Tax & Regulatory Services

Destination India

A Brief Overview of Tax and Regulatory Framework*

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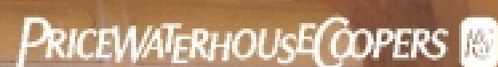

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A Brief Overview of Tax & Regulatory Framework

PricewaterhouseCoopers
India

June 2007

This guide is intended to provide investors with details of the current government policy on foreign collaborations and taxation in India.

Every effort has been made to ensure that the contents are accurate at the time of writing. However, readers should always seek specific advice from PricewaterhouseCoopers experts before acting on the information provided. Addresses of PricewaterhouseCoopers offices in India are listed in **Annexure 6** of this publication.

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Foreword

With GDP growth at 9.4% during financial year 2006-07 and prospects of maintaining the growth rate, the Indian economy is one of the fastest growing in the world. Its rapidly increasing consuming class provides the world with a huge market potential. Given its strategic strengths and rapidly paced economy, India serves as an ideal catalyst for investors to launch into the Asian market.

During FY 2006-07, India received an estimated USD 16 billion in FDI inflows, growing three-folds over the previous year. The Government is targeting FDI inflows of USD 25 billion during the FY 2007-08. India's attractiveness is growing – in 2005, it displaced US as the second most favoured destination for FDI in the world after China in the AT Kearney FDI Confidence Index. India's long term potential is evidenced by the fact that the median age is 25 years - India is now poised to reap its demographic dividend.

The purpose of this publication is to provide potential investors with an introduction to the more important aspects of doing business and investing in India. The publication has been compiled by a team of PricewaterhouseCoopers' inward investment specialists in India, drawing on their extensive knowledge and experience of the typical issues faced by first time investors to India.

The publication provides an introductory summary to the laws, regulations and practices in India, and we invite you to contact us for further details. Our specialists will be pleased to provide advice and assistance tailored to your specific requirements.

Addresses of PricewaterhouseCoopers offices in India are provided in **Annexure 6** to this publication.

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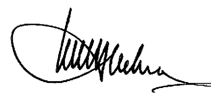

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Abbreviations

AAR	Authority on Advance Rulings
ADC	Additional Duty of Customs in lieu of Sales Tax
ARC	Asset Reconstruction Company
AY	Assessment Year
BCD	Basic Customs Duty
BCTT	Banking Cash Transaction Tax
BED	Basic Excise Duty
BOT	Build-Own-Transfer
BPO	Business Process Outsourcing
BRIC	Brazil, Russia, India, China
CBDT	Central Board of Direct Taxes
CBEC	Central Board of Excise and Customs
CCI	Controller of Capital Issues
CENVAT	Central Value Added Tax
CIF	Cost Insurance Freight
CST	Central Sales Tax
CVD	Countervailing Duty/Additional Duty of Customs in lieu of excise
DDT	Dividend Distribution Tax
DIPP	Department of Industrial Policy and Promotion
DTAA	Double Taxation Avoidance Agreement
DTA	Domestic Tariff Area
ECB	External Commercial Borrowings
EC	Education Cess
EHTP	Electronic Hardware Technology Park
EOU	Export Oriented Unit
FBT	Fringe Benefit Tax
FCCB	Foreign Currency Convertible Bond
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FII	Foreign Institutional Investor
FIIA	Foreign Investment Implementation Authority
FIPB	Foreign Investment Promotion Board
FM	Frequency Modulation
FTS	Fee for Technical Services
FY	Financial Year
GDP	Gross Domestic Product
GDR	Global Depository Receipt
HSN	Harmonized System of Nomenclature
IPR	Intellectual Property Right
IRDA	Insurance Regulatory & Development Authority
ISP	Internet Service Provider
IT	Information Technology
ITA	Information Technology Agreement
IT Act	Income-tax Act, 1961
JV	Joint Venture
LNG	Liquified Natural Gas
MAT	Minimum Alternate Tax
MRP	Maximum Retail Price
NBFC	Non Banking Financial Company
NFE	Net Foreign Exchange
NIC	National Industrial Classification
NRI	Non Resident Indian
OECD	Organisation for Overseas Co-operation and Development
p.a.	Per Annum
PIO	Person of Indian Origin
PM	Prime Minister
PSU	Public Sector Undertaking
R&D	Research and Development
RBI	Reserve Bank of India
RNR	Revenue Neutral Rate
ROC	Registrar of Companies
SEBI	Securities and Exchange Board of India
SED	Special Excise Duty
SEZ	Special Economic Zone
SHEC	Secondary & Higher Education Cess
SIA	Secretariat for Industrial Assistance
SSI	Small Scale Industry
STP	Software Technology Park
STPI	Software Technology Parks of India
STT	Securities Transaction Tax
USD	United States Dollar
VAT	Value Added Tax
VCC	Venture Capital Company
VCF	Venture Capital Fund
WTO	World Trade Organisation

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Chapter 1 Destination India

India today is a trillion dollar economy, a major emerging global market with all indications of a brighter future. The fear of instability in economic policies due to coalition governments, has been dispelled as, whatever the government and its components, the economic reforms have continued. It is noteworthy that the sectors freed from protection have grown to be internationally competitive; the IT, BPO and automobile sectors are well known examples.

During financial year 2006-07, India's GDP grew at an estimated 9.4% on top of a growth of 9.0% in the previous year making it one of the best performing economies in the world. Till 2012, India's government has targeted to maintain an annual growth rate of 9%. The now-famous BRIC Report by Goldman Sachs predicts that India's economy will become the third largest in the world by 2032, ranking just after the US and China.

India's foreign exchange reserves hit the USD 200 billion mark (over USD 203 billion on May 18, 2007), placing the country in an elite club of nations and reflecting investor confidence in its economy.

Economic Growth

Some of the areas where India has made its mark as an exporter are computer software, automobiles, auto components and pharmaceuticals. India's peak body for the IT industry, the National Association of Software and Service Companies (NASSCOM), sees at least 25% annual growth for the next five years. Between 2008 and 2010, annual export revenues from India's IT sector are predicted to touch USD 50 billion, a phenomenal performance from an industry that barely existed until the 1990s. India is already the world's leader in global outsourcing with more than 80% of the market.

India is being seen as the global destination for R&D, engineering design and prototype development, and a manufacturing hub for high technology products. India's rising middle class and strong demographic advantages will continue to fuel its growth. India has 25% of people in the world under the age of 25, and a full 80% of the population is under 45 years old. The BRIC Report estimates that the proportion of India's working-age population (15-60 years) is set to peak around 2020 at just under 64% of the country's total population. Importantly, this peak looks set to continue for another 15 years before registering a decline. That spells good news for investing in India in the future because India can defer concerns of an ageing population becoming a major drag on economic growth, for a long period of time.

Demographic Advantage

In terms of purchasing power parity, India is the fourth largest economy in the world. A rapidly growing consumer class has emerged since India began its reforms programme in 1991, illustrated by the rapid increase in use of consumer durables. According to the BRIC Report, the middle class (defined as per capita incomes of more than USD 3,000) in India is set to double in three years and increase four-fold in a decade. If India continues on its current high growth path, incomes will almost triple over the next two decades, and the country will become the world's fifth-largest consumer market by 2025, as predicted by McKinsey.

Foreign Trade

India's economy is gradually, but surely, opening up. The quantitative restrictions on imports ended in 2001, opening up the economy to foreign businesses, especially in consumer goods. Barriers to trade and investment are coming down. The peak customs duty rate is down to 10% in 2007 (for non agricultural and other specified goods). The customs duty rates are now nearer the ASEAN rates of between 8-10%. India's trade has been increasing rapidly, growing at an average annual rate in real terms of around 13% over the last 10 years – twice the rate of overall world trade.

Foreign Direct Investment

Today India has probably one of the most open liberal investment regimes among the emerging economies. Opportunities exist for investment in India in sectors as diverse as tourism and infrastructure, petrochemicals and mining technology and engineering. There are new areas where companies can invest like real estate development, biotechnology and bio-informatics. India's government has passed the Special Economic Zones Act, 2005 which provides an internationally competitive and comfortable environment in which to manufacture and/or provide services for export out of India.

The combination of macroeconomic stability, commitment to continued liberalization and the expanding trade and economic linkages make India an attractive destination for 300% over the last FY.

"The question for CEOs the world over was no longer 'should my company go to India'?, but rather 'can my company afford not to be in India?'….on the economic front, it is clearly Opportunity India."

Kamal Nath, Minister of Commerce & Industry, Government of India

There have been a number of key elements in India's growth, but among the most critical is that it is a democracy with political consensus on the economy. India has a well-established, independent judiciary and normal business risks are tempered by the presence of independent courts, politicians, and a free press. India has abundantly available qualified and competent human resource base – fluent in English, with R&D skills, technological training and managerial capabilities. India has untapped natural resources, rich mineral base and agricultural surplus and a huge manufacturing capability spanning almost all sectors. The consumer market is large and expanding exponentially. Special investment and tax incentives are available for promoting exports and for infrastructural development. In terms of potential, with its large scale investment absorption capacity and with economic fundamentals and momentum so strong, India offers attractive returns to prospective investors.

Chapter 2 India - Overview

Vital Statistics

Size	:	3.3 million sq. kms. World's 7th largest nation
Population	:	Over 1.1 billion people, World's 2nd most populous nation
Political set up	:	Parliamentary democracy since independence from British Rule in 1947
Written Constitution	:	Preamble: "Justice - social, economic and political, liberty of thought, expression, belief, faith and worship, equality of status and opportunity, and to promote among them fraternity assuring the dignity of individual and the unity of the Nation."
Fundamental Rights	:	Guaranteed by the Constitution
State Religion	:	Secular State - there is no state religion
Directive principles of State Policy	:	Promotion of peoples' welfare in a social order
Union of India	:	28 Federal States and 7 Union Territories
Parliament	:	Two Houses - Lok Sabha (Lower House) and Rajya Sabha (Upper House).
Head of State	:	President
Head of Government	:	Prime Minister
Independent Judiciary	:	Supreme Court - highest judicial authority in India High Court - Head of judicial hierarchy in the State
Language	:	Official Language is Hindi, but English is the preferred language for conducting business and is widely read and spoken

Laws Governing Business

India has an exhaustive legal framework governing all aspects of business. Some of the important ones include:

Arbitration and Reconciliation Act, 1996

Law relating to alternate redressal of disputes amongst parties.

Central Excise Act, 1944

Governs duty levied on manufacture.

Companies Act, 1956

Governs all Corporate bodies.

Competition Act, 2002

Law to ensure free and fair competition in the market.

Act	Description
Consumer Protection Act, 1986	Law relating to protection of consumers from unscrupulous traders/manufacturers.
Customs Act, 1962	Deals with import regulations.
Customs Tariff Act, 1975	The Act puts in place a uniform commodity classification code based on globally adopted Harmonised System of Nomenclature (HSN) for use in all trade-related transactions.
Environment Protection Act, 1986	Provides framework for seeking environmental clearances.
Factories Act, 1948	Law regulating labour in factories.
Foreign Exchange Management Act, 1999	Regulates foreign exchange transactions including foreign investment.
Income Tax Act, 1961	Governs direct taxes on income of all persons, both corporate and non-corporate as well as residents and non-residents.
Industrial Disputes Act & Workmen Compensation Act, 1951	Labour laws dealing with disputes.
Industries (Development & Regulation) Act, 1951	An Act to provide for the development and regulation of certain industries.
Information Technology Act, 1999	Law governing E-commerce transactions.
Money Laundering Act	Prevents money laundering and provides for confiscation of property derived from, or involved in, money laundering.
Patents Act, Copyright Act, Trade Marks Act	Protects intellectual property rights.
Central Sales Tax Act, 1956	Governs the levy of tax on all inter-state sales in India.
Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002	Puts in place securitisation and asset foreclosure laws creating a legal framework for establishment of Asset Reconstruction Companies.

Special Economic Zones Act, 2005

A comprehensive Act :

- Provides for the establishment, development and management of the Special Economic Zones for the promotion of Exports and for matters connected therewith or incidental thereto.
- Provides for fiscal and economic incentives for developer of / units in SEZ.

Right to Information Act, 2005

The Act sets out right of every citizen to access information under the control of public authorities and to promote transparency and accountability in the working of every public authority.

- Provides for constitution of a Central Information Commission and State Information Commission.

Chapter 3 Regulatory Authorities - Role and Facilitation

There are various regulatory bodies, which act as a first point of contact between the foreign investors and Indian Government. A brief outline of the functions entrusted to key regulators, relevant to foreign investments in India, is given in this chapter.

