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Happy Diwali & a Prosperous New Year!!

From,

Nanubhai Desai & Co.

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INCOME TAX

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REVERSE MORTGAGE SCHEME, 2008

In exercise of the powers conferred under clause (xvi) of section 47 of the Income-tax Act, 1961 (43 of 1961), the Central Government has devised the Reverse Mortgage Scheme, 2008, vide notification no. 93/2008, dated 30-9-2008.

International Taxation

General

AMENDMENT TO THE DTAA BETWEEN INDIA AND JAPAN

In exercise of the powers conferred under section 90 of the Income-tax Act, 1961, the Central Government has made the following amendment to the Double taxation avoidance Agreement (DTAA) between India & Japan, vide notification no.96/2008.

In the said notification, in the Annexure, in Article 11 of the Convention, exemption available vide para 3 of Article 11, the taxability of the amount of interest earned by various identified government institutions, shall now be extended in favour of "International business unit of Japan Finance Corporation", in lieu of the existing entity, being the export – import bank of Japan, with effect from 1st October, 2008.

Case laws

1. Sony India Pvt. Ltd. Case (Delhi Tribunal)

Background & Facts

- The assessee, Sony India (P) Ltd., a wholly owned subsidiary of Sony Corporation, Japan is engaged in assembly & distribution of colour televisions & audio products.
- The assessee, in its ordinary course of business, enters into a number of international transactions like import – export of finished goods, import of components, availing of services from its foreign Associated Enterprises (AEs), reimbursement of advertisement expenses, sharing of costs, etc., with its foreign AEs, at arm's length price (ALP).

Contentions of the TPO & the assessee

Contentions of the Transfer pricing officer (TPO) & the assessee during the audit proceedings, for determination of the ALP, are as follows:

- **Comparables & Testing party**
  - The TPO rejected a few of the comparables taken into consideration by the assessee for determination of the ALP, on the ground that the said

comparables were having related or controlled party transactions. Some of the comparables were rejected, as they were loss making entities.
- Further, the TPO asserted that the foreign AE cannot be taken as a tested party in case of import of components & finished goods.

- **Ascertainment of ALP in case of TV sets to AE**
  - The assessee used marginal costing principles for pricing the international transaction in relation to export for television sets to the AEs, on account of unutilized idle capacity. However, the TPO rejected the contention of the assessee & determined the ALP by applying the average operating profit of comparables on total cost for the units exported to the AEs.

- **Computation of Operating profit**
  - The TPO did not allow the assessee to take reimbursement of advertisement expenditure received from the AE, while computing the operating profit, on the ground that the amount received from AE was in the form of assistance & thus cannot be taken as a part of the operating profit.
  - The TPO also rejected a few sources of income like service revenue, scrap sale, rebate received, etc. as included by the assessee under the head other income while computation of the operating profit.

- **Application of +/- 5 % range on ALP**
  - The benefit of 5 % range, as per proviso to section 92C (2), was not allowed by the TPO for the computation of the ALP, as the transfer pricing shown by the assessee was beyond the range of +/- 5 %

The CIT Appeals (‘CIT (A)’) affirmed to the contentions of the TPO on most of the grounds. The assessee, aggrieved by the order of the CIT (A), preferred the appeal before the Tribunal.

Decision & Conclusion

- **Comparables & Testing party**
  - The Tribunal concluded that an entity can be taken as comparable, if its related party transactions do not exceed 10 to 15 % of its total revenue. Transactions done within this limit cannot be held to be significant to influence the profitability of comparables.
  - The Tribunal further asserted that the impact of a related party transaction vis-à-vis sales and not profit is to be judged; as profit is influenced by various other factors.
  - The Tribunal did not agree to the contention of the TPO for rejection of loss making entities as comparables, stating that losses & competition are normal business; and thus cumulative effect of various factors should be taken into consideration.

- **Ascertainment of ALP in case of TV sets to AE**
  - In relation to export of TV sets to AE, the Tribunal held that unutilized capacity cannot justify export of TV sets to foreign AEs at a price less than

the price to any unrelated party. Furthermore, the tribunal asserted that charging of a lesser price should be substantiated by showing that a similar price was charged for a similar item under similar circumstances.

- **Computation of Operating profit**
  - The Tribunal, by referring to the OECD Guidelines and US Transfer Pricing Regulations, held that the TPO was not justified in disallowing the reimbursement of advertisement expenditure received from the assessee's foreign AEs. The Tribunal discussed the doctrine of **'form over substance'** and held that actual transaction entered into between the AEs has to be given due consideration & that the tax authorities have no right to rewrite the transaction unless it is bogus or entered into to avoid or evade taxes.
  - Moreover, the Tribunal seconded to the contention of the assessee concerning 'other income items' & allowed them to be taken into consideration for the computation of operating profit.

- **Application of +/- 5 % range on ALP**
  - As regard to the application of +/- 5 % range on ALP, the Tribunal held that the benefit of the 5 % range shall be available in all cases, irrespective of the fact that the value of international transaction as disclosed by the assessee is outside the +/- 5 % range.

1. Philips Software Centre Pvt. Ltd. Case (ITAT Bangalore Bench)

Background & Facts

- The assessee, Philips Software Centre Pvt. Ltd. (Philips), is a risk-insulated captive software development services company. It renders services to its overseas Associated Enterprises (AEs).To substantiate the arm's length nature of its international transactions, Philips has considered the Cost Plus Method ('CPM') as the most appropriate method and the transactional net margin method ('TNMM') was considered as a supplementary method.
- The data of comparable companies for the Financial Year 2002 – 2003 that existed immediately prior to the 'specified date' (i.e. tax return due date for Assessment Year 2003 - 2004) was used as required under Rule 10D (4) of the income Tax Rules, 1962. Consequently, the search resulted in a set of nine comparable companies which were used as a base for making adjustments for difference in depreciation policy to arrive at the Arm's Length Price (ALP).
- However, the TPO disagreed with the depreciation adjustment and initiated a fresh search on a different database and thereby selected TNMM method over CPM Method. Accordingly, the TPO passed an order

computing ALP by using the mean margin of seven comparables at 21.14%. The CIT (A) granted a marginal relief to Phillips and reduced the profit margin from 21.14 % to 20.47%.

- The assessee filed an appeal with the Tribunal and raised the following issues-
  - TPO selected TNMM method & a database different from the one selected by the assessee, without providing any reasons
  - TPO rejected the comparables of the assessee without highlighting any deficiency or insufficiency in them,
  - TPO normalised the margins of super-profit making companies, even though such an action was nowhere covered/ included in the Indian TP provisions.
- The Revenue argued on the following aspects-
  - The TPO averred that it had rightly taken TNMM as the most appropriate method since Phillips had itself used TNMM as a supplementary method and also that Phillips did not compute the profit margins correctly under the CPM.
  - Even though Phillips charged higher rates of depreciation than those of the comparable companies, the method followed by them to compute the depreciation adjustment was not correct.
  - The claim of a risk adjustment which was indicated by the difference between the prime lending rate ('PLR') and the bank rate was not supported by any logic.

Decision & Conclusion

After considering arguments of both the parties, the Tribunal issued its order in favour of the assessee. The judgement of the Tribunal is summarised as under:

- The Tribunal stated that while the motive of tax avoidance need not be shown at the time of initiating transfer pricing provisions but the same is required to be shown at the stage of making the assessment. Since the same was not done, the TPO's order shall be void. Furthermore, the Tribunal stated that the assessee's selection of CPM could not be substituted by the TPO with another method, without showing cause, that assessee's method was erroneous.
- The Tribunal accepted the adjustments made by Phillips to the comparable companies to eliminate differences on account of risk profiles, working capital position and accounting policies (including for depreciation).
- The Tribunal further stated that the TPO should not normalise the profits of super profit making comparable companies by replacing them with profit margins of the next highest profit making companies from the set of final comparables. Such companies should have been excluded from the list of comparables.

- It was thus concluded that the transactions with its associated enterprises satisfied the arm's length test and, that the order of the TPO was bad in law and on facts.

3. Golf In Dubai, L.L.C. – Advance Ruling

Background & Facts

- The applicant, Golf In Dubai, LLC. (GID) is a company registered in UAE & engaged in the business of promoting Golf nationally as well as internationally by way of organizing Golf tournaments in different countries. The main source of income from these tournaments is for organizing such events. The applicant organized two such tournaments in India, one in Bangalore at Eagleton Golf Club and the other in Delhi at the Delhi Golf Club (DGC).
- EMAAR – MGF was the sponsoror for these tournaments. The applicant entered into a formal agreement with EMAAR – MGF, for a period of three years, eyeing such tournaments in future. GID paid 15,000 USD to Eagleton & 80,000 USD to DCG as fees for right to use the premises.
- Since GID did not have any permanent establishment (PE) in India, they engaged the services of Par Golf Tours & Accessories Pvt. Ltd., a consulting company for golf, at Kolkatta, for organizing the golf tournaments in India.
- In the wake of organizing both these tournaments as referred to above, the applicant has received the following income from the Indian sponsors: -
  - Sponsorship fee, which essentially represents reimbursement expenses on prize money, accommodation for players, Golf course fee, catering, advertisements and publicity expenses, etc.,
  - The management fee, which represents the actual fee for organizing the tournament, and
  - Income from sale of merchandise at the venue and over the internet.
- The revenue contended that GID has a PE in India, primarily under Article 5(1) of the India – UAE Treaty (the Treaty), Golf course of the DGC and the Eagleton, being the fixed place of business of the applicant in India. The Revenue, further, asserted that though the activity of the applicant lasted for only 6 – 7 days in India, the applicant intends to conduct similar such tournaments in India on a regular basis.
- Moreover, the Revenue contended that ParGolf has provided service to the applicant for organizing the events in India & thus there exists an Agency PE in terms of paragraphs 4 and 5 of Article 5 of the Treaty.
- However, according to the applicant, the concept of PE embodies periodicity/ regularity and in the case of the applicant, the business of organizing Golf events has neither been carried on regularly nor there is certainty that it will be carried on regularly. Thus, it has been contended

that the requirements of Article 5(1) of the Treaty do not stand satisfied in the instant case.

