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# Doing Business in India: Budget 2007-2008

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# Doing Business in India: Budget 2007-2008

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The Budget presentation by the Indian Finance Minister ("FM") is an important annual fiscal event for the nation. It not only narrates the fiscal achievements of the past year, but also announces the fiscal policy measures of the government for the forthcoming year. Of most importance is the Finance Bill, presented along with the Budget, through which changes are proposed to the Indian tax regime. The changes to the Indian Income Tax Act, 1961 ("ITA"), the principal income tax legislation in India, are made through the Finance Act, which is enacted by the Parliament after passing the Finance Bill.

On February 28, 2007 the FM, P. Chidambaram announced India's much-anticipated Budget for the year 2007-2008. Several changes were expected in the hope of sustaining and furthering investments (foreign or otherwise) into India Inc. However, only a few changes have been announced in the Budget and these affect select industries. In this article, we analyse the key aspects of the Budget that would be of relevance to the international business community from the perspective of doing business in and with India.

## I. Direct Taxes

### A. Rates

The direct tax rates remain largely unchanged. An additional higher education cess of 1 percent has been introduced and a few other taxes been introduced/raised, the details and impact of which are discussed below.

*1. Corporate tax rates*

The basic corporate tax rates on Indian resident and non-resident companies have not been increased.[1] The rates of capital gains tax and Securities Transaction Tax ("STT") were also left untouched. However, the *effective* corporate tax rates have increased as a consequence of the rate of education cess being increased from 2 percent to 3 percent. Thus, though the rate of tax on Indian and foreign companies continues at a rate of 30 percent and 40 percent respectively, the effective corporate tax rate (inclusive of surcharge and education cess) has shot up to 33.99 percent and 42.23 percent as opposed to the former rates of 33.66 percent and 41.82 percent respectively.

*2. Dividend tax*

In India, companies that declare dividends are required to pay an additional corporate tax known as Dividend Distribution Tax ("DDT"). However, the shareholders of the company (residents as well as non-residents) are exempt from tax on the dividends. This DDT has been increased from 12.5 percent to 15 percent. Along with the surcharge and education cess, the effective rate for DDT will be 16.995 percent. This has the impact of reducing the cash flow, on account of dividend distribution to an investor, in an Indian company. Generally, as DDT is a tax on the paying company and not a tax on the shareholder it is not available for credit against the home country income tax on the dividend received in the hands of the investor.

Thus, a resident company would, in aggregate, be subjected to an effective rate of tax at 44 percent (inclusive of the corporate tax and the DDT).

The taxation of a U.S. corporate shareholder on the income earned from an Indian company is illustrated in the tables below. Table 1 explains the tax treatment in India and would be applicable to any foreign corporate shareholder. Table 2 explains the tax treatment of such income earned by the shareholder of the Indian company in the United States.

**Table 1: Flow of dividends in India**

| # | Particulars | Amount |
|---|---|---|
| | Taxable Income | 100 |
| | Less: Corporate Tax at 33.99% | 33.99 |
| | Profits after tax ("PAT") | 66.01 |
| | Less: Transfer to reserve (10% of PAT[a]) | 6.60 |
| | Profits available for distribution | 59.41 |
| | Less: Dividend Distribution Tax (16.995%) | 10.10 |
| | Dividends Distributed to Shareholder | 49.31 |

[a] This is the requirement under the Companies Act, 1956

**Table 2: Tax treatment in the United States**

| # | Particulars | Amount |
|---|---|---|
| | Taxable Income (Dividends received from Indian company) | 49.31 |
| | Less: Corporate Tax at 35%[b] | 17.26 |
| | Net after tax income in the hands of U.S. shareholder from the profit of 100 made by Indian company | 32.05 |

[b] Provided underlying tax credit is not available in the United States

### B. Withholding Tax

There have been several changes in the withholding tax rates applicable to payments made to Indian residents. In the context of this article, a significant change is that fees for professional services or fees for technical services will now be subject to a higher withholding tax of 10 percent as compared

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to the current rate of 5 percent. Further, though the Budget has not changed the rates of capital gains tax, it has broadened the tax base for capital gains tax by amending the definition of "capital assets". Accordingly, the transfer of personal assets such as archaeological collections and works of art will now attract capital gains tax.

