India

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This article surveys significant legal developments in India during the year 2012.1

I. Changes to Foreign Direct Investment Policy

On September 20, 2012, the government of India issued several press notes liberalizing foreign direct investment (FDI) norms in multi-brand retail (MBR), single-brand retail, aviation, power exchanges, and broadcasting. The foreign community has welcomed the liberalization in these sectors. The liberalization envisages: (a) foreign investment up to 51 percent in companies operating in the MBR sector; (b) foreign airlines holding up to 49 percent in companies operating scheduled and non-scheduled air transport services; (c) foreign investment up to 49 percent in power exchanges; and (d) foreign investment up to 74 percent in companies undertaking certain key carriage services in the broadcasting sector.

A. Multi-Brand Retail (MBR)

The most contentious and politically sensitive of the new changes to FDI policy is the opening up of MBR. Keeping in mind the sensitivities involved, liberalization in this sector has come with some riders. Investments in MBR require prior approval from the Department of Industrial Policy and Promotion2 as well as the Foreign Investment Pro-

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2. The Department of Industrial Policy and Promotion (DIPP) is a Department of Government of India under the Ministry of Commerce and Industry. DEPT INDUS. POL'y & PROMOTION, http://dipp.nic.in (last visited Feb. 27, 2013).
motion Board (FIPB). Several other conditions have also been imposed, such as minimum capitalization of US $100 million of which 50 percent is to be invested in "back end infrastructure" such as processing, manufacturing, and storage. Such investments must be made within three years. Further, Indian companies with FDI may only set up retail outlets in cities with a population of more than one million.

To counter opposition from other political parties, the Central Government has provided that, as regards MBR in a particular state, the relevant state governments may decide whether to allow FDI in MBR. As of October 1, 2012, ten state governments or union territories have confirmed that foreign investment in MBR is welcome.

B. SINGLE-BRAND RETAIL (SBR)

While FDI norms in SBR were liberalized early in 2012, the restrictions imposed were seen as too stringent. The Central Government relaxed two of the most restrictive conditions. The foreign investor is no longer required to be the direct owner of the brand. The Central Government now merely requires that the foreign investor should have a "legally tenable agreement with the brand owner." The onus of compliance with this condition would be on the Indian entity.

The Central Government also made a huge departure from its earlier stand requiring the foreign investor to mandatorily source 30 percent of the value of the products from "Indian small industries/village and cottage industries, artisans, and craftsmen (Small Industries)." The requirement now is merely to source 30 percent of the value of the products from India with an option of sourcing them from Small Industries.

C. AVIATION

Prodded by the dire circumstances in which some domestic aviation players have found themselves, the Central Government permitted foreign airlines to invest up to 49 percent in companies operating scheduled and non-scheduled air transport services with prior

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5. Id.
6. Id.
7. Id. Annexure. These are: Andhra Pradesh, Assam, Delhi, Haryana, Jammu & Kashmir, Maharashtra, Manipur, Rajasthan, Uttarakhand, Daman and Diu, and Dadra and Nagar Haveli. But see No FDI in Multi-Brand Retail Sector in State, IBN LIVE (Sept. 25, 2012, 7:53 AM), http://ibnlive.in.com/inews/no-fdi-in-multi-brand-retail-sector-in-state/294270-60-115.html (regarding the state government of Karnataka's decision not to allow FDD).
9. Id.
10. Id.
FIPB approval. Participation of foreign airlines was previously restricted to companies operating cargo airlines, helicopters, and sea plane services.

Further, certain "safeguards" have been put in place. The Chairman and two-thirds of the directors are required to be Indian citizens, and "substantial ownership and effective control" must lie with Indians. Additional conditions have been imposed from the perspective of national security, and all foreign nationals who are to be associated with the sector will need prior security clearance from the Central Government.

D. BROADCASTING

After several years of deliberation, the Central Government finally liberalized the FDI norms applicable to key broadcasting carriage services from 49 percent to 74 percent. Broadcast-carriage services include direct-to-home satellite distribution, cable television distribution, Internet television, and mobile television. Before the amendment, foreign investment up to 49 percent was permitted in companies undertaking these services with prior approval from FIPB.