Secretariat for Industrial Assistance (SIA)

The SIA, functioning within the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, acts as a gateway to industrial investment in India. It provides a single window clearance for Entrepreneurial Assistance and facilitates the processing of investors' applications requiring Government approval. Broadly SIA performs the following functions: -

- Assists entrepreneurs and investors in setting up projects and further monitoring the implementation of these projects;
- Liaisons with State Governments and other governmental bodies for seeking necessary clearances;
- Notifies all Government policy relating to investment and technology.

SIA, in providing such functions, acts through its specialized divisions like Foreign Investment Promotion Board, Foreign Investment Promotion Council, and Foreign Investment Implementation Authority.

Foreign Investment Promotion Board (FIPB)

The FIPB is the nodal agency for all matters concerning foreign direct investment as well as its promotion into the country. The main functions of FIPB, among others, include:

- Ensuring expeditious clearance of the proposals for foreign investment;
- Reviewing periodically the implementation of the proposals cleared by the Board;
- Reviewing the general and sectoral policy guidelines and in consultation with Administrative Ministries, incorporate a set of transparent rules for each of these sectors;
- Undertaking investment promotion activities including establishment of contact with and inviting selected international companies to invest in India in appropriate projects.

The FIPB (functioning under the Ministry of Finance), in its approach to granting approvals, maintains flexibility of purposeful negotiations with investors and considers project proposals in totality, free from parameters, with a view to maximizing foreign direct investment into the country. The Board meets once every week ensuring speedy disposal of applications.

Project Approval Board (PAB)

The PAB was constituted to undertake:

- Detailed reviews in respect of pendencies of letters of intent, industrial licences and foreign collaborations. The review by PAB identifies delays in various agencies involved and fixes targets for clearing arrears.
- Review the progress of implementation of letters of intent and industrial licences upto the stage of actual commissioning of capacity.

The PAB provides a forum at which policy questions that affect a large number of applications are brought up and resolved.

Reserve Bank of India (RBI)

The RBI, India's Central Bank, was established on April 1, 1935. The Banking Regulations Act, passed in 1949, brought the RBI under government control. Its basic purpose is to secure monetary stability and developing India's financial structure in line with national socio-economic objectives and policies. The following functions have been outlined for RBI to reach its desired objective:

- Formulating, implementing and monitoring the monetary policy for ensuring adequate flow of credit to productive sectors.
- Prescribing broad parameters of banking operations within the country's banking and financial system functions.
- Administering external trade and payment, thus promoting orderly development and maintenance of foreign exchange market in India.

The RBI also acts as a banker to Central/State Governments, commercial banks, state cooperative banks and some financial institutions. It further plays a potent role in maintaining the exchange value of the Rupee and acts as an agent of the Government in respect of India's membership of International Monetary Fund.

Registrar of Companies (ROC)

The ROC plays a crucial role in the governance of Companies Act, the nodal law on regulating companies doing business in India. The ROC is primarily responsible for:

- Ensuring adherence to the filing and registration requirements under the Companies Act;
- Collecting and making publicly available information on companies registered within its jurisdiction;
- Bringing non-compliant companies and officers to Court, where necessary.

In a nutshell, the ROC has two distinct, but complementary roles - (i) facilitating business and commerce by providing a vehicle for the incorporation of companies, registration of documents and charges, and (ii) assisting in regulation of business and commerce by striking-off and prosecuting companies which fail to comply with their statutory obligations under the Companies Act.

Securities and Exchange Board of India (SEBI)

SEBI was established with the prime objective of protecting the interests of investors in securities, promoting the development of, and regulating, the securities market and for matters connected therewith or incidental thereto. Its primary functions include:

- Promoting fair dealing in issue of securities;
- Ensuring that the capital markets function efficiently, transparently and economically in the better interests of both the issuers and the investors;
- Safeguarding the interests of investors from unethical practices;

- Coordinating and monitoring the working of stock exchanges across the nation and intermediation with stock brokers.

Focusing on the principle of investor protection, SEBI acts as a vigilant watchdog in the securities market, both primary and secondary.

Central Board of Excise and Customs (CBEC)

CBEC is part of the Department of Revenue under the Ministry of Finance, Government of India. It is responsible for:

- Formulation of policy concerning levy and collection of Customs and Central Excise duties and service tax; and
- Administration of matters relating thereto.

The Board is the administrative authority for its subordinate organizations like Custom Houses, Central Excise Commissionerates and the Central Revenues Control Laboratory.

Central Board of Direct Taxes (CBDT)

The CBDT is a statutory authority functioning under the Central Board of Revenue Act, 1963. It governs matters relating to:

- Levy and collection of direct taxes;
- Formulation of policy concerning administrative reforms and changes for the effective functioning of Income-tax Department.

Authority for Advance Rulings (AAR)

The AAR has been constituted under the Income-tax Act, 1961 in order to help taxpayers plan their Income-tax matters well in advance and to avoid long drawn out and expensive litigation. A non-resident applicant can seek advance ruling on any question of law or fact in relation to a transaction, which has been undertaken or is proposed to be undertaken by the non-resident applicant. A separate Authority for Advance Rulings has also been constituted under the indirect tax regime. This is discussed later.

Independent Regulators

Telecom	: Telecom Regulatory Authority of India (TRAI)
Insurance	: Insurance Regulatory & Development Authority (IRDA)
Power	: Central Electricity Regulatory Commission (CERC)
Banks & NBFC	: Reserve Bank of India (RBI)

Chapter 4 Highlights of Industrial Policy

Licensing

As part of the economy-wide liberalization programme, the Government has substantially removed bureaucratic controls on industry. Licensing has been completely abolished except in five industries viz.,

1. Distillation and brewing of alcoholic drinks
2. Cigars and Cigarettes of tobacco
3. Electronic Aerospace and Defence equipment
4. Industrial explosives
5. Hazardous chemicals

- Manufacture of items reserved for Small Scale Sector;
- Proposals attracting locational restrictions.

The exemption from Licensing also applies to all substantial expansion of existing units.

Two sectors are reserved for public sector viz., Atomic Energy & Railways.

Location

- No Industrial Approval required from Central Government (except for industries subject to compulsory licensing) if not located in 23 urban areas with population more than one million (as per 1991 census).
- Industries of polluting nature may be located outside 25 km of the periphery of urban areas with population of more than one million, or in prior designated Industrial Areas. Local zoning and land use regulations as also environmental regulations apply.
- Industries like Electronics, Computer software and Printing are exempt from such locational restriction.

Policy relating to Small-Scale Undertakings

- A small-scale industrial (SSI) unit is an industrial undertaking having an investment of less than Rs. 10 million in plant and machinery. This limit can be extended to Rs. 50 million in certain cases.
- There are 114 items reserved for the small-scale sector ranging from food and allied industry chemical and chemical products.
- Manufacture of items reserved for the small-scale sector requires an industrial license.
- Foreign direct investment (FDI) / corporate equity up to 24% is permitted in the small-scale sector. SSI status is lost if FDI / corporate equity exceeds 24%. However, the company can manufacture SSI reserved item upon undertaking an export obligation of 50%.
- SSI units enjoy a number of concessions, privileges and preferences such as excise duty exemption / concession up to specified limits on turnover, inapplicability of some labour laws, concessional finance from scheduled banks, etc.

Chapter 5 Foreign Collaborations in India

Government Policy on Technology Transfer and Foreign Equity Investment

The Indian Government embarked on liberalizing the Indian regulatory framework with specific reference to foreign investment, through the Statement on Industrial Policy of 1991. Since then the Indian regulatory environment for foreign investment has been eased consistently to make it increasingly investor-friendly.

Under the current FDI framework, foreign investment is permitted from all categories of investors and in all sectors except -

- Citizens/entities of Pakistan and Bangladesh
- Certain sectors, namely :
  - Atomic Energy
  - Lottery Business/ Gambling & Betting
  - Agriculture (excluding floriculture, horticulture, seed development, animal husbandry, pisciculture and cultivation of vegetables, mushrooms etc.)
  - Plantations (excluding Tea plantation)
  - Retail Trading (other than Single Brand retail)

For other sectors, there are two approval routes for foreign investment in India:

- Automatic route under delegated powers exercised by the Reserve Bank of India (RBI),
- Approval by the Government through the Foreign Investment Promotion Board (FIPB) under the Ministry of Finance.

These are discussed in brief below.

Foreign Direct Investment (FDI)

Automatic Route

- FDI is permitted under the automatic route (i.e. without requiring prior approval) for all items/activities except the following:
  - where the foreign collaborator has an existing venture/tie-up in India in the same field ('same field' means 1987 NIC code) as on January 12, 2005, with the exception of following cases which would not require prior FIPB approval :
    - investment by a Venture Capital Fund registered with SEBI;
    - existing joint venture has less than 3% investment by either party;
    - existing joint venture is defunct or sick.
  - proposals falling outside notified sectoral policy/caps or sectors in which FDI is not permitted.

FIPB Route

In all other cases of foreign investment, where the project does not qualify for automatic approval, as given above, prior approval is required from FIPB.

Decision of the FIPB is normally conveyed within 30 days of submitting the application.

The proposal for foreign investment is decided on a case-to-case basis depending upon the merits of the case and in accordance with the prescribed sectoral policy (please refer Chapter 10 for details).

Generally, preference is given to projects in high priority industries, infrastructure sector, those having export potential, large-scale employment opportunities, linkages

with agro sector, social relevance or relating to infusion of capital and induction of technology.

Downstream investment

Downstream investments by foreign owned Indian holding companies are treated at par with FDI guidelines.

Domestic funds cannot be leveraged by the foreign owned Indian holding company for downstream investments.

Investment by Non Resident Indians (NRIs)

NRIs are also permitted to purchase and sell shares/convertible debentures under the portfolio investment scheme on repatriation and/or non repatriation basis through a branch designated by an authorised dealer for the purpose and duly approved by the RBI, subject to fulfillment of certain conditions. Under the non-repatriation scheme (i.e. capital is not repatriable outside India), NRIs are permitted to invest in all activities except in a company which is a Chit-Fund or a Nidhi Company or is engaged in agricultural / plantation activities, or real estate business[1], or construction of farmhouses or dealing in transfer of development rights.

Under the Portfolio Investment Scheme, the total holding by each NRI cannot exceed 5% of the total paid up equity capital or 5% of the paid up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all NRIs put together cannot exceed 10% of paid up equity capital or paid up value of each series of convertible debentures. This limit of 10% may be increased to 24% by the concerned Indian company by sanction of the shareholders through a special resolution.

Investment by Way of Acquisition of Shares

Acquisitions may be made from an existing Indian company which is either a privately held company or a company in which public are interested i.e., a company listed on stock exchange, provided a resolution to this effect has been passed by the Board of Directors of the Indian Company.

Acquisition of shares of a public listed company is subject to the guidelines of the Securities Exchange Board of India (SEBI). SEBI's Take-Over Code Regulations require that any person acquiring 15% or more of the voting capital in a public listed company should make a public offer to acquire a minimum 20% stake from the public.

Foreign investors looking at acquiring equity in an existing Indian company through stock acquisitions require FIPB approval. In case of financial services sector also, stock acquisitions will be allowed with prior approval.

As per RBI valuation norms, acquisition price should not be lower than

- Prevailing market price, in case of listed companies,
- Fair Market Value as per CCI valuation guidelines, in case of unlisted companies.

[1] For this purpose, Real estate business does not include development of township, construction of residential/commercial premises, roads, bridges, etc.

Investment by Foreign Institutional Investors

A registered Foreign Institutional Investor (FII) may, through SEBI, apply to RBI for permission to purchase the shares and convertible debentures of an Indian company under Portfolio Investment Scheme.

FIIs are permitted by RBI to purchase shares/convertible debentures of an Indian company through registered brokers on recognized stock exchanges in India. They are also permitted to purchase shares/convertible debentures of an Indian company through private placement/ arrangement.

The total holding by each FII / SEBI approved sub-account of FII cannot exceed 10% of the total paid-up equity capital or 10% of the paid-up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all FIIs/sub-accounts of FIIs put together cannot exceed 24% of paid-up equity capital or paid-up value of each series of convertible debentures. This limit of 24% may be increased to the specified sectoral cap / statutory ceiling, as applicable, by the Indian company concerned by passing a Board of Directors' resolution followed by sanction of the shareholders through a special resolution to that effect.

