

# Legal Update: INDIA

For the International Business Community

Budget - 2001

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## From the Editor

Dear Viewer,

The Indian Finance Minister announced the Budget for the year 2001-2002 today, attempting to introduce "second-generation" economic reforms. With the exception of knowledge-based industries, he appears to have achieved a virtually impossible tight rope act by balancing the otherwise antithetical concepts of growth and equity. On the whole, the Budget comes across as a clever amalgamation of political correctness, market reform and fiscal discipline. It has every indication of putting India right back on the trajectory of economic growth. Core sectors like agriculture, food processing and infrastructure have received a good deal of governmental attention. He has also kept to his word of containing the fiscal deficit for the financial year 2000 – 2001 to the promised limit. He has introduced an austere flavor by putting governmental agencies and departments on a stringent diet, particularly in terms of expenditure cuts and quantitative reductions. Labor reform has finally been introduced.

He has provided the much-needed shot in the arm to the ailing capital markets by slashing the dividend distribution tax and withdrawing the principal portion of surcharge. He has taken further steps on the road to full capital account convertibility by announcing two-way fungibility for American / Global Depository Receipts issued by Indian companies and by opening up more fast-track windows for overseas investments.

However, it would seem that the carpet has been pulled from under the software industry's feet, with the Budget renegeing on the issue of taxation of stock options in the hands of employees of foreign and unlisted Indian companies. The provisions which took away the tax benefits available to EOUs in the event of a change in ownership, have not been done away with, except in relation to public companies. This continues to mar corporate restructuring and M&A activity in the software sector. Another area of serious concern is the rather premature introduction of transfer pricing provisions, without adequately streamlining the tax administration, which could increase risk of abuse of power and batter investor confidence, particularly in the knowledge-based sectors. E-commerce has been brought within the tax net through the back door by its inclusion under service tax.

It is felt that the initial euphoria surrounding the budget may be misplaced, as there are also implied threats to some of the blue-eyed sectors of the economy. However, there is still cause to celebrate, as overall tax rates have been brought down by abolition of surcharge.

February 28, 2001

-The International Tax Division

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## DIRECT TAXES

The Budget 2001-2002 ("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 kept up his promise of withdrawing the surcharge, by retaining only the 2% surcharge introduced on account of the Gujarat earthquake. The table below gives the rates of tax (including surcharge) applicable to resident and non-resident individuals/Hindu undivided families, association of persons, etc:

Income (in Rs.)	Tax
0-50,000	NIL
50,001-60,000	10.0%
60,001-150,000	20.4%
150,001 and above	30.6%

The table below gives the rates of tax (including surcharge) applicable to domestic companies, foreign companies, partnership firms and the maximum rate applicable to co-operative societies:

Status	Tax
Domestic Companies	35.7%
Partnership firms	35.7%
Foreign Companies	48.0%
Co-operative societies	30.6%

The presumptive rate of tax of 4.8% for foreign telecasting companies has been withdrawn, and such companies shall be subject to tax at the rate of 48% on net profit, subject to applicable tax treaties.

It is further proposed to widen the definition of the term "royalty" to include equipment royalty that is payment made in respect of "use or right to use, any industrial, commercial or scientific equipment".

The dividend distribution tax payable by domestic companies and mutual funds has been slashed down from 20% to 10% (plus a surcharge of 2%). The dividends in the hands of the shareholders/unitholders continues to be exempt from tax.

## ADRs / GDRs

One of the highlights of the Budget is the liberalization on the ADR/GDR front which includes the following:

- Dual fungibility of ADRs/GDRs. This means that ADRs when converted into underlying shares can once again be converted into ADRs and *vice versa*.
- Indian companies can now use upto 100% of their ADR/GDR proceeds for acquiring companies abroad, as opposed to the existing 50% limit. This is expected to give a great boost to overseas acquisitions.
- Existing shareholders of Indian companies can now offer their shares for sale in an ADR/GDR issue. Previously, Indian companies could only make a fresh issue of shares and offer for sales by existing shareholders were not permitted except in special cases where for instance, the government was divesting.
- In a bid to promote overseas acquisitions by Indian companies that have issued ADRs/GDRs, such companies will now be permitted to invest either upto an amount of USD 100 million or an amount equal to 10 times their exports in any given year, whichever is higher, for the purpose of acquisitions abroad. Earlier, this option was available only under the ADR/GDR share-swap mechanism.