Considering the sensitive nature of up-linking and down-linking of news and current affairs programs for television and FM radio, these services continue to require prior FIPB approval. In addition, Indian citizens are required to make up a majority of the Board of such companies. Also, prior clearance is required for effecting changes to the Board and security clearance is required for all foreign personnel likely to be deployed for more than sixty days in a year with the entity.

E. POWER EXCHANGES

Although 100 percent FDI was already permitted in the companies operating in the power sector, previously there was no explicit clarity on the FDI regime in relation to power exchanges. Now the Central Government has explicitly provided that 49 percent foreign investment, which includes 26 percent FDI under Government route, would be allowed in power exchanges in India. The new norms are expected to help power exchanges attract much needed funds and technology.
II. Recent Tax Policy Developments In India

This has been a vibrant year for tax policy in India. Losing the Vodafone appeal\(^\text{18}\) in the Supreme Court of India shook the administration from some sort of deep slumber to rise up and make the Indian economic landscape more competitive in pursuit of developing a sophisticated economy. The Finance Act 2012 (FA 2012) introduced some ambitious provisions to overcome the Vodafone impediment. But the Government was equally quick to announce a re-think of its plans. The whole exercise depicted the uncertainty and doubt that characterize Indian policy-making.

A. Draft Report on Taxation of Indirect Share Transfers and The General Anti-Avoidance Rules (GAAR)

The Shome Committee (Committee),\(^\text{19}\) after making its recommendations on applicability of GAAR in the Indian context, has also made available its findings on taxing indirect share transfers.\(^\text{20}\) In furtherance of its additional mandate, the Committee clarified the distinction between the two issues involved: (a) feasibility of retrospective amendments and (b) taxation of indirect share transfers.

The Committee unambiguously noted that the amendments introduced by FA 2012 were not retroactive in nature and should be applied only prospectively. It also noted that the Government should recourse to retrospective legislation only in "rarest of rare" cases.\(^\text{21}\) Nevertheless, the Committee made recommendations in event the amendments are applied retroactively, namely that (a) any tax on capital gains that may be levied should be imposed directly rather than representatively assessed or assessed in default, and (b) no interest or penalty should be charged on the amount of tax liability.\(^\text{22}\) The Committee also suggested fine-tuning the amendments to remove scope of arbitrary application, unintentional charges, and other concerns of foreign investors.\(^\text{23}\)

The amendment places a qualification—"substantially derives its value from India"—without specifying as to what constitutes "substantial" for a stock sale to come under the purview of Section 9 of the Income Tax Act 1961 (Section 9).\(^\text{24}\) The Committee instead recommended introducing the objective criteria contained in Draft Tax Code bill, i.e., 50

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\(^{19}\) The Prime Minister of India constituted an Expert Committee on the GAAR guidelines to undertake public consultations and finalize the said guidelines. The Expert Committee on GAAR consisted of Dr. Parthasarathi Shome (Chairman), Shri N. Rangachary, Dr. Ajay Shah, and Shri Sunil Gupta. Subsequently, the Prime Minister referred an additional issue to the Committee on the implications of abovementioned amendment made to the Act relating to taxation of overseas assets, where the underlying asset is in India, in the context of all non-resident tax payers. Based on consultations and written representations received from various stakeholders, the Committee issued the Draft Report on Retrospective Amendments Relating to Indirect Transfer in September 2012.


\(^{21}\) Id.

\(^{22}\) Id. at 65.

\(^{23}\) Id. at 64-65.

\(^{24}\) Id. at 8.
percent of net global assets.\textsuperscript{25} It also recommended shaping Section 9 in a manner to exempt intra-group corporate restructurings, dividends paid by foreign corporations, and large publicly listed foreign corporations.\textsuperscript{26} Further, investors in Foreign Institutional Investors (FII), whether Indian tax residents or not, should not be separately taxed since the FII is a tax-paying entity as warranted by the Securities and Exchange Board of India (SEBI) guidelines.\textsuperscript{27} For the benefit of small shareholders and private equity investors, the Committee also recommended exempting situations where the holding company, along with its associates, holds less than 26 percent of the Indian entity share capital or voting rights.\textsuperscript{28}

\section{The Kelkar Report on Fiscal Consolidation}

Fiscal management is an international issue, with governments all over the world struggling to balance growth, debt, and public spending. A careful analysis of trends in 2012-2013 suggests a likely fiscal deficit of around 6.1 percent if immediate mid-year corrective actions are not taken, which is far higher than the budget estimate of 5.1 percent of GDP.

