

**INDIAN BUDGET.  
ECONOMY  
&  
PHILOSOPHY  
2002.**

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To

Clients & Friends,

Dear Sirs,

1. We are presenting herewith, our brief analysis of the Finance Act, 2002 (Budget, 2002). All the modifications passed in April, 2002 are already incorporated in this analytical note.
2. We have tried to explain some of the provisions by giving illustrations and computations. Notes in the margin are summaries for the whole paragraphs.
3. This note is essentially for our clients — who may find the provisions applicable in their own tax matters.

Some paragraphs are meant for professionals and discussed in little more details. Such paragraphs are marked (P). Corporate executives may be interested in these.

Budget contains several provisions. A reader may not be interested in all the provisions. Hence we have grouped the paragraphs in the following parts:

- Part A** : Tax rates, personal income & deductions – Like salaries, house property income, LIC deduction etc.
- Part B** : Corporate/Business matters — Like Transfer Pricing, export reliefs etc.
- Part C** : NRIs.
- Part D** : Economy and Philosophy, Indian Budget & Myths.

Hope, you will find the same useful.

With Best Regards,

Yours sincerely,

Rashmin Sanghvi and Associates

## **BUDGET**

Finance Minister has faced very tough times.

1. Indo-Pak war danger remains. In any case, a huge expenditure of 'military on border' is continuing.
2. Even otherwise, continuing increase in expenses is a matter of fact.
3. Government is already insolvent.
4. Direct tax rates are at their historically lowest. There is no scope for further reductions.

In such a situation, making low deficit budget which is good for economy; and yet pleases the people is most difficult. Hence Finance Minister has not attempted such a budget.

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## **BUDGET 2002**

### **Part A – Tax Rates, Personal Income & Deductions**

#### **1. Tax rates**

The basic tax rates have remained unchanged except for two areas where the tax rates have been altered.

##### **1.1 Surcharge**

The surcharge of 2% levied due to Gujarat earthquake has been removed. In its place, a surcharge of 5% for national security is being levied. There is a net increase in surcharge of 3%. For those in 30% tax bracket, the increase in tax rate works out to 0.9%.

The new maximum marginal rates are:

For Individuals — 31.5%.

For Companies & Firms — 36.75%.

##### **1.2 Foreign companies**

Foreign companies were levied a tax @ 48%. The budget has reduced the tax to 40%. However, so far the foreign companies were not levied any surcharge. Now they will also be levied a surcharge. Thus, their tax cost becomes 42% instead of 48%.

Foreign companies will now be taxed @ 42% instead of 48%.

**The difference** between tax rates for foreign companies and Indian companies has certain **reasons**. The Government's stand is that India has a **classical system** of taxation whereby the company and the shareholders are treated separately. Thus, the company pays tax on its profits, and the shareholders pay tax on dividend. In case of foreign companies, the tax can be collected only once — on net profits of the foreign company. When the foreign company declares dividend to its shareholders, India cannot levy tax on the dividends as it is outside India's jurisdiction. Therefore, the foreign companies are levied a higher rate of tax. It was argued by foreign companies that the difference in the rate of tax for foreign companies (48%) and domestic companies (35%) was still quite large. Therefore, to reduce the difference, the rate has been brought down to 40%. Now the argument that there should be lower (or no) difference between tax rates of domestic and foreign companies may not hold good. In fact the situation is actually opposite. The Indian companies and the shareholders together have to pay more tax. Kindly see para 6, where we have given an illustration of impact on taxation of foreign companies. For professionals, a brief history on Double taxation is also given in paragraph 5.7.

- Rebate due to PPF, LIC has been reduced for different categories of income.
2. **Rebate for PPF, LIC, etc. — Section 88**
- 2.1 A tax rebate of 20% is allowed for investments in LIC, PPF, etc. The budget proposes to reduce the rebate for certain categories.
- A person who has income before deductions under chapter VI-A (80L deduction for bank interest, 80G deduction for donation, etc.) of up to Rs. 1,50,000 will continue to get rebate of 20%.
- If his income is between Rs. 1,50,001 and Rs. 5,00,000, the rebate will be equal to 15%.
- Those having income above Rs. 5,00,000/- will not get any rebate.
- For the last few years, the Government is making a series of provisions reducing incentives for investment in Government securities. It is clear that the Government wants to reduce its internal debt.
- 2.2 The maximum limit up to which investment can be made in PPF, LIC, etc. has been increased from Rs. 60,000 to Rs. 70,000. For subscription to eligible shares and units of mutual fund, an additional investment of Rs. 30,000 is permitted against the earlier limit of Rs. 20,000. Thus the maximum tax reduction which can be claimed for those having income between Rs. 1,50,001 and Rs. 5,00,000 is Rs. 15,000.
- Interest for housing loan will be available as a deduction up to Rs. 1,50,000. The property should be constructed or acquired within 3 years of taking the loan.
3. **House Property Income — Section 24**
- In case of self-occupied properties, a deduction for **interest on loans** was allowed up to Rs. 30,000. This deduction was increased to Rs. 1,50,000. However, for this increase, a restriction was provided. The new house property should be acquired before 1st April, 2003. The budget has done away with the time limit of acquiring the property. Instead, now it provides that the property should be acquired or constructed within three years from the end of the year in which the loan was taken. Thus, if loan is taken in March, 2002, the property should be acquired before 31st March, 2005. Now the deduction of Rs. 1,50,000 has become open ended and applicable for all properties acquired henceforth.
- Still, however, the above situation does not rectify a serious problem. In cities like Mumbai where the costs are far

higher than other smaller towns and cities, a modest property of 600 sq. ft. costs between Rs. 10,00,000 and Rs. 25,00,000. With the existing limit of Rs. 1,50,000, a maximum loan of about Rs. 12,50,000 can be taken to get full deduction of interest. A better way perhaps could be, that for one house property per family, full deduction of interest should be allowed. For more than one properties, the regular deduction of Rs. 30,000 should be allowed.

