India Update: March – April 2009

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Government to keep tabs on FDI in restricted areas

To study relationships between foreign and Indian partners of companies entering such sectors

The government will step up vigil against attempts by foreign firms to gain backdoor entry into restricted sectors, where they are not allowed to invest, through bogus partnerships with Indian firms.

The Foreign Investment Promotion Board (FIPB) will examine all domestic and international relationships between foreign and Indian partners of companies seeking to enter restricted sectors such as telecom and retail to ensure that Indian partners are not mere dummies of the foreign firm.

To prove that Indian investors are really in control of the joint venture that makes the downstream investment, they have to show that they do not have any relationship with the foreign partner anywhere else in the world that would compromise their independence in taking important decisions in the joint venture.

Therefore, all contractual agreements between the two parties anywhere in the world as well as crossholdings in each other's businesses will be examined to ensure that the decision maker is an Indian.

The nationality of a company's owner, the investor with more than 50% beneficial interest in equity, decides whether its downstream investment is foreign or domestic investment. The downstream investment of a cross-border joint venture is not foreign investment if more than 50% of its equity interest is 'beneficially' owned by resident Indians, making it a company owned and controlled by Indians.

Only quality-certified toys can be imported from China

Chinese toys conforming to international quality standards may be allowed in India, partially revoking an earlier ban.

China - with its produce commanding a 60% market share in the Indian toy segment - had threatened to take up India's six-month blanket ban on its imports with the World Trade Organization.

The latest move would let companies like the Pune-based subsidiary of Italian chocolate-maker Ferrero Rocher to source toys from China and decorate their specially packaged chocolates.

However, China may be able to export only 10% of what it used to ship to India as the quality norms asked for are quite demanding. Chinese toy exports to India were estimated at over Rs 1,000 crore[i] per annum.

The quality norms would ensure that unsafe toys do not get into the country even as it would allow bigger companies interested in importing high quality toys from China to do so.

A notification issued by the Directorate General of Foreign Trade - the body operating under the commerce department which regulates India's imports and exports – has said that import of Chinese toys conforming to the international standard consumer safety specification for toy safety (ASTM F963, ISO 8124 or IS 9873) and bearing certificates from agencies and laboratories accredited to the International Laboratory Accreditation Cooperation (an international cooperation of laboratory and inspection accreditation bodies) will be permitted.

The Indian toy industry is approximately worth Rs 2,500 crore of which Rs 1,000 crore is in the organised sector and the rest is in the unorganized sector.

Government may allow share swap with foreign companies

The government plans to allow Indian companies to enter into share-swap deals with foreign firms to facilitate merger and acquisition (M&A) activity, which has been hampered by a severe credit crunch.
The shares offered in such cashless exchanges could be of another company within the group that is not party to the deal. Pricing norms for such transactions will be framed by the Securities and Exchange Board of India (Sebi) after the proposal is approved by the Department of Industrial Policy and Promotion (DIPP).

As per the current Foreign Direct Investment (FDI) policy, cashless issue of shares through instruments such as warrants requires the approval of the Foreign Investment Promotion Board (FIPB).

The FDI policy, in its present form, does not make an explicit mention of foreign firms needing an approval from FIPB in the case of a share swap. In such cases, the companies involved need to obtain RBI's approval, as required under the provisions of the Foreign Exchange Management Act (FEMA).

SEZ units get service tax relief

The government has allowed companies located in Special Economic Zones (SEZs) to claim service tax refund for services availed outside the tax-free export zones. SEZ developers are also permitted to do the same.

For example, under the earlier norms, if a unit was transporting raw material from a port located outside the SEZ, service tax would have to be paid. Now the unit will be able to apply for refund.

The refund will be allowed only for services that are related to authorised operations (permitted activities within SEZs).

Another change pertains to services provided between units located within an

SEZ. Earlier, this was exempted but now firms have to claim refund instead of a blanket exemption.

The new notification mandates that the refund has to be collected from the respective Assistant Commissioner or Deputy Commissioner of the Central Excise department.

India allows entry of dairy products from Australia

At a time when Australian commodity exports are declining under the impact of the global recession, India has provided some relief by opening up its market for branded dairy products from Down Under. With this, some of the big branded cheese products such as Bega and King Island will be able to enter the Indian market. Australia has changed its national policy of injecting its cows with oestrogen hormones which facilitate smoother breeding. India had banned Australian dairy products in 2003 because of excess synthetic hormones detected in the products. Australia has decided not to use synthetic oestrogens, especially to gain access to the Indian market. India's reciprocation marks an increasing cooperation between the two countries on a whole range of issues encompassing economic, political and military areas.

No tax on expats for work unrelated to Indian operations

Tax liability of expatriate employees responsible for operations of a company in India as well as other countries in the region could go down substantially with a tax tribunal ruling that they need not pay tax on salary earned outside India for work unrelated to Indian operations.

The Delhi bench of the Income Tax Appellate Tribunal (ITAT) held that if the expat employee is able to substantiate that he has not performed any activity relating to Indian operations while working outside India, the salary for those days would not be taxable here.

The documentary evidence would be critical for taking this position.

The Income Tax Appellate Tribunal ruling relates to a case pertaining to Ellis D' Rozario, an expat employee of Dubai-based Master Foods Middle East FZE. The company had posted Mr Rozario, an Australian national, as regional manager for the Indian sub-continent at its New Delhi liaison office.

According to the employment contract between Mr Rozario and the company, he had to travel outside the country to look after the regional operations, a common practice followed by most multinational companies. The expat was a 'resident but not ordinarily resident' for the relevant tax year 2000-01.

According to the Income Tax Act, an individual is a resident in a previous year (the year for which tax liability is being calculated) if he has been in India during that year for 182 days or more. He is also treated as a resident if he is in India for 60 days or more in a year provided that he has also been in India for 365 days or more in the preceding four years.

The income-tax department contended that the salary received during Mr Rozario's visits outside India was liable to tax, as he also took updates or debriefs in respect of the Indian operations during the visit. Moreover, according to the employment contract, the expat was based in India, from where he rendered services to the company.

This was disputed by the taxpayer saying that the services performed outside India were unrelated to the Indian operations of the company and thus not liable to tax.

However, since the expatriate employee had not submitted any documentary evidence in respect of work done outside India for regional operations, the tribunal restored the matter to tax authorities for determining it.

Telecom regulator binds promoters to 3-year lock-in

Telecom Regulatory Authority of India (TRAI) has recommended a three-year lock-in period for sale of first promoters' - promoters whose stake was taken into consideration while calculating net worth of the company when it applied for licences - equity.

