Analytical Articles on Budget 2012

Vinod Kothari Consultants P Ltd

Presenting our insights on the Budget 2012

"Thode se phool
Bahot saare Kaante
Kahin se Tode
Kahin pe baante"

-Vinod Kothari

Union Budget 2012-13

"I must be cruel only to be kind," Mr. Mukherjee on Friday quoted Hamlet, Prince of Denmark, from Shakespeare's famous play, while talking about tough policy decisions he needs to take for the good of economy in long run. Presenting Union Budget 2012-13 in Lok Sabha, he said income upto Rs 2 lakh would be tax free; income from Rs 2 to 5 lakh would be taxed at 10%; from Rs 5 to 10 lakh at 20%; and income above Rs 10 lakh would attract tax of 30%.

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Foreword

The Finance Minister, Pranab Mukherjee presented the Union Budget for the year 2012-13, his seventh on the 16th March, 2012. At the very beginning of his speech, Mr. Mukherjee remarked that "*this was a year of recovery interrupted". By "interrupted"* he meant that there were adverse events across the globe that obstacles the crystallization of hopes relating to the previous Budget. But keeping in view '*cross-country comparison, Indian still remains among the front runners in economic growth.'* Let us see how far this Budget goes to fill up the vaccum left unfilled by the previous budget and helps India be amongst "*front runners in economic growth*."

We at Vinod Kothari & Co. have put together this booklet compiling few articles where we have tried to cover all aspects of the budget and its impact on the industry.

We would be happy to get readers' comments and suggestions.

Budget 2012 and the Vodafone ruling: FM travels back in time to undo ruling

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The proposed amendment to Section 9 is travel back in time machine, and travel wide to the world at large, and catch all transactions all over the world over last 50 years! Hats off to the imaginative and ambitious person who has drafted the clause!

The Finance Bill 2012-2013 has carried out several major amendments to the Income tax Act, 1961 to negate the effect of the court decisions and make transactions having effect in India taxable. Notably, the amendment (that is, insertion of proposed Section 9) dates back to 1st April 1962-the day the Income Tax Act came into force.

This article seeks to analyse and set out the interpretations and principles laid down by the Indian courts on what this substance would comprise and how the same may be established, vis-a-vis the retrospective amendments that the Finance Bill 2012-2013 brings.

Taxability of offshore entities in India-judicial overview
If an offshore entity having a transaction in relation to Indian assets fails the 'substance' test, it will be taxable in India. The important question is, what constitutes this 'substance' or when can it be said that the offshore entity is outside the domain of applicability of the Indian tax laws. The taxability of an offshore entity in India, inter alia, depends on the following key factors:

(a) Whether the entity is set up offshore merely to avail treat benefits?

(b) Whether the situs of a capital asset is in India;

(c) Whether the effective management of the offshore entity is being carried out of India; and

(d) Whether the offshore entity can be said to be non-resident of India for tax purposes.

The Indian courts have adjudicated on taxability of offshore entities on grounds of treaty shopping in a few cases, which may be referred to while determining the issue of taxability in India. Few of the importance cases are summarized as hereunder:

1. McDowell and Company vs Commercial Tax Officer

The five-judge bench laid down that tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods.

It can, therefore, be concluded that as long as tax planning is within the ambits of law, it is legitimate.

2. Union of India vs Azadi Bachao Andolan

The matter related to validity of investing through Mauritius and the question of 'residency' while determining taxability in India. The divisionbench of the apex court discussed and held several important aspects:

(a) For availing the treaty benefits under the India-Mauritius Double Taxation Avoidance Agreement, the Tax Residency Certificate (TRC) issued by the Mauritius Revenue Authority is sufficient proof to residency of the entity in Mauritius. It was further upheld that capital gains from sale of shares held in India by a Mauritius entity would be taxable in Mauritius where such Mauritius entity holds a TRC.
It may be noted that to obtain a TRC, the Mauritius entity needs to establish sufficient substance, viz. At least two directors shall be residentin Mauritius, the entity shall have board meetings and decisions making process taking place in Mauritius, a bank account in Mauritius shall be maintained and all monies shall be channelled through such account, all accounting records shall at all times be maintained at the registered office at Mauritius, etc.

(b) Analysing the McDowells decision, the division bench said that the decision may be interpreted to mean that a taxpayer shall have the liberty to choose the alternative which is more tax efficient and the act which is otherwise valid in law cannot be non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests. The Court, therefore, declared the form over substance supremacy in case of tax planning.

The Vodafone thriller

The Bombay High Court holding the tax liability in India on the Vodafonetransaction (sale of shares) between two non-resident entities, sent shivers of worry across the investors. Though the major aspect of the case was whether the corporate veil of the non-Indian entities can be lifted, mostly a question of form vs substance, the apex court also analysed and adjudicated upon the Mauritius route for investments into India. Not only did the Supreme Court hold transfer of shares between two non-Indian entities as not taxable in India (even though the underlying assets were located in India), the Supreme Court has, inter alia, also laid down several important principles that highlight the 'substance requirement' and taxability of offshore entities:

(a) *Validity of tax planning:*

(i) The cardinal principle is that if a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. The court stated the 'Look At' principle: it is the task of the court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach.

(ii) A transaction may fail if it is a 'fiscal nullity' which would arise where a transaction is devoid of any commercial substance.

(b) *Lifting of corporate veil:*

(i) A holding company and its subsidiaries are separate legal entities and, therefore, shall be resident of the country of incorporation, except where the business of the holding company is the business of the subsidiary (i.e. the subsidiary is an alter ego of the holding company). However, in a

concurring judgement, justice KS Radhakrishnan was of the view that the identity of a subsidiary can be ignored where special circumstances exist indicating that it is a mere facade concealing true facts. Therefore, rejecting the alter ego stance, justice KS Radhakrishnan stated that the court will not permit a corporate entity to be used as a means to carry out fraud or evade tax, i.e. the business purpose test shall be satisfied.

(ii) India has a "judicial anti-avoidance rule" which allows the revenue authorities to invoke "substance over form" or "pierce the corporate veil" if it discharges its burden of establishing that the transaction in which the corporate entity is used is a "sham or tax avoidant". The lack of business purpose must not be a result of dissecting the legal form of a transaction. An investor shall be looked at in a holistic manner keeping in mind the following factors: (i) participation in investment, (ii) duration of existence of holding structure (prior to acquisition), (iii) period of business operations in India, (iv) generation of taxable revenues in India, (v) timing of exit and (vi) continuity of business on exit.

(c) *Situs of capital asset in India:*

(i) For taxation in case of transfer of capital asset in India, three elements shall exist: transfer, existence of a capital asset and situation in India. Section 9(1)(i) of the Income Tax Act, 1961 (I-T Act) does not cover indirect transfers.

(ii) Controlling interest is not a separate capital asset.
(iii) Section 9 of the I-T Act covers only income arising from a transfer of a capital asset situated in India and it does not purport to cover income arising from the indirect transfer of capital asset in India. This section does not have any "look through provision".

(d) *Observation on the Mauritius route:*

In the absence of a 'Limitation on Benefits' clause in the Indian-Mauritius DTAA, the court upheld the sufficiency of TRC in order to avail the benefits under the Mauritius Treaty. However, taking a step further from the Azadi Bachao case, the court also recognized the situations where the TRC can be ignored:

(i) Where there is no commercial substance and Mauritius entity has been made out to be the owner of the capital asset in India only to avoid taxation;

(ii) Where the treaty is used with a fraudulent purpose of evasion of tax;

(iii) Where round tripping can be established.

Retrospectivity of Section 9 of the I-T Act

The Finance Bill introduces retrospective amendments in Section 9 of the I-T Act. Section 9, it may be noted, deals with income accruing or arising in India. Indian taxation laws work on a residence cum territorial model of taxation whereby, in case of residents, global income is charged to tax, and in case of non-residents, income accruing or arising in India is taxable.

To put the proposed amendment of the I-T Act succinctly, it means to say that if a transfer of a share or other interest in a company or entity has taken place out of India, but the value of the share or unit depends primarily on assets in India, then income arising from sale of such share or unit shall be

deemed to accrue or arise in India. Vodafone was using international holding companies for shifting the tax base out of India. There is no doubt that the assets with reference to which Vodafone acquired Indian telephony business were all Indian subscribers. But the transfer took place in shares of offshore holding companies. The proposed amendment would mean, Vodafone will be called upon to pay taxes to the tune of Rs12,000 crore. Of course, there will be a question of additional taxes, penalty and interest.

The proposed amendment will not be limited to Vodafone. Hundreds of holding company transfers that take place out of India will all be subjected to tax in India.

Taken to its extension, transfer of all depository receipts out of India pertain to assets in India-as the GDRs/ ADRs are nothing but proxies of shares. Hence, all such transfers also become taxable in India. However outrageous this may seem, all those non-residents who hold GDRs and ADRs in Indian companies may be slapped with tax liability in India. Those may be difficult to catch-as they are not subjected to the jurisdiction of the tax officers in India, but what about transfers of participatory notes, and other similar instruments issued by FIIs? They all derive their value from assets in India.

Summary and concluding remarks

In the author's view, it was quite logical for the tax authorities to write a substance-over-form rule-which is what courts in UK such as Indofood International Finance have done. The approach should have been to give recognition to the substance over form rule. However, what has been done in Section 9 is travel back in time machine, and travel wide to the world at large, and catch all transactions all over the world, that have bargained Indian assets over last 50 years ! Hats off to the imaginative and ambitious person who might have drafted the clause!

