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Analysis and Path Ahead

Thought Leadership

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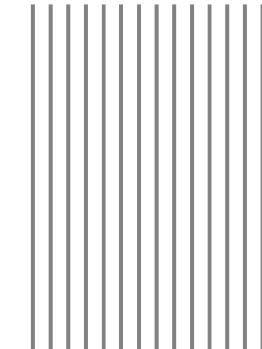

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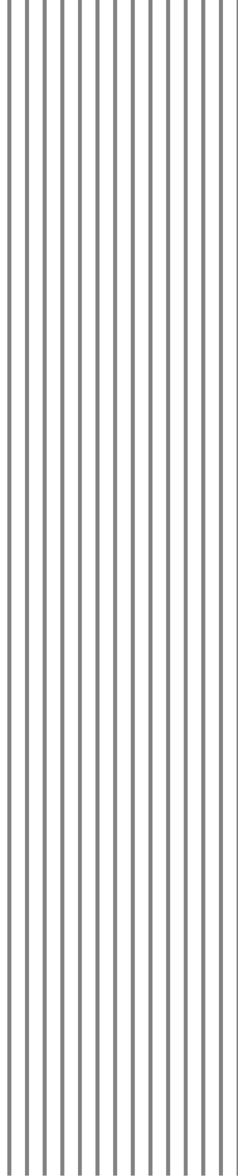

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Foreword

The 2008 Budget has been drawn up with an eye firmly on the forthcoming elections. The key focus points in the Budget are the farmers, the consumers and inflation. The centrepiece of the Budget proposals is the farm debt waiver. At Rs 60,000 crores, it represents around 3 percent of all outstanding bank loans. While previous Governments have implemented debt waivers, nothing approaches the scale and magnitude of the current proposal. This move is expected to benefit over 40 million farmers, although at around 1.2 percent of GDP combined with the risk of moral hazard, there may be a price to pay in the longer term.

With the economy showing distinct signs of slowing down, the Budget seeks to provide support to private consumption through a combination of an across the board reduction in excise duties and central sales tax and by placing more money in the pockets of consumers through an increase in the base income exemption threshold from Rs 110,000 to Rs 150,000. Consumption will likely find further boost following the implementation of the Sixth Pay Commission report. These tax cuts should also bring down headline inflation, provided the savings are passed on to the consumers.

The Budget forecasts a nominal GDP growth of around 13 percent; adjusted for inflation, this places real growth next year at around 8 to 8.5 percent. The Fiscal deficit target has been set somewhat ambitiously at 2.5 percent; the Revenue deficit target at 1 percent also appears optimistic, and is predicated on continuing tax buoyancy -15 percent and 20 percent year on year for indirect and direct taxes, respectively.

There were few changes to the tax structure, rates and framework. Surprisingly, there was no reference made to the new income tax code. There was also little discussion on the implementation of Goods and Services Tax by 2010. Limited tax relief has been provided for dividend distributions by subsidiaries to parents, although the rationale for the construct adopted is unclear. Tax on short term capital gains has been raised from 10 percent to 15 percent, one of few proposals that increases the rate of tax. While the rate of service tax has been maintained, its reach continues to extend inexorably. Customs duty rate reductions have been kept in abeyance, in view of the appreciating rupee. The Banking Cash Transaction Tax has been quietly buried; regrettably Fringe Benefit Tax, that was introduced the same time, continues to survive and torment. Procedural and other amendments appear to be focused on enhancing tax collections. On the other hand, amendments and policy prescriptions that could potentially alleviate difficulties that taxpayers continue to experience do not appear to have received adequate attention. A disturbing though predictable feature of the Budget is the number of amendments that have been made with retrospective effect; while described as clarifications, these seek to alter taxing positions going back several years.

Tax reform and tax policy are no longer the sole preserve of the annual Budgeting exercise, and we expect the journey of tax reforms and changes to be fast paced over the next few years. Whether it is introduction of a CFC legislation, or the GST regime, change is certain and this will require all quarters to continuously reinvent.

We have in this publication, as part of our Thought Leadership initiative, provided an outlook on a series of tax and policy aspects that are likely to occupy the mind space of taxpayers and investors in the coming fiscal year and continue to provide food for thought.

Bobby Parikh
Mukesh Butani

March 8, 2008

Tax policy and tax administration reforms – key to buoyancy

Tax reforms in India have largely concentrated on tax rates than tax administration, but key to greater compliance is a friendly tax environment.

BY MUKESH BUTANI AND TANMOY CHAKRABARTI

Introduction

Comprehending the bigger objective of resource mobilization for the economy seldom has its desired trickle down effect beyond the minds of policymakers and economic thinkers but taxpayers have often agreed that if they pay taxes in a taxpayer friendly environment they hardly mind it. However, whether a country's tax environment is taxpayer friendly is the question on which, hinges the success or failure of tax policy. Unless and until taxpayers understand the need and importance of paying taxes and to ensure that the Government presents a friendly backdrop, the mismatch shall continue to happen and any tax reform procedure shall fail to achieve its desired objectives.

India's grandeur in terms of its size and intricate political dynamics has historically had bearing in every economic policy it has embarked upon. Taxation policies have not been immune to this either. However, with the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) in 2004, taxation policy has come on top of the Government's agenda.

Despite efforts by successive Governments to develop a tax reform strategy encompassing an entire gamut of reforms, cost of compliance in India still remains high by global standards and it can no way be regarded an easy tax paying nation. This is due to the fact that subsequent tax reforms agenda though recognized the need to improve tax administration but the efforts have been more concentrated on bringing changes to tax rate structure. The cost of compliance in India still remains one of the highest in the world.

It is of utmost importance, thus, to bridge the gap between willingness of taxpayers to pay taxes and the noble intent of policymakers to mobilize revenue through revenue collections.

On the backdrop of the current federal budget, it shall be interesting to see whether India is on course to achieve what it set to achieve in terms of tax reforms and what it needs to do further.

Genesis of reforms

A brief historical perspective shall demonstrate that perhaps policymakers did not have much choice until the millennium came.

The seventies saw exorbitantly high tax rates in India without justification and inputs were taxed indiscriminately pretty much until the arrival of 1991 tax reforms. Tax administration mechanisms were complex and arbitrary and this called for an urgent need to undertake reform initiatives as evident from the Wanchoo Direct Taxes Enquiry Committee report (Government of India, 1971), which

quoted as follows :

"…the marginal rate of taxation is as high as 92.75 percent, the net profit on concealment can be as much as 4,300 percent of the after tax income. We will not be surprised that placed in such a situation, it would be difficult for a person to resist the temptation to evade taxes…"

We have progressed a long way from those days of higher rates and tax reforms agenda was the key instrument in Dr Manmohan Singh's liberalization policy of 1991.

Though the Tax Reforms Committee (TRC) reports did initiate reforms in tax administration including deployment of modern information technology and on-line linkage of new identification numbers to a national network, no constructive results materialized.

Despite political upheaval (two major changes in Government), most of the above policy recommendations were implemented and more importantly perhaps the broad thrust on tax reforms that Chelliah Committee report wished to provide was acknowledged and accepted by subsequent Finance Ministers. By 2000, following the TRC recommendations, India's tax system looked moving towards the right direction. Some of the key reform initiatives in tax administration procedures during the period leading upto the Kelkar Committee of Direct and Indirect taxes (in 2002) are listed in the following table:

Year	Reform initiative
1993	40 additional posts of Commissioner of Income-tax (Appeals) created. Authority for Advance Rulings set up
1994	New PAN introduced. Regional Computer Centres (RCCs) were set up in Chennai, Delhi and Mumbai
1995	New procedure for search assessment introduced
1996	77 posts of Commissioners of Income-tax created
1999	Samman Scheme introduced to honour deserving tax payers
2001	Jurisdiction pattern was revamped
2002	Computerized processing of returns all over the country introduced

Given this backdrop, the need to further reforms were felt and for the first time tax-to-GDP ratio and improvement of tax administration and taxpayer services for increasing voluntary compliance came into the forefront.

Dr Shome's report of the Advisory Group of India 2001 highlighted the agenda for the future and then came the "Kelkar" reports of Task Forces on Direct and Indirect Taxes which paved the way for FRBMA in 2003 – the backbone of India's fiscal reforms in the new millennium.

Taxation Reforms and FRBMA

The Indian Parliament passed the FRBMA in 2004 under the United Progressive Alliance (UPA) regime though the law was drafted by the regime led by Bharatiya Janata Party (BJP). The law became operational with notification of the Act and statutory Rules by the current UPA Government in July, 2004.

The FRBMA is based on the report "Implementation of the Fiscal Responsibility and Budget Management Act", 2003 by the task force headed by Dr Vijay Kelkar.

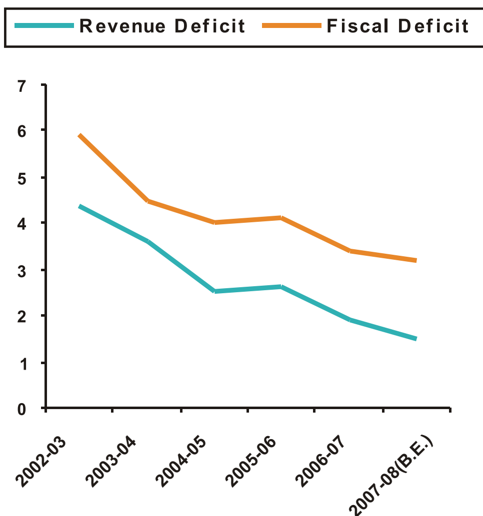
FRBMA was enacted with the basic objectives of reduction of fiscal deficit and total elimination of revenue deficit within a stipulated timeframe, and is the

cornerstone of revenue mobilization initiatives by the Centre.

Recent public finance statistics, undoubtedly shows India's commitment towards adherence to FRBMA targets have reaped benefits. Backed by strong Gross Domestic Product (GDP) growth figures, fiscal consolidation process has made India a stronger force, widely acknowledged by global economy.

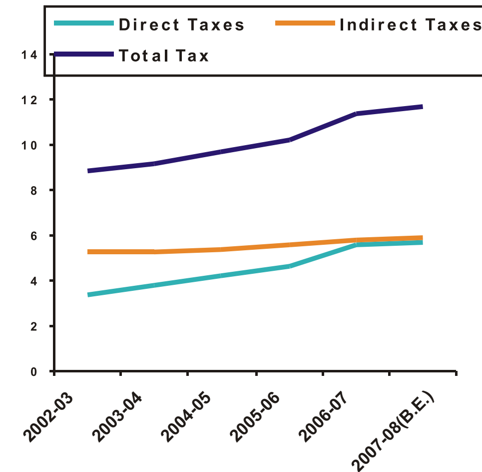
On tax-to-GDP front, India has improved significantly over the years. Though it is debatable whether India's tax-to-GDP statistics is the proper representation of the revenue mobility, but undoubtedly the progress made is commendable. A cursory glance at the three graphs below shall provide enough evidence of India's achievement in fiscal prudence post-FRBMA enactment. These figures derived from the Government statistics exhibits the fall in deficit indicators, the buoyancy in tax collections and rising tax-to-GDP ratio in India over the last few years.

Figure 1: India: Deficit Indicators



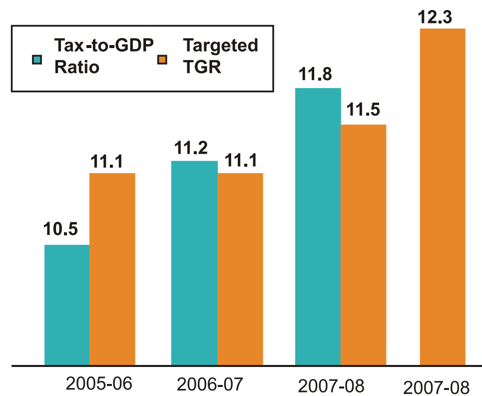
Source: Ministry of Finance

Figure 2: India: Federal tax collections



Source: Ministry of Finance

Figure 3: India: Tax-to-GDP ratio



Source: Ministry of Finance

Concerns do remain insofar as quality of Government expenditure is concerned but by Government's own admission that should not prove as a major deterrent in the fiscal consolidation process.

Fiscal prudence exhibited by both Federal and State Governments post FRBMA enactment is undoubtedly praiseworthy.

Though post FRBMA enactment, tax administrative effort has been at a faster pace than the pre-FRMBA regime, cost of compliance and rates of voluntary compliance by the taxpayer continues to remain a worry factor for policymakers. Some of the key administrative reform

FRMBA set to establish an economically efficient, effective and equitable tax system which will facilitate voluntary compliance

initiatives undertaken during the post-FRBMA enactment are highlighted in the following table:

Year	Reform initiative
2005	• Computerized Help Centres were set up through Public-Private Partnership Model to provide facilities for small taxpayers for filing return of income, challans, computing income and tax, and other tax related advice
2006	• Facility for online tracking of tax payments and tax deducted at source made available to taxpayers • Income Tax Department became fully computerized • Risk Management System for Customs • Electronic Data Interchange (EDI): Extension of EDI to more locations
2007	• Scheme of mandatory e-payment of taxes is proposed to be made effective from April 1, 2008· Pilot project on e-payment of customs duty in Delhi was completed· Mandatory e-payment for major taxpayers in service tax

Areas of Concern

Subsequent reforms though have brought India to a much better level when tax administration is concerned but there are key issues which definitely need to be addressed. Two most significant of those are discussed below:

Voluntary Compliance

While developing an econometric model based on direct tax collections, a recent publication (Kumar, Nagar, Samanta, December, 2007) have drawn the following interesting results:

- Voluntary compliance in India is not more than 50 percent in either income tax or corporate tax
- Around 44 percent of companies do not file their corporate tax returns. Lack of proper enforcement mechanism is cited as one of the major causes
- Delinquent taxes (taxpayers who despite having taxes due from them have not paid them) have shown a steady rise of 30 percent compounded annual growth rate
- Penalties on individual taxpayers do act as a deterrent but such an effect is not very predictable in the case of corporate taxpayers

Economists have developed a voluntary compliance index resulting from their analysis and widespread fluctuation in the index only establishes the fact that India's voluntary compliance myth needs additional time to correct itself. Considering the period from 1995 to 2007, the increase in voluntary compliance is only by 5 percentage points. To the analysts, this is certainly not an appreciable rise, considering the fact India is engaged in an exercise of fiscal prudence post FRBMA enactment.

The authors go on to conclude that efforts of the Income Tax department in facilitating the speedy allotment of Permanent Account Numbers, facilities for online preparation of tax returns and their filing, electronic clearing of refund payments, launching of Tax Return Preparer Scheme etc, may have certainly made tax filing and tax payment easier and encouraged voluntary compliance, but without sufficient and effective tax enforcement mechanism, desired voluntary compliance may not be there.

While fiscal prudence exhibited by both Federal and State Governments post FRBMA enactment is undoubtedly praiseworthy

Cost of Compliance

A recent report published jointly by World Bank and Pricewaterhousecoopers (Paying Taxes 2008) puts forth a case for India to improve tax administration.

In the World Bank-PwC report, economies are ranked on their ease of doing business, from 1–178, in the ascending order. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business.

India has a dismal ranking of 165 amongst 178 economies. Cause of concern is India's ranking has fallen by seven places in one year.

These rankings take into consideration various aspects of taxation. In every parameter India has a low score. The key results are explained in the following table:

Indicator	India	OECD
Compliance Time (Hours)	271	183.3
Payments (Number)	60	15.1
Total tax rate (% profit)	70.6	46.2

Source: Paying taxes, 2008

The data shows the tax that a medium-size company must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes. These measures include the number of payments an entrepreneur must make; the number of hours spent preparing, filing, and paying; and the percentage of their profits they must pay in taxes.

These figures on voluntary compliance and cost of compliance bring down India's competitiveness to a great extent and may be a dampener in the short to medium term.

Path Ahead

Globally, several best practices are followed to ensure smooth tax administration system and it seems India needs to adopt the same too. Currently since focus seemed to have been on ensuring smooth compliance mechanism through usage of information technology, we can highlight some issues as suggested by OECD from the experiences in its member countries:

- Revenue bodies that have achieved a relatively high compliance of electronic services typically have a multi-faceted set of strategies to promote usage by taxpayer
- Information campaigns utilizing a variety of channels are an essential component of revenue bodies' set of strategies
- The use of incentives (eg faster refunds of overpaid taxes and extended filing periods) appears to play a significant role in encouraging a greater level of compliance, particularly concerning the personal income tax
- Mandatory electronic filing arrangements have typically targeted larger businesses and Revenue has typically taken a cautious "soft approach" in the early years of these arrangements
- Tax professionals, who prepare a fair proportion of tax returns in many countries, are critical stakeholders to the effective operation of electronic filing systems and should be consulted widely and regularly on the development and operation of electronic filing systems
- Taxpayer service charters describing taxpayers rights and obligation should be implemented to garner a more taxpayer friendly environment

India's voluntary compliance myth needs additional time to correct itself

- Enforcement mechanism to be strengthened and made accountable

- Caller accessibility system to be established where calls answered within 2 minutes of entering the queue

- Taxpayer is treated as a client who provides satisfaction ratings; and client evaluation of products / satisfaction with service

Though, it appears that we may have implement some of the OECD suggested measures, our progress will be tardy, if implementation is not monitored and measured. An illustration would be Tax Ombudsman initiative implemented in 2006. It is time to assess the impact of such initiatives. We have of course maintained that India's Tax Ombudsman should have been lent a legislative tooth.

One of the expectations from this budget was the much awaited announcement of "New Income Tax Code". This code shall simplify and replace the nearly five decades-old law. It is expected the new code will go a long way to ensure a better tax administration system.

In summary, need of the hour is to achieve the most optimal policy where enforcement mechanism for non-compliance is stringent and taxpayer is ensured a friendly environment. Certainly, it shall be an icing on the cake following India's growing importance in the world market.

Cost of compliance bring down India's competitiveness to a great extent and may be a dampener in the short to medium term

Personally, we feel that the working paper on New Income Tax Code will become a reality in the current session of the Parliament. However, one needs to wait and examine if the paper adequately deals with tax administration challenges and strategies to deal with it.

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IT blues – phasing out tax holidays in the time of recession

Does India's IT sector require a resetting of the tax holiday clock?

BY ABHISHEK GOENKA AND VINAY SAMBARAGIMATH

A time for introspection

Now that the dust has settled on the Union Budget 2008, it is time to introspect and ponder over the impending sunset clause on the tax holiday for the Indian software industry provided under section 10A of the IT Act, bringing the curtains down on one of India's most celebrated fiscal incentive, which many believe led to a nascent IT industry turning into one of the most significant drivers for the Indian economy.

Seen in the backdrop of the looming recession in the US, slowing growth rates of the Indian IT sector and the steady and appreciating trend in the Rupee, the stark reality facing the IT sector in India is hard to miss and it is not difficult to see why there has been such a clamor by the Indian IT industry, with intense lobbying for resetting the tax holiday clock under section 10A of the IT Act.

Tax holidays - Policies of Government over a period of time

Globally, tax reforms and policies are most often influenced by economic realities coupled with cost of implementation and compliance and the developed status of the nation.

In India also, over the years, from almost being a watchdog of the Indian Industry with heavy socialist overtures, the Governmental policies have matured to embrace a capitalistic philosophy and has sought to be an enabler for growing trade and business and integrating India with the world economy. Tax policies in India have always sought to do a balancing act between the aim of garnering revenues for social and infrastructure development coupled with incentivizing and enabling change in specific sectors of the Indian economy. More specifically, the policies have had multiple objectives of growth, encouraging specific industries, employment generation, fresh investments in rural and less developed areas and shoring up foreign exchange reserves by encouraging exports (particularly in an era where India was struggling to cope with its balance of payments position and much of its exports were from traditional sectors).

Undeniably, the tax sops provided by the Government over the years has been instrumental in giving India a new global face of the knowledge economy. Seen in the context of the GDP growth being sustained over the last couple of years at near double digits, ballooning exchange reserves, lowering fiscal deficits and increased tax to GDP ratio, the policies of the Government over the last decade seem to have achieved the stated objectives remarkably well and has also enabled India to largely escape unscathed from many instances of global turmoil in other economies.

