India update – January – February 2009

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FII registration up by record 376

Registration of foreign institutional investors (FIIs) with the Securities and Exchange Board of India (Sebi) surged by a record 376 in 2008.

The jump in FII registration is attributed to the market regulator simplifying registration norms in October 2007.

With the 2008 figure, the total number of FIIs registered in India has increased to 1,595. In 2007, a total of 226 FIIs were registered with Sebi, and in 2006, as many as 170 had opened their offices in India.

The number of registered FIIs in India has gone up despite the fact that their selling in the domestic market was the steepest and that their portfolios had eroded hugely during the year.

The list of new foreign investors included those who were investing through Participatory Notes (PNs). Besides, there were many pension funds that had entered the domestic market for the first time. These funds had just started investing, while some other newly-registered FIIs were sitting on the fence, waiting for the equity market to settle down.

Among the 376 new entrants, 165 FIIs were from the US, compared to 110 in 2007, five from China and one each from Bahrain, Brunei, Kenya, Poland and Thailand.

The number of FIIs from countries such as Mauritius, Australia, Singapore, France, Britain, UAE and Cayman Islands has more than doubled. Of the total registered FIIs, 560 are from the US, 254 from the UK (120 in 2007), 99 each from Luxembourg and Singapore, 71 from Mauritius, 68 from Hong Kong and over 60 from Canada, Australia and Ireland.

MNC retailers' liaison hubs to escape tax net

AAR rules in Ikea's favour, sets precedent

A ruling that the liaison office of home furnishing multinational Ikea is not liable to pay income tax here could set an important precedent and benefit overseas retailers that have set up similar operations to oversee sourcing of goods from India.

In a recent decision, the Authority for Advance Rulings (AAR) said the liaison office of Ikea Trading (Hong Kong) does not earn any income in India because its activities are confined to the purchase of goods that are exported by Indian vendors to the company or its nominees.

While an advance ruling is binding only on the applicant and the tax department, it has persuasive value as other taxpayers can cite it in similar subsequent cases.

The income-tax department wanted Ikea Hong Kong to be treated as an 'intermediate entity' that earns revenue for the services provided by the Indian office. Such treatment would have created a taxable presence in India.

But the advance rulings body was of the view that even though export was done by the Indian seller, the goods purchased by Ikea Hong Kong through its liaison office were meant to be exported. The liaison office carries out price surveys of potential suppliers, does quality checks, social audits of suppliers and collects samples for the Hong Kong-based parent.

Cabinet likely to waive 49% divestment clause for Pepsi

Nod to pave way for company to invest more funds in its India operations

After deliberating for over a year, the government may finally flag off PepsiCo's plea for waiver of the mandatory 49% disinvestment in its Indian bottling arms. The company had sought exemption from the divestment clause, arguing that 100% foreign investment is now allowed in food processing.

The proposal is likely to be approved in a meeting of the Cabinet Committee on Economic Affairs (CCEA). The approval would also pave way for the parent company to invest funds in its Indian arm, a matter which has been stuck due to absence of government approval in the 'divestment clause' case.

In 2000, the policy was liberalised to permit 100% foreign equity in the sector and the divestment clause does not make any sense now. All concerned ministries and departments, including the department of industrial policy on promotion, department of economic affairs and the ministry of food processing have given their consent for deletion of the divestment clause.

The Foreign Investment Promotion Board (FIPB), which considered PepsiCo's proposal for the third time in October this year, felt the company's proposal to inject Rs 215 crore in the Indian venture could be cleared only if it honoured its commitment on mandatory divestment of its bottling operations.

A precedent was set when the government made Coca-Cola divest 49% in its bottling operations in 2002, despite the cola company's repeated requests for a waiver. But the company bought the stake back subsequently. However, FIPB did not reject PepsiCo's request for a waiver. Instead, it referred the proposal to CCEA. The divestment clause was made mandatory to provide domestic investors a window of opportunity in sectors like food processing. Since FDI in sectors like soft drinks was not considered a priority, officials made companies in such sectors undertake a commitment to divest in favour of domestic investors.

PepsiCo India Holdings has 100% stake in Aradhana Soft Drinks Company and the deadline for divesting 49% expired in December 2007. While FIPB had made it mandatory for both Coke and Pepsi to reduce their stake in Indian units to 51% in five years, the policy has since been modified. The rider is not imposed on newcomers and 100% FDI in food processing has been permitted through the automatic route.

Foreign law firms get tax reprieve from Bombay HC

Foreign law firms have received a shot in the arm following a judgement from the Bombay High Court which clearly states that their income will be taxable in India only to the extent of their operations in India.

An early beneficiary of the judgement has been Clifford Chance, a UK-based legal firm which during 1996-97 was appointed as legal advisors for three projects in India — Bhadravati power project, Vizag power project and Ravva oil and gas fields project. In the subsequent financial year, it began work on the Vemagiri power project as well. Only the Bhadravati project had an Indian firm — Ispat Industries — which was the JV partner for construction of the power plant. The partners for the other projects were "not resident" in the country.

Clifford Chance was remunerated on an hourly rate basis with each of its partners and employees maintaining detailed time sheets. This was a record of the time spent on doing such work in India and outside it. The bills so raised were paid to Clifford Chance by the clients outside India. The law firm filed a return showing an income liable to Indian taxation of Rs 5.08 crore.

According to the Income-Tax Department, the entire fee received by Clifford Chance from its clients for the four projects was taxable in India. This was irrespective of the fact that such fee was received for services rendered by it outside. The determining factor has been the place where the legal firm's services were utilized and not the place where the services were performed. As such, the taxable income calculated by the department was Rs 17.26 crore.

Clifford Chance's contention was that under the provisions of the Income-Tax Act and the Double Taxation Avoidance Agreement between India and UK, only that portion of its income from the clients which was attributable to the services performed by it in India could be subjected to Indian taxation. The Income-Tax Tribunal as well as the Appellate Authority ruled in favour of the department. This was on the grounds that even though services rendered by Clifford Chance outside India had to be excluded while computing tax, the advice given by the legal firm was for projects that were to be executed in the country.

It was argued before the Bombay High Court that the tax on professionals who have been in the country for over 90 days would be taxable under the Income-Tax Act. In order to be taxed here, the income must accrue or arise in India. Applying this to a legal professional rendering advisory services, his presence at the time of rendering advice would be the basis for determining where income is taxable, he contended. It was further submitted that the income of an individual from professional services, therefore, is taxable in the state of residence. It is additionally taxable in the other contracting state if the services are performed in that other state.

TDS on contract manufacturing

Small and medium-sized firms that undertake manufacturing for large companies may now have to forego a part of their revenues upfront as tax deducted at source (TDS) under new rules being considered by the government to widen the tax net and make revenue collections more efficient.

The government is proposing changes to tax laws that will mandate companies outsourcing manufacturing work to smaller producers to deduct a 2% tax on the order value while making payments.
This TDS will be adjusted against actual tax dues at the time these firms pay advance taxes or file annual tax returns. The move may raise working capital requirements and, therefore, costs for the actual producers, who in turn would pass on the burden to the outsourcers, and eventually to the final consumers in the form of higher prices.