Retrospective taxation: questions of law and propriety

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Taxes are said to be the price we pay for being civilised; taxmen may, however, choose to charge this price in most uncivil ways. Legislating with retrospective effect (also known as ex post facto law) is surely not civil – as it goes against the generic rule that every man must be aware of what his obligations are, and a law that creates obligations dating back in the past exposes men to a price that he could not have been aware of. This may be constitutionally good, but surely not civil. F A Hayek is credited with oft-cited passage: "Stripped of all technicalities [the rule of law] means the government in all its actions is bound by rules fixed and announced beforehand — rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's affairs on the basis of this knowledge"[1]. Political theorist Joseph Raz says: "A person cannot be guided by a law which did not exist at the time when the action occurred. It is fundamentally unfair to hold a person to be in contravention of the law when that law did not exist when the alleged contravention occurred"[2].

Despite what political theoreticians might have advised over centuries, Parliamentarians care least for equity and justice when it comes to enacting retrospective laws. This action becomes highly contemptuous when the Parliament re-enacts a rule to override a ruling of the court, where the government was a party. This essentially means the rule of law has no meaning – if the highest judicial forum of the land gives a ruling interpreting a law as it was, and the Parliament then rewrites a law as it wants it to be, retrospectively, there are two big casualties – one, respect for the judiciary, and second, certainty of law.

Retrospective taxation across the World

Examples of retrospective tax law amendments, particularly if they are anti-avoidance, are not uncommon. In fact, the famous Westminster principle is the supremacy of the Parliament – the right to enact a law includes the right to enact a law retrospectively or retroactively.

In UK, section 58 of UK Finance Act 2008 was changed retrospectively to affect the residential status of foreign partnerships and trusts. The amendment was challenged in *R v. HMRC,* [2011] EWCA Civ 89, where the question pertained to the residential status of Isle of Man trusts which, with a negligible contribution of capital from UK resident, was allegedly use to escape tax otherwise taxable in the UK. The Court of Appeal held: "If Section 58 were not made retrospective, the claimants would obtain a windfall at the expense of the general body of taxpayers. It would be unfair to the general body of

[1] Road to Serfdom, 1944
[2] The Rule of Law and its Virtue' (1977) *93 LQR* 195

resident taxpayers not to have given Section 58 retrospective effect. The claimants entered into schemes with the intention of deliberately avoiding UK tax. HMRC never accepted that the schemes worked and the tax liabilities were not settled before the legislation was applied to them".

Prior to this, in *Robert Huitson vs. HMRC*[3], courts had approved retrospective anti-avoidance legislation. To this, the comment of an academic, on the BBC, was: "Is it the thin end of a very dangerous wedge, allowing HMRC to get its own way without bothering to argue its case in the courts? Or will retrospection be used only exceptionally, most commonly in response to artificial tax planning schemes? What is certain is that backdating legislation is a cheap, quick and certain way of closing a tax loophole, and it may be irresistibly tempting for the government to use the same method again.[4]"

In fact, the amendment made by the Finance Act 2008 of UK was very similar to the proposed amendment to Section 9 of the IT Act by Budget 2012. The amendment was to change the residential status of foreign partnerships which had UK partners. The amendment was done to override the rulings in *Padmore v. IRC*[5].

Australia has also enacted retrospective laws, including those to overcome adverse rulings of courts. Australian Parliament's Legislation Handbook, which provides recommendations for legislative procedure, suggests the following with regard to retrospective legislation: "Provisions that have a retrospective operation adversely affecting rights or imposing liabilities are to be included only in exceptional circumstances and on explicit policy authority."

In the USA, though there is a Constitutional prohibition against passing ex post facto laws by Clause 3 of Article I, Section 9 of the U.S. Constitution. However, substance due process amendments in taxation laws have been made retrospectively in certain cases. Notably, these are procedural issues – not issue of imposing a tax retrospectively.

Proposed amendments to section 9 of the IT Act

The Finance Bill 2012 has proposed several retrospective amendments in certain key provisions of the IT Act, with retrospective effect (i.e. from the date of coming into force of the IT Act, which are likely to have far reaching effects on the foreign direct investments in India.

Key amendments affecting the tax liability of the foreign direct investment in India are summarized hereunder:

(a) *Section 2(14) – definition of capital asset:* Definition of property has been amended to include shall be deemed to have always included *any rights in or in relation to an Indian company*, including rights of management or control *or any other rights whatsoever*.

(b) *Section 9(1) – income deemed to accrue or arise in India:* The following explanations have been added:

(i) the expression *through* shall mean and include and shall be deemed to have always meant and included *by means of*, *in consequence of* or *by reason of*; and

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[3] [2010] EWHC 97 (Admin)

[4] http://news.bbc.co.uk/2/hi/business/8496921.stm

[5] (1987) STC 36 affirmed by the Court of Appeal (1989) STC 493

(ii) an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, *if the share or interest derives, directly or indirectly, its value substantially from the assets located in India*.

(c) *Section 149(1)(c) – time limit for notice:* A reassessment can be done if four years, but not more than *sixteen years*, have elapsed from the end of the relevant assessment year unless the income in relation to any *asset (including financial interest in any entity) located outside India*, chargeable to tax, has escaped assessment.

Precedents of retrospective amendments in India:

The legislature surely has the power to amend laws retrospectively. There is a plethora of case laws that recognize this power of the Legislature to retrospectively amend a statute when[6]:

(a) A Legislature can by a retrospective amendment in law, validate such law which has been declared by court to be invalid provided the infirmities and vitiating factors noticed in the declaratory-judgment are removed or cured.

(b) If by such validating and curative exercise made by the Legislature, the earlier judgment becomes irrelevant and unenforceable, that cannot be called an impermissible legislative overruling of the judicial decision.

Though an amendment presumes the constitutional validity of a statue, constitutional validity of a retrospective amendment may not be free from doubt. The Apex Court, in case of *Sri Prithvi Cotton Mills Ltd. v. Broach Borough Municipality*[7], analyzed the validity of the retrospective amendment of a statute in light of Article 19(1)(g) of the Constitution of India, i.e. a fundamental right to practise any profession, or to carry on any occupation, trade or business. The Court said:

> "In testing whether a retrospective imposition of a tax operates so harshly as to violate fundamental rights under article 19(1)(g), the factors considered relevant include the context in which retroactivity was contemplated such as whether the law is one of validation of taxing statute struck-down by courts for certain defects; the period of such retroactivity, and the *decree and extent of any unforeseen or unforeseeable financial burden imposed for the past period* etc." [emphasis supplied]

The BBC note cited above which says retrospective amendment to the law is cheap, quick and certain way of closing a tax loophole, and that governments may find itself irresistibly tempting to use this remedy. India is one example where governments have gone overboard to use the power to undo court rulings with retrospective amendments.

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[6] See, *Rai Ramanakrishna v. State of Bihar* (1963 50 ITR 171), *Assistant Collector of Central Excise, Calcutta Division v. National Tobacco Co. of India Ltd.*, [1973] 1 S.C.R. 822; *Ujagar Prints v. Union of India* [1989] 179 ITR 317 / [1989] 3 SCC 488

[7] [1970] 1 S.C.R. 388

Ishikawajima case[8]

One such famous example is the amendments in the Finance Act 2007 and subsequent amendment in Finance Act 2010 to nullify the effect and tests laid down in the *Ishikawajima case*, which also dealt with amendment in Section 9 of the IT Act.

The Supreme Court, in this case, laid down the tests for applicability of Section 9(1)(vii) of the IT Act, (dealing with income by way of fee for technical services) to be applicable, it is necessary that:

(a) services provided by a non-resident assessee under a contract should be utilized within India; and

(b) such services should be rendered in India or should have a link with India that entire income from fees, etc., becomes taxable in India.

Thus, for a non-resident to be taxed on income for services, such a service must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax.

The principle of this territorial nexus was outdone by a retrospective amendment in the Finance Act 2007 (valid with effect from June 1, 1976) which provided that the income will be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India. This amendment by the Finance Act 2007 did not affect the principles of the *Ishikawajima case* as it did not address the criteria of utilization and rendering of services in India. Therefore, the said principles of the Supreme Court still held good post the amendment brought forth by the Finance Act 2007. This was upheld and also followed in the *Clifford Chance case*[9].

Consequently, the Legislature further retrospectively amended Section 9 (valid with effect from June 1, 1976) and provided that the income from technical services shall be included in total incomes of the non-resident whether or not (i) the non-resident has a residence or place of business or business connection in India; or (ii) the non-resident has rendered services in India. Thus, it was recognized by the Mumbai Bench of the Income Tax Appellate Tribunal in case of *Ashapura Minichem Ltd. v. ADIT*[10] that the principles set out by the Supreme Court are no longer valid.

Lohia Machines case[11]

Years ago, there was an amendment in Section 80J of the IT Act whereby the definition of "capital employed" was retrospectively amended to remove debentures and long-term borrowings from the scope of the term. In this particular case, Nani Palkhivala and other senior counsels argued at length against retrospective legislation.