Technology Transfer

For promoting an industrial environment, which accords priority to the acquisition of technological capability, foreign technology induction is encouraged both through FDI and through foreign technology collaboration agreements. Foreign collaboration agreements are permitted either through the automatic approval route or with prior approval from the Government.

Automatic Approval

No approvals are required in respect to all those foreign technology agreements, which involve:

- a lump sum payment of up to USD 2 million;
- royalty[1] payable up to 5 per cent on net domestic sales and 8 per cent on exports.

Government Approval

Approval from the Government of India is necessary for the following categories of foreign technical collaboration agreements:

- **Proposals attracting compulsory licensing;**
- Items of manufacture reserved for the small-scale sector;
- Proposals involving any existing joint venture, or technology transfer/ trademark agreement in the `same field' in India;
- Proposals not meeting any or all of the parameters for automatic approval.

It is permissible for an Indian Company to issue equity shares against lumpsum fee and royalty in convertible foreign currency already due for payment / repayment, subject to meeting all applicable tax liabilities and procedures.

[1] Royalty is to be calculated on the basis of the net ex-factory sale price of the product, exclusive to excise duties minus the cost of standard bought-out components and the landed cost of imported components, irrespective of the source of procurement, including ocean freight, insurance, customs duties etc.

Chapter 6 Funding Options

A foreign company which sets up a subsidiary in India can fund its Indian subsidiary through alternative options which primarily consist of the following:

Equity Capital

Regulatory Approvals

In accordance with FDI guidelines (see Chapter 5).

Tax Implications on Dividends

- Dividends paid by Indian Company would be exempt from tax in India in hands of the shareholder.
- A 16.995% (including 10% surcharge + 3% cess) distribution tax would be required to be paid by Indian Company in respect of any dividends paid to shareholders.

Transfer to Reserve Rules

Corporate laws in India provide for a mandatory transfer of distributable profits to free reserves of the Indian company on the event of dividend declaration. In case Indian Company declares dividend in excess of 20% of paid up capital, minimum 10% of distributable profits would be required to be transferred to statutory free reserves. Amounts transferred to statutory reserves can be ploughed back into the business of the company. These can be distributed to equity shareholders only on liquidation or in case of inadequate profits (as per prescribed conditions).

Repatriation of Capital

Equity funds can be repatriated only on liquidation or on transfer of shares. Limited buy-back provisions are available under corporate laws. Capital reduction can be undertaken in certain circumstances with court approval.

External Commercial Borrowings (ECBs)

Indian companies (other than financial intermediaries) are allowed to raise ECBs from any internationally recognized source such as banks, financial institutions, capital markets, export credit agencies, suppliers of equipment, foreign collaborators, foreign equity holders.

ECB can be raised from *foreign equity holders* holding the prescribed minimum level of equity in the Indian borrower company:

- ECB up to USD 5 million – minimum equity of 25% held directly by the lender;
- ECB more than USD 5 million – minimum equity of 25% held directly by the lender and debt-equity ratio not exceeding 4:1 (i.e. the proposed ECB not exceeding four times the direct foreign equity holding).

The prevailing ECB policy stipulates certain end-uses:

- For import of capital goods, new projects, modernization / expansion. This window can be availed only for projects in real sector - industrial sector and infrastructure sector - in India.
- For overseas acquisition by Indian Companies
- 1st stage acquisition of shares in disinvestment process and in the public offer stage under the Government's disinvestment program.

ECBs not permitted for working capital / on-lending / investment in capital market / in real estate.

ECBs should have the following prescribed minimum average maturities:

- Minimum 3 years average maturity for ECBs equal to or less than USD 20 million, otherwise 5 years' All-in-cost ceiling' are as given below:
- 3-5 years maturity 150 basis points* over 6-month LIBOR
- > 5 years maturity 250 basis points* over 6-month LIBOR

Guarantees / standby letter of credit by banks, financial institutions are not permitted. The approval requirements for ECBs have been significantly liberalized. No prior approvals are required in respect of ECBs complying with the prescribed minimum maturity, "all-in-cost" ceilings and end-use requirements. All other ECBs require prior approval from an empowered committee of RBI.

Indian corporates raising ECBs have to retain the funds abroad until the time of their utilization.

The current guideline for prepayment of ECBs states that prepayment upto USD 400 million can be done without any approvals, subject to compliance with the minimum average maturity of the loan.

It is permissible for an Indian Company to issue equity shares against external commercial borrowings in convertible foreign currency already due for payment / repayment, subject to meeting all applicable tax liabilities and procedures.

Preference Shares

Indian companies can mobilize foreign investments through issue of preference shares. All preference shares have to be redeemed out of accumulated profits / proceeds of fresh capital within a period of 20 years as per Indian Company Law and the proposals are processed either through the automatic route or FIPB route as the case may be. The following guidelines apply:

- Issue of preference shares is permissible only as rupee denominated instrument in accordance with Indian Companies Act.
- Preference shares, carrying a conversion option, are considered as foreign direct equity for purposes of sectoral caps on foreign equity. If the preference shares are structured without conversion option, they fall outside the FDI cap and would also have to comply with ECB norms
- The dividend rate should not exceed the limit prescribed by the Ministry of Finance (currently fixed at 300 Basis Points above State Bank of India's Prime Lending Rate).

The MoF has issued a Press Release stating that Preference Shares which can be redeemed should adhere to ECB guidelines.

Global Depository Receipts (GDRs) / American Depository Receipts (ADRs) / Foreign Currency Convertible Bonds (FCCBs)

Foreign investment through GDRs/ADRs/FCCBs is also treated as FDI. Indian companies are permitted to raise capital in the international market through the issue of GDRs/ADRs/FCCBs, subject to certain restrictions.

Issue of ADRs / GDRs does not require any prior approvals (either from Ministry of Finance / FIPB or RBI) except where the FDI after such issue would exceed the sectoral caps (as specified under Automatic Route on page 10), in which case prior approval from FIPB would be required. Issue of FCCBs up to USD 500 million also does not require any prior approvals. Only companies listed on the stock exchange are allowed to raise capital through GDRs/ADRs/FCCBs. End use of FCCB proceeds have to comply with ECB norms.

Chapter 7 Significant Exchange Control Regulations

Exchange control is regulated under the Foreign Exchange Management Act (FEMA), 1999. Under the FEMA, foreign exchange transactions have been divided into two broad categories - current account transactions and capital account transactions. Transactions that alter the assets or liabilities outside India of a person resident in India or in India, of a person resident outside India have been classified as capital account transactions. All other transactions would be current account transactions.

The Indian Rupee is fully convertible for current account transactions, subject to a negative list of transactions that are prohibited / require prior approval.

A foreign-invested Indian company is treated on par with other locally incorporated companies. Accordingly, the exchange control laws and regulations for residents apply to foreign-invested companies as well.

Current Account Transactions

Foreign nationals/ Indian citizens who are not permanently resident in India and have been deputed by a foreign company to its office / branch / subsidiary / JV in India are allowed to make recurring remittances abroad for family maintenance up to 100% of their net salary. Further, up to 75% of salary of a foreign national/ Indian citizen deputed by a foreign company to its Indian office / branch / subsidiary / JV can be paid abroad by the foreign company subject to the foreign national / Indian citizen paying applicable taxes in India.

Prior approval of the RBI is required for acquiring foreign currency above certain limits for the following purposes:

- Holiday travel over USD 10,000 per person p.a.
- Gift over USD 5,000 / donation over USD 10,000 per remitter / donor p.a.
- Business travel over USD 25,000 per person per visit
- Foreign studies as per estimate of institution or USD 100,000 per academic year, whichever is higher
- Consultancy services procured from abroad over USD 1,000,000 per project Consultancy services procured from abroad over USD 10,000,000 per project for companies executing infrastructure projects
- Reimbursement of pre incorporation expenses over USD 100,000

Certain specified remittances are prohibited:

- Remittance out of lottery winnings
- Remittance of income from racing / riding etc. or any other hobby
- Remittance for purchase of lottery tickets, banned / prescribed magazines, football pools, sweepstakes etc
- Payment of commission on exports made towards equity investments in Joint Ventures/ Wholly Owned subsidiaries abroad of Indian Companies.
- Payment of commission on exports under the Rupee State Credit Route
- Payment related to “Call Back Services” of telephones

Capital Account Transactions

Capital account transactions can be undertaken only to the extent permitted. RBI has prescribed a list of capital account transactions, which *inter alia* include the following:

- investments overseas by residents (please refer to Chapter 5 for details)
- borrowing / lending in foreign exchange
- export/ import of currency
- transfer / acquisition of immovable property in / outside India

Remittances exceeding USD 100,000 p.a. (over and above ceilings prescribed for other remittances mentioned above) by a resident individual for any current account or capital account transaction.

Under the Foreign Exchange Management Act, 1999 regulations, resident individuals are permitted to remit up to USD 100,000 per calendar year (Jan-Dec) for any current or capital account transaction or a combination of both subject to specified terms and conditions. This is in addition to facility of foreign travel up to USD 10,000. All other transactions which are otherwise not permissible under FEMA and those in the nature of remittance for margins or margin calls to overseas exchanges / overseas counterparty are not allowed under the Scheme.

Miscellaneous

Repatriation of Capital : Foreign capital invested in India is generally repatriable, along with capital appreciation, if any, after the payment of taxes due on them, provided the investment was on repatriation basis

Acquisition of immovable property in India : Generally foreigners are not permitted to acquire immovable property except in certain cases, where the property is required for the business of the Indian branch / office / subsidiary of the foreign entity. NRI/ PIOs are also permitted to acquire certain properties.

Royalties and Technical Know-how Fees: Indian companies that enter into technology transfer agreements with foreign companies are permitted to remit payments towards know-how and royalty under the terms of the foreign collaboration agreement, subject to limits. (Please refer to Chapter 5).

Dividends: Dividends are freely repatriable after the payment of Dividend Distribution Tax by the Indian company declaring the dividend. No permission of RBI is necessary for effecting remittance, subject to specified compliances

Remittances by Branch/Project Office : No prior approval is required for remitting profits earned by Indian branches of companies (other than banks) incorporated outside India to their Head Offices outside India. Remittances of winding-up proceeds of a branch / liaison office of a foreign company in India are permitted subject to RBI approval. Remittances of winding-up proceeds of a project office of a foreign company in India are permitted under the automatic route subject to fulfillment of necessary compliances.

Chapter 8 Tax Incentive Schemes

Export Oriented Units (EOUs)

The EOU Scheme was introduced by the Government in 1980 with a view to promoting exports.

- EOUs are extended a host of incentives and facilities, including duty free imports of all types of capital goods, raw material, and consumables as well as tax deductions against export income.
- These units are permitted to be set up for a varied range of business activities including manufacture, services, software development, agriculture, aquaculture, animal husbandry, floriculture, horticulture and sericulture.

Please refer to **Annexure 1** for details of incentives and benefits available to EOUs.

Tax Incentives

Undertakings set-up in EOUs are eligible for a deduction of 100% of export profits derived therefrom for 10 years up to 31st March 2009.

The exemption from Minimum Alternate Tax enjoyed by these units has been withdrawn with effect from April 1, 2007.

Special Economic Zones (SEZs)

The SEZ Policy was introduced by the Government in 2000 with a view to provide an internationally competitive and hassle free environment for exports. The SEZ Act, 2005 along with the Rules framed thereunder, , provides the umbrella legal framework, covering all important legal and regulatory aspects of SEZ development as well as for units operating in SEZs.

SEZs are duty free enclaves, deemed to be outside the customs territory of India for the purposes of carrying out authorised activities. At present there are more than 30 operational SEZs in India. In addition, about 350 SEZs are in various stages of approval and establishment spread throughout the country.

SEZ developers are entitled to 100% tax holiday (of profits and gains derived from business of developing SEZ) for 10 continuous years out of 15 years beginning from the year in which the SEZ is notified by the Government. SEZ developers also enjoy exemption from Minimum Alternate Tax as well as Dividend Distribution Tax. Expenditure on the developing of the SEZ shall also be exempt from all duties of customs, excise, CST, service tax, etc.

SEZ units shall enjoy 100% tax holiday for 5 years and 50% for the next 10 years (during the last 5 years subject to certain additional conditions) out of profits derived from actual exports of goods and services. The tax holiday period commences from the year in which the SEZ unit begins to manufacture or produce or provide services.

Please refer to **Annexure 2** for the salient features and benefits of the SEZ Policy.