Manufacturers in sectors such as FMCG, consumer electronics, automobiles, pharmaceuticals and readymade garments outsource the actual manufacturing to smaller entities. Large companies such as Hindustan Unilever (HUL) and Procter & Gamble (P&G) are extensive users of the outsourcing model, which allows them to lower costs and focus on marketing, distribution and brand building. Small and medium sized firms that undertake work for large companies account for a quarter of the country's manufacturing output, according to industry estimates.

Move to have wide impact

While the 2% tax deduction might seem nominal, the actual effect would be significant, given that small producers typically work on margins of 4-5%. The government's proposed move is aimed at bringing contract manufacturing deals under the scrutiny of the income-tax department and thereby widening the tax net. A large number of outsourcing agreements escape the tax net as they are currently treated as buyer-seller agreements.

The income-tax department now wants to treat these deals as 'work contracts', which will make them liable for TDS. Presently, if a company outsources manufacturing of a complete product, it is not covered by TDS, whereas tax would be deducted at source if it outsources only a part of the manufacturing. This ambiguity in the law has led to confusion and large scale litigation, and may have allowed many companies to escape TDS and even taxation altogether. For example, at present, if a shirt manufacturer buys shirts from another contract maker and puts only its brand name, the company does not need to deduct tax on the payment it makes. But now, the finance ministry wants to cover such transactions too, as most such buyer-seller agreements are actually work contracts wherein one large manufacturer gives specifications of the product to a smaller manufacturer.

In some cases, the smaller contract manufacturer is also bound to destroy the product if it manufactures more than the specified number of items or does not follow prescribed specifications.

In sectors such as automobiles, vehicle manufacturers and component makers have a very active exchange of ideas on design and specifications of parts, distinguishing them clearly from pure buyer-seller deals.

Upfront tax deductions on payments to contractors and sub-contractors are covered by Section 194C of the Income-Tax Act, 1961. According to this provision, the entity outsourcing a works contract is required "to deduct 2% of the amount paid to in lieu of the contract". The proposed rule changes seek to clear the air to cover even such contract manufacturing deals and give ready revenue to the government.

FDI only in allied nuclear business

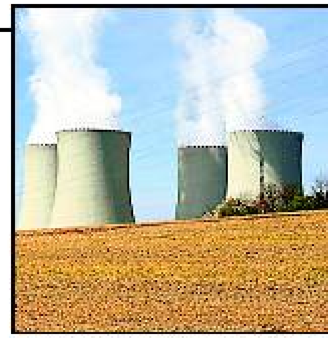
The government will allow participation of foreign investors in activities such as construction of power plants, but will not allow foreign participation in nuclear power generation business.

The new nuclear policy, which is being drafted, permits no stake for foreign players in reactor operation business. Experience in operating nuclear power generation business in other countries doesn't count in India. There are national security reasons also to be taken into account.

The government may allow domestic private firms in the nuclear power business under a joint venture with Nuclear Power Corporation of India (NPCIL). Their equity participation will be capped at 26%. When the domestic players gain adequate experience the government may raise the cap.

The Atomic Energy Act of 1962 defines a government company as "a company in which not less than 51% of the paid up share capital is held by the Central government". Hence there is no need to amend the act to allow private players stake up to 49% in joint ventures with Nuclear Power Corporation.

According to government officials, foreign players will be allowed in other phases of nuclear commerce including, plant construction, fuel supply and maintenance. Engineering, procurement and construction contracts will be awarded to the foreign companies or the consortiums that they form. Companies from France, US and Russia have been looking at the business opportunities available in India after the nuclear co-operation treaty has been signed.



Expats make Provident Fund deposits as treaties remain stuck

If expats from France, Belgium and Germany thought they could escape from contributing 12% of their basic salaries to the Employees' Provident Fund Organisation (EPFO) with India signing bilateral agreements with these countries providing for an exemption from such a contribution, here's a reality check.

These bilateral agreements are yet to come into effect, as they are awaiting ratification by their respective Parliaments. In some cases, the ratification could take up to two years, according to officials in the EPFO. This means that expats from these countries will have to continue making provident fund (PF) deposits to the EPFO, just like expats from any other non-signatory country.

The delay in ratification of these agreements and subsequently their becoming effective also means that domestic employers will have to bear the additional expense of the contribution. They will have to match the amount contributed by expats towards the pension and provident fund schemes of the organisation. The EPFO began demanding contributions for foreign workers employed in India from November 1st, 2008.

Belgium is expected to ratify the agreement by April this year. The agreement was signed in 2007. The agreements with France and Germany may take two years before they are ratified by parliaments in these countries.

India has a short-term agreement with Germany that gives exemption to detached workers for up to 60 months.

India is negotiating social security agreements with 11 other countries, which are in different stages and can take around five-six years to be in place, according to the officials. Once such an agreement is concluded between two countries, workers from each country, need to pay to the social security system of one country only.

Directors in the dock

Separating the liability of the company and its managers for offences is a tricky judicial task.

The liability of directors for the fault of their companies has been set out in various statutes. Though there are special provisions dealing with this aspect, this is one of the most litigated issues. Delhi is still watching the forensic embers which enveloped the Ansals who ran the Uphaar cinema that was gutted due to the negligence of the employees. It took more than a decade to decide their vicarious liability. Recently, there were three significant judgments dealing with this question. Two of them took more than two decades to reach the Supreme Court, indicating how complex the issue could become, or could be made so by legal professionals.

The Supreme Court took a tough stand against Modi Carpets Ltd for discharging noxious effluents into the Sai River in Uttar Pradesh. In 1985, the Allahabad high court had stayed the prosecution of the company, its chairman and other top officers. In 2004, the high court quashed the complaint so far as it related to the joint managing director, B K Modi. In the appeal, UP Pollution Control Board vs. B K Modi, the Supreme Court ruled that Modi should appear before the special magistrate (pollution) and that court will decide whether the joint MD was personally liable or not. It chastised the high court for exercising its inherent power in a casual manner. Such power should not be exercised to “stifle a legitimate prosecution”, the Supreme Court said.

It recalled an earlier judgement in the case of Mohan Meakins Ltd, which faced similar charges. The directors were arraigned for discharging pollutants into the Gomti River. The legal wrangle over the role of the honchos dragged on from 1985 till 2000 when the Supreme Court cleared their prosecution. The courts below had quashed the complaints against them. Both these cases started in 1985 and the Supreme Court asserted that “the lapse of such long period cannot be a reason to absolve them from the trial.”

In matters affecting public health, the Modi judgement explained, the court cannot afford to deal with cases lightly. “The message must go to all concerned persons, whether small or big, that the courts will share the parliamentary concern to check the escalating pollution levels and restore the balance in our environment…Those who discharge noxious polluting effluents into water bodies should be dealt with strictly, irrespective of technical objections," the court emphasised.

Another judgement of recent weeks, Tamil Nadu Electricity Board vs. Rasipuram Textiles Ltd, dealt with theft of power in which top men of the company were implicated under the Indian Electricity Act. During the two decades of litigation, the managing director and one director had expired. The trial court held that if the surviving directors were not in charge of and responsible for the day-to-day functioning of the mills, it was for them to prove it, and it was not done by them. Therefore they should stand trial. On appeal, the district judge and the Madras high court ruled that the burden of proving that the directors were personally responsible was on the electricity board. The Supreme Court supported this view. Thus the directors were spared in this case.