The ruling makes references to several previous decisions of courts on the power of retrospective legislation. A N Sen, J., in his dissenting judgment, remarked: "The mere fact that any statutory provision has been amended with retrospective effect does not by itself make the amendment unreasonable. Unreasonableness or arbitrariness of any such amendment with retrospective effect has necessarily to be judged on the merits of the amendment in the light of the facts and circumstances under which such amendment is made". The withdrawal of a benefit unequivocally

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[8] *Ishikawajima Harima Heavy Industries Ltd*. v. *Director of Income Tax, Mumbai* (2007) 3 SCC 481
[9] *Clifford Chance v. DCIT* (2009) 318 ITR 237 (Bom)
[10] (2010) 5 Taxman 57 (Bom)
[11] *Lohia Machines Ltd vs Union of India* AIR 1985 SC 421

available from the past will amount to imposition of a new tax, and this was considered by Justice Sen as unreasonable and arbitrary. Several court rulings have relied upon the reasonableness test to uphold or overthrow retrospective amendments.

Impact of retrospective amendment of Section 9 of IT Act

The possible impact the proposed amendment may have could be:

(a) Reopening of cases assessed on the basis of decisions favouring taxpayer and recovery of taxes with interest. The cases, in light of amendment make in Section 149(1)(c) could be opened for a span of the preceding 16 years (being the new limitation period), which could be detrimental to the taxpayers.

(b) The non-residents who have already liquidated their investments in India, and have mitigated tax liability under the beneficial provisions of the IT Act, will now also be subject to a fresh look at tax liability arising in the preceding 16 years.

(c) Conflict with the provisions of the Double Tax Avoidance Agreements ("**DTAA**"), between India and various countries, as the amendment is against the true spirit, nature and scope of the DTAA. This impact is further aggravated by virtue of amendment in Section 90 of the IT Act (relation to the DTAA), proposed to be applicable from April 1, 2012, which now provides that the provisions of the IT Act shall be applicable even if they are less beneficial than the DTAA to the taxpayer. Before the Finance Bill 2012, Section 90 provided that between the DTAA and the IT Act, benefit of the provisions which more beneficial to a taxpayer could be availed.

(d) Furthermore, insertion of a fresh Chapter X-A on the General Anti-Avoidance Rule, which may apply to any step or part of the arrangement, puts the onus on the taxpayer to establish the bona fide purpose of an arrangement.

Summary and concluding remarks

The key question, for the proposed amendment to Section 9 of the IT Act, is:

(a) whether the amendment is merely clarificatory in nature; and

(b) does it amount to imposing a new tax.

If there is a new tax which in substance never existed, the proposed amendment amounts to imposition of a new tax, which may be taken to be arbitrary or unreasonable.

The proposed amendment is preceded by the words "*For the removal of doubts, it is hereby clarified that.....*" However, the amendment that follows is far from either clarificatory, or for removal of doubt. What the amendment does, in substance, is to change the situs of an income from the place of legal domicile of the entity to the place where effective assets are based. It cannot be said that the tax rule was always based on effective situs of the asset, rather than legal situs. If this was merely a case for removal of doubts, other than the *Vodafone case*, has the CBDT ever chased takeovers of Indian companies that have happened outside India? It cannot be that the tax officers also had a doubt on the territorial sweep of Indian tax laws.

In fact, it would be logical to contend that the proposed amendments have caused a substance shift of tax base, and therefore, amount to a retrospective new tax rather than a clarificatory amendment. If that was not the case, there was little reason for the accompanying amendments that allow the taxmen a long rope to go 16 years to catch what might be taxable under the new law and was not taxable under the existing law. If all that was lacking in Section 9 was clarity, the government did not need 16 years to respond.

In the opinion of the authors, the ease with which the ruling of the Supreme Court has been upturned, and the fact that the DTAAs are to give way to the long arms of the IT Act stretching back to 16 years, would make any foreign investor think thrice before investing in India. The Finance Minister's proposal puts the very credibility of India as an investment destination at stake, as the government's action shows that it is not the rule of law that prevails in India – it is the rule of the executive.

No service tax on financial leasing services

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The Union Budget 2012 has introduced universal service tax. All services other than those that are negative-listed are liable to service tax. However, as the transfer of right to use is completely taken out from the purview of service tax, operating lease and financial lease are completely out of service tax

The Union Budget 2012 has introduced universal service tax-that is, all services other than those that are negative-listed are liable to service tax. The negative list is a narrow band of 17 services. The markets in general and the consumers have reacted adversely to this. The reaction is natural-as service tax is an indirect levy and affects cost of goods and services across the board. Given the list of 17 services, there is apparently no exemption for banking and financial services, and consequently all banking services, other than merely interest have come for service tax.

However, an interesting point that emerges is-what about leasing contracts? It is a matter of common knowledge that the option to lease capital goods, instead of taking a loan, was quite popular in the early 1990s in India when introduction of sales tax, and later on, introduction of service tax, made that business very complicated. Recently the Supreme Court in the case of Association of Leasing and Financial Services upheld the levy of both service tax and sales tax on certain lease transactions. It should be noted that "transfer of right to use goods" is included in the definition of "sale" under sales-tax/ VAT laws. Financial leasing was also covered by the definition of "banking and financial services" under service tax.

With the introduction of universal service tax, a question that comes is-what will be the position of operating leases and financial leases for service tax purposes?

(a) **Universal definition of "services"**

The service tax law as proposed in the Budget has introduced a universal definition of "service". The proposed section 65B (44) of the Finance Bill defines "service" to mean any activity carried out by a person for another for consideration, includes a "declared service", but excluding a transfer of title in goods or immovable property, transaction in money or actionable claims, and services by an employee to an employer. All other services are included within the framework of services, unless they are covered by the negative list given in Section 66D.

The concept of "declared services" is perhaps clarificatory and assertive-to state the legislative

intention that these services will, without getting into whether there is an element of service involved in such activities or not, be necessarily included in the definition of "services". Therefore, all declared services are services.

(b) **Transfer of right to use goods:**

The finance minister has repeatedly stated that the introduction of universal service tax is to pave the way for a comprehensive GST. Under a comprehensive GST, it cannot be that the same activity is liable to tax under two separate heads. Therefore, the overlaps between sales tax/VAT and service tax, which exist currently, get eliminated under GST.

In light of the fact the "transfer of right to use" is defined as "sale" undersales tax/VAT laws, there is a good reason to say that a transaction involving transfer of right to use goods should not come under service-tax law.

Now, in light of this, let us have a look at the list of "declared services" under Section 66E. Item (f) provides for the following: (f) transfer of goods by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods (emphasis supplied). The first few expressions-hiring, leasing, licensing, etc-are intended to covertransactions of leases. But then the excluding expression-"without a transfer of right to use goods" would mean, wherever there is a transfer of right to use goods, the transaction will not be a declared service, and therefore, not a service. The idea of "declared services" is to explicitly include certain services and that explicit inclusion clause explicitly excludes a case where there is a transfer of right to use goods, the exclusion should be given effect to.

(c) A question that may come up is-if the idea is to exclude transfer of right to use goods, then why would the law include leasing, hiring, etc. After all, what is leasing other than the transfer of right to use goods. In fact, the present service tax law also has a clause-65 (105) (zzzj) which covers supply of tangible goods including machinery, equipment and appliancesfor use, without transferring right of possession and effective control of such machinery, equipment and appliance. This clause flows from the ruling of the Supreme Court in Bharat Sanchar Nigam and other rulings which distinguished between "transfer of right to use" and "provision of right to use", such that in transactions where control is not handed over, the transaction will not amount to a transfer of right to use.

There is a good justification in the proposed amendments intending to exempt "transfer of right to use goods"-as discussed earlier. Transfer of right to use goods is chargeable to sales-tax/VAT, and hence, it is logical that service tax should not override on the domain occupied by sales tax.

Consequence on financial and operating leases:

In our view, as the transfer of right to use is completely taken out from the purview of service tax, we are of the view that operating lease and financial lease are completely out of service tax.

We are of the view that this is clearly a booster for the leasing industry, which is seemingly

reviving. VAT continues to apply, but VAT is offsettable.

Good days are back for the leasing industry!

(Vinod Kothari is internationally recognised as an author, trainer and expert on specialised areas in finance, including securitisation, asset-based finance, credit derivatives, accounting for derivatives and financial instruments, microfinance, etc.)

Issue of shares at premium: premium becomes penal

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Issue of shares by smaller companies at disproportionate premium has been a rampant practice. A new company, just incorporated, issues shares of Rs 10 at astronomical premiums – anywhere fromm Rs 90 to 990. Companies have to pay stamp duty and incorporation fees based on their paid up capital. Paid up capital includes the legal equity of the company – not the premium. Hence, while the premium is, for all purposes, a part of the net worth of the company, it does not count as a part of paid up capital. With this, it was highly unwise for issuers not to take advantage of the legislative arbitrage and issue shares at par. Questions were being raised on premium issues – sometimes by the Companies Registry, sometimes by Courts during a merger/restructuring petition. However, there was nothing as such to challenge this practice.

The Budget 2012 proposals deal a severe blow, by calling upon companies to pay tax on the difference between the issue price and the "fair value" of shares. While the proposal will curb the malpractices on issue of shares at a premium, it would open doors to corruption and litigation, as now, every closely-held company has to satisfy the tax officer that the issue price is the fair value. In other words, instead of the tax officer making a case as to why he does not regard the issue price as fair value, the onus shifts to the assessee – making every such issue gullible, unless proved otherwise.