If a promoter wants to exit before three years, 50 per cent of the profit earned on the sale transaction will go to the company as a special reserve and can be utilized for telecom network expansion only. The balance 50 per cent of the profit shall be transferred to the government, according to TRAI recommendations.

Additionally, the promoter will have to take prior written approval of the department of telecommunications (DoT) and fulfil all roll out obligations.

As a result, the promoter can only get back his original investment in the company - there will be no incentive for any promoter to sell his equity in less than 36 months.

Further, if the promoter wants to pledge his shares, he will have to take prior written permission of the DoT.

TRAI wants that the recommendations should be implemented retrospectively from the date of issue of licence. However, the final decision lies with Ministry of Finance in consultation with Ministry of Law, according to the recommendations.

The recommendations permit issuance of fresh shares by private placement or public issue. However, in such cases the equity of original promoters should not fall below 10 per cent equity in the company.

Earlier, DoT had sought TRAI's recommendations on this issue as in November the Telecom Commission had approved a three-year lock-in period.

Maintenance funds may be taxed

The Income Tax Department proposes to bring maintenance reserves of airline companies under the tax net.

The department is likely to send notices to airline companies to tax their maintenance reserves, which range from Rs 200 crore to Rs 500 crore depending on the scale of operations.

Finance executives at airlines said that around 25 per cent of the lease rental was earmarked as maintenance reserve. Lease rentals per aircraft are Rs. 1.2-1.7 crore a month, depending on the aircraft make and the agreement between the airlines and the leasing companies.

The Indian aviation industry has a combined fleet of 300 aircraft, around 50 per cent of which is estimated to be leased, while the rest is owned. Taking an average monthly lease rental of Rs 1.5

crore per air-craft, the total amount of maintenance reserves to be under taxes would come to around Rs. 750 crore.

An airline has to allocate funds for maintenance reserve, which is meant to take care of maintenance of aircraft under lease from overseas players. This amount is over and above the lease payments made for the aircrafts.

The department proposes to tax the amount under Section 40 (a) (ia) of the Income Tax Act, 1961 which disallows the expenses to be deducted from income if the assessee has failed to deduct tax at source while making payments. An amendment had been made in 2006 that made rent payments and fees for technical and professional services also liable to TDS (tax deducted at source). This means, if a company has not deducted tax while making rent payments or fees for technical or professional services, the entire expenses, in which these items figure will be disallowed for education from income while computing taxes.

Airline executives are of the view that since maintenance reserves were part of the lease rental, they were exempted from tax. There are special purpose vehicles (SPV) with leasing companies that are located in tax-free regions. Therefore, even if the exemption is withdrawn, airline executives believe that they are protected because of the tax avoidance treaties with some countries.

For instance, Jet Airways had set up an SPV with Washington Aircraft Hire Company and North American Aircraft Hire Company, both located in Cayman Islands. SpiceJet has agreements with companies like Babcock & Brown and GECAS. Their SPVs are set up in Ireland.

129 VC applications cleared, $10-bn investment likely

After a long waiting period of over four years, foreign venture capital investors (FVCIs) have seen the light of day with 129 such applications getting regulatory clearances in the last four months. Based on the intention for investment as mentioned in their applications, collectively these funds are estimated to have the potential to invest $10 billion in Indian companies.

The Securities and Exchange Board of India (Sebi) had amended the regulations for foreign venture capital funds and investors in April 2004 and since then several applications were filed with the market regulator. However, the Reserve Bank of India (RBI) then did not give necessary clearance as there was a huge foreign capital inflow into the country, making it difficult to manage those funds. With the situation now having changed, the RBI has started giving clearances and in last four months, a total of 129 such investors have been given the green light.

RBI pricing norms related to foreign direct investments (FDI) are not applicable to FVCIs and if their investment is for more than a year, then the post-IPO lock-in is not applied to them. These terms make it attractive to float FVCIs. Most of the FVCIs cleared by Sebi are registered in Mauritius. The list includes entities floated by Carlyle, General Atlantic, West Bridge, Ascendas, New York Life, Standard Chartered PE, Citigroup and Blackstone among others. There have also been many FVCIs floated by Indian companies. These include IDFC PE and JM Financial.

However, while approving these applications, the RBI has restricted their investments to nine sectors, including infrastructure, IT hardware, agriculture and poultry.

The restrictions relating to investing only in nine sectors is based on the benefits available under Section 10 (23FB) of the Income Tax Act, which allows tax pass-through to venture funds.

Companies get nod to hedge carbon credits, freight deals abroad

RBI nod to use overseas bourses also grants both commodity status

The Reserve Bank of India (RBI) has allowed Indian companies to hedge carbon credits and freight contracts on overseas exchanges. With this, carbon credits and freight have been recognised as commodities by the RBI, and will join the ranks of metals, bullion, energy and agricultural produce, which are already permitted to be hedged abroad.

India second favourite investment destination among Japanese firms

India remains the second favourite investment destination for Japanese companies, a survey by the Japan Bank of International Cooperation (JBIC) has revealed.

About 58 per cent of the 620 companies surveyed said they found India a promising investment destination, compared with 50 per cent in last year's survey. The report observed that though China retained the top position, its percentage share decreased to 63 per cent from 68 per cent.

According to the data available with JBIC, a financial institution based on that country's external economic policy, Japanese FDI into India tripled to $5.4 billion in 2008 from $1.78 billion in the previous year.

The key reason for the increasing momentum of Japanese investments in India is the growth potential of the local market. Moreover, cheap labour and qualified human resources also contributed to large investment flows to India. However, the surveyed companies identified poor infrastructure as a hindrance to investment.

A JBIC release said that 108 companies had concrete plans to enter the Indian market in 2008, as against 89 in the previous year.

Japanese automobile and general machinery companies were the most interested in India as an investment destination. But the attractiveness of food processing and textile sector dropped in the latest survey.

7-years lock-in proposed for FDI in power equipment manufacturing

The government is likely to stipulate a seven-year lock-in period for foreign companies setting up manufacturing facilities for new generation power equipment to discourage non-serious players.

Large and fuel efficient 'super critical' equipment, expected to be used in many new power projects, are not manufactured in India at present. Current guidelines governing power equipment manufacturing do not have any provision to stop fly-by-night operators. The sector is open to 100% foreign direct investment under the automatic route.

So far five companies - BHEL, L&T-Mitsubishi combine, Alstom-Bharat Forge, Toshiba-JSW and Italian company Ansaldo Caldie - have expressed interest in taking part in bulk tenders for super critical equipment. The government expects some Chinese, Russian and East European companies to join the fray.