The Government's efforts in recent years have been to broad base and encourage development into the Indian heartland and aid in development of large land parcels

Tax policies in India have always sought to do a balancing act between the aim of garnering revenues for social and infrastructure development and incentivising and enabling change in specific sectors of the Indian economy

into Special Economic Zones (SEZ) creating export hubs and which could carry along with it a ripple effect of ancillary and allied development of the service industry. Toward this, the Government has announced an attractive package of incentives around the SEZ scheme.

At the same time, the Government has been peddling with the idea of moderating tax rates and doing away with a multitude of the tax holidays, including tax holidays under section 10A of the IT Act which is now in its last year.

The changes in tax incentives would need to be seen in the context of expectations and achievements of such incentives. This debate and discussion around the Government's philosophy of phasing away tax holidays has only increased over the last couple of years, especially since there are no agreed yardsticks to measure the impact of tax incentives specifically.

Maturing of the IT Industry and looming recession

The IT industry on its part has embraced the opportunities thrown by a burgeoning and flat world economy in general and the US economy in particular, over the last decade and more. With increased competitive pressures on costs in advanced economies, the IT industry in India has flourished from being a tentative player undertaking Tier 1 offshoring work to a hardcore and advanced hub for undertaking research and development, designing, testing and delivering IT consulting services to the world market.

As a proportion of national GDP, the Indian technology sector revenues have grown from 1.2 per cent in FY 1998 to an estimated 5.5 per cent in FY 2008

The sector has grown at an average annual growth rate in excess of 30 percent over the last couple of years and has truly evolved over a period of time. As per the recent NASSCOM Strategic Review 2008 Report, the aggregate IT and ITeS revenues for fiscal 2008 is expected to reach USD 64 billion, representing a 33 percent growth rate. The report envisages the IT / ITeS revenues to touch USD 73-75 billion over the next 2 years. As a proportion of national GDP, India's technology sector revenues have grown from 1.2 per cent in FY 1998 to an estimated 5.5 per cent in FY 2008 which is a quantum increase and significant contribution. Clearly, the IT sector has emerged as significant export revenue earner and an employment provider with an estimated direct employment to about 2 million people with an additional 6 million people estimated to be employed in associated industries.

Tax incentives and policies of the Government without doubt have played a large part in facilitating the changing landscape of the Indian IT industry. As another measure of performance, aided by economic opportunities and world class visions of the techno-entrepreneurs, the sector has created a number of Indian companies which have matured into buying other companies across the world and creating Indian MNCs which was unthinkable some years ago.

On the other hand, the American markets, in which the IT sector predominantly operates, is clearly witnessing a downward trend owing to near recession in the US economy with lower IT spending. Federal Reserve chief Ben Bernanke has recently said that the outlook for the US economy in 2008 has worsened. This comes in the back of a consistent view being taken by various bankers, like Lehman Brothers, Merrill Lynch and Goldman Sachs, who have in their 2008 forecasts indicated that the US economy is facing recessionary trends with slowdown in growth on account of the housing crisis and tighter credit conditions. The slowdown in the US economy is in turn projected to take its toll on the IT spending by companies. Forrester Research predicts that the global IT spending would grow by 6 percent, after a 12 percent increase in

2007. The US economy in or near recession would be the main cause for the slower 2008 growth pulling down the growth in IT spending both in US and the major trading partners. Forrester has predicted that IT spending in the US will grow by less than 3 percent.

With a heavy dependence on the US markets, the alarm bells might have begun to ring across the Indian IT companies with recent reports citing companies actually retrenching employees and loosing clients.

However, seen another way, the Indian IT industry may actually benefit by the lower IT budgets since this in turn could mean greater opportunities to leverage across a higher value chain and it might be a little too early to cry wolf in response to the slowdown in the US economy having an impact on the Indian IT industry.

Continuation of tax incentives for the IT Industry – for the right reasons

What started as a fiscal aid for neutralizing the various negative factors facing early entrepreneurs in the industry and to encourage investments, exports and a falling currency, is now being perceived as having become an integral part and necessity of doing business, so much so that a belief is created that without the tax sops, the industry becomes uncompetitive vis-à-vis the other developing countries.

When seen in the context of the looming downturn in the global IT sector, which is projected to be a creeping sub 3 percent in the backdrop of a blistering growth rate over the last decade in the IT sector of well over 30 percent, lobbying for an extension of the tax holidays could appear to be the most tempting option for the industry.

Interdependencies of the industry with the global economy is a sign of maturity and ability to withstand downturns in the industry, recessions, job cuts, reduced budget spends is the true test of success beyond the infancy stage in any industry. Although the growth rate for IT industry might be slowing, it is headed to the next phase of "consolidation - shape up or fit out" and it is likely that a more sustainable pattern emerges, after the catch up phase of the last decade. The question remains, therefore, whether slowdowns and upturns in the world markets in which an industry operates should merit fiscal incentives in India.

When viewed from the Government's perspective, tax incentives always have to be balanced amongst a host of competing sectors and competing industries with an opportunity cost for development combined with a crying need for massive investments and long term gestation in the infrastructure sectors like power, ports and other service sectors like tourism and hospitality which are yet to reach the same level of sophistication and maturity as the globally accepted Indian IT industry.

Indian tax policies should be based on the bedrock of encouraging growth and sustenance for sectors which are competing for development and not for protection from global recession or currency movements. Similarly tax incentives based on size within an industry - for instance extending tax holidays for Small and Medium Enterprises or companies below a threshold turnover or years of operation may not merit any specific advantages when compared to similarly sized companies in other sectors.

The IT industry should continue lobbying for tax breaks and holidays, albeit for the next level of advancement and going higher up the value chain. With the challenge of the US recession around the corner and the industry well poised with a 10 year plus tax holiday regime under the SEZ scheme, it might be just the right time for creating intellectual value for the Indian

> *Interdependencies of the industry with the global economy is a sign of maturity and ability to withstand downturns in the industry, recessions is a true test of success beyond infancy*

It might be just the right time for creating intellectual value for the Indian economy and possibly seek policy initiatives and tax benefits centered around creation of intellectual property in India

economy and possibly seek policy initiatives and tax benefits centered around creation of intellectual property in India alongside product and patent development. This would create an environment to enable creation of a highly sophisticated and world class knowledge economy and not just be the back office of the world.

Seen in the context of the above, the IT Industry may truly have to brace for a sunset in the tax holidays as a token of recognition that the IT industry is ready for the next sunrise on its own strong fundamentals with confidence.

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REITs – a move in the right direction

An economy on a high growth path, high disposable income amongst Indians and a search for alternate investment avenues make this an opportune time for introduction of REITs in India.

BY ABHISHEK GOENKA AND AJAY ROTTI

Real Estate Investment Trusts or REITs have been eagerly anticipated in India since the time other Asian markets introduced them in the beginning of this decade and started reaping the benefits. Japan, South Korea and Singapore are amongst the Asian nations which have left India behind on giving impetus to the real estate sector through REITs.

The Planning Commission of India recommended in 2002 that India should make use of REITs to "open the investment floodgate for the real estate sector." At the same time, there were representations made from some players in the financial markets, real estate sector and real estate funds recommending the introduction of REITs. However, the Indian regulators were reluctant and hesitant on introducing a regulation to govern REITs despite the Indian real estate market attracting the attention of investors around the globe.

Ascendas India Trust, the first India focused REIT, has raised SGD 500 million from the Singapore market. Singapore with its established REIT market is attracting many Indian developers, who lacking a home market, are hoping to list REITs in Singapore.

In December, 2007, the Securities and Exchange Board of India (SEBI), the market regulator in India, issued draft guidelines for regulating REITs in India. The draft guidelines have been put up for public comments. As an introduction for putting up the draft guidelines for public comments, SEBI has acknowledged that "REITs play a crucial role and have become a preferred public property investment vehicle around the world." With this backdrop, SEBI introduced the draft guidelines "to encourage and facilitate healthy growth of REITs in India."

What are REITs?

REIT as a concept is based on the fundamental principle of collective investments like mutual funds. REITs pool investors' funds and invest the funds generated in commercial and residential properties. Every individual investor who has pooled his money into a REIT becomes a shareholder or a unit holder and thereby becomes an owner of one unit of a property owned by the REIT. The REIT would earn income from the pool of property in form of rentals, sales, etc which would then be distributed to the investor as dividends. REITs in most countries enjoy single stage taxation.

Typically, REITs makes money in following ways:

- Gains from any appreciation in value of the property;
- Developing commercial space;
- Renting and leasing commercial space, and

REITs pool investors' funds and invest the funds generated in commercial and residential properties

- Financing mortgages and loans on property.

In developed countries, there are REITs that specialise in one or more of these activities. Equity REITs, for instance, make their money from buying, developing or owning property. They make much of their money from the rent and lease charges that they get from their tenants; a part of their income may also come from gains made on the appreciation in property values. Mortgage REITs are engaged exclusively in financing property deals. They derive their income from the interest earned on loans to real estate owners. Hybrid REITs, as their names suggest, may combine the two activities to generate income.

What are the benefits of REITs?

REITs benefit all the stakeholders involved. The investor class, the real estate developers in particular and the real estate industry, the financial markets and the economy on the whole.

For the investor class, REITs offer an innovative option for trading in real estate properties which would be out of the reach of individual investors. The economic success story of REITs is based on enabling all investors the accessibility to income producing commercial real estate as well as liquidity to buy and sell shares of diversified portfolios of properties – from shopping malls to apartment complexes. Institutions such as insurance companies and pension funds are major investors in REITs in the developed world.

For the investor class, REITs offer an innovative option for trading in real estate properties which would be out of the reach of individual investors

For the real estate developers, it offers a route of raising more money for the real estate business. REIT is one of the most popular forms of investment tool in developed markets such as the US, UK and Australia.

The draft regulations for REITs in India

As per the draft guidelines, a scheme should be launched by a trust and be managed by a real estate investment management company, with both parties having to register with SEBI. The trust and the management company for such real estate funds must have a net worth of not less than Rs 5 crore, adequate infrastructure, and professionals with requisite experience in related field.

According to the draft regulations, REITs shall be allowed to launch only close-ended schemes. Further, REITs will not be allowed to launch any scheme without a rating from an approved rating agency and these schemes have to be listed on the stock exchanges mentioned in the offer document. On distributions, the proposed scheme requires REITs to distribute as dividends each year not less than 90 percent of its annual net profit after tax.

The market regulator has also proposed certain limitations on REITs as regards investment in properties. It is proposed not to allow REITs to invest more than 20 percent of total asset value in incomplete and non-income generating assets. REITs would be allowed to borrow only up to 20 percent of the gross assets of the scheme. Further, the overall exposure of each trust to single project is to be limited to 15 percent and the exposure for projects undertaken by the same group of companies is limited to 25 percent. The schemes are mandated to invest only in income generating real estate and not in vacant land.

A resemblance to Mutual Funds in India?

The market regulator, SEBI, has observed in the preamble to the draft REIT regulation "REITs can become the investment vehicle of choice for institutional and retail investors looking to

participate in real estate ownership, management and development. They provide a similar structure for investors buying into real estate as mutual funds provide for investment in stocks."

Undeniably, the proposed operation and regulation of REITs in India is largely based on the operation and regulation of mutual funds. However, a closer look at the draft REITs regulations reveal some inherent differences which are required for the successful introduction and regulation of the REITs. Some of the key differences are enumerated below.

The draft REITs regulations require units of every scheme to be compulsorily listed on a recognized stock exchange immediately after the date of allotment of units and not later than 6 weeks from the date of closure of the scheme. However, in case of mutual funds, listing is not mandatory in prescribed situations - such as where the scheme provides a monthly income facility, or a repurchase facility, or where the scheme is a capital protection oriented scheme, etc.

As per the draft REIT guidelines, a REIT scheme may borrow for financing investment or operating purposes but aggregate borrowings shall not at any time exceed
1/5th of the value of total gross assets of the scheme. However, mutual funds are allowed to borrow only for a short term period not exceeding 6 months and only for the purposes of repurchase, redemption of units or payment of interest or dividend to unit holders.

Currently, mutual funds which are registered with the SEBI are exempt from tax and Non-resident Indians and Foreign Institutional Investors are granted general permission to invest in units of mutual funds subject to complying with prescribed conditions. However, the draft REITs guidelines do not provide any guidance on the tax treatment of REITs or on the category of foreign investors that can invest in REITs.

Benefits in the Indian context

REITs have globally offered many benefits to all the stakeholders. REITs would also provide some additional benefits given the Indian context.

The Indian real estate space has been attracting foreign investors with its attractive returns. REITs would give foreign funds another opportunity to get a share in the Indian real estate markets. Although rules were eased on investment in the sector in early 2005, foreign investors are still not allowed to invest in completed income generating buildings, which could be possible under REITs.

For individual investors, investing in the Indian real estate sector is a notoriously daunting task given the sky-rocketing prices and price volatility and the legal issues relating to clear titles of properties. Investing through a REIT would address most of these issues.

Absence of a taxation regime could make it a non-starter

The proposed guidelines are largely inline with the regulations of other countries which have successfully implemented REITs. However, the Indian regulations currently do not provide any tax benefits to the REITs or to its investors. In most countries REITs enjoy a tax benefits. It is important that a taxation regime for these funds is also announced, so that the legislation can actually be implemented. The amendment in the last budget where the pass through status for venture capital funds was removed has created some anxiety on the final shape of the regulations.

Mutual funds currently enjoy pass through status which means that the income earned by the funds is tax-free. But

Unless tax breaks as applicable to mutual funds are extended by the Government, a local REIT market could be a potential non-starter

depending upon the nature of the fund, any income distributed by the mutual fund attracts a dividend distribution tax. However, the unit holders do not have to pay tax on their dividend income.

REITs schemes necessarily have to be close-ended funds. An investor can acquire shares in a closed-end fund only by buying shares on a secondary market - as opposed to an open-end fund where shares are issued or redeemed after the fund is launched. Currently, investors are not liable to pay tax on long term capital gain arising from transfer of units of equity-oriented mutual funds. The Government could consider extending a similar treatment to capital gains on transfer of units of REITs.

Industry observers feel that unless tax breaks as applicable to mutual funds are extended by the Government to the REITs, a local REIT market could be a potential non-starter. In other markets, where REITs have been successful, the single stage taxation of REITs has always been one of the imperative benefits which have made REITs attractive. Amendments to the stamp duty laws would also be required.

It was widely expected that Budget 2008 would introduce some provisions relating to taxation of REITs. However, with that not happening, it is now unclear when the Government would finally take the required steps.

Conclusion

Implementation of REITs requires a cautious approach given that India still has a relatively immature real estate market which took off in a big way only in 2005 after the easing of foreign investment rules. The Government will also have to put in place a stable regulatory environment to ensure the success of REITs. It could involve a quick resolution and announcement of a taxation regime, announcement of a policy on applicability of stamp duty to REITs, etc.

Once REITs do sweep into the Indian markets, investing will surely become less daunting for investors in property market

Once REITs sweep into the Indian markets, investing will surely become less daunting for millions of investors in the property market.

An economy on a high trajectory growth path, high disposable income amongst Indians and a search for alternate investment avenues make this an opportune time for introduction of REITs in India.

REITs provide better access to competitively priced capital, as well as stronger and more professional property businesses. Given the fact that a significant portion of the urban development in India is being undertaken by the private players, introduction of REITs would be a move which would boost the real estate sector in particular and the Indian economy at large.

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Green energy – tapping India's potential

Fiscal push essential for "green energy".

BY GOKUL CHAUDHRI, PRERNA MEHNDIRATTA AND SHWETA AGGARWAL

Need for Green Energy

Climate change, a global challenge, has wide sweeping implications for rapidly developing economies including India. The increased emission of Green House Gases (GHGs): carbon dioxide, methane, nitrous oxide in the atmosphere trap the solar heat impacting global and regional weather patterns that disturb the ecological balance created over millenniums.

The predominant share of global emissions is attributed to developed countries. The growing energy needs of the emerging economies, predominantly India and China, risks enhanced environmental damage from conventional carbon based sources of energy.

"Green Energy" is a popular term to describe energy derived from resources that are regenerative, for all practical purposes non-depleting, and environmentally benign. These comprises bio-mass, fuel wood, solar, wind, hydro, hydrogen, fuel cells, tidal, geo-thermal, etc

The hopes are for green energy to significantly replace the use of non-renewable fossil fuel energy, thereby mitigating the impact of climate change. In recognition of the concerns of climate change and high oil prices, there is increasing government support for "green energy" around the globe.

Global Investment in green energy

An estimated USD 71 billion was invested in renewable power and heating capacity worldwide in 2007 (excluding large hydropower), of which 47 percent was in wind power and 30 percent was in solar photovoltaic (PV).

The Kyoto Protocol sets mandatory targets for developed nations to collectively reduce GHG emissions. As a step to enhance usage of green energy, countries have set targets. To illustrate, Germany aims to produce 27 percent of its total energy from renewable sources by 2020; several states in US have signed up the "25 by 25" energy plan which aims at 25 percent of power supply to come from advanced energy sources by 2025.

Countries are encouraging the use of renewable energy sources by incentivising generation from renewable sources and granting subsidies to offset the added expense of converting from fossil fuel to renewable energy.

Global policies

Incentives comprise preferred terms for power off-take, tax breaks and soft loans.

Countries offer attractive power off-take with preferential price on supplies from renewable sources, potential price variation and longer duration Power Purchase Agreement. Tax incentives include renewable energy tax holiday,

The use of green energy to a great extent will replace the use of non-renewable fossil fuel energy thereby mitigating climate change

brown energy penalties and accelerated depreciation. Some have introduced tax credit certificates (TCC). TCCs are tax credits granted to renewable power projects on the basis of units of power generated. Soft loan for early stage energy technologies are also provided.

In the United States, every kilo watt of power generated results in tax credit of 1.5 cent in 1993 dollar terms (indexed for inflation) for wind, biomass and geothermal projects. Spain grants tax credit of 6 percent for investment in fixed assets in specified renewable energy sectors. Germany, Spain and other European countries mandate purchase of renewable energy at a preferred tariff to other conventional power sources.

The United Kingdom accelerates depreciation to 100 percent in the first-year on designated energy-saving plant and machinery, and imposes Renewable Obligation (RO) which requires every licensed electricity suppliers to source an increasing proportion of electricity from renewable sources. Similar US laws mandate that 15 percent of energy consumption by investor owned utilities should be sourced from renewable projects by 2020.

Grants are provided in the United Kingdom (the Clear Skies program) up to GBP 50,000, or 50 percent of installed costs for renewable energy projects. There are grants of a maximum of 30 percent of the cost of equipment and for construction activities for biogas, natural gas, bio-ethanol and hydrogen projects.

Countries are encouraging use of renewable energy sources by extending favourable power offtake policies, tax holidays and grants to offset the added expense of converting from fossil fuel to renewable energy

The Indian Scenario

Energy policies have historically focused on conventional sources of energy such as coal, oil and gas. Today, with increased economic growth resulting in accelerated oil imports and recognition of the impact of climate change, the policy thrust is emerging towards renewable energy.

India has potential of over 100,000 MW from green energy, only 10 percent has been exploited.

The plan for new clean energy measures include feed in tariff for solar energy, similar to those implemented in Europe, by early 2008. The policy unveiled in September, 2007 entitles investors in solar power projects to capital subsidies and tax benefits.

In early January, 2008, the Ministry of New and Renewable Energy announced generation based incentive for solar power plants during the 11th plan period. This provides an incentive of Rs 12 per / KWhr for electricity generated from solar photovoltaic and a maximum of Rs 10 per / KWhr for electricity generated through solar thermal power plants and fed to the grid from a grid interactive solar power plant of a capacity of 1 MWp and above. The incentive at a fixed rate for 10 years is available for an aggregate installed capacity of 50 MWP during the 11th plan period. Each state will be allowed to set up an aggregate of 10 MWP installed capacity.

State level policy initiatives are also emerging. The state of Andhra Pradesh plans policy for harnessing wind energy by providing incentives to private developers. Tamil Nadu has set a minimum of 10 percent for purchase of renewable energy by power distributors. West Bengal is in the process of developing a feed in tariff scheme for solar power.