The Kelkar Report\textsuperscript{29} highlights two major concerns: (1) if the growth rate is not maintained, it will create a surge in unemployment; and (2) lowered tax collections. The Kelkar Report attaches immense significance to tax reforms to support Government revenue since disinvestment receipts are not likely to yield the appropriate returns given the situation of the equity markets. It makes a favorable reference for Exchange-Traded Funds (ETF), and it opines that ETF can help retail investors to diversify their risks.\textsuperscript{30}

The Kelkar Report recommends that permanent account numbers (PAN) should be mandatory for all financial transactions.\textsuperscript{31} It also calls for streamlining and digitizing the procedure surrounding tax deduction at source (TDS), return filing, collection, and refunds.\textsuperscript{32} It urges the Government to review the Direct Tax Code bill, as in its current form it is “is likely to result in considerable unacceptable losses on a continuing basis.”\textsuperscript{33}

\section{Report on Measures to Tackle Black Money}

A multi-agency study (the Report) was commissioned by the Government to examine the existing legal and administrative framework to deal with the menace of black money, under the leadership of the Chairman of the Central Board of Direct Taxes (CBDT)—the
apex of the direct tax administration body in India.\textsuperscript{34} The Report outlines the sources of black money, attempts to measure the flow of such illegitimate funds, and reviews the legal framework to deal with the menace of black money.\textsuperscript{35} Interesting recommendations have been made in the context of using the Income Tax Act as a deterrent, such as prosecuting unaccounted wealth cases through the escaped assessment provisions of the Income Tax Act.\textsuperscript{36} The Report also highlights the lack of a single database and calls for co-operation between different agencies like the Reserve Bank of India (RBI), the Securities & Exchange Board of India (SEBI), Income Tax Department, Ministry of Home Affairs, and State Government functionalities to develop a common platform.\textsuperscript{37} Information collected can then be used for national level regulation.

The Report also calls for computerized processing of agricultural income returns by State Governments to allow for verification when credit is given for the purposes of income tax.\textsuperscript{38} Agricultural income tax levy varies across States and is an avenue for bringing black money into the financial system. To check black money funds of Indian nationals being invested by foreign financial institutions, the Report introduces the idea of mandatory reporting of global transactions by such institutions beyond a threshold limit.\textsuperscript{39}

D. \textbf{Final Report of the Accounting Standards Committee}

Section 145 of the Income Tax Act stipulates that a taxpayer can follow either a cash or mercantile system of accounting to compute income under the headings: “Profits and gains of business or profession” and “Income from other sources.”\textsuperscript{40} “The Finance Act, 1995 empowered the Central Government to notify the Accounting Standards for any class of [taxpayers] or for any class of income.”\textsuperscript{41} The rationale behind this system was that the Institute of Chartered Accountants of India (ICAI) issued Accounting Standards (AS) were flexible and a taxpayer could avoid payment of tax by following a particular system.\textsuperscript{42}

The CBDT formed a Committee to harmonize the ICAI’s Accounting Standards with the provisions of the Income Tax Act “for the purposes of notification under the Act and also to suggest amendments to the Act necessitated by transition to International Financial Reporting Standards (IFRS).”\textsuperscript{43} The report lays down proposals for “Tax Accounting Standards” (TAS) aimed at harmonizing the provisions of the Act and the ICAI-issued AS and IFRS. It clarifies that, by means of TAS, the taxpayer shall be burdened with the compliance of maintaining two sets of accounts—one for the corporate law mandated and

\begin{itemize}
  \item \textsuperscript{34} Gov't of India, Ministry of Fin., Report of the Committee, Measures to Tackle Black Money in India and Abroad (2012), \textit{available at} http://www.dor.gov.in/node/1053.
  \item \textsuperscript{35} Id.
  \item \textsuperscript{36} Id. at 3.
  \item \textsuperscript{37} See id. at 26.
  \item \textsuperscript{38} Id. at 31.
  \item \textsuperscript{39} Id. at 32.
  \item \textsuperscript{41} Id.
  \item \textsuperscript{42} Id.
\end{itemize}
conforming to the ICAI AS, and the other in compliance of TAS. Instead, TAS would be used only for computation of taxable income.

