January, 2015 The team of Vaish Associates Advocates wishes you a prosperous Year 2015!

Key Highlights...

- ✓ *Eligibility of non-compete fees for tax deduction*
- ✓ *FDI in Construction sector amended*
- ✓ *Easing of FDI norms for medical devices sector*
- ✓ *Overseas investments by AIFs*
- ✓ *Tests for taxation of trusts*

I. Eligibility of Non-Compete Fee for Tax Deduction

In the matter of **ACIT vs. Clariant Chemicals India Ltd.**, the Income-tax Appellate Tribunal (ITAT) has ruled that where companies pay non-compete fees to their executives, companies can claim tax deduction for such payments. The facts of the case are as follows.

Clariant Chemicals had paid Rs 15.4 million to late KJ Bharucha as non-compete fee after his retirement on March 2006. This fee represented compensation for not joining any company or sharing any expertise with rival companies in the same business for 3 years. The company had debited this non-compete fee from its profit and loss accounts as revenue expenditure. The taxman however argued that payment of non-compete fee would result in enduring benefits to the company and therefore it should be treated as capital expenditure.

The subject of treating non-compete fees as revenue expenditure has, for long time, been a bone of contention between the taxpayer and the revenue department. In a previous ruling in the case of DCIT v Intervet Limted (ITA No. 315/Hyd/2003), the Mumbai ITAT had said that non-compete fees paid to ward off a potential threat would enable a company to run its business more effectively and profitably, and hence the same are to be allowed as revenue expenditure. The present ruling in Clariant's case also re-iterates the same position.

Source: ITA 7428/M/11 & 8079/M/11,

See: http://itatonline.org/archives/wp-content/uploads/clariant_non_compete.pdf

VA View

While this judgment is expected to bring relief to many companies, it should be remembered that if the restrictive covenant on the outgoing executives is for an indefinite period or enduring in nature, then the non-compete fees paid by the company would be treated as capital expenditure. Such a payment is revenue in nature as it is only for protecting the existing business for a temporary period and the non-compete fees have been paid for stabilizing of operations and is an integral part of profit earning process. The same principle should also apply in case of non-compete fees paid by one business partner to the other in case of separation in a joint venture.

II. *Foreign Direct Investment in Construction Sector Amended*

The Union Cabinet has given its approval for amending the existing FDI policy on the construction development sector in line with the budget announcement of the government. Under the extant FDI policy, 100% FDI in construction development sector is permitted under the automatic route subject to certain conditions which are as follows:

- ✓ Minimum area to be developed under each project would be:
  - In case of development of serviced plots, there is now no condition of minimum land area.
  - In case of construction-development projects, a minimum floor area of 20,000 sq. meters.
  - In case of a combination project, any one of the aforesaid two conditions will need to be complied with.
- ✓ The investee company will be required to bring minimum FDI of US$ 5 million within 6 (six) months of commencement of the project. The commencement of the project will be the date of approval of the building plan/lay out plan by the relevant statutory authority. Subsequent tranches of FDI can be brought till the period of 10 (ten) years from the commencement of the project or before the completion of the project, whichever expires earlier.
- ✓ The investor will be permitted to exit on completion of the project or after 3 (three) years from the date of final investment, subject to development of trunk infrastructure.
- ✓ The Government may, in view of facts and circumstances of a case, permit repatriation of FDI or transfer of stake by one non-resident investor to another non-resident investor, before the completion of the project. These proposals will be considered by FIPB on case to case basis.
- ✓ The project shall conform to the norms and standards, as laid down in the applicable building control regulations and other regulations of the state government/municipal/local body concerned.
- ✓ The Indian investee company will be permitted to sell only developed plots. Developed plots will mean plots where trunk infrastructure including roads, water supply, street lighting, drainage and sewerage, have been made available.
- ✓ The Indian investee company shall be responsible for obtaining all necessary approvals and complying with all other requirements as prescribed under applicable rules/bye-laws/ regulations of the state government/municipal/local body concerned.
- ✓ The state government/municipal/local body concerned, which approves the building/development plans, will monitor compliance of the above conditions by the developer.