The equity lock-in clause would ensure that there would be no bids from some Chinese and Russian firms, whose track record is not satisfactory. The tenders would also make it mandatory for all interested companies to get their technology transfer agreements in place before bidding begins. In addition to the technology transfer agreement, companies would also need to have a licence from the parent company to sell and manufacture its products in India. Moreover, the companies winning in the bulk tendering will have to adhere to a phased manufacturing programme (PMP) with monitoring of milestones and levels of indigenization achieved. Any deviation from the agreed PMP will attract penalty of up to 5% of the contract price. Prior to the submission of the bid, the manufacturing company (a subsidiary or a joint venture company) must be registered in India and should have obtained certificate for commencement of business. Technology transfer to the Indian manufacturing company should be completed by the time eighth 660/800 MW super critical equipment set is supplied by the bidder.

The proposed changes (equity lock-in) would first be tested in bulk order for 11 units of 660 MW power generation equipment sets. It would then be applied for any future tendering for all super critical equipment.

Out of 11 units, nine would be used by National Thermal Power Corporation (NTPC) and the remaining two by Damodar Valley Corporation (DVC). The government targets power generation capacity in excess of 78,500 MW during the Eleventh Plan. A large portion of this capacity would be super critical. The country so far has only BHEL with large scale power equipment manufacturing capability. L&T is now sprucing up its operations to include manufacturing of main power equipment.

The bulk tender is aimed at attracting more equipment manufacturing companies into India to ensure that shortage of equipment does not derail the capacity addition programme.

MNC arms may get to fund growth from internal accruals

Indian subsidiaries of foreign firms will soon be allowed to fund additional investments from internal accruals, a temporary measure aimed at easing companies' cash flows in the backdrop of the global liquidity crisis.

The Foreign Investment Promotion Board (FIPB) will examine each proposal to use internally-generated funds for investment before giving its approval and the measure will be in force until the global economy gets back on track.

Current rules only allow such subsidiaries to make additional investments with money from overseas but no prior government approval is needed. The question of allowing greater flexibility in investments came up when FIPB examined a request by Dun & Bradstreet Information Services India, a subsidiary of credit information provider Dun & Bradstreet (D&B), to fund its equity participation in a joint venture through internal accruals as well as overseas remittances.

While FIPB allowed D&B India to tap its Indian earnings for funding downstream investments in the country, it has also decided to allow foreign multinationals to access the window on a case-by-case basis, subject to minimum capitalisation norms and approval by the foreign investment agency.

Margin allowed in transfer pricing transaction

Transfer pricing provisions were introduced in India by the Finance Act 2001 so as to protect its rights to collect a fair share of tax in respect of cross border transactions. Accordingly an international transaction entered into between associated enterprises at a price which doesn't conform to the arm's length principles, and which results in understatement of income in India, will be hit by transfer pricing provisions.

Where the Assessing Officer is of the opinion that the prices charged in international transactions have not been determined on arm's length principles, the Assessing Officer may determine the arms length price himself or, under specified circumstances, by making reference to a Transfer Pricing Officer.

Where the arm's length price determined by the Assessing Officer is different than what the taxpayer has disclosed, the Assessing Officer will compute the taxable income of the taxpayer on the basis of arm's length price determined by him.

Determination of arm's length price often presents practical difficulties because the said price can be calculated on the basis of several specified methods.

The Central Board of Direct Taxes, realizing practical difficulties, has issued a circular (Circular No. 12 of 2001 dated 23/8/2001) which states, "This is a new legislation. In the initial years of its implementation, there may be room for different interpretations leading to uncertainties with regard to determination of arm's length price of an international transaction. While it would be necessary to protect our tax base, there is a need to ensure that the taxpayers are not put to avoidable hardship in the implementation of these regulations."

The Board has also prescribed rules 10A to 10E in the Income-tax Rules, 1962, giving the manner and the circumstances in which different methods would be applied in determining arm's length price and the factors governing the selection of the most appropriate method.

The Board has also allowed a margin in the adjustment to the arm's length price which reads as: "The Assessing Officer shall not make any adjustment to the arm's length price determined by the taxpayer, if such price is up to 5 per cent. less or up to 5 per cent more than the price determined by the Assessing Officer. In such cases the price declared by the taxpayer may be accepted."

The margin of 5 per cent is to be applied to the arm's length price determined by the Assessing Officer, and not to the margin of profit calculated by him.

The above issue arose in a recent case of ACIT Vs SDRC India Private Ltd. decided by ITAT Delhi on 6/3/2009 in respect of transactions between SDRC USA and its Indian subsidiary. In the said case, the Indian subsidiary earned income on account of software development services rendered by it to its parent company.

The agreement between them provides that in consideration for software development services, the US company shall pay the Indian company an amount equal to the cost of providing development services plus a mark-up of 5 per cent.

The Assessing Officer did not accept the mark up of 5 percent. He made an addition to income by increasing the mark up to 10 percent. The Hon'ble Tribunal relying on the CBDT circular no. 12 held that the addition made by the Assessing Officer by increasing the mark up to 10 per cent was not correct and accordingly the addition made by Assessing Officer was deleted.

The aforesaid decision will provide an authority that an Assessing Officer should not make any adjustment to the arm's length price determined by a the taxpayer if such price is up to 5 percent less or up to 5 percent more than the price determined by the Assessing Officer. The circular of the Board is clear that in such cases the price declared by the taxpayer should be accepted.

Foreign investors in real estate locked for 3 years

Foreign investors in Indian real estate cannot sell their stakes to another foreign investor before three years as per a recent decision of the Foreign Investment Promotion Board (FIPB).

With this, the FIPB has overruled a provision in the FDI policy that exempts foreign players from the rule in cases where fund transfer is from one non-resident to another. Till now, this three-year lock-in was applicable only on foreign investment in real estate and not on investors.

The FIPB view is contrary to the stand taken by the Department of Industrial Policy and Promotion (DIPP), the nodal agency that formulates FDI rules in the country. DIPP's view is that a foreign investor can repatriate funds if it offloads its stake to another foreign investor as the actual investment in a project would remain intact and only its ownership would change.

Although Press Note 2 of 2005 has an enabling clause to permit sale of investment between two non-residents before the end of lock in, it has not been allowed so far.

The issue came up in the last FIPB meeting, when the board took up private equity fund 2I Capital's request to sell its investment in Delhi-based real estate firm Uppal Housing to Mauritius-based fund ICP Investments.

The company had sought approval for transferring 1.9 crore shares in the Indian real estate company to the Mauritian company. According to the company's proposal, the fund transfer involved no repatriation of funds but physical transfer of shares from one investor to another.

