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India Budget Insights 2011-12

***The International Tax Team of Nishith Desai Associates* summarizes various tax structures and its repercussions of the Union Budget 2011.**

Earlier in the day, the Indian Finance Minister presented the 2011 Budget amidst the backdrop of a reviving economy, increased trade and investment flows, and a remarkably positive outlook for the financial year 2011-12. In a welcome move, the Government has decided to allow foreign investors meeting specified KYC standards to invest into SEBI registered Mutual Funds. This will provide a boost to Indian stock markets and also offer interesting investment avenues for foreign investors. The Budget also proposes to increase the existing limits for investments by Foreign Institutional Investors into corporate bonds issued by infrastructure companies. In tune with this spirit, the Government has already introduced a consolidated Foreign Direct Investment (**FDI**) policy backed by simplified procedures aimed at further liberalizing FDI into India.

However, it seems that the positive impact of these measures has been dented by the Government's decision to impose minimum alternate tax (**MAT**) at the rate of 18.5% on Special Economic Zone (**SEZ**) developers as well as units set up in SEZs. These entities shall hence lose the MAT exemption which they currently enjoy. SEZ developers would also be subject to a dividend distribution tax (**DDT**) at the rate of 15% on dividends distributed to their shareholders. Currently, SEZ developers are exempt from paying DDT and the Budget proposals would cumulatively give rise to tax costs of around 30% which can distort cash flows. It is unfortunate that the Government has refused to meet the legitimate expectations of investors who have invested billions on the basis that specific incentives would be available. The Government's fluctuating policy stance may give rise to issues of credibility in the eyes of the investing community.

While these are the most noteworthy dimensions of the 2011 Budget, the following are some of its other salient features.

Tax rates

The 2011 Budget does not propose any significant change to the corporate tax rate apart from a minor reduction in the surcharge from 2.5 to 2% for foreign companies and 7.5% to 5% for Indian companies. Further, the rate of DDT on dividends distributed by domestic companies to its shareholders remains constant at 15%. The existing rate of MAT is proposed to be marginally increased from 18% to 18.5%. Apart from SEZ developers and units, MAT would also be imposed on limited liability partnerships.

Direct Taxes Code

The Finance Minister has resolved to push the much debated Direct Taxes Code Bill (**DTC**) through Parliament in the course of the year, with the aim of implementing it from the financial year, 2012. The DTC is currently being scrutinized by the Parliamentary Standing Committee on Finance which has been in active dialogue with a number of professionals and industry bodies. The major concern with the DTC is the proposed general anti-avoidance rules (**GAAR**) which provide wide discretionary powers to the tax authorities to disregard and re-characterize transactions and instruments, and re-allocate income between parties. The near absolute powers conferred upon the tax authorities will provide further scope for corruption in a country where this has already become a huge problem. The GAAR framework also overrides India's tax treaties and is bound to create immense uncertainty in the investment and business environment.

Reduced tax on repatriated dividends

With a view to incentivize repatriation of offshore funds, the Budget proposes to reduce the tax on in-bound dividends received by Indian companies from their foreign subsidiaries from 30% to 15%. This incentive could have greater relevance to Indian companies that would be taxed on undistributed passive income earned by their controlled foreign corporations under the proposed DTC.

On the flipside, however, the Indian company would not be entitled to a deduction in respect of expenditure connected with the earning of such foreign dividend thereby potentially raising the overall tax costs. This is likely to impact the globalization strategy of Indian companies raising debt to fund overseas acquisitions.

It is suggested that the Government should provide greater incentive for repatriation of offshore funds by introducing a participation exemption in relation to dividends and capital gains arising accruing from eligible foreign subsidiaries. This system has been widely followed in evolved tax regimes such as Netherlands and other countries in the European Union.

Anti avoidance

The Budget also proposes a number of administrative and substantive measures to counter anti-avoidance and to further India's commitments as member of the G20 Financial Action Task Force against money laundering.

One proposal is to extend the transfer pricing regime to transactions by residents with parties located in notified offshore jurisdictions, being non-cooperative territories that have not signed a tax information exchange agreement (**TIEA**) with India. Income earned by residents of such jurisdictions from Indian sources may be subject to an enhanced withholding tax of 30% irrespective of a lower withholding rate provided under domestic law or an applicable tax treaty.