FDI is not permitted in an entity which is engaged or proposes to engage in real estate business, construction of farm houses and trading in Transferable Development Rights (TDRs).

Source: http://dipp.nic.in/English/acts_rules/Press_Notes/pn10_2014.pdf

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The move by the Government to liberalize FDI in construction is expected to result in enhanced inflows into the construction development sector and is likely to attract investments in new areas thereby meeting the Government agendas of infrastructure development, low cost affordable housing in the country, development of smart cities and job enhancement.

With the relaxation of the capitalization norms for investment and the minimum area requirements, this sector will attract small investors and larger penetration in mid-tier cities and hence act as a catalyst to encourage FDI.

III. *Easing of FDI Norms for Medical Devices Sector*

The Union Cabinet has approved the proposal to amend the extant FDI policy as contained in the Consolidated FDI Policy Circular 2014 relating to medical devices.

Until now, medical devices sector was not separately covered and it fell under the pharmaceutical sector and all the conditions of the FDI policy on the pharmaceutical sector, including the condition relating to non-compete clause, applied on brown-field project proposals of medical devices industry. The condition of non-compete was imposed to enable Indian manufacturers to continue manufacturing generic drugs at low cost.

As per the extant FDI policy for pharmaceuticals sector, FDI up to 100% is permitted subject to certain conditions. FDI for green-field projects is under automatic route but brown-field projects are under government route. Under the new proposal, FDI up to 100%, under the automatic route is permitted for manufacturing of medical devices, irrespective of whether the project is green-field or brown-field.

The new proposal defines medical devices as any instrument, apparatus, appliance, implant, material or other article, whether used alone or in combination, including the software intended by its manufacturer to be used specially for human beings or animals for one or more of the specific purposes of (a) diagnosis, prevention, monitoring, treatment or alleviation of any disease or disorder, (b) diagnosis, monitoring, treatment, alleviation of, or assistance for, any injury or handicap,(c) investigation, replacement or modification or support of the anatomy or of a physiological process,(d) supporting or sustaining life, (e) disinfection of medical devices,(f) control of conception, and which does not achieve its primary intended action in or on the human body or animals by any pharmacological or immunological or metabolic means, but which may be assisted in its intended function by such means. Medical devices shall cover an accessory to such an instrument, apparatus, appliance, material or other article, as well as a device which is reagent, reagent product, calibrator, control material, kit, instrument, apparatus, equipment or system whether used alone or in combination thereof intended to be used for examination and providing information for medical or diagnostic purposes by means of in vitro examination of specimens derived from the human body or animals.

Source: http://pib.nic.in/newsite/PrintRelease.aspx?relid=114030

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Presently, medical devices were part of the Drugs & Cosmetics Act, 1940 and fall under the Pharmaceutical sector. Though 100% FDI was permitted, companies were required to seek an approval from the Foreign Investment Promotion Board to acquire an existing company. Easing of norms for medical devices industry by creating a special carve-out in the existing FDI policy in the pharma sector will encourage FDI inflows.

Also the condition of 'non-compete' was not permitted in the Pharmaceutical sector except under certain circumstances with approval of FIPB, so that the Indian manufacturers can continue manufacturing generic drugs and catering to the needs of the large number of people in the country and in other developing countries who cannot afford branded and patented drugs. This condition is not made applicable to 'medical devices' industry of the country where the country is substantially import dependent and the sector is adversely impacted because of the lack of adequate capital and required technology.

IV. *Overseas Investments by Alternative Investment Funds*

The Reserve Bank of India has issued a Circular dated December 9, 2014, permitting SEBI registered alternative investment funds ("**AIFs**") to invest overseas, in accordance its Circular No. 49 dated April 30, 2007 and Circular No. 50, dated May 4, 2007 (the 2007 Circulars).