**4. Tax to be deducted at source by individuals and HUFs — Section 194-A, etc.**

Individuals and HUFs who require a tax audit will have to deduct tax at source from various payments.

Before making payment of income, tax has to be deducted at source under various provisions. For most of the provisions, individual persons and HUFs were not required to deduct tax at source. Now the budget proposes that those individuals and HUFs who are required to get their books of account audited under the tax audit rules, will be required to deduct tax at source from various payments. (Tax audit is required by a businessman having a turnover exceeding Rs. 40,00,000 and by professionals having gross receipts exceeding Rs. 10,00,000.)

Thus, now payments of following kinds can be made by individuals and HUFs only after deducting proper tax at source.

- (i) interest on loans; (S. 194-A)
- (ii) payments to sub-contractors; (S. 194-C)
- (iii) commission and brokerage; (S. 194-H)
- (iv) rent for immovable property; (S. 194-I) and
- (v) fees for professional or technical services (S. 194-J).

Such individuals and HUFs will now have to go through the entire procedure of TDS. They will have to deduct proper tax at source, pay the same to the Government within the prescribed time, issue proper TDS certificates to the payees, and file annual TDS returns.

As far as salary payments are concerned, individuals and HUFs were always liable to deduct tax at source where applicable.

## **Part B - Corporate / Business matters**

### **5. Tax on dividend – Sections 10(33), 115-O**

#### **5.1 Changes**

Dividends are now again taxable in the hands of shareholders.

About five years ago, Mr. P. Chidambaram had removed tax on dividend received by shareholders. In its place, a flat tax @ 10% was levied on the company which distributed the dividend. It was argued that this was a simple method of levying the tax. Instead of collecting tax from millions of shareholders, the tax was collected only at one point.

Now the budget has brought back the old system. Shareholders will have to pay the tax on dividends. This will increase the tax burden, as the tax on companies was 10%; whereas the shareholders will have to pay their normal tax on the dividend.

#### **5.2 T.D.S. – Section 194**

The company declaring dividend, will have to deduct tax at source. However, in case of an individual person, if he receives dividend of up to **Rs. 1,000** in a year, from the same company, then tax does not have to be deducted at source.

#### **5.3 Section 80L**

Further dividends will be eligible for deduction up to **Rs. 9,000** per annum. This deduction is to be considered together for bank interest, dividend and mutual fund dividend under Section 80-L.

#### **5.4 Relief for dividends earned by Indian companies — Section 80-M**

To reduce the cascading effect of multiple taxation, Indian companies have been given relief. If an Indian company receives dividend from another Indian company, a deduction is given from the income, if the company which receives dividend, in turn distributes dividend before the due date of filing the return. Thus, for example, if

company A receives Rs. 10 lakhs as dividend from company B in F.Y. 2002-03; then company A must distribute dividend by 31st October, 2003. If it distributes Rs. 10 lakhs or more, the entire amount will be tax-free. If it distributes less than Rs. 10 lakhs, the difference will be taxed.

**5.5 Dividends from mutual funds – Sections 10(33), 115-R, 115-BBB**

Dividends from mutual funds will be taxable in the hands of unitholders.

Dividends received from **mutual funds** and UTI were also not taxed in the hands of the shareholders. Instead the mutual fund had to pay a tax on dividends distributed @ 10%. Now, dividends will be taxed in the hands of the unit holders. The mutual fund and UTI will not have to pay tax on distribution of income.

A small concession has been given in case of units of **open ended equity oriented fund**. An open ended equity oriented fund means – 1964 scheme of UTI, and those funds where at least 50% of funds are invested in equity shares. Open ended equity funds did not have to pay tax on incomes distributed up to 31-3-2002. Now any dividend received from such an open ended fund would be **taxable @ 10%** instead of the regular rates. This lower rate of tax will continue for dividends received **up to 31-3-2003**. After that, regular tax will be payable.

There is however, a small anomaly here. A person who has income below Rs. 50,000 will also have to pay tax @ 10% on dividend from open ended equity fund. This perhaps is not the intention. However, the legal language states the above position.

It may be noted, however, that in most cases, Double Tax Avoidance Agreements would apply. Under the DTA, the rate may be reduced to 10% or 15%.

5.6 (P) The changed impact in the tax system can be explained in the following illustration.

<b>Sr. No.</b>	<b>Particulars</b>	<b>System for Financial Year ended 31-3-2002 Rs.</b>	<b>F.Y. ended 31-3-2003 Rs.</b>
1.	Assume, A company earned taxable income of	1,000	1,000
2.1	Corporate tax rate	35.7%	36.75%
2.2	Tax Rs.	357	368
3.	Net available funds Rs.	643	632
4.	Assume that full amount is utilised by company for payment of dividend and respective tax –		
4.1	Dividend tax @ 10%.	58	000
4.2	Dividend declared	585	632
5.	Tax in the hands of the shareholder. For individuals @ highest rate of 31.5%	000	199
6.	Net balance with shareholder	585	433
7.	Total taxes paid (2.2 + 4.1 + 5)	415	567

**5.7 Double Tax Avoidance Treaties (P)**

The dividend tax u/s. 115-O was paid by the company and not the shareholder. In the circumstances, there was a controversy. Would a shareholder who is non-resident of India, get the credit in his own country for the tax paid in India by the company! Some countries' tax departments were granting this credit. For other countries, it remained a doubtful issue.

Now, with deletion of S. 115-O, the controversy also disappears.

## 6. Non-residents and foreign companies (P)

### 6.1 Tax cost for foreign companies (P)

The tax rate on foreign companies has been reduced from 48% to 42%. Considering the reduction in the tax rate, and tax on dividends, the impact on foreign company can be as under.

Foreign Companies' tax rate is reduced by 6%.

#### Example 1

Normally a foreign company can do business in India through an Indian company. However for some activities, it is possible to do business directly, without having to set up an Indian company. This can be so in the case of infrastructure projects like roads, ports, etc. Under the current position, the tax for assessment year 2002-03 will be as under:

In the first column it is assumed that the foreign company invests in a wholly owned Indian subsidiary. In the next column it is assumed that the foreign company directly does business in India.