The Consumer Protection Act also has a provision which makes the directors liable for the fault of the company. The National Consumer Commission delivered a judgement in the case of Ashish Birla vs. Murlidhar Patil in which a cooperative bank failed to repay a depositor the amount with interest. The depositor sued the bank as well as its directors. The consumer forum, the Maharashtra state forum and the National Commission agreed with the depositor and ordered the directors "jointly and severally" to pay the amount with interest. "We would like to remove the corporate veil and hold that the directors are responsible for the deficiency in service of the bank," the commission said.

The question of the director's liability arises more frequently in the case of cheques issued by companies and later dishonoured by the banks for want of sufficient funds. Three years ago, the Supreme Court had laid down the principles to be followed in deciding the liability of directors under the Negotiable Instruments Act (SMS Pharmaceuticals vs. Neeta Bhalla). However, this has not reduced the flow of appeals before the court. In one recent case, BSNL prosecuted the honorary chairman of a company who pleaded that he was not drawing any remuneration. However, the Supreme Court stated that he should prove his status before the trial court.

The position of the directors who stand guarantee for the company's loan is even more complex; and if the company goes under, it would be murkier still, according to the decisions delivered by different courts.

100% FDI allowed in facsimile editions of foreign newspapers

The government has allowed up to 100 per cent foreign direct investment (FDI) in the segment, but with certain riders.

According to the new FDI norms for facsimile editions issued by the commerce ministry, up to 100 per cent FDI is allowed in facsimile editions of international newspapers provided that the foreign investment in the Indian subsidiary is by the owner of the original foreign newspaper.

Also, the policy specifies that such a publication can be undertaken only by an entity incorporated or registered in India under the provisions of the Companies Act, 1956.

Earlier, the print media policy allowed only up to 26 per cent foreign investment, including the FDI cap.

It should be noted that not a single such edition could start operations during the past two years since a policy of facsimile edition of international newspapers was brought out by the Ministry of Information and Broadcasting. The Foreign Investment Promotion Board (FIPB) has, in January, cleared the proposal of US-based Dow Jones to start the facsimile edition of its newspaper, The Wall Street Journal, in India.

Before the norms on facsimile editions were announced in June, 2005, only International Herald Tribune (IHT) was available in the country as a facsimile edition through its tie-up with the Deccan Chronicle group. However, IHT's publishers did not pursue its publications once the new norms came into effect.

After having applied for mandatory government clearances, UK-based The Independent could not start its facsimile editions apparently because its investment in the Hindi newspaper group, Dainik Jagran, was close to the permissible cap of 26 per cent then.

The FDI cap for publishing of Indian editions of foreign magazines dealing in news and current affairs has been kept at 26 per cent, inclusive of FDI and investment by non-resident Indians, foreign institutional investors and person of Indian origin.

37 foreign companies set up single-brand shops

51% FDI in the retail model was allowed in early 2006

More than one-and-a-half years after FDI was allowed in single-brand retail, at least 37 foreign brands have entered the country, and over a dozen are seeking permission to set shop. A slowdown in India doesn't seem to have so far weighed on the entry of international brands, which are mostly from advanced countries in the grip of recession.

A senior official in the ministry of commerce and industry says there has been greater interest among foreign brands to invest in the country after a slow start in 2006. The government allowed 51% foreign direct investment in single-brand retail in early 2006.

Several marquee brands in different segments, including fashion, apparel, footwear, watches, sportswear, sport equipment, luggage and home furnishings have entered the country in two years either through the joint venture route or licensing agreement with a local partner.

Fendi, Nike, Lladro, Rino Greggio, Damro, Etam, Zegna and Lee Cooper were among the first to get FDI permission under the single brand retail window. Premium fashion brands such as Armani, Dolce & Gabbana, Louis Vuitton, Salvatore Ferragamo, sportswear retailer Puma, Lerros and S Oliver, luggage brand Piquadro, Marks & Spencer, La Perla, Jimmy Choo and Toy Watch have also set foot in India. A few marquee brands like Diesel and Starbucks are waiting in the wings.

Meanwhile, there are several brands which have been waiting for the government to allow 100% FDI in retail. Furniture retailer Ikea says it will wait for the policy to change rather than choose a partner for its India entry.

Most foreign companies would like to

have complete control over their operations here. And there have been instances where joint ventures have withered as the two partners struggled for control. Also, foreign brands may impose certain restrictions on their local partner that may cause business to falter.

In the short term, retailers feel a significant dip in rentals in malls and high street may actually encourage more brands to look at India.

USFDA opens offices in India

The US Food and Drug Administration opened its offices in New Delhi and Mumbai. The office will regulate the quality of medicines from Indian drug makers sold in the US. The office would also expedite the process for getting FDA's approval for Indian drug markers interested in exporting their medicines the US.
As part of its Beyond Our Borders initiative, the US department will send 10 USFDA officials to India, besides 14 other locations around the world, including China, Europe and Latin America.

The officials will inspect the facilities that export medicines to the US and work with the government and the pharmaceutical industry to develop certification programmes to further enhance trading relationship between the two countries. While USFDA offices in the country would mean fast approvals for Indian drug makers, this may also bring in stricter and more frequent inspections of their facilities. India is the fourth largest supplier of drugs and biologics to the United States.

Sandvik in Press Note 1 battle with Eimco Elecon

Another battle over the contentious Press Note 1 guidelines on foreign direct investment is brewing — this time between Pune-based Sandvik Asia, a publicly-listed company in India in which Sweden's Sandvik has a 91 per cent stake, and its partner Gujarat-based Eimco Elecon.

Sweden's Sandvik has a 91 per cent stake in Sandvik Asia. Another subsidiary, Sandvik Mining and Construction, owns 25.1 per cent in Eimco, whose Indian promoter Bhanubhai Patel holds 48 per cent.

A few months ago, Sandvik Asia sought Foreign Investment Promotion Board (FIPB) approval to acquire a majority, but undisclosed, stake in Tamil Nadu-based drilling equipment manufacturer Revathi Equipment for Rs 500 crore, to expand its mining and construction business.

Last month, Eimco told the government that Sandvik has to take a "no-objection certificate" (NOC) required under foreign direct investment (FDI) norms, laid down in Press Note 1. The Press Note stipulates that a foreign company with a joint venture in India must get an NOC from the current partner, if it is setting up another joint venture or subsidiary in the same or a similar business.

FIPB, which has deferred the case last month, is divided over the contentious proposal. The commerce department has supported Sandvik's proposal but asked the FIPB to consider Eimco's objections. The departments of industrial and policy (DIPP), heavy industries, and revenue have objected to the proposal saying an NOC is required.

In its representation to FIPB, Eimco Elecon has said Sandvik controls 25.10 per cent of the company's paid-up capital. After Sandvik became a joint venture partner, the Swedish giant signed three technology transfer agreements. Eimco has contended that if the new JV of Sandvik is allowed, there would be confusion as products offered by different manufacturers using the same technology would be available in the same market creating confusion.

Sandvik has argued that some of the technology agreements with Elecon were with two US-based companies that Sandvik acquired in 1997. These agreements, Sandvik has said, were terminated in 2006, and all Eimco's rights ceased to exist.

Sandvik has also argued that the technology agreement between Voest Alpine and Eimco, which still exists, is not in the same field of business as Revathi. Alpine was acquired by Tamrock in 1996, which later merged with Sandvik.