Tax authorities have been provided with additional administrative powers while requisitioning documents and other information from tax payers. The Government has also sought to keep a close tab on the functioning of liaison offices of foreign entities and to specifically check if they are operating as branches or places of business which may give rise to tax liability for the foreign entity.

Service tax

The existing service tax rate of 10.3% (including surcharge) remains unchanged. However, in a notable departure from the existing service tax regime, the Government has advanced the point to taxation to the time when services are provided rather when payment is received. This provision can give rise to several difficulties, especially in cases of deferred consideration, or termination or breach of contract after the services are provided.

The Budget also proposes to add a number of new services to the service tax net including legal advisory services provided by a business entity to an individual, legal representational services provided by any person (including individuals) to a business entity and arbitration services provided by an arbitral tribunal to a business entity.

Sector specific benefits

On the bright side, the industry can look forward to a number of sector specific tax reliefs. Notable among these include a reduced withholding rate of 5% (as opposed to 20%) on interest received by foreign investors who have invested into notified infrastructure debt funds.

An enhanced weighted deduction of 200% would be available for contributions made to approved scientific research programmes. Specific excise duty and customs related concessions have also been provided for the manufacture and import of certain environmentally friendly products.

To Conclude

India’s economy is poised to grow at a rate of around 9% in the coming year which clearly stands out when contrasted with global recessionary trends that continue to affect several parts of the world.

With a view to sustain India’s high-growth strategy the Government has expressed its commitment towards inclusive development, increased accountability and better governance. A number of monetary initiatives have been proposed to counter the menace of inflation. The Budget also proposes a number of non-tax stimulus measures with a view to provide a boost to important sectors such as agriculture, banking and infrastructure

While the 2011 Budget does have a number of welcome features, especially on the non-tax front, the withdrawal of specific tax benefits for SEZ developers and units and changes to the service tax regime may not augur well with the industry. The Government will lose credibility in the eyes of investors if it frequently resorts to retrospective amendments, policy changes and introduction and revocation of incentives. India’s fiscal policy should seek to capture the full potential of foreign and domestic investment that is offered by a high GDP growth rate. A long term approach aimed at certainty and stability in fiscal policy is definitely the need of the hour.

DIRECT TAX

Income Tax Rates

The Finance Bill, 2011 (**Budget**) has proposed certain changes to the existing rates as prescribed in the Income Tax Act, 1961 (**ITA**) with respect to tax rates applicable to individual taxpayers, surcharge on tax in case of companies (including foreign companies), MAT, tax on dividends ***etc***. These changes have been highlighted below.

- **Corporate Tax Rates**

The corporate income tax rate, as per the Budget remains unchanged at the rate of 30% for an Indian company and 40% for a foreign company. However, the surcharge on income tax for companies with total income exceeding INR 10 million has been reduced. In case of domestic companies, the surcharge has been brought down from 7.5% to 5% while, for foreign companies it has been reduced to 2% from the existing 2.5%. There has been no change made to the education cess which is presently levied at the rate of 3%.

Further, no change has been made to the 30% tax rate applicable to co-operative societies, firms and local authorities.

- **Personal Tax Rates**

For the fiscal year 2011-12, the effective rates of taxes on Individuals, Hindu Undivided Families (**HUF**), Association of Persons, ***etc***. shall be as follows. A notable change in the Budget is the reduction in age limit prescribed to avail the beneficial tax treatment extended to ‘senior citizens’ from 65 to 60 years.

Income (in INR)	Rate
Upto 180,000	NIL
180,001 to 500,000	10%
500,001 to 800,000	20%

Above 800,000	30%

Further, a new class of 'very senior citizens' comprising of individuals aged 80 years or more has also been created. The effective rate of taxation for such persons is as follows:

Income (in INR)	Rate
Upto 500,000	NIL
500,001 to 800,000	20%
Above 800,000	30%

- **Minimum Alternate Tax (MAT)**

Effective from April 1, 2012, the Budget has proposed to increase the rate of MAT to 18.5% from the present 18% levied on book profits. The existing rules regarding set off and carry forward shall continue to apply.

Tax on inbound dividends lowered? Not always!

The Budget has proposed to reduce the tax on dividends received by Indian companies from their overseas subsidiaries from the existing rate of 30% to 15%.

The object of this proposal is to incentivize repatriation of funds back to India. The reduced tax rate assumes greater significance when viewed in light of the controlled foreign corporation (**CFC**) regime proposed in the DTC. Under the proposed DTC, the undistributed passive income earned by an Indian company's CFC located in an offshore low tax jurisdiction would be taxed in the hands of the Indian company at the rate of 30%. Therefore, it would be beneficial for the Indian company to receive dividends from the CFC, which would now be subject to the lower rate of 15%.