Provisions of section 56 (2) (viib)

Lately, section 56 of the IT Act has become a potent tool for the government to slap taxes on transactions which are seen as dubious. Couple of years earlier, the government introduced tax on purchase of shares at consideration lower than fair value.

Proposed clause (viib) to section 56 (2) seeks to levy tax on the difference between the issue price and fair value, in case of closely-held companies. The difference will be taken as "income from other sources" of the company issuing the shares.

Exceptions from the rule are:

- Widely-held companies
- Issue of shares to non-residents
- Issue of shares to venture capital fund (VCF).

The clause is applicable to shares – this would include both equity shares and preference shares. If the company has issued convertible debentures, apparently the clause will not be applicable.

Fair value for closely held companies:

In order to escape taxes under this section, the issue price has to equal to the fair value. "Fair value" is defined as higher of (i) value computed as per valuation rules, to be laid down; or (ii) value as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, *on the date of issue of shares*, of its assets, including intangible assets being goodwill, know-how, patents, copyrights,

trademarks, licences, franchises or any other business or commercial rights of similar nature (emphasis supplied).

The key question here is – whether the value on the date of issue is the value before the issue, or the value after the issue. It is established rule that under SEBI rules, even in case of public issues, the value of shares is seen as the value after the issue. The impact of dilution of earnings, or dilution or NAV, or their increase, is always relevant in determination of the issue price.

If the value of shares is the value after the issue, then a premium issue has no problem, since the NAV after the issue increases to the extent of the premium. If a share of Rs 10 is issued at a price of Rs 90, the NAV post-issue will also be Rs 100.

However, the implications of the new provision will be too stringent for anyone to risk issuing of shares at a premium.

Budget brings chrysalis times for Venture Capital Funds

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The Union Budget 2012-13 has made some key changes in the Income Tax Act, 1961 ("**IT Act**") to the provisions relating to income of a Venture Capital Fund ("**VCF**") from the venture capital undertakings ("**VCU**"), which surely provides some breather to the venture capital industry and encourages the industry to implement growth.

Relaxation under Section 10(23)(FB) of the IT Act

The Section provided for exemption from inclusion in income (for the purposes of taxation) from investment into a VCU, only if the investment by the VCU is in the specified 9 sectors viz. 1) nanotechnology, 2) information technology relating to hardware and software development, 3) seed research and development, 4) bio-technology, 5) research and development of new chemical entities in the pharmaceutical sector, 6) production of bio-fuels, 7) building and operating composite hotel-cum-convention centre with seating capacity of more than 3000, 8) development, operating and maintenance of any infrastructure facility and 9) dairy or poultry industry ("Specified Exempted Sectors").
The highlight of the budget for the industry has been doing away with the restrictions on the VCFs for tax exemption only from these Specified Exempted Sectors and opening it to all sectors subject to the negative list specified in the SEBI VCF Regulations, 1996. Hence, any income of a VCF derived from its investment into a VCU, without limitation to any sector, will be exempt from tax in the hands of the VCF.
The restrictions were made applicable four years ago, with the intention to boost investment in these Specific Exempted Sectors. However, this relaxation would open up investments in other sectors that are also vital to the economy of the country.

Reciprocal effect of relaxation under 10(23)(FB)

Currently, approval is granted to a Foreign Venture Capital Investor for making investments only in the Specified Exempted Sectors. This seems to be linked to Section 10(23)(FB), although no specific provision in the SEBI FVCI Regulations or the IT Act has been made in this regard.
It is likely that with the proposed amendment in the said section, relaxation may also be given to a FVCI for making investments in India (whether in a VCF or otherwise), subject of course to the restrictions placed under the SEBI FVCI Regulations.

Payment of tax by investors on accrual basis by investor

Currently Section 115U provided for indefinite deferral of taxation in the hands of the investors and was taxable when distributed to the investors by the VCFs, i.e., income from the VCU was taxable in the hands of the beneficiaries/ investors as if the investment was directly made in the VCU by the beneficiaries. The Finance Minister has proposed accrual based taxation for the investors, which means investors to be

taxed as and when income arises/ accrues is received by the VCF/ VCC rationalizing the pass through status conditions.

The implication of this provision may not be so much in the interest of a VCF as well as an investor for the following reasons:

(a) The investor will be liable to pay tax on an annual basis (primarily on the dividend income during the term of the VCF) even though such income may not be received by the investor annually.

(b) By virtue of the foregoing, the VCFs may be required (by investor demand) to make distributions on an annual basis. This may curtail the reinvestments of income by a VCF and could result in less return than expected at the end of the VCF term. The financial structuring of a VCF may need to undergo changes and responsibility of maintaining records may further arise.

It would be interesting to see how the parity in the interests of the investor and VCF will be achieved.

Further, a new clause is proposed to be introduced under section 56(2) of the Income Tax Act, 1961, to curb tax avoidance, wherein issue of shares in excess of fair value by closely held companies, is proposed to be made taxable in the hands of the issuer. This would mean share premium received by the private company over the fair market value on subscription of shares is proposed to be taxable in the hands of the issuer company. However specific exemption has been carved out where the consideration for issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund. Another exemption has been specifically provided for under section 68 of the Income Tax Act, 1961, wherein satisfactorily explaining the sources of funds of the shareholder, in the case of closely held companies, would not apply if the shareholder is a well regulated entity, i.e. a Venture Capital Fund, Venture Capital Company registered with the Securities Exchange Board of India (SEBI). While there are certain exemptions granted to the venture capital funds specifically, VCFs/ VCCs shall no more be exempt from dividend distribution tax and TDS provision/ withholding tax.

Taxability of non-residents

The Finance Bill 2012 has proposed amendments which are likely to have far reaching effects on the foreign direct investments in India including FVCIs.

Section 9(1) – income deemed to accrue or arise in India: The following explanations have been added:

(iii) the expression through shall mean and include and shall be deemed to have always meant and included by means of, in consequence of or by reason of; and

(iv) an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

While domestic funds may have a reason to cheer, amendments in Section 9 with respect to *Income deemed to accrue or arise in India* have broadened the definition of "capital asset or asset" to mean "*an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India,* ***if the share or interest derives, directly or indirectly, its value substantially from the assets located in India." (emphasis ours)*** having an impact on foreign venture capital investors, with investors raising eyebrows on the taxability issue. Also, Section 9 read with Section 149(1)(c) will have a retrospective effect on the applicability of the provisions of Section 9, it would act as a two edged sword for the FVCIs.

Section 90A (2) of the Income Tax Act, which for the purpose of double taxation relief, allowed the applicability of the provisions of the act to the extent they were beneficial to the assessee, have now been amended by the Finance Minister by insertion of sub-section 2A to section 90A stating "*Notwithstanding*

*anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee, even if such provisions are **not** beneficial to him*."

The Budget calls for insertion of a fresh Chapter X-A on the General Anti-Avoidance Rule, which may apply to any step or part of the arrangement, puts the onus on the taxpayer to establish the bona fide purpose of an arrangement.

This would mean the GAAR provisions having a treaty override provision could spell trouble for offshore funds. So, anything which looked like tax planning could be well taken to be tax evasion at the discretion of the tax authorities; terming the arrangement entered into with the objective of obtaining tax benefit without *commercial substance*. This would mean supremacy of provisions IT Act prevailing of DTAAs conflicting with the nature and spirit of DTAAs.

From offshore fund structures and FVCIs perspective it would be interesting to see whether applicability of Section 9 and GAAR provisions would impact the flow of funds and investments and in turn on the industry.

Venture capital funds play a vital role in encouraging entrepreneurship and thereby resulting in the growth of the economy. The proposed changes are welcomed for domestic funds as it puts the venture capital industry at par with other countries, however with the proposed implementation of the SEBI Alternate Investment Funds Regulation which will replace the SEBI Venture Capital Fund Regulations, it is yet to be seen if the proposed changes will get carried forward and implemented likewise.

Budget incentivizes MSME growth

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Union Finance Minister Pranab Mukherjee has announced incentives for micro, small and medium enterprise (MSME) sector while presenting his seventh federal budget for the Financial Year 2012-13 in the Lok Sabha. Though there is not much to cheer, some of the proposals are fair enough for the SMEs which form a larger chunk of Indian economy.

Proposals in Budget 2012-13

- ✓ Setting up a fund of Rs. 5000 crores, to be called India Opportunities Venture Fund, with SIDBI.
- ✓ Approval of the policy which requires Ministries and CPSEs to make a minimum of 20 per cent of their annual purchases from MSEs. Of this, 4 per cent will be earmarked for procurement from MSEs owned by SC/ST entrepreneurs.
- ✓ Raising of turnover limit for compulsory tax audit of accounts as well as for presumptive taxation from 60 lakh to 1 crore.
- ✓ Exemption from capital gains tax on sale of a residential property, if the sale consideration is used for subscription in equity of a manufacturing SME company for purchase of new plant and machinery.
- ✓ Reduction in basic customs duty to 2.5 per cent with concessional CVD of 6 per cent on specified parts, components and raw materials for the manufacture of some disposables and instruments for MSMEs engaged in production of low-cost medical devices.
- ✓ Full exemption from basic customs duty and CVD is also being extended to specified raw materials for the manufacture of coronary stents and heart valves. These concessions would be subject to actual user condition.
- ✓ To enable MSMEs greater access to finance, two SME exchanges have been launched in Mumbai recently, as informed by the Finance Minister.