E. Way Forward

Phenomenal changes in the Indian tax regime have been coming for years now, in the form of the Direct Tax Code bill and the Goods and Services Tax (GST) bill. The Government has expressed its commitment to both legislative proposals. The Direct Tax Code bill is being reviewed in context of the Parliamentary Standing Committee’s findings and is expected to be introduced in the Parliament soon.44

While tax policy reforms are being debated and discussed, there is also a need to overhaul the tax administration system. Only time will tell whether India can live up to its commitment or if it shall once again yield disappointment because of over-promise and under-performance, which—in the given scenario—it can hardly afford to do.

III. 2012 Developments in India's Defense Offset Program

India has embarked upon a multi-year program to improve its national defense capabilities. The metrics are impressive. Since 2001, India’s defense spending rose by more than 60 percent to US $40.44 billion for 2012-2013, of which US $18 billion was slated for capital acquisitions.45 Arms acquisitions are conducted under the Defense Procurement Procedure (DPP). Since 2005, the DPP has required offsets for major defense contracts. On any defense deal worth more than Rs. 300 crores, 30 percent of the acquisition cost of foreign defense articles or services must be offset by qualifying transactions.46 The financial value of offset obligations is high; India has signed seventeen offset contracts worth US $4 billion.47 As much as US $10 billion in future offset contracts may be in the pipeline, especially if India completes negotiation with Dassault for 126 Rafale fighters.48

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45. See GOV’T OF INDIA, MINISTRY OF DEF., http://mod.nic.in/reports/welcome.html (last visited Feb. 27, 2013) (listing Annual Reports for India’s defense spending for 2001-2012); see also Laxman K. Behera, India’s Defence Budget 2012-13, INSTITUTE FOR DEFENCE STUDIES & ANALYSES (Mar. 20, 2012), http://idsa.in/idsa comments/IndiasDefenceBudget2012-13_LaxmanBehera_200312 (stating that the Union Budget for 2012-2013 sets defense outlays at Rs. 193,407.29 crores (US $40.44 billion), of which the planned capital expenditure budget was Rs. 79,578 crores).


47. Greg Waldron, Offset Deals Boost Indian industry, FLIGHT INT’L (May 22, 2012) (reporting on remarks of Defence Minister A.K. Antony to India’s Parliament; in total, India has secured offset business worth $4.3 billion from 17 contracts, with the aerospace sector accounting for 15 of these, all signed from 2007).

48. See Jay Menon, Rafale’s Win Is India’s Gain as Well, AVIATION WEEK & SPACE TECH., Feb. 1, 2012 (Dassault contract requires 50 percent reinvestment into India industry; India’s defense sector expected to receive about US $8 billion in offsets).
Offset commitments are made in the form of contracts between the Indian government and the foreign seller.49 Foreign sellers must purchase supplies or services from or make equity or in-kind investments in Indian ventures.50 Offsets are a compulsory form of countertrade. India permits offset demands to be satisfied both by "direct" purchases or investments, such as buying supplies or services from the extant Indian domestic aerospace industry, as well as "indirect" transactions, such as investment or purchase of supplies or services in adjacent sectors such as civil aviation and inland/coastal security.51 Each offset contract imposes substantial penalties upon vendors for non-performance, including a penalty of up to 20 percent of total offset obligation for non-performance and the risk of exclusion from future purchases.52

The goals of the offset program are to foster a domestic defense industry, to reduce dependency upon foreign sources, and to create employment in aerospace manufacturing. The results of the offset program have been disappointing, so far.53 On August 1, 2012, the Ministry of Defense (MoD) announced major revisions to the Defense Offset Guidelines contained in the DPP.54 These are a positive step that may improve the efficacy of India's offset efforts.

