

LEGAL UPDATE: INDIA

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Budget 2000-2001

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The first budget of the new millennium presented by the Finance Minister Mr. Yashwant Sinha on February 29, 2000 was somewhat disappointing. The budget does not seek to contain the fiscal deficit. It is retrograde in so far as it increases surcharge on income tax by 50% from 10% to 15% and dividend distribution tax by 100% from 10% to 20% both for companies and mutual funds. It lacks innovation and creativity. It claims to provide incentives to Venture Capital Funds but in reality in some respect leaves them doubly taxed. Only redeeming feature of the budget is reduction of customs duties on some of the items such as computer hardware and cell phones. In some respect it may be described as "hen killer" budget.

This edition of "Legal Update" attempts to bring into focus some of the important changes proposed by the Budget 2000-2001.

DIRECT TAXES

Personal and Corporate Tax Rates:

The Budget 2000-2001 ("the Bill") has made no significant changes to the tax rates in respect of Individuals and Corporates including the standard deduction in respect of individuals. Thus domestic companies continue to be taxed at the rate of 38.5% (including a 10% surcharge) and the foreign companies at the rate of 48%. An additional surcharge of 5%, leading to a total surcharge of 15% on the tax payable under the Income Tax Act ("ITA") has been levied on all

non-corporate taxpayers except for individuals whose income is Rs. 150,000 or less. The table below gives the rates of tax as applicable in case of individuals:

Income (In Rs.)	Tax
Up to 50,000	0%
> 50,000 - 60,000	10%
> 60,000 - 150,000	22%
> 150,000	34.5%

For partnership firms effective tax rate would be 40.25%.

The Bill seeks to reduce Minimum Alternate Tax (MAT) applicable to domestic companies and branches of foreign companies from 10.5% to 7.5% (plus surcharge of 10%) i.e. 8.25% on the book profits. Book profits for the purpose of MAT means profits as shown in financial statements presented to the shareholders.

At present, profits of an industrial undertaking set up in backward area or infrastructure facility or other eligible industrial undertakings for deduction under section 80IA are now not covered under MAT. It is proposed by the Finance Minister to cover such units under MAT. However, profits from export of goods, computer software and film software and incomes that are exempt from tax are excluded from the profits liable to MAT.

Fill investment limit in Indian companies under portfolio investment scheme increased from 30% to 40%.

The distribution tax payable by the domestic companies under section 115O on dividends has been increased from 10% to 20%. However, the dividends in the hands of shareholders still continue to remain tax exempt.

HIGHLIGHTS

- No significant change in tax rates.
- MAT reduced to 7.5%.
- Foreign exchange earnings to become taxable in phased manner.
- New FTZs and EOUs not to get tax benefits.
- Advance Ruling provisions streamlined.
- 20% distribution tax proposed for Co.s, MFs and VCFs.
- SEBI to be single window clearance agency for VCF.
- Customs incentives to IT, telecom and entertainment industry.
- FIIs allowed to invest upto 40% in Indian companies.

Export Incentives:

At present, profits from export of goods, software, projects, film software, royalties received from foreign source and remuneration received in foreign exchange are exempt from tax to the extent of 50% to 100% of such profits. This exemption is proposed to be withdrawn in a phased manner over 5 years. For the year 2000-2001, 20% of export profits would be taxed at normal corporate tax rates. This would mean that, now an exporter would have to pay tax at an effective rate of 7.7% (inclusive of 10% surcharge) for the year 2000-2001. The tax rates will be as follows for the subsequent years:

Year	Effective tax Rate (inclusive of 10% surcharge)
2001-2002	15.4%
2002-2003	23.1%
2003-2004	30.8%
2004-2005	38.5%

Units set up in Free Trade Zones and Technology Parks:

At present, a unit setup in Free Trade Zone (FTZ) or Hardware and Software Technology park enjoys a tax holiday for ten years from the year in which it starts commercial production. It is proposed by the finance minister that only units set up before April 1, 2001 would be eligible for these tax incentives.

Export Oriented Units:

At present profits of a 100% Export Oriented Unit (EOU) is exempt from tax for 10 years from the year in which it starts its commercial production. It is proposed by the Bill that such benefit will only be available to a unit which begins to manufacture or produce any article or thing before March 31, 2000.

Advance Rulings:

At present, an advance ruling can be sought only by non-residents and by notified categories of residents. The

bill proposes that even residents can seek a ruling if they are undertaking transactions with non-residents. Further, besides a question of law or fact, an advance ruling can now be sought on computation of total income pending before any income tax authority or appellate authority.