### C. Transfer Pricing

Several ambiguities continue to prevail in India's transfer pricing regulations. Transfer Pricing Officers ("TPOs") who are specified officers appointed by the Tax Department to deal with transfer pricing cases, are to be given a shorter time period within which to pass their orders determining the arm's length price. Further, the Assessing Officer ("AO") is currently required to proceed with the computation of income of the taxpayer *"having regard to"* the arm's length price determined by the TPO. This discretion seems to be withdrawn and the AO is now required to compute income of the taxpayer *"in conformity with"* the arm's length price determined by the TPO. This will bring relief to many companies that are currently litigating against the arbitrary assessments that have been made by the AO.

### D. Capital Markets

In a welcome change, the Budget has announced that financial institutions will now be permitted to short sell securities, provided the transactions are settled by delivery. Securities lending and borrowing to facilitate delivery will be permitted. This is expected to provide the much needed stability to the capital markets. However Foreign Institutional Investors ("FIIs") will still need to wait to be able to short sell in the Indian markets. Currently, FIIs are permitted to short sell only derivatives.

Indian companies will be allowed to unlock a part of their holdings in group companies in order to meet their financing requirements by issue of Exchangeable Bonds. Further, the Budget has provided some simplification for participants in the securities market by making the Permanent Account Number[2] ("PAN") the sole identification number for all operations on the capital market. This is undeniably a positive step forward as there has been a lot of uncertainty regarding the different identification numbers required for participants in the capital market, such as MAPIN (for intermediaries), MIN (for investors in mutual funds) and so on.

#### *1. Venture Capital Funds ("VCFs")*

Currently, any income of a VCF set up to raise funds for investments in Venture Capital Undertakings ("VCUs")[3] and registered with the Securities and Exchange Board of India ("SEBI") is exempt from taxation. With a view to restricting the prevailing tax exemption only to certain sectors, the exemption will now only be available to income from Indian unlisted companies engaged in specified businesses such as:

- nano-technology;
- information technology relating to hardware and software development;
- seed research and development;
- dairy or poultry industry;
- bio-technology;
- research and development of new chemical entities in the pharmaceutical sector;
- production of bio-fuels; and
- building and operating composite hotel-cum-convention centres with seating capacity of more than three thousand.

Thus, even while recognising that VCFs provide a useful source of risk capital to start up new ventures, the Budget has sent out shock waves to the venture capital industry by restricting the current pass through status accorded to any SEBI registered VCF set up in India.

These changes to the VCF regime were not necessary, in that even though the VCF was not taxed, the investors paid tax on distribution. The investors in the VCF were taxed as if they had made the investment directly in the VCU. At the very least, completed transactions should have been "grand-fathered" from these adverse changes. In most countries, venture capital investments are pooled into tax transparent entities. The absence of providing for such tax transparent entities in India would make it challenging for Indian companies to attract venture capital funding.

#### *2. Mutual funds*

Currently, Indian residents are allowed to invest in foreign securities by remitting up to U.S.$ 50,000 per financial year and domestic mutual funds are allowed to invest up to 10 percent of their net assets in foreign securities. The Budget has proposed a convergence of the different regulations by permitting individuals to invest in foreign securities through Indian mutual funds.

### E. Software Technology Parks (STP) and Special Economic Zones (SEZ)

Entities set up in 100 percent Export Oriented Units ("EOUs")/STPs are currently exempt from the payment of corporate tax on profits from the "export of computer software", for a period of 10 years which ends on March 31, 2009. This tax holiday has significantly helped the growth of the IT industry in India and hence several representations were made by the IT industry for an extension of the tax holiday beyond March 31, 2009. However, the FM has not acceded to this request. Instead, EOUs/STPs enjoying this tax holiday under the ITA have been brought within the purview of Minimum Alternate Tax ("MAT"). When the income tax payable on the total income as computed under the provisions of the ITA is less than 10 percent of the book profits of a company, the company is subject to MAT. In such an instance, the book profit is deemed to be the total income of the company for the purpose of tax, and this book profit is subject to tax at the rate of 10 percent. The MAT mechanism ensures that every company pays a tax of at least 10 percent of its book profits.