Electronic Hardware Technology Park (EHTP) and Software Technology Park (STP) Schemes

In a bid to enhance the export potential of the electronics industry and develop an efficient electronic component and information technology industry, EHTP and STP schemes have been announced which offer a package of incentives and facilities like duty free imports in line with the EOU scheme, deemed exports benefits and tax holidays. Export oriented IT enabled services like call centers, data processing, medical transcription etc. are also eligible to be registered under the STP scheme.

The Directors of STPs in respect of STP proposals and the Designated Officers in respect of EHTP proposals accord automatic approval subject to compliance with the same set of conditions as are applicable to EOUs.

Tax Incentives

Undertakings set-up in Electronic Hardware Technology Park (EHTP) or Software Technology Park (STP), are eligible for a deduction of 100% of export profits derived therefrom for 10 years up to 31st March 2009.

The exemption from Minimum Alternate Tax enjoyed by these units has been withdrawn from April 1, 2007.

The salient features and benefits of the STP Scheme are given in **Annexure 3.**

Setting up of Industrial Parks

The Industrial Parks Scheme has been introduced with a view to enhance the development of infrastructure facilities for the purposes of industrial use.

Secretariat for industrial Assistance, Department of Industrial Policy and Promotion (DIPP) accords approval to set up Industrial Parks, which meet all the criteria laid down for automatic approval like minimum area required to be developed, minimum number of industrial units to be provided, minimum investment on infrastructure development etc.

For developers of Industrial Parks

100% tax deduction is available to the developers of Industrial Parks (notified by DIPP on or before 31th March 2009) for any 10 consecutive assessment years out of 15 years beginning from the year in which the undertaking or the enterprise develops and begins to operate an industrial park.

Units in Industrial Parks in specified States

Income tax holiday and excemption from CENVAT is available for units set up in industrial parks in the states of Uttarakhand, Himachal Pradesh, Sikkim and North East States, subject to certain conditions. These have been summarized below:

State	Incentives	Validity Period	Eligible Units
Uttarakhand/ Himachal Pradesh	100% income tax holiday (commencing from initial year) for first 5 years, balance years - 30% (25% in case the assessee is not a company)	10 years	Units engaged in specified activities that (a)begin manufacturing /commence operations or (b) undertake substantial expansion from January 7, 2003 upto March 31, 2012
	100% exemption from CENVAT	10 years	New units commencing commercial production or existing units undertaking more than 25% expansion in installed capacity on or after Jan 7, 2003 but before March 31, 2010
Sikkim	100% income tax holiday (commencing from initial year)	10 years	Units engaged in specified activities that (a) begin manufacturing/commence operations or (b) undertake substantial expansion from Dec. 23, 2002 upto March 31, 2007
	Exemption of balance duty amount after settingoff CENVAT credits	10 years	New units commencing commercial production or existing units undertaking more than 25% expansion in installed capacity on or after December 23, 2002 but before March 31, 2007
Other North-Eastern States	100% income tax holiday (commencing from initial year)	10 years	Units engaged in specified activities that (a) begin manufacturing /commence operations or (b) undertake substantial expansion from Dec 24, 1997 up to March 31, 2007
	Exemption of balance duty amount after setting off CENVAT credits	10 years	New units commencing commercial production or existing units undertaking more than 25% expansion on or after Dec. 24, 1997

Units carrying out eligible business in North-Eastern States

A 100% tax holiday for a period of 10 consecutive years (beginning with the initial year) is available to units carrying out prescribed eligible business in North Eastern States (including Sikkim) that (a) begin manufacturing /producing any eligible article or thing, or (b) undertake substantial expansion, from April 1, 2007 up to April 1, 2017. The eligible business includes business of hotel (not below two star category), adventure and leisure sports including ropeways, providing medical and health services, running an old-age home, operating vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and para-medical, civil aviation related training, fashion designing and industrial training, running information technology related training center, manufacturing of information technology hardware and bio-technology.

Tax Holiday in Respect of Infrastructure Project / Power / Housing

Undertakings engaged in prescribed infrastructure projects are eligible for tax deduction of profits from relevant business as below: -

- 100% tax deduction for 10 consecutive years in a block of 20 years to undertakings engaged in developing / operating and maintaining / developing, operating and maintaining infrastructure facilities like roads, bridges, rail systems, highway projects, water supply projects, water treatment systems, irrigation projects, sanitation and sewerage systems or solid waste management system.
- 100% tax deduction for 10 years in a block of 15 years to undertakings involved in developing / operating and maintaining, / developing, operating and maintaining, ports, airports, inland waterways or inland ports. The Finance Act, 2007 has extended similar benefit to navigational channel in the sea. A similar deduction is also available to undertakings set up before March 31, 2010 for generation/ generation and distribution of power.
- The Finance Act, 2007 has provided a 10 year tax holiday to any undertaking carrying on business of laying and operating a cross country natural gas distribution network, including pipelines and storage facilities being an integral part of such network, subject to certain specified conditions. The deduction would be available for 10 consecutive years in a block of 15 years beginning with year in which the undertaking lays and begins to operate the cross country natural gas distribution network.

Tax Holiday In Respect Of Other Facilities

Food Processing Units

A 100% tax holiday for first 5 years and a deduction of 30% (25% in case the assessee is not a company) of profits for the next 5 years is available to undertakings engaged in the business of processing, preservation & packaging of fruits & vegetables or in the integrated business of handling storage and transportation of food grains, starting operation on or after April 1, 2001.

Scientific Research & Development

A 100% tax holiday for a period of 10 consecutive years (beginning with the initial year) is available to a company registered in India and carrying on, as its main object , scientific research & development subject to fulfillment of certain conditions. The time limit for obtaining approval from the prescribed authority is upto March 31, 2007

If certain conditions are met, deduction is available of one and one-half times of scientific research expenditure incurred by a company on in-house R&D facility in bio-technology or in the manufacture or production of drugs, pharma, electronic equipments, computers, telecom equipments, chemicals or other specified articles. Currently , this weighted deduction is available till financial year 2006-07.. The Finance Act, 2007 has extended this benefit upto FY 2011-12.

Hotels and Convention Centers

The Finance Act, 2007 provides a 5 year 100% tax holiday commencing from the initial year (subject to certain conditions) in respect of profit derived from the business of hotels (two, three and four star) and convention centers located in specified areas. This tax holiday would be available provided the construction is completed and operations are started during the period April 1, 2007 to March 31, 2010.

Chapter 9 Entity Options in India

A foreign company looking at setting up operations in India has the following options for formulating its entry strategy:

Entry Strategy 1: Operating as an Indian Company, through:

Option	Description
Option 1 Wholly owned Subsidiary Company	A foreign company can set up a wholly owned subsidiary company in India for carrying out its activities. Such subsidiary is treated as an Indian resident and an Indian Company for all Indian regulations (incl. Income Tax, FEMA and Companies Act), despite being 100% foreign owned. At least two and seven shareholders are mandatory for a private limited and public limited company respectively.
Option 2 Joint Venture with an Indian Partner preferably with majority equity participation	Though a wholly owned subsidiary has been the most preferred option, foreign companies have also been setting up shop in India by forging strategic alliances with Indian partners. The trend in this respect is to choose a partner who is in the same field/area of activity and has sufficient experience and expertise in the relevent line of activity.
The foreign investment guidelines for setting up an Indian subsidiary company or participating in a joint venture company with an Indian partner have already been discussed in Chapter 5.	

Entry Strategy 2: Operating as a Foreign Company, through:

Option	Description
Option 1 Liaison Office	Setting up a Liaison or Representative Office is a common practice for foreign companies seeking to enter the Indian market. The role of such offices is limited to collecting information about the possible market and providing information about the company and its products to prospective Indian customers. Such offices act as “listening and transmission posts” and provide a two-way information flow between the foreign company and the Indian customers. A Liaison Office is not allowed to undertake any business activity other than liaison activities in India and cannot, therefore, earn any income in India, in terms of the approval granted by RBI.
Option 2 Project Office	Foreign Companies planning to execute specific projects in India can set up temporary project /site offices in India for this purpose. RBI has granted general permission to a foreign entity for setting up a project office in India, subject to fulfillment of certain conditions. The foreign entity only has to furnish a report to the jurisdictional Regional Office of RBI giving the particulars of the project / contract.

Option 3 Branch Office	Foreign companies engaged in manufacturing and trading activities abroad can set up Branch Offices in India for the following purposes, with the prior approval of RBI: ■ Export/Import of goods, ■ Rendering professional or consultancy services, ■ Carrying out research work, in which the parent company is engaged, ■ Promoting technical or financial collaborations between Indian companies and parent or overseas group company, ■ Representing the parent company in India and acting as buying/selling agent in India, ■ Rendering services in Information Technology and development of software in India, ■ Rendering technical support to the products supplied by parent/group companies, ■ Foreign airline/shipping company. In general, manufacturing activity cannot be undertaken through a branch office. However, foreign companies can establish branch office / unit for manufacturing in a SEZ subject to fulfillment of certain conditions.

Chapter 10 Summary of Guidelines for Foreign Direct Investment in Some Specific Sectors

A synopsis of the prevalent FDI caps in various sectors is given below:

Advertising and Films

Advertising industry : FDI is permitted up to 100% through the automatic route.

Film industry : FDI in all film-related activities, such as film financing, production, distribution, exhibition, marketing etc., is permitted up to 100% for all companies under the automatic route.

Agriculture and allied services

FDI/NRI investment is not permitted in agriculture, with the following exceptions:

Tea sector (including tea plantations): FDI upto 100% is allowed with prior approval of the FIPB and subject to the following conditions –

- Compulsory disinvestment of 26% equity in favour of an Indian partner/Indian public within a period of five years
- Prior approval of the State Government is required for any future change in land use.

FDI up to 100% on the automatic route is permitted in Floriculture, Horticulture, Development of Seeds, Animal Husbandry, Pisciculture, Aquaculture, cultivation of vegetables and mushrooms under controlled conditions and services related to agro and allied sectors.

100% FDI in processing and warehousing of Coffee and Rubber is now permitted under the automatic route.

Asset Reconstruction Companies

FDI upto 49% permitted with prior FIPB approval. Where any individual investment exceeds 10% of the equity, such investor shall not hold any controlling interest in the ARC. Investments by FIIs are not allowed.

Atomic Energy

Under this sector, the following three activities are permitted to receive FDI/NRI investments after approval from the FIPB:

- Mining and mineral separation,
- Value addition per se to the mining and mineral separation products,
- Integrated activities (comprising of both the above).

FDI up to 74% is permitted in both pure value addition and integrated projects.

For pure value addition projects as well as integrated projects with value addition up to any intermediate stage, FDI is permitted up to 74% through joint venture companies with Central/State PSUs in which equity holding of at least one PSU is not less than 26%. However, in exceptional cases, FDI beyond 74% will be permitted subject to clearance of the Atomic Energy Commission before FIPB approval.

Banking

- Public Sector Banks – FDI and portfolio investment allowed up to 20% under the automatic route. Voting rights for shareholders is limited to 1%.
- Private Sector Banks – FDI (from all sources) up to 74% is allowed under the automatic route. Voting rights per shareholder is restricted to 10%. (On May 4, 2005, the Cabinet approved an amendment to the Banking Regulation Act, linking voting rights to shareholding. However, it will become effective on issue of notification by RBI).
- A foreign bank may operate in India through only one of three channels viz., (i) branch/es (ii) a wholly-owned subsidiary and (iii) a subsidiary with aggregate foreign investment up to a maximum of 74% in a private bank.

Broadcasting

TV software production

100% FDI permitted subject to:

- all future laws on broadcasting and no claim of privilege or protection by virtue of approval accorded,
- not undertaking any broadcasting from Indian soil without Government approval,

Setting up hardware facilities such as Uplinking Hubs, etc.

FDI limit up to 49% inclusive of both FDI & Portfolio Investment to set up uplinking hub (teleports) for leasing or hiring out their facilities to the broadcasters.

Cable Networks

FDI limit upto 49% inclusive of both FDI & Portfolio Investment. Companies with minimum 51% of paid up share capital held by Indian citizens, are eligible for providing cable TV services under the Cable Television Network Rules (1994).

Direct-To-Home

Maximum 49% foreign equity including FDI/ NRI/ FII. Within the foreign equity, FDI component should not exceed 20%.

Terrestrial Broadcasting FM

FDI upto 20% is permitted inclusive of NRI, PIO and portfolio investments.

Terrestrial TV

No private operator is permitted.

Note : 26% cap is imposed for purposes of uplinking from India with respect to all forms of foreign investment in TV channels devoted to news and current affairs.

Cigarettes

Up to 100% foreign equity is allowed subject to industrial licensing. Automatic route is not available.