The 50% decrease in the tax rate on inbound dividends would definitely be viewed as a relief for globalized Indian companies which seek to repatriate profits earned outside India to India. The tax payable by the Indian entity may further reduce on taking into account taxes paid in the other country which may be credited in accordance with the beneficial provisions of an available tax treaty.

It must be noted that the Budget has provided for a disincentive in that expenditure incurred in connection with the earning of such dividend would not be tax deductible. Currently, an Indian company leveraging itself through debt for investing in an offshore subsidiary should be entitled to deduct its interest expenditure against the dividend income earned from the foreign subsidiary. By removing this benefit of expenditure deduction, the proposal may effectively increase tax costs and vitiate the policy objective behind the reduction in tax rate. Therefore, in certain cases, domestic companies may be motivated to structure their offshore investments in the form of debt so as to obtain expenditure deduction benefits in respect of borrowed capital funding. This sort of structuring may however be hit by thin capitalization norms in the relevant offshore jurisdiction as well as the general anti-avoidance rules proposed under the DTC.

Mutual Funds

- **Foreign Investment in Equity linked Mutual Funds**

Foreign investment in listed securities is currently open only to foreign investors registered as a Foreign Institutional Investor (**FII**) (or as a sub-account) with the Securities and Exchange Board of India (**SEBI**) and Non-Resident Indians (**NRIs**). Though categories of foreign corporate and individuals sub-accounts do exist in theory, the eligibility criteria had raised the threshold significantly, leaving non-residents with little choice but to come through intermediated structures like FII or broad based sub-accounts. Further, indirect access to the Indian markets through the Offshore Derivative Instruments (**ODI**) has always remained shrouded with uncertainty and restrictions.

It may be recollected that the ***"Report of the Working Group on Foreign Investment"*** (**Working Group Report**) had proposed for a single window for portfolio investment, wherein investors intending to make portfolio investments (to be defined by the government) would be categorized under a single investment regime, thereby doing away with their categorization as a FII, FVCI or FDI with respect to such portfolio investments.

As a welcome move, the Finance Minister has announced that equity schemes of mutual funds registered with SEBI (**Mutual Funds**) may accept subscriptions from foreign investors directly provided they fulfill the KYC requirements as prescribed by SEBI from time to time. This announcement once implemented would allow market access for large overseas institutional investors as well as overseas retail investors desirous of participating in the Indian capital markets, without an intermediary. This move seems to have been motivated as a first step towards implementing the proposals of the Working Group Report and is clearly one of the most significant developments proposed in this Budget as far as the Indian capital markets are concerned.

Having said that, the Indian AMCs need to be mindful of various regulatory and tax obligations that they may be exposed to in other jurisdictions while accepting contributions from a diverse investor base around the globe. For example, one would need to examine the applicability of the US Dodd Frank legislation to the AMCs and registration requirements in the US for mutual funds accepting contribution from US investors, both from a securities law as well as tax perspective.

- **Debt Mutual Funds**

Effective from June 1, 2011, the Budget has proposed to increase the rate of income tax on income distributed by debt mutual funds to persons other than an individual or HUF to 30%, presently taxed at the rate of 25% in case of money market mutual funds or liquid funds and 20% in case of debt funds other than money market mutual funds and liquid funds. In relation distribution to individuals and HUF, the same tax rates shall continue to apply.

Augmenting the Indian debt markets – Push for Infrastructure Sector

Historically, India has witnessed a low level of investment in infrastructure and infrastructure facilities and services in India have remained largely inadequate, thereby providing significant opportunities for investment. In recent times, however, the Indian Government has recognized the need to develop India's infrastructure sector in order to sustain long term economic growth. In the year 2008-2009, the investment in infrastructure reached 7.18% of India's GDP in 2008-2009. Moreover, the significant initiatives and reforms introduced by the Indian Government in recent years demonstrate its intention to accord priority towards the development of infrastructure in India. Thus, in order to promote investment in the infrastructure sector, the Indian Finance Minister in the previous Indian Budget (2010-2011) introduced a deduction of up to INR 20,000 from the taxable income of an individual or a HUF for investments made by such persons in certain long term infrastructure bonds. The present Budget has extended this exemption for an additional year which demonstrates the Government's commitment to promoting investment in the infrastructure sector.