Fiscal push is imperative to promote use of renewable energy, to realization of the policy initiatives.

India presently provides tax incentives for renewable energy projects with accelerated depreciation on specified equipments and tax holiday for power generation businesses. A 10 year tax holiday (in a block of 15 years) is available

to power businesses beginning with the year in which the power generation commences. The tax holiday has a sunset clause of April 1, 2010 (the generation of power must begin before this date for tax holiday). Accelerated depreciation ranging between 80 to 100 percent is available on specified plant and machinery used in power sector. Tax holiday, of 5 years, is available for collection and processing of bio-degradable waste.

The long term potential of the renewable energy sector makes it important for the country to nurture this industry in its nascent growth phase. In evolving the policy framework, India can benefit from the experiences of developed countries.

The present tax regime incentivises investment in renewable energy through accelerated depreciation and also grants a 10 year tax holiday. The benefit of accelerated depreciation on investments overlaps the tax holiday and hence off-sets the incremental effect that is sought to be provided. The tax regime does not materially differentiate between the energy generated from conventional or from renewable sources as the tax holiday is available to all power generation. Such a fiscal framework fails to recognize that energy from renewable sources have higher investment and technology costs, and may not be competitive with conventional sources of energy, such as coal. Thus, a level playing field requires incremental fiscal incentives for renewable energy for this sector to gain competitive strength and ensure long term energy and environmental security for the nation.

Equally important is the need to shift the fiscal incentives from investment based incentives with generation based incentive scheme. Additionally, the incentive based incentives need to be made marketable for developers to off-set the higher cost of capital investment. With this backdrop, the expectations from the Union Budget 2008 included:

- Introduction of sector specific tax holiday for promotion of renewable energy
- Removal of the sunset clause of tax holiday in power sector for power generation from renewable sources
- Grant of generation based incentives ie TCC
- Extension of 5 year tax holiday for production of bio-fuels, bio-gas to 10 years
- Tax exemption to Venture Capital Companys / Venture Capital Funds on income from Venture Capital Undertakings engaged in renewable sector
- Weighted deduction on capital expenditure on R&D in renewable energy sector
- Exemption for CER, known as carbon credits, generated under the Kyoto Protocol

The Union Budget 2008

The Finance Minister in the speech, introducing the Union Budget 2008, recognized the impact of climate change and the need for renewable energy. The need for and the establishment of permanent institutional mechanisms has been announced. No specific fiscal incentives or rationalization of the fiscal framework has been proposed in this Finance Bill 2008.

Unfinished agenda

The much hoped fiscal push may possibly emerge in conjunction with the permanent institutional mechanisms announced to be established. In parallel, efforts by

India announced a generation based incentive for solar power during the 11th plan period. Fiscal incentives in the form of a 10 year tax holiday and accelerated depreciation is available to power generated from renewable sources

states would be equally important for supporting the shift in the growing energy basket to the new and renewable energy sources. Whilst the fiscal push is delayed, it is important that when these arrive, there is clarity and stability in such initiatives to support long term and sustainable investment for the development of green energy in India.

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Funding options – Need for a liberal policy

With India's growth story remaining intact and the outlook looking promising, ECB policy framework necessitates a revisit to finance capital investment for sustained growth.

BY AMIT JAIN AND YATIN SHARMA

India growth story remains intact

The Indian economy is projected to grow at an average rate of 9 percent during the 11th Five year plan (2007-2012). Development of the infrastructure sector is one of the important drivers for sustaining the high rate of economic growth. Towards this end, the outlay for infrastructure during the Plan period has been pegged at USD 500 billion. Of this outlay, the private sector is expected to contribute significantly to augment investment in the infrastructure sector.

With expansion of the economy in recent years, there has been a surge in foreign capital inflows in the country, thereby creating concerns on currency appreciation and inflation. This has swayed Government of India policy which has taken several monetary and Policy measures to control foreign inflows into Indian especially relating to External Commercial Borrowings (ECBs).

ECB a preferred funding option

Equity and quasi-equity instruments (preference shares) have been the conventional way of raising funds by corporates. Equity provides ownership rights, however, is combined with perils of uncertainly in flow of income, especially where investments are made in sectors having a longer gestation period. Borrowings and debt instruments provide relatively assured income, which coupled with convertible options, provide future ownership rights. However, such borrowing / debt funding is highly regulated.

While Indian companies can issue equity shares and fully convertible debentures / preference shares subject to Foreign Direct Investment (FDI) restrictions, non-convertible, optionally convertible or partially convertible preference shares or debentures are considered as debt instruments and are regulated under the ECB guidelines.

ECBs are an attractive means of raising funds considering high interest rate arbitrage between domestic and foreign debt. As per the prevailing ECB guidelines, an eligible borrower (an Indian company qualifies as eligible borrower) can raise foreign debts (ECB) from an eligible lender upto USD 500 million under automatic route. ECB raised under the automatic route is subject to a minimum maturity of 3 years in case the amount of debt does not exceed USD 20 million, and 5 years in other cases. An eligible borrower can raise an additional USD 250 million under the approval route, subject to a minimum maturity of 10 years.

The cost total of debt servicing (ie interest) for ECBs is capped at 150 basis point over 6 month LIBOR with a minimum maturity of 3-5 years and 250 basis point over the

LIBOR with maturity of 5 years or more. ECB proceeds are to be utilized for specified purposes, primarily catering to industrial and infrastructure sector and overseas direct investments. ECB proceeds cannot be used to meet general corporate expenses or working capital requirements.

Whilst ECBs are relatively economical source of funding, it has been under the regulators scanner in the recent past. This is partly attributable to the very nature of the instrument and partly to the unabated inflow of foreign funds in certain sectors of the Indian economy (eg infrastructure, real-estate, etc) leading to sectoral imbalances.

The rising inflows of foreign funds through ECBs have created concerns over rupee appreciation, thus impacting the macro economic environment. In order to control the appreciating rupee, the Reserve Bank of India (RBI) narrowed down the permitted end-use of ECBs by putting an embargo on utilization of ECB proceeds in real estate. As a further measure, utilization of ECB for rupee expenditures has also been restricted to USD 20 million per borrower per financial year. The restriction on ECB for rupee expenditure has adversely impacted a number of sectors, especially the infrastructure sector, which requires huge capital outlays.

ECB restriction impact - Power Sector

The power sector is on an expansion mode wherein the capacity addition over the next 5 years is envisaged to increase by over 50 percent of the existing installed capacity. The financing model for this sector is highly leveraged with a debt to equity ratio of 70:30. Considering the quantum of debt funds required by this sector, cap on ECBs is deterrent.

Recently, to address the issue, the Ministry of Power (MoP) has sought a waiver of ECB norms for the power sector. The demand has been made in view of significant debt funding requirement of the sector, primarily for rupee expenditure.

A large portion of funds for the power sector is mobilized by Power Finance Corporation (PFC) and Rural Electrification Corporation (REC). However, the Non Banking Financial Companies (NBFC) status of these organizations restricts their ability to mobilize funds from abroad by tapping the ECB route. It has been suggested that ECB norms should not only be eased for the power sector but also for the institutions that enable mobilization of cost effective funds from abroad for this sector.

Convertible preference shares brought under the ECB umbrella

Optionally convertible / redeemable preference shares are increasingly being used as an investment instrument by investors. Such instruments provide preferential right over equity shares towards dividends, proceeds of liquidation, etc, (without voting rights) and opportunity to analyze the growth potential of the company before making a long term investment commitment via the equity route.

The Government of India through a Press Note has brought an amendment to the effect that partially / optionally convertible shares (other than fully convertible preference shares) will be regarded as ECB. This has further curtailed the ability to raise and utilize funds by companies at their discretion.

The maximum dividend payable on preference shares is capped at 300 basis points over the State Bank of India (SBI) prime lending rate. The rate of dividend thus works out to approximately 15 percent. However, under the extant ECB guidelines, the all-in-cost (including interest) on ECB is capped at 250 basis

point over LIBOR, which works out to approximately 7-8 percent. This impedes not only the inflow of foreign funds and end user utilization but also the investor sentiment by way of lower rate of return.

Unlocking value through FCEB

In 2008, the Government notified the scheme for issue of Foreign Currency Exchangeable Bonds (FCEB) to unlock a part of the holding in group companies for meeting financing requirements. FCEB is similar to Foreign Currency Convertible Bonds (FCCBs) in a way that the bond is expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency. The distinction being that in case of FCCB, the bond gets converted at the option of the holder into equity share of the issuing company. However, in the case of an FCEB, the bond gets converted into equity share of the offered company and not equity share of the issuing company.

Thus, a holding company can now issue bonds based on the underlying shares of its subsidiary, thereby providing an opportunity to unlock value in the group company. The investment under the scheme would need to comply with the FDI and ECB policy. Also, the utilization of FCEB proceeds is not permitted for on-lending or investment in capital market or acquiring a company in India.

Consistent with existing norms for taxation of FCCB, the interest arising from FCEB will be liable to tax withholding at 10 percent. The Finance Bill 2008 proposes to keep transfer of FCEBs outside India by one non-resident to another and conversion of FCEBs to shares outside the scope of Indian taxation. Further, on subsequent sale of shares in the offered company, the cost of acquisition of shares received upon conversion will be based on the price at which FCEB was availed.

ECB policy requires a revisit

Significant changes have taken place in the regulatory regime for ECBs over last one year. These changes have left void in funding options for Indian companies. Restrictions on issue of debts and quasi-debts instruments have left Indian companies scampering for new and innovative funding options which not only meet the business imperatives, but also provide access to cost effective funds. With the Indian growth story remaining intact, a large pool of international funds is ready to be accessed. Infrastructure projects require enormous funding, significant amount of which is highly leveraged. Access to cost effective source of debt would translate into lowering the overall project cost and have a trickle down affect.

The need of hour is a liberal policy framework which provides flexibility to companies to avail cost effective funds, enabling a prudent balance between equity and debt funding. It is imperative for the Government not to step back on its liberal policies to maintain the momentum of growth and infrastructure development.

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Treaty Shopping: The noose is tightening

With the economy growing from strength to strength, the Indian Government is forced to have a relook at its approach to tax treaties.

BY DIVYA BAWEJA, MANISH KHURANA & ABHAY SHARMA

Approach to tax treaties in India

Like most developing nations, India has negotiated most of its tax treaties along the lines of the United Nations Model Convention (UN Model Convention). The UN Model Convention provides for a source based rule of taxation which is preferred by developing nations, since they are importers of capital and technology.

Since this Convention was drafted keeping the interests of developing nations in mind, no real safeguards were put into place to prevent the abuse of tax treaties, as the need to attract foreign investment outweighed the loss suffered on account of possible revenue leakages.

The Indian economy however has made rapid strides in the past decade, and this coupled with the buoyant forex reserve situation has led to a rethink by the Government on their approach to tax treaties.

Given the aforesaid background, the idea of preventing treaty abuse by discouraging treaty shopping has gained strength.

What is treaty shopping?

The Supreme Court while examining the concept of treaty shopping in the landmark case of Union of India v Azadi Bachao Andolan (263 ITR 706), quoted with approval the following passage:

"Treaty shopping is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two Contracting States.".

In other words, the use of a jurisdiction to structure investment into a country which has a favorable tax treaty with such jurisdiction by a resident of a third country is termed as treaty shopping.

The concept of treaty shopping is an emotive one and has been the subject matter of debate and discussion in the past. As the noted English constitutional expert Francis Bennion once observed:

"The drafting of treaties is notoriously sloppy usually for a good reason. To get agreement, politic uncertainty is called for."

Taking the benefit of this uncertainty, many foreign investors have routed their investment into India via tax friendly jurisdictions. Given the favourable treatment of capital gains (and in some instances interest income) under their respective treaties with India; Mauritius, Cyprus, Singapore and UAE have emerged as favourite investment routes into India. The past couple of years have seen a concerted effort by the Indian Government to clamp down on treaty shopping.

"The drafting of treaties is notoriously sloppy usually for a good reason. To get agreement, politic uncertainty is called for".

Judicial view

In the Indian context, the decision of the Supreme Court in the case of Azadi Bachao is the locus classicus on the subject of treaty shopping. In the said case, the Supreme Court cited the following :

"A tax-saving motivation does not justify the taxing authorities or the courts in nullifying or disregarding a taxpayer's otherwise proper and bonafide choice among courses of action, and the state cannot complain, when a taxpayer resorts to a legal method available to him to compute his tax liability, that the result is more beneficial to the taxpayer than was intended."

The Supreme Court took the view that treaty shopping was not illegal by mere reason that an act which was valid in law could not be treated as "non-est" on the basis of an underlying motive which resulted in some economic detriment or prejudice to the national interest.

Further, the Supreme Court honoured the legal principle of "pacta sunt servanda", which when applied to the facts of the case meant that every treaty in force is binding on the parties to it and must be performed by them in good faith. The Apex Court also pointed out that a "purposive" interpretation must be given to a treaty, since treaties are negotiated keeping in mind various complex political, economic and other considerations and the revenue aspect cannot be the sole consideration while interpreting a treaty.

"A tax-saving motivation does not justify the taxing authorities or the courts in nullifying or disregarding a tax payer's otherwise proper and bona fide choice among courses of action"

The Vienna Convention and Organization for Economic Co-operation and Development (OECD) Approach

The Vienna Convention was enacted in 1969 and it entered into force in 1980. Article 26 of the said Convention contains the aforesaid doctrine of "pacta sunt servanda".

Further, Article 27 of the said Convention states that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.

These two Articles are very important in public international law. If domestic law overrides a tax treaty, the State would violate its international obligations.

Thus, the above principles "seem" to permit treaty shopping if a taxpayer is able to find a circumstance, where the taxpayer can benefit from a treaty. It must be noted that many countries frown on treaty shopping as they believe that it reduces the bilateral treaty function to a "treaty with the world".

The OECD Model Convention deals with the issue under the heading "Improper use of the Convention". The commentary opens by offering some support to the careful use of domestic anti-avoidance rules to combat "treaty abuse".

It proceeds, to deal in significant detail, with specific measures that could be incorporated in treaties themselves to combat specific types of abuse. One such key measure is the incorporation of a "Limitation on Benefits" clause in the treaties. Another approach that the OECD Model Convention advocates is the "exclusion" approach, wherein companies that have certain special legal characteristics and are tax exempt (or almost tax exempt) as per the domestic laws are not allowed the benefit of the treaty.

Limitation on Benefits clause

A Limitation on Benefits (LOB) clause essentially restricts the availability of treaty benefits by specifying certain criterion which must be fulfilled in order to claim the said benefits.

The US Model Convention was the first Convention that adopted a LOB clause.

The said clause does not exist in the UN model Convention. Even the OECD Model Convention contains no such specific clause, although the commentaries to the said Convention contain substantial discussions approving the application of LOB provisions in bilateral treaties in order to limit the ability of third state residents to obtain the treaty benefits.

Thus, while the India and US tax treaty, which was negotiated on the basis of US Model Convention, contains a comprehensive LOB clause, the tax treaty between India and Mauritius contains no such clause.

Steps undertaken to avoid abuse

The Indian Government has undertaken crucial steps by moving forward on renegotiating treaties with jurisdictions most commonly used to invest into India.

India entered into a protocol with Singapore effective August 1, 2005 to insert a clause based on economic criterion. The India Singapore tax treaty now provides that the benefit of the treaty shall not be available to a shell / conduit company. The said treaty defines a shell / conduit company as any legal entity with negligible or nil business operations or with no real and continuous business activities carried out in the contracting state in which it is setup. With respect to capital gains, a company set up in Singapore is treated as a shell / conduit company, if its total annual expenditure on operations in Singapore is less than SGD 200,000 in the 2 year period preceding the date on which the capital gains arise. Similar conditions exist for Indian companies investing into Singapore.

Recently, discussions have been concluded with UAE with an agreement to insert a protocol effective April 1, 2008 to amend the definition of the term "Resident" and incorporate the LOB clause. Henceforth, for a company set up in UAE to claim the benefits of the India and UAE tax treaty, not only would the company have to be incorporated in UAE, the effective control and management of the company would also have to lie in UAE. As previously stated, the treaty now provides for a LOB clause which clarifies that an entity set up with the primary intention of taking the benefits under the India UAE tax treaty would be ineligible to claim such treaty benefits.

Currently, income earned by a Mauritian / Cypriot resident by way of capital gains from a source in India is tax exempt under the respective treaties. This has led to residents of third countries structuring investment into India through shell companies in Mauritius / Cyprus, with the aim of taking the benefit of the beneficial treaty provisions. In fact, it is estimated that almost 60 percent of all investment by Foreign Institutional Investors into India is routed through Mauritius. The Mauritius Government has played its part by tightening its residency norms. As per the new norms, all board meetings of a company set up in Mauritius have to be held in Mauritius. Such company has to have two locals of repute and requisite qualifications as directors on its board and it needs to route all transactions through a bank account in Mauritius.

All this means that the operational costs of setting up and running a company in Mauritius have increased. However, given the sheer quantum of investments being routed through Mauritius and the amount of potential tax saving, the efficacy of the new measures is questionable. Much more needs to be done to prevent abuse of the tax treaty with Mauritius. The Indian Government has been mounting pressure on the Mauritian Government to amend the India Mauritius tax treaty so that existing loopholes maybe plugged. Towards this end, discussions are underway to amend the India Mauritius tax treaty as well as the India Cyprus tax

"Much more needs to be done to prevent abuse of the tax treaty with Mauritius. Towards this end, discussions are underway to amend the India Mauritius tax treaty as well as the India Cyprus tax treaty by inserting the clauses to discourage treaty shopping, including a possible LOB clause"

treaty by inserting the clauses to discourage treaty shopping, including a possible LOB clause.

An interesting point to note is that the Indian Government has already formulated a Model tax treaty which it intends to use for all future agreements and renegotiations. The Model tax treaty contains a LOB clause.

Conclusion

There is little or no doubt that given the current Indian economic scenario, treaty abuse must be prevented. The Indian Government has also viewed with concern issues such as erosion of the tax base, money laundering and round tripping that bear a direct correlation to the misuse of treaties.

However, the methodology adopted to prevent the treaty abuse is of paramount importance. The Indian Government has been adopting an approach of treaty renegotiation as the means of plugging any loophole in a treaty. They must continue with this approach of renegotiation of treaties and must not follow the German approach of making unilateral amendments in the domestic tax to override treaty provisions. Unilateral action would render the concept of tax treaties nugatory and that would deny legitimate treaty benefits to deserving taxpayers.

"Unilateral action would render the concept of tax treaties nugatory and that would deny legitimate treaty benefits to deserving taxpayers"

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Carbon credits – need for a fiscal regime

Urgent need for clear and enabling tax framework.

BY GOKUL CHAUDHRI, PRERNA MEHNDIRATTA AND SHWETA AGGARWAL

Overview

Life on earth is endangered with global warming resulting in climate change and a depleting ozone layer. The cause is the increasing concentration of Green House Gases (GHGs) in the atmosphere that blanket the surface, which trap heat waves within the atmosphere, and increase the global temperatures. The increase in global temperatures is resulting in potential ill effects on ecosystems, human health and economies.

United Nations Framework Convention on Climate Change (UNFCCC), a platform for global efforts to combat global warming, was created in 1992 by 165 States - the convention took effect on March 21, 1994. This led to the Kyoto Protocol in 1997 which came into force on February 16, 2005 and sets mandatory targets for industrialized nations (Annex 1 countries) to reduce their GHG emissions collectively by average 5.2 percent below 1990 levels by 2012. Australia recently acceded to the protocol; the US continues to be a notable exception. The individual targets for Annex 1 countries are listed in Annex B to the Kyoto Protocol.

The protocol provides mechanisms for industrialized nations to meet their GHG reduction commitments by acquiring GHG reduction credits – Joint Implementation Mechanism (JI), Clean Development Mechanism (CDM) and International emissions trading (IET).

JI mechanism is carried out between two Annex I countries. It enables industrialized countries with high costs for GHG reduction projects to take up such projects in other developed countries. JI yields Emission Reduction Units (ERUs).

