



cutting through complexity™

India Tax & Regulatory Defence Industry



| | |
|--------|--------|
| -13.8% | 36.1% |
| 16.9% | -17.4% |
| 2.7% | 17.9% |
| 8% | 1.9% |
| | 10.2% |

| Current (₹) | Stability | Current | One-day change |
|-------------|---------------|---------|----------------|
| 6,700 | Jan. 30, '18 | 1461 | -285 |
| 5,875 | May 10, '12 | 3820 | -270 |
| 6,750 | March 15, '12 | 786 | -180 |
| 7,625 | Nov. 30, '12 | 949 | -133 |
| 5,750 | Sept. 8, '11 | 652 | -116 |
| 7,995 | June 1, '06 | 787 | -201 |
| 6,875 | Feb. 1, '14 | | |
| 5,500 | Nov. 15, '12 | | |





I

Indian Economy

II

Indian defence sector – *an overview*

III

Policy environment

- (a) Defence Procurement Procedure
- (b) Regulatory Environment
- (c) Taxation Regime



Indian Economy

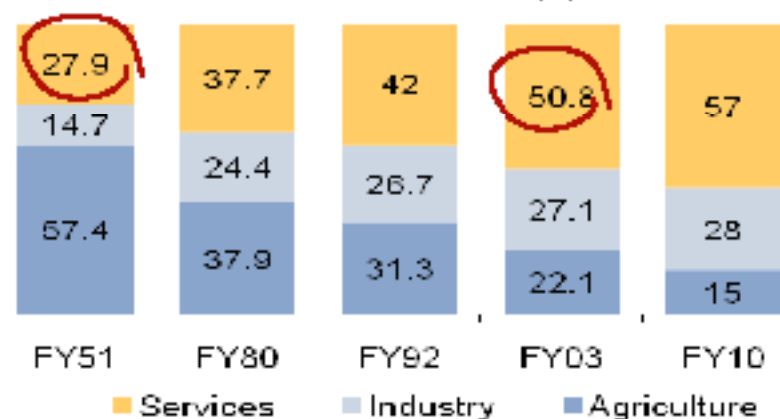
A decade of envious growth with consistently engaging reform process ...

GDP on a rise



A booming services sector and a dynamic industry landscape

Sectoral Contribution to GDP (%)