The Sandvik case is similar to that of a dispute between Larsen & Toubro's (L&T) and former partner Ralf Schneider Holdings. L&T had demanded that the German engineering giant acquire an NOC from it before setting up a 100 per cent subsidiary in India. L&T claimed it has a technical collaboration with the company and needed an NOC as the new company would operate in the same area. L&T's plea was, however, rejected by the FIPB and the application was cleared in December 2008.

French company inks Rs 800 cr deal with Cello

BIC buys 40% stake in stationery products maker with option to raise it to 55%

French pen and stationery manufacturer BIC has bought a 40% stake in Mumbai-based stationery products maker Cello Pens for Rs 800 crore ($160 million). The two companies have also agreed that in 2013, BIC has the option to increase its stake to 55% in the privately-held Indian firm.

The deal will enable Cello Pens to expand its existing global distribution network and give BIC a foothold in the Rs 2,000-crore Indian stationery market, which is growing at 20% annually. The alliance will allow the two companies to forge together a marketing and research strategy for Cello.

Cello recently hived off some properties and idle cash valued at Rs 375 crore on the balance sheet into a new company. The rest of the company was valued at Rs 2,000 crore, which is 18 times Cello's profit after tax.
The 12-year-old Cello claims to have revenues of Rs 450 crore with a 37% share of the local market. With a presence in over 35 countries, it sells over 4.2 million pens annually, of which 85% is sold locally.

BIC was established in France around 60 years ago. Today, it is one of the largest suppliers and manufacturers of stationery products in France and has a turnover of around €170 million (Rs 1,100 crore).

Its stationery products include pens, pencils, highlighters, markers, crayons, and correction products, which together constitute 43% of its overall sales.

Medical device firms ask for quality norms

The domestic medical device industry has asked the Ministry of Health & Family Welfare to establish quality norms for medical equipment to make them acceptable in the overseas markets. The Association of Indian Medical Devices Industry (AIMED), representing over 150 medical device manufacturers, has said the government should set up a globally recognised regulatory guidelines for quality control.

According to AIMED, medical devices should not be treated as medicines. Some of the Indian medical devices are till date controlled by the Drugs and Cosmetics Act and treated as similar to medicines, although world over it has been recognised as a separate industry. AIMED says that there are hardly any similarity in medicines and devices, therefore, the industry should be treated as a separate industry from pharmaceutical which is regulated by various rules and regulations.

India bans Chinese toy imports

The Directorate General of Foreign Trade (DGFT) has issued an order banning toy imports from China, which is India's biggest trade partner, for six months. The notification, however, gave no reason for the ban.

The domestic producers of toys, mainly from the small-scale sector, have been complaining about cheap toy imports.

According to industry estimates, Chinese toys account for half the country's toy market. According to commerce ministry data, toys worth more than $24 million (or Rs 120 crore) were imported in April-June 2008-09.

The Toy Association of India's President, Raj Kumar said the ban would severely hit imports of Chinese toys, but Indian authorities had likely taken the step in the interest of the economy.

Bill to curb courier companies scrapped

The government has withdrawn a proposed amendment to the Indian Postal Act that included making courier companies charge a hefty premium over post office Speed Post rates from customers, thereby costing them business.

The Department of Posts (DoP) will redraft the Bill and send it for the Cabinet's consideration.

The proposed Bill had controversial clauses like reducing the foreign direct investment (FDI) limit in the sector, levying additional charges on the courier companies in the form of universal service obligation (USO) fund and regulating the pricing of mail delivery by private companies.

The DoP has decided to withdraw the amendments after various ministries and the prime minister's office raised objections to the proposals. The Bill was also facing strong objections from courier companies as it proposed to curtail their power to send and receive mail and parcels.

The scrapped Bill had a provision that restricted courier companies to handling delivery of documents and letters weighing less than 300 gm. The Bill had also proposed a USO fee for courier companies on the lines of those paid by telecom service providers. Under the proposed USO fee, courier companies with annual turnover of Rs 25 lakh or more were to part with 10% of their turnover with the government.

The proposed Bill had also recommended lowering the foreign direct investment cap in the courier industry. It had also recommended that courier companies charge higher fees for mail delivery than those charged by the speed post service of the India Post if they wished to handle mails of lower than the prescribed weight under the Bill.

India Inc's foreign flight fettered

Companies struggle to keep acquired firms afloat

India Inc's overseas acquisition juggernaut has run into stormy recession winds, and companies are struggling to keep their targets afloat.

Only two years ago, there was no stopping domestic companies—particularly in the automobile and pharma sectors—flush with cash and bursting with nationalistic pride, in their expedition. With the slowdown now in their face, most are struggling to save the acquired firms from going under or making losses.

Big or small, the same bug has bitten them all. Groups like the Tatas are facing trouble with acquisitions such as those of steel producer Corus and car and SUV-maker Jaguar-Land Rover.

Corus, which was acquired by the Tatas in 2006, has, like all steel firms, seen a substantial fall in demand—in the long run, this will tell on the group's health. As far as JLR is concerned, UK business secretary Peter Mandelson was in India last month to discuss a bailout package. The Tatas have asked for a $1-billion loan from the British government, by unlocking credit from banks in the UK.

GMR is another case in point. Profits have dipped to Rs 24.2 crore from Rs 37.4 crore following its $1.1-billion acquisition of Dutch power company InterGen in June 2008.

Smaller companies have found it just as hard to shield their targets from the storm.

Sakthi Automotive Component recently declared two of its foundries in Germany insolvent.

Sakthi Automotive Component, the Rs 250-crore subsidiary of Sakthi Sugars, had acquired Intermet Europe from Intermet International of Fort Worth, Texas, US in 2007 for $130 million.

However, only about a month ago, after attempting to run the loss making firm for over a year, the company filed for insolvency for the German plants, putting a question mark on 800 jobs in the country.

Most companies lacked management skills

What went wrong? In many cases, the will took Indian companies to their destinations, but a crucial piece of luggage was left behind: the wherewithal to run overseas companies. Some companies lacked the management skill required in competitive markets like Europe and the US. Acquisitions were more of an emotional than a practical decision.

Another reason is that Indian companies had made acquisitions on the valuations based in 2007 and are now caught in high levels of debt. The auto sector is the worst hit. For some companies, their business model of sourcing cheap products from India for sale to overseas clients has been hit as orders have dried up in the West. Many more automobile component companies will have to sell off their foreign acquisitions or face the risk of insolvency

Companies in other sectors too are feeling the pinch. Many pharmaceutical companies, which had rushed to acquire firms abroad, are now unable to run them profitably. Ahmedabad-based Torrent Pharma, which acquired Heumann in Germany in 2005, has been struggling to turn around the latter. Chemicals major Gujarat Heavy Chemicals, which acquired Dan River in 2006, too filed for Chapter 11 for the latter in the US last year. "When we acquired Dan River, we wanted to change its business model. But we were unable to do that due to some bankers. However, in Rosebys we were successful in changing the business model," says GHCL chairman Sanjay Dalmia.