CDM mechanism is undertaken between Annex I and developing countries. It permits industrialized countries to take up GHG reduction projects in developing countries with lower project costs. The GHG reductions achieved by the CDM project entitle the project to earn carbon credits which are then used by the industrialized countries to meet its emission reduction commitments under the Kyoto Protocol. Carbon credits are given in the form of Certified Emission Reduction (CERs) which are expressed in tons of carbon dioxide equivalent (1 ton GHG emission reduction equals one CER). To be entitled to CERs, the CDM project has to be approved by the designated authority in the developing country (host country approval) and registered with the UNFCCC.

IET provides a trading platform where the developed countries with GHG emissions in excess of Kyoto commitments can offset their liability by buying carbon units from other countries and vice versa.

The Kyoto Protocol enlists specific sectors for undertaking JI and CDM projects such as renewable energy, waste management, power, energy efficiency, manufacturing industries and

The Kyoto Protocol, which came into force on February 16, 2005, sets mandatory targets for industrialized nations to reduce GHG emission levels collectively

construction, transport, oil and natural gas etc.

Under the Kyoto Protocol, the developing nations (non – Annex 1 countries) do not have individual targets to reduce GHG emissions. This creates an opportunity for the developing countries for earning revenue through generation and sale of CERs. In 2006, developing countries supplied nearly 450 million tonnes of carbon emissions for USD 5 billion.

Kyoto Protocol has prompted many emission reduction activities and spawned global carbon trading network. The first commitment period of Kyoto Protocol comes to end in 2012 and the fate of Kyoto Protocol beyond 2012 is yet to be decided – though it is logical that global initiatives for climate change will continue.

Global market scenario

CDM and JI projects grew from USD 2.8 billion in 2005 to USD 5.4 billion in 2006. On the supply side, China dominates the market followed by India while on the demand side, European countries account for 86 percent of the CDM and JI market with UK as the leader followed by Japan.

On the trading front, US and Australia provide platforms to countries to engage in carbon trade. These are known as Chicago Climate Exchange (CCX) and Australian Climate Exchange (ACE). CCX is a voluntary cap and trade based exchange for trading in North America and Brazil since 2003. ACE again is a voluntary exchange that started in July, 2007.

Indian scenario

India acceded to the Kyoto Protocol in August, 2002. Being a developing country it has no obligation to meet specified commitment levels, albeit, it can still be a frontrunner in the international fight against global warming through CDM. India presently has around 309 registered CDM projects (out of 918 projects worldwide) and 858 host country approved projects. Indian CDM projects broadly cover a range of different sectors viz power generation from renewable energy particularly wind and hydro power, biomass applications, waste heat and energy recycling. The country is yet to make a significant impact in the iron and steel, fuel production, fertilizers, petro - chemicals sectors.

The robust pipeline of projects indicates strong prospects for CDM in India and also creates a potential for India to earn revenues from sale of CERs.

The Government of India is in the process of creating a framework to regulate the carbon markets including

- Formulation of a new accounting standard prescribing the methodology for accounting revenues earned from sale of CERs by companies in their financial statements. This initiative is been undertaken in association with the Institute of Chartered Accountants of India (ICAI)

- Establishment of Multi Commodity Exchange (MCX) for futures trading in carbon credits in India on January 21, 2008 – making it Asia's first commodity exchange for carbon trading

- Scheme to promote replacement of incandescent bulbs with Compact Fluorescent Lamps (CFLs) by leveraging the sale of CERs

- Setting up of Bureau of Energy Efficiency (BEE) to put in operation energy conservation measures specifically to provide high-quality CFLs to domestic consumers

- Reserve Bank of India (RBI) is likely to clarify the classification of carbon credits from an exchange control perspective

Taxation of CERs – International scenario

Tax incentives on income generated from CERs are offered globally.

In China, preferential tax treatment is granted to renewable energy projects which generate CERs. Renewable energy projects are taxed at 2 percent of total CER benefits, while revenues from industrial gas projects, which have a lower sustainable development benefit, are taxed at 65 percent. The funds thus collected are contributed to a fund used to finance sustainable development in China.

Malaysian tax laws provide exemption to carbon credit income between 2008 and 2010 as an incentive for engaging in sustainable and environmentally sound practices.

Carbon benefits are taxed at the rate of 12.5 percent in Ireland. In accounting terms, the carbon benefits are treated as an intangible asset and have to be recorded at a Fair Market Value (FMV). Being an intangible asset these are liable to VAT.

Taxation of CERs – Indian scenario

CERs are a new concept in India.

The present income tax code does not contain provision for taxation or otherwise of income earned from generation and sale of CERs. As projects in India generate substantial revenues through CDM projects, there are a number of regulatory and tax issues that need to be resolved.

Taxability of income earned from sale of CERs is an important aspect that is to be addressed. Prolonged litigation else seems inevitable as absence of a defined tax treatment for CERs gives rise to alternate interpretations on the tax treatment, some of which are as follows:

Firstly, the classification of the income from generation and sale of CERs is debatable. One view could be that CERs are earned / generated in the course of carrying on business activities / incidental to the business of the taxpayer, and therefore these should be taxed as business income. The outcome of this scenario is that the income would be taxed at the normal rate of 33.99 percent (including surcharge and cess) for Indian corporates. The possibility of availing tax holiday benefits if available to the underlying business income could be explored; eligibility of this to CERs could then be another aspect of the tax debate.

Alternate view is to tax the gains on sale as capital gains on the basis that CERs is an intangible property and transfer of any property attracts capital gains tax in India. This gives rise to debate on ascertaining the real cost of acquisition, holding period (ie at the time of verification, certification or sale).

The liberal view could be for exempting the income as a capital receipt. Aligned to this thinking is the premise that carbon credits are a measure towards preventing undesirable climatic change and should be ranked at par with subsidies / grants granted by the Government.

The tax laws exempt monies received under Montreal Protocol, which is for phasing out the Ozone Depleting Substances – another initiative to combat climate change. Similar exemption would provide fiscal push and fiscal clarity for the generation and trade in CERs and enhance the economics of the underlying projects in India.

Being a developing country India has no obligation to meet specified commitment levels, albeit, it can still be a frontrunner in the international fight against global warming

What is in the offing?

The Union Budget 2008 did not propose any amendment or specific provisons for taxation or exemption to CERs. To foster the clean technologies and renewable energy sources, which are the primary sources for carbon credits, the Finance Minister indicated that a 'permanent institutional mechanism' would be established.

The tax proposals did introduce a new levy termed the Commodities Transaction Tax (CTT) on transactions on recognised commodities exchange. Commodities are defined to include goods specified for the purposes of the Forward Contracts Regulation Act (FCRA). Recently, FCRA has issued a clarification declaring carbon credits as a commodity / good. The trading of CERs on the commodities exchange may going forward attract CTT.

The debate on the tax treatment of income generated from CERs has just began. In view of the benefit of carbon reduction initiatives the income generated from CER's deserves not to be subject to endless litigation and tax costs. There is an urgent need to provide for an unambigious and progressive tax exemption for the development of carbon credit based project and market in India.

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CFC Rules – is India ready for it?

While Government debates introduction of Controlled Foreign Corporation (CFC) Rules, sufficient time should be allowed for India's changing economic scenario and net capital exporter status to stabilize.

BY MUKESH BUTANI AND ASHUTOSH MOHAN RASTOGI

Introduction

For some time now there have been murmurs of introducing Controlled Foreign Corporation (CFC) regulations in the Indian context. In this year speculation was rife that CFC rules may be introduced as part of Budget proposals for fiscal 2008 - 2009. However, the absence of any development is a pointer to the fact that perhaps Government may let corporates breathe easy for time being.

In November, 2002 the Government constituted a Working Group on Non- resident taxation (under chairmanship of Vijay Mathur) to suggest, amongst other things, ways to combat tax avoidance "in the context of the ability of companies to park profits overseas, in low or no tax jurisdictions, and defer liability to pay tax in India". The working group submitted its report in January, 2003 and recommended introduction of CFC regulations in India.

Perhaps, there are legitimate reasons for putting the legislation on hold. India is witnessing a spate of outbound investments supported by globally tax efficient structures. CFC regulations, if introduced at this juncture, may prove to be a setback for overseas acquisitions by Indian companies should they decide to plough profits into additional investments rather than repatriating earnings back home. With this as background, this article briefly discusses the concept and key features of CFC legislation before examining the rival arguments for their introduction.

Salient features

Several countries tax residents on their worldwide income with credit for any foreign taxes imposed on foreign-source income. Absent remedial legislation, however, domestic tax on foreign source income can be deferred easily by establishing a CFC or trust to receive such income.

Many countries have adopted detailed statutory rules to prevent or restrict the use of CFC's to avoid domestic tax at parent level. Under such rules, a CFC is not itself subject to residence country tax. Instead, resident shareholders of the CFC are taxed on their proportionate share of a portion or all of CFC's income. The quantum of such income must be determined in accordance with domestic tax rules and in domestic currency, notwithstanding the compliance burden these requirements may impose on taxpayers.

Scope and applicability

Usually, foreign companies controlled directly or indirectly by residents are covered within the ambit of CFC rules. Many countries apply "legal control test"

The working group submitted its report in January, 2003 and recommended introduction of CFC regulations in India

While Global approach taxes specific type of income (passive income), the Designated Jurisdiction approach targets CFC's located in identified low tax countries

which provides for a threshold of percentage to qualify as a CFC. The threshold varies significantly, for example, in US more than 50 percent voting rights / value of the shares is the trigger, whereas for France, it is just 10 percent. The definition of "control" is often extended by constructive and indirect ownership but only a few countries (such as UK) have adopted the defacto control test due to the practical difficulty in applying it.

Moreover, for identification of CFCs, either of the two approaches - global approach or the designated jurisdiction approach may be adopted. Under the global approach, no particular jurisdiction is targeted. Instead, the CFC rules apply to specific types of incomes such as passive income (income not arising from genuine business activity). On the other hand, a designated jurisdiction approach focuses upon a list of identified low-tax countries that may be designated as tax havens. Most countries have adopted designated jurisdiction approach. US and Canada are the only two countries that apply their rules to specified categories of income irrespective of whether the CFC is resident in a tax haven or high tax jurisdiction.

Exemptions and Relief provisions

CFC regulations is usually accompanied by several exemptions based on variety of factors. A CFC distributing certain percentage of income in a year may be exempt (as in UK) or it may be exempt if its income does not exceed a particular amount (de minimis exemption applied by Australia and UK). Similarly, in some countries, exemption is based on absence of motive to avoid tax.

Since CFC regime attributes income to shareholders before actual distribution of income, ordinarily relief provisions are also built-in to prevent double-taxation of such CFC's income distributed subsequently. Most countries provide relief for subsequent dividends out of previously taxed income of CFC, however, few countries provide relief for capital gains on shares of CFC that reflect previously taxed income of CFC.

While CFC income is taxed as deemed income or dividend in the hands of resident shareholders, no deduction is available for CFC losses against income of resident shareholder. Such losses can only be carried forward and set-off against future CFC income. The table below provides a comparative view of CFC regulations in major jurisdictions.

Country	Key Features (Control Test, CFC identification Approach and Exemptions)
US	• CFC results from ownership of 50 percent or more of voting rights or equity • Global approach • Active income test
UK	• CFC results from ownership of 50 percent or more of voting rights or equity / defacto control test • Designated jurisdiction approach • Number of exemptions available (deminimis test / distribution exemption / genuine commercial operations / motive test and public quotation test (trading of CFC's shares on stock exchange)
Canada	• CFC results from ownership of 50 percent or more of voting shares by resident(s)

	• Global approach • Active income test/deminimis test
Australia	• CFC results from ownership of 50 percent or more of equity by Australian resident(s) • Hybrid approach • Active income test

Indian Scenario

The basic structure of CFC legislation reflects two competing principles. On one hand, there is a desire to prevent tax avoidance and to advance traditional goals of fairness and economic efficiency; on the other hand, countries do not want to interfere unreasonably in the ability of resident corporations to compete in foreign markets. Hence, a balancing act between the two principles is required.

The introduction of CFC rules in India has to be examined in this background. Lately, several off-shore deals have come under the Indian Revenue's scanner. Revenue has been stretching to bring offshore deals within the tax net by invoking common law doctrines such as substance over form or lifting of corporate veil. Proponents for CFC rules argue that taxing income from such deals would be easier for Revenue if such rules are introduced.

OECD has also made recommendations to combat harmful tax practices and to this end measures have been proposed to update Indian tax law. Clearly, the moot question is not whether or not the regulations should be introduced in India, but when?

Currently, India is going through an euphoric phase in outbound investment. Outbound deals for financial year 2007 surpassed inbound deals in value. However, we should not loose sight of the fact that India still does not have full capital account convertibility and the level of outbound investment is still below countries with free foreign exchange regime. Thus, experts have questioned the wisdom in introducing CFC regulations at this stage citing it as premature. Perhaps a balanced view would be that the legislation should be introduced in a phased manner without undermining the momentum for outbound deals.

Key considerations

Going forward, if the Government does decide to introduce CFC rules, an important issue for the law makers to consider shall be the overriding effect of tax treaties. CFC regulations run contrary to the spirit of Article 7 of tax treaties as it results in taxation of profits of foreign corporations even without a permanent establishment in the home country. Hence, reconciling tax treaties with CFC legislation would be a challenge. The legislation shall have to be drafted carefully to be compatible with existing taxation laws and stand the test of legal validity.

Added to treaty complexity is definition of the term"resident" under the IT Act. The definitions were drafted and amended in an era when India believed (and still continues to) in source based taxation. A move towards legislating CFC rules would signal a shift to residence based taxation and would necessitate wide ranging changes in the domestic law.

Further, since India continues to grant tax and fiscal incentives to domestic businesses, the question would be if such passive income taxed under CFC would continue to be exempt - our feeling is it would not, however, this requires some thinking.

Another important aspect is tax

If CFC regulations are introduced, harmonizing it with existing tax and legal framework would be a challenge

consolidation, which we do not have as a part of our legislative framework. Consolidation allows taxpayers to set off profits and losses interse legal entities forming part of the same group. Legislating CFC rules in isolation could result in hardship to taxpayers. In most CFC jurisdictions, tax consolidation is an integral part of the legislation.

Additionally, the law makers should be mindful of the fact that CFC rules are often a complicated maze of regulations that impose onerous compliance requirements for taxpayers. The risk is that like transfer pricing regulations, CFC rules may end up being treated as an additional revenue mobilization avenue rather than an anti-tax avoidance measure. Hence, while law makers may refer to global best practices, they should capitalize on domestic experience with transfer pricing besides the level of preparedness, before ushering another set of anti-tax avoidance measures.

Our personal verdict is that we ought to wait atleast until the new Tax Code is stabilized and India's shift from being a capital importer to capital exporter matures, besides of course, our embracing OECD principles in totality.

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Stock Options – a changing regime

Companies across industries have used Stock Options as a strong compensation and HR tool. However, given the changing tax regime regulating Stock Options, its viability as a means of remuneration needs to be re-looked.

BY NITIN BAIJAL AND MANVI SHARMA

The story so far

Against the backdrop of economic progress and a growing recognition to India's talent pool, Stock Options emerged as an effective compensation tool for many Indian corporates, particularly infotech, pharmaceuticals, banks and financial services being the front-runners in introducing Stock Options in India. Stock Options have been popular among multinational companies, which typically extend global Stock Options to employees of their Indian subsidiaries. The success of Stock Options depended more on the expected long term capital appreciation and wealth creation for the employees, than on associated tax costs, though tax efficiency was one of the important considerations.

In developed economies, Stock Options have been one of the most tax-pro mechanisms for companies to share ownership with employees. In India, however, taxability of Stock Options has been much debated and has gradually evolved over the last decade with significant changes in the last two fiscal years.

Evolution of taxation of Stock Options in India

Until 1999, there were no specific provisions under the IT Act governing taxability of Stock Options, thereby leading to varying tax positions and considerable litigation. During such period, parallel was drawn from various international rulings on Stock Options. Thereafter, specific provisions to tax Stock Options were introduced under the IT Act in 1999, whereby Stock Options were taxed on exercise.

Over the next few years, the law relating to taxability of Stock Options underwent changes and the Revenue came out with Central Government (CG) guidelines in 2001. As a result of this amendment, taxability of Stock Options was dependent on whether a Stock Option Plan was compliant with the CG guidelines or not.

Under a Stock Option Plan compliant with CG guidelines, taxability got triggered at the stage of sale of shares as "capital gains" in the hands of the employees (difference between sale consideration and exercise price) thus resulting in single stage taxation.

Non-compliant Stock Option Plans were subject to tax in the hands of the employees at two stages - on exercise of Options as "salary" [on the difference between Fair Market Value (FMV) on the date of exercise and the exercise price] and as "capital gains" when the shares were actually sold.

Finance Bill 2007 brought a landmark change in the taxability of Stock Options by bringing them within the purview of FBT

Amendment by the Finance Act 2007

The Finance Act 2007 brought about a landmark change in taxability of Stock Options, by bringing them within the purview of Fringe Benefit Tax (FBT). This amendment sought to tax Stock Options as "fringe benefits", with FBT payable by the employer upon exercise of the option as opposed to earlier years, where such benefit was sought to be taxed in the hands of the employees. FBT is leviable on the difference between FMV of the shares on the date of vesting and the exercise price [valuation norms to determine the FMV were to be prescribed by the Central Board of Direct Taxes (CBDT), the apex tax body]. Though under this law, FBT liability shall get triggered upon exercise of the Options, the FMV on the vesting date is to be considered for valuation purposes. Thereafter, the employee shall be subject to capital gains tax at the time of sale of such shares (on the difference between the sale price and the value adopted for FBT purposes ie the FMV as on the date of vesting). Further, the employer has the option to recover the FBT from its employees.

This amendment came under widespread criticism by the industry and raised a host of open issues such as mechanism for valuation of Stock Options (in the absence of any valuation guidelines), taxability of Stock Options granted prior to April 1, 2007, liability of FBT on foreign companies issuing Stock Options, etc. This move also undermined the attractiveness of Stock Options as a compensation tool by imposing significant tax and administrative cost on the employer.

Finance Bill 2008 proposes a "deemed tax" status for FBT on Stock Options recovered from the employees. Credit mechanism for expatriate employees

Addressing open issues

In the latter part of 2007, the much awaited Stock Option valuation guidelines (October, 2007) and clarifications addressing various open issues (December, 2007) were brought out by the CBDT. Most ambiguities have been put to rest by virtue of these circulars. We have attempted to capture some of the significant developments prescribed vide the guidelines in the following paragraphs.

Stock options offered by a foreign company to employees of the Indian subsidiary

Where Stock Options are granted by a foreign company to employees of its Indian subsidiary, the Indian subsidiary (and not the foreign company) shall be liable to pay FBT. Liability of the Indian subsidiary is irrespective of whether there is charge back of Stock Option related costs or not to the foreign company.

If an employee of the Indian subsidiary, to whom Stock Options of the foreign company have been allotted, is outside India at the time of allotment of shares, then FBT shall be payable by the Indian subsidiary only on the part of the period during which such employee was based in India during the Grant Period. This is irrespective of the location of the employee at the time of allotment of shares.

Grant Period has been defined as the period commencing from the date of grant of Option and ending with the date of vesting of such Options.

Foreign company offering stock options to its own employees

A foreign company shall be liable to FBT in respect of Stock Options provided to its employees, based in India.

In case the employees are present in India for a part of the Grant Period, only proportionate amount shall be liable to FBT. Thus, a foreign company shall need to keep a track of the employees' stay days to effectively manage this compliance.

Valuation methodology prescribed

Specific guidelines have been introduced to arrive at the FMV of the shares of listed Indian companies, which is based on the volume of transactions on a recognized stock exchange in India on a particular day. For an unlisted Indian company and a foreign company, listed / unlisted outside India, FMV is to be determined by a Category I Merchant Banker registered with Securities and Exchange Board of India (SEBI). It has been provided that such a valuation shall be binding on the Revenue officer.

The valuation needs to be carried out on the vesting date of Options or any date within 180 days of the vesting date. This implies an additional burden on the employer in terms of obtaining valuation reports at regular intervals.