Consequences and our Analysis

The MSMEs and the agrarian sector have got a thrust from the Finance Minister as the budget reveals a host of fiscal measures specifically designed for often tormented sector. A fund for MSMEs for allowing more participation in equity will be channeled through SIDBI. Indian Opportunities Venture Fund is a one of its kind initiative and gives a great boost to the sector and its growth, helping entrepreneurs explore new initiatives. The SME exchanges launched recently, aim at addressing the funding and liquidity needs of SMEs as they are currently relying primarily on loans from banks and informal sources to raise capital.

Further increase in the compulsory tax audit limits and presumption taxation limits, reduction in customs duty and concessional CVD are aimed to provide momentum to MSMEs business.

The proposed exemption of capital gains on sale of residential properties, where the sale proceeds are to be invested in equity of manufacturing SMEs for purchase of new plant and machinery may will not be well received by external investors as recovery of money will take a longer period and there is no scope for easy exit in case of equity investment. Another concern for the sector would be service tax issues, which would add to the overhead cost and put additional pressures on margins.

The initiatives incentives the sectoral growth and are welcomed however it seems more like a neutral budget for the sector.

Key highlights of Union Budget 2012-12: Indirect Tax Aspect

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While presenting the Union Budget 2012-13, Hon'ble Finance Minister Mr. Pranab Mukherjee broke the general trend of starting with major components of **Indirect Taxes**-Excise and Customs, and initiated his speech on the topic "Indirect Taxes" with Service Tax. Here we enumerate the proposed amendments accordingly.

SERVICE TAX

It has been 18 years "service tax" was introduced, and it is high time for speeding up things in this field. Though services occupy a grand share in contributing to the Gross Domestic Product (GDP) of the economy, i.e. 59%, yet it has not fulfilled the expectation of contributing to the tax treasury of the government to that extent. Further, as a pro-active measure to achieve the ultimate transition to the GST era, the complex structure of service tax is to be aligned to that of excise and customs, though there is no definite commitment as to a fixed date for the introduction of GST. The budget proposals on income tax seek to concentrate on fulfilling these dual objectives.

Accordingly, two most important and significant changes are:

- ***Introduction of a negative list and a list of exemptions.***
- ***Raising the tax rate on taxable services from 10% to 12%***

The first objective of widening the tax net on services is sought to be achieved by following steps:

- *Taxation of services based on a negative list:*

  Instead of specifying services to be brought under the tax net each time, the concept of "negative list" has been brought in, i.e. all the services are to be taxed except those specified in the negative list- the services that are not to be taxed. Precisely, the negative list is a list of those services for which no duty will be charged. The negative list contains 17 heads for now. Major inclusions in the list are:

  - All services provided by the government or local authorities, except a few specified services where they compete with private sector.
  - Pre-school and school education, recognised education at higher levels and approved vocational education.
  - Renting of residential dwellings.
  - Entertainment and amusement services.
  - A large part of public transportation including inland waterways, urban railways and metered cabs.

- All services required for cultivation, breeding, production, processing or marketing up to the stage the produce is sold in the primary markets.

- *Exemption List:*

  Besides negative list, the Finance Minister has gifted the Service Sector with a list of exemptions. Why another list of exemptions has been introduced has not been explained in the Budget. The list has the following:

  - Health care, services provided by charities, religious persons, sportspersons, performing artists in folk and classical arts, individual advocates providing services to non-business entities, independent journalists, and services by way of animal care or car parking.
  - The services of business facilitators and correspondents to banks and insurance companies.
  - Construction services relating to specified infrastructure, canals, irrigation works, post-harvest infrastructure, residential dwelling, and low-cost mass housing up to an area of 60 sq. meter under the Scheme of Affordable Housing in Partnership.
  - Most amusing one- the Indian Cinema Industry from service tax on copyrights relating to recording of cinematographic films- since *"the industry has played a pivotal role in unifying our country in the wake of her considerable diversity"*

So, one may breathe easy that many of the services are still out of the tax net.

As far as the job of unifying the excise and service tax law is concerned, the Finance Minister proposes to set up a study team for the purpose of examining the possibility of a common tax code for both service tax and central excise. The following steps are also proposed:

- Common simplified registration form and a common return for Central Excise and Service Tax, to be named *EST-1* which will be short and simple.
- Introduction of *Revision Application Authority and Settlement Commission* to help resolve disputes with far greater ease.
- *Place of Supply Rules*, to be notified when the negative list is put into effect. These rules will determine the location where a service shall be deemed to be provided
- A new scheme that will simplify refunds of taxes that go into the export of services without resorting to voluminous documentation or verification
- Rationalization of rules pertaining to the *Point of Taxation* thereby providing greater clarity.

Further, to fill up the exchequer's coffers, ***service tax rate has been raised from 10% to 12%.*** Consequentially, the rates for services that have individual tax rates will also change. As explained by our Hon'ble FM, the *measures enumerated above are directed to move towards a simple, directive and progressive system, but the same are not going to make the exchequer richer in any significant way. The rise in service tax rate was required to maintain a healthy fiscal situation.*

OTHER INDIRECT TAXES:

Government seems to be too eager to make the exchequer richer and further richer. Read on:

- ***Standard rate on excise duty has been raised from 10% to 12%.*** The merit rate from 5 per cent to 6% and the lower merit rate from 1% to 2%. Lower merit rate for coal, fertilisers, mobile phones and precious metal jewellery is being retained at 1 per cent.

- Enhancement of excise duty on large cars from 22% to 24% and *ad valorem* duty of 27% on cars that attract a mixed rate of duty.

- The peak rate of customs duty of 10% on non-agricultural goods has been kept unchanged. Even the rates below the peak have not been revised, except for a few items.

But Government has a soft corner for some specific sectors that are presently under stress for which the Finance minister has come up with relief proposals, major being:

- *Agriculture & Related Sectors:*
    - Reduction of basic customs duty on specified coffee plantation and processing machinery, sugarcane planter, some water soluble fertilisers and liquid fertilisers, other than urea.
    - Full exemption from basic customs duty to Imports of equipment for initial setting up or substantial expansion of fertiliser projects, but only upto March 31, 2015.

- *Infrastructure:*
    - Full exemption from basic customs duty and a concessional CVD of 1 per cent to Steam coal till March 31, 2014; to Natural Gas and Liquified Natural Gas.

- *Mining*
    - Full exemption from basic customs duty to coal mining projects.
    - Reduction in basic customs duty on machinery and instruments for surveying and prospecting to 2.5%.

- *Railways and Roads*
    - Reduction in basic customs duty on equipment required for the the installation of Train Protection and Warning System and upgradation of track structure for high speed trains to 7.5%.
    - Full exemption from import duty on specified equipment imported for specified road construction contracts.

- *Civil Aviation*
    - Full exemption from basic customs duty to parts of aircraft and testing equipment imported for third party Maintenance, Repair and Overhaul (MRO) of civilian aircraft.

- *Manufacturing*
    - In the context of steel industry, reduction of basic customs duty on plant and machinery imported for setting up or substantial expansion of iron ore pellet plants or iron ore beneficiation plants, coating material for manufacture of electrical steel
    - Similar benefits have been extended to the textile industry, e.g. full exemption from basic duty to automatic silk reeling and processing machinery as well as its parts.

- *Health and Nutrition and Environment*
    - Concessions and benefits, reduction in basic excise duty for specific products and projects have been proposed, e.g. full exemption in respect of plant and machinery required for the initial set –up of solar thermal projects from special CVD.

However, basic excise duty has been raised on demerit goods like cigarettes for the purpose of additional resource mobilization.

Some rationalization measures are sought to be undertaken, like including the unbranded jewellery within the ambit of excise duty of 1% as in the case of branded precious metal jewellery, after providing for suitable exemptions in respect of turnover and similar aspects; full exemption to branded silver jewellery from excise duty, etc. In regard to baggage allowance, the duty-free allowance for eligible passengers of Indian origin has been increased from Rs. 25,000 to Rs. 35,000 and for children of up to 10 years from Rs. 12,000 to Rs. 15,000.

OUR TAKE ON THE AMENDMENTS

Finally, before ending up his speech, Hon'ble Finance Minister remarked, *"My proposals on Direct Taxes are estimated to result in a net revenue loss of Rs. 4500 crore for the year. Proposals relating to Indirect Taxes are estimated to result in a net revenue gain of Rs. 45,940 crore, leaving a net gain of Rs. 41,440 crore in the Budget."*

Therefore, the focus is on generating additional revenues from indirect taxes to make up for the probable loss attributable to proposals in the field of direct taxes. The Government hopes to book a net revenue gain of Rs. 27,280 crore for a full year by implementing his proposals relating to Customs and Central Excise and additional revenue of Rs. 18,660 crores by implementing proposals relating to Service Tax. However, this may be seen as a regressive approach because direct taxes are looked upon as being more democratic and a good tool of progressive taxation. Taxing production and trade results in imposing equal burden (though effective burden is definitely not equal) on the rich and the poor. Therefore, the Budget has placed the burden disproportionately on the people. The enhancement in rates of service tax and excise duty will result in faster outflow of money from the pocket of a common man- a situation that may possibly feed inflation. The good side is- reduction in the rates of customs duty in some core sectors will help in increasing the contributory share of those sectors in the overall GDP. In addition, the proposals may be seen as a step-ahead in reforming indirect tax system and creating a platform for smooth implementation of GST. So, the Budget can be tagged as a mixed bag-*"Thodi Khushi Thoda Gham"*.