Though DIPP had recommended giving permission for sale of 2I Capital's shares to ICP Investments, FIPB rejected it. DIPP argued the sale of shares was permissible between two non-residents within the lock-in period, but FIPB rejected it.

In a missive to FIPB, ICP Investments said it has already invested $45 million in Uppal Housing and has plans to make substantial investments.

However, if 2I Capital is not permitted to transfer its shares to ICP, Uppal Housing's projects may be jeopardized, the company has stated. The joint venture between Uppal Housing and 2I Capital has been terminated and the company still holds its shares, given the policy logjam.

SC tells foreign companies to deduct tax at source on expat salaries

Foreign companies operating in India through joint ventures are required to deduct TDS (tax deducted at source) from home salary or special allowances paid abroad to their employees working in India, the Supreme Court has ruled.

This is an obligation of the tax deductor companies under Section 192(1) of the Income Tax Act, "particularly when no work stood performed for the foreign company and the total remuneration stood paid only on account of services rendered in India".

The court clarified the law in a batch of 104 appeals from various high courts and tribunals, raising the question of obligation of the foreign companies.

On the question of extra-territorial operation of the Income Tax Act, the judgment explained that the general concept regarding the scope of the income tax law was that given a sufficient territorial connection between the person sought to be charged and the country seeking to tax him, income tax may extend to that person in respect of his foreign income. "The nexus can be based on the residence of the person or business connection within the territory of the taxing state and the situation within the state of the money or property from which the taxable income is derived," the judgment said.

Applying that principle, the court ruled that "if the payments of home salary abroad by the foreign company to the expatriate has any connection or nexus with his rendition of service in India, then such payment would constitute income which is deemed to accrue or arise to the recipient in India as salary earned in India in terms of Section 9(1)(ii)."

However, whether the home salary payment made by the foreign company in foreign currency abroad can be held to be "deemed to accrue or arise in India" would depend upon the in-depth examination of facts of each case. Therefore, the court directed the assessing officers to examine each of the 104 cases to ascertain whether the employee-assessee (recipient) has paid the tax due on the home salary/special allowances received from the foreign company.

E*Trade Mauritius too gets call for capital gains tax

Buoyed by a favourable Supreme Court order in the Vodafone tax case, the income-tax department has asked E*Trade Mauritius to pay capital gains tax on the sale of its shares held in Indian company IL&FS Investsmart to HSBC in September 2008.

E*Trade Mauritius is indirectly held by E*Trade Financial Corporation and is in the business of identifying opportunities for investment in the Asian region.

Though the sale was routed through a company based in Mauritius with which India had a Double Taxation Avoidance Agreement (DTAA), the Indian income-tax department held that since profit was generated in India, tax is liable to be paid here.

The overseas company dragged the department to court claiming that it could not be taxed in India under the India-Mauritius DTAA.

The Bombay High Court, after hearing both sides, directed the company to go back to the income-tax department and present its case before the director, international taxation. It simultaneously asked the director, international taxation to give the order within three months.

The court also directed the company to deposit Rs 24.5 crore with the high court. The director eventually gave the order, upholding the earlier order demanding Rs 24.5 crore.

This is the latest in the line of cross-border deals involving Indian companies. The income-tax department has already sent notices to Vodafone on its $11-billion acquisition of Indian telecom major Hutch Essar, from the Hong Kong-based Hutchison International. The ball is now in the income-tax department's court after a direction to the company from the Supreme Court to take up the matter with the department before approaching the high court.

The department has sent similar notices on the acquisition of Foster's Australia's Indian subsidiary, Foster's India, by British brewer SABMiller, Idea-Cellular AT&T deal etc.

Global hotel majors line up to enter India

Global hotel chains are lining up to open properties in India at a time the sector is grappling with falling occupancy levels and declining average room rents, forcing local developers and hoteliers to defer projects.

Companies such as MGM Mirage Hospitality, Wyndham Hotel Group, Langham Hotels International and Corinthia Hotels and Resorts are finalising plans to launch their brands in the country in the next two-three years. Hotel chains such as Dubai-based Jumeirah Group, Movenpick Hotels and Resorts and Swissotel Hotels and Resorts are also close to finalising their plans for India.

Industry experts say as many as 37 international hotels brands are knocking at India's doors.

The world's largest gaming company, MGM Grand, which forayed into the hospitality sector with three premium luxury brands, is finalising its India plans. The company has held discussions with Indian real estate players for this.

Bellagio is MGM's super luxury brand, on a par with a Four Season property, whereas the MGM Grand is positioned a tad below that, and can be compared with the Grand Hyatt, according to Evans.

The company is building properties in Mumbai and New Delhi to start with, which can become operational in the next three years depending on the realty partner.

The Wyndham group, which operates the Ramada brand, a four-star hotel in India, is also planning to launch its Days Inn and Super 8 brands. In all, the company plans to add 50 hotels of three brands in the next three years. It will bring other brands at a later stage.

Similarly, Hong Kong headquartered Langham Hotels is looking to take full advantage of the favourable economic scenario in the country, where raw material and construction prices have been sliding continuously. The company, which is constructing a property at Pune's Koregaon Park, is eyeing further expansion in the country.

CBDT task force to advise on preventing tax treaty abuse

With global and political will turned against tax havens, New Delhi is looking to turn the heat on Mauritius and Cyprus to amend tax treaties with these countries or bring in anti-abuse provisions in their local laws.

The Central Board of Direct Taxes (CBDT) has set up a special task force to suggest ways to prevent abuse of double taxation avoidance agreements (DTAAs). The task force would look at the prevalent global best practices adopted by the US and others to see how they can be replicated here and ensure India's tax treaties are transparent and promote information-sharing.

India's attempts to amend the treaty with Mauritius, from where the country receives 43% of its foreign investments, have so far met with tremendous diplomatic resistance from the island nation.

The just-concluded G-20 summit on global financial crisis in London had raised the pitch on scrapping DTAAs. DTAAs are pacts between two countries that seek to eliminate double taxation of income or gains arising in one country and paid to residents or companies of the other country.

The idea is to ensure that the same income is not taxed twice.

However, in some cases, these treaties are misused to avoid taxes, leading to a loss of revenue to a country's exchequer. This is called treaty shopping, where residents of a third country take advantage of a tax treaty between two countries, by routing their investments from there to avoid taxation. As per some available estimates, India loses more than $600 million every year in revenues on account of the DTAA with Mauritius.