#### Assessment Year – 2002-03

Sr. No	Particulars	Through Indian company Rs.	Business through branch Rs.
1.	Profit of Indian company/branch	1000	1000
2.	Less: Tax @ 35.7%/48%	357	480
3.	Profit after tax	643	520
4.	Dividend declared	583	520
5.	Tax on dividend @ 10.2% (Section 115-O)	60	NIL
6.	Total tax paid in India (2 + 5)	417	480

Business in India through a branch may have a lower tax cost than business through an Indian company.

Tax cost for the assessment year 2002-03 is lower if investment is done through an Indian company.

**Example 2**

The impact of budget 2002 (for assessment year 2003-04) is given in the table below. Facts are assumed as in example 1.

**Assessment Year – 2003-04**

Sr. No	Particulars	Through Indian company Rs.	Business through branch Rs.
1.	Profit of Indian company/branch	1000	1000
2.	Less: Tax @ 36.75%/42%	368	420
3.	Profit after tax	632	580
4.	Dividend declared	632	580
5.	Tax on dividend @ 20% (*) (Section 115A)	126	NIL
6.	Total tax paid (2 + 5)	<b>494</b>	<b>420</b>

As can be seen, now the tax cost through a company can be higher. Of course if foreign companies decide to accumulate funds in India, and not declare dividend, then the tax cost would be lower.

The above table explains the tax impact in India. Apart from the tax in India, the foreign company may also have to pay tax on dividends in its own country. Credit for tax paid in India will normally be available in their home country.

(\*) It may be noted, however, that in most cases, Double Tax Avoidance Agreements would apply. Under the DTA, the rate may be reduced to 10% or 15% etc.

It is obvious that whether a foreign company does business through a wholly owned subsidiary or a branch, will depend on several business and legal factors. Tax rate can be important, but secondary to business considerations.

**6.2 Grossing up of tax in case of royalty etc. (P) – Sections 10(6A) and 10(6B)**

In case of payments made by Indian residents to non-residents on account of payment of royalty, fees for technical services and technical fees, relief was given to payers. If the tax was borne by the payer, no grossing up was required to be done. This was subject to certain conditions. The budget has now done away with such reliefs. The reason is that any tax paid in India, is available as a credit to the non-resident in the foreign country. By allowing reliefs it was only the foreign Government which benefited. Hence the reliefs have been removed. This can be explained by an example.

Relief on grossing up of tax in case of royalty and fees for technical services has been removed.

Sr. No	Particulars	No Grossing up of tax is done	Grossing up of tax is done
1.	Royalty	1000	1000
2.	Tax in India @ 20%	200	200
3.	Grossed up tax	200	250
4.	Total cost (2 + 3) to Indian payer	1200	1250
5.	Tax in foreign country say @ 30%	360	375
6.	Less: Tax paid in India	200	250
7.	Balance tax paid in foreign country	160	125
8.	<b>Total taxes</b>		
	In India	200	250
	In foreign country	160	125
	<b>Total tax</b>	<b>360</b>	<b>375</b>

Thus the tax in India will now be higher. However total cost of taxes is not increased significantly.

In case of royalties and fees for technical services, the relief for grossing up continues to be available for agreements entered prior to 1-6-2002. However, in case of technician's fees, no such relief will be available for cases where services have commenced prior to this budget.

## 7. Sale of immovable property (S. 50-C)

### 7.1 Form 37-I – Acquisition

The 'acquisition chapter' under Income-tax Act is deleted. Value adopted by State Government valuation officer will be deemed to be the selling price.

Sale of immovable property exceeding the specified limits, requires an approval from income tax department. Application in form 37-I has to be filed under Chapter XXC. In Mumbai the limit was Rs. 75 lakhs. The budget has done away with the clearance. Sale effected, from 1st October, 2002 will not require this clearance. There will be NO Acquisition of immovable properties by the Government on the grounds of black money. Transfer of immovable properties has now become easier and simpler. This is welcome.

### 7.2 Value for Registration

In its place, new provisions are proposed which would apply to **all properties irrespective of the value.**

The new Section 50C provides that if the sale consideration of the property is less than the value adopted for stamp duty, then the stamp duty valuation by the State Government authorities will be considered as the sale price.

This can lead to several difficulties.

In Maharashtra, the stamp duty authority has a **ready reckoner** – giving value of the property which they will consider for stamp duty. It gives the value of the property according to the area and the street where property is located. Obviously this reckoner is only a guide.

One is aware that two flats in the same building can command different prices, and the difference can be substantial. The value of flats in two different buildings can definitely be different. The ready reckoner does not take these into account. Still the budget proposes to adopt the valuation as per stamp duty authorities.

### 7.3 If the tax-payer does not agree with the valuation by stamp duty authorities, and he has not appealed against such valuation, then the income tax officer can refer the valuation to a valuation officer.

If the income tax valuation officer values the property lower than the stamp duty valuation, then the tax

valuation officer's value will apply. If the value is higher, then the stamp duty valuation will apply. Thus the value to be considered will be:

**Lower of** : Stamp duty valuation and valuation by income tax valuation officer.

and

**Higher of** : Sale price, and stamp duty valuation.

**7.4** If the tax-payer has appealed to any authority or court in respect of stamp duty valuation, then one will have to wait for the judgment. This may create a difficulty as the assessment has to be completed within two years of the end of the financial year, whereas the court decision may take years.

**7.5** (P) There is also a fundamental legal issue. What is taxable is the income "actually earned". In the case of K. P. Varghese, (131 ITR 597) it was held by the Honourable Supreme Court that even if the sale price is below the market value, the Income-Tax officer has to prove that there was an actual receipt of sale price. If income was not actually earned, it cannot be considered to be taxable. Thus where the property has been genuinely sold for a price which is less than the market price, additional tax cannot be charged. This is a settled principle. Based on this Supreme Court decision, the Government had to delete section 52 of the Income-tax Act which had a similar deeming provision.