ECBs for power, aviation and housing sector welcomed with open arms

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Year 2011-2012 witnessed a lot of activity in the External Commercial Borrowings **("ECB")** Sector with reforms all round the year, with ECB limits raised, MFIs permitted to raise ECBs, infrastructure companies permitted to raise ECBs in Renminbi and so on. The Union Budget 2012-13, has proposed amendments that intend to use ECBs as a nedicine for some ailing and some vital sectors to the economy.

Proposed changes

ECBs to part-finance the rupee debt of existing power projects.
ECB allowed for meeting working capital requirements to the aviation industry to address the immediate financing concerns of the sector.
ECBs for low cost housing projects

- ECBs for capital expenditure on the maintenance and operations of toll systems for roads and highways so long as they are a part of infrastructure projects with a view to encourage public private partnerships in road construction projects.
- Withholding tax rates for interest payments on ECBs pertaining to infrastructure sectors like power, roads and bridges, airlines, ports and shipyards, affordable housing, fertilizer and dams is proposed to be reduced from 20 % to 5 % for 3years.

The accolade

Indian power companies are unable to sustain their operations due to increased raw material prices. High interest rates on loans from Indian Banks due to high CRR by the Reserve Bank of India is adding up to the troubles of the power sector. The government now proposes to permit the power companies to raise ECBs which would be at a lower interest cost than that in case of loans from Banks. This will help power companies to refinance debt on their books and which in turn will allow Indian Banks to be able to recover their rupee debt and distressing their loan books.

According to the pre-budget economic survey, India's airline industry is laden with a combined debt of $20 billion. To address the immediate financing concerns of the distressed Aviation sector, the Minister proposed to permit ECB for working capital requirements of the airline industry for a period of 1 year, upto US Dollar 1 billion. Till date ECB was not allowed at all for working capital finance as it is usually a mode for Capital expenditure– hence it is a great relaxation for Airline industry.

Further, reduction on withholding taxes on interest payments on ECBs from 20% to 5% for 3 years can potentially provide a relief to major Indian carriers like Jet Airways (India) Ltd, Air India Ltd and Kingfisher Airlines Ltd, which are badly in need for funds and weighed by accumulated debt.

Predominantly this step seems to be a boon for the aviation industry as while rupee loans carry 11-13% interest charges, foreign loans will cost less than 4-5% in interest, so this would be an added advantage. Also 49% FDI is considered for Aviation, so there is a huge scope for revival of the Aviation sector, which is suffering from huge losses currently.

The flip side:

Though the Government seems to have granted new life to the aviation sector by permitting it to raise funds even to meet its working capital requirements, but fresh taxes have been slapped on this sector which will further raise airfares. Companies would need a good balance sheet and credit rating to raise ECBs. Indian carriers have huge debt and interest burden, continuing losses and mostly a negative net worth. Hence the effectiveness of this decision resulting in any tangible gains is doubtful now given the deteriorating financial condition of the airlines.

Housing for low income groups has been a major concern for our economy and ECBs for this sector has provided a breather to the sector. However, the sector still needs a lot of clarity in terms on guidelines on what is covered under the gambit of 'affordable housing, ' limits for projects under affordable housing segment and so on which together would make these amendments more effective.

Though it seems to be a positive step and a lot of companies would be eager to now tap this route for availing foreign loans, it would be too early to comment on the destiny of these proposed amendments and its contribution in stabilizing the Indian economy. India enjoys a strong position as a global investment centre with the country registering high economic growth figures even during the peak of financial meltdown. Investors would be keen to provide loans and this seems to have a favourable effect on the strapped aviation and infrastructure sector. The only issue which is of upright concern is handling foreign exchange risk effectively as the repayment value could be high due to rate fluctuations and the already stressed borrowers may suffer greater losses.

Key highlights of Union Budget 2012-13: Direct Tax Aspect

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The Hon'ble Minister of Finance Mr. Pranab Mukherjee presented the seventh Union Budget for the Financial Year 2012-13 ("Budget 2012") before Lok Sabha on March 16, 2012 bringing in another phase of opinions and views on the same by experts and common man alike. The major highlights from direct tax point of view are:

1. **Tax Slabs**

   a) For Individuals:

   i. The exemption limit in the income tax slab has been proposed to be revised from Rs. 1,80,000 to Rs. 2,00,000 for the general category of individual taxpayers giving a tax relief of Rs. 2000.

   ii. The proposed personal income tax slabs are:

Income upto Rs.2 lakh	NIL
Income above Rs.2 lakh and upto Rs.5 lakh	10%
Income above Rs.5 lakh and upto Rs.10 lakh	20%
Income above Rs.10 lakh	30%

   iii. The upper limit of 20% tax slab is proposed to be raised from Rs. 8 lakhs to Rs. 10lakhs.

   iv. Individuals to be taxed at par with women with the above proposal

   b) For Women:

   i. No changes proposed. Existing slab to apply on income beyond the exempted limit i.e. Rs. 2,00,000

   c) For Senior Citizens:

   i. Tax slabs to remain unchanged

   ii. Tax sops in the form of exemption from payment of advance tax for senior citizens not having income from business has been proposed.
   Earlier every assessee was required to pay advance tax during a financial year, where the amount of such tax payable by the assessee during the year is Rs. 10000 or more. With this proposal, the senior citizens drawing no income from business would not be required to pay any advance tax, even if they fall within the tax bracket.

2. **Other proposals for Individuals:**

a) Proposal to allow individual tax payers deduction of upto Rs. 10000 for interest from savings bank accounts.

With this it is expected to help the small tax payers with salary income of upto Rs. 5lakhs and interest from savings bank accounts upto Rs. 10000, as they would not be required to file income tax returns.

b) Within the existing limit for deduction allowed for health insurance, it is proposed to allow a deduction of upto Rs. 5000 for preventive health check up.

This would be included for calculation of the upper limit u/s 80D.

3. **<u>For corporates</u>**:

a) No change in the tax rate. Thus, corporate tax remains at 40%.

b) In order to provide low cost funds to some stressed infrastructure sectors, it is proposed that the rate of withholding tax on interest payments on ECBs be reduced from 20% to 5% for three years for the following sectors:
Powers, airlines, road and bridges, ports and shipyards, affordable housing, fertilizer and dams.

For the Power sector in addition to this, it is proposed to increase the sunset clause by one year to set up power sector undertakings i.e. on or before March 31, 2013 for claiming 100% deduction of profits for 10 years.

c) Restriction on Venture Capital Funds (VCFs) to invest in only 9 specified sectors proposed to be removed. Thus, VCFs can now invest in other sectors also and get the advantage of a pass through.

d) Repatriation of dividends from foreign subsidiaries of Indian subsidiaries of Indian companies to be continued to be allowed at 15% till 31.03.2013. Thus, the provisions of section 115BBD remain the same as introduced wef 01 April, 2012.

e) Investment linked deduction for capital expenditure proposed to be provided at an enhanced rate of 150% for some proposed sectors. Also, new sectors are proposed to be added. The current rate is 100% for specified businesses u/s 35AD.

f) Proposal to extend weighted deduction of 200 per cent for R&D expenditure in an inhouse facility for a further period of 5 years beyond March 31, 2012.

g) It is proposed to provide weighted deduction of 150% on expenditure incurred for agri-extension services. This is in addition to proposed reforms to the agriculture sector like reduction of excise duty, customs duty and full exemption from basic customs duty for import of equipment for fertilizer projects.

4. **<u>For SMEs:</u>**

The Budget 2012 has laid down specific stress on SMEs and has identified them as “building blocks of our economy”. The following tax reforms have been proposed.

a) The turnover limit for compulsory tax audit of accounts and presumptive taxation of SMEs is to be increased from Rs. 60 lakhs to Rs. 1 crore.

b) India Opportunities Venture Fund of Rs. 5000 crores with SIDBI is proposed to be set up for more equity participation

c) Capital gains tax has been proposed to be exempted for sale of residential property, if the sale proceeds are utilized for equity subscription in a manufacturing SME for purchase of new plant and machinery.

d) A reduction in basic customs duty to 2.5 per cent with concessional CVD of 6 per cent on specified parts, components and raw materials for the manufacture of some disposables and instruments for MSMEs engaged in production of low-cost medical devices has been proposed and full exemption from basic customs duty and CVD is also being extended to specified raw materials for the manufacture of coronary stents and heart valves. These concessions would be subject to actual user condition.

5. **Skill Development:**
The Budget 2012 also contains specific reforms for skill development. Taking this forward in the direct tax sector, it is proposed to provide weighted deduction @ 150% of expenditure incurred on skill development in manufacturing sector. This has also been done keeping in mind the shortage of skilled labour and to aid employment.

6. **TDS and TCS**
Certain reforms have also been brought about in TDS and TCS for curbing black money.
    a) TCS for purchase of bullion or jewellery in cash in excess of Rs. 2 lakhs
    b) TCS on trading in coal, lignite and iron ore. How far this will help in the recent cases of illegal mining remains to be seen.
    c) TDS on transfer of immovable property above a threshold limit. This is however, exclusive of agricultural land.
    d) In order to keep a tab on unaccounted money, the onus of proof on closely held companies has been increased for funds received from shareholders. Also share premium in excess of fair market value is proposed to be taxed.