Issue of Stock Options to non-employees

The benefits arising from issuance of Stock Options to non-employees, including non-executive directors, shall not be subject to FBT, but would be taxable in their hands as per the normal provisions of the IT Act.

Deductibility of FBT cost

In a case where the employer purchases shares for subsequent transfer to its employees, such expenditure shall be allowable as a deduction in computing the taxable income of the employer company, since the employer is incurring a commercial (actual) expenditure. However, if such shares are allotted to employees from within the share capital of the company, no deduction is allowable in computing the taxable income of the employer company, since it shall be a notional expenditure.

Recovery of FBT

Recovery of FBT from an employee shall not be construed as income for an employer. The law does not prescribe any specific mechanism or timing for recovery of FBT by the employer. Thus, it is open for an employer to formulate its own recovery mechanism. FBT shall apply on Stock Options granted prior to April 1, 2007, as long as the shares are allotted or transferred to the employees after the said date. The employer can recover FBT from the employees on such Options as well. Also, the Stock Option Plan needs to be suitably amended to factor the recovery of FBT from the employees.

Foreign tax credit

Where FBT is recovered by the employer from employees, such employee can claim a credit in a foreign country for FBT paid by the employer in India, subject to the laws of the other country. This issue was clarified by the guidelines in December, 2007 and has now been specifically brought into the Finance Bill 2008.

Finance Bill 2008

Finance Bill 2008 proposes to accord a “deemed tax” status for FBT on Stock Options recovered from the employees. Accordingly, FBT recovered from the employees shall be deemed to be tax paid by such employees. As explained in the Memorandum to the Finance Bill 2008, an employee may be able to avail tax credit for such deemed tax in foreign country; thus it may be possible for expatriates to avail credit for such deemed tax (FBT recovered from the employer) in their home country (country of residence). However, this will be subject to the domestic laws of the home country. Thus, the efficacy of this amendment remains to be seen.

In contrast, an Indian employee has not been extended this benefit and shall not be able to avail a set-off of such deemed tax (FBT recovered) against his tax liability on other income or any other tax liability or claim a refund of the same.

Such discrimination between the Indian employees and expatriates is likely to trigger a multitude of representations to bring about parity in law.

Conclusion

In summary, the tax laws governing stock options have seen radical changes. This has resulted in corporates rethinking their remuneration philosophy due to the onerous regulations introduced in law over time. Thus, the effectiveness of granting such options needs a re-look.

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Interpretation of PE and "attribution" principles – alignment with international law

By FRANK D'SOUZA AND VISHAL AGARWAL

Indian tax law is source as well as residence based. This implies that India will cast a net as wide as possible to ensure that it taxes as much income as possible and then may grant relief from tax as it deems fit in accordance with its fiscal policy. With the growing relevance of international trade and commerce in furthering a country's economy, it became imperative to scale down this taxing principle as more foreign firms chose to do business with India. This gave rise to the need for double taxation avoidance agreements.

The effect of such agreements is that the right to tax vesting in the Indian State through its principal tax law is given up for a narrower taxation alternative. This is most apparent in the context of business profits accruing in India where the various deeming provisions expand the scope of what income accrues and arises in India. Under the Indian tax law, all such business profits are taxable (special rates may be available for some kinds of income) on a net income basis. Under tax treaty law, such profits are not taxable unless they are "attributable" to a "permanent establishment" (PE) that a foreign enterprise has in India.

For the Indian Revenue which has historically been used to dealing with taxation of foreign enterprise, under the provisions of the Indian tax law, the transition to applying and interpreting provisions of the treaty has been difficult (the old mindset of whatever "accrues" in India sought to be taxable in India, still prevails). This is also heightened by the fact that there have been dramatic changes to business models – moving away from brick and mortar operations to e-commerce based activities.

Given the debate over interpretation of treaties, in absence of corresponding local legislation, the tax payer in India, has sought to regularly rely on the OECD, the UN and the US Model Conventions and its Commentary to interpret provisions of the tax treaties.

International jurisprudence (specifically in the context of certain European economies, which have themselves spearheaded the work on the OECD Convention and related Commentary) has, however, held the view that the OECD commentary is merely recommendatory and is not law and does not bind the nations in interpreting the tax treaties they have negotiated and that the local laws would continue to prevail regardless of what the commentary says.

India in contrast has atleast at the Apex Court level, demonstrated significant maturity. The ruling in the case of Azadi Bachao Andolan, widely considered a landmark ruling on the principles of international taxation as are to be interpreted in India, has extensively

Did the Finance Minister, as he (correctly) gave away trillions to rural India, miss to account for the billions that (arguably) were (incorrectly) collected from Corporate India?

What was propagated as the "turning point" for Indian transfer pricing, eventually became a piece of text providing splendid guidance on micro issues but at the epitome being grossly misplaced

Revenue has set up its expectation in terms of documentation requirements to be very high and in some aspects probably unachievable

referred to the OECD and UN Model Convention and Commentary, though no remark about its interpretive value has been made.

Despite the above apparent disparity, at a conceptual level, it appears that the interpretation of what constitutes a PE has been consistent across jurisdictions. It is fairly settled in international law that in order to constitute a fixed place PE, there must be a "fixed place" at the "disposal" of an enterprise in the other contracting state, through which the enterprise conducts its business. In the context of an agent PE several rulings issued by various European Courts have held that mere control of a company is not sufficient to prove the existence of a PE; however it may constitute evidence which if supported by serious, accurate and consistent circumstances could lead to a determination that a PE exists. The circumstances could include:

- Ability to negotiate prices
- Ability to grant discounts and payment facilities to existing or new clients without the prior approval of the overseas entity
- Ability to conclude contracts on behalf of the overseas entity

Courts have held that they would search for substance over form and not simply rely on whose name contracts have been executed in. An Italian Court has also held that a separate legal and taxable entity can also create a PE for a foreign entity if the nature of work undertaken so indicates.

A look at the above jurisprudence immediately begs a comparison with the ruling of the Mumbai tax Tribunal in the case Sony Entertainment Television (SET) Satellite (Singapore) Pte Ltd where it was held that a dependent agent PE is created in a situation where it can be established that the foreign enterprise is carrying out its business through an agent instead of undertaking this business directly and the activity of this agent is significantly integrated into the business of the foreign enterprise. In such situations, the dependent agent creates a PE for the non-resident and the agent as well as the PE can each be separately assessed. This ability of a dependent agent to create a PE for a non-resident enterprise, which is separately assessable has also found support with the Apex Court in India in its ruling in the case of Morgan Stanley & Co referred to earlier.

It, therefore, appears that the principles laid down to determine the existence of a PE are uniformly applied for the greater part, globally.

Once a PE is established to exist, the issue that as yet remains far from well settled is what profits ought to be attributed to this PE? Further, the presence of transfer pricing laws in each country has raised the question of whether profits ascertained using transfer pricing principles are sufficient to determine what is attributable to a PE under the tax treaties as well. The Indian cases of Morgan Stanley and SET (Singapore) Pte seem to suggest that this is not the case and that a separate evaluation will need to be undertaken considering the assets, functions and risks for each, separately.

Commentary has also been issued by the OECD on attribution of profits. The OECD discusses two main approaches to the determination of profits: the 'relevant business activity" approach and the "functionally separate entity" approach,

which is the preferred approach. Under the first approach, the profits of an enterprise resulting from a business activity supported by the PE have to be allocated between the residence country and the source country. The second approach does not link the profit attributed to the PE by reference to the profit of the enterprise as a whole because the PE is deemed to be a "distinct and separate" enterprise. Either of these approaches may result in double taxation, if the assessed profits differ in the country where the PE is situated and the home country. It would be essential to ensure that the total profits (and losses) of the enterprise as a unit are attributed to the PE and to the head office in a way that avoids double taxation. The transfer pricing principles in the Indian context, however, follow their own rules which are not entirely consistent with those enunciated by the OECD.

A decision of the Delhi Tribunal in the case of Motorola Inc and Others addressed attribution of income to a PE in India of a Finnish company. The ruling concerned the taxability of revenues arising to the Finnish company from supply of telecommunication equipment and software to Indian telecommunication operators. The ITAT directed attribution of profits to a PE by beginning with the worldwide net profit margin of the company and then applying this margin to the turnover of the PE, thus in a sense not applying the preferred OECD approach.

Another consideration in identifying the profits that are attributable to the PE is ascertaining the manner in which deductions are to be claimed from attributed revenues. This is significant given that a PE is not a legally separate enterprise. Internationally case law has held that:

- The nexus of the head office expenditure with the income generated by the PE is a natural consequence of its lack of legal autonomy, which obliges the states to allow the deduction of the expenses incurred for the purposes of the computation of income attributable to the PE

- The economic link between the expenses incurred and the services performed a PE would determine the allowability of the expenditure in computation of profit attributable to the PE

- The right to tax the gain from the alienation of any kind of property should be given to state that has the right to tax that property and the income therefrom

These principles are materially similar to Indian case law on the subject though the Kolkata Tribunal in the case of ABN AMRO Bank has taken a view that interest paid to the head office by the Indian PE of a banking company is not available as a tax deduction. Given that the Indian tax treaty with the Netherlands (like most other treaties) specifically allows such a deduction, this seems more like an aberration than the law really. This is reflected in a subsequent ruling by the Mumbai Tribunal which has attempted to distance itself from the ruling of the Kolkata Tribunal simply on the basis that it was concerned with income and not an expense of the PE, while referring to similar provisions in the respective tax treaties. At lower levels, it appears that the Commissioners have been inclined to follow the ruling of the Mumbai Tribunal as well.

Thus, attributing profits to a PE is one of the most conceptually difficult and

To its credit, the thinking of Tribunal has been aligned to international practices and at times ahead of the present legislative framework

Transfer pricing has always been regarded as a mix of law and economics and no Courts would never be able to confine it to a particular legal text or order

practically complex issues in international taxation. Maybe, the difference lies not only in the nature of the tax rules, but also the fact that there exist significant differences in the accounting standards followed by nations generally. Also the regulatory environment and the requirements of the regulators regarding revenue recognition and prudential norms, especially in the case of banking enterprises, get in the way of establishing a common platform and acceptable and comparable basis for profit allocation across jurisdictions.

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Big 4 of transfer pricing decisions

The year saw first few strings of jurisprudence being articulated by the Indian Tax Tribunal on transfer pricing related matters. This article examines emerging trends and reality around these decisions.

BY RAJESHREE SABNAVIS AND SANJIV MALHOTRA

So its transfer pricing once again

As the coffee spilled and Santana played, looking through the fine print of the Budget 2008, we could sense a feeling of being left out (yet again). Not a line on the much celebrated issues of transfer pricing. Although one could possible ask "what is it that should have been covered?" Some said Advance Pricing Agreements (APAs), while others were stuck on clarifications / amendments of varied kinds. Did the Finance Minister, as he (correctly) gave away trillions to rural India, miss to account for the billions that (arguably) were (incorrectly) collected from Corporate India? Whether the Indian transfer pricing regime still stood where it was seven years back; while in other jurisdictions the regulations and principles had reached a higher zone? Was India far behind in terms of applying the principles laid down by the OECD? Well, perhaps not.

Though on paper nothing substantial has changed, there is little doubt that the learning over the years has been tremendous. This year saw the Tax Tribunal deciding on varied facets of transfer pricing. It all started with the Aztec then Mentor Graphics and very recently the cases of Ranbaxy and Cargill India were decided.

A lot has been said and written on these decisions and hence it is not the intent of the authors to appraise on the facts of these cases but to try to reflect on / translate the possible impact and crystal-ball gaze what could be in store for the future.

Once upon a time…

Based on rough estimates, Indian Revenue would have issued at least 3,000 odd transfer pricing orders till date. Some of the more celebrated ones include those related to IT and ITeS companies in Bangalore and financial services in Mumbai. However, winning the race by miles are the BIG 4 Tribunal decisions.

One interesting fact about these decisions is that all of them are on different issues but seem to carry the same thought process. While Aztec seeks to clarify disputes on the legal interpretation of administrative provisions, Mentor went into comparability analyses and computation of arm's length price / range. Then came Ranbaxy which talked about choice of tested party and finally Cargill gave Revenue's view on levy of penalties. Of course, there were other finer points dealt by them too.

The buzz was on an all time high when a special bench was constituted for Aztec in Bangalore and President of the Tribunal presided upon the same. Though the final

outcome was not of much surprise, the tax fraternity was pleased with the integrities in which the Bench examined the case. Also, as one expected, Aztec today stands as a landmark decision on issues such as those relating to burden of proof, powers of tax inspectors, manner of conducting the audit etc and thus putting to rest many of the transfer pricing controversies which were purely legalistic in nature. Aztec being the first transfer pricing order by the Tax Tribunal also laid the foundations to certain important fundamentals in a very subtle manner such as those relating to use of secondary analyses, comparability criteria, multiple year data etc. Well, as far as, the taxpayer was concerned, one may say that nothing substantial happened as the case was finally sent back to the tax inspector for re-examination.

To be or not to be

The quandary still continues on what overnight became the "mentor" of all court cases. This case gave tax consultants an interpretation for the arm's length range which was so liberal and far fetched (in context of the Indian regulations) that even they had never dared to present it to the Revenue. Although, very much aligned to the internationally accepted standards; regarding every point in the comparable set as an independent arm's length price was in clear contradiction with the Indian transfer pricing regulations. However, Mentor Graphics showcased the Tribunals understanding on the issues around choice of comparables. An important principle worth narrating relates to the need to make adjustments in order to improve the comparability standards. To sum up, the excitement around this case was as short lived as a water bubble. What was propagated as the "turning point" for Indian transfer pricing, eventually became a piece of text providing splendid guidance on micro issues but at the epitome being grossly misplaced as regards the concept of arm's length price / range was concerned.

New kids on the block

Last two months saw the entry of Ranbaxy and Cargill in the league. Ranbaxy was essentially a case wherein Commissioner was of the view that order issued by the tax inspector was not correct and hence even though the tax inspector held all transactions to be at arm's length, Ranbaxy had to face a transfer pricing adjustment. As Ranbaxy appealed to the Tax Tribunal on many legalistic points relating to the powers of the Commissioner, the Tribunal went on to comment on the sanity of the transfer pricing adjustment. The entire case primarily revolved around the question of use of foreign enterprise(s) as the tested party and it was held that unless (very) stringent documentation requirements are met, tested party should be the Indian entity. This order comes out as one wherein the Revenue has set up its expectation in terms of documentation requirements to be very high and in some aspects probably unachievable. Not to say that Tribunal has been incorrect in holding that based on the required information (such as break-up of all costs, revenue etc under a TNMM) the transfer pricing analyses would be much more convincing, practically it is impossible to gather such data for foreign tested party and international comparables.

Lastly, the Cargill order deals with the case wherein the Revenue levied a penalty for non-compliance of transfer pricing documentation. Surprisingly, the Tribunal has held that the documents and information prescribed under Indian transfer pricing rules are voluminous and it would be in the rarest cases that all clauses of such rules are attracted and hence required to be satisfied. In a highly contrasting and back-to-back fashion the

Tribunal has on one hand laid very high expectations for documentation (in Ranbaxy's case) but on the other has come out as very liberal on the penal consequences for non-compliance of documentation requirements.

Moral of the story

Having touched based on these orders more or less in a standalone basis, if one were to now put the pieces together; this is what it looks like:

- There is not much left to be fought on administrative / legal issues such as reference to the transfer pricing officer, powers of the tax inspector make such references and rely upon the order of the transfer pricing officer
- The transaction price (between two associated enterprises) has to be at arm's length. It is immaterial if there was an intent or rationale to indulge in tax evasion / avoidance
- International commentaries such as OECD transfer pricing guidelines and those issued by US IRS are been given due regard as long as they are not inconsistent with the domestic regulations
- Use of multiple year analyses / data by the taxpayer appears be very difficult to sustain
- Use of foreign enterprise as the tested party is froth with risk and it would be very easy of the Revenue to reject such analyses on the grounds of insufficiency of information
- Revenue appears be open to more statistical / economic adjustments to the data set to improve comparability standards
- Use of more than one transfer pricing method for a given transaction would become more prevalent
- Basic controversies such as use of 5 percent safe harbor clause still remain unaddressed

In the end

Another perspective that needs to be given thought is the perceived role of the Tribunal. Unlike standard corporate tax issues, it would be unfair to expect that Tribunal can / should dwell upon each and every facet of the transfer pricing analyses. To illustrate, the Tribunal may hold that a particular adjustment say a working capital adjustment should be carried out, however, the computational part would have to be verified by the transfer pricing officer. This brings in the inherent risk of the case being “remanded” or sent back for re-examination.

A fair expectation would be that Tribunal should lay down the principles and methodologies for such analyses and thereon the task of the tax inspector / transfer pricing officer be limited to number crunching. To its credit, the thinking of Tribunal has been aligned to international practices and at times ahead of the present legislative framework. For instance, use of supplementary analyses or a second transfer pricing methodology is something that OECD very recently published its view on (though in a limited sense was there in the original transfer pricing guidelines). The only area of discomfort is that all the orders so passed reflects the thinking of the President (as he presided on all four matters) and hence it is big risk that the views of other jurisdictional Tribunals get restricted to the view of one personality. This also has meant great delay in disposition of transfer pricing cases.

One staggering result of the continued uncertainty at the domestic arena has been that more and more taxpayers are looking at Mutual Agreement Procedures (MAP) under the tax treaty to be a more pragmatic way of seeking relief. As the three year period of filing MAP application would be getting over this month (in relation to FY 2001-02 audits), one expects a huge number of applications being filed at the overseas levels.

To conclude, just as one price cannot be regarded as the arm's length price in all situations, no particular principle articulated (for transfer pricing) can be said to have a universal application. This would mean that while such orders and the ones to come would reflect the thinking of the judiciary, they cannot be looked as critical parameters to determine the arm's length price. Transfer pricing has always been regarded as a mix of law and economics and Courts would never be able to confine it to a particular legal text or order.

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Exploration of potentials in Oil & Gas – Impact of Budget 2008

This article is an attempt to capture the significant changes in Budget 2008 on the indirect taxes front for one of the key sectors of the economy – the oil & gas sector.

BY RAJEEV DIMRI and ABHISHEK DUTTA

Introduction

The Oil & Gas sector is one of the thrust areas for the Government considering its importance in the Indian economy. The 10th Planning Commission reiterates the Government's commitment to intensify exploration and effectively exploit available hydrocarbon reserves. Reduction of dependence on crude oil imports by expanding domestic exploration and production has been recognized as the key achievement of self sufficiency in oil and gas resources.

This being the case, this sector is one of the key sectors which should be the beneficiary of a stable and friendly tax environment, also because of the "high risk, high reward" characteristic of this business. This sentiment has also been widely expressed in the run up to Budget 2008 through the specific expectation that the industry had from the Government.

Pre Budget 2008 Regime and expectations from the Budget

Typically, the costs for this sector on account of taxes arise due to non-creditability of the input taxes. These taxes are applicable on the contractors undertaking exploration, erection, installation and construction during the set up phase of a project. The taxes applicable to the contractor services, goods and equipment are passed on to the E&P Company. Since the E&P Company is unable to recoup the credits, these become a cost of the overall project.

From a service tax perspective, the Government has made constant attempts to widen the tax net on the sector. The taxation of consulting engineering; technical, inspection and certification; technical testing and analyses, erection, commissioning or installation; management, maintenance and repair; mining of mineral, oil and gas; survey and exploration of mineral, oil and gas; and works contract services is reflective of this trend.

While customs duty benefits on the basis of end use are available to this industry, these benefits are limited to few specified goods. There exists a good case to expand the list to include all goods that are normally required for the industry.

The cost on contractor's equipment on account of customs duty has also been a cause for continual increment in cost of E&P projects in India.

Till recently (ie 2006-07) taxation of the industry was limited in its scope to the pre mining operations. However, with last year's Budget, the expanse of service tax was widened to cover within itself activities during the mining phase as well.