GLOBAL SHOCKWAVES

Aquirer	Target	Net profit*	Net profit**
Wockhardt May '07	Negma	52	13.43
United Spirits May '07	W&M	65.11	30.59
Sakthi Sugars Apr '07	Intermet Europe	9.06	2.17
Setco Jan '07	Haldex Brakes	3.69	5.03
L&T Nov '07	Gulf Interstate	481.7	152
Amtek Auto Feb '08	American Railcar	59.65	48

*Before acquisition (quarter)
**After acquisition (last reported quarter)
Rs Crore

SALAM | PURNIMA

Trent in JV with Inditex for Zara

Trent, the retail arm of the Tata Group, has formed a joint venture with the Inditex Group to develop and promote the foreign company's Zara stores in India. Inditex is a leading Spain-based fashion retailer. Inditex will hold a 51% stake in the joint venture with the Tata Company holding the remaining 49%. The partnership plans to open stores in New Delhi, Mumbai and other major cities of India next year.

Tax authorities put companies setting up SEZ arms under scanner

Firms transferring profits from regular business to SEZ units to claim undue tax benefits

The Income-Tax department is scrutinizing companies that have set up subsidiaries or units in special economic zones (SEZ) after it found that many of these firms were using their SEZ operations as a vehicle for claiming undue tax benefits.

The modus operandi adopted by a number of companies is to manipulate the accounts to transfer the profits generated in their regular business to the subsidiaries set up in these zones. SEZ units are exempted from taxation under Section 10 A and Section 10 AA of the Income-Tax Act.

The benefits from such unscrupulous operations are two-fold: First, a company can claim exemption for the income for which tax has to be paid in normal course. Second, it can show high turnover and profit in the balance sheet which is attractive to the stock market and yet stay out of the tax net.

The investigation wing of the Mumbai income-tax department has come across this novel modus operandi of tax evasion after it raided three companies having subsidiaries in SEZs. The department found that the main purpose of setting up companies in SEZ is to claim tax exemptions accorded to SEZ units. The companies manipulated the accounts to create a picture of huge transactions and profits from the SEZ subsidiaries while, in fact, these units by and large were just dummy units without any serious operation.

GST may not cover alcohol

Demerit good alcohol may be kept outside the ambit of the Goods and Services Tax (GST) regime, which is scheduled to be implemented from April next year, to protect the revenues of the states. A demerit good is a good whose consumption is considered unhealthy.

Tobacco, another demerit good, may be brought under GST with input tax credit — where taxes on inputs are set off against the tax paid on the finished goods. However, the Centre may be allowed to levy excise duty without the input tax credit, over and above the GST rate, to protect its revenues.

These proposals form part of the recommendations of a sub-panel of the Empowered Committee of State Finances Ministers, which is giving final touches to the dual GST structure for the country, in consultation with the Centre. The committee is an apex body that resolves all central and state economic matters, and also has representatives from the Union finance ministry.

Under the GST structure, both the Centre and states will have the power to tax all goods and services at every stage of value addition. The tax rate will be uniform and consist of state and central tax components.

Already, taxes on petroleum products, which contribute nearly 40 per cent of tax collections, have been kept outside GST regime to protect the revenues of Centre and states, as the GST rate will be moderate. The combined GST rate is likely to be around 16 per cent. An estimate of how much taxes on alcohol and tobacco contribute to the revenue of the states is not known.

Currently, alcohol sales are taxed by states at a floor rate of 20 per cent. But the rate is high as 36 per cent in some states.

The state tax officers' panel also recommended that states should continue to collect excise duty on alcohol. States also collect licence fees from liquor manufacturers and distributors, prompting them to lobby to keep the product outside GST.

On tobacco, the panel has recommended that it should be subjected to GST with input tax credit. However, the Centre may be allowed to levy excise duty on tobacco products, over and above GST and without input tax credit to ensure its revenues are not affected under the benign tax regime.

Tobacco is taxed at 12.5 per cent at the state level, while the Centre levies excise duty on tobacco at various rates.

There are some other products like electricity on which the states and Centre are yet to take a final view on keeping them outside the GST regime.

ITC-Sheraton ruling holds hope for foreign hoteliers

International hoteliers operating in the country through sales agreements with Indian hotels can expect some relief after the Delhi High Court ruled on January 30 that income paid by the Indian partner to its foreign counterpart is exempt from tax since it cannot be considered royalty or technical fees.

The ruling in favour of US-based Sheraton International Inc was in response to an appeal filed by the income-tax (I-T) department challenging the service agreement between ITC and Sheraton International Inc.

The I-T department has taxed 75 per cent of the revenues that ITC paid to Sheraton for four assessment years — 1995-96, 1996-97, 1999-2000 and 2000-01 — as royalty or technical fees under section 9 (1)(vi) of the Income Tax Act, 1961.

The high court, however, has said royalty and technical fees are strictly meant for transfer of technological know-how or other types of included services. An Indian hotelier signs a commercial service agreement for advertising, publicity and promotion of their properties worldwide. So payments (usually a percentage of the room sales) for marketing-related services and the use of trademarks are incidental to the main objective of the commercial agreement.

Before the high court order, the tribunal had ruled in favour of the assessee in 2002 but had held that such income could be taxed as business income. In this case, however, the income cannot be taxed as business income since the foreign hotel group does not have a permanent establishment (PE) in India. The significance of this is that to tax income as business income, the assessee needs to have a PE in India to which the income can be attributed.

The service agreement between ITC and Sheraton was signed in 1979. Before 1991, the year in which India and the United States signed a double taxation avoidance treaty (DTAA), this income was taxed as business income by deducting tax at source under section 195(2) of the Income Tax Act. After the DTAA came into force, the assessee claimed exemption by stating that it has no PE in India.

Thereafter since 1999, the revenue department has been taxing such income as royalty and technical fees. Sheraton International operates in India through a commercial agreement with ITC which manages Welcomgroup Maurya Sheraton, New Delhi, Welcomgroup Mughal Sheraton, Agra, Welcomgroup Chola Sheraton, Chennai, Welcomgroup Windsor Manor, Bangalore and so on.

Tax experts are of the view the high court ruling will benefit other foreign hoteliers that have signed similar agreements with their Indian counterparts to manage their brands.

Centre examining issue of bulk arms licence for private agencies

With 26/11 strikes in Mumbai pushing up the demand for better security systems among individuals and corporates, the Centre is examining the demand of private security agencies to be issued bulk arms licences. The home ministry has started a consultation process with the states on the possible amendments to the entire gamut of Arms Act 1959, including allowing guards in banks and private security agencies to keep non-prohibited firearms after due training.

In a letter sent to the states in December 2008, MHA has sought their views and suggestions on the how the outdated Arms Act can be reviewed and tuned into modern-day security needs. According to MHA sources, states have been asked to give inputs on matters like whether Arms Act must be liberalised in the first place, given the risk that a freer licensing regime poses the risk of arms getting into the hands of criminals and anti-social elements; whether bulk licences should be issued to private security firms; what kind of training must be given to a person who is to be issued firearms; and whether weapons of non-prohibited bores can be imported or allowed to be manufactured here in private or joint sectors.

The need for a consultation process with states was felt as each state has different arms licensing norms, though the broad policy is that small arms light weapons (SALW) licences can be issued to individuals alone. This had resulted in most private security firms either hiring ex-Army personnel who had an individual arms licence or asking their clients to procure the licences. Even in banks, the armed guard is only a 'retainer' — officially speaking, one who is authorised to only transport the firearm for repairs and back — of the firearm, even as the license is issued in the name of the bank manager.