- Further, the applicant contended that there is no Agency PE also as GID had entered into similar arrangements for organizing the tournament with various third party vendors, both in Bangalore and Delhi. Moreover, all the vendors were independent contractors who acted in their ordinary course of business operations.
- The questions before the Advance Ruling Authority (AAR) were –

Q 1. Whether GID could be deemed to have a PE in India in terms of Article 5 of Treaty?

Q 2. Whether Eagleton and/or DGC could be deemed to be an agency PE of GID in India?

Q 3. If the answer to any of the queries above is in affirmative, whether any or all of the income generated by GID from the Golf tournament held in India, be liable to income tax in India in terms of Article 7 of the Treaty?

Q 4. In the event that GID does not have a PE in India, would any of the income arising to GID be taxable in India under any other provision of the Treaty?

Ruling by the AAR

The AAR, on referral to the facts and circumstances of the case, gave a ruling in favour of the applicant. The answer to the questions raised to the AAR have been summarised as follows.

1. The AAR referred to the definition of PE as stated in the OECD Commentary& stated that the applicant does not have a PE in India in terms of Article 5 of the Treaty. The AAR averred that merely having access to the Golf course is not sufficient in the sense that the 'place' must be 'fixed' and should also be at the ' complete disposal of the enterprise/person'.
2. In view of ruling on Que. No.1 above, this question requires no ruling.
3. & 4. Since it has been ruled that the applicant does not have a PE in India, the receipts earned by the applicant shall not be liable to income tax in India, in terms of Article 7 of the Treaty or under any other provisions of the Treaty.

REGULATIONS GOVERNING INVESTMENTS

RBI clears participation of FIIs in IDRs

The Reserve Bank of India (RBI) and Finance Ministry have recently cleared the proposal of participation of Foreign Institutional Investors (FIIs) in Indian Depository Receipts (IDRs). The same has been forwarded to the Ministry of Corporate Affairs for clearance before the decision is notified. The Ministry of Corporate Affairs would also consider whether to allow Non-Resident Indians (NRIs) to subscribe to IDRs. IDRs are Indian counterparts of Global Depository Receipts (GDRs) that enable foreign companies to raise money from the Indian markets.

The Securities and Exchange Board of India (Sebi), has set Rs 50 crore as the minimum amount for issuing IDRs in which the minimum investment by retail investors has been set at Rs 2 lakh. In its original form, persons of Indian origin (PIOs) and resident Indians were permitted to invest in IDRs. NRIs and FIIs are required to take RBI's permission before investing in such instruments.

Revision to the definition of Infrastructure sector under ECB Policy

On 22nd September 2008, the government had liberalized the norms for overseas borrowing by increasing the limit of borrowing from $100 millions to $500 million for infrastructure sector under the Approval route. In continuation to the liberalisation of the ECB policy, on 8th October 2008, the government expands the definition of infrastructure.

Prior to this revision for the purpose of the ECB scheme, Infrastructure sector covered the following sectors, namely, (i) power, (ii) telecommunication, (iii) railways, (iv) Road including bridges, (v) sea port and airport (vi) industrial parks and (vii) urban infrastructure (water supply, sanitation and sewage projects).

Now as per the revised ECB policy, the definition of infrastructure sector is expanded to mining, exploration and refining sector to the existing list of sectors. This new definition of Infrastructure sector for the purpose of ECB shall come into force with immediate effect.

All other features of the ECB policy such as USD 500 million limit per borrower, per financial year under the Automatic Route, eligible borrower, recognized lender, end-use of foreign currency expenditure for import of capital goods and overseas investments, average maturity period, prepayment, refinancing of existing ECB and reporting arrangements shall remain unchanged.

Further liberalization in ECB guidelines

Having regard to the financial turbulence world over & in a measure to enhance liquidity, the Reserve bank of India (RBI) and the government of India have further liberalized the External Commercial Borrowing (ECB) policy for Indian companies. The RBI increased the amount of ECB from $100 millions to $500 millions per borrower per financial year, permitting transactions for Rupee expenditure and / or foreign currency expenditure under the automatic route. The liberalization in ECB policy is mainly to encourage the inflows and help corporates to raise funds for projects.

The new policy will provide the companies to pay higher interest of upto 500 bps over the six month libor on ECBs. RBI has also done away with requirement of minimum average maturity period of seven years for ECB of more than $100 million for rupee expenditure in the infrastructure sector. In order to further develop the telecom sector in the country, payment for obtaining license/permit for 3G Spectrum will be considered an eligible end - use for the purpose of ECB.

Formerely, the ECB proceeds were required to be parked overseas until their actual requirement arises in India. But now it is allowed to bring in the ECB funds even if there is no immediate requirement of money. However, the rupee funds will not be continued to be permitted to be used for investment in capital markets, real estate or for inter- corporate lending.

Earlier the ECB norms were tightened by the government to keep a check on the foreign exchange inflows, which led to rupee appreciation. Now the conditions are totally reversed i.e. the outflows have increased and the rupee is under pressure. This made RBI to liberalize the ECB policy and enhance the all – in – cost ceilings. The all – in – cost ceiling are as under:-

<table>
<tr><th rowspan="2">Average Maturity Period</th><th colspan="2">All-in-Cost ceilings over 6 Months LIBOR*</th></tr>
<tr><th>Existing</th><th>Revised</th></tr>
<tr><td>Three years and up to five years</td><td>200 bps</td><td>300 bps</td></tr>
<tr><td>More than five years and up to seven years</td><td>350 bps</td><td rowspan="2">500 bps</td></tr>
<tr><td>More than seven years</td><td>450 bps</td></tr>
</table>

* for the respective currency of borrowing or applicable benchmark.

Removal of restrictions on P-notes

On 6th October 2008, the market regulator Securities & Exchange Board of India (Sebi) has taken some important measures in support of FII (Foreign Institutional Investors). On the outlook of the bad performance of capital market and to bolster the capital flow in Indian capital market, SEBI removed the restrictions on issuance of Offshore Derivative Instruments ("**ODIs**"), popularly known as Participatory Notes ("**PNs**"), which had been made mandatory on FIIs in October last year. The rule of 40% cap on ODIs in both cash as well as derivative contracts shall be scrapped.

Last year (October 2007) saw a momentous rise in investments by FIIs in India. By the end of September 2007, FIIs' total investments in equities were at Rs 51,166 crore whereas the investment for the whole of the previous year (2006) was only about Rs 36,540 crore. The massive flow of funds from FII to Indian stock market led to overheating of the markets and that made it difficult for the regulator to manage the excess liquidity. So SEBI banned the fresh issues of P – Notes with Indian derivatives as underlying. It had also mandated unwinding of such positions within 18 months. SEBI had also restricted issuance of P-notes in the spot segment to 40% of assets under custody. P-notes are issued by FIIs registered in India to unregistered overseas investors. The aim behind this was to keep a check on the flow of funds on Indian market by the FIIs.

The ban on P – notes did not affect the Indian markets. But the crunch in US markets has spread all over the world and has also affected the Indian markets. On top of that, big investment firms like Lehman brothers, etc. went bankrupt. All these cumulatively resulted in FIIs selling off their investments in the domestic markets. As a result, rupee started devaluing and the regulator SEBI thought it fit & appropriate to take control of the situation. SEBI removed the restrictions on P-notes, the 40% cap on P-notes and now the P- note holders are not required to wind up their positions in Indian stock market.

ACCOUNTS & AUDIT

NO IMMEDIATE PLAN TO EXTEND IFRS CONVERGENCE DEADLINE- ICAI

The Central Council of the Institute of Chartered Accountants of India (ICAI) has denied recently postponing the date of convergence with International Financial Reporting Standards (IFRS), which is April 1, 2011, in the wake of global financial market meltdown. ICAI had earlier announced that the Indian accounting standards would be fully in line with IFRS from April 1, 2011.

Guidance note on accounting standard – ICAI

Recently the Institute of Chartered Accountants of India (ICAI) has come out with new Guidance Note on implementing Accounting Standard 32, Financial Instrument. This Guidance Note suggests possible ways to apply some of the disclosure requirements as prescribed in AS 32, Financial Instrument. The Guidance Note does not create any additional requirements.

IAASB Issues Seven Revised ISAs

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), recently released seven International Standards on Auditing (ISAs) following the consideration and approval of due process by the Public Interest Oversight Board (PIOB). The ISAs are in the new style following the conventions developed in the IAASB's project to improve the clarity, and therefore the application, of its standards. Some of the standards have been substantively revised, while others have been redrafted to apply the new conventions. The standards will provide further momentum toward achieving convergence and contribute to enhancing understanding of the purpose and scope of audits, and their effective conduct.

The New Standards

The clarified ISAs include ISA 200 (Revised and Redrafted), Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing. This fundamental ISA contains an overview of an audit to aid in understanding its purpose and scope; defines the respective authority of the requirements and guidance in ISAs and contains the most fundamental requirements for auditors. It emphasizes the importance of

sound and consistent professional judgment by the auditor and the necessity for sufficient audit evidence to support the auditor's opinion.

In addition to ISA 200 (Revised and Redrafted), the IAASB also released:

- ISA 320 (Revised and Redrafted), Materiality in Planning and Performing an Audit;
- ISA 450 (Revised and Redrafted), Evaluation of Misstatements Identified during the Audit;
- ISA 530 (Redrafted), Audit Sampling;
- ISA 610 (Redrafted), Using the Work of Internal Auditors;
- ISA 705 (Revised and Redrafted), Modifications to the Opinion in the Independent Auditor's Report; and
- ISA 706 (Revised and Redrafted), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.