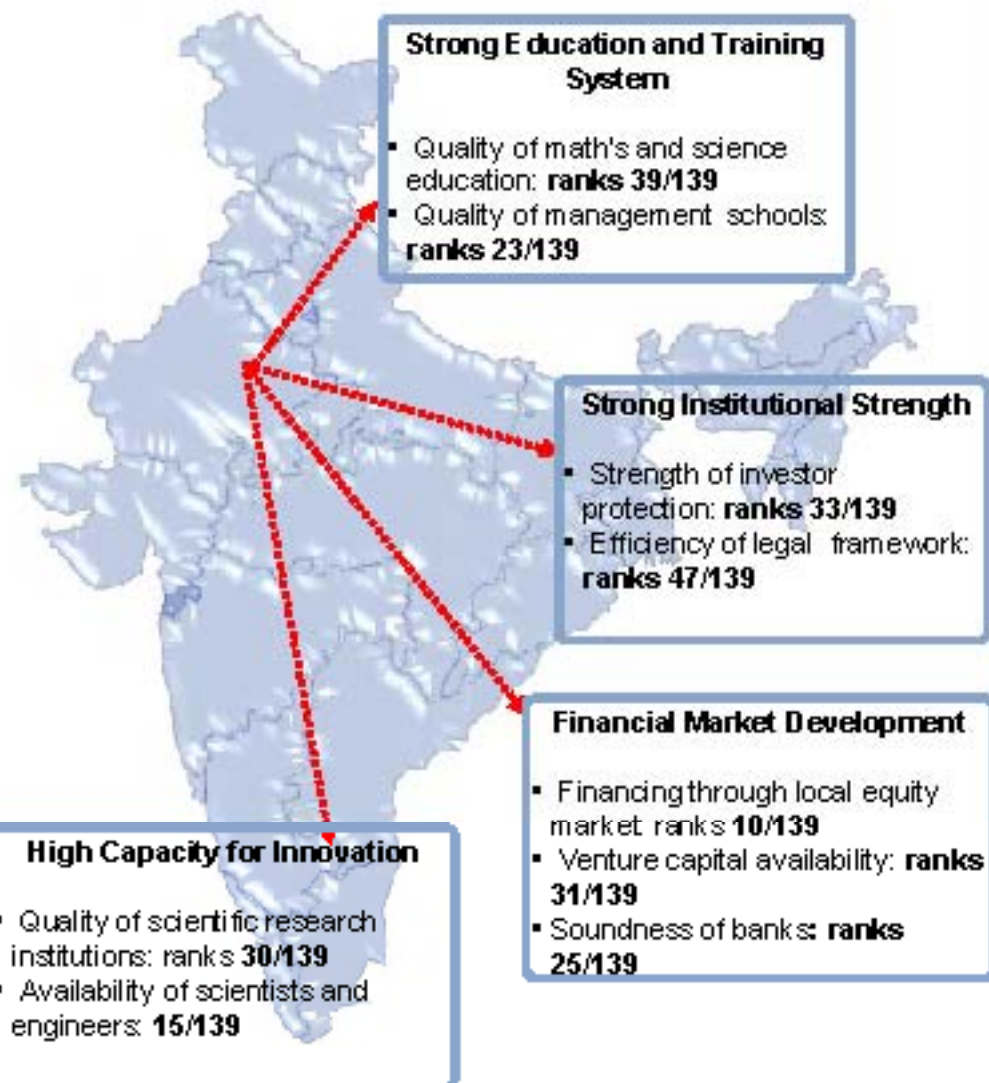
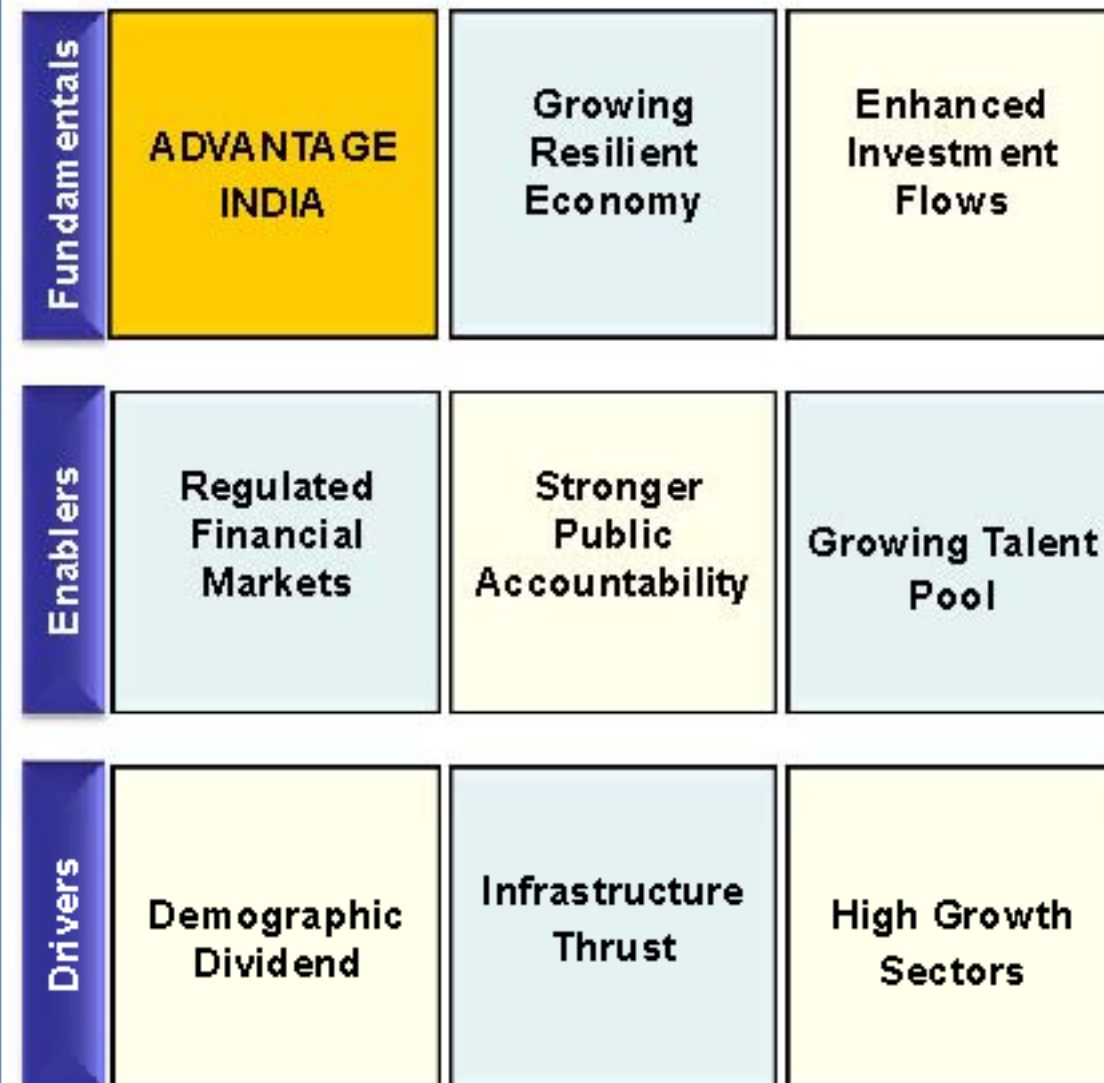
Decade of reforms

- 4th largest economy by PPP (Purchase Power Parity)
- 2nd fastest growing economy in the world
- 3rd Highest FDI Attractiveness - CAGR of 24.55% over the last decade
- 3rd largest investor base in the World
- ~100 companies have a mkt cap of over \$1bn
- Over 1000 companies have received Foreign Institutional investment
- 390 Fortune 500 companies have outsourced software development to India
- 125 of 500 Fortune 500 cos have R&D bases in India
- 2% of bad Loans in India banks (vs ~20% in China)

India's economic reforms have paved the way for increased participation from private & foreign players

| | |
|---------------------------------------|--|
| Trade & Industrial Policy Reforms | Boosted industrial and export performance by dismantling restrictive licensing and tariff regime |
| Liberalization of FDI Norms | Rise in the total volume of foreign investments in the economy and increased access to world markets |
| Financial and Capital Markets Reforms | Increased resilience of the financial system to withstand crisis owing to stringent control and risk management mechanisms like Basel II, IFRS |
| Privatization | Provided investments to expand and improve infrastructure through PPP models |