From a service tax perspective, the Government has made constant attempts to widen the tax net on the sector

Budget 2008 reflects the desire of the Revenue to maximize collections from the industry, with specific proposals aimed at a widened tax base, as well as certain proposals that would increase the cost of projects

This along with a consistent effort of the Government to bring services like EPC contracts within the ambit of service tax on a comprehensive basis would have seen tax revenues from this sector soar.

It could be argued that this would lead to a "catch 22" situation with the stated objective of the Government to provide a fillip to this sector, with the increasing reluctance of the Revenue planners to let go the significant tax collections from this sector.

Budget 2008 - Highlights and its impact

Budget 2008 reflects the desire of the Revenue to maximize collections from the industry, with specific proposals aimed at a widened tax base, as well as certain proposals that would increase the cost of projects.

The imposition of use tax is one such proposal that appears to be aimed at maximization of tax revenue from this sector. This would apply in situations where tangible goods would be provided to a service recipient without the transfer of the right to possess and control those goods. The JS (TRU) circular issued in this regard lists certain illustrative goods which are sought to be covered under this taxable category. These are "offshore construction vessels & barges, geo-technical vessels, tug and barge flotillas, rigs and high value machineries". Such goods are typically provided by oilfield service providers to E&P companies during the exploration and set up phase. The imposition of service tax on such goods will further burden the industry with added service cost.

The rate increase in the composition scheme for works contract services from 2 percent to 4 percent would impact onshore contracts for exploration, installation and construction of facilities.

In addition to the above, some of the indirect cost enhancements would arise out of the expansion of the category of IT software services on an over all basis. Software of various kinds developed for survey, exploration and map making and utilized by survey & exploration companies, as well as E&P companies would be covered under this category.

Further, E&P companies typically source these software and developments thereof from offshore service providers, leading to a liability to discharge service tax on this account. It could be argued that since import of goods is exempt for E&P companies, similarly import of services should also be treated at par. However, as of now, no such relief has been received by the sector.

Another such service procured from offshore service provider could be in relation to remote management of various goods located in India for the execution of the project. Such services could now be taxed under management, maintenance and repair services.

Typically, the oilfield service providers import equipments for specific purposes and re-export them once their purpose is served. In this scenario, they have the option to pay duty and subsequently claim a refund of the duty paid. Alternatively, they may pay a concessional rate of duty at the time of importation subject to conditions of re-export within a specified time period.

Budget 2008 proposes that for the latter scheme the period for which the goods can remain in India be extended to 18 months. For duty drawback there is a reduction in the period from 36 months at par with the above scheme to 18 months.

This is a mixed bag for service providers who import equipments for providing services. While those opting for concessional route (and therefore relatively smaller projects) would be better placed to import goods for a short term, reduction in time limit for claiming drawback would be a cause for increased cost for the service providers, which would be passed on to the E&P companies.

In conclusion

Budget 2008 has been an unenthusiastic proposal from the perspective of Oil & Gas sector. Aside from increase in input costs on account of indirect taxes, the Government seems to be going against its stated position of continued encouragement to this sector, as well as containment of inflation.

Although there is a strong need to contain the cost of operations for the E&P companies in India, the likelihood of any developments on this count in the near future appears remote.

The impact of indirect taxes needs to be better understood by E&P companies as well as oil field service providers for undertaking the operations on a continued basis.

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Budget proposals for Service tax on IT industry

India's IT industry faced numerous challenges on service tax creating additional tax burden and disputes, most of which were addressed in Budget 2008.

BY MAHESH JAISING AND KUNAL WADHWA

Indian IT industry over the past years

The IT industry has had a phenomenal growth in the past 10 years and continues to play a significant role in India's economy, contributing 5.5 percent of the Gross Domestic Product (GDP) and USD 48 billion in Financial Year 2007 (FY) including generating huge employment in India. There is a strong optimism of the industry to achieve its aspired target of USD 64 billion in exports by end of FY 2008[1].

Pre-budget service tax regime governing the Information Technology (IT) software industry

Software related services form the key segment in the IT industry in India. The export software services remain the mainstay of the IT industry contributing USD 31.3 billion out of USD 48 billion during FY 2007, beating the forecast to register a 33 percent growth[1].

Typically, software services as referred to by the IT industry include the following:

- Software coding services including study, analysis, design, programming, adaptation, upgradation, enhancement, implementation and consultancy relating to IT software; and
- Software maintenance services (also known as Application Maintenance Services).

Service tax on software development

Services in the nature of advice, consultancy or technical assistance in relation to computer software engineering are outside the purview of taxable services (ie non?taxable services) under "consulting engineer services" and under the specific exclusion for "information technology services" under "business auxiliary services".

Service tax on software maintenance services

Maintenance or repair activity including reconditioning, restoration, or servicing of any goods is liable to service tax under the category of "management, maintenance or repair services"[2]. Based on the Supreme Court's decision in Tata Consultancy Services v State of AP[3], a clarification issued by the Revenue[4] and an Explanation inserted in the definition of "management, maintenance or repair services" on June 1, 2007 wherein computer software was clarified to qualify as "goods", it emerges that maintenance of computer software is liable to tax under "management, maintenance or repair services".

Pre-budget service tax regime posed challenges and disputes for the IT industry. Hence, the industry looked forward to Budget 2008 for relief

Export of software related services

As software development services are "non taxable services", the provisions of Export of Services Rules, 2005 (Export Rules) would not be applicable.

However, software maintenance services being taxable, one of the key conditions for such services to qualify as an export was that the service should be partly or wholly performed outside India.[5] The applicability and satisfaction of this condition by IT Companies doing remote maintenance by accessing servers situated outside India was a matter of debate and hence, has resulted in disputes in some cases.

Shortcomings of the pre–budget service tax regime

Classification disputes

The IT industry enjoyed various exemptions / exclusions from the levy of service tax and attracted the levy only on selected services of the sector. In view of this, in several instances of availment of exemptions by the IT companies, the same was unnecessarily disputed by the service tax authorities. Some of the disputes are as follows:

- Enterprise Resource Planning implementation services treated as non-taxable by the IT industry but treated as taxable by the service tax department under "management consultancy services"

- Software development contracts on time and material basis treated as non-taxable by the IT industry but treated as taxable by the service tax department under "manpower supply and recruitment agency services"

- Software service providers unable to avail credit as the services are non taxable

Shortcomings of the pre-budget service tax regime were mainly on classification disputes, denial of credit and export of software maintenance services

Software service providers are denied credit of tax paid on input services (even though they satisfy the test of export) on account of the fact that they render "non-taxable services".

Approximately 25 percent to 30 percent of the business expenses relate to the following input services:

- Contract labour;

- Rent;

- Telecommunication cost; and

- Other expenses.

Accordingly, service tax on input services consumed by the IT industry (both domestic and international) typically amounts to around 3 percent to 4 percent of the total business expenses, which is a significant cost when Indian companies have to compete internationally.

Given the exclusion of most software services from the purview of service tax, the taxes paid on inputs services is not available as credit and has resulted in increased cost for providing these services.

Issues in relation to export of software maintenance services

As stated earlier, there was a dispute whether Application Maintenance Services (in most cases) when provided remotely from India to overseas customers qualified as export services and hence, service tax on such services were disputed.

Therefore, even though the Export Rules were introduced with the intention of identifying export of services and to provide tax relief to the service providers who export services, in the scenario of exporting of remote software maintenance services performed in India, the basic premises of such relief was dilute.

Budget 2008 proposals

"Information technology software services" proposed to be introduced

A new category of "Information technology software services" is proposed to be introduced to include the following:

- Development, study, analysis, design and programming of IT software;
- Adaptation, upgradation, enhancement, implementation and other similar services in relation to IT software;
- Provision of advice, consultancy and assistance on matters relating to IT software; and
- Acquiring right to use IT software for commercial exploitation and right to use IT software supplied electronically.

The above services shall be taxable under service tax only when provided to any person for use in the course, or furtherance, of business or commerce.

The new category has attempted to cover all software services of the IT industry that were earlier outside the levy and has brought the IT industry on the same plain with related services like Information Technology Enabled Services (which was already taxable under service tax). The above category has sought to tax customised software related services and brought this segment at par with the duty impact (at 12 percent) on packaged software.

Acquisition of right to use IT software for commercial exploitation and right to use IT software supplied electronically.

The above definition covers acquiring the right to use IT software for commercial exploitation, including the right to reproduce, distribute and sell software components for the creation and inclusion in other IT software products and right to use IT software supplied electronically. Hence, any amount paid for acquiring software for exploitation or for downloading of software electronically (generally paid as royalty) would fall within the purview of this service and would attract service tax at 12.36 percent.

As highlighted earlier, software downloaded electronically from the internet did not attract any excise or customs duty. Such transactions shall now be leviable to service tax under the new category.

Consequent amendments to existing service categories

Consequent to the above amendment, the following changes to existing service categories are also proposed:

- Exclusion to computer software engineering services omitted under "consulting engineer's service"
- Exclusion to "information technology services" in the definition of "business auxiliary service" omitted
- "Technical testing and analysis service" definition amended to include technical testing and analysis of "information technology software"
- "Technical inspection and certification service" definition amended to include technical inspection, examination and certification of "information technology software"

These amendments are made to align the taxation of software under specific service categories providing comprehensive coverage of software related services under service tax.

Export of Service Rules amended wef March 1, 2008 wherein the location of goods, material or immovable property in relation to specific services (including software maintenance services) shall be the location of performance of such services

Amendment to Export Rules

Export Rules have been amended to provide that in case the following services are provided in relation to goods or material or immovable property located outside India at the time of provision of the service, then whether the service is performed in India or outside India, the service shall be treated as taxable service performed outside India:

- Management, maintenance or repair services;
- Technical testing and analysis services; and
- Technical inspection and certification services.

The above would apply only where the services are provided remotely through internet or any electronic network including a computer network or through any other means.

With this amendment, the location of the goods or material or immovable property shall determine the place of performance of the service.

This amendment shall have prospective effect and shall be applicable from March 1, 2008.

Accordingly, this amendment has provided much awaited relief to exporters of software maintenance and software testing services in satisfying the test of partly or wholly performed outside India.

Further, the converse of the above also applies to Taxation of Services (Provided from outside India and Received in India) Rules, 2006, ie, the Import of Service Rules.

With the new budget proposals, export and domestic industry shall benefit on unlocking of substantial credits and resolution of classification disputes – however, domestic services to attract tax cost where no credit available

Impact of service tax proposals on the software industry

Export industry

Large amounts of credits unlocked

Exporters of IT software services can avail credit of tax paid on input services (generally 3 percent to 4 percent of revenue) used in providing IT software services that are exported, thereby reducing their cost of operations and making them more competitive in the international market. Further, for service exporters housed outside STPI units / SEZ units, credit of excise duty / CVD paid on inputs / capital goods used for providing IT software services shall also be available.

Test of export of maintenance and testing services made simpler

With the amendment to the Export Rules, the key test to be satisfied for maintenance or repair services and technical testing services shall be the location of the goods or material or immovable property to determine the place of performance of the service.

This is a welcome amendment for the IT industry as the test of performance of services outside India was disputed by the authorities in cases of remote software maintenance from India.

However, this amendment has prospective effect from March 1, 2008 and shall not provide relief to the past period. Hence, for the period prior to March 1, 2008, the disputes are likely to continue. In fact the ground level authorities are likely to argue that the amendment justifies the reason for disputing that the services were “export services” in the past.

Scope of new entry, ie, for use in the course, or furtherance, of business or commerce

Service exporters providing services to non?business customers like government or non?profit organisations would need to examine the impact of the restricted scope of the entry. Should the same not be covered under the new entry, it would result in a restriction of credits attributable to such services.

Domestic industry

Marginal increase in cost of software services

The domestic software industry mainly caters to the services industry and manufacturers, who should be eligible to avail credit of the service tax paid on such IT software services. However, service tax shall remain a cost in the hands of customers involved in trading. We have provided below, the percentage of software services availed in various industries:

Industry	Percent
Banking and financial	38.1
Telecom	19.8
Manufacturing	12.9
Retail	7.6
Media and entertainment	4.2
Construction	4.0
Healthcare	3.0
Transportation	2.1
Others	8.4

(Source: NASSCOM)

As a significant portion of the customer base should be able to avail credit, there should be no significant impact on the domestic industry by the proposed introduction of service tax on IT software services.

Classification disputes to reduce

On introduction of one consolidated definition for "information technology software services" and consequent amendments to existing definitions, one can seemingly expect fewer disputes regarding classification of the various fields of software.

Further, for existing disputes, support could be taken from the fact that levy of tax only comes in now by virtue of the specific inclusion of this taxable entry.

Large amount of credit unlocked

Substantial amounts of credit of service tax on input services and excise duty / CVD on inputs / capital goods shall now be eligible to be availed by service providers providing IT software services.

Implications on domestic software licenses

The new category of "information technology software services" shall impact the following:

- Payments of royalty for software by Indian companies to foreign companies

- Transactions where software is supplied electronically. In cases where packaged software is supplied by Compact Disc's and also supplied electronically, it would need to be examined in detail whether the amendment would impact such transactions as well.

With the proposed introduction of "information technology software services", payments of royalty for software by companies for commercial exploitation as well as software supplied electronically is now under the purview of service tax

Scope of new entry, ie, for use in the course, or furtherance, of business or commerce

Domestic service providers providing services to non-business customers like government or non-profit organisations would need to examine the impact of the restricted scope of the entry. It is likely that disputes on the non-payment of service tax on these services may also arise. Further, credit restrictions would be there where these services are provided along with services covered under the entry.

Expectations

The IT industry expects that the new category shall be included in Rule 3(1)(iii) of the Export Rules, wherein the key criteria to be satisfied for qualifying as export is that service recipient should be located outside India.

This is supported by the existing classification of "consulting engineer services" and "business auxiliary services", under which information technology services were classified pre–budget.

Several steps to be taken by the IT industry post the passing of the Budget proposals

Concluding remarks

Even though most of the corporate tax expectations of the IT industry (like extension of the tax holiday to STPI units and relief from Fringe Benefit Tax on certain expenses) were not fulfilled by the Budget 2008, the industry can nevertheless breathe a sigh of relief with certain major changes in the service tax regime such as IT software services being proposed to be made taxable and the amendment with respect to the export of software maintenance / testing services.

The IT industry should now examine the following:

- Study of existing operations to determine classification of services pursuant to amendment in the law
- Availment of credits of tax / duty paid on input services and input / capital goods by following compliance procedures like registration, returns, record keeping, etc
- Identification of contracts for customers like SEZ units, government or non-profit organisations, which shall be outside the levy of service tax
- Domestic IT software services providers may notice that certain customers face additional cost for the services (ie where no credit available to the customer)

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References:

1 Source: NASSCOM

2 As specified in clause (c) of the definition of management, maintenance or repair services

3 2004 (178) ELT 22 (SC)

4 Vide Circular no 81/2/2005 – ST dated October 7, 2005 issued by the Central Board of Excise and Customs

5 Rule 3 (1) (ii) of the Export of Services Rules, 2005

6 Vide Notification 6/2006 – CE dated March 1, 2006

Trading in carbon credits – indirect tax implications and issues

Lack of clarity on the treatment of carbon credits for indirect tax purposes may impact India's growth in the carbon credit commodity trading market.

BY SUJIT GHOSH AND SAURABH KANCHAN

Background

The past few decades has witnessed the end of the grand period of equilibrium maintained by the Earth's atmosphere. Carbon emissions have been identified as one of the dominant causes that can be attributed to the change in the fundamental structure of the global climate. The issue of need for reduction in carbon emissions was debated in the United Nations Conference on Environment and Development (Earth Summit) held at the Rio de Janeiro in 1992, resulting in the adoption of United Nations Framework Convention on Climate Change (UNFCCC), an international treaty on environment.

The Kyoto Protocol, 1998 was adopted by the parties to UNFCCC with the ultimate objective of achieving quantified emission limitation by enacting specific policies and measures for minimizing adverse effects of climate change, effects on international trade and economic impact on the parties to the Protocol. The Protocol provides for various mechanisms like Joint Implementation, Clean Development Mechanism (CDM) and International Emission Trading for boosting cost effectiveness of climate change mitigation. Developed nations ratifying this Protocol commit to reducing carbon emissions to a percentage of 1990 levels. The Protocol fixes emission reduction limits on Annex 1 nations (developed nations). The Annex 1 nations have the option of meeting their emission reduction commitments by utilising technology which aids them in such an endeavor as well as purchasing carbon credits from developing nations. The developing nations can participate in this initiative of "global green existence" by registering projects as per CDM with the UNFCCC under the Kyoto Protocol.

India and carbon credits

CDM, a mechanism, established by the Protocol for project based emission reduction activities in developing countries is designed to meet the twin objectives of addressing the sustainable needs of the host country and assisting the Annex 1 nations in complying with their commitments to limit and reduce the emission of greenhouse gases. Quantification of greenhouse gases emission benefit of a project is calculated as the difference between baseline emissions and project emissions. Carbon credit or one Certified Emission Reduction (CER) corresponds to a reduction in emissions equivalent to one tonne of carbon-dioxide by the project activity.

Union Budget 2008 does not provide any clarification on the treatment of carbon credits from an indirect tax perspective

India, being a developing nation is not required to mandatorily reduce carbon emissions to a limit specified under the Protocol. Thus India alongwith other developing nations is at an advantage as it

CERs, if made liable to indirect taxes, may adversely impact the carbon credit trading boom in India, thus making India a less attractive destination for carbon credit shopping

can implement the approved CDM projects, for the purposes of trading the "entitlement certificates" ie CERs as issued by the UNFCCC for onward sale to potential global buyers. Statistics reveal that 1/3rd of the total CDM projects registered with UNFCCC are from India. India's carbon credits' trading is expected to reach USD 100 billion by 2010. As a consequence of CDM projects, the Indian industry has managed to generate over 27 million carbon credits in 2007. Indian projects get further impetus by way of investments and finance from Annex 1 nations who are the potential buyers of the CERs generated by the projects. Key buyers of CER include European Union and Japan amongst others. The Multi Commodity Exchange of India Ltd. entered into an alliance with the Chicago Climate Exchange in 2005 for introducing carbon credit trading in India. This association has integrated the Indian markets with its global counterparts for covering risks associated with futures trading of carbon credits and ensuring best prices at which the trade can be effectuated. CDM projects mostly in key sectors such as energy (renewable and non-renewable), agriculture, manufacturing, mining and mineral production etc would thus result in providing a boost to the Indian economy. The major CDM projects are located in the states of Rajasthan, Maharashtra, Andhra Pradesh, Karnataka, Himachal Pradesh and Punjab.

Carbon credit trading – an indirect tax perspective

Trading in CERs though at a nascent stage has resulted in huge foreign exchange revenue earnings for the Indian suppliers. Typically, an overseas buyer requiring carbon credits for meeting its emission reduction targets enters into an Emission Reduction Purchase Agreement (ERPA) with a company engaged in an emission reducing project located in a developing nation. The ERPA specifically lays down the conditions pertaining to the quantity and rate of carbon credit to be purchased along with the delivery mechanism on satisfaction of which the ownership of the credits would stand transferred in favour of the overseas buyer. However, on account of the ambiguity on treatment of CERs from an indirect tax perspective, the following issues remain relevant for the Indian supplier of CERs:

- Whether CERs can be classified as goods or services for indirect tax purposes. Consequently, whether CERs would attract Value Added Tax (VAT) (levied on sale of goods) or service tax (levied on rendition of services)

- Whether sale of CERs to overseas buyers would qualify as exports of goods or services, as the case may be

For the purposes of determining whether VAT or service tax would be applicable on arrangement involving sale of CERs, it is relevant to determine whether CERs are classifiable as goods or services. At present, the indirect tax legislations do not provide any guidelines for treatment of CERs and jurisprudence on this issue is yet to evolve in the Indian context. In absence of any clarification, rationale for treating CERs as goods may be stated as under:

- Courts and appellate authorities have consistently held that intangible rights are “goods” and transfer thereof is liable to VAT

  It was observed by the Supreme Court in Vikas Sales Corporation judgement of 1996 that a Duty Free Entitlement Passbook (DEPB) for all practical purposes represents merchandise and is treated and dealt with as such in the commercial world. DEPB is neither a chose in action nor an actionable claim. It has a value of its

own. It is by itself a property and it is for this reason that it is freely bought and sold in the market. For all purposes and intent, it is goods.