- **New tax incentives for dedicated infrastructure debt funds**

In line with this policy, of promoting investment in the infrastructure sector, the Budget has proposed to introduce certain tax exemptions in respect of dedicated infrastructure debt funds. It is hoped that these tax incentives would augment long term and low cost foreign investment in the infrastructure sector. The proposed tax incentives contained in the Budget are as follows-

i. The ITA, would be amended to enable the Central Government to notify any infrastructure debt fund which is set up in accordance with the prescribed guidelines, and once notified, the income of such debt fund would be exempt from tax.
ii. Currently, in case of loans / debt provided to Indian companies in foreign currency, any interest paid on such loans / debt to a non-resident is subject to a withholding tax of 20% of the gross amount of the interest (in the absence of a lower rate prescribed by an available tax treaty). However, in case of a notified infrastructure debt fund, the Budget has proposed that any interest paid to a non-resident in respect of its debt investment in such fund would be subject to a withholding tax of (only) 5% of the gross amount of interest.
iii. **Increase in the debt investment limit for FIIs in respect of bonds issued by infrastructure companies**

Currently, the overall limit provided to FIIs registered with SEBI for investing in corporate debt market is US$ 15 billion, with an additional US$ 5 billion available for investing in corporate bonds issued by companies in the infrastructure sector. In a move that will provide a boost to foreign inflows in the infrastructure sector, the Budget has proposed the FII limit for investment in corporate bonds, with residual maturity of over five years issued by companies in infrastructure sector, to be raised by an additional limit of US$ 20 billion, thereby taking the limit to US$ 25 billion for investing in the bonds issued by infrastructure companies. At present, FIIs and their sub-accounts can only invest in listed debt instruments; however an exception has been made for infrastructure companies. Therefore, FIIs and their sub-accounts are now permitted to invest in unlisted bonds of infrastructure companies since most of the infrastructure companies are organized in the form of special purpose vehicles. Further, the Budget proposes that the investments in unlisted bonds would be subject to a lock-in for a minimum of three years, however, FIIs will be allowed to trade amongst themselves during such lock-in period.

The Indian regulators have time and again identified the need to create more liquid debt markets especially for capital intensive sectors like infrastructure where an active debt market is almost a pre-requisite. The move to increase the debt investment limit for FIIs in respect of bonds issued by infrastructure companies and to provide tax incentives to notified infrastructure debt funds is clearly a step further in this direction.

Death knell for SEZs ?

In the previous Indian Budget (2010-2011) , the Finance Minister in a disappointing move did not extend the tax holiday for units set up in software technology parks, 100% export-oriented units etc. The Finance Minister in the present Budget in a surprise move has sought to curtail key tax benefits available to units setup in SEZs and developers of such SEZs.

Currently a MAT of 18% is payable on the book profits of every company. In this respect, the mechanism of calculation of book profits has been provided in the ITA after carrying out certain adjustments. An exemption is allowed from payment of MAT in respect of income earned from any business carried on by a unit setup in a SEZ or income earned by a developer of a SEZ. However, the Budget has proposed to levy MAT at the rate of 18.5% on the book profits of a unit setup in SEZ or a person developing a SEZ. The MAT paid may be carried forward for a period of 10 years to be set-off against regular tax payable during the subsequent years.

Another tax sop enjoyed by the developers of SEZ that has been withdrawn pertains to levy of DDT at the rate of 15% on the profits distributed as dividend by a developer of a SEZ. The removal of this sop coupled with the imposition of MAT would no doubt be viewed by many as a big disincentive to developing or setting up a unit in a SEZ.

A peculiar problem may also arise with respect to the MAT credit that would be available with a unit or a developer for set off against future tax liability. In quite a few cases, especially in the case of developers in the first couple of years of their tax holiday, the MAT credit with respect to such years may lapse or be on the verge of lapsing by the time such developers are taxable under the normal tax provisions, since the MAT credit can only be carried forward for a period of 10 years. It is pertinent to point out here that a unit setup in a SEZ or a person developing a SEZ is entitled to a 100% tax holiday for a period ranging from 5 to 10 years. Further, in case of a foreign investor investing in a unit setup in a SEZ or a developer of a SEZ, claiming a tax credit in its home tax jurisdiction for the MAT paid in India may pose a challenge.

