology, information technology relating to hardware and software development, seed research and development, dairy or poultry industry, bio-technology, research and development of new chemical entities in the pharmaceutical sector, production of bio-fuels, or building and operating composite hotel-cum-convention centres with seating capacity of more than three thousand.

The changes in the VCF regime were not necessary as the investors paid tax on distribution received from the VCFs in any case. At least completed transactions should have been "grandfathered" from these adverse changes. In most countries, venture capital investments are pooled into tax transparent entities. Absence of such tax transparent entities in India would make it challenging for the Indian companies to attract venture capital funding.

- **Mutual Funds**

Currently Indian residents are allowed to invest in foreign securities by remitting upto US\$ 50,000 per financial year and domestic mutual funds are allowed to invest upto 10% of their net assets in foreign securities. The Budget has proposed a

¹ PAN is an identification used for tax purposes in India.

convergence of the different regulations by permitting individuals to invest in foreign securities through Indian mutual funds.

The Budget has increased the tax on income distributed by money market mutual funds and liquid funds to 25%. This could be of concern to the institutions and corporates who generally invest their cash surpluses in such funds. Any income distributed by a mutual fund (other than an equity oriented fund and money market or liquid fund) to an individual or a HUF will be subject to an income distribution tax at the rate of 12.5% while income distributed to a person other than an individual or a HUF will be subject to an income distribution tax at the rate of 20%.

- **Commodities Trading**

Currently any income received by Investor Protection Funds set up by recognised stock exchanges by way of contributions received from recognised stock exchanges and its members is exempt from tax. In order to provide a level playing field to commodity exchanges, a similar tax exemption is proposed for Investor Protection Funds set up by them. Further, the Government will set up an expert committee to examine forward trading in commodities.

Banking

The Budget proposes to extend the Securitisation and Reconstruction of Financial Assets and Enforcement of Securitisation of Interest (SARFAESI) Act to loans advanced by Regional Rural Banks ("RRBs"). It is proposed to permit RRBs to accept NRE/FCNR deposits.

Special Economic Zones ("SEZ") and Software Technology Parks ("STP")

The FM has not acceded to the plea of the IT industry to extend the tax holiday which is set to expire in fiscal year commencing in April 2009. Instead, the FM has levied MAT on STP/EOUs enjoying tax holiday under section 10A and 10B.

The golden run enjoyed by the IT industry seems to be nearing an end, and a new regime has emerged in the form of SEZs. The graded tax holiday for 15 years is available to units set up in SEZs. The Budget seeks to restrict the tax holiday only to "new" units set up in the SEZs. The new unit should not be set up by the splitting up or reconstruction of an existing business. Further, it should not be formed by the transfer of old plant or machinery. By introducing this provision, the FM has clarified that the tax holiday will not be available to old STP or EOUs that may migrate to SEZs. The new units set up in SEZs will continue to remain exempt from MAT.

Pharmaceutical Industry

The pharmaceutical industry has not received any significant benefits in the Budget, except for the extension of the weighted deduction in respect of any expenditure incurred by a company on in-house research and development facility as approved by the Department of Scientific and Industrial Research ("DSIR"). The extension was set to expire in March 31, 2007 and has been further extended till March 31, 2012. However, the 10 years tax holiday available to research and development companies under section 80IB(8A), which is set to expire in March 31, 2007 has not been extended.

Real Estate

Contrary to the expectation of the real estate industry, the FM has not extended the tax holiday available to the real estate developers with respect to income derived from developing and building housing projects. Accordingly, income of the real estate developers from developing and building housing projects approved by the local authority after April 1, 2007 will be taxable.

Infrastructure

To facilitate the creation of urban infrastructure, the Budget has proposed an exemption for interest on notified bonds issued by State Pooled Finance Entities. Mutual Funds will be allowed to launch dedicated infrastructure funds to promote flow of funds into the infrastructure sector.

The Budget proposes to extend the 10 year tax holiday under section 80-IA to undertakings that lay and operate cross country natural gas distribution network, and storage facilities integrated to the network as well as navigation channels in the sea. Further, the tax exemption for setting up industrial undertakings in the State of Jammu and Kashmir, which expires on March 31, 2007, is sought to be extended by 5 more years.

However, in a surprising move, the Budget seeks to withdraw the tax holiday available to infrastructure units, which undergo merger or demerger after March 31, 2007. This change is counter intuitive and may act as a disincentive for Indian companies looking to undertake inorganic expansions.

Hotels

Welcoming the Commonwealth Games in the India, a new 5-year tax holiday is sought to be introduced for convention centers and 2, 3 or 4 star hotels as classified by the Central Government and which become operational between April 1, 2007 and March 31, 2010 in Delhi and specified adjacent districts.

Aircrafts

The Indian airline industry is undergoing a transformational phase. The Budget seeks to do little to give any direct tax incentives to this industry. The withholding tax exemption on lease rentals paid on lease of aircrafts and aircraft engines under agreements executed prior to March 31, 2007 has not been extended. However, the benefit of set-off of accumulated losses and unabsorbed depreciation will be available to public sector companies engaged in the business of operation of aircraft, post-merger. The amendment seems to strategically coincide with the proposed merger of Indian Airlines and Air India.