The RBI, by its 2007 Circulars had allowed domestic venture capital funds, registered with SEBI under the SEBI VCF Regulations, 1996, to invest only in equity and equity-linked instruments of off-shore venture capital undertakings, subject to an overall limit of US$ 500 million for all VCFs collectively. Registered VCFs interested in investing in equity and equity linked instruments of off-shore VCUs were required to obtain prior approval of the SEBI, but no prior approval of the RBI was required. The 2007 Circulars stipulated that SEBI would provide limits to individual VCFs investing in off-shore VCUs.

The 2007 Circulars are in line with the amendment made to Regulation 12 (b) of the SEBI VCF Regulations, which introduced Regulation 12(ba) allowing VCFs to invest in securities of foreign companies, subject to such conditions or guidelines laid down by SEBI or RBI, from time to time.

Source: http://rbidocs.rbi.org.in/rdocs/notification/PDFs/48AIFAP091214.pdf

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Till now, there was no provision in the Foreign Exchange Management (Transferor Issue of Any Foreign Security) Regulations, 2004 and its circulars, which specifically enabled AIFs to invest in instruments or securities issued by overseas entities. This circular has come as an enabling step to enable AIFs to invest overseas.

However, the investment opportunities made available to registered AIFs through the circular are quite narrow in scope. The 2007 circulars only allow investments in equity and equity-linked instruments of off-shore VCUs.

V. Tests for Taxation of Trusts

The Bangalore ITAT in the case of **India Advantage Fund–VII v. Dy. Commissioner of Income Tax** has examined the general representative tax principles in India, conditions of taxation of an AOP, tests for determinacy of beneficiaries in case of a trust.

ICICI Venture Fund Management Company settled a private trust with an object of the fund investing in mezzanine instrument to earn returns for the investors. Western India Trustee and Executor India Limited were appointed as the trustees and were empowered to call for contributions from the contributors which will be invested by the trustee in accordance with the objects of the trust. The contributors to the fund were the beneficiaries. The trustee appointed ICICI Venture Fund as the investment manager for the fund.

The grounds considered by the assessing officer for applying tax at maximum marginal rate on the assessee-trust were (a) the trust is not a revocable trust, (b) the beneficiaries of the trust are indeterminable and (c) the assessee should be assessed as an AOP.

In the present case, since the contributors could revoke their contribution (by virtue of the power conferred in the document) it was concluded that the powers of revocation existed. Therefore in case of revocable trusts the income arising to the beneficiaries shall be chargeable to income tax as income of the transferor. So the assessment in the hands of the transferee/representative assessee was not proper.

The ITAT also held that as long as the trust deed gives the details of the beneficiaries and the description of the person who is to be benefited, the beneficiaries cannot be said to be uncertain. In the present case, since the trust deed defines the beneficiaries to be such persons who have agreed to make a contribution to the trust in accordance with the contribution agreement, it was deemed to be sufficient for identification of beneficiaries.

Finally, in the instant case the beneficiaries entered into separate agreements with the trustee/ trust. There is no inter se arrangement between one contributory/beneficiary and the other contributory/beneficiary as each of them enters into separate contribution arrangement. Hence the beneficiaries did not come together for the common purpose. The ITAT held that since the beneficiaries were mere recipients of the income earned by the trust, they cannot therefore be regarded as an AOP.

Source: ITA No. 178/Bang/2012

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The principles elucidated in this ruling have been discussed in several other rulings in the past and the consolidated view now gives much needed clarity on the fund taxability. This is a welcome decision in the area of taxation of trusts, and shall prove to be relevant and useful to the domestic alternative asset management industry.