These ISAs form part of the IAASB's program to redraft existing standards following the clarity drafting conventions. * To date, the IAASB has released 22 final clarity redrafted ISAs. The IAASB is on track to finalize its complete set of clarified ISAs by the end of this year. All clarified ISAs will be effective from a single date, for audits of financial statements for periods beginning on or after December 15, 2009.

Opportunity for Indian corporates to acquire companies outside of India

Overview of the present global financial scenario

Since 2001, after the dotcom craze ended and the bear market began, it is observed that the Federal Reserve started aggressively slashing short-term interest rates to stave off recession. Eventually the rates were reduced as low as 1%. This cheap money sparked a new wave of risk taking. Homeowners, armed with easy credit and supported with irrational government schemes that entitled even unworthy individuals to borrow at ease, snapped up properties as if they were playing Monopoly. As prices soared, buyers were able to afford ever-larger properties only by taking out risky mortgages that lenders were happily approving with little documentation or money down. Wall Street investment banks, simultaneously, engineered a new financial model whereby they bundled the riskiest of these mortgages, then slice and dice these portfolios into tradable bonds (now referred to as 'junk bonds') to be sold to other banks and investors. Amazingly, bond-rating agencies slapped their highest ratings on the "best" of this debt. This house of cards came down when subprime borrowers began defaulting on their mortgages. The impact of this was that housing prices started to tumble, unleashing a domino effect on mortgage-backed securities. Banks and brokerages that had borrowed money to boost the impact of those investments had to race to raise capital. Some, like Merrill Lynch, were forced to sell. Others, like Lehman Brothers, weren't so lucky. The collapse of the big five financial giants on Wall Street — Fannie Mae, Freddie Mac, AIG, Lehman Brothers and Merrill Lynch — with revenues totalling nearly $322 billion in 2007, followed by two of the largest banks — Washington Mutual (WaMu) and Wachovia — has sent shock waves through global financial markets.

*GRAVITY OF THE CRISIS**

The gravity of the financial crisis that has hit the US economy can be gauged from the fact that the cost of the rescue of these financial giants to the Federal Reserve and Treasury Department has been estimated at close to a trillion dollars (equivalent to India's national income). According to some analysts, the total cost on this count could go up to $2 trillion since the financial turmoil is not likely to end anytime soon. Most of these banks had created debts to the tune of 30-40 times their equity against the prudential norm of not exceeding ten times. According to some estimates, the derivatives trade had grown five times between 2002 and 2007 to exceed

$500 trillion, thus making this 'shadow' economy almost ten times bigger than the real economy of the world. After a tense week and prolonged debate, the US Congress on October 3, finally passed the $700-billion financial bailout plan to avert a major national crisis. However, even after the clearance of the bailout package, the stock markets, world over, have plunged further as the feeling of uncertainty continues. The financial turmoil is fast spreading to Europe, whose economies are also showing signs of sliding into a recession, and the ripple effects are bound to have some adverse effects on the rest of the world, including China and India.
(source: The Hindu Business Line)*

Dr Duwuri Subbarao, Governor, Reserve Bank of India, and Leader of the Indian delegation at the International Monetary and Financial Committee Meeting, at the International Monetary Fund, Washington DC, on October 11, 2008:

> *"There is the problem of contagion – across markets, across institutions and across countries. Each day, there is news of the crisis spreading to a newer part of the world or to a newer institution. What we are going through is an unprecedented crisis."*

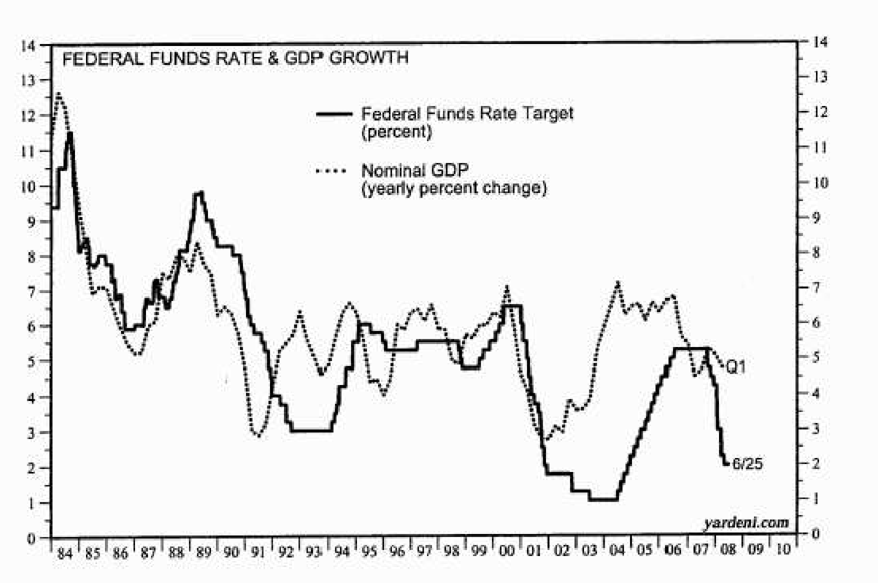
As per one recent article of Mr Warren E. Buffett, published on 16 October 2008, he categorically stated that the financial world is in a mess.

> *"THE financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary. So ... I've been buying American stocks……………………"*

As per Marc Faber, the current economic scenario would lead to a colossal bust.

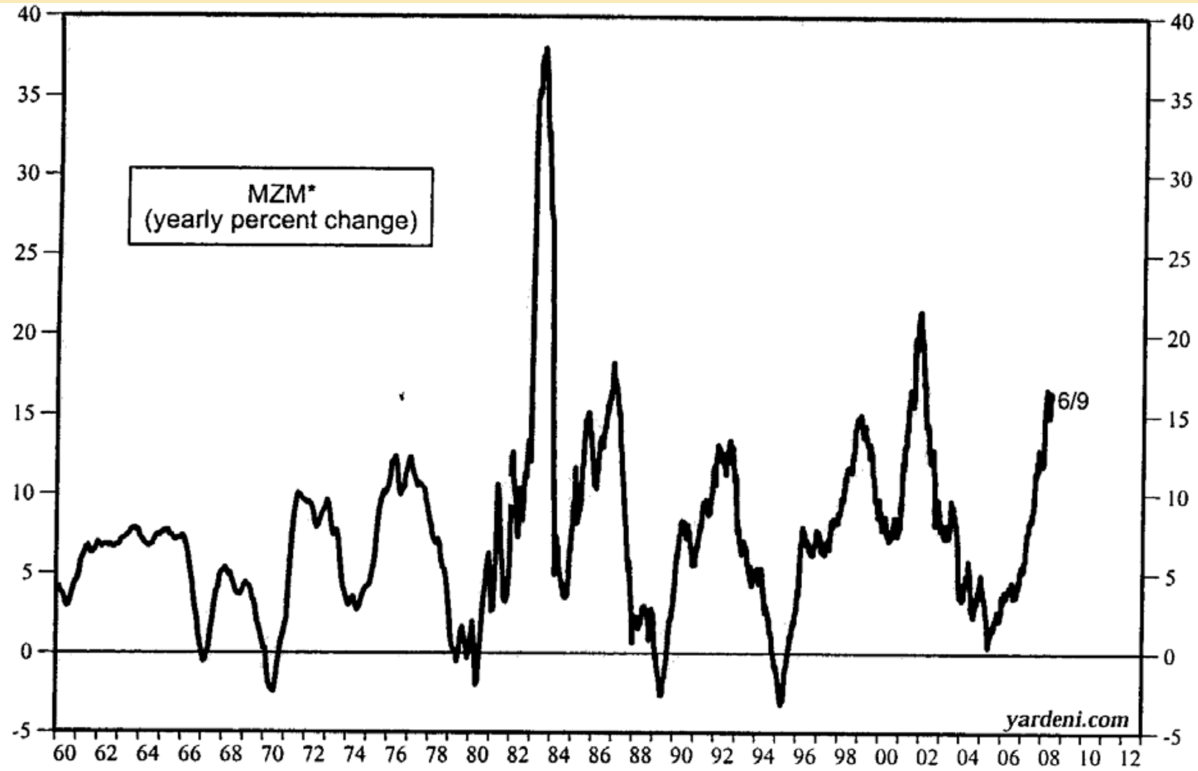
> *"We had an unprecedented global economic boom. A global bust is likely to happen."*
> *"It is quite likely that the current synchronized global economic boom and the universal, all-encompassing asset bubble will lead to a colossal bust."*

As per the analysis of Mr Faber, the policy of Federal Reserve to adopt artifical low interest rate has resulted into strong money supply and credit growth – the root of the present credit crisis.



US economy began to expand in November 2001, but Fed Fund Rate remained at 1% until June 2004

MONEY SUPPLY AND CREDIT GROWTH



Source: Presentation by Mr Marc Faber

The financial crisis has now caught up with emerging markets—with a vengeance. Wherever you look, in Eastern Europe and the Baltics, Latin America or Asia, the financial carnage is evident. Even China, the most immune to contagion, is going to see its growth decline from 12 percent to 9 percent. Elsewhere, panic in global financial markets has compelled the International Monetary Fund (IMF), which previously was trying to adapt to a no-crisis world, back in the lending and financial rescue business. While the IMF engages in talks with Hungary, Iceland, Ukraine, Pakistan, and other countries, the United States and its European partners have begun discussions about stepping in with credit lifelines to middle income developing countries in desperate need of dollar loans to avoid default.