Although the golden tax regime for the IT industry is nearing an end, a new regime has emerged in the form of Special Economic Zones ("SEZs"). Units set up in an SEZ benefit from a package of direct and indirect tax incentives combined with an integrated infrastructure for export production and quick approval mechanisms. A graded tax holiday for 15 years is available to units set up in SEZs. However, the Budget seeks to restrict this tax holiday only to "new" units set up in SEZs. In other words, the unit in SEZ should not be set up by the splitting up or reconstruction of an existing business. Further, it should not be formed by the transfer of old plant or machinery. By introducing this provision, the FM has clarified that existing STPs or EOUs that migrate to an SEZ would not

be entitled to the tax holiday under the SEZ regime. On the plus side, the new units set up in SEZs will continue to remain exempt from MAT.

### F. Infrastructure

Currently, the ITA provides a 10-year tax holiday to an enterprise or an undertaking engaged in development of infrastructure facilities, Industrial Parks and SEZs. The Budget proposes to extend this 10-year tax holiday to undertakings that lay and operate cross country, natural gas distribution network and storage facilities integrated to the network, as well as navigation channels in the sea.

However, in a surprising move, the Budget seeks to withdraw the tax holiday available to infrastructure units, which undergo a merger or demerger after March 31, 2007. This change may act as a disincentive for Indian companies looking to undertake inorganic expansions. Further, the Budget clarifies that those persons who execute civil construction work or any other works contract with respect to the development of infrastructure facilities will not be entitled to this 10-year tax holiday.

### G. Hotels

With a view to meeting the logistical requirements of the Commonwealth Games to be hosted by India in the National Capital Territory of Delhi in 2010, and to boost the number of convention centres in India, a new five-year tax holiday has been proposed. This tax holiday would be applicable to convention centres and 2, 3 or 4 star hotels in the National Capital Territory of Delhi and specified adjacent districts. Further, the convention centre or hotel is required to become operational between April 1, 2007 and March 31, 2010 in order to be entitled to this tax holiday.

### H. Employee Stock Options/Sweat Equity and Fringe Benefits Tax (“FBT”)

The FM has sought to change the tax incidence on employee stock options and sweat equity. Currently, shares that are issued under an Employee Stock Option Plan (“ESOP”) are taxable in the hands of the employees only at the time of sale of shares, provided the ESOP is in compliance with the relevant guidelines issued by the Government of India. Hence, employees currently do not have any tax liability either on vesting or exercise of options or on allotment of shares pursuant to an ESOP. Sweat equity shares are currently taxed in the hands of the employees at the time of issuance.

The Budget proposes bringing ESOPs and sweat equity shares under the FBT regime. FBT is a tax that is levied on employers on the fringe benefits provided or deemed to have been provided to their employees. In accordance with the proposed amendment, the issuing company is required to pay FBT at the time of exercise of stock options and at the time of issuance of sweat equity, thus doing away with the requirement of having to comply with the Central Government Guidelines. Foreign companies with employees in India would then be burdened with an additional tax liability as a consequence of the proposed levy of FBT on ESOPs. Employees, who are covered under an ESOP or are issued sweat equity, would continue to be taxed only on capital gains when the shares are sold. However, it is expected that the tax burden of the company with respect to FBT could be passed on by the employers to the employees.

The levy of FBT on exercise of stock options will make it difficult for companies to predict the tax outflow due to varying market prices. Another uncertainty that requires attention is the issue of a possible double taxation in the case of sweat equity as sweat equity may continue to be taxed as salary in the hands of the employees and would also be subject to FBT in the hands of the company at the time of issue. This seems to be an oversight on the part of the Budget.

## II. Indirect Taxes

### A. Customs

The peak rate of customs duty (on non-agricultural products) has been reduced to 10 percent from the existing 12.5 percent, with a few exceptions. The special provisions that have been introduced are summarised below by sector:

- *Aircraft Industry:* Import of aircraft, helicopters and parts would become more expensive for private aircraft users and non-scheduled airlines. Customs duty of 3 percent along with countervailing duty of 16 percent and special additional customs duty of 4 percent has been imposed on these imports. However, aircrafts not registered in India and which are brought into India for the purpose of a flight to or across India, are exempt from customs duty.
- *Gems and Jewellery:* A number of reductions have been introduced to encourage export of gems and jewellery. Customs duty on export of cut and polished diamonds has been reduced to 3 percent from 5 percent. Export of rough synthetic gemstones will now be taxable at 5 percent (instead of 12.5 percent). Unworked corals will be taxed at 10 percent (as opposed to the previous rate of 30 percent).
- *Research and Development Institutions:* Research institutions registered with the DSIR, will pay customs duty at the rate of 5 percent and nil countervailing duty on imports of specified equipment and items. Specified items domestically procured by such research institutions are also exempt from excise duty.
- *Dredging:* All dredgers will be exempt from customs duty.
- *Petrol and diesel:* Ad valorem customs duty on petrol and diesel has been reduced from 8 percent to 6 percent. Bio diesel has been completely exempted from excise duty.

