

BUDGET 2002-03 : INDIA

For the International Business Community

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From the Editors

Dear reader,

The Budget for the year 2002-2003 was presented in the Indian Parliament amongst high expectations in terms of capital market reforms and the lowering of interest rates in the background of a high fiscal deficit. The focus of this Budget seems to be on reforms in the agricultural and food sectors, defence and collections. For the private sector, the Budget is fairly tepid and has failed to address key concerns such as greater movement towards capital account convertibility and significant tax breaks for emerging industries like entertainment. The move to reduce the tax incentives available to companies engaged in the export of IT products/services is detrimental to the credibility of the Government and the sanctity of the tax incentives offered by it, on the basis of which several foreign investors have set up operations in India. Though the Finance Minister focused on public investment in infrastructure in his Budget speech, no concrete tax breaks have been offered in the Budget.

For international investors, a few welcome changes have been ushered in by the Budget with the reduction of tax rates on foreign companies from 48% to 42% (inclusive of a 5% surcharge), the permission extended to Indian mutual funds to invest in foreign rated securities, an increase in the overseas direct investment limits by Indian companies and the liberalization of sectoral caps for portfolio investment by Foreign Institutional Investors. Tax benefits available to re-conversion of shares into American Depository Receipts/Global Depository Receipts are extended to unlisted companies though the corresponding changes in the regulatory regime still needs to be introduced. These changes should provide some buoyancy to the capital markets and an impetus to international mergers and acquisitions.

Although the Budget did not make any significant moves towards capital account convertibility, it permits full convertibility of rupee deposits by Non-resident Indians and has brought the issue of Foreign Currency Convertible Bonds by Indian companies under the automatic route. The abolition of dividend distribution tax and shifting of the tax liability on dividends back to shareholders may re-emphasize the need to rely on tax treaties such as the one with Mauritius.

The common thread running through the Budget is an emphasis on stability and revenue. This is evidenced by the widening of the tax net on the services industry and the balance in the revenue collections from customs duties seems to have been cleverly maintained. In a significant move, the Customs Tariff Act has been amended to provide for imposition of a transitional duty on imports from China. This seems to be a strong measure taken to protect the domestic industries.

On the face of it, though the Budget may appear to be lackluster, it does have a few interesting aspects in terms of deregulation of the agriculture and food sector, increased benefits to Indian companies looking to globalize and incentives for foreign investors.

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-The International Tax Team

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Tax Rates

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The Budget 2002-03 (the "Bill") has made no changes to the basic tax rates in respect of individuals and corporates, including the standard deduction in respect of individuals. The Finance Minister proposes to withdraw the 2% surcharge introduced on account of the Gujarat earthquake and has introduced a surcharge of 5% on account of national security. The table below gives the rates of tax (including surcharge of 5%) applicable to resident and non-resident individuals:

Income (in INR)	Tax
0-50,000	NIL
50,001-60,000	10.0%
60,001-150,000	21.0%
150,001 and above	31.5%

The Finance Minister, in a welcome move to correct the disparity between the rates of tax applicable to domestic companies as opposed to foreign companies has lowered the rate of tax applicable to foreign companies from 48% to 40%. The table below gives the rates of tax (including surcharge) applicable to partnership firms, domestic companies and foreign companies:

Status	Tax
Partnership firms	36.75%
Domestic Companies	36.75%
Foreign Companies	42.00%

Corporates

The dividend distribution tax payable by domestic companies has been done away with and now dividends paid by domestic companies will be taxed in the hands of the shareholders at the normal rates applicable to them. Further, a company declaring dividend would be required to withhold tax at the rate of 10%. In case of inter company dividends, the Finance Minister has proposed to reintroduce section 80M in the Indian Income Tax Act, 1961 ("ITA"), under which a deduction equivalent to the amount of dividend distributed would be available to a domestic company, which receives dividend from another domestic company and redistributes it as dividends to its shareholders. Taxation of dividends in the hands of the shareholders will now offer foreign investor an opportunity to reduce the dividend tax by routing investments through countries like Mauritius, Cyprus, etc.