Across Asia, there are pronounced signs of a rapid economic slowdown. According to some commentators, Japan, which posted a second quarter economic contraction of 3 percent, is already in recession. Growth rates in China are still high, but have declined sharply from nearly 12 percent last year to 9 percent for the third quarter of this year. Sketchy reports are already emerging from the country's major manufacturing zones of a wave of factory closures and job losses. South Korea recently announced the lowest growth figure in four years for the third quarter—an annualised 3.9 percent. The international ratings agency Moody's recently forecast a growth rate of 2.2 percent for South Korea next year. The region's heavy reliance on exports makes it particularly vulnerable to any global downturn. Exports accounted for 46.7 percent of gross domestic product in Asia, excluding Japan, in 2007. According to Morgan Stanley Asia Chairman Steven Roach, this is an 11 percent rise since the 1997-98 Asian financial crisis. Asia may not be exposed to the international credit crunch, Roach noted, "but it's certainly levered to the global economy."

Recession in Europe and the US (*source: Warnings of recession send global share markets plunging By Peter Symonds - 25 October 2008***)**

Editorial in a recent London edition of Financial Times entitled "Low Expectations Could Get Lower" commented:

"When there was just a financial crisis, the problem was runs on banks. Now there is a real economy crisis, and the problem is runs on everything. The global economy is stalling and even low expectations are being dashed. Economic activity across the world, everywhere from the US to China, has fallen back. In the UK, data released this week showed that gross domestic product fell by 0.5 percent in the third quarter. This fall is much bigger than anticipated—but worse may follow. By any sensible definition, the UK is already in a recession."

The same newspaper produced a map of Europe akin to a weather map covered with economic clouds, storms and uncertainties. The entire continent showed slowing economies and steeply rising unemployment—the only exception showing "some sunny prospects" was the tiny island of Cyprus.

An International Monetary Fund (IMF) report released this week warned that average growth for the Eurozone plus the UK, Sweden and Denmark would be only 1.3 percent this year and 0.2 percent next year. "Confronted with a crisis in the financial system that is of unprecedented scale, scope and complexity, on top of a commodity price shock, it's hardly surprising that Europe's economy is entering a major slowdown," the IMF's acting European director Alessandro Leipold stated. The report advised all countries to make contingency plans for "a hard landing".

The social consequences of the economic crisis for the working class will be immense. The International Labour Organisation has forecast that 20 million jobs will be destroyed worldwide before the end of the year.

In Europe, as a Reuters report explained: "The inevitable question from workers to governments is: You found billions of euros for the banks, what are you doing now to protect jobs?" The article cited a Reuters survey of economists which predicted that unemployment would jump in France from 7.2 to 8.5 percent by the end of next year. In Spain, where the jobless rate is already 11.3 percent, analysts predicted it could hit 19 percent.

Fears of a global recession were reflected in further plunges on European stock markets yesterday: Britain's FTSE 100 fell by 5 percent, France's CAC 40 dropped by 3.5 percent and the German DAX lost almost 5 percent. Russia shut its stock exchange until Tuesday after the market lost more than one tenth of its value on Friday. The rout continued across the Atlantic in Wall Street, where the Dow Jones Industrial Average finished down 3.6 percent after wild fluctuations throughout the day.

Plunging sales figures around the world are hitting the auto industry hard. US automaker Chrysler, which is in merger negotiations with General Motors, told employees yesterday that the company will slash its white collar workforce by 25 percent, some 5,000 jobs, next month. This comes on top of the elimination of 1,000 jobs at the end of last month. French carmaker PSA Peugeot Citroen is planning "massive" production cuts in the fourth quarter.

Another clear indicator of global downturn is the continuing fall in prices for commodities—the basic inputs for production. OPEC met in emergency session yesterday and imposed a cut in production of 1.5 million barrels a day, or 1.7 percent of world production, in an attempt to prop up prices that have fallen 40 percent since September 10. The announcement failed to halt the slide, with crude oil futures falling another 6 percent.

The Reuters/Jeffries CRB Index of 19 raw materials hit a four-year low this week—the gauge has plummeted 41 percent since hitting a record high in July. Prices for copper, zinc, sugar and coffee were all battered again yesterday. The sharp falls are already having a dramatic economic impact on commodity exporting countries such as Australia and Argentina, but the most savage effects will be on the poorest countries around the world.

Amid this tempest tearing through world capitalism, the leaders of the G-20 are preparing to meet in Washington on November 15 to discuss measures to shore up the global financial system. If they manage to agree on anything, it will be that the brunt of the economic crisis must be imposed on working people in the form of job losses and severe cuts to social spending in order to defend the wealthy elites—as has already been the case with all of the rescue packages so far announced.

Reflection of the world economy on Asian bourses

For the week ended on 24 October 2008, the the Sensex index on Bombay Stock Exchange (BSE) plunged by almost 16 percent and the rupee devalued further against the US dollar amid fears of a marked economic slowdown.

World share markets also plunged on Friday 24 October 2008, as further signs emerged that the global economy is heading for a deep and protracted recession. The largest falls were in Asia, where major exporters are being hit by shrinking markets in the US and Europe. Japan's Nikkei 225 sank by 9.6 percent, India's Sensex fell 11 percent on Friday and South Korea's Kospi plunged 10.6 percent. Across the region, the picture was similar: Hong Kong's Hang Seng was down 8.3 percent, Singapore's Strait Times Index fell 8.3 percent and Taiwan share prices fell 3.2 percent to hit a new five-year low.

As per the available information, losses for the week across the region's eight top markets totalled nearly $820 billion, according to FactSet Research data. The Kospi was down more than 20 percent, the Nikkei down 12 percent and the Sensex down nearly 13 percent.

Impact on Indian economy

Dr Duwuri Subbarao, Governor, Reserve Bank of India, and Leader of the Indian delegation at the International Monetary and Financial Committee Meeting, at the International Monetary Fund, Washington DC, on October 11, 2008:

"India, with its strong internal drivers for growth, may escape the worst consequences of the global financial crisis. Indian banks have very limited exposure to the US mortgage market, directly or through derivatives, and to the failed and stressed financial institutions. The equity and the forex markets provide the channels through which the global crisis can spread to the Indian system. The other three segments of the financial markets - money, debt and credit markets - could be impacted indirectly. Risk aversion, deleveraging and frozen money markets have not only raised the cost of funds for Indian corporates but also its availability in the international markets. This will mean additional demand for domestic bank credit in the near term. Reduced investor interest in emerging

economies could impact capital flows significantly. The impending recession will also impact on Indian exports."

It is evident that since India has played a very important role in world trade (in a role of back office hub – due to availability cheap labour), India is vulnerable to a global downturn.

In an interview with Figaro this month, Singh admitted that a global slowdown would "compromise India's export markets." North America and the European Union, which are both heading for recession, accounted for 16 percent and 21 percent respectively of India's exports. The fastest-growing sector--IT and services known as Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO)--is likely to be seriously affected.

India is sometimes dubbed the "office of the world" because major corporations from around the globe have exploited its large supply of highly-trained, English-speaking graduates to cut business service costs. In 2003-2004, BPO and KPO services earned $ 3.1 billion in export revenues, rising to $8.4 billion in 2006-2007. Nasscom reported that the number of jobs in this sector rose from 216,000 to 553,000 over the same period, and was expected to reach 700,000 this financial year.

Last year, 61 percent of India's BPO and KPO exports were to the US. About 40 percent of Fortune 500 companies in the US favour India for outsourcing their business services. IDBI Capital Market services research head Shahina Mukadam warned: "The slowdown is going to impact on the BPO firms in India. This will eventually result in an overall slowdown of the BPO industry."

The Economic Times explained: "In India, around 60 percent of the companies operating in the IT-BPO sector have been working for American financial corporations like Goldman Sachs, Washington Mutual, Citigroup, Bank of America, Morgan Stanley and Lehman Brothers. Tata Consultancy Services and Satyam Computers have been working for Merrill Lynch, and Wipro has a number of American corporations as its clients that are bruised by the present collapse."

The article added: "It is anybody's guess that layoffs are certain to take place in Bangalore, Hyderabad, Chennai, Gurgaon, Noida, etc." It predicted that 2.3 million young employees working in BPO and other IT sectors would be affected by the financial crisis.

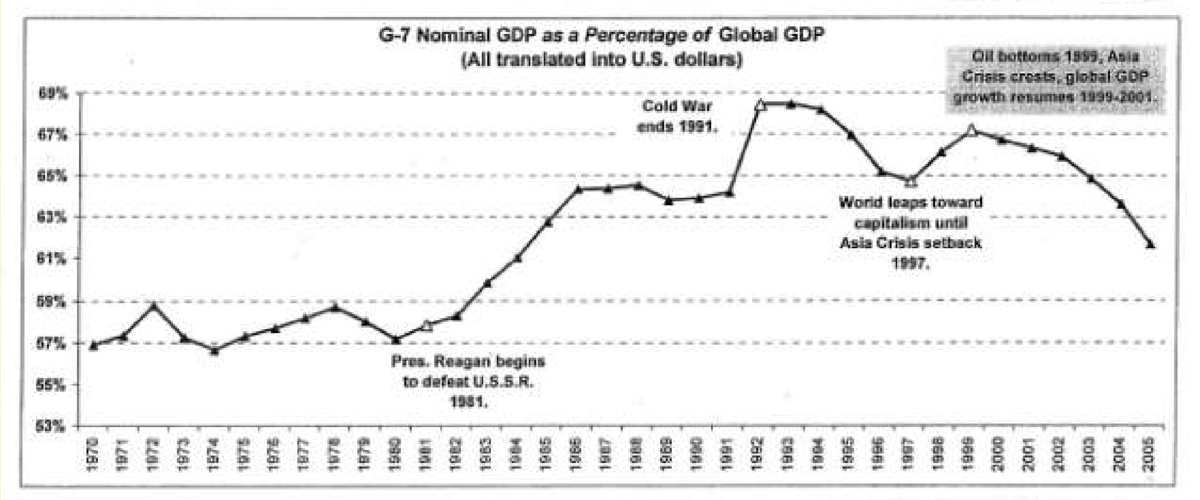
Hardest hit by the economic crisis will be the poorest layers of Indian society whose living standards have already declined as a result of nearly two decades of economic restructuring. The social gulf between rich and poor in India is immense. In March, Forbes magazine reported that the number of billionaires had increased to 53 and their combined wealth was equal to 31 percent of the country's GDP. At the same time, a recent World Bank report found that 42 percent of the population or 456 million people are living below the official poverty line of $1.25 a day.