## NBFCs

It is proposed to include foreign investment in non-banking financial companies ("NBFCs") under the automatic route pursuant to which upto 100% foreign investment will be permitted subject to the criteria that USD 50 million is infused into the Indian company. Furthermore, the original condition that 25% of their holding should be divested by the foreign investor in the domestic market has now been done away with. Previously, prior approval of the Foreign Investment Promotion Board was needed for any foreign investment in NBFCs.

## Overseas investments

Beneficial amendments have also been proposed on the overseas direct investment front, in addition to the benefits made available to Indian companies who have issued ADRs / GDRs:

- Indian companies can invest abroad up to USD 50 million on an annual basis under the automatic route without being subject to any profitability criteria. Under the existing Regulations, a company may make overseas investments only if it has a track record of profitability in the immediately preceding 3 years. Further, this USD 50 million limit was till now applicable to a block of three financial years.

- Indian companies with a proven track record wishing to invest larger amounts may now get a block allocation in advance from the RBI for investments overseas.
- Partnership firms, duly registered in India, providing professional services have now been permitted to make overseas investments.

RBI will be revising its existing guidelines to include the changes referred to above with regard to overseas direct investment as well as ADRs / GDRs.

### Infrastructure

Tax exemption given to income and long term capital gains of infrastructure capital funds and companies is now extended to co-operative banks in respect of their investment in infrastructure facility. The definition of infrastructure facility has been expanded to include an undertaking that develops, operates and maintains "special economic zone" and undertakings engaged in providing broadband network and internet services. The exemption would now be available to undertakings set up till March 31, 2006.

100% exemption to infrastructure facilities is extended to 10 years instead of 5 years. In case of infrastructure facility engaged in highways, water supply system, rail system, etc., the taxpayer would have the choice to elect any 10 consecutive years out of 20 years starting from the first year in which the enterprise is engaged in such activity. In case of infrastructure facility engaged in port, airport etc., the 10 year period would be from a block of 15 years. This change would give the infrastructure facility the possibility of recouping the losses of the long gestation period.

### EOUs, SEZs & STPs

The tax exemption under Sections 10A and 10B of the Income Tax Act, 1961 (ITA) would be available to units which relocate from FTZ or EPZ to SEZ for 10 years beginning the year in which they begin the operation in such FTZ or SEZ rather than when they were first set up in one of those zones. However, all these benefits would terminate at the end of financial year 2009.

Profits from domestic sales upto 25%, which were earlier eligible for export exemption will now be taxable. This brings the exemption under this section in line with the exemption under sections 80HHC and 80HHE.

Export profit will now be computed with reference to the total profit and total turnover of the undertaking rather than that of the

business of the taxpayer. On-site services as well as processing and management of electronic data are now included in the definition of export of software services and would therefore, be eligible for the tax holiday.

A company in which public is substantially interested will no longer lose the benefit under this provision, if more than 49% of its shareholding changes. However, private companies and closely held companies would continue to lose the benefit if there is a change in more than 49% of their shareholding. This would greatly hamper the consolidation within the software industry, through mergers and acquisitions.

### Telecom

The definition of infrastructure facility in this sector now includes broad band network and internet services. 100% exemption from tax is extended to undertakings providing telecommunication services for first 5 years and thereafter 30% of income would be exempt for a further period of 5 years.

### Transfer Pricing

The Transfer Pricing regulations have been introduced in the Finance Bill, 2001. These regulations provide that pricing of international transactions between two associated enterprises, either or both of whom are non-residents should be in confirmation with the arm's length principle.

The allocation or apportionment of any cost or expense incurred or any contribution made in connection with a benefit, service or facility provided by one enterprise to another must also be determined having regard to the arm's length price. "Arm's length price" is defined to mean a price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

Exhaustive definitions have been provided for the terms 'associated enterprise' and 'international transactions' to which the transfer pricing regulations would apply. The bill also includes deeming provisions to include certain enterprises within the scope of the regulations, like in cases where one enterprise holds 26% of the voting power of another enterprise, or when loans advanced by one enterprise exceeds 51% of the book value of the assets of the other enterprise, or where one enterprise guarantees more than 10% of the total borrowings of the other enterprise etc. In such cases, the two enterprises are deemed to be associated enterprises.