Adopting the value as per stamp duty authority as the sale price, can be struck down by a court as unconstitutional.

This principle can equally apply here. It is possible that in an appeal, this section can be struck down as unconstitutional. One will have to wait and see how things develop.

**7.6** In this situation, one will have to find some safe way. Under stamp duty law, there are primarily two ways of valuing a property. One is where the purchaser applies for adjudication. The stamp duty is determined by the stamp duty authority and stamp duty is paid. Thus before finalising the transaction, one may go for adjudication.

The other method is that after signing the agreement, the buyer of property pays the duty, and then gives the agreement for registration. If there is an increase in valuation by stamp duty authorities, then additional stamp duty has to be paid. This will create difficulties in tax assessments.

With the new provision, it may be advisable to go in for adjudication in most of the cases.

## **8. Transfer Pricing (Chapter X of the Income-tax Act) (P)**

Transfer pricing provisions will now apply only where both conditions are fulfilled—i) regarding control and management and ii) any one of the thirteen specific criteria.

Last year the Government had introduced elaborate anti-transfer pricing rules. There were certain anomalies and difficulties in the rules. These have been taken care of in this budget. The changes brought in the budget are discussed below.

### **8.1** Briefly – Section 92A provides for two sets of conditions in sub-sections (1) and (2). There was a controversy. Are both these sets independent or cumulative! In other words, two or more concerns would be treated as associated concerns if –

(i) any one of the sets of conditions were applicable;

OR

(ii) both the sets were applicable.

Finance Act, 2002 has now provided that the concerns will be treated as 'Associated Concerns' only if both the sub-sections 92A(1) and 92A(2) are applicable.

The same technical matter is stated below in a businessman's language.

### **8.2 Meaning of associated enterprise — Section 92A**

Transfer Pricing rules apply only if the transactions take place between two or more associated enterprises. The definition of associated enterprise is very wide. It is stated [S. 92A(1)] that if one enterprise participates in another enterprise's capital, control or management, then the two enterprises are associated enterprises. This is alright. However S. 92A(2) further provides thirteen different criteria whereby two enterprises could become associated enterprises. Some criteria are so wide that even normal

business transactions between unrelated parties would make them associated enterprises. For example, if a foreign bank gives loan to an unrelated Indian borrower, and the loan exceeds 51% of the borrower's assets, then the foreign bank and the Indian borrower become associated enterprises. Transfer Pricing rules would apply to them.

Several representations were made by various organisations. Even OECD had suggested to make the changes.

Now the Finance Act provides that two or more enterprises will be treated as "associated enterprises" only if they fulfil both the conditions:

- (i) One enterprise participates in the control management or capital of the other enterprise. This is the primary condition to be fulfilled.
- (ii) Additionally, at least anyone of the thirteen conditions provided in S. 92A(2) is also fulfilled. (e.g. giving of loan exceeding 51% of assets etc.) Thus without the basic criteria of control, capital or management, participation; two enterprises cannot be associated enterprises. This is a **welcome amendment**.

**8.3** The transfer pricing rules provided that income shall be computed according to the market prices of transactions between two associated enterprises. Legally, it meant that if the market prices were lower than the prices at which transactions had taken place, then for the purposes of income-tax, the market prices would have been considered. That is; the tax will have to be paid on lower amount of profit than what is recorded in the accounts. This may happen where for example a foreign company has invested in a subsidiary in India. To support the subsidiary in the initial years, it may purchase the goods from the subsidiary at prices which are higher than the market prices. Thus the profits of the Indian subsidiary, as per accounts will be higher than profits as per market prices. As per the old rules, the subsidiary would be entitled (in fact, required) to file Income-tax return on lower income at market prices.

T. P. rules can only increase income; cannot reduce the income.

The budget has now provided that the intention is not to lower the tax revenues. Therefore, transfer pricing rules will apply only if it results in increase of revenue to the Government. [Section 92(3).]

### 8.4.1 Two way impacts

Many financial transactions have two way effects. Taxable income of one assessee may become tax deductible expenditure of another person. If because of arm's length price, one person's income is modified, should the other affected person's income also be appropriately modified?

This issue becomes clear from the following illustration:

### 8.4.2 Illustration

U.K. Ltd., a British holding company has an Indian subsidiary – I Ltd. U. K. Ltd. charges royalty to I Ltd. Let us say, following are the amounts involved.

Royalty at arm's length price /		
Market Price	@ 5%	Rs. 5,00,000
Actual charged	@ 2%	Rs. 2,00,000
Difference		<u>Rs. 3,00,000</u>

I Ltd.'s income is increased by Rs. 3,00,000 because of undercharging. At the same time, U.K. Ltd.'s income is reduced by Rs. 3,00,000.

Section 92(3) restrains I Ltd. from reducing its income by applying the market price.

However, U.K. Ltd. will have to increase its income u/s. 92(1) at the market price.

This issue was drawn to the attention of the Government by representations. However, they have sought to ignore the same.

### 8.4.3 “Kings I win, Scales you lose”

Government of India has very well adopted this principle declared by the late actor Kishore Kumar in the humorous film “Chalti Ka Naam Gaadi”. (*Chat Main Jeeta, Pat Too Haara.*)

Seriously speaking, T. P. Law is a new chapter in Indian Income-tax Law. It has to evolve and be refined. We hope that the Government will see logic and refine such anomalies.

### **8.5 Permissible variation from market price.**

Transfer Pricing rules can result into computation of different market prices. This is because transfer pricing is a subjective exercise and not an exact science.

A 5% variation from market price is to be ignored.

The rules provided that if there were more than one prices computed under any method of the transfer pricing rules, the arithmetical mean would be considered as the market price. This was not considered to be proper. For example, assume that there are three prices – 100, 105 and 120. The average of the three prices is 108. In such a case, although the person may have transacted his business at a price of 100, still it would not be considered as the market price. To take care of such a situation the tax department had come out with a circular that a variation of 5% would be considered alright. Now this variation of 5% has been incorporated in the law itself. Although, the variation of 5% is perhaps inadequate, it is nevertheless welcome.