A global recession will undermine other major export sectors of the Indian economy, including textile and clothing, and lead to mass layoffs. At present, 14 million young people enter the labour market every year but only

10 million get jobs, most on very low wages. Price rises are already eroding living standards. India's inflation rate reached a 13-year high in August of 12.63 percent and is still hovering around 12 percent. A weakening rupee will drive prices up further.

Financial crisis — What Indian Corporates should do

As per the recent presentation of Mr Marc Faber, faster growth would be witnessed in the emerging economies.



Source: Barry Bannister, Stifel Nicolaus & Co.

Policy makers of developed countries are coordinating and taking measures to manage the crisis. It is strongly felt that whilst managing the crisis, the implications of that management for emerging and developing economies would be explicitly factored in. Additionally, it would be desirable that emerging and developing economies should be taken into confidence and consulted whenever the policies and actions of the developed countries have implications for them.

We strongly believe that in short term the prevailing 'credit crisis' shall be appropriately addressed & dealt by the policy makers across the globe. We feel that all of them collectively would endeavor to revive the investors' sentiments and create climate conducive for investments and trade. This would present great investment opportunities for many Indian Corporates to acquire businesses/assets outside of India at attractive valuation.

International Operations: points for consideration

Structuring outbound investments would require careful consideration of not only Indian statutes but also the relevant statutes of the overseas jurisdiction. The operations could be structured having regard to not only tax consideration but also other factors (marketing plans, technological developments, commercial establishment, etc.). It would be difficult to list out all the relevant points. However, an attempt has been made to list out broad consideration which one should pay attention to.

Income Tax consideration

Tax consequences for Indian Company

It would be necessary to review the operations (including import and export activities) of Indian company. The earnings / outflow in foreign currency by Indian company, amongst other relevant factors, would suggest the necessity of structuring the overseas operation of Indian company.

Before concluding the structure, it would be important to review the tax benefits availed by the Indian company. The structure should not jeopardize the tax benefits ordinarily enjoyed by the Indian company.

The projected financial results of the overseas operations should be reviewed. It would be important to note that whilst for the accounting purposes, the Indian company would be allowed to consolidate the results of the overseas subsidiary, under the scheme of the Income tax act, the loss incurred by the subsidiary will not be available to reduce the tax base of the Indian company. Also, it would be important to review the amount and timing of the surplus of foreign entity and its significance for Indian operations

Tax consequences for Foreign Company

The place of incorporation of the overseas company should be determined having regard to the proximity to the market place. However, in order to ensure maximum tax efficiency, it would be important to ensure that the holding company for the overseas operations as well as the operating entities are established at an appropriate jurisdiction.

It would be necessary to examine the nature of activities likely to be carried out by the operating entities so as to conclude the character of income/expense in the hands of the operating entities. Coupled with the same, an analysis of the functions likely to be carried out by the operating entities should be examined. It would be pertinent to note that the same would be useful particularly for the transactions carried out by the operating entities within the group.

The structure would also depend upon the proposed business activities of the group as a whole and also of the operating entities individually. For example, activities by the operating entity for distributing the products manufactured by other group company would envisage some income in the hands of the distribution company. However, at the same time, due consideration will required to be given to the overall mark up expected by the group company which manufactures the products.

Another factor to be borne in mind would be to take advantage of the start up cost. If the operating entity in a foreign jurisdiction is likely to incur start up losses, it would be advisable to establish a representative office of the parent company at the said jurisdiction. This would facilitate the parent company to reduce its taxable income.

Flow of income within the group companies would oblige the remitting company to withhold appropriate amount of income tax. If the group company receiving the income is not in a position to take benefit of such taxes fully, the group as a whole shall not achieve the desired tax efficiency.

Tax consequences for Employees

Deputation or Secondment of the employees of the group to the group company shall require careful planning, particularly if the time likely to be spent by the employee in the foreign jurisdiction is more than 183 days in a financial year. The structure should take into account the likely movement of the employees of the group companies for the international operations.

Additional income tax liability for the deputation or secondment of the employees would add up to the cost of the group as a whole. The structure should minimize the situations which could give rise to any such additional income tax liability.

Transfer Pricing Regulations

The term ‘Transfer Pricing’ in common parlance refers to the price arrived amongst two or more part of multinational enterprise, located at different tax jurisdictions for the purpose of transferring goods and or services. Considering such proximity or the relationship of the contracting parties, such transfers of goods and or services are being sought to be examined minutely by the Tax Officers to ensure that the tax base of such multinational enterprise is divided fairly and the terms and the conditions for the transfer of the goods and or services within the group are at the terms and conditions which would have been otherwise adopted while negotiating similar transfers between the two or more independent entities. In other words the transactions between the multinational enterprise should be concluded at Arms’ Length Price (ALP).

Before concluding the structure, it would be necessary to review the nature of transactions likely to be carried out between the group companies specifically to check the ALP. For this purpose, it would be necessary to check if comparable transactions are available in the public domain to benchmark the same to conclude the ALP.

Thin capitalization rules

When Multinational enterprise set up operations in a new jurisdiction, from the Tax-Angle, it would prefer Debt over Equity for obvious reasons that the as compared to the dividend pay out, interest payment would increase the tax efficiency. Tax Authorities in Countries see Debt Financing to be a source of revenue leakage – technically called Thin Capitalization which Describes "Hidden Equity Capitalization" through Excessive Loans. It connotes use of Interest bearing Debt by majority Shareholders that results in Heavy interest payments that are hidden distributions in Reality. "Thin Capitalization Rules" are Anti-Avoidance measures employed by nations to plug the Revenue leakage.

The structure should ensure that the relevant operating entities shall meet with the Thin Capitalization rules.

CFC rules

CFC stands for Controlled Foreign Corporation. CFC refers to a Foreign Company (say Company M in Mauritius) controlled (owned) by a company resident of other country (say Company I of India). CFC Regulations seeks to bring to income tax, the income of Foreign Company (Company M) in the country (India) of the controlling / holding company (Company I), as determined and quantified under the CFC Regulations. Such CFC Regulations are introduced in the taxation laws of several countries to bring to income tax the specified amount and nature of income arising to the resident company from the foreign company controlled by the said resident company, but for such regulations the same income would have escaped from income tax in the country where the controlling company is resident.

The structure should ensure that the Holding company for the overseas operations would meet with the CFC rules of the relevant country.

Divestment of HC/operating entity

Before concluding the structure, it would be necessary to borne in mind that in an event of divestment of the Holding company and or operating entity, the likely tax liability arising on profit/gain made on such divestment is minimized.

Having regard to the dynamics of today's business, the structure should provide desired flexibility of divesting the holding company without any adverse tax consequences.

Tax credits in India

Under the provisions of the income tax act, the Indian Company earning any income/profit/gain from foreign company is entitled to tax credit.

The tax treaty signed by India with several jurisdictions enables the Indian company to claim credit of taxes which could have been paid at the foreign jurisdiction.

The tax credit which could be available to the Indian company could be either full or partial.

The structure should take into account the provisions of the relevant tax treaty entered into between the relevant countries and the provisions of the Income Tax Act.

Withholding taxes from India

The Indian company making payment to an overseas group entity would be required to withhold appropriate amount of income tax at source. Failure to deduct the same shall attract penalty/interest in the hands of the Indian company.

The tax efficiency of the structure shall depend upon the applicability of withholding tax rates. For example, income in the nature of capital gains earned by an overseas entity incorporated and managed at Mauritius, shall not be subject to any withholding tax in India.

Income Tax laws of the foreign jurisdiction

Finally, the provisions of the domestic law of the relevant jurisdiction shall play a significant role in concluding the jurisdiction of the operating entity.

To provide a quick reference, comparative table providing the tax provisions of Singapore, Mauritius and Hong Kong is provided below:

Comparator	Singapore	Mauritius	Hong Kong
Corporate Tax Rate	20 %	20 % / 15 %	17.5 %
Capital Gain Tax	Tax Exempt	Tax Exempt	Tax Exempt
Taxation of foreign dividend income	Tax Exempt	Taxable	Tax Exempt
Underlying tax credit under	Yes	Yes	Not Applicable
National law foreign tax credit layers	Single Tier	Unlimited	Not Applicable
Method of credit	Source by source	Full tax Credit	Not Applicable
Underlying tax credit in treaty	Yes [Article 25 (2)]	Yes [Article 23 (2) (b)]	Not Applicable

Provisions of FEMA

The overseas operations could be carried out by the Indian company under following routes:

i. Joint Venture Company
ii. Office
iii. WOS

However, to conclude the route for carrying out the overseas operations, due regard shall be required to be given to the following factors:

i. Networth of the Indian Company
ii. Balance in RFC account/EEFC account (limits do not apply)
iii. ADR/GDR (limits do not apply)
iv. Value of investments (if more than US$ 5m, additional conditions are laid down)

Provisions of Service Tax Regulations

Under Indian statutes, the cross border services are classified in two parts – Import of Services and Export of Services. Exhaustive rules are laid down to provide for taxability/partial exemption under specified circumstances from the levy of service tax. This requires to be carefully examined.