.....Advantage India

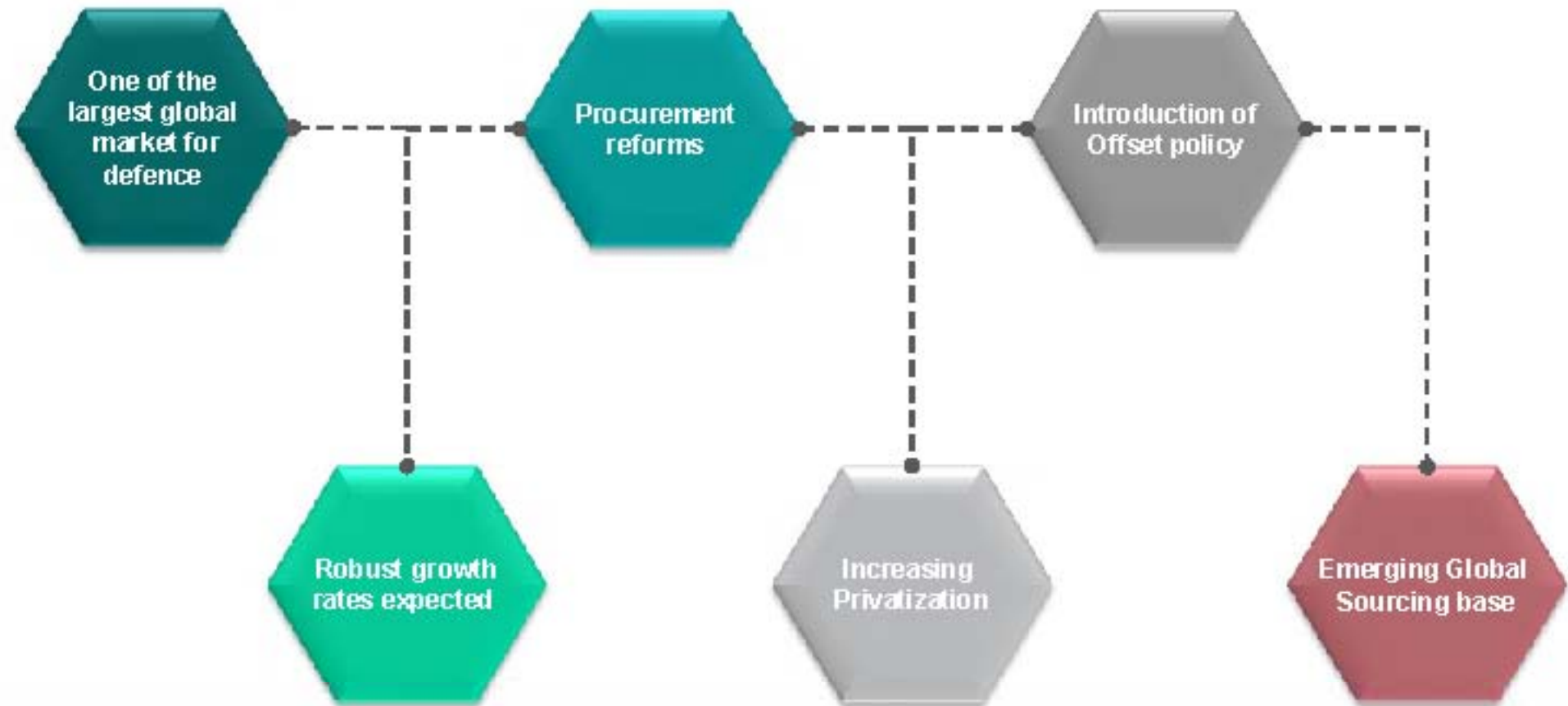




Indian Defence Sector

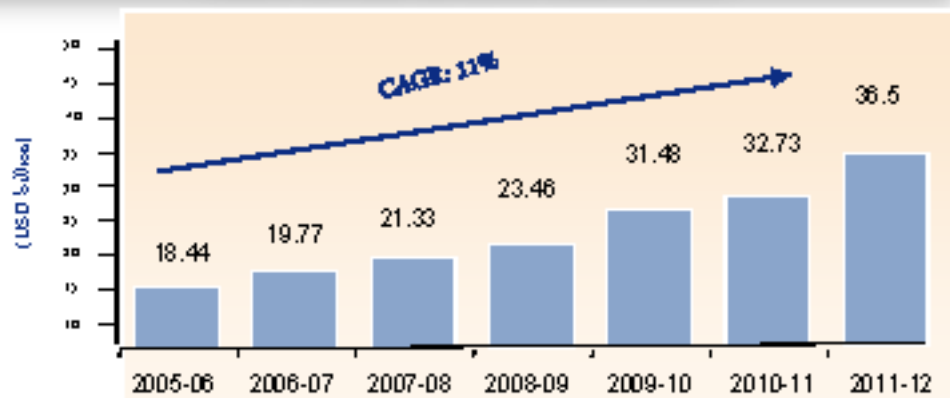
- an overview

Indian defence sector – a cache of opportunities

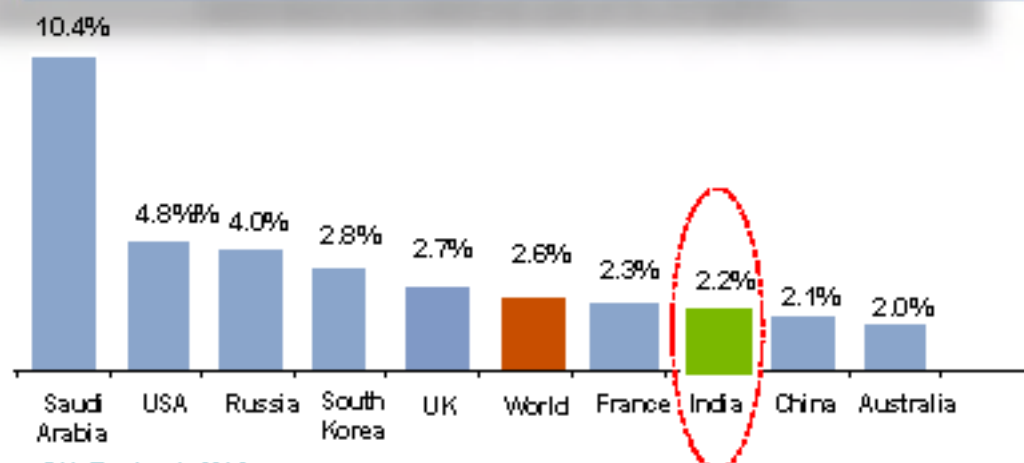


The opportunity ahead.....

India's annual defence expenditure

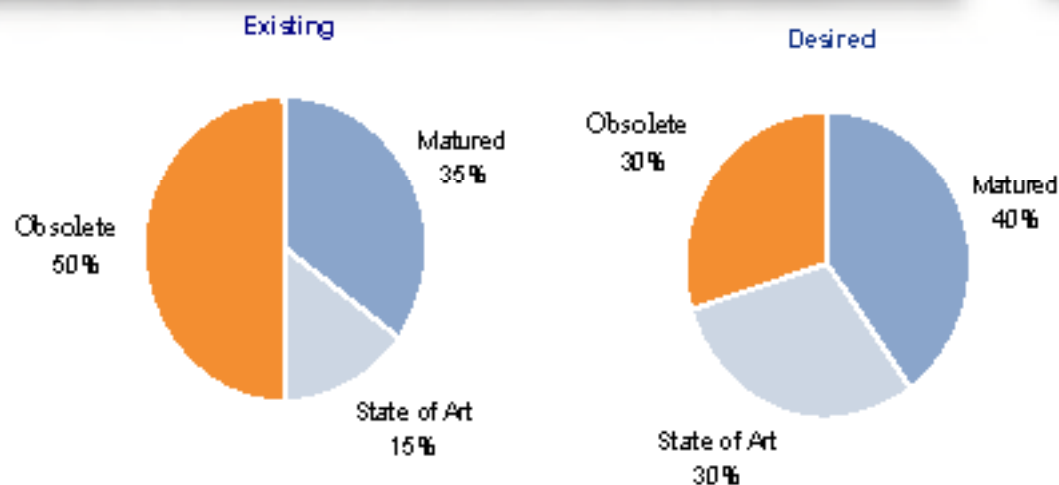


Spenders on defence (as a % of GDP)



Source: CIA Factbook 2010

Existing and desired state of artillery of the Indian forces



Top 10 military spenders

| Country | USD Billion | % WorldShare |
|-------------|-------------|--------------|
| USA | 696 | 48 |
| China | 119 | 70 |
| UK | 94 | 37 |
| France | 80 | 34 |
| Russia | 67 | 34 |
| Japan | 55 | 30 |
| Germany | 52 | 28 |
| South Korea | 52 | 28 |
| India | 43 | 25 |
| Italy | 39 | 23 |

Source: http://en.wikipedia.org/wiki/List_of_countries_by_military_expenditure#SIPRI_Yearbook_2010