The levy of MAT on units setup in a SEZ and developers of a SEZ is not unexpected, especially given that the proposed DTC provides for imposition of MAT on income earned by units setup in a SEZ or by a developer of a SEZ. It is nonetheless a move which raises questions as to direction of the governmental policy with respect to SEZs. The government is keen on SEZs being one of the engines of growth of the economy and therefore promotes their growth on the ground that creation of SEZs shall benefit the country in terms of creation of additional employment, world class infrastructure and shall help make development uniform by creation of SEZs in different regions of the country. On the other hand, the move to remove tax sops with respect to SEZs seems at odds with the avowed governmental policy. Proponents of SEZs would no doubt be quick to term this move as retrograde especially given that lack of quality infrastructure is viewed as the Achilles heel of the Indian economy. Another key concern that this move raises is that a taxpayer is entitled to certainty in terms of tax law, so as to plan his / her economic affairs, and the removal of these tax sops has a regressive impact in many ways which adversely affects taxpayers who would have based their business models on the availability of these very benefits and incurred additional expenses to move into or develop a SEZ. One suspects this proposal may face stiff opposition in the coming weeks.

Levy of MAT on LLPs

The Budget has proposed to levy MAT on limited liability partnerships (**LLP**). It has been provided that where the regular income tax payable by a LLP for a particular financial year is less than the corresponding alternate minimum tax computed at the rate of 18.5% on its adjusted total income, such alternate minimum tax shall be deemed to be the income tax liability of such LLP. Further, the Budget has provided for the computation of 'adjusted total income' by increasing the total income of a LLP for the relevant year by specific deductions claimed under the ITA, including those claimed by a SEZ unit of such taxpayer, if any. LLPs shall be permitted to carry over the credit for the alternate minimum tax for a period of 10 years and to use the same to set off any regular income tax liability payable by such LLP in a subsequent year. It should be noted that under the present regime MAT is applicable only to companies.

LLPs were introduced in India ***vide*** the Limited Liability Partnership Act, 2008 (**LLP Act**); combining the beneficial features of a company and partnership, such as distinct legal personality, limited liability while allowing for operational flexibility, ***etc***. The ITA currently provides a beneficial tax regime for LLPs with a single-tier tax of 30% (such income is not taxed again in the hands of the limited partners) and exempts LLPs from DDT and MAT. Thus, the taxation of LLPs was broadly in line with that for partnerships. This made LLPs an attractive vehicle for undertaking business activities.

The LLP Act was formulated to provide an entity form which provides flexibility in doing business and it was made particularly attractive by exempting it from the purview of DDT and MAT. However, the current Budget proposal in this regard may act as a disincentive for the adoption of the LLP model, especially when compared to the partnership model, since partnerships still fall outside the purview of MAT, albeit the partners have unlimited liability. Interestingly, while the rate of MAT is proposed to be the same for both LLPs as well as companies, the manner of calculation is seemingly quite different. While MAT in relation to companies would be calculated on the book profits of such a company, for LLPs it would be computed on the adjusted total income of the LLP. This is likely to cause confusion, since the term 'total income' in relation to a LLP has not been defined, either in the ITA or the Budget.

Transfer pricing amendments

The Budget has sought to remedy a long standing problem pertaining to the use of current year's data in the preparation of a transfer pricing report. Presently, according to the ITA, any company entering into an international transaction with an associated entity is generally under an obligation to have a transfer pricing report prepared for the correct determination of the arms' length price. In the preparation of this report, reliance is usually placed on publicly available information from a database pertaining to companies which can be compared to the business carried on by the taxpayer.

Further, the ITA mandates the filing of the aforementioned report before September 30 of each year. However, information pertaining to comparable companies for the relevant year is usually unavailable while preparing the report ***i.e.*** before the end of September. Therefore the taxpayers are left with no option but to use data of comparable companies pertaining to previous financial years other than the year under assessment. Despite being aware of this practical difficulty, the Income Tax Department has on many occasions, in the course of assessment (which happens subsequent to filing of the report by when the relevant data is available), sought to place reliance on data of the relevant year. This approach has lead to myriad of litigation pertaining to the reliance of the Income Tax Department on information which was not available to the taxpayer at the time of preparation of the report.