New Delhi had also considered a limitation of benefit clause in the treaty, to prevent ineligible entities from taking advantage. Through this clause, the government can put in conditions such as listing on the local stock exchange in any of the countries, ceiling on turnover and cap on expenditure for carrying out operations in one of the contracting states. Both India-Mauritius and India-Cyprus tax treaties provide that capital gains arising in India from the sale of securities can only be taxed in Mauritius and Cyprus respectively. This leads to zero taxation as there is no capital gains tax in these countries.

After failing in its attempt to amend the tax treaty, the UPA government tried to introduce treaty anti-abuse provisions in Budget 2007, but dropped the idea subsequently as work on the new comprehensive direct tax code had begun by then.

Indian tax authorities have upped their ante after the Vodafone-Hutch deal in which the transaction was carried out through subsidiaries domiciled in Mauritius and Cayman Islands, in the case that involves a tax demand of about $1.7 billion.

However, now, since direct tax code may not come into effect anytime soon, effort may be made to bring some such provisions in the tax laws in the forthcoming Budget itself, since all leading political parties have expressed desire to contain such tax havens. Senior BJP leader LK Advani has also raised his pitch against black money stashed away in such tax havens.

It may be noted that India has already amended its tax treaty with the United Arab Emirates.

Chicago Mercantile eyes India entry

The Chicago Mercantile Exchange (CME), the world's biggest exchange, is looking at entering India. It is in talks with several Indian exchanges to explore the possibility of picking up equity stake.

CME has two major exchanges in its fold, C-Bot and Nymex, and trades in derivatives instruments across markets such as interest rates, commodities, currencies and equities.

Though CME prefers a dominant role in the exchanges where it has equity investment, this would not be possible in India. The government allows a foreign entity only 5 per cent stake in exchanges.

Goldman Sachs, a leading investment bank, holds 7 per cent stake in NCDEX while the New York Stock Exchange-listed Intercontinental Exchange (ICE), a leading player in energy derivatives, holds 8 per cent. While Fidelity holds a little over 9 per cent in the Financial Technologies group-promoted MCX. Fidelity is also looking for buyers for its stake. All of them will have to reduce their stake to 5 per cent by June as per the rules and are said to be in talks with CME, apart from other investors, to sell their stake.

These investors have asked for extension of time to reduce their stake and the commodity futures market regulator, Forward Markets Commission (FMC) is understood to be in favour of such an extension. The final decision will however be taken by the government.

Satellite radio policy opens playing field

The floodgates are set to open for satellite radio services in the country with the government finalising a fresh set of policy guidelines. With satellite services, you can catch subscription-based broadcasts on everything from sports and weather to niche music channels, even on a cross-country drive, aided by compatible receiver sets.

Ten-year licences will be offered through a bidding process on a revenue-share basis, with commercial advertisements banned to protect local FM broadcasters.

Religious organizations and political parties will be barred from setting up the channels.

Private news channels are not allowed, but talk and current affairs are. News broadcasts or audio feeds of state-run All India Radio and Doordarshan will be allowed.

Uplinking of signals will be from India through locally registered firms. No commercial advertisements would be allowed.

The move opens up the field for others to compete with WorldSpace, which beams programmes from Singapore and hosts a variety of programmes, including in regional Indian languages. WorldSpace India broadcasts on the basis of a one-off approval given in 1998.

The operators would be allowed a maximum of two minutes per hour of promotional material about the channels. Broadcast of public interest announcements for a maximum of one hour per day might be made mandatory.

In line with direct-to-home (DTH) television services, foreign investment including portfolio and direct investment will be capped at 74 per cent.

Successful bidders will pay an annual licence fee equal to 4 per cent of their gross revenue and provide a bank guarantee of Rs. 10 crore or the annual fee, whichever is higher.

10-year 'lock-in' for violators of clinical test norms

Amended law proposes imprisonment for officials of errant companies and scrapping of licence

The government plans to amend the Drugs & Cosmetics Act to slap up to 10 years of imprisonment and cancellation of licence for violating norms for testing drugs on humans in India.

The move comes in the wake of the drug regulator's failure to take action against several companies even after finding gaps in their clinical trials during audits, due to the absence of legal provisions.

The proposed norms for conducting clinical trials of experimental drugs in India, framed by ICMR, have been approved by the ministries of law and health.

The move is intended to improve the country's image in this area, which has been sullied by some cases of alleged unethical and sub-standard practices.

India has become a hub for clinical trials of drugs with a clinical research market estimated at $389 million, which is forecast to touch $1 billion by 2010.
Having a tough, credible regulatory set-up is crucial to enable the growth of this industry while protecting the rights of Indians who volunteer to become test subjects.

India does not allow phase 1 trials, or initial experimentation on human subjects after a drug is found effective on laboratory animals, for molecules developed abroad. This prevents Indians from being the initial guinea pigs for foreign drug companies.

Recently, DCGI conducted the first audit of a clinical trial for Wyeth's advanced pneumonia vaccine after an infant's death was reported during the trial last October. It turned out that the child had been administered not the experimental vaccine but an already licensed, widely distributed vaccine in the double blind study. But the child should not have been enrolled in the study at all since it suffered from a cardiac condition, the drug regulator's audit had found.

However, in the absence of legal provisions, the regulator is still weighing future action in the Wyeth case. In another incident last year, 49 children died during clinical trials at the country's premier medical institution All India Institute of Medical Sciences. Later, a high-level committee found that none of the drugs had been tested on healthy children and rather they were suffering from high-risk illnesses and were also in a serious condition.

The most important part of these guidelines is that the person undergoing the experiment is informed about the risks involved while giving consent. The norms also specify the eligibility of a human subject to participate in the experiment.
The health ministry now plans to bring in a separate provision in the Drugs & Cosmetics Act to deal with offenders to check unethical human experiments in India.

So far, India has established only voluntary guidelines for testing experimental drugs on humans. Drug makers as well as companies who conduct such experiments for a fee may choose to register themselves with the ICMR or with the World Health Organisation (WHO). But this is not yet mandatory.

No M&As on competition panel's plate

The Competition Commission of India (CCI) will not take up local as well as foreign mergers and acquisitions immediately, as it looks to fine-tune its merger regulations before assuming the role of a full-fledged regulator.

However, the commission, which will be operational shortly, will take up cases of anti-competitive practices, cartelization and abuse of dominance, as the competition law allows the government to notify its various provisions in phases.