**8.6** The issue of transfer pricing is very subjective and requires good knowledge of the industry. Currently each Income Tax Officer is authorised to assess the transfer pricing cases. This issue can cause difficulties. Just as professionals cannot be aware of all industries, assessing officers also cannot be aware of all industries. The budget has now provided that if the Income Tax Officer considers it appropriate, he may transfer the issue of determining the transfer price of international transactions to a Transfer Pricing Officer.

Overall this is a welcome step. With a special transfer pricing officer, it should be easier to sort out transfer pricing issues.

### **8.7 Due date for Audit**

There was a difficulty regarding audit under transfer pricing rules. The due date for transfer pricing audit was as under:

For companies – 31st October  
For others – 31st July

Normally, under the Income-tax Act, wherever an audit is required, the due date is 31st October (whether it is a company or a non-company). However, under the transfer

pricing rules the date was 31st July for non-companies even where a tax audit was to be required. Therefore, such entities would have to file the transfer pricing audit report by 31st July and the tax audit report and income-tax return by 31st October. Now, the budget proposes to align the date to 31st October for all assessees undergoing audit.

### **8.8 Ignorance is Bliss**

A very interesting situation has emerged due to T. P. provisions. Those who read and understand the provisions – mainly practising chartered accountants – are scared of the widespread and serious impact of the T. P. provisions.

However, some of the clients, to whom it directly applies are blissfully unaware of the applicability of T. P. provisions; and consequences of non-fulfilment of the provisions.

The provisions apply to all assessees — whether corporate or individuals; and whether having a collaboration etc. or not.

Hopefully, with this year's audit exercise; all clients will understand the provisions and maintain proper records from the current year.

### **9. Restrictive covenants — Section 28(vii)**

Payments of the kind of restrictive covenants will now be taxable.

There are some fundamental concepts of “revenue” and “capital” receipts in the income tax law. “Revenue” receipts are taxable. “Capital” receipts are generally not taxable. “Capital” receipts mean those receipts which are not “earned” incomes. For example, inheritance or gifts received. They cannot be attributed to any particular activity or asset.

In case of restrictive covenants, some persons receive payments for not doing any particular business, or not using any rights, etc. It is believed that such receipts are capital receipts and hence not taxable.

**Example** — If an employee leaves his service, and the employer pays him a lump sum amount for not joining a competitor, it becomes a payment for restrictive covenant.

It is however always a debatable issue whether such a receipt is taxable or not.

The budget now provides that such receipts is be taxable.

This is a fair provision as the amount received under such agreements usually pertain to commercial transactions. Hence to treat the receipts as taxable is only logical.

#### **10. Export Oriented Units etc. Sections 10A & 10B**

Export Oriented Units and units in Free Trade Zones are exempt from tax for the specified period. For the financial year 2002-2003, the budget proposes that the exemption from tax will be available only for 90% of the income. For the balance 10%, they will have to pay regular tax. The reason given by the Finance Minister is that such units being totally exempt from tax, surcharge cannot be levied on such units. Therefore, some tax is being levied on them. The effective rate including surcharge in case of companies will be 3.675%.

Incomes of Export Oriented Units and units in Free Trade Zones will be exempt up to 90% for FY 2002-03.

This reduction in the relief applies only for financial year 2002-2003.

Units in Special Economic Zones have been granted exemption from this tax (Section 10A(1A)). Such units which commence manufacturing or development of software on or after 1st April, 2002, are exempt from tax completely. The tax exemption is available for first 5 years. Thereafter the exemption is available up to 50% of the profits for the next 2 years.

#### **11. Tax on perquisites provided to employees — Section 10(10CC)**

In August, 2001, the Government had come out with elaborate perquisite valuation rules. These rules have increased the tax liability of employees. Although, in principle there is nothing wrong in taxing the perquisites, several representations were made to reduce the tax impact on employees.

Employers can pay tax on non-monetary perquisites and there will be no grossing up of tax.

The budget has given some relief for the difficulties caused by increased perquisite taxation.

**11.1** Normally, if tax liability of an employee is borne by the employer, the tax has to be grossed up. It is now provided that, if the “employer” pays the tax on “non-monetary perquisites” then grossing up will not have to be done.

Non-monetary perquisites mean benefits/facilities granted to employees like free housing, car, utility expenses, etc.

<i>Example</i>	<i>Without Grossing up of tax</i>	<i>Grossing up of tax</i>
Salary	2,00,000	2,00,000
Non-monetary perquisite value	50,000	50,000
Total	2,50,000	2,50,000
Tax on above (excluding surcharge)	49,000	49,000
Average rate of tax	19.6%	
Tax on non-monetary perquisite is at the average rate of 19.6%	9,800	9,800
If grossing up has to be done, tax will be – grossed @ 30%. (9,800 X 100/70)		14,000

The budget provides that the tax need not be grossed up. Thus, in this illustration, there is a saving of Rs. 5,200 for salary in 30% tax bracket.

- 11.2 If the employer bears the tax of the employee on the non-monetary perquisites, the tax on such perquisite has to be paid to the government along with tax deducted at source from other salary. It has been provided that the tax on non-monetary perquisites will be at average rates of tax. Section 192(1B). Thus in the above example, the average rate of tax is 19.6%.
- 11.3 However, as the employee does not pay tax on the same, as a corollary, no deduction as an expense is allowed to the employer. Section 40(a)(v). This can have the following impact on the costs. Two situations are given:
- A. Normal provisions, where the employee bears the tax on his salary.
  - B. Proposed provisions, where the employer bears the tax on non-monetary perquisite, and the tax is NOT grossed up.

**Note:** All taxes are for Assessment Year 2002-03. For the sake of simplicity in calculations, the surcharge is ignored.