Civil Aviation & Airports

In the Domestic Airlines sector, FDI up to 49% is permitted under the automatic route. NRI investment is permitted upto 100% under the automatic route. However, no direct or indirect equity participation by foreign airlines is allowed.

100% FDI under the automatic route is permitted in setting up of Greenfield airport projects (existing projects would require FIPB approval for FDI beyond 74%).

Coal and Lignite

FDI is permitted up to 100% for private Indian companies, which set up or operate power projects and coal or lignite mines for captive consumption. A company setting up coal processing plants is allowed FDI up to 100% subject to compliance with the condition that it will not do coal mining and supply the washed or sized coal to parties supplying raw coal to coal processing plants instead of selling it in the open market.

100% FDI is permitted under the automatic route in captive mining of coal or lignite for consumption by eligible users.

FDI is permitted up to 50% under the automatic route in all the above cases subject to the condition that such investment shall not exceed 49% of the equity of a PSU.

Defence

FDI, including NRI investment, in this sector is permitted up to 26% subject to prior approval of the Government and compliance with the security and licensing requirements and guidelines issued by the Ministry of Defence.

According to the guidelines for production of arms and ammunitions, the management of the applicant company/ partnership should be in Indian hands with majority representation on the Board as well as the Chief Executive being resident Indians. Further, there would be a three year lock- in period for transfer of equity from one foreign investor to another foreign investor.

Insurance

FDI in the insurance sector is permitted up to 26% under the automatic route subject to obtaining license from the Insurance Regulatory & Development Authority (IRDA).

Lottery Business, Gambling & Betting

FDI / foreign technical collaboration in any form is prohibited in Lottery Business, Gambling & Betting.

Mass Rapid Transport System

FDI up to 100% is allowed under the automatic route in mass rapid transport systems, including associated real estate development, in all metropolitan cities.

Mining

FDI is allowed up to 100% under the automatic route for activities such as exploration and mining of gold and silver (and minerals other than diamonds and precious stones), metallurgy and processing.

For exploration and mining of diamonds and precious stones, FDI is allowed up to 100% under the automatic route.

For companies which seek to set up 100% wholly owned subsidiaries in the mining sector, permission may be given subject to the condition that the applicant has no existing Joint Venture for the same area and/or the particular mineral.

Non-banking Financial Services

FDI/NRI investments allowed in 19 specified activities subject to minimum capitalization norms indicated below: (i) Merchant Banking (ii) Underwriting (iii) Portfolio Management services (iv) Investment Advisory Services (v) Financial Consultancy (vi) Stock Broking (vii) Asset Management (viii) Venture Capital (ix) Custodial Services (x) Factoring (xi) Credit Reference Agencies (xii) Credit Rating Agencies (xiii) Leasing and Finance (xiv) Housing Finance (xv) Forex Broking (xvi)

Credit Card Business (xvii) Money Changing Business (xviii) Micro Credit (xix) Rural Credit.

Minimum Capitalization Norms (Foreign Equity)

For fund based activities

- USD 0.5 million upfront - where the foreign equity is upto 51% .
- USD 5 million upfront - where the foreign equity is more than 51% but upto 75%.
- USD 50 million (USD 7.5 million upfront and USD 42.5 million in 24 months) - where the foreign equity is more than 75%.

For non-fund based NBFCs, the minimum capitalization norms has been fixed at USD 0.5 million.

Foreign investors bringing in at least USD 50 million have now been permitted to set up 100% operating subsidiaries without having to disinvest a minimum of 25% of its equity to Indian entities. Joint Venture operating NBFCs, having up to 75% foreign investment, have been allowed to set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries complying with the minimum capitalisation norms.

FDI in this sector is permitted under the automatic route subject to compliance with the guidelines issued by RBI.

Petroleum

Other Than Refining

100% FDI is permitted under the automatic route in respect of the following subject to existing policy and regulatory framework in the petroleum sector.

- Oil Exploration
- Petroleum Product Pipelines
- Petroleum Products Marketing
- Laying of Natural Gas/LNG pipelines
- Market study and formulation and investment financing in the petroleum sector.

Refining

In case of a Public Sector Units, FDI is limited to 26% (26% being held by PSUs and balance 48% by public). In case of private Indian companies, FDI up to 100% is permitted under the automatic route.

Pollution Control and Management

For activities like manufacture of pollution control equipment and consultancy for integration of pollution control systems, FDI is permitted up to 100% under the automatic route.

Ports and Harbors

Up to 100% FDI is allowed through the automatic route for construction and maintenance of ports and harbors (BOT projects).

Postal Services

FDI up to 100% is permitted for courier services excluding distribution of letters, subject to grant of prior approval by the Government.

Power

FDI in the power sector is permitted up to 100%, in respect of projects relating to electricity generation, transmission and distribution, other than atomic reactor power plants. There is no limit on the project cost and quantum of the FDI.

Print Media

FDI up to 100% is permitted in publishing/printing scientific and technical magazines, periodicals and journals.

In the news and current affairs category, for instance newspapers, FDI has been allowed up to 26%. However, this is further subject to certain conditions:

- The largest shareholder must hold at least 51% equity;
- Three – fourth (3/4) of directors and all executive and editorial staff have to be resident Indians.

Real Estate

FDI up to 100% under the automatic route is permitted in -

- Townships
- Housing
- Built-up infrastructure
- Construction-development projects (including but not restricted to – Housing, Commercial premises, Hotels, Resorts, Hospitals, Educational institutions, Recreational facilities, City and regional level infrastructure).

- subject to certain conditions (such as minimum area to be developed, minimum capitalisation to be USD 10 million for a wholly owned subsidiary and USD 5 million for a JV with an Indian partner – minimum 3 years lock-in from the completion of capitalisation).

However, investment by NRIs is permitted in the following additional activities:

- Investment in manufacture of building material, which is also open to FDI.
- Investment in participatory ventures in the above activities, and
- Investment in housing finance institutions (which is also open to FDI as NBFC).

Roads and Highways

Investment by the private sector, including FDI, is permitted up to 100% through the automatic route for the construction and maintenance of roads, highways, vehicular bridges and tunnels and toll roads.

Satellite

FDI up to 74% with prior FIPB approval is permitted for establishment and operation of satellites.

Stock Exchanges, depositories and clearing corporations

Foreign investment upto 49% is permitted with separate FDI cap of 26% and FII cap of 23%

- FDI will be allowed with specific prior approval of FIPB; and
- FII will be allowed only through purchases in the secondary market.

Telecommunications

- Composite FDI holding of upto 74% is permitted in Basic, Cellular, Unified Access Services, National /International Long Distance, V-Sat, Public Mobile Radio Trunked Services (PMRTS), Global Mobile Personal Communications Services (GMPCS), ISPs with gateways, radio-paging and end-to-end bandwidth.
- 100% FDI is permitted in ISPs not providing gateways, Infrastructure Providers providing dark fibre, electronic mail and voice mail, subject to the condition that such companies would divest 26% of their equity in favour of the Indian public in 5 years (provided these companies are listed in other parts of the world).

The above services would be subject to licensing and security requirements.

Trading

100% FDI is permitted under the automatic route for wholesale cash and carry trading and trading for exports

100% FDI permitted with FIPB approval for –

a) Trading of items sourced from small scale sector

b) Test marketing of such items for which a company has approval for manufacture

51% FDI permitted with FIPB approval for Single Brand product retailing subject to the following conditions:

i) Products to be sold should be of a 'Single Brand' only

ii) Products should be sold under the same brand internationally

iii) 'Single Brand' product-retailing would cover only products which are branded during manufacturing.

Venture Capital Fund (VCF) and Venture Capital Company (VCC)

Offshore venture capital funds / companies are allowed to invest in domestic venture capital funds / companies subject to SEBI's investment norms & other regulations.

Chapter 11 Taxation in India

The law relating to income tax is contained in the Income-tax Act, 1961(IT Act). There are specific statutes for other taxes. Central tax statutes are passed by the Parliament and state tax statutes by the State Assemblies. Tax rates and duties are reviewed annually when budgets are presented, the latest, Budget 2007 was tabled in the Parliament on February 28, 2007. Amendments to the statutes are made through the annual Finance Acts or specific Amendment Acts every year.

This chapter gives an overview of the direct and indirect tax regime prevalent in India.

Direct Taxes

Rate of Tax

Corporate Tax

The Finance Act 2007 has specified the following rates:

Company	Where taxable income exceeds INR 10 Million*	Other cases
Domestic Company	33.99% (30% plus surcharge of 10% plus education cess of 3%)	30.9% (30% plus education cess of 3%)
Foreign Company	42.23% (40% plus surcharge of 2.5% and education cess of 3%)	41.2% (40% plus and education cess of 3%)

* Marginal relief is provided in cases where incremental tax liability exceeds incremental income.

Individual Tax

Residents / Not Ordinary Residents and Non Residents

Maximum effective rate of tax is **33.99%** (30% plus surcharge and of 10% and education cess of 3%), where taxable income exceeds Rs.1 million. Otherwise Maximum effective rate of tax is **30.9%** (30% plus education cess of 3%).

Dividend Tax

Dividend income is exempt in the hands of the shareholders. However, a Dividend Distribution Tax (DDT) is levied on Companies declaring dividend. The effective DDT rate is 16.995% (15% plus 10% surcharge, and education cess of 3%) An exemption from DDT has been granted in case of profits of SEZ developers.

Minimum Alternate Tax (MAT)

With an object to bring zero tax companies under tax net, MAT @ 10% (plus applicable surcharge, and education cess) of book profits is levied on companies whose tax payable under normal Income Tax provisions is less than 10% of book profits. Further, MAT is not applicable to SEZ developers / Units in respect of income arising on or after April 1, 2005.

The effective MAT rate is as follows:

Company	Where taxable income exceeds Rs. 10 Million	Other Cases
Domestic Company	11.33.%	10.3%
Foreign Company	10.557%	10.3%

A credit of such tax paid under MAT provisions by a company w.e.f. financial year 2005-06 shall be allowed against the tax liability which arises in subsequent seven years under the normal provisions of the IT Act.

Capital Gains

Particulars	Tax rates	
	Resident	Non-residents
a. Short Term capital assets (Other than (b) below) (Note 1)	Normal corporate/ individual tax rates	Normal corporate/ individual tax rates
b. Short term capital assets-being shares and units of equity oriented fund which have been charged to Securities Transaction Tax (STT)	10%	10%
c. Long term capital assets-being listed shares in a company or unit of an equity oriented fund, which have been charged to STT	Exempt	Exempt
d. Other long term capital asset	20%	20%

Surcharge and education cess as applicable, would also be levied.

Note:

1. Short-term capital asset is one which is held for a period of less than 36 months (12 months in case of shares, listed securities, units of mutual funds and zero coupon bonds).

Indexation of cost of acquisition and improvement of a long-term capital asset of any nature (other than debentures) is available to Residents. However, the benefit of indexation is available to Non-residents only on long-term capital asset other than shares/ debentures of an Indian Company acquired in foreign currency.

Computation of Total Income – General

- All incomes accruing or arising in India are taxable in India subject to Double Taxation Avoidance Agreement (DTAA) with the country of residence of the taxpayer.
- Taxable income is computed for uniform accounting year, i.e. the fiscal year from 1st April to 31st March.
- The taxable income is called "**Total Income**" which is computed after adding certain disallowances, such as loss on sale of asset and miscellaneous expenditure written off, and reducing certain allowances/benefits from the book profits.

Depreciation

Depreciation is allowed separately at following rates for computing taxable income:

Factory Building	-	10%
Furniture & Fittings	-	10%
Plant & Machinery (general)	-	15%
Computers	-	60%
Motorcars, other than those used in a business of running them on hire	-	15%
Intangible assets (such as know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature).	-	25%

For certain priority items, such as energy saving devices and pollution control equipment, depreciation is allowed at higher rates. Undertakings engaged in the business of generation or generation and distribution of power have the option to claim tax depreciation at the above-mentioned rates or on straight-line basis at rates prescribed in the Income-tax Rules, 1962. The rates vary from 1.95% to 33.40%.

In case of a new asset, depreciation for the full year is allowed only if the asset is put to use for 180 days or more during the fiscal year, otherwise depreciation is allowed only at half the prescribed rate.

In addition to the above, an additional depreciation of 20% of actual cost of new plant or machinery acquired and installed after March 31, 2005 is allowed to a taxpayer engaged in business of manufacture or production of any article or thing in the year in which such new plant or machinery is acquired and installed

Incentive Provisions

Please see Chapter 8.