CCI's revised regulations on mergers and acquisitions — combinations, in legal parlance — will make the application of competition law more rational by excluding from regulation the deals which do not adversely affect competition but are covered by the asset-turnover criteria. The idea is to further fine-tune the merger regulation drafted earlier by CCI during the tenure of its former member and acting chairman Vinod Dhall. Considering its impact on corporate deals, the full commission, chaired by former World Bank executive director Dhanendra Kumar, will do some more consultation with the corporate world before finalising it.

The model code of conduct in force ahead of national elections does not prevent the government from notifying competition law provisions as it is merely operationalising a statutory body. The competition law was amended in 2007 to give adjudication powers to the CCI.

Government sets June 30 deadline for unbundling of SEBs

The government could complete its six-year-old initiative to unbundle state electricity boards (SEBs) into separate entities for power generation, transmission, distribution and trading business by June 30 this year.

The seven states that are yet to unbundle — Kerala, Tamil Nadu, Bihar, Jharkhand, Punjab, Himachal Pradesh and Meghalaya — have been given what is being called a final deadline to unbundle.

This unbundling is mandated by the Electricity Act of 2003 which prohibits SEBs from functioning as integrated power utilities.

The procedure for unbundling of an SEB includes transferring of its rights and liabilities to the state government through a "transfer scheme", followed by its subsequent transfer to a government company.

The employees of SEBs have been generally opposed to unbundling as they fear it would lead to privatization and subsequent job losses.

FDI inflows defy slowdown, January figure doubles

Foreign direct investment (FDI) inflows into India nearly doubled to Rs 13,400 crore in January compared with the previous month's tally of Rs 6,900 crore, on account of higher inflows from Mauritius, Singapore and Japan.

The three Asian countries together contributed more than 55% of the total inflows in the month that witnessed a revival after three months of decline, according to the data compiled by the commerce and industry ministry.

The year 2008-09 started on an impressive note by recording FDI inflows of Rs 15,000 crore in April, followed by Rs 16,000 crore in May. Inflows started slowing down in October, which saw inflows of Rs 7,284 crore, and remained low till December 2008.

FDI inflows during the April-January period stood at Rs 1,05,700 crore compared with Rs 98,664 crore in the fiscal year 2007-08, despite a recession that affected most of the developed world.

Mauritius remained the largest source of foreign investment, with the island nation contributing Rs 9,545 crore in FDI inflows during the April-January period, as against Rs 6,545 crore in the same period of the last fiscal.

Singapore replaced the US as the second largest source of long-term investments into India. Singapore, which was placed fourth, last year, saw its investments growing to Rs 3,237 crore during the period from Rs 1,532 crore in the same period last year.

However, the FDI figures captured by government statistics may not necessarily reflect the actual origin of investment. For instance, tax havens like Mauritius are used by investors from across the world to invest in India.

While Mauritius remains the top source of such FDI routed into India, other tax havens are also catching up. European hub Cyprus is gaining ground as a favoured route for channeling FDI into the country. Investments from Cyprus climbed to Rs 1,040 crore in the April-January period of 2008-09 from Rs 653 crore in the same period of the previous fiscal.

Among industry segments, services sector was the highest recipient of FDI at Rs 5,061 crore. FDI flowing into sectors such as computers, telecom and real estate stood at Rs 1,600 crore, Rs 2,374 crore and Rs 2,408 crore, respectively.

Single-window clearance for automakers gets government push

The Union ministry for heavy industries has asked states to set up a single-window clearance system for the automotive sector for putting upcoming manufacturing projects on the fast track.

The aim is to offer manufacturers all local clearances such as factory licences, land allotment, environmental certifications, and power supply at a single facility.

Currently, the automobile industry in India is concentrated around manufacturing hubs like Manesar in Gurgaon, Pune and Chennai.

Royalty fee cap may be raised up to 5%

The government is examining a proposal to allow foreign hospitality and technology companies to charge up to 5% of domestic sales as royalty or trademark fee from Indian companies for the use of their brand, trademark or technology.

The Centre is planning to raise the caps on royalty and trademark licence fees from 2% and 1%, respectively, of revenues generated in India and exempt firms from seeking the Foreign Investment Promotion Board's (FIPB) approval if the payments are less than 5%.

Also, foreign companies could be allowed to introduce charges like consultation fee, management fees and advisory fees. The Reserve Bank now allows foreign companies to charge technical know-how, trademark and royalty charges.

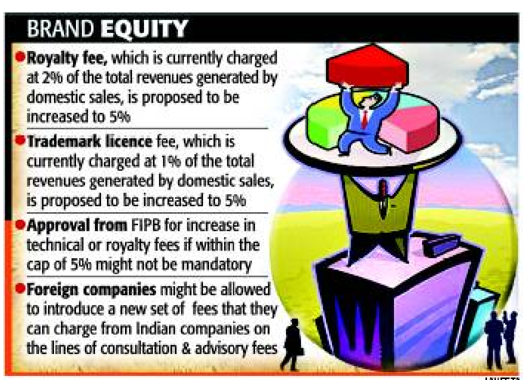
As per the current rules, a company needs

FIPB's approval for charging more than the stipulated limits as royalty or trademark fee. This is done on a case-to-case basis.

US-based Hilton Hotels recently approached FIPB, seeking a single permission to charge trademark and royalty fee up to 5% on all its future projects under all its brands. A Hilton India official said the proposal would not cover its existing joint venture with DLF. The company also sought permission to increase international marketing fee and technical assistance fee from Indian ventures.

Canada's Four Seasons, meanwhile, has sought the board's approval for revising various technical charges, which otherwise do not come under the RBI's list of charges. In February, the board had cleared a proposal from potato major McCain to take an annual service fee from its Indian subsidiary.

According to the FIPB official, the government is now of the view that a blanket policy should be framed for raising limits on such payments and including services which hitherto are not part of the policy.



Central bank puts off policy on foreign banks' presence

Citing the current global financial turmoil and concerns regarding the financial strength of banks around the world, the Reserve Bank of India (RBI) has decided to leave unchanged its policy on presence of foreign banks in the country.

The second phase of the 'Roadmap for Presence of Foreign Banks in India' has thus been put on hold. The second phase was related to the extension of national treatment to wholly-owned subsidiaries, dilution of stake and permitting mergers and acquisitions of any private sector bank in India with foreign banks.

In view of the current global financial market turmoil, there are uncertainties surrounding the financial strength of banks around the world. Further, the regulatory and supervisory policies at national and international levels are under review, RBI said in its annual policy for 2009-10.

RBI would continue with the current policy and procedures governing the presence of foreign banks in India. A review will happen once there is greater clarity regarding stability, recovery of the global financial system, and a shared understanding on the regulatory and supervisory architecture around the world.