Also, as per the current Arms Act, individuals can only source arms manufactured by Indian Ordnance factories or private manufacturers (single and double-barrel guns). However, given the heightened terror threat to private sector installations and the limited force availability, a need was felt to arm private security services on par with police and para-military personnel. "The current terror scenario means that private security firms guarding corporates in key sectors cannot rely on outdated weapons any longer and must be allowed access to imported arms to take on AK-47 wielding terrorists," an MHA official noted.

Another point touched upon by MHA with states is if some level of training should be given to the user of the weapon. The states have been asked for their suggestion on whether training should be made mandatory or if a minimum training course or regimen can be specified for private security guards for each category of weapon.

Post 26/11, requests for arms licenses have been pouring in both from individual and private security agencies. While individuals have demanded easier norms and speedy disposal of requests for issue and renewal of arms licences — the letter, seeks the states' views on how implementation of pre-verification norms can be tightened in certain states — private security firms have been pressing the government for bulk arms licenses.

New norms for MNC drug prices

Negotiations to be based on prices in other markets and production cost

In a move that would prevent MNCs from selling their drugs at a huge premium in India, the government may soon finalise norms for monitoring prices of costly imported patented medicines for diseases such as diabetes, arthritis, obesity, cancer and heart diseases. The government finds it difficult to keep a check on prices of imported medicines even if they are under price control as it has no means of verifying production cost.

Under the new norms, the government will negotiate prices for imported medicines for identified diseases based on prices of the same medicine in other markets and the cost of production estimated by it. For other imported patented drugs, the companies would be expected to voluntarily keep prices lower in India.

At present, imported brands circumvent price control norms as the drug price regulator, National Pharmaceutical Pricing Authority (NPPA), has no means of verifying their production cost. To determine the cost, NPPA relies on MNCs' version of the production cost and sets profit margins as a percentage of their landed costs. As the margin is decided in percentage terms, raising the landed cost helps MNCs get a higher margin.

The move is expected to benefit consumers as big pharma companies launch their patented medicines in the country at high prices and with a 20-year patent protection resulting in monopoly pricing. The proposed pricing mechanism for patented drugs would ensure that essential medicines not available here due to patent protection are affordable. While the MNCs are ready to negotiate prices for essential drugs, they want to restrict it for government's bulk procurement programme and supplies to government hospitals.

Sebi to probe open offer manoeuvre by MNCs

Foreign parents of some of the smaller MNC subsidiaries in India may not be strictly adhering to Sebi's pricing norms while making an open offer in India, prompting the market regulator to look into such cases in the interest of the shareholders.

While Sebi has prescribed specific norms for open offers resulting from an indirect change in control, the matter of concern, according to merchant bankers, is that promoters are not following uniform method to calculate the offer price.

Such concerns relate to the reference date they consider while pricing the open offer. There have been many cases of indirect acquisition or indirect change in control, most commonly seen in subsidiaries of MNCs, where the parent company is acquired by another MNC through a global acquisition. In such cases, the offer price—which is average of past 26 weeks, or two immediately preceding weeks prior to the open offer, whichever is higher—has to be calculated based on two reference dates: first, the date of public announcement for global acquisition of parent company and second, the date of public announcement for open offer in India. The higher of the two prices worked out using two different reference dates should ideally be offered to the shareholders.

Some feel no consistent policy is being adopted while pricing open offers in India. In some cases the date of announcement of global acquisition has been considered and in some it wasn't. It is only in current market conditions that such issues become relevant as the historical price will be higher than current prices.

Recently, Sebi sought clarification from Disa India, the Indian subsidiary of Denmark-based Disa Holding, on pricing of open offer, after which the foreign parents have deferred the offer. They are also likely to revise the terms and conditions of the offer after Sebi issues its observations. The offer for an acquisition of 20% equity at Rs 1,657 per share, was originally scheduled to open on February 5, 2009.

Disa India is the latest example of an indirect change in control resulting from global acquisition of parent company. On March 11, 2008, Mid Europe Partners announced the acquisition of Disa globally from Procuritas. The global transaction was completed on September 4, 2008. About three and a half months later, an open offer was made to the shareholders of Disa India at a price of Rs 1,657 per share, which was based on the average prices for the 26-week and 2-week period preceding December 17, 2008. The foreign parents have not considered March 11 2008, the date of announcement of global acquisition, as reference date for calculation of the open offer price.

The term "Public Announcement" has not been defined under Sebi Takeover Code, which creates confusion about what reference date should be used for pricing open offer. In deals where the parent company was listed globally and there was an open offer, the date of global acquisition has been considered for pricing.

However, where the global deal is between unlisted companies, there is no formal open offer and usually a press release is issued relating to the global acquisition. Any global acquisitions are subject to anti-trust approvals and take one-two months before the transaction is completed.

New FDI norms come into effect, confusion stays

The Department of Industrial Policy and Promotion (DIPP) has formally issued its new guidelines for calculation of foreign investment in Indian companies. The new guidelines enumerated under two Press Notes — PN 2 and PN 3 of 2009 — failed to clear the confusion spawned by the new norms over the national identity of some important companies hitherto considered to be unalloyedly Indian, such as ICICI Bank and HDFC, or over foreign investments in barred sectors such as multi-brand retail and gambling through the indirect route.

The Press Notes have also not defined the term 'beneficial ownership' which forms the cornerstone of the new guidelines. The Companies Act 1956 also does not define beneficial ownership.

According to the PN 2 — which lays down guidelines for calculation of total foreign holding in Indian companies — if a company is owned and controlled by Indians, its investments would be counted as Indian. Also, if in a company, foreign holding is less than 50% and foreigners have no other 'beneficial interest' in the company, it will be considered as Indian-controlled. And this company would be able to invest in all the sectors, including those where FDI is prohibited at present as per the new norms. The PN does not explicitly say that such investments would not be allowed. This thereby allows foreign investment in barred sectors through the backdoor.

An Indian company would be deemed controlled by non-residents, if foreign entities have the power to appoint directors on board or it has a majority foreign holding in it. Investments by such an entity downstream would also be deemed foreign. The only exception will be when a joint venture company creates a wholly owned subsidiary in India. In that situation, the foreign holding in the downstream company will be treated as equal to the level of FDI in the parent company.

In all sectors attracting caps on foreign investment, the equity beyond the prescribed sectoral cap, would have to be owned by resident Indians or Indian companies, as per the PN2.

In sectors like broadcasting and defence, where the sectoral cap is below 49%, the company would need to be owned and controlled by an Indian. Hence, the equity held by the largest Indian shareholder would have to be at least 51% of the total equity, it adds.

The other Press Note PN 3 — laying down guidelines for transfer of ownership and control — makes it mandatory for an Indian company to seek the FIPB's nod if it intends to transfer ownership or control to a foreign company in restricted sectors such as telecom, defence production, air transport services, broadcasting. The government has also made it mandatory for companies to provide full details about beneficial ownership to the FIPB while seeking its approval. Companies that do not comply with the new norms, they are liable to face action under Foreign Exchange Management Act (FEMA) regulations.

PN 3 also states that FII holdings, ADRs/GDRs, NRI investment and foreign investment through foreign currency convertible bonds would now be included while calculating FDI levels of Indian companies. These were not included in the FDI calculation up till now.

The new rule will not apply to sectors like insurance, a government official clarified. In case of insurance, FDI ceiling will continue to be calculated in accordance with the IRDA (Registration of Indian Insurance Companies) Regulations, 2000. The same will hold true in sectors like banking, commodity exchanges and stock exchanges — all regulated under RBI guidelines.

