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Key Announcements
Budget for Financial Year 2007-08
India

February 28, 2007

The Union Minister of Finance, Mr. P. Chidambaram today announced the Union Budget for the financial year 2007-2008 (the "**Budget**").

As was expected, the Budget was tailored to please the masses and several announcements providing nominal incentives for them were made. However, what was unexpected, were announcements which may generally have an adverse effect on the corporate sector. Announcements such as the increase in rate of dividend distribution tax[1], bring information technology companies under a minimum alternative tax regime, subjecting employee stock options to the fringe benefit tax etc may have such an effect.

A few positive announcements related to fine tuning regulations to enable individuals to make investments in overseas securities through mutual funds, permitting short selling settled by delivery and securities lending and borrowing by institutions, permitting the issuance of new financial instruments such as exchangeable bonds, encouraging the growth of the small and medium enterprises, facilitating the development of infrastructure etc.

Some of the announcements which may have an impact on the foreign business community investing in India are as follows:

[1] As the name suggests, this is a tax payable on the distribution of dividends.

Venture Capital Funds

Some foreign venture capital funds follow a dual structure of making investments into India, pursuant to which the foreign funds make Indian investments through an Indian venture capital fund. As per the current tax regime, Indian venture capital funds registered with the securities regulator of India are treated as pass through entities. However, this exemption will now be taken-away for those funds which do not invest in sectors such as biotechnology, information technology relating to hardware and software development, nanotechnology, seed research and development, research and development of new chemical entities in the pharmaceutical sector, diary industry, poultry industry, production of bio-fuels and hotel-cum-convention centres of a certain description and size.

This announcement may adversely affect some of the foreign funds investing in India through Indian venture capital funds and appropriate re-structuring may need to be undertaken to ensure that notwithstanding the limitation of benefit, the Indian venture capital fund retains a pass-through status.

Employee Stock Options

Employee Stock Options are proposed to be brought under the controversial Fringe Benefits Tax[2].

This is an extremely unwelcome move since one of the key challenges for a fast growing economy is to retain and reward its employees.

While many corporates in the start-up and early stages use employee stock options to retain their employees, with the imposition of the said tax this would become more difficult to achieve.

[2] This is a tax imposed on certain benefits provided to employees.

Dividend Distribution Tax

The dividend distribution tax rate has been increased from the current rate of 12.5% to 15%.

Service Tax

Certain additional services such as the following have been brought within the fold of service tax:

(1) Renting of immovable property for use in commerce or business.
(2) Design services.
(3) Asset Management Services provided by individuals.
(4) Development and supply of content for use in telecom and advertising purposes.

On the other hand to promote clinical trials in India they have been exempted from service tax liability.

Capital Markets

The capital markets were provided a boost by the following announcements:

(1) Promoting self regulation of market participants under regulations to be made by the securities regulator.
(2) Permitting mutual funds to launch and operate dedicated infrastructure funds.
(3) Converging different regulations to enable individuals to invest in overseas securities through Indian mutual funds.
(4) Allowing short-selling settled by delivery, and securities lending and borrowing to facilitate delivery by institutions.
(5) Enabling Indian companies to issue exchangeable bonds ton unlock part of their holdings in group companies.

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NB: This budget update has been prepared by Gandhi & Associates relying on the speech made by the Minister of Finance, Mr. P Chidambaram on February 28, 2007. The contents of this update are not intended to be legal advice. The exact implications of these announcements can be ascertained only after the Finance Bill comes into force. You must not act upon any of the information contained in this budget update prior to seeking legal advice from legal professionals entitled to practice Indian laws. Gandhi & Associates will not be liable at any time in any manner whatsoever for any losses whether direct or indirect caused to you as a result of any action whatsoever taken by you in pursuance of this budget update.