

LEGAL UPDATE: INDIA

FOR THE INTERNATIONAL BUSINESS COMMUNITY

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Budget 1999-2000

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The finance minister Mr. Yashwant Sinha presented the fiscal budget for the year 1999-2000 on February 27, 1999. The main goal of his budget is said to be to "kick start" the economy. The budget proposes measures to give boost to the agrorural economy, housing and infrastructure projects, capital markets and to further facilitate foreign direct investment into India. It also proposes to rationalize customs and excise duty structures. The budget can be described as a 'house keeping' budget as the Finance Minister has attempted to place the house in order before moving on with the reforms process.

This edition of "Legal Update" attempts to bring into focus some of the important changes proposed by the Budget 1999-2000.

DIRECT TAXES

Personal and Corporate Tax Rates

The Budget 1999-2000 ("the Bill") has made no changes in the tax rates in respect of Individuals and Corporate including the standard deduction in respect of individuals. Thus domestic companies continue to be taxed at the rate of 35% and the foreign companies at the rate of 48%. However, an additional surcharge at the rate of ten percent (10%) on the tax payable under the Income Tax Act ("ITA") has been levied on all taxpayers except non-residents, foreign companies and persons having income of Rs. 60,000 or less.

The table below gives the new rates of tax in case of individuals:

Income (In Rs.)	Tax
Up to 50,000	0%
> 50,000 - 60,000	10%
> 60,000 - 150,000	20%*
> 150,000	30%*

* These slabs are subject to a surcharge of 10% on aggregate tax.

The Bill seeks to reduce the general rate of tax on long term capital gains from 20% to 10% in respect of listed securities; however, without the benefit of inflation indexation.

Business Reorganization:

The Finance Minister has proposed several measures to rationalize provisions relating to amalgamation of companies and introduced new provisions relating to demerger of companies. It is also proposed to relax the provisions of ITA, so that accumulated losses of an Indian subsidiary of a foreign company can be carried forward when there is a change in its shareholding pattern as a result of a scheme of amalgamation or demerger of the parent company provided at least 51% shareholders continue to be the shareholders in the amalgamated or the resulting company.

Amalgamation :

The Bill proposes to allow carry forward and set off of accumulated losses and unabsorbed depreciation of the amalgamating company in the hands of the amalgamated company provided :

- (i) the amalgamated company holds continuously for 5 years 3/4th of assets of amalgamating company and
- (ii) carries on business of



- Amalgamations and demergers made tax neutral
- Income from open-ended MFs tax exempt
- Clarity on taxation of ESOPs and Sweat Equity
- Share buy-back to trigger capital gains tax only
- Stamp duty on bonds to be abolished
- Slump sale to be subject to capital gains tax
- Continuance of same business not necessary for carry forward of losses
- Export of film software tax exempt
- Stock Exchanges to allow trading terminals abroad for NRIs
- Interest on hedging to be tax exempt
- Infrastructure tax holiday extended to cold chains
- Leave salaries of expatriates taxable in India
- R&D expenses allowed a 125% tax deduction
- Y2K Expenses fully tax deductible
- List of eligible industries for venture capital investments expanded
- Customs & excise rates rationalized

amalgamating company for a period of 5 years.

Demerger:

Despite the absence of specific provisions in the Indian Companies Act, 1956, it is proposed to recognize demerger for genuine reorganization of business. The Bill proposes the following:

- Demergers would be tax neutral
- Tax-benefits and concessions enjoyed by a demerged company would be available to the resulting company.
- The accumulated losses and unabsorbed depreciation would be allowed to be carried forward by the resulting company.
- No capital gains tax would be levied on transfer of capital assets from the demerged company to the resulting company.
- Shares issued by the resulting company to the demerged company would not be regarded as deemed dividend.

Demerger of Foreign Companies :

It is proposed that demerger of an undertaking of a foreign company to an Indian company would not attract capital gains tax. It is also proposed that the demerger of an undertaking of a foreign company to another foreign company would be exempt from capital gains tax, provided 75% of the shareholders of the demerged company remain the shareholders of the resulting company and such a transfer is not subject to capital gains tax in the country of registration of the demerged company.

The condition for continuation of same business for carry forward of losses removed.

The proceeds in case of slump sale to be subject only to capital gains tax.

Foreign Direct Investment :

The Finance Minister has announced that all the foreign investment proposals will be cleared by the Foreign Investment Promotion Board within 30 days. The list of industries in which automatic approval is available is also sought to be expanded. It is proposed to create a Foreign Investment Implementation Authority to facilitate implementation of foreign investment proposals.