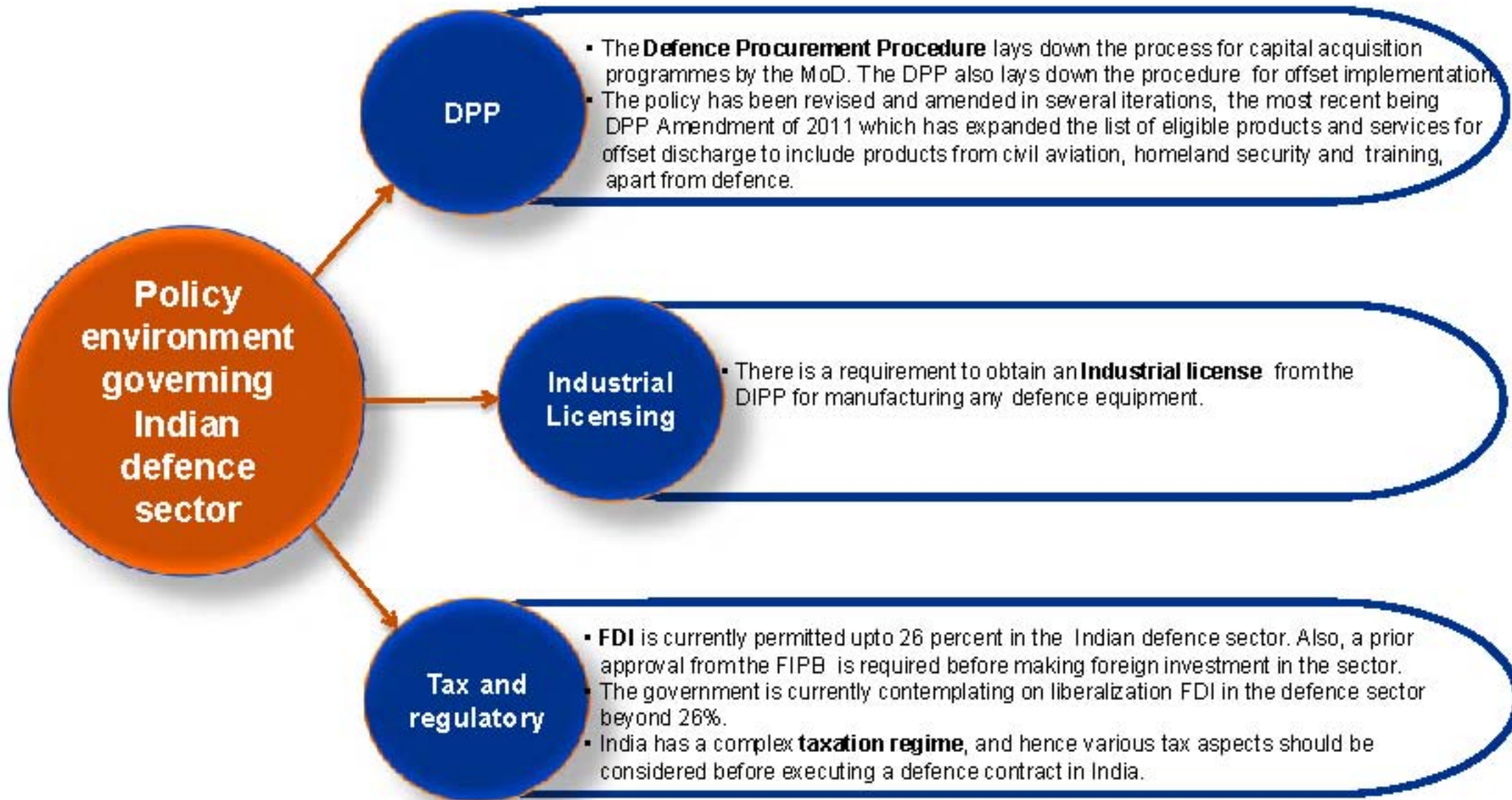
Policy environment

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| Feb. '12 | | |

Share price
Good price
Oct. Nov. Dec. Jan.