Additional depreciation of 15% is proposed to be allowed on plant and machinery acquired after April 1, 2002. Further, long term capital loss will now be set off only against long term capital gain.

Inbound and Outbound Investments

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The Finance Minister announced that India would continue its liberalization as regards Capital Account Convertibility and the following measures have been announced in this direction:

- Non-Resident Indians ("NRIs") would get full convertibility on their deposit schemes. The existing Foreign Currency Non-Resident Scheme and the Non-Resident External ("NRE") Rupee Scheme will continue to be repatriable. Existing Non-Resident (Non-Repatriable) Rupee Accounts which do not offer full convertibility would be terminated and the balances in such schemes would be credited on maturity to a convertible NRE account.
- NRIs would be free to repatriate in foreign currency their current earnings in India such as rent, dividend, pension, interest etc. based on appropriate certification.
- Indian companies wishing to invest in joint ventures or wholly-owned subsidiaries overseas are currently permitted to do so under the automatic route (i.e, without needing any prior regulatory approvals) up to a maximum of USD 50 million per annum. This limit on overseas investments by Indian companies is proposed to be increased to USD 100 million per annum. As regards the source of funds that may be used for such investments, Indian companies are currently permitted to remit funds through authorized dealers equivalent to 25% of their net worth, which is now proposed to be increased to 50% of such company's net worth.
- External Commercial Borrowings by Indian companies are currently permitted to be prepaid to the extent of the balances available in the Exchange Earner's Foreign Currency Account of the company concerned, which are restricted to 50% of the export proceeds of the company. The Reserve Bank of India ("RBI") will now consider requests for utilization of higher amounts from the export proceeds by Indian companies for this purpose.
- currently, an Indian company cannot issue Foreign Currency Convertible Bonds ("FCCBs") without the prior approval of the Ministry of Finance. This requirement is proposed to be relaxed partially to the effect that Indian companies may now issue FCCBs under the automatic route up to a limit of USD 50 million. The RBI would be issuing detailed guidelines in this regard shortly. However, the current stipulations regarding minimum price for conversion of the FCCBs into equity shares have to be

complied with, failing which the approval of the Foreign Investment Promotion Board would be required.

- it is proposed that a new law will be enacted to give effect to anti-money laundering provisions and introduce sufficient safeguards to prevent funds flowing in and out of India for criminal purposes.

Capital Markets

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The salient changes proposed by the Bill in respect of the capital markets are described in brief below:

- portfolio investment by Foreign Institutional Investors (“**FIIs**”) will now not be subject to the sectoral caps for foreign direct investment, except in certain sectors.
- Mutual Funds will now be permitted to invest in rated securities of foreign companies of certain countries. Earlier, the ability of mutual funds to invest in foreign securities was limited to investing in Overseas Depository Receipts, subject to prior regulatory approvals.
- concessional rate of tax on dividends and long term capital gains arising from transfer of Overseas Depository Receipts is now extended to holders of Overseas Depository Receipts issued or re-issued against the existing shares of an Indian company, whether listed or unlisted. Thus, such benefits would now be available to holders of Overseas Depository Receipts issued by way of offer for sale of existing shares and shares re-issued under dual fungibility.
- income received by a person from a mutual fund will now be taxed at normal rates applicable to them. However, income received by a unit holder from an open-ended equity-oriented scheme of a mutual fund for the fiscal year 2002-03 will be taxed at 10%.
- in order to give a boost to M&A in the telecom sector, the Bill proposes to extend the benefit of carry forward of losses in the hands of the amalgamating company engaged in the business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services to the amalgamated company.
- any consideration for not carrying out any activity in relation to any business or not sharing intellectual properties will now be taxable as business income in the hands of the recipient.

Infrastructure

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As part of the concerted effort to bolster domestic infrastructure, the Finance Minister has proposed to step up public investment in key infrastructure sectors. An Infrastructure Equity Fund of INR 10 billion is proposed to be set up to help in providing equity investment for infrastructure projects. As a further thrust to infrastructure development, income derived by a person operating in a Special Economic Zone (“**SEZ**”) will now be allowed a tax deduction in respect of income from the SEZ under section 80-IA of the ITA. Since the present port trusts structure does not allow Indian major ports to have the flexibility needed for efficient management and for raising institutional funding, it is proposed to corporatize major ports in a phased manner. International airports at the four metros would be upgraded to international standards by inducting private sector management and investment through long term leasing systems.