ESOP and Sweat equity:

The Bill has clarified that the difference between the market value and the cost at which the stocks are offered will be treated as perquisite in the hands of the employees on the date of exercise of the option. Upon sale, the difference between the sale proceeds and the market value at exercise will be taxed as capital gains. There is no proposal to cover taxation of ESOPs in foreign parent companies granted to employees of Indian subsidiaries. Dividends and long-term capital gains received by a resident employee from purchase of GDRs under an employees stock option plan of a domestic company engaged in information technology software and information technology service, is proposed to be taxed at the rate of 10%, being the rate of tax applicable to non-resident holders of GDRs.

Stamp duty on debt instruments within the depository mode to be abolished.

Mutual Funds :

The Bill introduces a 10% additional tax on income distributions from the Unit Trust of India (UTI) and other Mutual Funds. However, income distributed under US-64 Scheme of the UTI and other open-ended equity oriented schemes of UTI and Mutual Funds would be exempt from this 10% levy for three financial years commencing from April 1, 1999. The UTI is the largest Mutual Fund in India. This

concession is expected to give a shot in the arm to the ailing Mutual Fund industry in India.

Share Buy-back :

The Companies (Amendment) Ordinance, 1998 promulgated in 1998, made changes in the Companies Act, 1956, permitting Indian companies to purchase their own shares. It is now clarified that the payment made by a company on purchase of its own shares is not to be regarded as deemed dividend. The gains, if any, earned by the shareholders on buy-back of shares, will be subject to capital gains tax.

Extension of exemption of interest on external commercial borrowings in certain cases

Sectoral Incentives:

Film Industry:

The Bill proposes to insert a new provision to provide for a 100% deduction to an Indian company in respect of profits and gains in convertible foreign exchange from export or transfer by any means out of India, of any film software, TV software, music software and TV news software, etc. together with telecast rights. The exemption will be effective from March 1, 1999 and will apply to the assessment year 2000 – 2001 and all subsequent years.

Tourism :

Currently, income from the business of a hotel, tour operation and travel agency is allowed as a deduction in computing the total income, to the extent of the following amounts:

- 50 % of the profits derived from services provided to foreign tourists;
- so much of the remaining profits as are credited to a reserve fund to be utilized in a prescribed manner.

It is proposed that the amount credited to the reserve fund can also be invested in the equity shares of a public company carrying on the business of new hotels, or setting up a new facility, as may be notified by the Central Government.

Civil Aviation:

Under Section 10(15A) of the ITA an exemption is provided to the payments made by an Indian company engaged in the business of operation of aircrafts, in respect of agreements to acquire an aircraft or an aircraft engine on lease from the Government of a foreign state or a foreign enterprise entered into on or before 1.4.1997. It is proposed to extend the exemption to agreements entered into on or after 1.4.1999 also.

In relation to this amendment, it is also proposed to amend Section 10(6BB) of the ITA, so as to restrict the income – tax exemption in respect of tax paid by an Indian Company engaged in the business of operation of aircrafts on the income derived by the government of a foreign state or a foreign enterprise as consideration for acquiring an aircraft or aircraft engine under an agreement entered between April 1, 1997 and March 31, 1999.

A special 10 year tax holiday proposed to encourage setting up of industries in North-Eastern region.

Venture Capital :

It is proposed to exempt the dividends and long-term capital gains earned by venture capital funds or companies from equity investments made in Venture Capital Undertakings (VCUs). VCUs have been defined to mean unlisted domestic companies engaged in software, IT, production of basic drugs in pharmaceutical sector, biotechnology, agriculture and allied sectors etc. in accordance with prescribed guidelines. A sunset clause for investment after March

31, 1999 is inserted in the existing tax exemption provisions for venture capital funds.

Infrastructure:

Under section 80-IA of ITA, undertakings engaged in operating infrastructure facility which includes, roads, highways, bridges, airports, ports and rail systems are offered a tax holiday for 5 years and a tax deduction of 25/30% of profits for the next 5 years. This benefit is also available to undertakings generating or generating and distributing power, undertakings developing and operating industrial parks and undertakings engaged in providing telecom services. This benefit has to be availed of within a period of 10 consecutive years out of the initial 12 years. It is now proposed to enhance the period of 12 years to 15 years. It is also proposed to extend this benefit to cold chain facilities for agricultural products.

Presently, the infrastructure facility had to be operated on BOOT basis. This is no longer necessary. It is now proposed to encourage private sector participation by offering tax exemption to a person other than developer or owner, who operates and maintains the infrastructure facility. Similar tax exemption is now extended under section 10(23G) of the ITA to the infrastructure funds or companies earning interest, dividends or long-term capital gains from investments in such infrastructure facilities. It is also now available to undertakings which set up new transmission or distribution lines after April 1, 1999 but before March 31, 2003.