In a welcome move, the Budget has sought to extend the time line for filing the transfer pricing report as well as the corporate income tax return of companies who have entered into an international transaction with associated enterprises by two months ***i.e.*** to November 30 so as to enable them to place reliance on data of the current year under assessment. While this is a welcome move, its efficacy may be limited, since the data would be available after the transaction has been concluded at a particular price, which could lead to unnecessary adjustments by the tax officer. Perhaps a paradigm shift could be considered where the data used for fixing the price in a financial year, is that of the previous financial year, and perhaps a minimal adjustment could be made to the same, depending on inflation, etc.

The current transfer pricing provisions mandate that the most appropriate method is chosen to compute the arm's length price. These provisions recognize that transfer pricing is not a perfect science and therefore allow the taxpayer a 5% variation between the actual price charged by the taxpayer and the arm's length price determined. However, the amendment proposed by the present Budget, has attempted to peg the percentage of this variation to a number which would be determined by the Central Board of Direct Taxes (**CBDT**). The rationale for this move is that a fixed margin of 5% across all segments of business activity and range of international transactions has "outlived" its utility. In this background, the CBDT would consider specifying industry centric permitted variations, contingent on the scope of variations possible in the individual industrial sectors. This move must be treated with a degree of apprehension, since it would introduce an element of uncertainty as to what would constitute an acceptable variation. Also, in certain situations, it may lead to a situation of conflict between the taxpayer and the Income Tax Department since they may disagree on which business segment is applicable to the taxpayer.

Black Money and Toolbox Provisions

In the recent past, the issue of black money parked by Indian residents in offshore jurisdictions has gained much attention. India views ineffective exchange of information as a major impediment to tracking and dealing with such black money. The Budget has proposed a two-prong strategy to deal with the issue ***i.e. firstly***, increased co-operation with the international community, and ***secondly***, laying down an anti-avoidance regime specific to jurisdictions which are hesitant in exchanging information. Efforts to increase cooperation have been made through the conclusion of Tax Information Exchange Agreements and tax treaties with a wide network of countries over the last one year, as well as addition of personnel to the tax enforcement arm. The Budget has proposed the introduction of a provision in the ITA, to provide for anti-avoidance measures in cases of transactions entered into with persons located in countries and jurisdictions which do not effectively exchange information with India. Such '***Toolbox***' provisions would enable the Central Government to notify any territory outside India, with regard to which there is a lack of effective exchange of information.

Further, the Budget has proposed that a Central Government notification could result in significant tax implications which are as detailed below. It is noteworthy that the Budget does not restrict the scope of the 'notification' to non-treaty jurisdictions or provide clarity on what should constitute ineffective exchange of information. In case the avoidance provision is sought to be applied with respect to a treaty jurisdiction, it may be considered problematic to the extent that it interferes with our ability to fulfill our treaty obligations with other countries. Hopefully there will be some clarity introduced in this regard.

- **Inbound receipts:**

With respect to inbound remittances from persons situated in notified jurisdictions, there could be two kinds of consequences under the proposed provision. ***Firstly***, if an Indian taxpayer receives any sum from a person located in a notified jurisdictional area, the proposed provision could apply to tax any such sum, unless the taxpayer is able to explain with respect to the source of such money in the hands of such taxpayer / beneficial owner. While similar requirements are contained in provisions of the ITA pertaining to unexplained income, this provision would place the ***onus*** on an Indian recipient to determine the source of funds of a ***third party*** payer.

Secondly, the person situated in the notified jurisdiction would be considered an associated enterprise with respect to the transacting party, and all arrangements would be required to be undertaken at arm's length. This introduces a transfer pricing component into transactions even between unrelated parties.

- **Outbound payments**:

The proposed provision imposes four kinds of requirements on payments made by an Indian resident to persons situated in a notified jurisdiction.

Firstly, if the payment is to a financial institution in a notified jurisdiction, such payment is proposed to be disallowed unless the paying taxpayer authorizes (in prescribed form) the Indian tax authorities to seek relevant information from such financial institutions, on behalf of the taxpayer. ***Secondly***, if the payment results in any other kind of deduction of expenses / allowances (including depreciation) to the taxpayer, they shall be disallowed unless the taxpayer maintains such documents and furnishes such information as prescribed in this regard. ***Thirdly***, as discussed in the section above on inbound receipts, arrangements with persons situated in notified jurisdictions would be considered subject to the transfer pricing regulations, irrespective of whether they take place between related parties. ***Lastly***, payments to persons situated in notified jurisdictions would be subject to a rate of withholding tax which is the higher of a) the rates in force b) the rates prescribed under the relevant provisions of the ITA c) 30%.