Taxing liaison offices: Revenue to move HC

Tribunal rules that the offices cannot be termed permanent establishments

The revenue department has decided to challenge an Income Tax Appellate Tribunal (ITAT) order that liaison offices of foreign firms operating in India cannot be termed as permanent establishments (PEs).

The tribunal's December 24 ruling concerned Tokyo-based Mitsui and Company, which has investments in various sectors in India, including machinery, chemicals, energy, lifestyle, iron and steel, information technology and food products.

The Income Tax Department had attributed 50 per cent of the income Mitsui earned from its Indian operations to the liaison office, which it termed a PE, for assessment year 2002-03. Tax officials said that if a company had a PE in India, the income would be taxed as business income. If a foreign company operating in India is taxed on its business income and the country does not have a specific double taxation avoidance treaty with India, the tax rate on income and gains is 55 per cent.

However, the department is in the process of filing a petition challenging the order in the high court since the ruling has revenue implications running into hundreds of crores. This is because almost all international tax cases hinge on whether or not the company has a PE in India.

The Organisation for Economic Co-operation and Development (OECD) tax guidelines say a foreign firm is deemed to have a PE in a country if it employs an agent, other than an independent agent, to regularly act for it and conclude contracts on its behalf.

Although the order did not clearly specify the reason clearly, a liaison office might not be termed as PE if it did not employ any agent to carry out the business or conclude contracts on its behalf. If a company's income is not taxed as business income, it is taxed as royalty or technical fees.

On PEs, the Supreme Court had in July 2007 ruled out any tax liability in India of US-based investment bank Morgan Stanley on income from its India-based outsourcing outfit, Morgan Stanley Advantage Services (MSAS). The Supreme Court quashed the Income Tax Department's contention that MSAS was not a PE.

Tax department officials do not agree with the tribunal's ruling. They say that when the economy was opened up in 1991, many foreign companies opened liaison offices to explore investment and other opportunities. In 1995, the ITAT had given a ruling that a liaison office was not a PE. However, these liaison offices are no longer mere offices as major investments are being made through these offices.

Corporates can bring in FDI via partly-paid shares

Companies can bring in foreign capital through issue of partly paid-up shares if these are converted into fully paid-up shares in 18 months.

A recent ruling by the Foreign Investment Promotion Board (FIPB), the government body that clears foreign investment proposals, has removed ambiguities in the rules regarding partly paid-up shares.

Till recently, foreign direct investment (FDI) through this route was allowed on a case-to-case basis before confusion crept in delaying clearance of such proposals.

While the Foreign Exchange Management Act (FEMA) does not allow issue of partly paid-up shares by Indian companies to non-residents, the Companies Act permits it. The FDI policy was so far silent on this instrument.
Now, with the FIPB's latest deliberation, Indian companies can issue partly paid-up equity shares to foreign firms.

While issuing partly paid-up share capital, a company receives only part of the agreed value of the equity upfront. The rest of the amount can be paid by the investor in instalments. In contrast, those buying fully paid-up equity make full payment towards the value of the shares bought.

The issue came up at the last FIPB meeting, when the board took up a long-pending proposal of Indian cable company Wire & Wireless to issue partly paid-up equity shares to raise Rs 450 crore.

The FIPB had rejected the proposal once at an earlier meeting.

The Department of Industrial Policy & Promotion (DIPP) supported the proposal and said partly paid-up equity shares should be treated the same way as warrants. A warrant is a security that entitles the holder to buy stock of the company at a specified price.

The FIPB took note of DIPP's view and said there should be synergy between proposals of warrants and partly paid-up shares. "Since issue of warrants in both listed and unlisted companies is allowed subject to the condition that shares in lieu of that should be issued in 18 months from the date of issue, the same analogy will hold in case of partly paid-up equity shares," the board said.

FDI cap in mortgage guarantee companies at 49%

FIPB asks US company to sell 51% stake in India arm

The government has asked the US-based mortgage insurance company Genworth

Financial to divest 51% stake in its Indian arm to domestic partners, following the guidelines of the Reserve Bank of India to limit foreign direct investment in mortgage guarantee firms at 49%.

In asking the US company to divest majority stake, the Foreign Investment Promotion Board (FIPB) reversed its 2006 decision to allow Genworth to set up a wholly-owned subsidiary in the country.

As per the RBI guidelines issued in February 2008, the FIPB decided to limit FDI in mortgage guarantee companies. The guidelines prohibit a foreign investor to hold more than 49% equity stake in such a firm.

Mortgage guarantee is an insurance tool that helps an individual in buying a house with minimal down payment. Normally, banks extend housing loans after the buyers agree to pay 20% or more of the total amount. The property is purchased in the name of the bank and the buyer makes the payment in instalments. If the buyer stops paying instalments, the mortgage guarantee firm protects the lender from the financial loss. As lenders have the protection, they are able to offer more mortgage loans with lower down payments.

The FIPB, keeping in view RBI's guidelines, asked Genworth to reduce its equity stake in the Indian operation — Genworth India. Genworth had approached FIPB to clarify the position in the wake of RBI's directive last year to cap FDI in such companies at 49%. Genworth wanted to infuse $41 million in the equity capital of its Indian subsidiary.

Genworth has informed FIPB it is in the process of identifying potential Indian partners who could pick up 51% equity stake in its local arm, the official said.

Several other such firms of the US — such as PMI Group, Mortgage Guaranty Insurance Corp and Radian — had also shown interests in setting up wholly-owned subsidiaries in India, the official said.

According to the RBI guidelines of last year, mortgage guarantee companies cannot be a subsidiary of a company registered outside India. Moreover, no individual or company registered outside India can, directly or indirectly, have any controlling interest in mortgage Guarantee Company.

Government may not ease norms for foreign banks

India will not allow a greater role for foreign banks in the Indian banking system when the review of the next round of banking reforms begins later this year because of uncertainties surrounding the current global financial crisis.

The second phase of reforms was expected to address areas like extending "national treatment" to foreign banks, which means that foreign banks would be treated on a par with Indian ones under the World Trade Organisation (WTO) agreement. Other items that are to be considered include permitting listing foreign banks' wholly-owned subsidiaries in India and the acquisition of sound Indian banks by foreign banks.

During the first phase of reforms, between March 2005 and March 2009, foreign banks were permitted to establish a presence by way of setting up a wholly-owned banking subsidiary or converting branches into such subsidiaries. Given the cost structures, levels of disclosure and supervision and tax, however, foreign banks did not see value in doing this and continued to operate through branches. Under the WTO agreement, India committed to allow foreign banks to open 12 branches in a year.

Banking is the segment that has been most affected by the global meltdown.

India will, therefore, push other financial sector reforms like voting rights proportionate to ownership in private banks (it is currently capped at 10 per cent irrespective of shareholding) and higher foreign capital participation in domestic bond and futures markets.

The finance ministry is also pushing for financial sector reforms that will increase the efficiency of intermediation. Given India's high savings rate the focus of the reforms would be to channel these into investments at low cost.

States to go after companies overpricing drugs

NPPA refers 39 long-pending & big cases of overcharging to states as it manages to recover only 10% dues

Drug makers, such as Dr Reddy's Laboratories, Wyeth, GlaxoSmithKline (GSK) Pharmaceuticals and Alkem Laboratories, may now have to face state officials for failing to pay up penalties for overpricing. The central government is working jointly with states for recovering the amount overcharged by such companies on medicines from consumers.