The revisions expand the definitions of "eligible supplies" and "eligible services" that qualify for offset credit. Liberalized offset "banking" rules should encourage foreign original equipment manufacturers (OEMs) to create joint ventures and other offset projects in advance of defense contracts. The revised Guidelines give foreign companies more time in which to satisfy offset requirements. Offsets now can be satisfied both through FDI (still limited to 26 percent in the case of defense ventures) as well as "in-kind" provision of equipment or transfer of technology (ToT).55 For the first time, "multipliers" may apply to determine the credit amount, where particularly-desired technologies are supplied, or for direct purchases of supplies or services from Micro-, Small-, and Medium-sized (MSME) enterprises.56

These changes will encourage more foreign OEMs to tie-up with Indian partners and to cultivate an Indian supply base from the MSME community. At the same time, however, certain new provisions will be very challenging to meet; for example, "buyback" and "value addition" requirements that reduce what can be earned through transfer of equipment or ToT.57

49. 2012 DEFENCE OFFSET GUIDELINES, supra note 46, ¶ 2.4.
50. Id. ¶ 3.1(a)-(b) (direct purchase and foreign direct investment in joint ventures).
51. Id. app. D, Annexure VI (List of Products and Services Eligible for Discharge of Offset Obligations).
52. Id. ¶¶ 8.13-14 (penalties and debarment).
54. See Memorandum from Rajkumar Gathwal, Director (Acquisition), Ministry of Def., Gov't of India to Vice Army Chief of Staff et al. (July 27, 2012), http://mod.nic.in/dpm/welcome.html (click link for "DPP-2011-Revised Offset Guidelines").
55. 2012 DEFENCE OFFSET GUIDELINES, supra note 46, ¶ 3.1 (c)-(e) (investment in kind — transfer of technology; investment in kind — provision of equipment; provision of equipment or transfer of technology to Government institutions).
56. Id. ¶¶ 5.11-12 (1.50 multiplier for micro, small, and medium enterprises; multiplier of up to 3.0 for technology acquisition by DRDO).
57. Id. ¶¶ 5.6-7, 5.9 (40 percent minimum buyback requirement applies to discharge of offset obligations through investment "in kind" in Indian enterprises through provision of equipment; offset credit for transfer of technology to Indian enterprise shall be 10 percent of the value of the buyback during the period of the
As elsewhere, in India the achievement of business success in a highly regulated industry is a function not only of law and regulation but also of the bureaucracy and method of administration. Here, the 2012 Revised Guidelines took important and positive steps. A new bureaucratic enterprise, the Defense Offset Management Wing (DOMW), has been created within the MoD. DOMW is responsible for formulation of offset guidelines and for post-contract administration; it works with the Acquisition Wing of MOD in the evaluation of proposed offset proposals.

The bureaucratic changes could prove as important as the new flexibility in the Revised Guidelines. Foreign OEMs need to know how they can structure investment, joint ventures, and supply chain arrangements in order to satisfy offset requirements. Similarly, companies who look to be suppliers to these OEMs need to know what the rules are and how they will be applied. All parties need assurance they can rely upon advice given and that guidance will be consistently applied. Uncertainty acts as a deterrent to business planning and adds to compliance risk.

Overall, there are many positive steps in the revised Offset Guidelines. The revisions will serve India's national aims by making the offset program more businesslike, realistic, and achievable. No one's interest is served by an offset regime that reads well but only disappoints in practice. At the same time, and considering that India's DPP is a work-in-progress, there are further measures that can be taken—some requiring a change to law or policy, some not.

The new Guidelines apply only to offset contracts resulting from procurements initiated after August 2012. The Government should revisit this restriction because of the high likelihood that some offset commitments made before the revised Guidelines will prove incapable of satisfaction. Allowing the newer rules to apply to pre-existing offset obligations, to permit addition or substitution of qualified India Offset Partners on a case-by-case basis, may prove very much in the mutual interest of India and its foreign suppliers.

offset contract, to the extent of value addition in India; value addition applies to direct purchase/export of eligible products and is determined by subtracting from the purchase price the value of import content and any fees/royalty paid).

58. Id. ¶ 6.2.
59. This is because the offset obligations are implemented through an Offset Contract that, in turn, commits the seller to satisfy offset obligations as set forth in the Request For Proposal. The newest version of the Defence Offset Guidelines would be referenced only in Requests for Proposals issued after August 1, 2012.