Taxation of Know-how Fee in the Hands of Foreign Companies

Under domestic law, the royalties/technical fees payable to non residents having a permanent establishment in India are taxed on net basis. On the other hand, the royalties/technical fees payable to non residents not having a permanent establishment in India are taxed on gross basis. Concessional tax rates, as given below, apply if the agreement relates to a matter included in industrial policy or the agreement has been approved by the Government of India:

- For contracts entered on or after 1st June 2005 — 10%
- For contracts entered into after 31st May 1997 but before 1st June 2005 — 20%
- For contracts entered into on or before 31st May 1997 — 30%

(Surcharge and education cess, as applicable would also be levied.)

Fringe Benefit Tax (FBT)

An additional tax termed as “Fringe Benefit Tax” has been introduced with effect from Financial Year 2005-06. It provides for levy of an additional tax @ 30% (plus applicable surcharge and education cess) in the hands of the employer on the value of fringe benefits provided to the employees other than perquisites on which tax is paid / payable by the employee. The Finance Act, 2007 has also brought Employee Stock Option Plans also under the purview of FBT.

Banking cash transaction tax

Banking cash transaction tax is leviable @ 0.1% on the following:

- Amount of cash withdrawn from a schedule bank (by whatever mode) on a single day from an account (except savings account) exceeding:
  - INR 50,000 in case of individual (w.e.f. June 1, 2007)
  - INR 100,000 in other cases
- Amount of cash received on encashment of term deposit(s) on a single day from a scheduled bank exceeding:
  - INR 50,000 in case of individual (w.e.f. June 1, 2007)
  - INR 100,000 in other cases

Double Tax Avoidance Agreements

Double Tax Avoidance Agreements override the Indian Income-tax Act provisions to the extent they are more beneficial to the Assessee (concessional tax rates applicable under certain double tax avoidance conventions that India has signed with various countries is given in a tabular form under **Annexure 4**).

Relief is granted in respect of income chargeable to tax, both under the IT Act of India and the Income Tax laws in that other country, in order to promote mutual economic relations, trade and investment.

Advance Rulings

To facilitate proper planning and to avoid any future disputes under the Income Tax Act, a non-resident can approach the high-powered Authority for Advance Rulings to determine the income tax aspects of any proposed or current transaction.

Advance ruling can also be sought by a resident to determine the tax liability of a non-resident with whom a transaction has been undertaken or proposed to be undertaken.

In Addition

Certain notified residents may also apply to the Authority for Advance Rulings to seek a ruling in respect of issues relating to computation of total income.

Such advance rulings would be binding on the person seeking it in relation to the transaction and the Income Tax department cannot challenge the same unless there is some change in the facts or law affecting that transaction.

Other Direct Taxes

Wealth Tax

Wealth tax is charged in respect of the net wealth as on March 31st every year (referred to as 'valuation date'). Wealth tax is charged both on individuals and companies at the rate of 1% of the amount by which the 'net wealth' exceeds Rs. 1.5 million. The term 'net wealth' broadly represents excess of prescribed assets over the concerned debts. Prescribed Assets include guest house & residential house, motor cars, jewellery-bullion-utensils of gold & silver etc., yachts, boats, aircraft, urban land and cash in hand. A debt is an obligation to pay liquidated or certain sum of money incurred in relation to those assets, which are included in the 'net wealth'.

Transfer Pricing

Detailed provisions relating to transfer pricing were introduced by the Finance Act, 2001 in order to facilitate the computation of reasonable, fair and equitable profits and tax in India in the case of businesses carried on by multinational companies. Simply put, Transfer Pricing is the process of adjusting the prices of cross-border transactions between related / associated parties. The transfer pricing provisions generally follow the OECD guidelines relating to the same. However, there are certain fundamental differences in that the Indian provisions require the computation of an "arms length price" as against the internationally accepted norm of arms length range. Further the arms length price is to be computed as the "arithmetic mean" of comparable results. A variance of around 5% of the mean may be opted for.

The Section 92 of the IT Act provides that the price of any transaction between associated enterprises, either or both of whom are non resident for tax purposes ('international transaction'), shall be computed having regard to the arm's length principle.

Two enterprises are considered to be associated if there is direct/indirect participation in the management or control or capital of an enterprise by another enterprise or by same persons in both the enterprises.

In determining whether there is participation in management or control, various factors are taken into consideration including:

- Direct / indirect shareholding having 26% or more of voting power,
- Advancing of loans of 51% or more of total assets,
- Appointment of more than 50% of the board of directors,
- Goods manufactured are sold under influenced prices.
- Dependence on IPRs owned by either party

Determination of "arms length price"

A very important aspect of the concept of Transfer Pricing is the process of determining the arm's length price. The Central Board of Direct Taxes (CBDT) has prescribed five methods for determining the arm's length price :

- Comparable Uncontrolled Price Method
- Resale Price Method
- Cost plus method
- Profit Split Method
- Transactional Net Margin Method

The choice of the appropriate method is determined with respect to the nature and class of transaction, the classes of associated persons, the functions performed by them and other relevant factors.

Burden of Proof and Assessment

The burden of proving that the international transactions are in accordance with the arms length principle lies with the taxpayer. For this purpose, the IT Act requires the maintenance of prescribed information and documents relating to international transactions undertaken between associated enterprises. Failure to do so attracts very stiff penalties.

Also, it is mandatory to obtain an accountant's certificate in a prescribed format in respect of all international transactions between associated enterprises. Such report would have to contain prescribed particulars of the transaction, and would have to be filed with the tax authorities by October 31 (in case of companies) of the relevant assessment year.

Once the accountants certificate has been filed the concerned tax officer may call for the prescribed documentation in the assessment proceedings. Based on available information, the tax officer may adjust or recompute the prices used in international transactions. Such an adjustment would attract tax and interest on the additional amount. Potentially, a penalty of 100% to 300% of the tax on the adjusted amount could also be levied.

With the approval of the Commissioner of Income-tax, the Assessing Officer may refer the case for a detailed review to specially appointed Transfer Pricing Officers (TPO). The order of such TPO would have to be considered by the Assessing Officer in finalizing this assessment.

Indirect Taxes

Customs Duty

Customs or import duties are levied by the Central Government of India on the goods imported into India. The rate at which customs duty is leviable on the goods depends on the classification of the goods determined under the Customs Tariff. The Customs Tariff is aligned with the HSN provided by the World Customs Oraganisation..

The Finance Act, 2007 has reduced the peak customs duty to 10% for all goods other than agricultural and other specified products. However, the Central Government has the power to generally exempt goods of any specified description from the whole or any part of duties of customs leviable thereon. In addition, preferential/concessional rates of duty are also available under the various Trade Agreements.

The customs duties are levied on the transaction value of the imported goods. In this regard, the Finance Act, 2007 has substituted the existing Section 14 of the Customs Act. The amendment makes the concept of transaction value the sole basis for valuation of export as well as import goods, thereby removing all confusion as to be use of deemed value for customs valuation.

General principles adopted for valuation of the goods under the Customs Act are in conformity with the WTO agreement on customs valuation. In furtherance of this, Customs Valuation Rules for export and import goods have been drafted. These have been released for public comment and are yet to be finalized.

The types of customs duties applicable are as follows: -

- Basic Customs Duty (BCD)- this is calculated at the effective rate applied to the landed value of the goods, which comprises of CIF value and the landing charges.
- Additional Duty of Customs in lieu of excise (CVD)- this is equivalent to the excise duty applicable on like goods manufactured in India. and is calculated on the landed value and the basic customs duty. However, on the most of the consumer goods intended for retail sale duty is calculated based on the maximum retail price (MRP) printed on their packs.
- Additional Duty of Customs in lieu of Sales Tax/VAT(ADC): In addition, all imports w.e.f. 01.03.2006 are chargeable to an additional duty of customs @ 4% in lieu of sales tax/VAT with few exceptions. The exemptions inter alia include:
  - Goods which are fully exempt from basic customs duty and Additional Duty of Customs in lieu of excise.
  - Petroleum crude, kerosene for PDS, LPG for domestic supply, petrol, diesel, coal & coke.
  - Goods for export promotion schemes under which imports are allowed at zero duty.
  - Imports by 100% Export Oriented Units (EOUs) and units in EHTPs/STPs or SEZs.
  - DTA clearance of EOUs / EHTPs / STPs / SEZ units, provided such goods are not exempt from sales tax / VAT.

Education Cess (EC) @3% is also levied on the aggregate of duties of customs (except safeguard duty, countervailing duty and antidumping duty). Goods attracting customs duties at bound rates under international commitments (for

example, IT Agreement, Indo-US Textile Agreement) have been exempted from these cess.

Authority for Advance Rulings (AAR) gives advance rulings on issues related to customs duties for setting up a joint venture in India. The Finance Act 2005 had brought about the following amendments in the Advance Ruling provision.

- Facility of seeking an advance ruling has been made available to an existing Joint Venture in India.
- Central Government is empowered to notify any class or category of person as eligible for availing the benefit of an advance ruling.
- Advance rulings may also be sought with regard to determination of the Rules of Origin of goods and matters relating thereto.

CENVAT (Excise Duty)

Central Value Added Tax (CENVAT) is a duty of excise levied by the Central Government on manufacture of movable and marketable goods in India. The duty is levied at the rates specified in the Excise Tariff. Till the FY 2005-2006, two types of excise i.e. Basic Excise Duty (BED) and Special Excise Duty (SED) were levied. However, the Budget 2006-2007 has, vide notification NO. 09/2006 dated 1.03.2006, exempted the payment of SED.

The rate at which excise duty is leviable on the goods depends on the classification of the goods under the Excise Tariff. The Excise Tariff is primarily based on the Harmonized System of Nomenclature (HSN). The Government has w.e.f. April 1, 2005 adopted an eight digit classification under the Excise Tariff so as to bring it in conformity with the Customs Tariff.

The excise duty on most of the consumer goods, which are intended for retail sale is payable on the basis of the Maximum Retail Price (MRP) printed on the goods. However, abatements at the rates ranging from 30% to 50% are admissible from the MRP for the purposes of charging BED as well as SED. Budget 2007 proposes to bring IT products under MRP system of excise payments. The other goods are generally chargeable to duty on the 'transaction value' of the goods sold to an independent buyer. In addition, the Central Government has the power to fix tariff values for charging ad valorem duties on the goods.

The three duty rates comprising of BED and SED under the rationalised structure are Nil, 8%, 16%. In addition, there are more than 55 general Notifications granting partial or complete exemption to specified goods from payment of excise duties. The education cess @ 2% is applicable on the aggregate of excise duties. The Budget 2007 has also introduced an additional Secondary & Higher Education Cess (SHEC) @ 1% on the aggregate of excise duties.

The central excise duty is a modified VAT wherein a manufacturer is allowed credit of the excise duty paid on locally sourced goods and the Additional Duty of Customs on imported goods. The CENVAT credit can be utilized for payment of excise duty on the clearance of dutiable final products manufactured in India. The Finance Act 2004 had introduced the integration of goods and services tax. Therefore manufacturers of dutiable final products would also be eligible to avail CENVAT credit of the service taxes paid on input services used both in or in relation to manufacture of final products and clearances of final products from the place of removal. In addition, CENVAT credit would be admissible on the following input services:

- Services used in relation to setting up of a factory or an office relating to such factory
- Advertisement or sales promotion services
- Services in relation to procurement of inputs
- Activities relating to management of business such as accounting, auditing, financing, recruitment and quality control.

Authority for Advance Rulings (AAR) gives advance rulings on issues related to excise duty for setting up a joint venture in India. The amendments brought about to the Advance Ruling provisions vide the Finance Act, 2005 discussed earlier would be applicable to excise and service taxes as well.

Sales Tax

Sales tax is levied on the sale of virtually all movable goods in India. Indian regulatory framework has granted power to State Legislature to levy sales tax on goods sold within that State. The levy of sales tax and the rates applicable thereto, therefore, varies according to the sales tax law of the relevant State.

All goods sold in the course of interstate trade are subject to Central Sales Tax and the rates vary between 3%, 10% or the State sales tax rate, whichever is higher. Where goods are bought and sold by registered dealers, for use as inputs in the manufacture of other goods or activities (such as mining or telecommunication networks), the rate of sales tax is 3%, provided Form 'C' is issued by the purchasing dealer. In the absence of Form 'C', the rate would be 10% or the State sales tax rate, which ever is higher.