The Supreme Court in the case of Tata Consultancy Services as confirmed in the Bharat Sanchar Nigam Limited case held that "goods" may be a tangible property or an intangible one. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) capable of being bought and sold; and (c) capable of being transmitted, transferred, delivered, stored and possessed.

On this basis CERs may qualify as goods since they have an inherent value of their own and are capable of being freely bought and sold in the market as well as capable of being transferred, delivered, possessed etc.

- CER futures are globally traded across major commodity exchanges. It is important to remember that CERs traded on such exchanges are in the nature of commodity derivatives with the underlying commodity being CERs. In India, forward contracts for goods are governed by Forward Contract (Regulation) Act, 1952 (FCRA). Recently, the Government has issued a notification bringing CERs within the purview of FCRA.

This lends credence to the argument that CERs are increasingly being recognized as goods.

In the event of CERs being taxed as goods, it is felt that they should be accorded the same treatment as "electricity" for VAT purposes ie either CERs be excluded from the purview of VAT or be specified in the schedule of exempted goods.

While the arguments for treating CERs as goods are fairly compelling, one must not lose sight of the fact that intangible rights have in certain instances been defined as taxable services under the service tax legislation. Some illustrations to support the case in point are temporary enjoyment of intellectual property rights taxable as "intellectual property rights services", sale of time slots on electronic media for advertising purposes taxable as "broadcasting services" and the recent budget proposal for treating right to use goods without transfer of effective possession or control of relevant goods, as a separate taxable service. Going forward, the Government may spring yet another surprise by defining "generation of CERs" as a taxable service.

Mere determination of the issue of goods versus services for CERs would not resolve taxpayer's predicament. Given the fact that CERs generated by projects in India are sold to overseas buyers, it becomes imperative to determine if such sale amounts to export out of India, of goods or services, as the case may be. Should such sale or service qualify as export, VAT or service tax would not be applicable. This, in turn requires the tax payer to answer the vexed issue of situs of intangible property such as CERs.

Rationale for arguing that CERs generated by projects in India reside in India at the time of their generation is that such CERs are generated in India and relate to projects located in India. At the same time, one cannot ignore the fact that CERs come into existence not merely on their generation but on certification and registration outside India.

Similarly, sale of CERs to overseas buyers may be argued to operate as export of CERs on the following basis:

- Since CERs are intangibles, establishing physical movement for the purposes of qualifying as exports may not be possible for the supplier. However, such supplies may be established as exports if the delivery

mechanism outlined under the ERPA and the documents evidencing such delivery, establish delivery outside India

- The CERs delivered outside India are used by the buyers, as a set off against their quantum of carbon emissions, in respect of projects located outside India

Thus, delivery and consumption of CERs outside India may provide credence to the argument of export of CERs.

Be that as it may, jurisprudence in the area of situs of intangible property is yet to crystallize. In a one off year 2006, judgement of the Gujarat High Court in the case of Ambalal Sarabhai Enterprises, the Court held that situs of sale or transfer of incorporeal rights such as promotion literature, copyright, technology etc would determine the jurisdiction for levy of sales tax. Situs of such incorporeal rights would not be relevant for this purpose. However, this judgement was rendered in the context of determining which state was eligible to tax the transaction in question. As such, this judgement does not address the issue of export of intangible property.

The Institute of Chartered Accountants of India (ICAI) is currently working on accounting norms for CERs

CERs, if made liable to indirect taxes, may adversely impact the carbon credit trading boom in India. Indirect taxes embedded in an arrangement involving sale / provision of services in respect of CERs would thus influence the pricing and may make India a less attractive destination for carbon credit shopping. It is expected that the Government may grant tax sops on carbon credit trading with a view to ensure its global commitment to reduction of carbon emissions coupled with the growth of its economy.

Conclusion

Lack of clarity on the treatment of CERs for indirect tax purposes exposes companies engaged in projects generating carbon credits to the threat of significant tax demands. The past year saw the Institute for Solid Waste Research and Ecological Balance urge the Union Government to exempt carbon credit earnings from income tax as well as service tax and to issue separate Government Orders to dispel all doubts on this issue. Various sectors had specifically sought clarification on the treatment of CERs in their Budget wishlist. However, the Union Budget 2008 merely makes a passing reference to setting up of a trading platform for carbon emissions and does not shed any light on the aspect of taxation of CERs.

The Institute of Chartered Accountants of India (ICAI) is currently working on accounting norms for CERs. As per the ICAI, companies who earn revenue by selling carbon credits will have to make their financial statements as per the new norms from April 1, 2008. However, the new accounting norm on this issue is yet to be notified by the ICAI. It thus has to be seen whether CERs are classified as a tradable commodity as per the accounting norm.

Entrepreneurs and Venture Capitalists seeking to commit sustained capital inflows to "green projects" in the country would be indebted to the powers that be if clarity on treatment of CERs for indirect tax purposes is issued.

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Benefit of refunds to Service exporters – A study

Policy framework for zero-rating exports has evolved overtime to enable service providers to claw back input tax costs in relation to "eligible exports".

BY AJAY MEHRA AND DIVYESH LAPSIWALA

Service tax applies on specified taxable services. One of the stated intentions of tax regulations in India has been to "zero-rate" exports out of the country, and therefore the widely accepted proposition that India should export "goods" and "services" and not taxes.

Although service tax was introduced in 1994, the framework did not provide for a clear treatment of taxable services exported out of India until recently. While the principle that service tax should not apply on exports was enunciated in a clarification issued in April, 2003, a structured enactment under the regulation was made operational only from March 15, 2005. These regulations are referred to as the "Export of Services Rules, 2005" or the Export Rules.

The Export Rules provided for bases to determine what is "export" for a particular service and provided for a waiver of output taxes on such export services. This was coupled with notifications (issued in April, 2005) granting rebate of duties and taxes incurred by a service exporter. This, therefore, set the framework for zero-rating exports by waiving tax on output and granting rebate for input taxes.

The above notifications were supplemented by amendments made to Rule 5 of the Cenvat Credit Rules, 2004 (Cenvat Rules) in March 2006, providing service exporters alternate methods to claw back input taxes related services "exported" by them.

One of the most efficient and easy to implement options for claiming back credits has been provided under the framework of the Cenvat Rules. An exporter is permitted to use input taxes related to exported services against other liabilities. This provides for a real-time adjustment of taxes on inputs related to exported services. It is only when such an adjustment is not possible in full, thus resulting in amounts locked up in unutilized credits; the exporter needs recourse to other alternate refund/ rebate mechanisms.

In the following paragraphs, we have analyzed the alternate mechanisms that are currently available to service providers, the conditions and key processes relevant for each alternative, as well as the factors to be considered while choosing one over the other(s).

Alternate schemes of rebate/ refund

The alternatives can be classified into two broad heads: (a) rebate under Export Rules; and (b) refund under Cenvat Rules. The alternatives are generally mutually exclusive, and refund claimed under one of them debars the exporter from claiming refunds under any other alternative.

Rebate under Export Rules

The Government has notified two schemes under the Export Rules for grant of rebate:

- Notification 11/2005-ST (N11), which provides for rebate linked to service tax paid on services exported
- Notification 12/2005-ST (N12), which provides for grant of rebate of duties and taxes on inputs and input services used for providing output services

In essence, N11 suggests that unutilized credits should be used to pay taxes on output, which would then be refunded as a "rebate" (given the principle that exports do not trigger a tax payment). A mechanism similar to this is fairly popular under excise regulations (under Rule 18 of the Central Excise Rules, 2002).

N11 applies to all exports (other than to Nepal and Bhutan) for which payment is received in convertible foreign exchange. For this purpose, the exporter should:

- Avail cenvat credit of all eligible input taxes;
- Utilize the credit to pay service tax on exported services;
- Collect payment for such exported services in convertible foreign exchange; and
- File for a refund of taxes paid on services exported on a periodic basis.

N12 grants rebate on the taxes incurred in relation to services exported. The objective is to refund to the exporter the entire tax burden (in terms of excise duty on inputs and service tax on input services) borne by him on the exported service.

Like N11, N12 also applies to all exports (other than to Nepal and Bhutan) for which payment is received in convertible foreign exchange.

For this purpose, the exporter should:

- Not avail credit under Cenvat Rules for the taxes embedded in inputs and input services used for providing output services;
- Prior to export, file a declaration with the Revenue, describing the service intended to be exported along with details of input and input services likely to be used for providing such exported services. The declaration includes estimate for export billings and collections as well estimated input taxes that would be incurred (and later to be claimed as a refund);
- Collect payment for such exported services in convertible foreign exchange; and
- File for a refund of taxes paid on inputs and input services in relation to the exported services on a periodic basis.

Refund under Cenvat Rules

Rule 5 facilitates refunds to service exporters who are unable to fully utilize all input credits against output service tax liability.

Rule 5 applies to all exports for which payment is received in convertible foreign exchange. For this purpose, the exporter should:

- Avail cenvat credit of all eligible input taxes;
- First, utilize such credit on payment of domestic tax liabilities; and
- For the unutilized portion, apply for

refund on a periodic basis as per the following formula:

Maximum Refund = A * B / C
where:

A = Credit taken on inputs and input services during the given period
B = Turnover of Export services
C = Total turnover (ie total turnover of all output services including Exempt services, whether exported or not)

Illustration

Let's say for simplicity the rate of service tax is 10 percent. A service exporter has the following data related to a particular period for which he wants to claim rebate/ refund:

Input taxes incurred (out of which Rs 250 exclusively relates to domestic services)	Rs 1,000
Turnover of Exported Services	Rs 4,000
Turnover of Domestic Services	Rs 1,000

For rebate under N11, the exporter should:

- Avail all credits;
- Pay tax on exports by using the credit. Maximum tax payable Rs 400 [10 percent of Rs 4,000]; and
- Balanced unutilized Rs 600 should be allowed to be carried forward.

For rebate under N12, the exporter should:

- File declaration before export;
- Apply rebate claim for Rs 750 representing service tax paid on input services used for providing exported services;
- Avail credit of Rs 250 and utilize for paying Rs 100 as tax on domestic services; and
- Balance Rs 150 should be allowed to be carried forward

For refund under Rule 5, the exporter should:

- Avail all credits;
- Pay tax on domestic services (Rs 100);
- Apply for refund of Rs 720 as per prescribed formula available [900*4,000/5,000]; and
- Balance Rs 180 should be allowed to be carried forward.

This is a simplistic example to elucidate the provisions. In this illustration, N12 maximizes the refund available. However, the results could differ on a case to case basis. For example, if the input credit exclusively related to domestic services were to be Rs 350 (instead of Rs 250 currently) the refunds would be Rs 400, Rs 650 and Rs 720 under N11, N12 and Rule 5 respectively, making Rule 5 as the best option. Thus, it can be seen that selection of an appropriate scheme is an involved exercise, backed by on numeric data.

As discussed earlier, claiming refund under one scheme debars the service exporter from claiming refunds under the other two schemes. An interesting point to be analyzed is whether the service exporter can claim a refund of that portion of credits which was excluded from the eligible refund amount based on the method prescribed under a particular scheme, under another scheme.

Selection of the most appropriate alternative to claim refunds is an involved exercise, and should be backed up by numeric data

Time limit for filing

All rebate / refund claims are to be filed within one year from the "relevant date" as prescribed by Section 11B of the Central

Excise Act, 1944. Section 11B is designed to deal primarily with export of goods and prescribes that rebate / refund claims should be filed within one year from the date of crossing the customs frontiers for export-out-of-India. However, for service exports the concept is more nebulous as they are not physically exported. Moreover, it becomes difficult to determine date of export or event resulting in export in case of services arising out of long term ongoing contracts.

Given this, there is currently significant debate as to what should be considered as a reference date to compute the time limit of one year.

While there is no clarity yet on the above issue, as the regulations permit exporters to file claims on a quarterly basis, at a practical level, the business should register claims every quarter and ensure that even in the worst case scenario, the claim is not time-barred.

There can be no well defined set of rules to determine the most suitable scheme, however, some pointers may help the decision making process

The debate would continue to be relevant if an exporter is seeking to claim rebate / refunds for past periods in arrear.

Recent jurisprudence

Given that the rebate / refund mechanism was introduced fairly recently, guidance in terms of case laws has started to emerge only recently.

In January this year, in the case of WNS Global Services (2008-TIOL-228-CESTAT-MUM) the Mumbai Tribunal has ruled that export refund provisions under Rule 5 (introduced in March, 2006) are available for refund of taxes for prior periods also, as long as the claim is filed within the time limit prescribed under Section 11B. While the possibility of the Revenue appealing against this cannot be ruled out, the case law is significant for interpreting the effective date from which refunds can be claimed under Rule 5, and therefore would lend further support to export claims under similar fact pattern.

More and more litigation and resultant principles of interpretation are expected to emerge over time, and therefore, in addition to being proactive in taking positions under one refund scheme or another, service exporters should closely watch this space to be able to react in a timely manner.

Bar of unjust enrichment

One of the cardinal principles applied to grant of any refund under excise or service tax is that the claimant should not be unjustly enriched if the refund is allowed. For example, if a service provider disputes applicability of service tax on output services, but charges service tax and recovers it from the customers, if later the matter is ruled in favour, the service provider would be precluded from obtaining a refund of the service tax collected and deposited by him as the burden of tax has already been passed by such service provider to his customer(s). The customer(s) would then become the persons entitled for refund, provided they have not passed the burden of tax to a third person.

For rebate / refund related to exports, a question arises whether the above principle would be applicable. While one school of thought is that unjust enrichment should not apply to export refunds, the question becomes somewhat relevant for certain service exporters especially if they invoice clients on a “cost-plus” basis and charge all expenses on a tax inclusive-basis to Profit and Loss account as an “expense”, instead of recording the credit portion (of the expense) as a recoverable in the Balance Sheet. In such cases, tax so debited to Profit and Loss account forms part of the cost which is billed out to (and therefore recovered from) clients. The question is, will this amount to unjust enrichment.

Selection of an appropriate scheme

As we have seen earlier, selection would be governed by attendant facts and actual number crunching. However, we have highlighted certain broad-based principles that could aid the selection process:

- Documentation requirements under N12 are very high (in terms of pre-declaration, approval of declaration, and subsequent refund claim) as compared to N11 and Rule 5 (only refund claim on a periodic basis)

- Rule 5 and N12 relate to refunds of input taxes on inputs and input services only. N11 provides the flexibility to claim refund of taxes on capital goods as well

- For N12, service provider needs to demonstrate direct and specific nexus of input taxes claimed as refund with the exported service. Such direct linkage is not as rigorously required for N11 and Rule 5 refunds

- Rule 5 allows refund of input taxes availed during the period for which refund is being claimed. It appears that opening balances brought forward cannot be refunded under Rule 5. N11 does not specifically debar refund of opening balances

- Computations under N12 can get complex when the service provider renders exported services as well as domestic services as the declaration should contain only input taxes related to exported services, and no credit can be availed of such input taxes; whereas the service provider would want to avail credit of the balance inputs – something that will be required to be tracked real-time, based on actual usage to determine which part of input taxes should recorded as credit. This is especially relevant for common inputs and input services.

Conclusion

The introduction of rebate / refund provisions is arguably the most significant development under service tax. Zero-rating of exports has provided exporters a platform to obtain refund of input taxes, which reduces costs and improves the bottom-line. Businesses should, therefore, setup robust processes to map all data and documents required for processing refund applications. Further, tracking should be real-time basis to promptly trigger filings under the most suitable scheme so that time-barring provisions do not hinder refunds, which are otherwise eligible.

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Time-bar and unjust enrichment to be monitored closely to ensure there are no technical glitches in the refund claims

Real Estate – evolving indirect tax issues

The real estate sector is at the archetypical turning point, leaving behind in its trail days of operating as a largely unorganized and fragmented sector, while looking forward to days of intense activity marked by involvement of large players, significant investment and much more. An analysis of the larger indirect tax issues and considerations.

BY MALINI MALLIKARJUN AND PRASHANTH BHAT

Introduction

Historically, the key indirect tax that has impacted the real estate sector was that of works contract tax (which has since been rechristened VAT). And, that too, was limited to the activity of construction. With the increasing scope and ambit of VAT, and the introduction and gradual expansion of service tax to many services, the impact of these indirect taxes on the real estate sector has increased. Alongwith the legislative changes that have altered the turn of events, there have been judicial precedents and departmental circulars. While some of these developments were perhaps needed, and should in the long term result in the required clarity on tax implications, they also result in some unanswered questions.

Many players, different considerations

Land owners typically transfer development rights outright or enter into joint development agreements (JDA). Outright transfer is akin to transfer of rights. In case of JDA, people pool resources and come together to achieve common objective. Such arrangements do not involve transfer of goods or provision of services, as is commonly understood.

Developers develop and construct the properties for purposes of commercial exploitation by way of sale or lease to customers.

Contractors provide the services of actually constructing the property for the builders / developers.

Indirect taxes impact both the transaction between the contractor and developers; and the transaction between the developer and buyers / lessees. However, the interplay of taxes and issues are different at both legs; generally speaking, while the tax practices are relatively clear in case of transactions between contractor and developers, there remain some uncertainties on the indirect tax implications on transactions between developers and buyers.

Construction activity

Over two decades ago, the issue of whether a composite contract for construction is liable to sales tax or not was subject matter of constant debate. The issue was laid to rest with 46th amendment to the constitution in 1982, by which the definition of "sale" was amended to include "transfer of property in goods involved in the execution of works contract" as a deemed sale. Accordingly all the State sales tax legislations were

There are uncertainties in the tax practices being followed on transactions between builders / developers and buyers

amended to enable the States to impose sales tax on the goods transferred under a composite contract for construction. And detailed provisions were also introduced to arrive at the taxable material portion of the total construction contract value.

However, construction service was first subject to service tax wef September 10, 2004. But the levy was restricted to construction activity in relation to commercial property. With the widening of the service tax net, construction of residential complex has also been brought within the ambit of service tax, wef June 16, 2005.

Indirect Taxes on construction activities has evolved over a period of time and has come a long way

Additionally, in the last budget, a taxable category of works contract services was introduced, which also covers construction of commercial, industrial and residential complexes. Providers of such services were given an option to pay service tax under the composition scheme at the rate of 2.06 percent.

Hence, the issue that has been widely debated in the industry over the last year is the meaning and intent behind the obvious overlap between the erstwhile category of construction services, and the newly introduced category of works contract services. The issue is also of whether the contractor could chose between the categories of construction services and works contract services.

While the construction category has abetment for materials, the contractor could not claim any credit. The composition rate of 2.06 percent, coupled with eligibility to avail credit of taxes and duties paid on input services and capital goods, acted as an incentive for contractors to opt for payment of service tax under the composition scheme.

In this Budget, however, the rate of tax under composition scheme for works contract service has been increased from 2.06 percent to 4.12 percent wef March 1, 2008.

This increase in rate has rekindled the issue of whether a contractor has a choice between the two seemingly competing categories of taxable services.

While the increase in rate of composition scheme for works contractors to 4.12 percent appears to be aimed at bringing down the disparity between the service tax rates for works contract services and other categories of service tax, the increase by 2.06 percent would result in an increase in the overall project cost.

Composition Rate for ongoing contracts

Under the composition scheme, the option to pay service tax at the composite rate has to be exercised for every contract, prior to payment of service tax in respect of the said works contract. Once exercised, the option shall be applicable for the entire works contract and shall not be withdrawn until completion of the works contract.

Now that the composition rate of service tax has been increased to 4 percent, this condition seems to have unduly trapped the works contractors, who had opted for this scheme based on the concessional rate of tax of 2.06 percent, especially with regard to the ongoing contracts. The contracts in many cases are all inclusive with any additional burden being absorbed by the contractors.

Since the main provision of the composition scheme has been amended mid way, it is unclear whether the increased rate will at all apply to ongoing contracts, especially since the contractor does not have the option to opt out of the composition scheme for such contracts.