7. **Miscellaneous:**

    a) The Budget 2012 has also proposed changes in the capital market by reducing the securities transaction tax by 20%. Although the change may seem to be marginal, it will have a huge effect for bulk transactions effected.
    b) Proposal to extend the levy of Minimum Alternate Tax on all persons other than companies, claiming profit linked deductions.
    c) The Budget proposed to introduce a General tax Avoidance Rule to counter rampant tax avoidance schemes.

Conclusion

Overall, the Budget 2012 has not brought about any sweeping changes as expected, except for revising the tax slabs, which again would not affect the entire salaried class. By providing tax sops in the form of increasing/maintaining the rates of weighted deductions, deductions for interest from savings bank account, removing the restriction on VCFs, the Finance Minister has strived to bring about some positive change for all and predicted a loss of Rs. 4500 crores to the National treasury, yet with the proposed tax reforms in indirect tax, the Government still stands at a win-win situation. The Budget 2012 had very little for the common man or the corporate world to cheer about and hopefully Union Budget 2013 will come with better proposed reforms.

Finance Minister closed the Budget saying the aim was to encourage investment and initiatives, however, in actual, the Budget 2012 sets only modest targets for trimming a ballooning fiscal deficit and disappointing investors.

Budget reflection – Infrastructural Development high on agenda, IDFs score

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In a bid to ramp up investments in infrastructure development space, Budget 2012-13 has several offerings with an allocation of Rs. 50 lakh crores to infrastructure in the 12th five year plan, laund of Infrastructure Debt Funds with an initial size of Rs. 8000 crores, increasing the sectors for viability gap funding, increasing limits for tax free bonds, sends a clear message to the *aam aadmi*, the Finance Minister has given immense focus to infrastructural development critical to the development to the economy.

Amendments proposed by the budget are:

- Infrastructure Debt Fund launched to tap the overseas markets for long term pension and insurance funds, for financing infrastructure projects.
- India Infrastructure Finance Company Limited (IIFCL) setting up a structure for credit enhancement and take-out finance.
- Tax free bonds for financing infrastructure projects doubled to Rs. 60,000 crore.
- More sectors included in the list of sectors eligible for Viability Gap Funding (VGF) under the scheme for support to Public Private Partnership (PPP) in infrastructure. These sectors are irrigation (including dams, channels and embankments), terminal markets, common infrastructure in agriculture markets, soil testing laboratories and capital investment in fertilizer. Furthermore, oil and gas/LNG storage facilities, oil and gas pipelines, fixed network for telecommunication and telecommunication towers are also made eligible sectors for VGF.
- Full exemption from basic customs duty and a concessional CVD of 1 per cent to Steam coal for a period of two years till March 31, 2014. Full exemption from basic duty to Natural Gas and Liquified Natural Gas and Uranium concentrate, Sintered Uranium Dioxide in natural and pellet form.
- Full exemption from import duty on specified equipment imported for road construction by contractors of Ministry of Road Transport and Highways, NHAI and State Governments extended to contracts awarded by Metropolitan Development Authorities. Tunnel boring machines and parts for their assembly are covered by this exemption. Import free of duty without end-use condition.

Tax incentives:

- A new section 194 LC has been introduced for tax deducted at source in case of certain interest payments made to a non-residents by a specified Indian company engaged in prescribed business of infrastructure development.

- Section 115A of the Income Tax Act provides that any interest income received by any non-resident from the Government or an Indian concern shall be taxable at the rate of 20% on the gross amount of such interest income. The interest income received by a non-resident from a notified Infrastructure Debt Fund (IDF) is taxable at a reduced rate of 5% on gross amount of such interest income.
- Further Section 115A of the Income Tax Act to provide that any interest paid by a specified company to a non-resident in respect of borrowing made in foreign currency from sources outside India between 1st July, 2012 and 1st July, 2015, under an agreement, including rate of the interest payable, approved by the Central Government, shall be taxable at the rate of 5% (plus applicable surcharge and cess).

Infrastructure sector in one way or the other has been suffering regulatory delays and called for governmental reforms and our FM did not disappoint with the proposed reforms.

Highlights of Union Budget 2012-13

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Union Budget is the much awaited by the *aam aadmi* looking forward to the government's tyranny or relief that would follow for another year. While it is crucial for us to understand the fine prints of the budget and we may be critical on the budget and its offering, we hereby also would like to give a bird's eye view on what the budget has in store for the public and our economy.

Investment sector

External Commercial Borrowings (ECB)

During the year 2011-12, the limit on External Commercial Borrowings (ECB) raised from USD 500 million to USD 750 million and qualified foreign investors were allowed to invest in specified Indian mutual funds and directly in equities. With the budget the following proposal are to be looked forward to:

- External Commercial Borrowings (ECB) ***to be allowed to part finance Rupee debt of existing power projects;***
- ECB proposed to be allowed for capital expenditure on the maintenance and operations of toll systems for roads and highways, ***if they are part of original project*** so as to encourage Public Private Partnership (PPP);
- To overcome the financial crisis in airline industry, ECB to be permitted ***for working capital requirement*** of airline industry for a period of one year, ***subject to a total ceiling of US $ 1 billion***;
    - Introduced now as previously airline industry was out of the ECB purview
    - ECBs were only for Capital expenditure but it is notable that keeping in mind the crisis in civil aviation sector, ECBs are being liberalized to the extent of being used for working capital requirements as well
- ECB proposed for low cost housing projects;
    - Clarity on which projects the money is to be taken and the operational requirements may be dealt with in the amended regulations, as nothing specified at the moment;
- Rate of withholding tax on interest payment on ***ECBs proposed to be reduced from 20 per cent to 5 per cent for 3 years*** for certain sectors in order to provide low cost funds to stressed infrastructure sectors;
    - A relief for airline industry, especially for Jet airways, Kingfisher

With the above proposals ECBs are surely relaxed and liberalized. The Regulations shall be changed to give effect to the above proposals. Year 2011 until Mid March 2012 witnessed lot of changes in ECB Regulations. With these proposals Regulations are to set yet another reform!

Priority sector lending

- Revised Guidelines to be issues after consultation with stakeholders;
- A committee set up by RBI to reexamine the existing classification

Others

- Restriction on Venture Capital Funds to invest only in 9 specified sectors proposed to be removed;
- Rs. 5,000 crore India Opportunities Venture Fund to be set up with SIDBI;
- Government has approved guidelines for establishing joint venture companies by defense PSUs in PPP mode.
- To allow FDI in multi-brand retail upto 51 per cent, subject to consensus with the State Government
    - Presently, FDI in single brand and in cash and carry wholesale trade is permitted to the extent of 100 per cent;
- Revised guidelines on priority sector lending to be issued after stakeholder consultation.
- Proposal to allow foreign airlines to participate upto 49 per cent in the equity of an air transport undertaking under active consideration of the government.
- Government to raise almost Rs. 30,000 vide disinvestment; at least 51 per cent ownership and management control to remain with Government
- Temporary arrangement to use disinvestment proceeds for capital expenditure in social sector schemes extended for one more year.
- first Infrastructure Debt Fund with an initial size of Rs.8000 Crore
- Tax free bonds for financing infrastructure projects raised to Rs. 60000 Crore
- Enhancement in the limit of indirect finance under priority sector from Rs. 5 lakh to Rs. 10 lakh.

Capital markets

- To allow Qualified Institutional Investors (QFIs) to invest in Indian Corporate Bond Market
- Qualified foreign investors, or QFIs, can be individuals, groups or associations based abroad.
- This will open avenues for those foreign individual participants who are keen in investing in India
- with the objective of encouraging greater foreign participation in Indian capital market, Permitting two-way fungibility in Indian Depository Receipts subject to a ceiling
- IPO process to be simplified; Cost incurred for IPO to be lowered. Moreover, it would be mandatory for companies with IPO issues of Rs. 10Crore or above, to issue in electronic form through nationwide brokers;

Taxation

Direct Tax

- Direct Tax Code (DTC) was to be enacted wef April 01, 2012. However, after receiving the report by the Parliamentary Standing Committee, the report is yet to be reviewed, hence the enactment likely to be deferred
- For implementation of Goods and Services tax (GST), recommendations of Parliamentary Standing Committee awaited;
- The Rajiv Gandhi Equity Savings Scheme, being introduced newly would allow for income tax deduction of 50 per cent to new retail investors, who invest up to Rs. 50,000 directly in equities and whose annual income is below Rs. 10 lakh. The Scheme to have a lock in period of 3 years
    - Details to be announced later
- Exemption limit for the general category of individual taxpayers from Rs. 1,80,000 to Rs. 2,00,000.