In a situation wherein the service tax liability can not be eliminated, the structure should ensure that proper credit for such additional service tax liability is available to set off against the service tax exposure of the group.

Commercial aspects (Raising funds for expansion, risk mitigation, etc.)

The structure should ensure that it provides enough flexibility and access to the foreign capital market for international acquisitions as well as for financing the international operations. This would suggest that the holding company could be situated at Singapore, UK, USA, etc..
For the purpose of raising debt, Hong Kong or London could be the jurisdiction which is regarded as an ideal location to identify syndicators/lenders of international repute.

The structure should also ensure that the operating entity has the requisite legal status (i.e. of a Company or of a Partnership firm). The sound legal status shall offer the multinational enterprise the desired protection against the uncertain business scenario. Also, the legal status should offer the desired comfort to the customers/vendors of the operating entity.

Establishment of entity at foreign location

Before concluding the structure, due weightage shall required to be given to the following

- Time required to set up the entity as well as to wind up the entity.
- Cost for setting up the entity and also for the recurring expenses to comply with the statutory compliances of the foreign jurisdiction.
- Advantages which are offered/available to the group as a whole by establishing a particular entity at the given location

Overview of salient provisions of Foreign Exchange Management Act

Introduction

Investment by Indian Company to acquire shares of the Target Company outside India shall be governed by the provisions of Foreign Exchange Management Act 1999 (FEMA) read with relevant regulations issued by RBI from time to time. In terms of Section 6(3) of Foreign Exchange Management Act, 1999, Reserve Bank of India regulates acquisition and transfer of a foreign security by a person resident in India Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 vide Notification No. FEMA 120/RB-2004 dated July 7, 2004 (as amended vide Notification No. FEMA 132/2005-RB dated 31st March 2005, Notification No. FEMA 135/2005-RB dated 17th May 2005 and Notification No. FEMA 139/2005-RB dated 11th August 2006 & other notifications issued thereafter from time to time (hereinafter referred to as 'the Notification').

Transactions and Investments by an Indian Company outside India are subject to the provisions of FEMA.

Overseas investments in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) have been recognised as an important avenue for promoting global business by Indian entrepreneurs. Joint ventures are perceived as a medium of economic co-operation between India and other countries. Transfer of technology and skill, sharing of results of R&D, access to wider global market, promotion of brand image, generation of employment and utilisation of raw materials available in India and in the host country are other significant benefits arising out of such overseas investments. They are also important drivers of foreign trade through increased exports of plant and machinery and goods from India and also a source of foreign exchange earnings by way of dividend earnings, royalty, technical know-how fee and other entitlements on such investments.

In keeping with the spirit of liberalisation, which has become the hallmark of economic policy in general, and Foreign Exchange regulations in particular, the Reserve Bank has been progressively relaxing its rules and simplifying the procedures both for current account as well as capital account transactions.

Statutory basis

Section 6 of the Foreign Exchange Management Act empowers the Reserve Bank to specify, in consultation with the Central Government the classes of permissible Capital Account transactions and limits upto which foreign exchange is admissible for such transactions. Section 6(3) of the Act further empowers the Reserve Bank to prohibit, restrict or regulate various transactions referred to in the sub-clauses of that sub-section, by making Regulations.

In exercise of the above powers, the Reserve Bank has in supersession of earlier Notification No.FEMA19/RB-2000 dated 3rd May 2000 and amendments thereto, issued Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 vide Notification No. FEMA 120/RB-2004 dated July 7, 2004 (as amended vide Notification No. FEMA 132/2005-RB dated 31st March 2005, Notification No. FEMA 135/2005-RB dated 17th May 2005 and Notification No. FEMA 139/2005-RB dated 11th August 2006 (hereinafter referred to as 'the Notification'). The Notification seeks to regulate acquisition and transfer of a foreign security by a person resident in India i.e. investment by Indian entities in overseas joint ventures and wholly owned subsidiaries as also investment by a person resident in India in shares and securities issued outside India. The summary of the said notifications have been provided below to the extent applicable to the facts of Indian Company.

General Permission

In terms of Regulation 4 of the Notification, general permission has been granted to residents for purchase / acquisition of securities and sale of shares / securities so acquired -

- out of funds held in RFC account; and
- as bonus shares on existing holding of foreign currency shares.
- out of their foreign currency resources outside India.

Foreign currency account with the bank outside India

Reserve Bank of India wide its notification no FEMA47/2001-RB dated Dec 05, 2001 notified that a firm or a company or a body corporate registered or incorporated in India may open, hold and maintain in the name of its office or its branch set up outside India or its representative posted outside India, a foreign currency account with a bank outside India by making remittances from India for the purpose of normal business operations of the office/branch or representative.

It has been provided that the overseas branch/office has been set up or representative is posted overseas for conducting normal business activities of the Indian entity.

The limit for total remittances made by the Indian entity, to all such accounts in an accounting year shall not exceed 2 per cent of the average annual sales/income or turnover during last two accounting years of the Indian entity, where the remittances are made to meet initial expenses of the branch or office or representative, and 1 per cent of such average annual sales/income or turnover where the remittances are made to meet recurring expenses of the branch or office or representative. The restriction shall not apply in a case where the remittances to the account are made out of funds held in EEFC account of the Indian entity, or the overseas branch/office is set up or representative posted by a 100% EOU or a unit in EPZ or in a Hardware Technology Park or in a Software Technology Park, within two years of establishment of the Unit.

Direct Investment Outside India

Automatic Route

Indian Company is permitted to make investment in an overseas joint venture (JV) / wholly owned subsidiary (WOS) by submitting form ODA (refer Annexure I), duly completed, to a designated branch of an authorised dealer bank, upto 300 per cent of its net worth as on the date of the last audited balance sheet. This ceiling will not be applicable where the investment is proposed to be made out of balances held in Exchange Earners' Foreign Currency account of Indian Company.

The above ceiling will include contribution to the capital of the overseas JV / WOS, loan granted to the JV / WOS, and 50 per cent of guarantees issued to or on behalf of the JV / WOS. Such investments are subject to the following conditions:

- Indian Company may only extend loan / guarantee to an overseas concern in which it has equity participation. Indian Company may offer any form of guarantee - corporate or personal / primary or collateral / guarantee by the promoter company / guarantee by group company, sister concern or associate company in India; provided that
- All financial commitments including all forms of guarantees are within the overall prescribed ceiling for overseas investment of Indian Company i.e. currently within 200 per cent of the networth of the Indian Company.
- No guarantee is 'open ended' i.e. the amount of the guarantee should be specified upfront, and
- As in the case of corporate guarantees, all guarantees are required to be reported to RBI, in Form ODR.

Method of Funding

Investment in an overseas JV / WOS may be funded out of one or more of the following sources: -

i). drawal of foreign exchange from an authorised dealer bank in India.
ii). capitalisation of exports.
iii). utilisation of proceeds of External Commercial Borrowings (ECBs) / Foreign Currency Convertible Bonds (FCCBs).
iv). balances held in EEFC account of the Indian Company.
v). utilisation of proceeds of foreign currency funds raised through ADR / GDR issues.

In respect of (iv) and (v) above, the ceiling of 300 per cent of networth will not apply.

Capitalisation of exports and other dues

Indian Company is also permitted to capitalise the payments due from the foreign entity towards exports, fees, royalties or any other entitlements due from the foreign entity for supplying technical know-how, consultancy, managerial and other services within the ceilings applicable. Export proceeds remaining unrealised beyond a period of six months from the date of export will require the prior approval of the Reserve Bank before capitalisation.

Approval of the Reserve Bank

Prior approval of the Reserve Bank would be required in all other cases of direct investment abroad. For this purpose, application together with necessary documents should be made in

i). Form ODB if the investment is for acquiring shares of foreign company engaged in the same core activity in exchange of ADRs / GDRs issued to the later in excess of 300 per cent of the networth of Indian Company or ten times the export earnings (whichever is higher) or for acquisition of shares of a company outside India, in lieu of fees due to it for professional services rendered to the said company.
ii). Form ODI in all other cases.

Reserve Bank would inter alia, take into account the following factors while considering such applications:

1. Prima facie viability of the JV / WOS outside India;
2. Contribution to external trade and other benefits which will accrue to India through such investment;
3. Financial position and business track record of Indian Company and the foreign entity;
4. Expertise and experience of Indian Company in the same or related line of activity of the JV / WOS outside India.

Post investment changes / additional investment in existing JV / WOS

A JV / WOS set up by Indian Company as per the Regulations may diversify its activities / set up step down subsidiary / alter the shareholding pattern in the overseas entity subject to Indian Company reporting to the Reserve Bank, the details of such decisions taken by the JV / WOS within 30 days of the approval of those decisions by the competent authority concerned of such JV / WOS in terms of local laws of the host country, and, include the same in the Annual Performance Report (APR) required to be forwarded annually to the Reserve Bank.

Obligations of Indian Entity

An Indian entity which has made direct investment abroad is under obligation to (a) receive share certificate or any other document as an evidence of investment, (b) repatriate to India the dues receivable from foreign entity and (c) submit the documents / Annual Performance Report to the Reserve Bank, in accordance with the provisions specified in Regulation 15 of the Notification.