Specified equipment for ports and airports have been subject to reduced rates of custom duty of 10%.

Banking and Finance

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The Finance Minister has announced a number of reforms for the banking and finance sector aimed at enhancing its competitiveness and efficiency.

- A new bill to strengthen the rights of banks and financial institutions to foreclose on loans and to enforce security obtained is proposed to be introduced. The bill would also allow for securitisation of money locked up in long-term debt.
- currently, the foreign banks are permitted to operate in India through branches. It is proposed to give them an option to operate through subsidiaries, which will have to comply with all the banking regulations that are applicable to the domestic banks, such as priority sector lending etc.
- a pilot Asset Reconstruction Company is proposed to be set up by June 30, 2002 to initiate measures to take over the Non-Performing Assets (“**NPA**s”) of the banks and also to develop a market for the securitization of the loans. Existing public & private banks, financial institutions and multilateral agencies are expected to participate in this company.
- to enable the banks and financial institutions to effectively manage their NPAs, the banks will now be allowed to deduct an amount upto 7.5% of the provision made by them in respect of bad and doubtful debts while calculating their income. The

optional deduction in respect of the bad and doubtful debts as it stood on the last day of the accounting year has been enhanced upto 10%.

- the administered interest rates is proposed to be brought down by 0.5% from March 1, 2002.

Tourism

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In view of its impact on growth of employment, generation of foreign exchange reserves and promotion of national integration, the Bill proposes to implement a comprehensive tourism development package under which:

- 6 tourism circuits are to be identified and developed to international standards during the fiscal year 2002-03
- Special Purpose Vehicles would be allowed to raise resources from both public and private sectors for infrastructure development in these circuits
- Expenditure Tax in case of hotels would be levied only on room charges. Further the threshold for levy of expenditure tax has been increased for room charges of INR 3,000 per day from the existing INR 2,000 per day
- the deduction in respect of earnings in convertible foreign exchange relating to the business of hotel, tour operators or travel agents to be enhanced to 50% and 30% for financial year commencing from April 1, 2002 and April 1, 2003 respectively.
- Exemption from service tax on the services provided by the hotels which was due to expire on March 31, 2002 has been extended up to March 31, 2003.

Entertainment

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With a view to encourage setting up of multiplexes in non-metropolitan areas and convention centers, the Bill proposes that 50% of the income of multiplexes will be exempt from tax for 5 consecutive years subject to the fulfillment of certain conditions. It is also proposed that customs duties on earth stations and studio equipment be reduced from 35% to 25%. However, service tax has been levied on event management companies and cable service operators.

Housing & Urban Development

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- The pre-emptive right of the Government to purchase immovable property in case of transfer where the consideration is less than the fair market value is proposed to be withdrawn with effect from July 1, 2002.

- The Finance Minister has proposed to set up an Urban Reform Incentive Fund with an initial allocation of INR 5 billion to incentivise state Governments to initiate reforms in some of the following areas: (a) Rent Control laws and the repeal of the Urban Land Ceiling Acts; (b) rationalization of high stamp duty regimes; (c) revision of bye-laws to streamline the approval process for constructions; (d) revision of municipal laws; and (e) simplification of the procedure for conversion of agricultural land into non-agricultural land.

- To provide an impetus to the housing sector, investments in bonds issued by the National Housing Bank would be eligible for exemption from capital gains tax.

Shipping

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The Finance Minister in his Budget for the year 2001 had provided exemption from tax to the profits of a shipping company to the extent the profits were credited to a special reserve account to be utilised for the purchase of new ships. However, the aggregate of the amounts that could be transferred to such reserves was limited to twice the amount of the paid up share capital of that company. Considering the competitive position attained by the Indian shipping industry internationally, the Finance Minister has proposed to extend this limit to cover share premium reserves and general reserves. Further the Finance Minister has exempted shipping companies from the purview of Minimum Alternate Tax to the extent of transfer of profits to such special reserve.