- This measure will provide tax relief upto Rs. 2,000 to every taxpayer of this category

- The upper limit of the 20 per cent tax slab raised from Rs.8 lakh to Rs.10 lakh.
- A deduction of upto Rs. 10,000 for interest from savings bank accounts for individual tax payers
- deduction of upto Rs.5,000 for preventive health check-up
- Senior citizens who do not have any income from business to be exempted from the payment of advance tax.
- Securities Transaction Tax (STT) reduced from 0.125% to 0.1%, i.e. reduction by 20%
- 15% rate for dividends from foreign companies extended for FY 2012-13
- the rate of withholding tax on interest payments on external commercial borrowings is proposed to be reduced from 20 per cent to 5 per cent for three years for sectors like power, airlines, affordable housing, roads and bridges;
- Investment linked deduction of capital expenditure incurred to be provided at the enhanced rate of 150 per cent, as against the current rate of 100 per cent in cold chain facilities, hospitals, fertilizers, affordable housing, warehouse for storage of food grains;
- Additional depreciation of 20 per cent in the initial year is proposed to be extended to new assets acquired by power generation companies.
- exempt capital gains tax on sale of a residential property, if the sale consideration is used for subscription in equity of a manufacturing SME company for purchase of new plant and machinery.
- Turnover limit for compulsory tax audit for SMEs raised from Rs.60 lakh to Rs.1 crore
- To levy Alternate Minimum Tax (AMT) on all persons other than companies, claiming profit linked deductions.
- Relief from long-term capital gains tax on transfer of residential property if invested in a manufacturing small or medium enterprise
- Introduction of a General Anti Avoidance Rule (GAAR)
- Introduction of compulsory reporting requirement in case of assets held abroad.
- Allowing for reopening of assessment upto 16 years in relation to assets held abroad.
- Increasing the onus of proof on closely held companies for funds received from shareholders as well as taxing share premium in excess of fair market value
  - Amendment in section 56, i.e. Income from other sources
  - This provision shall not apply where the consideration for issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund.
  - Strict norms expected to be coming up especially for NBFCs

Indirect Tax

- Service tax rate enhanced from 10 per cent to 12 per cent
- Scope of service tax widened. All services except the 17 head in the negative list and list of exemptions including health care, sports person, artists etc. are to be taxed
- The 17 heads are those mostly relating to government, pre-school education, renting of residential dwellings, entertainment, public transportation etc
- a common simplified registration form and a common return for Central Excise and Service Tax, to be named EST-1
- Cascading of taxes has been significantly reduced by permitting utilisation of input tax credits
- CENVAT credits in a number of areas are being restored.
- A new scheme introduced that will simplify refunds without resorting to voluminous documentation or verification. As an added incentive, such refunds will also be admissible for taxes on taxable services that have been exempted.
- The duty enhanced from 22 per cent to 24 per cent for large cars

- Basic customs duty reduced from 7.5 per cent to 2.5 per cent on sugarcane planter, root or tuber crop and parts for such manufacture
- Reduction in basic customs duty from 7.5 per cent to 5 per cent on specified coffee plantation and processing machinery;
- Exemption from basic custom duty for import of equipment for initial setting or expansion of fertilizer projects
- Full exemption from import duty on specified equipment imported for road construction by contractors of Ministry of Road Transport and Highways, NHAI and State Governments
- Full exemption from basic customs duty parts of aircraft and testing equipment imported for this purpose.
- Reduction of basic customs duty on plant and machinery imported for setting up or substantial expansion of iron ore pellet plants or iron ore beneficiation plants from 7.5 per cent to 2.5 per cent
- Textile industry relieved from many basic custom duty and exemption being provided under:
  - Full exemption for automatic shuttle-less looms from basic customs duty of 5 per cent
  - Reduction in basic customs duty on wool waste and wool tops from 15 per cent to 5 per cent
  - full exemption from basic customs duty to aramid yarn and fabric used for the manufacture of bullet proof helmets
- Full exemption from custom duty on waste paper, LCD and LED TV panels, handmade matches
- Extend concessional basic customs duty of 5 per cent with full exemption from excise duty/CVD to six specified life-saving drugs/ vaccines
- Custom duty on Gold doubled
- Full exemption to branded silver jewellery from excise duty.

Corporate Governance

- Wider shareholder participation through e-voting;
  - As per the MCA Circular no. 35/2011 it was mandatory for all listed company from FY 2012 but vide another circular 72/2011 dated December 27, 2011, the same was optional. It is now proposed to again make it mandatory for top listed companies. Companies Bill also does not make it mandatory, so if the Bill is passed, change in expected;
  - This will also help NRI investors to be active participants
- After the previous year's strategy to tackle the illegal transfers, 82 Double Taxation Avoidance Agreements (DTAA) and 17 Tax Information Exchange Agreements (TIEA) have been finalized and information regarding bank accounts and assets held by Indians abroad has started flowing in. In some cases prosecution will be initiated;
- Directorate of Income Tax Criminal Investigation has been established in CBDT.
- Prevention of Money Laundering (Amendment) Bill, 2011 introduced in Parliament with a view to bring certain provisions of the Act in line with global standards;
- Prevention of Money Laundering (Amendment) Bill, 2011 introduced in Parliament with a view to bring certain provisions of the Act in line with global standards;
- White paper on Black Money to be introduced in the current session of Parliament
- The Bill in regards to Public procurement Legislation is to be introduced in the Budget session of the Parliament.

Micro, Small and Medium Enterprises (MSMEs)

- For MSMEs, the turnover limit for compulsory tax audit of accounts as well as for presumptive taxation is proposed to be raised from Rs. 60 lakh to Rs. 1 crore.
- To exempt capital gains tax on sale of a residential property

    - if the sale consideration is used for subscription in equity of a manufacturing SME company for purchase of new plant and machinery.
- Proposed to set up Rs.5,000 crore India Opportunities Venture Fund with SIDBI. In order to enhance availability of equity to MSME sector;
- To enable SMEs greater access to finance, two SME exchanges have been launched in Mumbai recently, as they rely greater on loans from banks and informal sources for capital purpose
- Ministries and Central Public Sector enterprises (CPSEs) to make minimum of 20% of their annual purchases from MSEs; of this, 4 per cent will be earmarked for procurement from MSEs owned by SC/ ST entrepreneurs;
- Reduction in basic customs duty to 2.5 per cent with concessional CVD of 6 per cent on specified parts, components and raw materials for the manufacture of some disposables and instruments.

Subsidies

- From 2012-13 subsidies related to food and for administering the Food Security Act will be fully provided for;
- Try to restrict the expenditure on Central subsidies to under 2 per cent of GDP in 2012-13. Over the next three years, it would be further brought down to 1.75 per cent of GDP.
- Pilot projects for direct transfer of subsidies into bank accounts of beneficiaries been introduced in Mysore and Rajasthan

Legislations

The following Bills are proposed to be moved:

- The Micro Finance Institutions (Development and Regulation) Bill, 2012;
- The National Housing Bank (Amendment) Bill, 2012;
- The Small Industries Development Bank of India (Amendment) Bill, 2012;
- National Bank for Agriculture and Rural Development (Amendment) Bill, 2012;
- Regional Rural Banks (Amendment) Bill, 2012;
- Indian Stamp (Amendment) Bill, 2012; and
- Public Debt Management Agency of India Bill, 2012.
- Recommendations received from the Standing Committee on:
    - The Pension Fund Regulatory and Development Authority Bill, 201,
    - The Banking Laws (Amendment) Bill, 2011" and
    - The Insurance Laws (Amendment) Bill, 2008.

Brief Profile of Authors

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Mr. Kothari is an associate practicing member of ICSI and is the proprietor of Vinod Kothari & Company, a Practising Company Secretary firm. In 1987, a voluntary organisation of Calcutta chose him as the Outstanding Young Person of Calcutta in the field of Finance and Taxation. Mr. Kothari won several academic awards.

He is Internationally recognised as author, trainer and consultant on specialised financial subjects, viz., securitisation, credit derivatives, accounting for financial instruments, etc. As such, he lectures all over the world. The locations where he has lectured on these subjects include New York, Washington, London, Milan, Frankfurt, Singapore, Hong Kong, Sydney, Colombia (South America), South Africa, Malaysia, **Jordan**, Dubai, Kuwait, **Egypt**, Sri Lanka, Bangladesh, etc.

Mr. Kothari's articles on asset-based finance, securitisation etc. have appeared in several national and international journals including Duke Journal of Comparative International Law (USA), US Banker (USA), Exportrader (Spain), Trade and Forfaiting Review (UK), Journal of International Banking Law and Regulation (UK), Equipment Finance Journal (USA), Monitordaily (USA), Analyst (India), etc. He also contributes to Euromoney's yearbooks on leasing and securitisation.

He is a Regular speaker at professional institutes, visiting faculty at Indian Institute of Management, Joka, Calcutta for several years, teaching a full fledged course for the final year students on **Structured Finance and Taxation**. Over 125 students sign up of the course every year. guest faculty at the National University of Juridical Sciences- the subject taught here are insolvency and credit interest enforcement laws in India and other countries. The course included a comparative study of the insolvency and creditors' rights in USA, UK and Australia.
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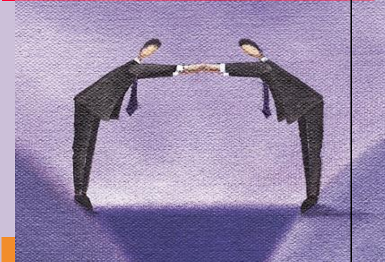

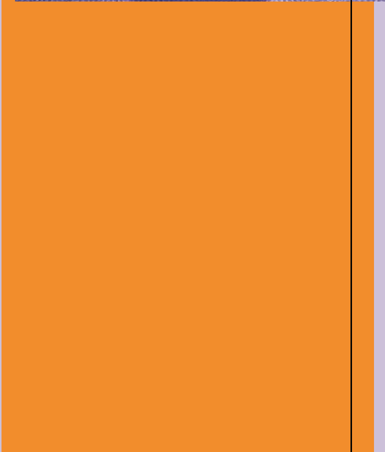

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