Telecommunications :

Provisions related to tax deductibility of telecommunication license fees are proposed to be rationalized with retrospective effect from April 1, 1996 to provide that the tax deduction shall be available in respect of fees incurred and actually paid, either before or after

the commencement of business which ever is later. No depreciation will be allowed on such license fees.

IT Sector :

A tax deduction of 125% is proposed for R&D expenses incurred in development of software.

Banking :

In order to strengthen the financial position of banks, the Bill proposes to give an option to the banks to claim a tax deduction of 5% of the loss or doubtful assets, for provision for bad and doubtful debts.

ECBs :

The Bill proposes to exempt interest payable by an industrial undertaking for hedging transaction on account of currency fluctuation.

NRIs :

NRIs and OCBs will be granted automatic approval for 100% investment in all industries except those which attract specific FDI investment ceilings and certain reserved industries. The stock exchanges will be permitted to open trading terminals abroad to facilitate investments by NRIs.

Gold Deposit Scheme, 1999 :

The budget has introduced a new Gold Deposit Scheme whereby gold can be deposited with banks for interest bearing certificates. It is proposed to exempt Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 from the definition of capital asset so as to exempt the capital gains arising from their transfer or redemption. It is also proposed to amend Section 10 (15) of the ITA so as to provide that the interest on Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999, shall not be included in computing the total income.

In this connection, an Explanation is proposed to be inserted to Section 2 (ea) of The Wealth Tax Act. This is to clarify that jewellery does not include the Gold Deposit Bond issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

Expatriates :

Section 9 of the ITA deems income earned under the head "salaries" to accrue or arise in India. The existing provision which states that salaries earned for services rendered in India will be taxable in India is sought to be expanded to provide that salary payable for leave which is both preceded and succeeded by service in India and forms part of the employment contract, shall also be taxable in India.

Research & Development Expenses:

Currently, 100% of any sum paid to any university, college or an institution or a scientific research association for the purpose of scientific, social or statistical research is allowed as tax deductible. It is now proposed to allow the weighted deduction of 125% in respect of such sums paid.

Depreciation :

As a measure to check evasion and tax avoidance, it is proposed that in respect of assets acquired outside India and subsequently brought to India for use in business, the actual cost of the asset was included in the 'block of assets'. It is now proposed to reduce the cost by a notional depreciation that would have been allowed under the provisions of ITA, had this asset been used in India.

A National Award for Excellence in Corporate Governance instituted.

Y2K Expenses :

It is proposed that the entire expenses incurred by the tax payers

in making their IT system Y2K compliant, will be allowed as tax deductible.

Housing Projects :

The Bill proposes that interest received by companies registered with National Housing Bank in relation to bad and doubtful debts would be chargeable to tax on cash basis. The limit on tax deductible interest amount on capital borrowed for acquisition or construction of self occupied residential houses is raised from Rs. 30,000 to Rs. 75,000 provided the house is acquired between April 1, 1999 and March 31, 2001.

Compulsory Acquisitions :

It is proposed to introduce a withholding tax of 10% on payments made in excess of Rs. 100,000 on account of compensation on compulsory acquisition of capital assets under any law.

Electronic Tax Collection Returns:

It is proposed to allow filing of tax collection returns in electronic form and that information contained in these returns shall be admitted as evidence in the matter of any proceedings under the ITA.

INDIRECT TAXES

Excise duty:

The Bill proposes to undertake major reforms in indirect taxes to boost productivity and employment. It proposes to overhaul the excise duty rate structure, by reducing major eleven rates to three rates- Merit rate of 8%, Central rate of 16% and Demerit rate of 24%. The Bill also proposes to restore the MODVAT credit to 100% thereby removing the limit of 95% imposed in the previous budget.

Customs Duty:

The Bill proposes to abolish the additional customs duty of 5% and rationalize the duty structure into

only 5 basic rates with the maximum basic rate at 40%. A surcharge of 10% on basic duty is proposed to be imposed across the board except in case of gold, silver, crude petroleum and petroleum products. Additional duty of customs is proposed to be imposed on henceforth-exempt project imports. The power of government to grant ad-hoc exemption from customs duty is proposed to be abolished except in case of goods of strategic value, secret nature or for charitable purposes.

The Road Ahead :

The Finance Minister has promised not to roll back any of the provisions introduced in the Bill. The insurance sector has been left untouched. The next budget should be more promising on the reforms map.

COMPLIMENTARY SUBSCRIPTIONS

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