**A. Normal provision**

		<b>Rs.</b>
1.	Salary	
1	Cash	2,00,000
1.2	Non-monetary perquisite	50,000
1.3	Total salary cost	2,50,000
2.	Tax deduction to employer @ 35%	87,500
3.	Net cost to employer	1,62,500
4.	Tax paid by employee	49,000
5.	Funds left with employee (1.1-4)	1,51,000
6.	Tax reduction for government (4-2)	(-) 38,500

**Note:**

Here, the Government is a loser. While the employer pays tax on his income at a lower rate; the employer gets a deduction and saves at a higher rate.

**B. Tax on perquisite by employer, and grossing up is not done**

1.	<b>Salary</b>	
1.1	Cash	2,00,000
1.2	Non-monetary perks	50,000
1.3	Total salary	2,50,000
2.	<b>Tax</b>	
2.1	Tax on Rs. 2,50,000	49,000
2.2	Average tax rate (49,000/2,50,000)	19.6%
2.3	Tax on perks at average rate (50,000 X 19.6%)	9,800
2.4	Balance tax deductible on salary income of Rs. 2,00,000. (49,000 - 9,800) Please see note below.	39,200
2.5	Tax deduction to employer on Rs. 2,50,000 @ 35%	87,500
2.6	Total cost to employer Rs. 2,50,000 + Rs. 9,800 - 87,500	1,72,300
2.7	Net funds available to the employee (2,00,000 - 39,800)	1,60,200
2.8	Tax reduction for Government (87,500 - 39,800 - 9,800)	37,900

Thus for the employer it is better to pay a gross salary.

Additional depreciation has been allowed up to 15%. In effect, it is only a preponement of depreciation. It is not additional.

**12. Additional depreciation – Section 32**

**12.1** The budget has allowed a deduction on account of additional depreciation equal to 15% of the cost of plant and machinery. This additional depreciation is given only for new industrial undertaking which began to manufacture on or after 1st April, 2002. The additional depreciation will also be available in case there is any substantial expansion by an existing industrial undertaking. To satisfy the test of substantial expansion, the installed capacity should be increased by at least 25% over the existing installed capacity. Some conditions have to be fulfilled.

- (i) The undertaking should not be formed by splitting up or reconstruction of a business already in existence.
- (ii) It should not be formed by transfer of any old plant and machinery.
- (iii) The plant or machinery should not have been used anywhere in India or outside India.
- (iv) Plant and machinery installed in office premises or residential accommodation will not be eligible for additional depreciation.
- (v) Office appliances, road transport vehicles, ships and aircrafts will not be eligible for additional depreciation.

These are measures to give incentives for making fresh investments in business.

**12.2** However the additional depreciation is not exactly a correct description. An example is considered below.

Assume that machine costing Rs. 1,00,000 is purchased. The normal depreciation is 25%. The depreciation will be as under:

<b>Year</b>		<b>Existing</b>	<b>Proposed</b>
1.	Written Down Value Depreciation	1,00,000 25,000	1,00,000 25,000+15,000 = 40,000
2.	Written Down Value Depreciation	75,000 18,750	60,000 15,000
3.	Written Down Value Depreciation	56,250 14,062	45,000 11,250
4.	Written Down Value Depreciation	42,188 10,547	33,750 8,437
5.	Written Down Value Depreciation	31,641 7,910	25,313 6,328

Thus what happens is that higher depreciation is available in the first year and lower depreciation is available in subsequent years. The depreciation is only pre-poned. It is not “additional”.

**13. Capital losses — Section 70**

So far short-term loss and long-term loss could be set off against each other. Now the budget has treated long-term gain/loss differently from short-term gain/loss.

Long-term capital loss can be only set off against long term capital gain.

Any **long-term capital loss** can be set off only against long-term gain. The loss which cannot be set off can be carried forward to subsequent years. The carried forward loss can be set off only against long-term capital gain.

The **short-term capital loss** can be set off against long-term gain or short-term gain.

### **Part C – NRIs**

#### **1. Bank accounts**

The Finance Minister Mr. Yashwant Sinha announced in his budget speech that all bank account schemes will become repatriable with effect from 1st April, 2002. The correct position is as under:

- 1.1** RBI had started NRNR scheme. Under the “Non-Resident Non-Repatriable Scheme”, NRIs had sent in foreign remittances. They were paid very high interest rates going up to 17% per annum (in some cases even higher). As per the scheme, the principal amount was non-repatriable. Hence all these deposits under NRNR schemes were non-repatriable.

By the Budget 2002, these amounts have been made repatriable. RBI has issued separate notification & circular. Both are enclosed herewith. The summarised provisions are that the NRNR schemes can continue until maturity. On maturity, these amounts will be credited to the NRE accounts of the concerned depositors. Thereafter, the NRI can either continue to hold the balance in NRE account; or convert the same into foreign exchange & hold in FCNR account; or remit the funds abroad.

- 1.2** There is another scheme – NRSR. Under this scheme, the principal amount and even interest were non-repatriable. Funds in this account will remain non-repatriable. On maturity of the fixed deposits under this scheme, the amounts will be transferred to NRO accounts. Once the amounts are in NRO accounts, the future interest income will be repatriable.

- 1.3** With effect from 1st April, 2002; both these schemes will be closed in the sense that no new accounts will be opened under these two schemes. Existing balances will be continued until maturity. On maturity, the amounts will be transferred.

- 1.4** The future interest income is of course repatriable. This is not as a part of the scheme. Rupee is convertible on current account since 1994 [RBI circular No. A.D. (M.A. Series) 18 dated 19th August, 1994]. Hence all revenue incomes earned by NRIs are fully repatriable (after payment of necessary taxes in India). There is nothing new in this.

Interest, dividend, rent, business income etc. revenue incomes can be repatriated abroad. Capital gains cannot be repatriated.

The procedure for remittance abroad is very simple. The NRI concerned has to maintain regular books of account. A chartered accountant should audit the accounts and give a certificate that the income pertains to revenue income for the concerned financial year; and the income-tax payable on the same has been paid. With this certificate, the NRI can approach his banker where he has maintained his bank accounts. The bank should remit the net revenue income in whatever currency the NRI wants.