The Bill proposes certain methods, which may be applied for determining arm's length price. These are:

- (a) Comparable uncontrolled price method;
- (b) Resale price method;
- (c) Cost plus method;
- (d) Profit split method;
- (e) Transactional net margin method;
- (f) such other method as may be prescribed by the Central Board of Direct Taxes ("CBDT").

Where more than one price is determined by any of these methods, the arm's length price shall be taken to be the arithmetical mean of such prices. Unlike the OECD guidelines which recognise primarily transaction-based methods viz (a), (b) and (c), the Indian Transfer pricing regulations also recognise other methods.

The burden of proof is spread over the taxpayer and the revenue authorities. The Revenue authorities can, only after giving the taxpayer an opportunity to explain, determine the price based on arm's length principle. A penalty is levied to the extent of 3 times of the amount of tax sought to be evaded or avoided in addition to the additional tax determined to be payable.

The transfer pricing regulations override the provisions relating to exemption available to EOUs etc. and the provisions relating to any other deductions that may be available from the tax payers' income.

The taxpayer who falls within the ambit of the transfer pricing regulations would have to report the details of the international transaction entered into with its associated enterprise to the Revenue authorities. The report should be certified by a qualified accountant and is required to be submitted to the Revenue authorities alongwith the tax audit report. Apart from the above provisions, certain rules relating the taxation of international transactions between associated enterprises would also be introduced subsequently.

It is uncertain whether the revenue authorities in India are geared to implement the above regulations in practice. The unfettered powers given to the tax authorities could lead to distress amongst the taxpayers and negative sentiment amongst foreign investors.

### ESOPs & Employee benefits

The Finance Minister has reneged on the issue of taxation of ESOPs. ESOPs would only be tax exempt if the companies

comply with SEBI ESOP Guidelines, 1999. Though the SEBI ESOP Guidelines do not apply to unlisted companies, they would now need to conform to these for tax exempt ESOPs and even then, it is not certain whether the tax concessions would be available to employees of private companies. This presents further impediment to start up companies who could use ESOPs as an effective tool to attract talent without affecting their cash flow. Further, no attempt has been made to provide clarity in respect of taxation of ESOPs granted by a company to the employees of its parent or subsidiary company. The Bill has also failed to address the issue of stock options to consultants and associates and deductibility to the employer for the cost of grant of ESOPs.

A good provision introduced by the Finance Minister is with respect to ADR/GDR linked ESOPs, whereby Indian resident employees of companies engaged in specified knowledge based industry or service or its subsidiary can be issued ADR/GDR linked ESOPs.

Resident Indian individuals can now remit upto US\$ 20,000 annually to exercise the stock option issued by their foreign parent company, instead of the earlier limit of US\$ 10,000 in a block of 5 years. These employees would now be able to participate in growth of their employer companies.

The Finance Bill proposes to bring within the tax net payments made to a prospective employee or ex-employee such as sign-on bonus, severance packages or non-compete payments received by an employee upon joining or leaving an employer. Further provisions have been included to bring the perquisite value (except in cases like car, housing, etc.) in lines with its cost to the employer.

### Capital Markets & FII's

In order to revive primary equity market, the Finance Minister has proposed to grant roll-over benefit to long term gains realized from the sale of listed securities of a company or units of a mutual fund provided that such gains are invested in public offering of equity shares by an Indian public company within a period of 6 months from the date of divestments and such shares are held for a period of one year. Further, investment limit for Foreign Institutional Investors ("FIIs") to invest in an Indian company has been increased from 40% to 49%. This combined with reduction in dividend distribution tax has given a boost to the Indian capital markets.

### Dividend Stripping

The Finance Bill proposes to plug the loophole of claiming the capital loss by purchasing securities cum-dividend and selling the same ex-dividend. It proposes that when securities are purchased cum-dividend and then subsequently sold ex-dividend, the loss to the extent of dividend amount will be ignored for computing income chargeable to tax.

#### Debt markets and Securitization

In order to develop and deepen a transparent and active debt market in general and Government securities market in particular, the Finance Minister has proposed to set up a clearing corporation and screen based trading. It is proposed that Reserve Bank of India ("RBI") will set up an electronic Negotiated Dealing System to facilitate transparent electronic bidding in auctions and dealings in Government securities on a real time basis.