VAT

State level sales tax was replaced by Value Added Tax w.e.f. April 1, 2005 in a majority of Indian states. The government of the State of Tamil Nadu has implemented VAT from January 1, 2007. With the introduction of VAT, the Tamil Nadu General Sales Tax Act, 1959 governing the state sales tax stands repealed. The sales tax regime is only applicable in the State of Uttar Pradesh and the Union Territory of Puducherry. Puducherry has indicated that it would be introducing the VAT by June 1, 2007.

- Under the VAT regime the VAT paid on goods purchased from within the State is eligible for VAT credit. The input VAT credit can be utilized against the VAT/ Central Sales Tax (CST) payable on the sale of goods. It is thus ensured that cascading effect of taxes is avoided and only the value addition is taxed.
- The Central Sales Tax is sought to be phased out. CST has been reduced from 4% to 3% w.e.f April 1, 2007. However, CST continues to coexist with the State VAT. Inter State procurement, on which central sales tax is charged by the originating State is eligible for input tax credit. Further, inter State branch/ consignment transfers are exempt from VAT and hence not eligible for input tax credit. However, certain states are allowing input tax credit in excess of 4% on inter state stock transfers.
- There would be no VAT on imports into India for the present. Exports will be zero rated. This would mean that while output exports will not be charged to VAT, inputs purchased and used in the manufacture of export goods will be refunded.

- The State VAT will be charged on uniform tax rates of 1%, 4% and 20%. Goods that are presently charged at either 8% or 12% will be charged at a Revenue Neutral Rate (RNR) of 12.5%. Most goods will thus be charged at this RNR.
- Turnover thresholds have been prescribed so as to keep out small traders from the ambit of the VAT. A turnover tax may be levied on such small traders in lieu of the VAT.
- VAT registered dealers will need to issue serially numbered invoices with prescribed particulars.
- The periodicity of filing of VAT returns will remain the same as prescribed in the erstwhile sales tax regime.
- A comprehensive self assessment of VAT has been introduced..
- Turnover taxes, surcharges, additional surcharges and the special additional tax have been abolished.
- Entry taxes will continue, if vatable, except where they are in lieu of octroi.

The Empowered Committee is currently considering introduction of coding in terms of the Harmonised System of Nomenclature for commodities under the VAT. The Central Government has been compensating the states in order to offset the revenue loss that has taken place on account of implementation of VAT.

Budget 2006 had taken a major step by indicating the date of 1st April, 2010 for the introduction of a national, integrated Goods and Services Tax (GST). Budget 2007 has reiterated the commitment towards introduction of a national level Goods & Services Tax (GST) by the said date. The Central Government has indicated that the Empowered Committee of State Finance Ministers would work with the Central Government in setting out a specific road map for the introduction of GST by the above date

Octroi Duty / Entry Tax

Octroi duty, levied by the local authority, is a tax on entry of goods within a local area for consumption, use or sale therein. Entry tax is levied by the state government on entry of goods into the state.

Stamp Duty

Stamp duty is levied at various rates on documents such as bills of exchange, promissory notes, insurance policies, contracts effecting transfer of shares, debenture, and conveyances for transfer of immovable property. Transfer of shares in India is subject to a stamp duty levy @ 0.25% on market value.

R &D Cess

R&D Cess of 5% is levied on all payments made for import of ‘technology’. The term ‘technology’ includes import of designs, drawings, publications and services of technical personnel (the amount leviable to cess includes technical personnel’s living costs in India).

Service Tax

Service tax is levied on specified ‘taxable services’ rendered at the rate of 12% of the gross value of taxable services. In addition a cess @3% is also leviable on the services in terms of the amendments made vide the Finance Act 2004. Service tax is currently leviable on approximately 98 services. Budget 2007 has proposed to cover 4 additional services as well as extend the scope of certain existing services.

In terms of the provisions of the Finance Act, 1994, as amended, service provider is required to be registered with the jurisdictional service tax authorities. Further, the Service Tax Rules, 2004 have been amended in relation to centralized registration whereby service recipients, liable to pay service tax, receiving services in more than one premise or office, and having a centralized billing or accounting system can opt for centralized registration by making an application to the Commissioner of Central Excise within whose jurisdiction the premise or office, from where the centralised billing or accounting is done, is located. Budget 2007 proposes to raise the threshold limit for small service providers to INR 8 lakhs. Accordingly, the threshold limit for the purposes of registration has also been increased to INR 7 lakhs.

Service tax was earlier charged on the gross value of the services which have been rendered. The Central Government has recently introduced the Service Tax (Determination of Value) Rules, 2006. The highlights of these rules are detailed below:

- Where the consideration received for taxable service is not wholly or partly in money, the value of taxable service would be equal to the gross amount charged by the service provider for similar service as sole consideration to any other person.
- Where such value of similar service is not available, the value of taxable service shall be determined by the service provider and shall not be less than the cost of provision of such services.
- Any expenditure or costs incurred in providing taxable services shall be included in the value of such services.
- Only such expenditure as is incurred as a pure agent of the service receiver shall be excluded from the value of taxable services.
- In case of services imported into India, the value of taxable services will be equal to the actual consideration charged.
- The Central Excise Officer has powers to question the valuation of such services and to re-determine the value after giving reasonable opportunity of being heard to the assessee.

Also as already stated, integration of goods and services tax has come into existence. Consequently, a service provider can avail CENVAT credit of excise duties paid on capital goods and inputs used for providing output services, apart from availing CENVAT credit of the service taxes paid on input services.

By the Finance Act 2005, the Central Government has inserted an Explanation in Section 65 (105) of the Finance Act, 1994. As a result, the scope of taxable services has been proposed to be expanded i.e. services provided from outside India to a recipient in India would be deemed to be provided to be taxable services provided in India and hence subject to service tax. In terms of the Services (Provided from Outside India and Received in India) Rules, 2006 where the taxable services are provided from outside India and received in India, the service recipient is required to get registered and to pay the tax in accordance with the relevant provisions of law. The taxable services under these rules shall not to be treated as output services for the purpose of availment of CENVAT credits on inputs/input services.

The Central Government has issued the Export of Service Rules, 2005 (Export Rules), In terms of the said Export Rules, no service tax would be chargeable on export services. The benefit of exemption from service tax would be available on services,

as exports thereof, only if the conditions specified therein are met. The conditions as amended w.e.f. March 1, 2007 are as follows:

- the taxable service is provided from outside India and is used outside India and
- payment for such service is received by the service provider in convertible foreign exchange.

Alternately, the service provider could discharge the service tax on exports and claim a rebate of the service tax paid. E-payment of service tax has been made mandatory for certain categories of large assessees w.e.f October 1, 2006.

In addition to the rebate of tax paid on the exported services, rebate provisions has also been notified with regard to the service tax paid on input services and excise duty paid on input goods used in providing the exported services.

Some other Indirect Taxes

Some states also provide for levies such as :

- Works Contract Tax - Tax imposed on the value of goods transferred in the execution of a works contract.
- Turnover Tax - Tax imposed on the value of turnover in excess of a certain limit.
- Purchase Tax - Tax imposed on the value of goods purchased from unregistered dealers.

Annexure 1

Export Oriented Units

Export Oriented Units (EOU) scheme is a 100% export oriented scheme, focusing on promotion of exports through grant of various incentives and benefits to registered Industrial units. Since its launch, the scheme has yielded far-reaching results and has re-triggered India's economic growth through increased exports and foreign direct investment.

What is an EOU?

A EOU is an industrial unit operating under customs bonding, which has undertaken to export its entire production of goods and services, except permissible sales in Domestic Tariff Area (DTA). Such units may be engaged in export of all kinds of goods & services (barring trading activities) including repair, remaking, testing, calibration, quality improvement, up-gradation of technology and re-engineering activities, etc. for export in freely convertible foreign currency (*subject to prescribed conditions*).

Can a DTA Unit convert to EOU?

- An existing DTA unit may also apply and convert into an EOU.
- While allowing such a conversion, the existing unfulfilled export obligation of the DTA unit shall be subsumed into those of the EOU.
- No concession in duties and taxes will be available for plant, machinery and equipment already installed.

Salient Features of EOU scheme

- Single window clearance
- No license required for import.
- No export / foreign exchange earning commitment - To be positive net foreign exchange earner (NFE) cumulatively over initial 5 years
- Duty free goods (other than capital goods & spares) to be utilized in two years. Further extension possible.
- EOUs can sell goods / services locally against payment in foreign exchange.
- Upto 50% of exports value can be sold locally with concessional duties and taxes (subject to positive NFE).
- Supplies from the DTA to EOUs regarded as 'deemed exports', entitling DTA suppliers to certain export benefits.

FDI Policy

- 100% Foreign Direct Investment permissible.
- Exemption from industrial licensing requirement for items reserved for SSI sector.

Income-tax Incentives

- 100% tax deduction on export profits till 31 March 2009.
- Exemption from Minimum Alternate Tax, enjoyed by these units, has been withdrawn with effect from financial year 2007-08.

Indirect tax Incentives

- Nil import duty
- Nil Excise Duty on procurement of goods from bonded warehouses in the DTA.
- Reimbursement of Central Sales Tax (CST) paid on purchases from DTA.
- Reimbursement of duty paid on furnace oil, procured from domestic oil companies, as per the notified drawback rates.

Liberal Exchange Controls

- 100% export earnings maintainable in Dollar A/c - minimal restrictions on business payments outside India from dollar balances.
- Extended credit period (1 year) for export realization.
- Re-export of defective imports / imports on loan basis permitted without G.R. waiver.

Other Incentives

- Sub-contracting permissible
- Inter-unit transfer of goods / services permitted.
- Capital goods may also be transferred / given on loan basis to other EOUs (with prior permissions).
- Scrap / waste / remnants / unutilized materials / surplus or obsolete capital goods may be exported or sold in the DTA on payment of duties.
- Job work on behalf of domestic exporters for direct export allowed.
- EOUs permitted to:
  - Export goods for holding participating in overseas exhibitions
  - Export goods for display / sales in permitted shops overseas.
  - Set-up show rooms / retail outlets at International airports.

Annexure 2

Special Economic Zones in India

"The objectives of SEZs include making available goods and services free of taxes and duties supported by integrated infrastructure for export production, quick approval mechanisms, and a package of incentives to attract foreign & domestic investments for promoting exports."

Ministry of Commerce & Industry, Government of India

Special Economic Zone (SEZ) is a specifically delineated, duty free enclave, deemed to be outside the customs territory of India for the purposes of carrying out authorized activities.

There are more than 30 operational SEZs in India. In addition, over 115 SEZs have been notified and around 350 are in various stages of approval.

The SEZ Act, 2006 and SEZ Rules, 2006 which came into force with effect from February 10, 2006, govern the development of SEZs. The Act provides the umbrella legal framework, covering all important legal and regulatory aspects of SEZ development as well as for units operating in these SEZs.

Scope of SEZ Act

- Establishment of SEZs and units
- Fiscal regime for developers and units
- Requirements, obligations, entitlements
- Single window clearance mechanism
- Establishment of administrative Authority for SEZ set up by Government of India
- Special courts and single enforcement agency to ensure speedy trial

Development of SEZs

SEZs are notified by the Ministry of Commerce and can be set up by private developers or by Central / State Governments, or jointly by any two or more of the above on a contiguous, vacant land. The Zones are required to have a minimum area which is as under.

Type	Total Area
Multi-product	1000 hectares (200 hectares in specified areas*) (Proposed maximum size : 5000 hectares)
Multi-services	100 hectares (50 hectares in specified areas*)
Sector specific	100 hectares (50 hectares in specified areas*)
Port / Airport based SEZ	100 hectares
Gems & Jewellery Sector Specific SEZ	10 hectares and minimum built up processing area of 50,000 sq.mtrs.
Biotech & Non-conventional Energy Sector Specific SEZ	10 hectares and minimum built up processing area of 40,000 sq.mtrs.
IT Sector Specific SEZ	10 hectares and minimum built up processing area of 100,000 sq.mtrs.
Free Trade & Warehousing Zone	40 hectares and minimum built up processing area of 100,000 sq.mtrs.

*Specified areas are Assam, Meghalaya, Nagaland, Arunachal Pradesh, Mizoram, Tripura, Himachal Pradesh, Uttranchal, Sikkim, J&K, Goa and UTs.