Exhaustive rules have been laid down with regard to

- Transfer by way of sale of shares of a JV / WOS
- Pledge of Shares
- Hedging of Overseas Direct Investments

Summary

In order to set up a wholly owned subsidiary Indian Company will have to do the following:

- To check whether the investments are falling under Automatic Route or Approval of RBI is required
- Compliance with the all the specified conditions under the provisions of FEMA

Overview of salient provisions of Income Tax Act 1961

Introduction

India has a well developed tax structure. The main taxes / duties that the Union Government is empowered to levy are Income Tax (except tax on agricultural income, which the State Governments can levy), Customs duties, Central Excise and Sales Tax and Service Tax. The principal taxes levied by the State Governments are Sales Tax, Stamp Duty, State Excise, Land Revenue, Tax on Professions and like. The Local Bodies are empowered to levy tax on properties, Octroi and for utilities like water supply, drainage, etc.

Since 1991 tax system in India has under gone a radical change, in line with liberal economic policy. Some of the changes are:

- Reduction in customs and excise duties
- Lowering corporate Tax
- Widening of the tax base and toning up the tax administration in India

It should be noted that the tax consequences provided in here are based on the present provisions of the Act (as applicable to AY 2009-10). The said provisions are amended by the Government from time to time. Accordingly, the tax consequences may change on amendments carried out by the Government.

The tax incidence on income arising in India shall depend upon the residential status of the taxpayer, nature of income and other relevant factors. As per the scheme of the IT Act, income earned by a resident any where in the world shall be taxed in India and with regard to the income earned by Non Resident shall be taxed under 'source based taxation' method, which entitles India to tax the income arising/accruing in India. Section 6 of the IT Act provides the tests that should be applied to ascertain the residential status of the taxpayer. As regard to the company incorporated at USA, since the entire control and management of the affairs of the company shall be exercised by the Board members at USA and also since the company shall be incorporated at USA, the Company shall be regarded as 'Non-Resident' for the purposes of the IT Act.

Section 9 (1) (i) of the IT Act provides that with regard to the non-resident all income accruing or arising, whether directly or indirectly, through or from any:

- business connection in India; or
- property in India; or
- asset or source of income in India; or

- a transfer of a capital asset situated in India, shall be deemed to accrue or arise in India.

Explanation (a) to that clause provides that in the case of a business of which all the operations are not carried out in India, the income of the business deemed under that clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India.

Consideration for overseas operations

For taxation of Foreign Company in India

Non-Resident (including a Foreign Company) would be subject to the provisions of the IT Act. Section 4 (Charge of Income Tax) read with Section 5 (Scope of total income) of the IT Act provides that a Non-Resident would be chargeable to tax in India only in respect of the income earned during a financial year which is either received or deemed to be received in India in that year; or which accrues or arises or is deemed to accrue or arise in India during such year. It is a common principle that tax liability in the hands of Non-Resident shall be determined on the basis of nature of relevant income. Depending upon the nature of income, Non-Resident shall be subject to Income Tax in India in the method and manner applicable to such income as prescribed under the provision of the IT Act read with concessions / exemptions provided under the treaty. In view of the provision of subsection 2 of section 90 of the IT Act and several judicial decisions in this regard, in relation to the tax payer to whom the treaty (viz. the agreement for avoidance for double taxation) applies, the provisions of the IT Act shall apply to the extent they are more beneficial to the concerned tax payer. It is a well established that tax payer who is liable to pay Income Tax in India has an option to avail the beneficial provision of the treaty vis-à-vis the provision of the IT Act. In this connection, reference is invited to the decision in CIT V/s Vishakapatanam Port Trust [1983] reported at 144 ITR Page 146 and CIT V/s Hindustan Paper Construction Limited [1994] reported at 77 Taxman 450. Accordingly, to conclude the tax incidence analysis of the relevant provisions of the IT Act as well as of the relevant treaty shall be necessary.

Indian Company should therefore give due consideration to the aforestated principle before concluding the international structure.

Taxability of foreign employee earning income from Indian Company

Under the provisions of the Act, taxation of individuals is based on their residential status. An individual is regarded as a ‘resident’ in a financial year (the financial year runs from April 1 to March 31), if he stays in India:

- For 182 days or more during the financial year ; or

- For atleast 60 days during the financial year and has been in India for an aggregate period of 365 days or more in the previous 4 financial years.

A person not satisfying both the above conditions is a non-resident in India in that financial year.

A resident individual is 'ordinarily resident', if he satisfies the following two conditions:

- He has not been 'non resident' in India in nine out of the previous ten financial years; and
- His stay in India exceeds 730 days in the previous seven financial years.

A resident not satisfying any one of the above conditions is a person who is 'Resident but not ordinarily resident'.

Tax Incidence for representative office of an Indian Company outside India

The representative office of Indian Company in foreign jurisdiction shall not generally attract any income tax at the said location.

Under the scheme of the tax treaties normally entered into by India with other foreign countries, the representative office of an Indian company in the foreign country shall not be regarded as 'Permanent Establishment' in the foreign country. Moreover, the functions performed by the representative office of Indian Company in the foreign country shall be merely that of representing the Head office and no business activities shall be carried on by such representative office.

As per the scheme of IT Act, Indian Company would be entitled to offset the loss/expenses incurred at the foreign country where the representative office is located, against its taxable income.

Tax Incidence of select income earned by Indian Company from it's overseas operations

The income earned by Indian Company from its overseas operations would be taxed in India. The tax incidence shall depend upon the nature of income. For example, the technical know how fees earned by Indian Company from overseas operations shall be regarded as its business income and shall be taxed accordingly. Similarly, capital gains earned by Indian Company from transfer of a capital asset shall be taxed under the head income from capital gain.

Indian Company would be entitled to claim credit of the taxes borne by it in the respective foreign country on such income.

Analysis of withholding tax rates applicable on the select income if earned by Indian Company has been tabulated below. For the purpose of the said table, analysis is restricted to select country. The table below would provide the withholding tax rates as applicable on the relevant income earned by Indian Company. It should be borne in mind that the nature of income earned by Indian Company should meet with the definition of such income provided under the relevant tax treaty signed by India.

Particulars	USA	Japan	China	**Switzerland**
Technical Know how fees	**15 per cent**	**10 per cent**	**10 per cent**	15 per cent
Royalty Income	**10 per cent**	**10 per cent**	**10 per cent**	10 per cent
Dividend Income	**15, 10 or 25 per cent (as may be applicable)**	**10 per cent**	**10 per cent**	15 per cent
Interest Income	**10 or 15 per cent (as the case may be)**	**10 per cent**	**10 per cent**	10 or 15 per cent (as the case may be)
Capital Gains	**As provided under the domestic law of USA**	**As provided under the domestic law of Japan**	**As provided under the domestic law of China**	Not subject to withholding tax if gain arises from the transfer of shares of a company which is resident of Switzerland
Credit available in India	**Yes**	**Yes**	**Yes**	Yes
Method of Credit	Not exceeding that part of the income tax (as computed before the deduction is given) which is attributable to the income which may be taxed in the United States, Japan, China or Switzerland, as the case may be			

Note:

1) Withholding tax rate for dividend income at USA: withholding Tax shall not exceed:

(a) 15 per cent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 per cent of the voting stock of the company paying the dividends;

(b) 25 per cent of the loss amount of the dividends in all other cases.

2) Withholding tax rate for interest income at USA: withholding Tax shall not exceed:

(a) 10 percent of the gross amount of the interest if such interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company); and

(b) 15 percent of the gross amount of the interest in all other cases.

3) Withholding tax rate for interest income at Switzerland: withholding Tax shall not exceed:

(a) where the interest is paid to a bank carrying on a bona fide banking business or to an enterprise which holds directly or indirectly at least 20 per cent of the capital of the company paying the interest which are a resident of the other Contracting State and are the beneficial owner of the interest, 10 percent of the gross amount of the interest; and

(b) 15 percent of the gross amount of the interest in all other cases.

The representative office of Indian Company in foreign jurisdiction shall not generally attract any income tax at the said location

Under the scheme of the tax treaties normally entered into by India with other foreign countries, the representative office of an Indian company in the foreign country shall not be regarded as 'Permanent Establishment' in the foreign country. Moreover, the functions performed by the representative office of Indian Company in the foreign country shall be merely that of representing the Head office and no business activities shall be carried on by such representative office.

As per the scheme of IT Act, Indian Company would be entitled to offset the loss/expenses incurred at the foreign country where the representative office is located, against its taxable income.

Overview of certain provisions of Transfer Pricing Regulations

The applicability of Transfer Pricing Regulations under the Act vis-à-vis the Treaty

Simply stated the terms ‘Transfer Pricing’ refers to the price arrived amongst two or more parts of a multinational enterprises for the purpose of transferring or providing goods and or services (including transfer of tangibles or intangibles, loan agreements, etc.).

Under the Act

With an aim to ensure that the amounts of profits that are sought to be taxed in India are not understated (or losses are not overstated) or overstated (or losses are not understated) either by declaring lower receipts or by declaring higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in same or similar circumstances, Transfer Pricing Regulations (‘TPR’) were introduced in the Indian Income Tax Act by the Finance Act 2001.

The TPR provides a statutory framework that would lead to the computation of reasonable, fair and equitable profits and incidence of income tax in India with regards to the transfers between different parts of a multinational enterprise.

The Indian TPR can be broadly divided under following categories:

Specific sections have been incorporated under the Act inter alia laying down the TPR. The same are further classified as:

- Definition - Associated Enterprises (under Section 92A), International Transactions (under Section 92B) and other relevant terms (under Section 92F)
- Computation of Income (under Section 92 by substituting the existing section) and Arm’s Length Price (under Section 92C)
- Procedural - Maintenance and keeping of information and or documents (under Section 92D) and Furnishing the Report of Accountant (under Section 92E).

Rules for determination of arm’s length price

Rules in support of the above sections have been incorporated under the Income Tax Rules (“the Rules”). The said rules are Rules 10A to 10E inter alia prescribing the manner of determination of arm’s length price, factors that need to be considered while making such determination, the methods that can be used for determining the arm’s length price and the nature and type of information / documents that should be maintained over and above the accountants report.