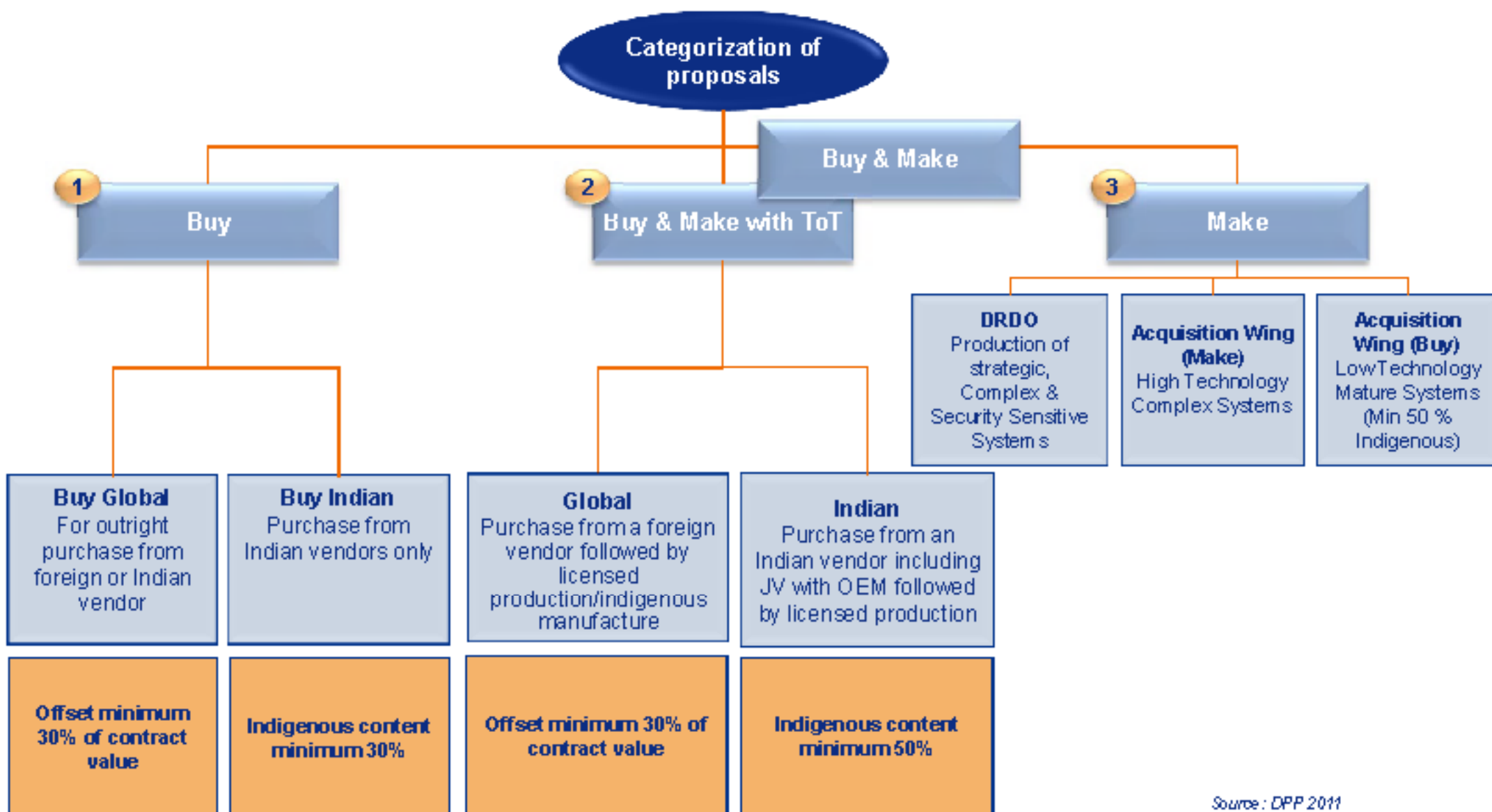
Last week

Policy environment



Defence Procurement Procedure

Categorization of proposals under DPP

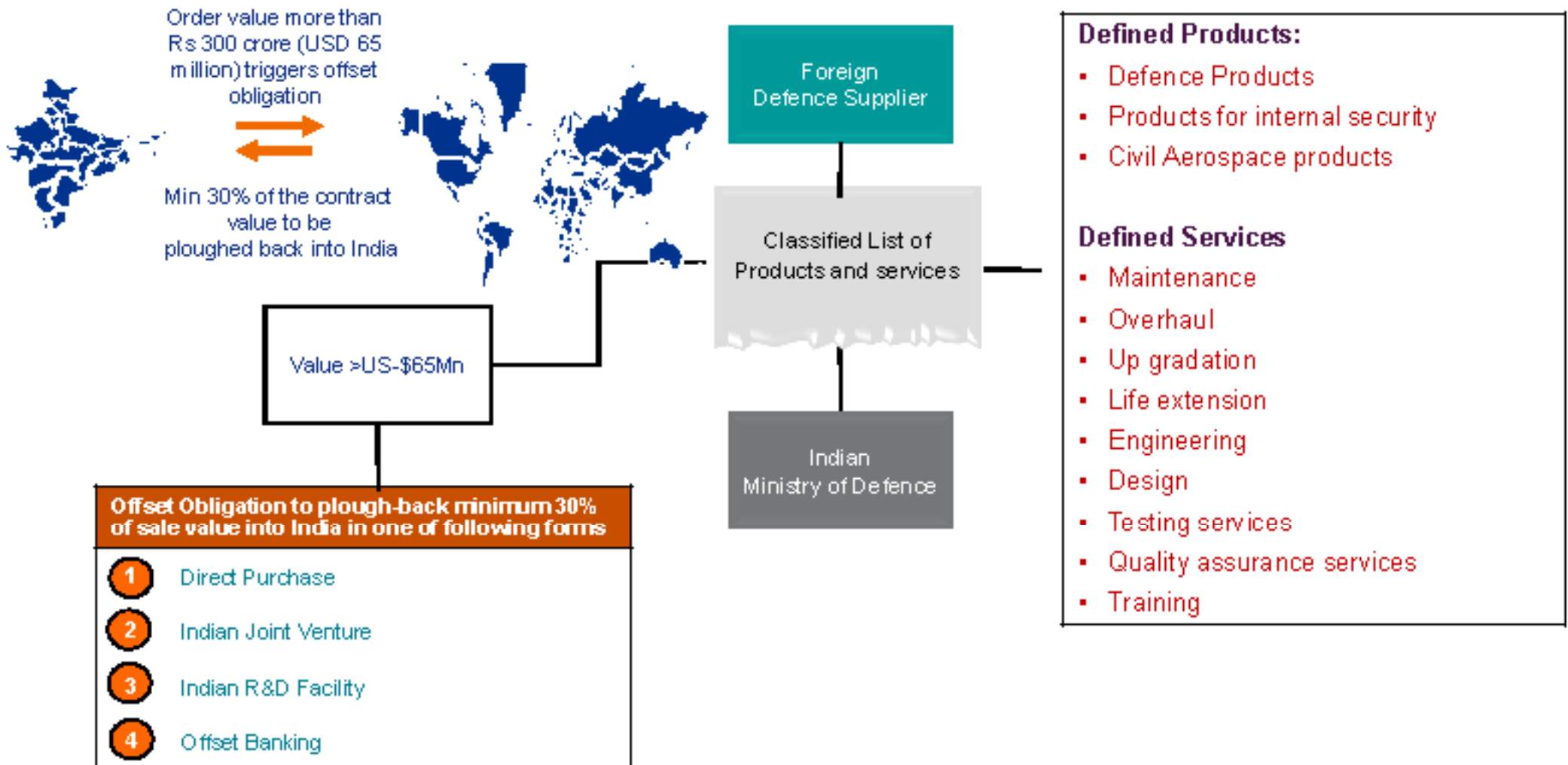


Source : DPP 2011

The offset policy

Scope of the provisions

Offset provisions are applicable for all capital procurements by Indian defence forces governed by the DPP valued over Rs 300 crore (USD 65 million). The DPP suggests a minimum offset limit of 30% of the contract value under "Buy (Global)" and "Buy and Make with Transfer of Technology" capital acquisition programmes