Fiscal Benefits to the Developer

Income Tax Incentives

- 100% tax deduction for 10 years out of 15 years beginning with the year in which the SEZ is notified by the government

- Exemption from Dividend Distribution Tax
- Exemption from Minimum Alternate Tax

Indirect Tax Incentives

- Nil import duty
- Nil Excise Duty
- Exemption from Central Sales Tax (CST)
- Exemption from Service tax
- Exemption from VAT / Sales-tax as per State Government policy
- Exemption from electricity duty on generated and purchased power

Stamp duty Incentives

- Exemption from payment of stamp duty as per state government policy

Who should set up a unit in SEZ?

Export oriented manufacturers and service providers (including IT and ITES providers, BPOs, contract manufacturers, etc.) have huge growth potential in Indian SEZs. IT hardware and software and telecom equipment suppliers can also set up units in SEZs for supply to domestic market.

FDI Policy

100% FDI permitted under automatic route for SEZ development. For units in SEZs, FDI Policy of Government of India will apply.

No minimum export obligation

- SEZ units to be net foreign exchange earners at the end of 5 years calculated cumulatively
- No limit on DTA sales provided full import duty is paid
- Supplies of IT hardware and software and telecom equipment to domestic markets, supply of goods and services to other SEZ/EOU/STPI units deemed as foreign exchange earning.

Fiscal benefits to a SEZ Unit

- 15 year income-tax deduction on export profits beginning with the year in which the unit begins to manufacture, produce or provide services – 100% for initial 5 years, 50% for the next 5 years and up to 50% for the balance 5 years equivalent to profits ploughed back for re-investment
- Tax deduction only for physical export
- Exemption from MAT
- Same indirect tax benefits as the SEZ Developer
- Exemption from electricity duty
- Exemption from payment of stamp duty as per state government policy

Liberal Exchange Controls

- 100% export earnings maintainable in foreign exchange in Special Foreign Currency Account – minimal restrictions on business payments outside India
- Unlimited credit period for export realization
- Branches of foreign companies in SEZ are eligible to undertake manufacturing activities.

Offshore Banking Units

Offshore Banking Unit means a branch of a bank in India located in the SEZ with the permission of RBI. Offshore Banking Units shall provide cheaper finance at international rates to Units in SEZs

Banks setting up Offshore Banking Units in SEZs entitled to tax deduction (beginning with the year in which they obtain requisite approvals) of 100% for first 5 years and 50% for next 5 years. Similar deduction available to units of International Financial Services Centre.

Annexure 3

Software Technology Parks of India (STPI)

Software Technology Parks (STP) scheme is a 100% export oriented scheme for encouraging development and export of computer software from India. The STP scheme has yielded excellent & far-reaching results over the years enabling India to remain competitive in the global market and positioning at the pinnacle of the global software industry.

There are 34 operational STPI National Centers in India. A STP Unit can be set-up even outside these designated centers.

Who should set up a unit in STPI?

Export oriented service providers (including software developers,

BPO, call centers, medical transcriptions, etc.).

Salient Features of STP scheme

- Single window clearance
- No export / foreign exchange earning commitment - To be positive net foreign exchange earner (NFE) cumulatively over initial 5 years
- Duty free goods (other than capital goods & spares) to be utilized in two years. Further extension possible.
- Capital goods can be sourced on lease.
- STP units can sell software / services locally against payment in foreign exchange.
- Upto 50% of exports value can be sold locally with concessional duties and taxes (subject to positive NFE).
- Supplies from the DTA to STP units regarded as 'deemed exports', entitling DTA suppliers to certain export benefits.

FDI Policy

100% Foreign Direct Investment permissible. No approvals required.

Income-tax Incentives

- 100% tax deduction of export profits till 31 March 2009.
- Exemption from Minimum Alternate Tax, enjoyed by these units has been withdrawn with effect from April 1, 2007.

Eligible IT-enabled services

- Back-Office Operations
- Call Centers
- Content Development or animation
- Data Processing
- Engineering and Design
- Geographic Information System Services
- Human Resources Services
- Insurance Claim Processing
- Legal Databases
- Medical Transcription
- Payroll
- Remote Maintenance
- Revenue Accounting
- Support Centers
- Web-site Services

Indirect tax Incentives

- Nil import duty
- Nil Excise Duty on procurement of goods from bonded warehouses in the DTA.
- Reimbursement of Central Sales Tax (CST) paid on purchases from DTA.
- Rebate of input service taxes.

Liberal Exchange Controls

- 100% export earnings maintainable in Dollar A/c - minimal restrictions on business payments outside India from dollar balances.
- Extended credit period (1 year) for export realization.
- Re-export of defective imports / imports on loan basis permitted without G.R. waiver.

Other benefits

- Concessional lease rentals in STP zones for initial 3 years.
- Sub-contracting permissible
- Inter-unit transfer of goods / services permitted.
- Capital goods may also be transferred / given on loan basis to other STP units (with prior permissions).

Annexure 4

Tax Rates under Double Taxation Avoidance Treaties

Name of the country	Interest	Dividend (Refer note a)	Royalty (Refer note m)	Fee for Technical Services (Refer note m)
Austria	10%	10%	10%	10%
Armenia	10%	10%	10%	10%
Australia	15%	15%	10% [b] 15% in other cases	No specific provision. However, it can be covered under Royalty
Bangladesh	10%	10%[c]; 15% in other cases	10%	No specific provision[e]
Belarus	10%	10%[i]; 15% in other cases	15%	15%
Belgium	10% [k]; 15% in other cases	15%	10%[f]	10%[f]
Brazil	15%	15%	25% if royalty arise from trademarks, 15% in other cases	No specific provision[e]
Bulgaria	15%	15%	15% if it relates to copyrights of literary, artistic or scientific work, 20% in other cases	20%
Canada	15%	15%[c]; in other cases 25%.	10%[b]; in other cases 15%	10%[b]; in other cases 15%
China	10%	10%	10%	10%
Czech Republic	10%	10%	10%	10%
Cyprus	10%	10%[c]; in other cases 15%	15% (including fee for included services)	10% (for technical fees)
Denmark	10%[k]; 15% in other cases	15%[i]; 25% in other cases	20%	20%
Finland	10%	15%	10%[b]; in other cases 15%	10%[b]; in other cases 15%
France	10%[f]	10%[f]	10%[f]	10%[f]
Germany	10%	10%	10%	10%
Greece	21.115%[l]	Exempt	10.558%[m]	No specific provision[e]
Hungary refer note (n)	10%[f]	10%[f]	10%[f]	10%[f]

Name of the country	Interest	Dividend (Refer note a)	Royalty (Refer note m)	Fee for Technical Services (Refer note m)
Indonesia	10%	10% [i]; 15% in other cases	15%	No specific provision[e]
Ireland	10%	10%	10%	10%
Israel	10%	10%	10%	10%
Italy refer note (p)	15%	15%[c] ; in other cases 25%	20%	20%
Japan refer note (r)	10%	10%	10%	10%
Jordan	10%	10%	20%	20%
Kazakstan	10%	10%	10%	10%
Kenya	15%	15%	20%	17.5% (for managerial, technical, professional or consultancy fees)
Republic of Korea	10% [o], 15% in other cases	15% [d]; 20% in other cases	15%	15%
Kyrgyz Republic	10%	10%	15%	15%
Libya Arab Jamahriya	21.115%[l]	Exempt	10.558%[m]	No specific provision[e]
Malaysia	10%	10%	10%	10%
Mauritius	21.115%[l]	5%[c]; in other cases 15%	15%	No specific provision[e]
Malta	10%	10%[i]; in other cases 15%	15% including fee for included services	10% on fee for technical, managerial and consultancy services
Mongolia	15%	15%	15%	15%
Morocco	10%	10%	10%	10%
Namibia	10%	10%	10%	10%
Nepal	10% [o], in other cases 15%	10%[c]; in other cases 15%	15%	No specific provision [e]
Netherlands	10% [f]	10% [f]	10% [f]	10% [f]
New Zealand	10%	15%	10%	10%
Norway	15%	15%[i]; in other cases 25%	10%[f]	10%[f]
Oman	10%	10%[c]; in other cases 12.5%	15%	15%
Philippines	10%[o]; in other cases 15%	15%[c]; in other cases 20%	15%	No specific provision[e]

Name of the country	Interest	Dividend (Refer note a)	Royalty (Refer note m)	Fee for Technical Services (Refer note m)
Poland	15%	15%	22.5%	22.5%
Qatar	10%	5%[c]; in other cases 10%	10%	10%
Portugal	10%	10%[i]; 15% in other cases	10%including fee for included services	No specific provision. However it can be covered under Royalty
Romania	15%	15%[i]; in other cases 20%	22.5%	22.5%
Russian Federation	10%	10%	10%	10%
Saudi Arabia(q)	10%	5%	10%	No Specific provision[e]
Singapore	10%[k];in other cases 15%	10%[i]; in other cases 15%	10%	10%
South Africa	10%	10%	10%	10%
Spain	15%	15%	20%[f], 10%[f][b]	20%[f]
Sri Lanka	10%	15%	10%	No specific provision[e]
Sweden	10%[f]	10%[f]	10%[f]	10%[f]
Sudan	10%	10%	10%	10%
Syria	7.5%	Exempt	10%	No specific provision[e]
Slovenia	10%	5%[c]; in other cases 15%	10%	10%
Switzerland	10%	10%	10%	10%
Tanzania	12.5%	10%[c]; in other cases 15%	20%	20% on management & professional fees
Thailand	10%[o],in other cases 25%	15%[c][h]; 20%[i] or [h]	15%	No specific provision[e]
Trinidad and Tobago	10%	10%	10%	10%
Turkey	10%[k]; in other cases 15%	15%	15%	15%
Turkmenistan	10%	10%	10%	10%
Uganda	10%	10%	10%	10%
Ukraine	10%	10%[i]; in other cases 15%	10%	10%
United Arab Emirates	5%[k]; in other cases 12.5%	5%[c]; in other cases 15%	10%	No specific provision[e]
United Arab Republic	21.115%[l]	Exempt	10.558%[m]	No specific provision[e]

Name of the country	Interest	Dividend (Refer note a)	Royalty (Refer note m)	Fee for Technical Services (Refer note m)
United Kingdom	10%[o]; in other cases 15%	15%	10%[b]; in other cases 15%	10%[b]; in other cases 15%
United States of America	10%[k]; in other cases 15%	15%[c]; in other cases 25%	10%[b]; in other cases 15%	10%[b]; in other cases 15%
Uzbekistan	15%	15%	15%	15%
Vietnam	10%	10%	10%	10%
Zambia	10%	5%[j]; in other cases 15%	10%	10% on managerial & consultancy fees

Notes:

(a) The treaty tax rates on dividend are not relevant in case of payment of dividend by Indian company since under the current Indian tax legislation, dividend distribution by such companies is exempt from Income Tax in the hands of recipient.

(b) For use of industrial, scientific or commercial equipment.

(c) If, beneficial owner is a company, which holds at least 10% of the capital of the company paying dividend

(d) If beneficial owner is a company, which owns 20% of capital of the company paying dividend/interest

(e) In absence of specific provision, it may be treated as business profits under respective treaties

(f) "Most Favored Nation" clause is applicable. The Protocol to the Treaty limits the scope and rate of taxation to that specified in similar Articles in Treaties signed subsequently by India with other OECD nations.

(g) In most of the treaties the Interest attributable to financing of exports and imports, loan granted by specified institutions is subject to NIL or lower withholding tax rates.

(h) Company paying dividend is engaged in industrial undertaking.

(i) If beneficial owner is a company which holds at least 25% of the shares of the company-paying dividend

(j) If the recipient is a company owning at least 25% of capital during the period of 6 months before date of payment

(k) If paid on a loan granted by a bank / financial institution.

(l) Tax rate under domestic tax laws is 20%, plus surcharge @2.5%, education cess of 3% is levied, effective tax rate being 21.115%.

(m) The Prescribed tax rate for Royalty & Fees for technical services, under domestic tax laws is 10% (plus surcharge @2.5%, education cess of 3%, the effective tax rate being 10.558%). The rate would apply for payments under the agreement entered on or after 1st June, 2005.

(n) As per the new DTA with Hungary, applicable from April 1, 2006.

(o) If interest is received by a bank or financial institution

(p) Protocol amending the DTAA with Italy (January 2006) stipulates rate of 10% for Dividend, Interest, Royalty and Fee for Technical Services.

(q) The provisions of the DTAA will have effect in India in respect of income derived on or after April 1, 2007.

(r) The protocol (notified by the Central Government on July 19, 2006) stipulates the new rate of 10% for Dividend, Interest, Royalty and Fee for Technical Services. In India, this new rate will be effective from April 1, 2007.

Annexure 5

Map of India

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