Agriculture

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The Finance Minister feels that the country would be benefited by an integrated food market where farmers would have the freedom to sell their produce anywhere in the country. This requires a number of amendments to various Central and state legislations. In order to achieve this, Central laws will be amended after a detailed review of existing legislation by the Government and state governments would be provided incentives to amend their state laws. The Finance Minister has also proposed to expand the futures and forward trading markets to cover all agricultural commodities.

Units set up in STP, EOU & SEZ

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The Bill proposes to reduce the 100% deduction available to export profits of the undertakings set up in Software Technology Parks ("STP"), 100% Export Oriented Units ("EOU"), SEZs to 90% from April 1, 2002. It should be noted that as per the amendments introduced in the earlier years these tax holidays would be completely withdrawn from the financial year 2008-09.

This is a retrograde step and undermines the sanctity of tax incentives offered by India on the basis of which foreign investors set up operations in India.

Tax Exemptions Withdrawn

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The Bill proposes to withdraw exemption on grossing up of tax in the following cases:

- Tax on the remuneration paid to foreign technicians for services rendered in India is borne by the Indian employer. Prior to the proposed amendment any tax perquisite borne by the Indian employer on remuneration payable to the technician was not included in computing the total income of the technician to the extent paid for an initial period of 48 months from the date of his arrival in India.
- tax on royalties and fees for technical services paid to a foreign company is borne by the Government or an Indian concern with whom the foreign company has entered into an agreement in relation to a matter included in the industrial policy of India, if the agreement is signed after June 1, 2002.
- tax on income (other than income from salary, royalties and fees for technical services) paid to foreign companies or non-residents, is borne by Government or an Indian concern, in pursuance of an agreement entered into by such Government or an Indian concern with the Government of foreign state or an international organization, if the agreement is signed after June 1, 2002.

Transfer Pricing

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The amendments proposed to these provisions are more clarificatory in nature and would apply retrospectively from the date of introduction of the provisions *i.e.* from April 1, 2001. It proposes to clarify that the transfer pricing regulations will apply only if adjustments result in upward revision of income or reduction of loss in India. With a view to provide flexibility in determining an arm's length price, it also proposes a range of 5 percent to the arithmetic mean.

Indirect Taxes

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Customs Duty

The Bill proposes to reduce the peak rate of customs duty from 35% to 30% and these rates will be further reduced to 10% on raw materials and 20% on manufactured goods by 2004-05. Inputs and all other materials including capital goods, whether

imported or purchased locally by manufacturing/processing units of SEZ and developers of the SEZ are proposed to be exempted from duty. As part of India's obligations under the Information Technology Agreement, the Indian Government had proposed to have a zero duty regime on Information Technology ("IT") products by 2003. However, after considering the recommendations of the local manufacturers, this regime has been postponed to 2005. Nevertheless, customs duties would be reduced to 10% and 5% on IT items as per the commitments under the World Trade Organization framework.

The Customs Tariff Act is amended so as to empower the Central Government to impose a Special Additional Duty on articles imported from the Republic of China into India that would cause or threaten to cause disruption to the domestic market.

Excise Duty

The Finance Minister has in the Bill continued with a flat rate of 16% as the rate of Central Value Added Tax or CENVAT. The Finance Minister proposes to abolish the Special Excise Duty of 16% on most of the items except for 8 items. Excise duty of 4% will be charged on certain items which were earlier exempt. Further, certain items which were charged at 4% will now be charged at 8%.

Service Tax

Due to the large scale growth of the services sector, the Bill has sought to widen the scope of service tax. Some of the new services that have been brought within the ambit of service tax include:

- Banking and other financial services rendered by body corporates;
- Cargo handling services;
- Cable operators;
- Event management;
- Fashion designing;
- Health and fitness services;
- Life insurance business, and insurance auxiliary services concerning life insurance business;
- Storage and warehousing of goods.