- 1.5 The existing NRO accounts will continue. All non-repatriable investments continue to remain non-repatriable. The NRI can place a fixed deposit out of his NRO account. This fixed deposit will remain non-repatriable. Except for this NRO account, now no other non-repatriable bank schemes are available for NRIs.

The repatriable schemes available for them are of course NRE accounts and FCNR accounts.

## 2. **Inheritance**

NRIs are allowed very limited facilities for sending funds out of India which they have received as inheritance.

RBI has come out with a press release that NRIs can now remit up to U.S. \$ 100,000 per calendar year out of assets in India which acquired as inheritance. Applications have to be made to RBI for this purpose.

Later when RBI comes out with a notification, it will be possible to remit the funds without a prior approval.

## 3. **Repatriation of sale proceeds of immovable property — Removal of lock-in period**

NRIs and persons of Indian origin can purchase immovable property on repatriation basis. For purchasing the property on repatriation basis, the funds should be sent from abroad. Repatriation is restricted to the amount of foreign exchange remitted for the property. There is a condition that the sale proceeds can be repatriated only after a lock in period of three years.

RBI has recently come out with a press release stating that the lock in period is now removed.

However, notification for the same has yet to be issued. Till the notification is issued, application has to be made to RBI for repatriation of funds before the end of 3 years.

### **Part D – Economy and Philosophy**

1. Can economy and philosophy (or religion) mix! (This important issue is discussed here very briefly as if two friends are discussing.)

**Maharshi Ved Vyas** has summarised the WHOLE of “Mahabharat” including Geeta into one Sloka –

“I am telling all the people raising both hands but no one listens to me —

**Artha, Kam and Moksha** all the three can be achieved only by **Dharma.**”

In other words,

Material wealth, desire fulfilment and the Nirvana all can be achieved only by religion.

So using philosophy in economics is possible and even practical.

2. Economics is defined in a ‘**Scarcity Oriented**’ manner –

“Human wants are unlimited (or infinite) and resources are scarce. The art and science of attempting to bridge the two is called economics.”

3. Now contrast this statement with the following Sloka –

“Aum Poornam Idaha, Poornam Idam,

Poornat Poornam Udachyate.

Poornasya Poornamadaya Poornam Eva Avashisyate”.

In other words, “God, Parbrahma is infinite. Every soul (including man, tree and insect) is infinite.

Infinite takes birth from the infinite. By taking out infinite from the infinite, what remains is infinite.”

In simple words, **every soul has infinite capability.**

Further,

All materials are produced from energy – **Chaitanya**. Chaitanya is infinite. Hence availability of any and all materials is infinite.

Every soul can have whatever he wants.

Nothing ever is destroyed. Only the basic energy (Chaitanya) keeps taking different forms.

All **resources are abundant**.

Nothing is scarce.

No human want need remain unfulfilled.

4. How can one believe in abundance when we see poverty everywhere!
5. There are some sources to understand the principle of abundance.

The easier one – Read Mr. Neale Donald Walsch’s series of books on “Conversation with God”. Total five books.

OR

Read the Upanishads or any good religious book of that level.

OR

Simply understand Saint Kabir’s philosophy – Entire Universe’s Knowledge is realised by “Love”.

6. What has Love got to do with Economics ?!
7. If, even without accepting, for the sake of argument, we assume that the principles of abundance in nature; and universal love are true;

Then,

Economic laws, by definition are wrong.

They are starting on a wrong premise of scarcity.

Since we are convinced of scarcity, our mind leads us to greed. Which leads to frauds resulting into lack of confidence and recession. It also leads to exploitation and unfair distribution of world’s resources.

If everyone believed in 'dharma' (synonym of philosophy, religion, love etc.), there would be no crisis of confidence. If everyone believed in love, there would be no unfair distribution of income and wealth. There would be no poverty.

8. Utopian talk.

9. Yes. It is something like the following hypothesis:

You can never win permanently by weapons.

However, if you win someone by love; you have won him forever.

Everyone believes in this principle. But very few practice it.

The day, people practice what they believe in; this world will be a different world.

Until then, we will keep generating economic theories and moving from one theory to another. Nobody understands it and everyone claims to understand. And hardly any theory works for long.

10. This leaves many issues open.

Yes. But (almost) all issues are answered in the three sources mentioned in paragraph (5) above.

It is guaranteed that the seeker will get ALL answers.

The beauty of philosophy is that we do not have to wait till the rest of the world practices. We can start practicing ourselves. And the number of people practising universal love is growing.

11. Isn't it beautiful that in the film - "Beautiful Mind"; Professor Nash, on winning the Nobel Prize says to his wife that 'the conclusion of my entire carrier is that — the most important thing in life is Love '.

## **Indian Budget & Myths**

### **1. Stock markets**

Our stock markets are the most vocal. They always expect more and more concessions. They always claim that if the market sentiment is bad, the small investor will not invest and hence recession will continue.

Big Myth.

The stock markets have consistently disappointed people. There have been series of scams. Right from Harshad Mehta to Ketan Parekh; people have caused huge losses to the small investor.

In between, so many company promoters have looted the investing public. These were aided and abetted by their merchant bankers and auditors; and people have lost confidence in all systems.

What can the poor Finance Minister do?!

In the last ten years, so many dream budgets have come. The moment, there is a favourable sentiment, markets go up; some cheaters come out in the field; skim the milk and disappear.

When these cheaters are skimming the milk; our media is broadcasting interviews with them and eulogising them as the biggest financial wizards.

### **2. Why SEBI cannot succeed in preventing the frauds!**

Answer is clear.

Our investors are greedy. They want 50% returns per year.

There is no business where the company can earn enough money to pay a return of 50% per year. So when an investor wants to earn 50%; he is inviting cheaters.

### **3. So many people raise the question —**

“Will Budget improve the economy?”

This question invites further queries.

“Isn't budget a mere piece of paper!

“Isn't it a statement of objectives and performance in financial terms!”

“Would it not be better to say –

“The economy will improve if ALL OF US start working for building our nation.