The first phase of the roadmap, released by the central bank in February 2005, was due for review this month and RBI had said it would take a call on whether to go ahead with the second phase based on the experiences of the first.

As part of the first phase, foreign banks, previously restricted to branch operations, were authorised to set up wholly-owned subsidiaries and acquire shareholdings in those Indian private sector banks identified as in need of restructuring.

Foreign banks, on their part, haven't shown much interest in the wholly-owned subsidiary model of operation. It is still unclear whether a wholly-owned subsidiary gets the same treatment as a private bank. There are also significant costs around stamp duties, there are some norms around local listing, which could be a point of consideration for foreign banks.

Instead, foreign banks opted to grow their balance sheets by setting up non-banking finance companies (NBFCs). However, the recent deterioration in asset quality of loans, especially in the retail portfolio, has prompted many foreign banks to slow their NBFC operations. Some hints to RBI's present decision could have been gleaned from the recent CFSA report.

The report, presented on March 30, advised that the opening of the banking space to foreign banks be gradual. It stressed that licensing of branches to foreign banks be based on the principle of reciprocity.

Service tax relief on rentals

The Delhi High Court has ruled that commercial renting of premises will not attract service tax.

The Centre will challenge the order in the Supreme Court.

Renting of immovable property for use in the course or furtherance of business cannot be regarded a service, and, therefore, can't be taxed, the court ruled while disposing of petitions by retailers such as Lifestyle, Shopper's Stop Home Solution and Barista Coffee.

The order comes as a major relief to realtors and all companies operating from rented space, particularly retailers and call centres. It also means a major revenue loss for the government, which collects over Rs 8,000 crore annually as tax on renting services, or more than one-tenth of its service tax net.

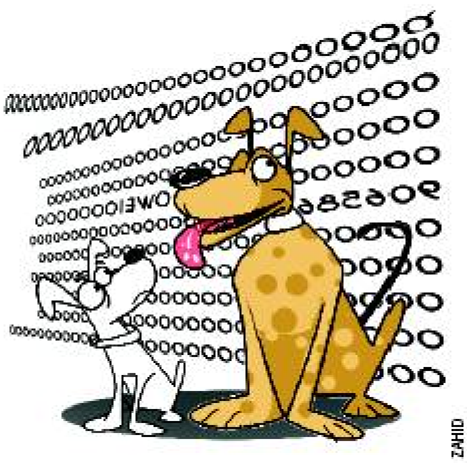
128 bit encryption may be allowed

The government proposes to raise encryption levels from the present 40 bits to 128 bits, before eventually moving to 256 bits, the standard adopted in Europe and the US. Higher encryption level will ensure more secure financial transactions on personal computers and phones. It is also vital for protecting internet data from hackers.

Most Western countries do not allow financial transactions on the internet through computers and mobile handsets, if the encryption level is less than 128 bits.

Last year, the government had forced all ISPs in the country to reduce encryption levels to the 40-bit standard. The logic behind the move was that India's security agencies lacked the technological capabilities to monitor data transfers on the internet when encryption levels were higher than 40 bits. Many industry experts agree that India's poor encryption standard is the reason behind low internet transactions.

The encryption issue came to the fore last year when the communications ministry threatened to ban Canada's RIM, the maker of BlackBerry handsets popular with corporates and professionals, as data transferred on these devices used the 256-bit advanced encryption standard. The communications ministry had demanded that RIM reduce its data security standards to the 40-bit encryption, a level that can be intercepted by Indian security agencies. After months of standoff, the issue was finally solved when RIM and the telecom department worked out a software solution that allowed India's security agencies to track emails exchanged on BlackBerry handsets. The government now plans to allow higher security standards as the country's intelligence has finally upgraded their technical capabilities. Besides, they also added that market regulator Sebi has recommended the use of 128-bit standards for internet-based securities trading. Another possible catalyst is that the Reserve Bank of India, in its guidelines on internet banking, has said 128-bit encryption should be the minimum level of security employed by banks.

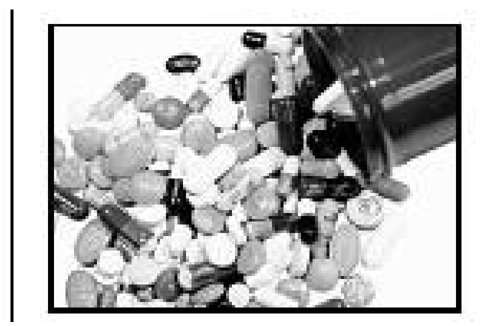


Fresh nod must for companies altering drug composition

Drug makers changing the composition of existing formulations to escape price caps will now have to come to the Centre for a fresh approval. In a move to keep a check on companies which replace price-controlled ingredients with ones outside price control, the Centre has directed state drug regulators not to allow them to sell such medicines with their old brand names. Instead, such drugs will be treated as new ones and the companies will have to go through the Centre's scrutiny before it gets a fresh approval.

The move is significant as companies are now likely to think twice before they make change in the existing composition and approach the centre for a fresh approval. This would also mean that companies will have to subscribe to a new brand name.

The decision comes in the wake of the National Pharmaceutical Pricing Authority (NPPA) seeking action from the Drug Controller General of India (DCGI) against companies that dodge price control by tweaking ingredients of medicines and then misguide consumers by retaining the original brand name.



Economy set to turn the corner

From rosy investments to vibrant hiring to smooth sailing for ports to fired-up output data, all signs are that the bounce is indeed back for the economy

Growth ahoy! A raft of lead indicators, investments that refuse to flag, rejuvenated hiring, sprightly freight movement at major ports and robust data from key manufacturing segments indicate that the downturn has bottomed out and that the economy is poised to regain its vigour.

Nomura's Composite Leading Index (CLI), UBS' Lead Economic Indicator (LEI) and ABN Amro's Purchasing Managers' Index (PMI) all point to a pick-up in growth soon. And CMIE's capex database, which tracks investments by companies, shows no big slowdown in this space.

A lead indicator is a composite of a variety of indices that track activity in vital economic sectors. And that's not all. The strong showing of sectors such as auto, cement, steel, capital goods, port traffic along with record telecom subscriber additions supports the strong turnaround thesis of these lead indicators.

After three months of rise on the trot, UBS' LEI index for India now stands at 2.1; it touched a low of -2.08 last December. The LEI is a composite indicator of variables like government bond yields, M1 money supply, currency risk premium, foreign exchange reserves and stock market gains.

UBS expects a sustained recovery thanks to India's low levels of excess capacity, private sector indebtedness and non-performing loans.