While the concern behind introduction of the above provision is understandable, it lacks certainty in determining '***lack of exchange of information with any country or territory outside India***'. As mentioned above, additional clarity is required on the application of the proposed law to notify jurisdictions with which India has negotiated a tax treaty bearing an exchange of information clause. Additionally, the application of this proposed legislation may be unduly harsh on taxpayers entering into genuine transactions with persons located in a notified jurisdictional area. Such situations could specifically arise due to application of withholding tax at a minimum rate of 30% since the proposed law leaves no scope of avoiding such high rate of withholding tax by disclosing information.

INDIRECT TAXES

Goods and Services Tax

The Finance Minister has reiterated his commitment towards the introduction of the long pending Goods and Services Tax (**GST**). Though political concurrence and constitutional issues have been a stumbling block in its introduction, there has nonetheless been a concerted move in this Budget towards making various alignments in terms of removal of exemptions, moderation of certain rates etc. As a step towards roll out of GST, Constitution Amendment Bill has been proposed to be introduced in the Parliament.

Service Tax

A key change brought about with respect to the levy of service tax is the move to alter the adoption of point of taxation rules for services and shift the basis for tax collection from "cash" towards "accrual". This would have a significant impact for all service providers since there would be a levy of service tax the moment the services are provided or the invoice is raised, even in the absence of payment received. This would result in significant cash flow issues and additional burden on service providers.

Additionally, there are certain new hospitality services that are proposed to be introduced into the service tax net ***viz***. restaurants and hotels / inns. Additionally, there has been some expansion in the scope of existing services which can have an impact on the legal and health care industry. This includes services provided by lawyers to business entities relating to litigation related activities and services provided by hospitals having more than 25 beds and central air conditioning.

A modified scheme with respect to refund of service tax to SEZ units and developers has been introduced, which would allow the SEZ units and developer to obtain tax-free receipt of services wholly consumed within the zone and get their refunds in a much easier manner.

Customs Duty and Central Excise

The peak rate of customs duty and excise duty of 10% has been kept constant. With a view to introduce GST, there has been an alignment of certain duty rates and removal of exemptions in respect of a number of products. Additionally, all clearance from SEZ into a Domestic Tariff Area has been exempted from Special Additional Duty subject to the condition that they have not been exempted from the levy of Value Added Tax / Sales Tax.

MISCELLANEOUS

BFSI sector Impact

Social reforms for the financial services sector:

- INR 60 billion for equity infusion in public sector banks,
- INR 5 billion for recapitalization of Regional Rural Banks;
- INR 50 billion to SIDBI for lending to Micro, Small and Medium Enterprises;
- Corpus of the Rural Infrastructure Development Fund has been raised to INR 180 billion
- INR 30 billion has been allocated to NABARD to assist financially unviable handloom weaver cooperative societies;
- Limit for priority sector housing has been enhanced by INR 500,000, interest subvention scheme to housing loans by upto INR 1.5 million and the Rural Housing Fund to INR 30 billion.

Investment oriented initiatives, through legislative reforms including proposed changes to:

- Insurance Laws (Amendment) Bill 2008,
- Life Insurance Corporation (Amendment) Bill, 2009,
- Banking Laws Amendment Bill, 2011
- Amendment to the RDBFI Act 1993;
- SARFAESI Act 2002 including setting up of a Central Electronic Registry to avoid multiple lending from different banks on the same property; and
- Introduction of INR 1 billion India Microfinance Equity Fund with SIDBI
- Additional banking licenses are proposed to be issued to private players.

Others

- The Budget has proposed an enhanced weighted deduction of 200% for contributions made to approved scientific research programmes. In addition, benefits in the nature of investment linked deduction for capital expenditure is extended to the low cost housing and fertilizer industries based on specified eligibility criteria.
- A liaison office set up by a foreign person will be required to prepare and deliver a statement of its activities in a financial year within 60 days from the end of such financial year.
- The Indian automobile market is amongst the top growers in the world and has shown nearly 30% growth this year. Adopting an environmental and cleantech approach for the Indian automobile industry, the Government has decided to launch the national mission for hybrid and electric vehicles in collaboration with all stakeholders. This commission would not only incentivize research and development but would also increase usage of renewable energy and pollution free vehicles. However, institution and implementation of such commission is awaited.

THE INTERNATIONAL TAX TEAM at Nishith Desai Associates has compiled this analysis of the 2011-12 Indian budget.

REFERENCES

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