Unabsorbed Depreciation:

As per the existing provisions of the ITA, the unabsorbed business losses are allowed to be carried forward and set-off against future business profits even if that particular business is discontinued. The Finance Minister has proposed to extend this benefit to unabsorbed depreciation as well.

Demerger:

At present, if a foreign company holds shares in an Indian company and it demerges, such transfer of Indian company's shares does not attract capital gains tax in India provided that 75% of shareholders continue to be shareholders of the demerged company. The bill proposes that 75% should be in terms of value of shares and not in terms of number of shareholders.

The bill provides for definition of 'networth' in case of a slump sale.

Tax on income distributed by mutual funds (MF) including Unit Trust of India (UTI):

Tax payable by Mutual funds or UTI on distribution of income has been increased from 10% to 20%. This would be further subject to surcharge as applicable. However, the open-ended equity oriented funds will continue to get the benefit of exemption from such tax for the next two years.

Income of 'Investor protection fund' set up by stock exchange to be exempt from tax.

ESOPs:

No change has been made in the tax treatment of ESOPs. It was anticipated that the ESOPs would be made taxable only once at the time of sale instead of at the time of exercise as perquisites and at the time of sale as capital gains, as is done currently.

OVERSEAS DIRECT INVESTMENT

The ceiling for overseas direct investment by Indian companies under automatic route is increased from existing USD 15 million to USD 50 million for Indian corporates. Any investment beyond this limit would be subject to approval by Committee on Overseas Investment. The Finance Minister announced that RBI would notify the new guidelines to acquire companies overseas shortly.

SECTORAL INCENTIVES**Film Industry:**

Last Finance Bill had made the income of a corporate from export of film software exempt from tax. This benefit is now proposed to be extended to non-corporate entities as well. However, like other export incentives, even this exemption will be withdrawn in a phased manner over 5 years.

The Import duty on cinematographic cameras and other related equipment will come down from 40 to 25 % and certain types of films from 50% to 5%.

Venture Capital Funds :

The Finance Minister has overhauled the provisions relating to venture capital funds (VCF). The approval from the tax department for setting up VCF has been dispensed with, but a VCF will be subject to Securities and Exchange Board of India (SEBI) guidelines. SEBI is proposed to be appointed as single point nodal agency for regulating offshore and domestic

VCF. Now, the entire income of VCFs will be tax exempt. However, a VCF would be liable to tax at the rate of 22% (including 10% surcharge) if VCF is a company and at the rate of 23% (including 15% surcharge) if the VCF is a Trust on income distributed by it. It would also be liable to tax at the same rates if it fails to distribute its income within the time period notified by SEBI with the approval of the Central Government. However, income in the hands of unitholders will be exempt from any income tax.

A VCF could be doubly taxed under the proposed provisions. If the income of the VCF is not distributed within the specified time the undistributed income would be taxed. Further, the same income would be taxed when it is in fact distributed. There is an ambiguity as to whether redemption of units would be subject to distribution tax.

Number of other issues arises in relation to structuring a VCF in India. It remains debatable whether foreign VCs should invest through domestic trusts or take benefit of new provisions at all.

This may adversely affect the growth of newly maturing VC industry in the country.

Interest rate on general provident fund reduced from 12% to 11%.

Infrastructure:

In addition to encouraging the private infrastructure service providers, the finance minister is planning to move ahead with programmes for corporatisation of public sector service providers in the areas of telecommunications, ports and airports.

The Finance Minister has announced a highly initiated road development project worth about Rs. 540,000 million, called the National

Highways Development Project (NHDP).

The plan outlay for the Central PSUs in the power sector is proposed to increase from Rs. 76,260 million to 91,940 million.

In order to reform the process of the power sector and modernize the old and inefficient plans, a new scheme providing assistance to State and union territory government will be introduced.

To overcome the problem of large dues of State Electricity Boards, a scheme for securitisation of these dues with the support of central government has been finalized.

Public Sector Undertakings:

The finance minister has also suggested to restructure and revive potentially viable Public Sector Undertakings (PSUs) and close down PSUs which can not be revived. It is proposed to bring down Government stake in all non-strategic PSUs to 26% or lower, if necessary.

Jewellery Exports:

The Bill proposes to reduce the basic customs duty on platinum and non-industrial diamonds from 40% to 15% in order to encourage production of quality jewellery and to provide a fillip to jewellery exports.