The Finance Minister assured that the clarifications will be issued by the CBDT to promote issuance of STRIPS, zero coupon bonds, deep discount bonds. It is also proposed to replace the old Public Debt Act with new Government Securities Act. In order to promote growth of securitization, it is proposed to introduce a comprehensive legislation on securitization.

#### Borrowing in Foreign Currency

Currently interest paid by an Indian borrower on monies borrowed in foreign currency i.e. external commercial borrowing is exempt from tax in India, subject to certain conditions. The Budget has proposed to withdraw this exemption for external commercial borrowings made on or after June 1, 2001. This could lead to increase in the cost of borrowing if the Indian tax has to be born by the borrower. It could even have adverse tax implications for lender institutions such as pension funds, which are exempt from tax in certain countries.

#### Power

In order to bolster domestic infrastructure, the Finance Minister emphasized the need to restore the financial viability of State Electricity Boards ("SEBs") across the nation. SEBs have been responsible for substantial annual commercial losses. As a part of the revival strategy, all MoUs entered into by SEBs with their respective state governments will now require installation of 100% metering by December 2001, an energy audit at all levels,

restructuring of SEBs, commercialization of distribution and a strict compliance with tariffs. The Electricity Bill is to be tabled by the Minister of Power in this session of Parliament.

#### Insurance

The tax rebate available to policy-holders paying premiums to the Life Insurance Corporation of India has been extended to all Indian-insurance companies that have been registered under the Insurance Act, 1938. However, the much-anticipated differential rate of tax applicable to shareholders and policy-holders of an insurance company has not been incorporated in the Budget.

#### Agriculture and food processing

The Finance Minister has left out the much apprehended tax on income from agriculture. The Budget allocation of funds to agriculture is proposed to be increased. Further National Bank for Agriculture and Rural Development ("NABARD") will help in mobilizing funds through tax relief bonds. For promoting food-processing industry, it is proposed to exempt food preparations based on fruits and vegetables completely from excise duty. Further it is proposed to offer 100% tax deduction for undertakings deriving profits from the integrated business of handling, storage and transportation of food grains for a period of five years and a deduction of 25% or 30% for subsequent period of five years.

#### Pharma & Bio-Technology sector

In order to further encourage Research and Development in the Pharmaceutical and biotechnology sectors the FM has proposed that a weighted deduction of 150% be given on additional activities in relation to drugs and pharmaceuticals, such as expenditure incurred on clinical drug trial, or on obtaining approval from any regulatory authority or for filing an application for a patent under the Patents Act, 1970.

#### E-Commerce

Chapter V of the Finance Bill provides that any service provided by a commercial concern to a customer, in relation to "online information and database access or retrieval will now be liable to pay service tax. The definition of online information and database retrieval systems is quite wide and could encompass a

number of companies such as online retailers, auctioneers, B2B marketplaces, content providers etc., who provide different kinds of information. Some of these companies may earn their revenues more through advertising, commissions, etc. rather than by the provision of information services to their subscribers. Hence, it remains to be seen what portion of revenues of such companies would fall within the service tax net.

#### VCFs & MFs

##### **Venture Capital Funds**

Currently venture capital funds ("VCFs") have been defined to include funds set up in the form of a trust. Now the scope is proposed to be expanded to include a venture capital scheme floated by the Unit Trust of India. Further the Budget has clarified that the gains realized by a VCF from divestment of shares held in venture capital undertakings ("VCUs"), which are primarily listed or to be listed Indian companies, will continue to be exempt from tax even after listing.

##### **Mutual Funds**

Currently income received by the unit holders of Unit Trust of India or a Mutual Fund is exempt from tax under section 10(33) of the Income Tax Act. The Finance Bill, 2001 proposes to clarify that this exemption will not be available on gains realized on transfer of units to an entity other than Unit Trust of India or Mutual Fund. This leads to believe that the gains realized on redemption of units, which is in essence, repurchase of units by the Unit Trust of India or Mutual Funds, should be exempt from tax in India.

#### Public Sector Undertakings

The government has extended considerable financial restructuring support to viable and potentially viable Public Sector Undertakings ("PSUs"). To maximize returns the Govt. has shifted the approach from the disinvestment of small lots of shares to sale of blocks of shares to strategic investors. The Govt. has already approved privatization of 27 companies. It is expected that in the current year companies like VSNL, Air India and Maruti Udyog Limited shall be privatized.