### B. Service Tax

The service tax rate remains the same at 12 percent (plus an education cess of 3 percent). New services have been included and these are summarised below:

- *Design Services in relation to the Commercial Sector:* Services provided in relation to the design of furniture, consumer products, industrial products, packages, logos *etc*.
- *Content Development for Mobile and Telecommunication Industries:* Services in relation to development and supply of mobile value added services, mobile content, content for use in telecommunication services (such as telephone services, data services, wired services, wireless services, carrier services, call management services *etc*).
- *Telecom Industry:* The provisions relating to taxation of services in relation to the telecom industry have been

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deleted. It is proposed that a committee be set up by the Department of Telecom for a subsequent introduction of a unified tax in respect of this sector.

- *Management Services:* The definition of "management consultant" has been expanded to include "business consultants" and now includes financial, human resources, marketing, production, logistics, supply chain and information technology management services.
- *Asset management services provided by Individuals:* Services relating to asset management including portfolio management and all forms of fund management, when rendered by individuals.
- *Commercial Leasing Services:* Renting of immovable property for commercial use. There is a specific exclusion for leasing to religious and educational bodies, and leasing of agricultural plots, parking spaces, land used for entertainment purposes, residential buildings *etc*.
- *Works Contracts (Turnkey projects etc):* Contracts for the erection of plant, machinery *etc*, construction or repair of buildings, turnkey projects etc. have been brought within the definition of works contract. Where a works contract is not divisible an option will be given for payment of tax at 2 percent in accordance with the composition scheme.
- Services relating to the mining of mineral, oil or gas have been included and it has been clarified that software maintenance and repair services will be taxable.
- *Exemptions:* The threshold exemption from service tax to small service providers has been increased from INR 400,000 to 800,000. Further, services relating to clinical trials, services provided by recognised Technology Business Incubators and Science and Technology Entrepreneurship Parks and those provided by "incubator" entrepreneurs, whose turnover does not exceed INR 5,000,000, have been exempted from the service tax net.

### C. VAT

It is proposed that a comprehensive Goods and Services Tax ("GST") regime is introduced from April 1, 2010. The Central Sales Tax is reduced from 4 percent to 3 percent.

## III. Conclusion

Several industries that had hoped for tax incentives and/or clarity on the incidence of tax in respect of certain transactions were left sorely disappointed. However, the FM seems to be keeping to his promise of phasing out and streamlining all the tax holidays. The clarity expected by Foreign Institutional Investors ("FIIs") with regard to their taxability continues to elude them. The pharmaceutical industry has not received any significant benefits in the Budget. The Indian airline industry, which is undergoing a transformational phase, has also been neglected. The change in taxation of VCFs seems uncalled for and has created considerable confusion in this key fledgling industry. The levy of FBT on ESOPs has placed a question mark on this much used tool for retention and attraction of talent, especially to start up companies. In summation, the key changes proposed by the Budget are:

- Increase in education cess and DDT rate thereby increasing the effective tax rate on corporates;
- Levy of MAT on EOUs/STPs that had thus far enjoyed a complete tax holiday;
- Tax holiday under the SEZ regime restricted to "new" units set up in SEZs;
- Tax pass through status accorded to SEBI registered VCFs restricted to VCFs investing in select industries;
- Financial institutions permitted to short sell securities, subject to transactions being settled by delivery;
- Sweat equity shares and shares issued pursuant to an ESOP brought within the purview of FBT.

While the focus of the FM seems to be to realign the allocation of resources to agriculture, education and infrastructure, for the most part, it appears to have done little in terms of incentivising industrial development. One hopes however, that going forward the Finance Ministry will shed light on the uncertainties in the tax regime that are being faced today and that the authors of India's high growth story will persist unheeded by this year's somewhat disappointing Budget proposals.

1 For tax purposes, a company incorporated in India is a tax resident in India. A company that is incorporated outside India is generally regarded as a non-resident, unless it is wholly controlled and managed from India.

2 PAN is an identification used for tax purposes in India.

3 A VCU is defined as an Indian company, which is not listed on any stock exchange.

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