Continued attractiveness of Composition Scheme

Under the category of construction services, the contractor has the option of

paying service tax on 33 percent of the value of the contract (after availing the prescribed abatement). Hence, the effective rate of service tax under the abatement scheme works out to be 4.07 percent, although the scheme prohibits Cenvat credit on inputs, input services and capital goods.

In comparison, the enhanced rate of 4.12 percent under works contract composition may still be beneficial for the contractors due to the availability of Cenvat credit on input service and capital goods.

Evolving issues on residential projects

The Supreme Court in the landmark judgment of K Raheja Development Corporation has held that if a developer enters into a contract for construction of residential apartment or unit in a residential complex, before construction is completed, it would be a works contract and attract the levy of sales tax. However, if the agreement is entered into after the flat or unit is already constructed, there would be no works contract, and hence no sales tax payable.

This decision triggered a spate of amendments in the VAT laws of States like Maharashtra to clearly include an agreement for carrying out the building or construction of immovable property within the definition of sale, for levy of VAT.

Hence, the emerging picture is one of Developers being liable to VAT on pre-construction sale transactions. Post-construction sale transactions, on the other hand, are perceived to out of the VAT net.

This development is significant from a service tax point of view as well, since if pre-construction sale arrangements are considered as works contract under VAT, arguably they could be considered as works contract for service tax as well, and accordingly brought to tax under the category of works contract service. However, the clarifications issued to date do not address the applicability of service tax in such cases.

This has resulted in varied practices being adopted by developers of residential projects regarding the applicability of service tax on the sale of each unit. While the industry is grappling with the seeming dual levy of VAT and service tax on the transactions between the contractor and the developer, and the developer and the buyer, the real challenge is that many of these tax costs may not be readily borne by the customers.

Evolving issues on commercial projects

The last budget saw the introduction of service tax on renting of immovable property which includes renting, letting, leasing, licensing or other similar arrangements of immovable property for use in the course or furtherance of business or commerce.

Since the introduction of service tax on rental of immovable properties, petitions have been filed by leading real estate associations challenging the levy. And, in fact, such a petition has been admitted in the Mumbai High Court on the ground of constitutional invalidity.

And the industry has been seeking a withdrawal of this levy, or at a minimum, introduction of a lower composition rate of tax. In the meanwhile, a recent circular seeks to deny the credit of service tax paid in relation to works contract services used in construction of immovable property to be let out, on the ground that the immovable property is neither "services" nor "goods". This circular also raises questions on the creditability of duties incurred on materials.

This clarification appears to be contrary to the definition of the term "input service"

The landmark SC decision in Raheja case has opened up huge avenues for the Government to impose VAT and service tax on pre-construction sale arrangements

which clearly includes services used in relation to setting up, modernization, renovation or repairs of a premises of provider of output service.

Imposition of service tax on supply of goods without transferring right of possession and effective control

In this Budget, service tax is proposed to be extended to services provided in relation to supply of tangible goods, including machinery, equipment and appliances, for use, without transferring right of possession and effective control of such machinery, equipment and appliances.

It is more or less settled principle under VAT, with the Courts also ruling, that no VAT can be imposed where the effective possession and control of the goods is not transferred to the person using the goods. This budget seeks to impose service tax on such arrangements.

Perhaps the much awaited Goods and Service Tax may provide relief to the real estate industry by eliminating duality of taxes, and providing cross-credits

This would impact industries such as the construction industry, where large machineries like excavators, wheel loaders, dump trucks, crawler carriers, compaction equipment, cranes, etc were taken on "hire basis" for use in construction activities.

Allowing or permitting use of space without transfer of possession or control of the immovable property is liable to service tax

The current Budget contains a proposal to clarify by way of removal of doubts that renting of immovable property service includes allowing or permitting the use of space in an immovable property, irrespective of the transfer of possession or control of the immovable property.

This amendment is mainly aimed at clarifying that use of immovable property allowed for placing vending / dispensing machines in malls and other commercial premises and erection of communication towers on buildings, whether or not involving any transfer of right of possession or control, would be liable to service tax under the category of renting of immovable properties.

Concluding remarks

As in the case of any developing industry, the real estate industry is going through a phase of evolving tax issues. With the Government striving for its share of revenues, through imposition of new taxes, and the lack of a fully fungible VAT system, a large chunk of the input taxes paid remain a cost in the system. This, along with the dual applicability of both VAT and service tax, has resulted in significantly high impact of taxes.

Perhaps the much awaited Goods and Service Tax (GST) may provide the solution to the real estate industry by eliminating duality of taxes, and providing cross-credits. And the industry is hopeful that the dust on the service tax issues will settle down as it did in the context of works contract tax issues. In this process of evolution, the industry has the benefit of having a progressive and vigilant judiciary on its side!

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Refund of additional duty of Customs - an analysis

Need for a stitch in time from the Government to make the exemption notification more meaningful and grant refund.

BY HIMANSHU TEWARI AND PRADEEP DIVGIKAR

The genesis of the levy and the exemption

Additional duty of customs was introduced on imported goods with an intention to countervail the levy of sales tax on sale or purchase of like goods in India. In its current form, the levy was introduced in 2005. Prior to 2005, this duty was collected as Special additional duty of customs. Specific exemptions have been granted from time to time on the levy of this duty. The most recent one is the notification 102/2007 – Customs, dated September 14, 2007 which grants exemption from levy of whole of additional duty of customs for goods imported in India for subsequent sale. Though exemption has been granted vide the notification, in absence of the enabling procedures, importers have not been able to get any refund till date.

The exemption Notification 102/2007

The notification has exempted goods imported into India for subsequent sale from the whole of the Additional duty of customs leviable on such goods under section 3(5) of the Customs Tariff Act. Following conditions are to be fulfilled for availing the benefits of the exemption:

- the importer of the said goods shall pay all duties, including the said additional duty of customs
- the sale invoice shall specifically mention that no credit of the additional duty of customs levied under section 3(5) shall be admissible
- the importer shall file a claim for refund of the said Additional duty of customs paid on the imported goods with the jurisdictional customs officer
- the importer shall pay on sale of the said goods , appropriate sales tax or value added tax, as the case may be

The importer shall also provide copies of certain specific documents as mentioned in the notification.

The notification also specifies that the jurisdictional customs officer shall sanction the refund on satisfying himself that the conditions referred to above are fulfilled.

A plain reading of the notification reveals the stated intent of the Central Government, which is, to create a level playing field between manufacturers and traders who effect imports for the furtherance of their respective businesses. Thus far, the manufacturer importers were at a distinct advantage vis-à-vis their trading counterparts in respect of the levy of the additional customs duty. For Trader, 4 percent duty used to become a cost stuck to the traded goods resulting in increased prices of the goods in the hands of the final customer.

The issuance of the notification to that extent has endeavored to alleviate the

Challenges - absence of clear instructions and plethora of documentation requirement may result in high cost of obtaining the refund

hardship of the trading community who were required to bear the brunt of double taxation (once at the time of importation and also at the time of domestic sale of the imported goods). The ultimate sufferer of this double jeopardy imposed on the trading community was the uncomplaining consumer in the Indian market who had to bear the trickle down effect of the price rise necessitated due to this levy. The notification has undoubtedly elicited a collective sigh of relief from the import trading community who are eager to avail the benefit of exemption envisaged by the same.

While several claims have been filed with customs, none of them have been processed till date (ie even after a lapse of 6 months since the issuance of the notification). Consequently, the initial euphoria in the trading community is slowly giving way to trepidation and anxiety.

We have also learnt that the department is awaiting certain clarifications on this account.

The notification also prescribes the list of documents that the importer will have to provide along with the refund claim. The principal documents that are required to be produced to the jurisdictional customs officer are as follows:

- Bill of entry along with customs attested import invoice and TR6 Challan evidencing duty payment
- Domestic sale invoices of the imported duty paid goods
- Document evidencing the payment of appropriate sales tax or Value Added Tax (VAT) by the importer on sale of such imported goods

The notification is silent on several key legal and technical issues leading to certain fears and apprehensions in the minds of the importers and also the dealing officers at the cutting edge level.

The challenges

The notification in it's present form is likely to throw a lot of challenges to both - the trade and the dealing officers of the customs department. Some of the key challenges are articulated as under:

- While the notification benefit is extended as an exemption from the levy of duty, the notification is phrased in a way which appears to give an impression that it is a conventional refund claim. There is every possibility that department may invoke the provisions of unjust enrichment and limitation of time bar on all the refund claims which will cause undue hardship to the claimant of refund. Many of the importers are, therefore, edgy and apprehensive about their claims being scuttled on these premises and are eagerly awaiting clarificatory instructions which will simplify the refund mechanism and reduce the cost of compliance. Realizing the fact that no refund claims have been processed under the notification till date, department may have to intervene and clarify the doubts so that the benefits flow to the intended beneficiaries in good time. The clarification should emphasize that the benefit is envisaged as an exemption and not a conventional refund claim. Clearly, the intention of the Government is not to limit the benefit of the exemption through invocation of the bar of limitation and unjust enrichment. The refund mechanism has only been adopted to safeguard Government revenue by repaying the amount collected as additional duty of customs only after confirming that sales tax / VAT has been paid.

- The notification requires trail of

documents demonstrating the correlation between additional duty of customs paid for the goods at the time of import and payment of sales tax / VAT at the time of sale of goods in India. In cases where multiple goods are imported in a single consignment and such goods are sold to a number of retail customers spread over various parts of India, demonstrating the correlation of multiple sales invoices covering various transactions with the duty payment at the time of import will be tedious and time consuming. It will help the cause, if the Government comes out with a simplified procedure to induce efficiency and simplicity in the refund claims process. However, as it stands today, importers may be required to introduce suitable changes in their systems which will help in accurate tracking / mapping of import and sale data. The system suitably adapted to above requirement may also help the importers in due course of time with the introduction of Goods Service Tax.

- At this juncture, it is not clear whether imported equipment subsequently leased or transferred under a Works Contract would also be eligible for claiming the refund of the said duty. Though lease and transfers under Works Contract are considered sale and VAT is levied on such transaction, it is to be explored whether such transaction would get covered under the scope of the phrase "import for subsequent sale"

Further analysis and the way forward

Inordinate delay in processing of the refund may result in significant amount of business capital getting locked in the Government exchequer.

To make the exemption notification more meaningful, a proper dispensation must be put in place to give effect to the underlying intention of the notification and make it operational. In this regard, following technical and administrative issues require urgent attention of the authorities:

- Non-applicability of the doctrine of limitation and unjust enrichment
- Simplification of documentation requirement to show correlation of multiple sale invoices in India with the import duty payment document
- Providing the necessary administrative infrastructure at each customs house to be able to handle the volume of refund claims
- Clarifying that import and further lease of equipment on payment of sales tax / VAT, would be covered under the benefit of the notification

Treading on the side of optimism there is a possibility that Government will initiate actions to operationalise the provisions of the notifications. But until such time that it happens, it would be necessary for the trading community to gear themselves for complying with the conditions specified in the notification to ensure that their legitimate claim meets the approval of the revenue officer of the customs department. Major players engaged in trading of imported goods must align their systems in adherence to the conditions specified in the notification and adopt a supply chain system that will facilitate a comprehensive and accurate tracking and mapping of their import consignments and the corresponding documents.

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Way forward
Proper supply chain documentation & active engagement with the government at various forums seeking hassle free and cost effective refund or exemption mechanism

GST by 2010 – an update and analysis

Process for roll out and implementation of GST – a long way to go.

BY SUJIT GHOSH AND ABHISHEK DUTTA

Background

The Goods and Services Tax (GST) is conceptualized as a comprehensive indirect tax on manufacture, sale and consumption of goods and services on a pan India basis. The objective of GST is to subsume all of the indirect taxes and local levies currently in vogue in India into a single tax, replacing multiple tax levies and to mitigate or completely eliminate the cascading effect of taxes.

Internationally, GST is a single levy for all transactions related to goods and services. Perhaps in anticipation of a single levy of such a nature, it had been acknowledged by the Finance Minister in the Union Budget 2007, that India needs to move towards a national level GST with the Center and the States sharing the revenue emanating from it.

In India, however, the power to levy and collect taxes has been segregated between the Centre and States under the Constitution. Since the framework of taxation in India is unique, the single GST structure may not be capable of implementation in India in its entirety.

This is because, empowering the Center with all the rights relating to taxation does not appear to be an option as it would impact the financial sovereignty of the states and may lead to the states being converted into spending agencies.

The Empowered Committee of State Finance Ministers [on Value Added Tax (VAT)] has been mandated by the Center to look into and ensure implementation of the GST regime. For this the Empowered Committee has also been aided by the Joint Working Group comprising of the then Advisor to the Finance Minister, Mr Parthasarathy Shome as well as various other secretaries to the Government of India as well as various states was constituted. The specific task mandated to the Joint Working Group was to "identify the possible alternative models for introduction of GST in India and examine their various characteristics and assess their suitability in India's fiscal federal context". After these studies, the Working Group was called upon to present its findings before the Empowered Committee for decision on the most appropriate model for introduction of GST in India.

In the last quarter of the past year, the Working Group is reported to have submitted its findings to the Empowered Committee. However, the findings have yet not been made public.

It has been however reported through secondary sources that per the Working Group's findings, India would move to a dual GST: a Central tax and separate State level taxes.

The Working Group has recommended a destination-based taxation, implying that tax would be collected in the state where the services / goods are consumed.

However, the final report of the

The objective of GST is to subsume all of the indirect taxes and local levies currently in vogue in India into a single tax, replacing multiple tax levies and to mitigate or completely eliminate the cascading effect of taxes

Empowered Committee to the Finance Minister in this regard is awaited and would clear the air regarding the final model of the GST to be adopted by the Government.

Expectations regarding GST in Budget 2008

The Budget for 2008 was widely perceived as a platform for the Finance Minister to initiate steps for laying out the roadmap for introduction of GST.

This may have involved amongst others, rationalizing excise duty and service tax to bring the rates at par, as well as notifying services, the taxation of which would have been in the State domain.

Budget 2008 vis-a-vis GST

It is felt that the Budget proposal does not make any significant inroads towards the implementation of GST. Perhaps one of the steps taken via the Budget that may be relevant from the perspective of implementation of GST could be the reduction in the duty of Central Excise from 16 percent to 14 percent. However, this recognition as well as the acknowledgment of the relation of this reduction with GST appears to be in hindsight as opposed to the reduction being specifically designed and introduced as a precursor to GST.

The Budget for 2008 was widely perceived as a platform for the Finance Minister to initiate steps for laying out the roadmap for introduction of GST

It has been proposed that the CST rate would be brought down to 2 percent with effect from April 1, 2008. However this announcement is tempered by a caveat towards finalization of the compensation package for the States. The finalization of compensation package must be consensual process leading to a single decision. Given that the precondition of reduction in CST is a consensus based decision of the Empowered Committee, one may not be too certain as to the sanctity of the deadline of April 1, 2008 as the date when the reduction in CST rate actually occurs.

Conclusion

While policy matters, constitutionality and the regulatory framework are the bedrock of the new system, the businesses would require sufficient time to get prepared for the changeover date and change their systems of accounting and compliance to adjust to the new system to be put in place.

In this regard, the turbulations faced by the industry during a pari materia transition from sales tax to VAT could provide some pointers to what lies in store with the transition to GST. Some of these issues on an overall basis which plagued the industry in the run up to VAT are as alive and fraught with uncertainty and trials. These could be in relation to the band of revenue neutral rates, treatment of deferrals and other incentives, compliance mechanisms – including the formats for returns etc, IT friendliness of the new regime, uniformity amongst States, design and scheme relating to input tax credit and set offs to name a few.

Another concern that needs to be addressed is the timely dissemination of information to various stake holders. With the Government of current years effectively postponing the proposed road map to the next Budget, coupled with the impending election (and therefore the consequent election year Budget), the incumbent Government and the States would be left with a very short lead time in which to achieve effective communication of their respective GST proposals.

In short, the other expectations and concerns of the industry during the implementation for the VAT phase could be summed up in the paragraph below:

"Although VAT has the potential to reward production and productivity, ensure transparency in indirect tax, reduce consumer prices, make Indian industry competitive, increase the tax payer base and bring the entire country into the fold of

wealth creation. But in the current form, VAT falls short and in some cases, will be counter productive. It will be prudent to defer the implementation by fixing a more practical later date. This will give the Government the time that is required to work out the details (where the devil often lies), obtain consensus and build confidence to all the constituents so that the entire country can benefit from a single Value Added Tax system." (Debate Column, Economic Times dated - December 11, 2001).

GST also raises similar hopes regarding its benefit as an efficient and substantial source of revenue for the Government but more or less similar concerns (on the lines of VAT) are likely to be faced by the industry.

Therefore, on the ground there is a long way to go and substantial steps to be taken in order to streamline the process of implementation of the target for the rollout of GST while addressing the concerns of the States as well as the industry.

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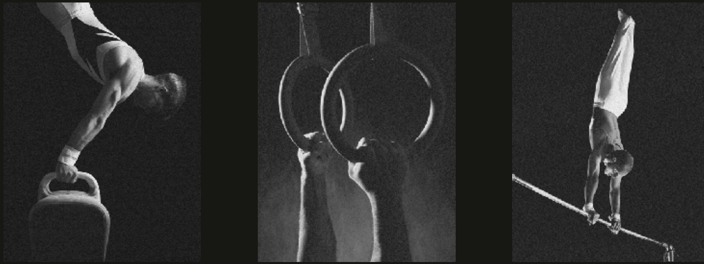
Glossary

ACE	Australian Climate Exchange
APA	Advance Pricing Agreements
BEE	Bureau of Energy Efficiency
BJP	Bharatiya Janata Party
CBDT	Central Board of Direct Taxes
CCX	Chicago Climate Exchange
CDM	Clean Development Mechanism
CER	Certified Emission Reduction
CFC	Controlled Foreign Corporation
CFL	Compact Fluorescent Lamps
CG	Central Government
CST	Central Sales Tax
CTT	Commodities Transaction Tax
CVD	Countervailing Duty
DEPB	Duty Free Entitlement Passbook
E&P	Exploration and Production
ECB	External Commercial Borrowings
EDI	Electronic Data Interchange
EPC	Engineering Procurement Contract
ERPA	Emission Reduction Purchase Agreement
ERU	Emission Reduction Units
Export Rules	Export of Services Rules, 2005
FBT	Fringe Benefit Tax
FCCB	Foreign Currency Convertible Bonds
FCEB	Foreign Currency Exchangeable Bonds
FCRA	Forward Contracts Regulation Act
FDI	Foreign Direct Investment
FMV	Fair Market Value
FRBMA	Fiscal Responsibility and Budget Management Act
FY	Financial Year
GST	Goods and Service Tax
GBP	Great Britain Pound
GDP	Gross Domestic Product
GHG	Green House Gases
ICAI	Institute of Chartered Accountants of India

IRS	Internal Revenue Services
IT	Information Technology
ITAT	Income Tax Appellate Tribunal
ITeS	Information Technology enabled Services
JDA	Joint Development Agreements
JI	Joint Implementation
JS (TRU)	Joint Secretary (Tax Research Unit)
KWhr	Kilo Watt per hour
LIBOR	London Inter Bank Offered Rate
MAP	Mutual Agreement Procedures
MCX	Multi Commodity Exchange
MNC	Multinational Corporation
MoP	Ministry of Power
MW	Megawatt
MWP	Mega Watt Power
NASSCOM	National Association of Software and Services Companies
NBFC	Non Banking Financial Companies
OECD	Organisation of Economic Cooperation and Development
PE	Permanent Establishment
PV	Photovoltaic
PFC	Power Finance Corporation
REC	Rural Electrification Corporation
REITs	Real Estate Investment Trusts
RO	Renewable Obligation
RBI	Reserve Bank of India
SBI	State Bank of India
SEBI	Securities and Exchange Board of India
SET	Sony Entertainment Television
SEZ	Special Economic Zone
SGD	Singapore Dollar
STPI	Software Technology Parks of India
TCC	Tax Credit Certificates
TNMM	Transaction Net Margin Method
TRC	Tax Reforms Committee
UK	United Kingdom
UNFCCC	United Nations Framework Convention on Climate Change
UPA	United Progressive Alliance
US	United States
USD	United States Dollar
VAT	Value Added Tax



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