Nomura's composite leading index (CLI)—used to identify the turning points in the growth rate cycle—rose in the first quarter of 2009 after four consecutive quarterly falls. As the CLI indicates a turnaround in non-agricultural GDP growth rate with a two quarter lead time, the pick-up in the first quarter of 2009 hints at a recovery from June.

ABN Amro's PMI—an indicator of the country's manufacturing scene based on a survey of 500 companies—has improved to 49.5 this March from 44 last December. A reading below 50 indicates contraction. The PMI jump to nearly 50 suggests that manufacturing has put the contraction days behind and is poised to enter an expansion phase.
The suggestion is that inventories have been run down, necessitating stepped-up production.

The economy can also take heart from the automobile sector. The number of cars sold in March at 1,66,837 was 45% higher than the 1,15,334 sold in December '08. Two-wheeler sales climbed 42% from 4,61,302 in December to 6,54,017 in March.

The index of industrial production, meanwhile, has inched its way to positive territory, even as capital goods production grew 10% in February.

And CMIE's capex database of new and ongoing investments indicates that both the rate of project announcements and the pace at which they are being commissioned remain robust. It says the downward revision of projected growth for this fiscal by the World Bank and IMF is baseless.

According to the database, the momentum in commissioning new projects will continue into the next fiscal. Over a 1,000 projects involving total investments of Rs 4,90,000 crore are on schedule and will be commissioned in 2009-10. Projects worth a record Rs 7,90,000 crore have been announced in the quarter ended March 2009 itself, suggesting that corporates haven't pared investments as expected.

As for trade data, despite overall imports slowing down, project import growth has remained robust (January saw a 200%

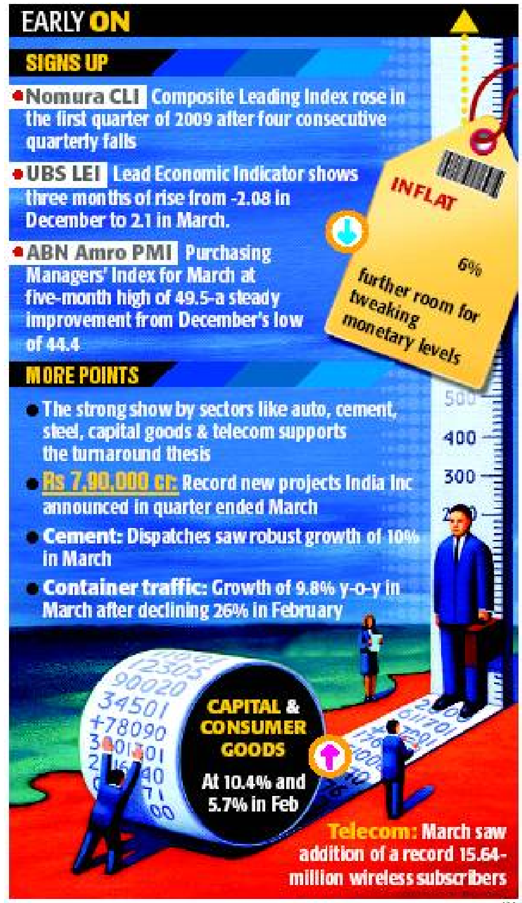
surge). While portfolio investment inflows have been fickle, direct investment inflows remain strong, inducing official expectation that FDI inflows in 2009 would best last year's realized inflow of $33 billion and touch $40 billion.

This should put to rest fears of a slowdown "as a result of weaker investment" as suggested by the IMF.

That should also allay concerns over OECD's warning of a downside risk to India's growth trajectory. In its interim growth outlook, OECD has warned that in case "...firms do not take into account a likely turnaround by the end of 2009 and hence scale down their investment plans more than expected".

In the current quarter, prospects look better for the manufacturing sector with six out of 12 sectors— textiles, metals & products, machinery, cement, FMCG and miscellaneous industry—likely to see a growth.

The prices of manufactured items, which have been firming up for the previous eight weeks after slipping from August, also hint at a demand revival.



JAI

FIIs' direct passage to India to be intact

The new rules for computing foreign investments in Indian companies announced in February are in for yet another clarification, this time on investments by foreign institutional investors (FIIs) in sectors that have curbs on foreign holdings and where government approval is required for overseas inflows. The Department of Industrial Policy and Promotion (DIPP) is planning to exempt FIIs from seeking government clearance for buying shares on the stock market.

The clarification is in response to finance ministry objections to treating portfolio investments by FIIs on a par with foreign direct investment (FDI). Clubbing the two types of investments under the new norms would, the ministry thinks, require FIIs to get the Foreign Investment Promotion Board's (FIPB) nod for buying shares of companies in sectors where foreign investment proposals need government permission. This would, in the finance ministry's view, restrict FII inflows into India.

The easing of norms would be limited to only exempting foreign funds from seeking FIPB nod. However, investments through this route must stay within the overall sectoral cap.

February's revised norms club all foreign investments such as FIIs, global depository receipts (GDRs), American depository receipts (ADRs) and foreign currency convertible bonds (FCCBs) together.

The finance ministry had told the DIPP—the agency sets the foreign investment policy—that subjecting FII investments to FIPB approval would be adding to the red tape. The ministry is also worried that such a norm would deter foreign funds from investing in the Indian market.

Under the RBI's portfolio investment scheme, registered FIIs have till date been allowed to trade on the bourses sans government approval. This was on the ground that foreign funds are primarily concerned with their own capital, the likelihood of value appreciation and of course, returns. They generally have no big influence on companies' operations unlike FDI, through which long-term interest can be sustained by pulling the management strings. Direct investors also have the right to appoint directors on the board.

In practice, FIIs have been buying and selling shares in sectors like telecom, where FDI needs FIPB approval, even after February's revised norms.

Besides reviewing the treatment of FIIs, the DIPP is also reviewing its policy on banks and sectors where FDI is totally prohibited.

Separate norms for medical devices soon

The government has decided to create separate quality guidelines for medical devices and not treat them as drugs by the end of May. It will also classify medical devices based on the risks involved. At present, medical devices are treated like drugs and are regulated by state drug regulators under the Drugs and Cosmetics Act.

The guidelines would make it mandatory for both domestic as well as global medical device makers to get their products certified by notified bodies like International Organization for Standardization (ISO) and Bureau of Indian Standards (BIS) before selling them in the Indian market.

The government move comes in the wake of the industry protesting against the present norms and delay in issuance of licence to domestic manufacturers. The idea is not just to provide uniform norms but also to ensure manufacture and sale of safe medical devices in the country.

Source

Press clippings

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[i] 1 Crore = 10,000,000