Employee Stock Options and Sweat Equity

The FM has changed the tax incidence on employee stock options and sweat equity. Currently, the shares issued under the Employee Stock Option Plan ("ESOP") are taxable in the hands of the employees only at the time of sale of shares provided the ESOP is in compliance with the guidelines issued by the Government of India. There is an exemption from taxation as a prerequisite at the time of exercise of options. Sweat equity is currently taxed in the hands of the employees at the time of issuance.

As per the proposed amendment, the issuing company will pay FBT at the time of exercise of stock options and at the time of issuance of sweat equity. The exercise of stock options will not be taxable as prerequisite in the hands of the employees. The employee would only be taxed on capital gains when the shares are sold. His tax basis would be the value of shares determined for the purposes of FBT. The requirement to comply with the Government of India guidelines has been done away with. However, there may be possible double taxation in the case of sweat equity as it will continue to be taxed as salary in the hands of the employees at the time of issue and will also be subject to FBT in the hands of the company. This seems to be an oversight on the part of the FM. Further, levy of FBT on exercise of stock options will make it difficult for the companies to predict the tax outflow due to varying market price. This may lead to the tax burden being passed on to the employees.

INDIRECT TAXES

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Customs and Excise

- Peak rate of customs duty on non agricultural products has been reduced to 10% from the existing 12.5%, with a few exceptions;

- The exemption limit available to small-scale industries, for the purpose of payment of excise duty, has been raised from INR 10 million to 15 million.
- **Special provisions for specific sectors:**
 - **Aircraft Industry:** Import of aircraft, helicopters and parts would become more expensive for private aircraft users and non-scheduled airlines. Customs duty of 3% along with countervailing duty of 16% and special additional duty of customs of 4% has been imposed on these imports. However, aircrafts not registered in India and which are brought into India for the purpose of flight to or across India, are exempt from customs duty.
 - **Gems and Jewellery:** A number of reductions have been introduced to encourage export of gems and jewellery. Customs duty on export of cut and polished diamonds has been reduced to 3% from 5%. Export of rough synthetic gemstones will now be taxable at 5% (instead of 12.5%). Unworked corals will be taxed at 10% (against earlier 30%).
 - **Research and Development Institutions:** Research institutions registered with the DSIR, will pay customs duty at the rate of 5% and nil countervailing duty on imports of specified equipment and items. Specified items domestically procured by such research institutions are also exempt from excise duty.
 - **Dredging:** All dredgers will be exempt from customs duty.
 - **Petrol and diesel:** Ad valorem customs duty on petrol and diesel has been reduced from 8% to 6%. Bio diesel has been completely exempted from excise duty.

Service tax

The service tax rate remains the same, at 12% (plus an education cess of 3%). Following new services have been included:

- **Design Services in relation to the Commercial Sector:** Services provided in relation to the design of furniture, consumer products, industrial products, packages, logos etc.
- **Content Development for Mobile and Telecommunication Industries:** Services in relation to development and supply of mobile value added services, mobile content, content for use in telecommunication services (such as telephone services, data services, wired services, wireless

services, carrier services, call management services etc).

- **Telecom Industry:** The provisions relating to taxation of services in relation to the telecom industry have been deleted. It is proposed that a committee be set up by the Department of Telecom for a subsequent introduction of a unified tax in respect of this sector.
- **Management Services:** The definition of “management consultant” has been expanded to include “business consultants” and now includes financial, human resources, marketing, production, logistics, supply chain and information technology management services.
- **Asset management services provided by Individuals:** Services relating to asset management including portfolio management and all forms of fund management, when rendered by individuals.
- **Commercial Leasing Services:** Renting of immovable property for commercial use. There is a specific exclusion for leasing to religious and educational bodies, and leasing of agricultural plots, parking spaces, land used for entertainment purposes, residential buildings etc.
- **Works Contracts (Turnkey projects etc):** Contracts for the erection of plant, machinery etc, construction or repair of buildings, turnkey projects etc. have been brought within the definition of works contract. Where works contract is not divisible option will be given optional for payment of tax at 2% as per the composition scheme to be notified.
- Services relating to the **mining of mineral, oil or gas** have been included and it has been clarified that **software maintenance and repair services** will be taxable.
- **Exemptions:** The threshold exemption from service tax to small service providers has been increased from INR 400,000 to 800,000. Further, services relating to clinical trials for new drugs, services provided by recognized Technology Business Incubators and Science and Technology Entrepreneurship Parks and those provided by incubatee entrepreneurs whose turnover does not exceed INR 5,000,000 have been exempted from the service tax net.

Value Added Tax ("VAT")

- Comprehensive Goods and Services Tax ("**GST**") regime to be introduced from April 1, 2010;
- Central Sales Tax reduced from 4% to 3%.

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