Regulatory Environment and key aspects of consideration

Automatic Route

- 100% FDI permitted in most sectors
- No prior approval necessary; only post-facto filings
- FDI should be brought through normal banking channels
- Investment represented by fresh issue of shares or acquisition of existing shares in Indian company from resident shareholders

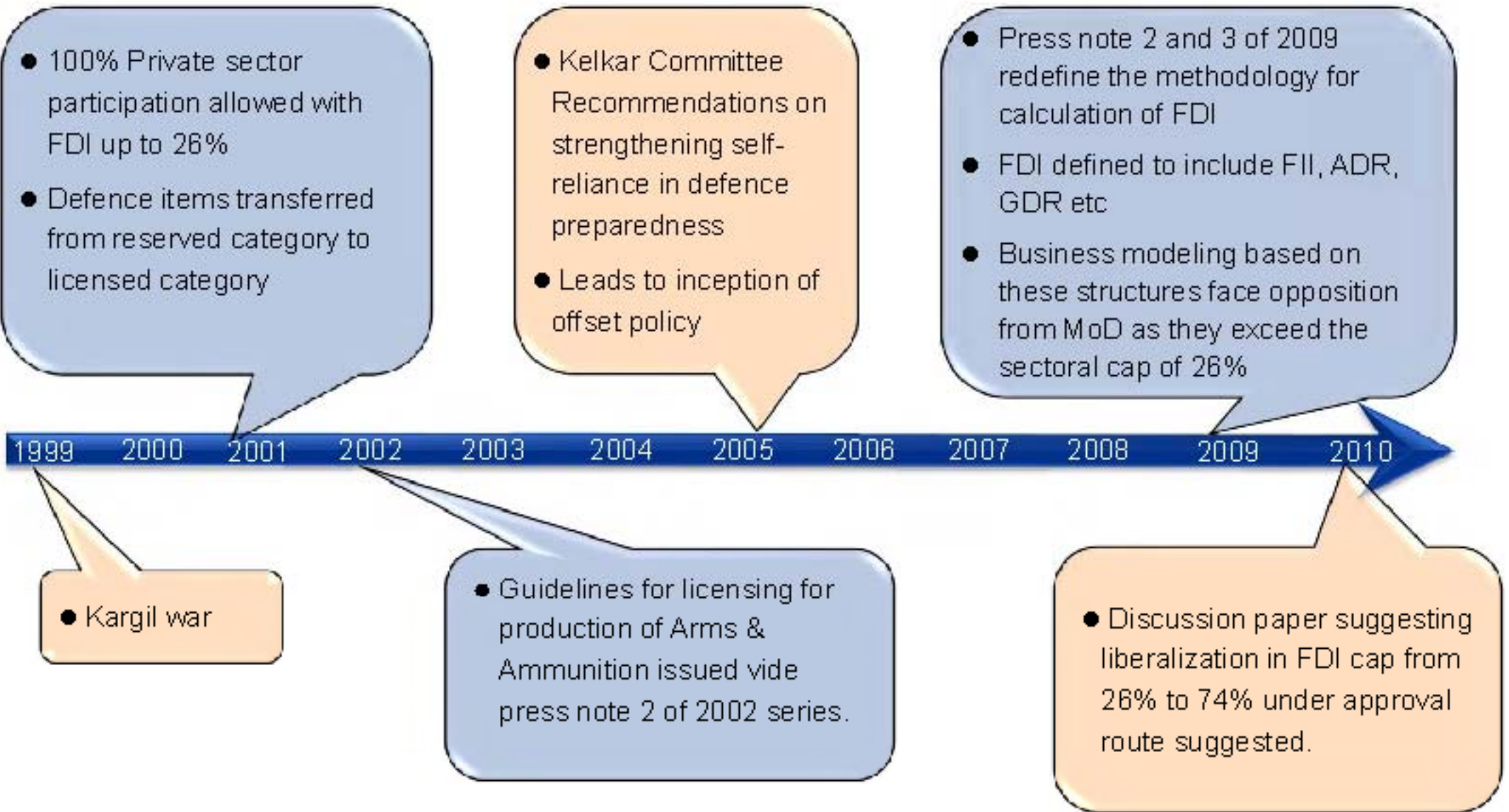
Prior Approval

- Generally, applicable in following cases:
 - Certain cases where FDI is regulated
 - **Defence sector with FDI permissible upto 26% subject to licensing under IDRA**
- Applications processed by FIPB

Negative List

- FDI not allowed in certain sensitive sectors e.g.:
 - Retail trading (except Single Brand Product retailing)
 - Atomic energy
 - Lottery business
 - Gambling and betting sector

Regulatory roadmap



Key regulatory challenges faced by Defence sector

Lack of clarity on definition of 'defence industry' for regulatory purposes

Applicable FDI cap for rendition of MRO and software services to defence sector- 100% automatic vs 26% approval.

Administrative hurdles in seeking industrial license

Bottlenecks in seeking DOFA clearance for offset ventures

No express guidelines for seeking 'case-by-case' approval for higher FDI

Key aspects of consideration : *Approvals and Compliance*



Approval for foreign investment

- Given that foreign investment in Defence sector is regulated, there is a requirement of obtaining an approval from the FIPB before making any foreign investments in the sector.