#### Depreciation

The Supreme Court of India had recently held that depreciation should be allowed to a taxpayer only if he chose to claim the

same. The Finance Minister has proposed to reverse this decision of the Supreme Court by making it compulsory for the taxpayer to claim depreciation. The rate of depreciation in respect of ships and inland water vessels which was in the range of 5 to 10% is proposed to be increased to 25%. Further depreciation rate for new commercial vehicles is proposed to be increased to 50% for a period of one year.

#### Labour laws

In a move to do away with the inherent rigidities currently existing in the labour legislation, the Finance Minister has proposed to streamline such provisions. Prior approval of the appropriate government was required vide Chapter VB of the Industrial Disputes Act, 1947 by employers in specified industrial establishments employing 100 workers or more before effecting lay-off, retrenchment and closure. However, it is proposed that the limit of 100 workers be enhanced to 1000 workers. In order to avoid lay-off, retrenchment and closure in a routine manner, the separation compensation has been increased from 15 days to 45 days for every completed year of service. Further, section 10 of the Contract Labour Act, 1970 is proposed to be amended to facilitate outsourcing of activities without any restrictions as well as offering contract appointments.

#### Education

The government in its endeavor to encourage Indian students to avail of technical and higher education has proposed a 100% deduction for payments made by the private sector to engineering institutions set up in rural areas and small towns. In a welcome move, it is proposed to offer loans for the above purpose at attractive rates of interest.

#### Service Tax

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

- Specified Banking and Financial Services,
- Port Services,
- Broadcasting Services,
- Sound Recording Services,
- Scientific and Technical Consulting Services,

- On-line Information & Data Base Retrieval services,
- Video Tape Production Services, and
- Services auxiliary to insurance.

The services provided to lease circuit line holders is also sought to be brought within the tax net.

## Indirect Tax

### Excise Duty:

The Finance Minister had in his last budget introduced a flat rate of 16% as the rate of Central Value Added Tax ("CENVAT"). In his endeavor to simplify and rationalize the tax regime and to ensure effective tax compliance he has proposed to reduce the special excise duty ("SED") rates which are currently 8%, 16% and 24% to a single rate of 16%.

As a consequence he proposes to abolish the 8% SED on certain items like glazed tiles, mattresses and articles of bedding, carpets and floor coverings, painted canvas, studio black cloth, scooters, motorcycles, taxis, etc. These items would be charged to CENVAT at a flat rate of 16%. A few items that attracted CENVAT at the rate of 8% would henceforth be charged at the normal rate of 16%. However in public interest, the Bill has made certain exceptions in cases of consumer products like cotton yarn, LPG, kerosene, diesel engines upto 10HP, which would continue to be charged at 8%.

By putting an end to the rate of 24% SED, the maximum duty on certain items like softdrinks, softdrinks concentrates and motor-cars have been reduced to a total of 32% from the existing 40%. However, the excise duties on certain items like cigarettes, the use of which is sought to be discouraged, have been hiked.

### Customs Duty:

The Bill has not made any change to the total number of customs duty slabs/rates, which were 35%, 25%, 15%, and 5%. However, the surcharge of 10% previously levied on customs duty is proposed to be abolished. There has been a manifold increase in the rate of customs duty applicable to certain agricultural products. The customs duty on IT and telecom products including their inputs and components have been proposed to be reduced to 15% from their current levels effective from March 1, 2001.

Since gems and jewellery have a high potential for export, the Bill has reduced the customs duty payable on cut and polished colour stones from 35% to 15%. The rate of duty on rough diamonds would be 5%. The exemption from customs duty,

which was enjoyed on a few items, has been proposed to be withdrawn and such items would now be subjected to a nominal customs duty of 5%. Import of second hand cars has been made more expensive with customs duty of 180%. Import of gold on the other hand, has been made easier with reduced customs duty. The Finance Minister has promised that the customs tariff would be brought down to East Asian levels, in a span of the next 3 years.

## Miscellaneous

- Sick Industrial Companies Act proposed to be repealed
- Legislation on foreclosure and enforcement of securities to be introduced, which will greatly benefit banking sector
- SIDBI, NABARD, National Housing Bank will no longer be exempt from tax
- Payments made on Voluntary Retirement Scheme to be amortized over five years
- Small savings interest rate reduced by 1 to 1.5%
- Tax deduction for interest on housing loans raised up from Rs. 100,000 to Rs. 150,000

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