IT and Telecommunications :

The Finance Minister has proposed certain direct measures to promote the growth of telecommunications and information technology industry. There have been significant cuts in basic customs duty rates in telecom equipment and computer hardware. The cuts in duties would boost the growth of telecommunications in India, which had been languishing from the inadequate state of infrastructure for growth. In particular, cellular telephony would benefit from increased market penetration. Duty on cellular phones has been reduced to 5%

However, the information technology sector also stands to lose some of its privileges it earlier enjoyed as a sunrise industry. The Budget now proposes that earnings from software exports, which had been exempted from income tax earlier, would now fall into the tax net.

Concessional rate of 10% on long-term capital gains tax to apply to units of Mutual Funds and UTI.

The Import duty on computer motherboards has been reduced from 50 to 20 per cent. The import duty on semiconductor components has been reduced from 15 per cent to five per cent. The import duty on microprocessors has been slashed from five per cent to nil. Import duty on integrated circuits has also been cut from five per cent to nil.

Banking :

It is proposed to accept the recommendations of the Narasimham Committee on Banking Sector Reforms for reducing the requirement of minimum shareholding by Government in nationalized banks to 33%. This will be done without changing the public sector character of banks while ensuring that fresh issue of shares is widely held by the public. The Committee had also expressed the view that the Boards of the banks should have sufficient autonomy. It is proposed to bring about necessary changes in the legislative provisions to accord the necessary autonomy to the Boards of the banks.

It is proposed to set up a working group for restructuring weak public sector banks. The Finance Minister promised not to close down any public sector banks.

Interest tax Act is proposed to be abolished with effect from March 31, 2000.

Shipping:

The bill proposes to provide tax sops for ailing shipping industry. At present, 50% of the profits of a company engaged in shipping activity are exempt from tax if they are transferred to a special reserve to be utilized for the purpose of acquisition of new ships. It is proposed to extend this benefit to entire profits of the shipping company provided they are transferred to special reserve.

INDIRECT TAXES**Customs Duty:**

The Bill reduces the peak rate of basic customs duty from 40% to 35%, thereby reducing the total number of customs duty rate slabs from 5 to 4, i.e. 35%, 25%, 15% and 5%. A surcharge of 10% continues as before. Crude oil and petroleum products, certain WTO bound items and gold and silver would continue to be exempt from this surcharge.

The Special Additional Duty (SAD) of customs, which was introduced in 1998-99 on manufacturer importers, will now be extended to traders as well.

The year 2000-2001 to be celebrated as 'Womens' Empowerment Year'.

Consequent to India's international trade treaty obligations, several hundred items will be placed on the free list for imports effective 1.4.2000. Most of these are consumer goods and a number of them are agricultural products. To accord adequate tariff protection for these items, they will be placed at the peak rate (35% plus surcharge), except for a few items like capital goods. Several duty incentives have been provided to three key sectors that have been picked up for special attention. These include the Information Technology sector, the telecommunications sector and the entertainment industry.

Excise Duty:

The Bill proposes a unified single rate of excise duty. It combines the three existing ad-valorem rates to a single rate of 16% Central Value Added Tax (CENVAT) to be levied by the Central Government.

In addition to the 16% CENVAT rate, the bill also proposes three rates of special excise of 8%, 16% and 24%. Unlike the CENVAT rate, the users will generally not be able to avail of VAT credit for these special excise duties.

As per the Bill, all inputs and all capital goods are now eligible to VAT. The only exception will be High Speed Diesel Oil and Petrol. However, the availability of VAT credit on capital goods will be spread over a period of two years, with effect from 1st April 2000.

Service Tax:

No changes have been proposed in service tax.

Stamp Duty:

Section 8A of the Indian Stamp Act, 1899, exempts the issue and transfer of certain dematerialized shares and units from stamp duty. The Bill proposes to extend the benefits of such exemption from the transfer of shares to the transfer of all securities as defined under the Securities Contracts Regulations (Act), 1956.

INTELLECTUAL PROPERTY PROTECTION

The Budget has also recognized that intellectual property is the currency of the knowledge economy. The Finance Minister has categorically stated that the Government would strive to remove all impediments for early implementation of the modernization project.

The contents of this paper should not be construed as legal opinion or professional advice.

Modernization of the Trademarks Registry would also be undertaken.

The Road Ahead :

It is proposed to set up a committee to look into tax reforms and taxation of insurance sector. Indian tax authorities have launched an assault on taxation of International electronic commerce transactions. The Finance Minister would have done well in clarifying India's position on taxation of such transactions. It is hoped that there will be more substantial steps to the reform road map in the next budget.

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