Finance Minister alone; or even the Central Government alone cannot improve the economy. We, the people of India have to act together.

We have to take our share of responsibility.

As Dr. Abdul Kalam has said in his widely spread speech, we have to stop blaming Government, stop asking what the Government can do; and take our share of responsibilities.

(A copy of Dr. Kalam’s speech with Rashmin’s comments is given on our web-site.)

#### **4. Central Government Balance Sheet**

- 4.1** In our note on Budget – 1993; we had shown how the Central Government presents a balance sheet which is not “True & Fair”.

In our note on Budget – 1997; we had stated that the Central Government of India is insolvent. Hence our investments in PPF and — LIC are not safe.

Repeated symptoms of this disease keep appearing. Consider the following:

U.P. Government does not have the money to pay electricity bills. Hence the electricity supply to the whole state was disrupted.

Mumbai municipality has no money to pay bonus to its employees. It was Mrs. Indira Gandhi, who, as a Prime Minister, had made bonus, a compulsory payment.

Maharashtra Government did not have the funds to pay salaries to its own staff. Funds received on issue of debentures by a State Government Corporation were used for payment of Government staff salaries.

Following are the figures from the Budget 2002.

**4.2 Central Government's Funds Flow : (Year 2002-03)**

**Rs. crores**

(i) Central Government's total revenue including income-tax – all taxes, interest, forest sales, etc. all. 2,45,000

(ii) Debt Servicing  
Loan repayment & interest payment. 2,58,000

(iii) **Conclusion —**

All current expenses of the Government – including staff salaries, defence expenditure and Ministers' foreign trips are financed by fresh borrowings. The annual deficit as projected for the current year – 2002-03 is Rs. 1,35,500 crores; or Rs. 3.71 billions per day. This does not include the deficits by the State Governments and other statutory bodies.

**4.3 Central Government Balance Sheet.**

**Budget for the year 2002-03**

	<b>Rs. billions</b>		<b>Rs. billions</b>
Total liabilities including Government securities, Provident funds, small savings etc. Other than external debt.	14,442	Total assets including all the assets of doubtful values	8,264
External Debt at market rate of conversion	1,947	Accumulated losses	8,125
<b>Total</b>	<b>16,389</b>		<b>16,389</b>

**Conclusion :** Our one billion people owe Rs. 16,000 billions. Or per person our debt is Rs. 16,000. Out of this debt, an amount of Rs. 8,000 billions is already lost. And every day our Governments keep increasing the debt.

And yet, the fact remains that :

We are very rich in natural resources. Our country can very well support the entire population at a good standard of living. If we manage our natural resources well enough, there need not be any poverty.

#### **4.4 FX reserves**

We may notice that, the Government's total external debt is about U.S. \$46 billions. As against that, the total FX (Foreign Exchange ) reserves held by the Government are above U.S. \$ 50 billions. We were never so comfortable in our FX position.

Even internally, the Government is constantly trying to reduce the debt. Hence it is reducing the rates of interest and the incentives available on Government securities. By reducing the interest rates, Government is reducing its budgetary deficit. However, this strategy is causing serious difficulties for all those who live on interest and pensions.

#### **5. Borrowers perish**

**5.1** We hold the belief that 'borrowers perish'. We keep advising that India has fallen into a debt trap. It must exercise restraint, control expenses and reduce debts, etc., etc.

Consider U.S.A. As per latest figures, its trade deficit is more than \$ 400 billions per year.

For the last twenty years, it has trade deficits and it has been a consistent borrower country. In the eighties, huge expenditure on defence required borrowings. After the collapse of U.S.S.R. and automatic end to the "Cold War", the U.S. expenditure on defence reduced. It was possible that the U.S. borrowings would stop.

However, the trade deficits have continued.

In these twenty years, USA has seen share market booms and busts; economic growth and recession. Through all these, the value of the U.S. dollar has remained steady or has risen.

Laws, they say, apply equally to all.

How is it then, that for India, the law of Economics is different and for U.S.A., the law is different!!

- 5.2 For a detailed explanation, see our article on the “U.S. \$”. It is available on our website – “rashminsanghvi.com”. It was written many years back but the theme remains valid.

Briefly –

Economics works on sentiments. Confidence or the lack of it determines a country’s economic working.

People who matter in the world finances, have a confidence in the U.S. economy. Hence they keep investing in U.S.A. Their investments finance U.S. borrowings. Hence U. S. \$ remains steady.

If and when the confidence is shaken up; U.S. will not be able to continue the miracle of strong \$ in the face of continued borrowings. When the \$ crashes, it will be as big a crash as that of the World Trade Center. All people dependent on or connected with the dollar will get the hit.

## 6. New problems & solutions

We are now seeing new problems; or  
New dimensions of existing problems.

We have huge stocks of food.

The surplus food is rotting in the godowns.

And there are crores of people who do not have two square meals a day.

In some areas, we do come across the poor people who do not want to work. But there is a large number of people who really want do some work, earn their livelihood and get food. An effective programme of “Food For Work” is being implemented by an NGO.

India has rich, abundant natural resources.

Indians are poor.

Because we have not managed our resources well.

And the distribution of our national income and wealth is not fair.

Neither subsidies; nor pre-1991 socialistic regulatory system; nor current “liberal” system have been able to solve the problem of ‘hunger amongst plenty’.

And our natural resources remain unutilised or inefficiently utilised.

There are several people all over India, who are working sincerely to remove hunger by managing the natural resources. Most of these people never appear in the media. No one knows about them. For one such tremendously successful exercise, on “Food For Work” see our web-site under the title “ Dharampur Development Abhiyan”. It is the success story of tribals living in the mountain-top forests of Valsad district in Gujarat.

May the tribe of these unsung heroes increase and may India enjoy the riches that it already owns.

*The more corrupt the Government,  
The more numerous the laws.*

*The more incompetent the Government,  
The more harsh the laws.*

*People of a nation get the Government  
that they deserve.*

**Rashmin Sanghvi**

**Naresh Ajwani**