VI. Tidbits

1. The Union Cabinet has approved the introduction of the Companies (Amendment) Bill, 2014 in Parliament to make certain amendments in the Companies Act, 2013. These are in respect of (i) omitting requirement for minimum paid up share capital, and consequential changes, (ii) making common seal optional, and consequential changes for authorization for execution of documents, (iii) prescribing specific punishment for deposits accepted in contravention of the new Act, (iv)prohibiting public inspection of Board resolutions filed in the Registry, (v) including provision for writing off past losses/depreciation before declaring dividend for the year, (vi) rectifying the requirement of transferring equity shares for which unclaimed/unpaid dividend has been transferred to the IEPF even though subsequent dividend(s) has been claimed, (vii) enabling provisions to prescribe thresholds beyond which fraud shall be reported to the Central Government, disclosures for the latter category also to be made in the Board's Report, (viii)exemption u/s 185 (Loans to Directors) provided for loans to wholly owned subsidiaries and guarantees/securities on loans taken from banks by subsidiaries, (ix)empowering Audit Committee to give omnibus approvals for related party transactions on annual basis, (x)replacing 'special resolution' with 'ordinary resolution' for approval of related party transactions by non-related shareholders, (xi)exempting related party transactions between holding companies and wholly owned subsidiaries from the requirement of approval of non-related shareholders, (xii) bail restrictions to apply only for offence relating to fraud u/s 447, (xiii) winding up cases to be heard by 2-member Bench instead of a 3-member Bench and (xiv) Special Courts to try only offences carrying imprisonment of two years or more.

   Source: http://pib.nic.in/newsite/printRelease.aspx?relid=112434

2. The Supreme Court of India rejected German pharmaceutical major Bayer's appeal against a Bombay High Court decision, which had refused to revoke a compulsory licence issued to India's Natco to sell a generic version of its blockbuster cancer drug Nexavar. Although Bayer holds the patent, Natco Pharma can continue selling a copy of the drug. Natco's version of the drug costs a fraction of Bayer's price.

   Source: Bayer Corporation v Union of India, Petitions For Special Leave To Appeal C Nos. 30145/2014 Arising Out Of Impugned Final Judgment And Order Dated 15/07/2014 In WP No. 1323/2013 Passed By The High Court Of Bombay

3. The government has increased foreign direct investment (FDI) limit from 26% to 49% in the insurance sector through an ordinance. Investments made on the basis of the ordinance will remain valid even if it lapses as a result of not being replaced by an Act within a specified time period. It is

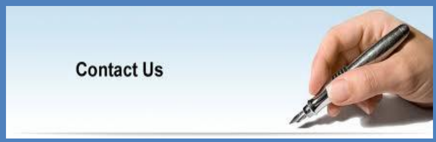
expected that both Houses of the Parliament will pass the pending insurance bill intended to replace the ordinance.

Source: http://pib.nic.in/newsite/PrintRelease.aspx?relid=114145

4. RBI has amended the Foreign Exchange Management (Transfer or Issue of any Foreign Security) (Amendment) Regulations, 2004 to the effect that, subject to the conditions prescribed in the notification, the designated AD bank may permit the following under the automatic route:

- ✓ creation of charge / pledge on the shares of the Joint Venture (JV)/ Wholly Owned Subsidiary (WOS) / Step Down Subsidiary (SDS) (irrespective of the level) of an Indian party in favour of a domestic or overseas lender for securing the funded and / or non-funded facility to be availed of by the Indian party or by its group companies / sister concerns / associate concerns or by any of its JV / WOS / SDS (irrespective of the level).
- ✓ creation of charge (by way of pledge, hypothecation, mortgage, or otherwise) on the domestic assets of an Indian party (or its group companies / sister concerns / associate concerns including the individual promoters / directors) in favour of an overseas lender for securing the funded and / or non-funded facility to be availed of by the JV / WOS / SDS (irrespective of the level) of the Indian party.
- ✓ creation of charge (by way of hypothecation, mortgage, or otherwise) on the overseas assets (excluding the shares) of the JV / WOS / SDS (irrespective of the level) of an Indian party in favour of a domestic lender for securing the funded and / or non-funded facility to be availed of by the Indian party or by its group companies / sister concerns / associate concerns or by any of its overseas JV / WOS / SDS (irrespective of the level).

Source: FEMA/322/RB-2014 dated 14th October, 2014 and A.P. (DIR Series) Circular No. 54 Dated 29th December, 2014



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