The drug price regulator, National Pharmaceutical Pricing Authority (NPPA), has referred 39 overcharging cases to various states for recovering the excess amount from these companies. These cases are referred on the basis of pendency of the case and the quantum of overcharging.

So far, the pricing authority has imposed a fine of around Rs 1,700 crore on companies. However, out of this, NPPA could recover only Rs 150 crore till October 2008.

The latest move is significant as this would ensure that NPPA's overcharging notices reach their logical conclusion. Involving the state machinery would enable the pricing authority to recover the overcharged amount along with the interest from companies which so far have managed to ignore NPPA's notices for overcharging. The regulator has directed several state governments to initiate recovery of more than Rs 110 crore from 30 companies. According to an NPPA notification, multinational firms GSK Pharmaceuticals and Wyeth are facing a penalty of Rs 7.53 crore and Rs 4.38 crore, respectively, in Maharashtra. The Hyderabad-based Dr Reddy's is facing two cases on recovery in Andhra Pradesh. Alkem Laboratories is also facing two overcharging cases in Maharashtra.

The drug price regulator issues notices to pharmaceutical companies whenever evidence of overcharging is found. The companies accused of violating price control norms were asked to deposit the overcharged amount with the government and explain the price hikes effected by them.

Sebi eases norms for preferential allotment of shares

The Securities and Exchange Board of India (Sebi) has exempted companies whose boards have been superseded by the government from the preferential allotment guidelines. The move is aimed at helping companies like Satyam Computers.

Investors who have sold shares of such companies in the past six months will still be eligible for preferential allotments. This facility is not allowed in case of other companies.

Also, companies like Satyam will not require shareholder approval for preferential allotments. The regulator has also relaxed the 15 day-period for completing allotments.

The regulator has also amended its disclosure and investor protection norms, under which it has altered preferential issue norms allowing companies to list warrants along with non-convertible debentures via qualified institutional placements. It has also raised the upfront amount payable for warrants allotted on preferential basis from the existing 10 per cent to 25 per cent. The regulator has mandated that the instruments allotted on preferential basis have to be locked-in for one year.

Further, Sebi has lowered the timeline for completing bonus issues from six months to 15 days where no shareholder approval is required and 60 days where the company requires shareholder approval. Also listed companies are now required to submit any significant changes made to the offer document to at least one month before filing the document to the registrar of companies or the stock exchanges.

Foreign borrowing costs soar for companies

Market disruption clause comes into play

Indian companies, which saw easy credit coming their way in better times, are now feeling the aftershocks of the financial earthquake that had its epicentre in the western world. Some local corporates and banks find that the cost of servicing their overseas loans has temporarily risen by 1-3% as lenders have for the first time invoked the 'market disruption clause'.

In a separate move, overseas lenders, which include both foreign and Indian banks with offshore branches, are also in the process of hiking interest rates from Indian corporates. These lenders are also seeking more collateral from companies that have broken their financial covenants as the slowdown eats into their balance sheets.

Corporates that have been affected by the invocation of the clause include a large private sector steel company, a Delhi based infrastructure firm, an offshoot of a large private sector conglomerate and two public sector banks. Companies that broke financial covenants and face a rate hike include the same Delhi-based corporate, an offshoot of a large private sector conglomerate and two major public sector institutions, among others. Bankers are awaiting the audited results of FY09 before taking a final decision in some cases.

The market disruption clause is found in most overseas loan agreements and gets triggered, usually for a quarter, if banks find it exceptionally difficult to raise funds or when their cost of borrowing rises substantially.

Rate hikes after banks invoked clause

Most interest rate hikes came after a host of banks invoked the clause during the quarter ended December 2008.

For most overseas loans, banks charge a premium over the benchmark London Interbank Offered Rate (Libor). In cases where the clause was invoked and the loan was re-priced, the interest rate was delinked from Libor. Instead, banks fixed this as a mark-up over their cost of fund. The clause is triggered based on a call taken by a majority of the banks—50% or two-thirds or 75%—in the loan syndicate.

The market disruption clause was invoked after a squeeze in global credit markets in the wake of the collapse of investment bank Lehman Brothers last September. Globally, bank borrowing costs have soared from Libor plus 10-15 bps to around Libor plus 50-60 bps currently. Borrowing costs for Indian public sector banks have risen even more sharply. A one-year loan that was pegged at 20 bps above Libor prior to the credit crisis would now be available for not less than Libor plus 150 bps.

With some corporates having breached their financial covenants, lenders have initiated talks with them to increase rates on their loans and/or to bring in additional collateral. A senior European banker said in a couple of cases, lenders were asking corporates to prepay their loans. All foreign banks are currently reviewing their corporate loan portfolios in order to identify any breach in covenants.

Financial covenants are conditions the corporate has agreed to with a bank while signing a loan pact. Some of the major covenants that have been broken include debt to EBIDTA ratio, debt to equity and interest coverage ratios. Corporates can also pay a fee for the breach of a covenant.

Press Note 4 offers relief to foreign companies

Inflow of foreign equity in sectors under the automatic route has become simpler due to the last foreign investment guidelines released by the Department of Industrial Policy and Promotion (DIPP)

Press Note 4 clarifies that operating-cum-investing companies and shell companies will not be required to take permission from the government to undertake downstream investment in sectors coming under the automatic route.

According to the current foreign investment policy, only 19 sectors, which have foreign investment caps, need government approval. The rest of the sectors in the Indian economy come under the automatic route, where the Reserve Bank of India has to be intimated when the investments are received.

While the Foreign Investment Promotion Board (FIPB) clears proposal with Foreign Direct Investment (FDI) less than Rs 600 crore, the Cabinet Committee on Economic Affairs decides on FDI proposals above Rs 600 crore.

Earlier, companies with even marginal foreign investment had to take permission from the government while undertaking downstream investments.

Press Note 2 of 2009 series, released on February 13, had said that downstream investments of companies in which Indians hold more than 50 per cent stake and have the power to appoint a majority of the board members, will not be counted as FDI. Thus, step-down investments by such companies will not have to follow any kind of restrictions or caps associated with FDI, even for sectors with caps or restrictions.

Press Note 4 specifies four kinds of companies while laying down norms for step-down investments by foreign-owned Indian firms.

Press Note 4 norms will mean that downstream investments in "Operating Companies" and "Operating and Investment Companies" will not require government approval in sectors that are designated as automatic. Moreover, downstream investments by "Operating and Investment Companies" in automatic sectors will only require intimation to the commerce ministry as well as the FIPB.

But conditions for "investing companies", as well as firms which are just shell companies are stringent, as down-stream investments into such companies will have to get government approval. But step-down investment by an investing company will not require government approval if it is being made into a sector under the automatic route.

Source

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Chadha & Co. is a law firm based in New Delhi, India, with a strong Corporate and Commercial practice. The Firm has a specialized inbound practice in advising domestic and foreign corporations doing business in India on all Indian laws and regulations that are relevant to their business.

Contact

Namita Chadha
Rahul Chadha

Chadha & Co.
Advocates & Legal Consultants
S – 327, Greater Kailash II
New Delhi – 110 048
India

Tel: +91 11 4163 9294
Fax: +91 11 4163 9295
Email: info@chadha-co.com