Under the Treaty

The TPR embedded in the Act are in line with the internationally recognized norms to determine the transfer price between two related parties. The Treaty would normally provide definition for identifying the applicability of transfer pricing rules under the Treaty. Article 9 of the treaty between India and US, India and Japan, India and China & India and Switzerland defines the Associated Enterprise (AE).

This definition is in line with the definition for AE provided under the Act.

Cross Border Mergers and Takeovers

Present scenario

In wake of the unprecedented financial turbulence across the globe, the representatives of various country have come together to bailout the stakeholders. It appears that to bolster the sentiments of the investment community, the policy makers would create a conducive environment for cross border trade & investments. This would offer tremendous opportunities for Indian corporates to expand it's overseas.

Several strategy of such expansion could be either Foreign companies being merged in to Indian Companies or Indian Companies taking over Foreign Companies or Foreign Companies being taken over by Foreign Companies and such Foreign Companies taken over by Indian Companies.

The inflationary factors felt by the today's global market, may open wide doors for Indian companies / players to acquire the companies outside India at lower consideration and gain in long term

Applicable statues for cross border mergers and takeovers

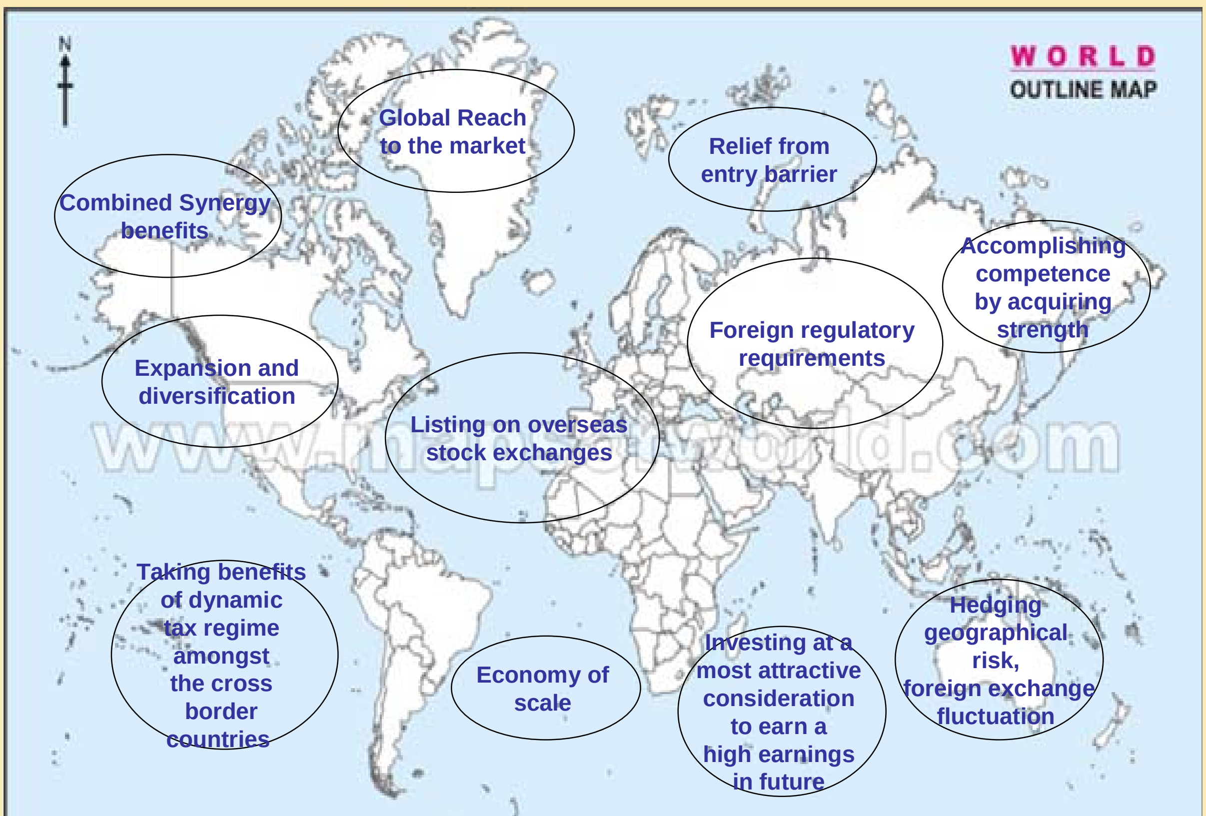
The table below would provide an overview of the applicable statutes under different scenario of expanding the business outside India by Indian corporates.

Applicable statutes	Strategy 1 – merging foreign company into Indian Company	Strategy 2 – take over of foreign company by Indian Company
Companies Act, 1956	Primarily section 391 to section 394	Section 372A dealing with investment by Indian Company
FEMA	The Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000	The Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000
Income Tax Act	• There would be no tax incidence in India on the merger of Foreign Company into Indian Company • The merger may attract tax in the foreign country of Foreign Company	This transaction should be tax neutral in India. However, the shareholders of Foreign Company may have to pay Income Tax, if any, in their country
Stamp Duty	Issue of shares may attract stamp duty	• Acquisition of shares does not require any conveyance

Applicable statutes	Strategy 1 – merging foreign company into Indian Company	Strategy 2 – take over of foreign company by Indian Company
		and hence, there is no question of any stamp duty arising in India • Its need to be verified whether acquisition of shares abroad attracts stamp duty in the country of the situs of the shares
Foreign laws	As may be applicable, as may be advised by foreign consultant	As may be applicable, as may be advised by foreign consultant

Key driving factors in Overseas / outbound investments

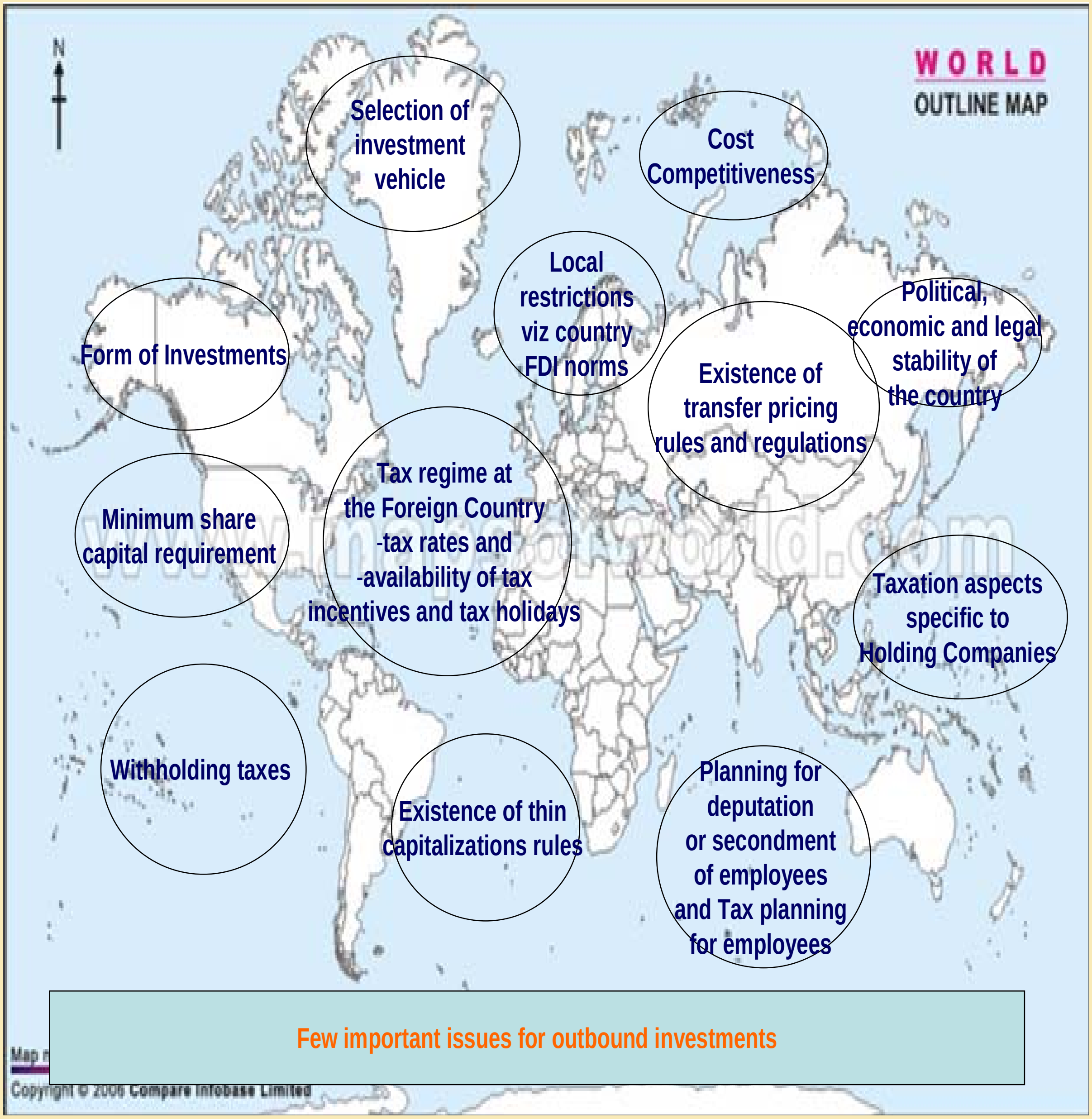
The diagram below would provide key driving factors for overseas/outbound investments.



Key driving factors in Overseas / outbound investments

Few important issues for outbound investments

Attention is invited to the following diagram that provides few important issues that should be borne in mind before concluding the structure for outbound investments by Indian Company.



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