Industrial License

- Any company intending to manufacture a 'defence equipment' is required to obtain a license under the Industries Development and Regulation Act, 1951 (IDRA).



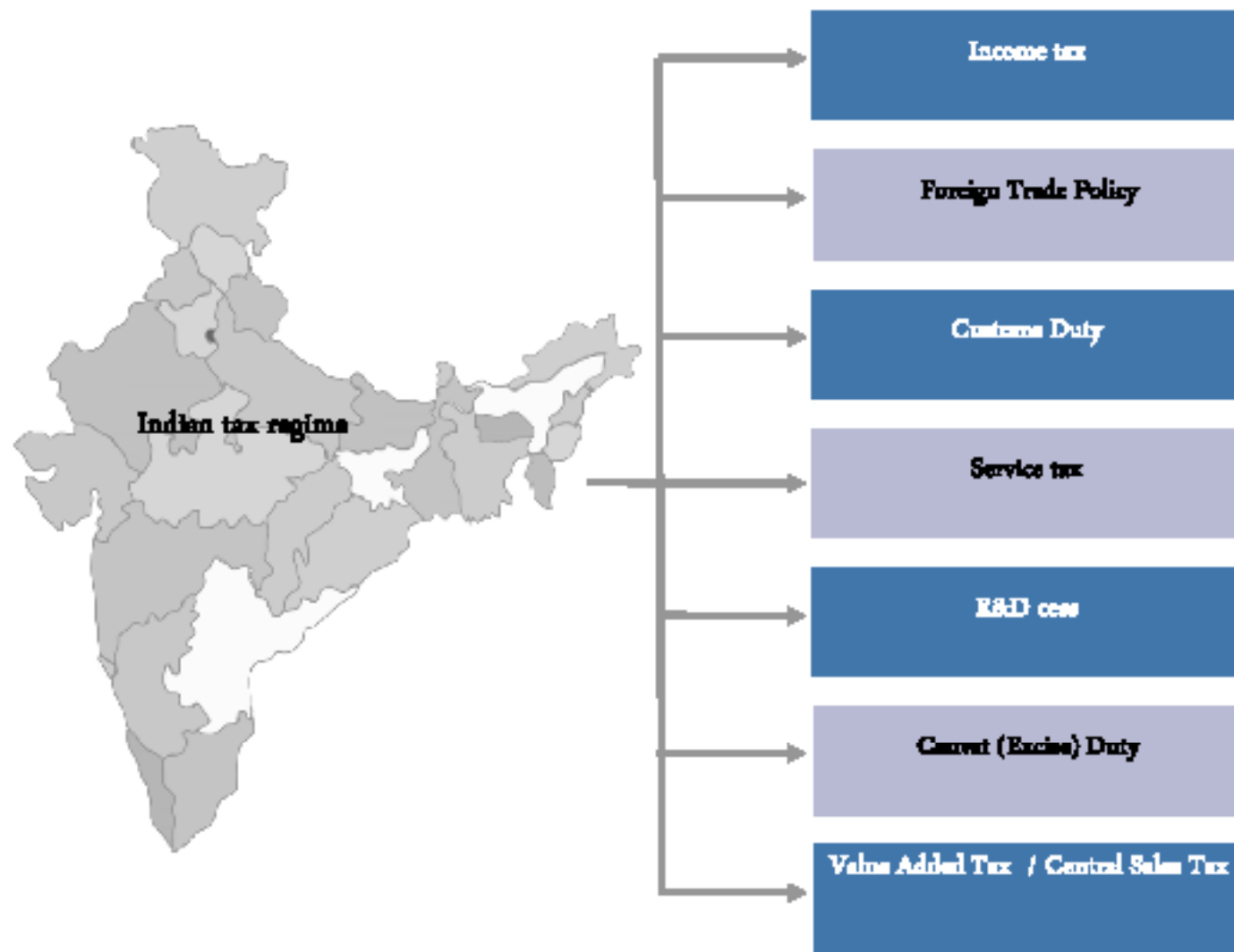
Offset

- In view of discharging the offset obligation a company should consider aspects such as compliance of the proposed offset venture with the extant regulatory regime (being FDI limits, licenses, approvals, etc)

Tax Considerations

- *contract structuring and related issues*

Taxation in India



| Direct Taxes | Rates* |
|------------------------------------|---------|
| Corporate tax (Domestic companies) | 32.445% |
| Corporate tax (Foreign companies) | 42.024% |
| Minimum alternate tax | 20.01% |
| Dividend distribution tax | 16.225% |

| Indirect Taxes | Rates* |
|------------------------|-----------------|
| Effective customs duty | 26.85% / 23.89% |
| Service tax | 10.3% |
| R&D Cess | 5% |
| Excise duty | 10.3% |
| State VAT | 4% to 14% |
| Central Sales Tax | 2% |

*General effective tax rates

Defence capital procurement procedure



RFP Bidding

Government issues a Request for Proposal (RFP) for capital acquisition program. The contenders complete RFP along with a bid price and submit the same to MoD within the stipulated time.

Contract Signing

The submitted proposal are evaluated by the MoD. The evaluation initially begins on technical grounds of the equipment. The contenders who qualify the 'technical parameters' are selected for commercial evaluation. During this phase, the lowest bidder i.e. L1 is selected and is awarded the contract.

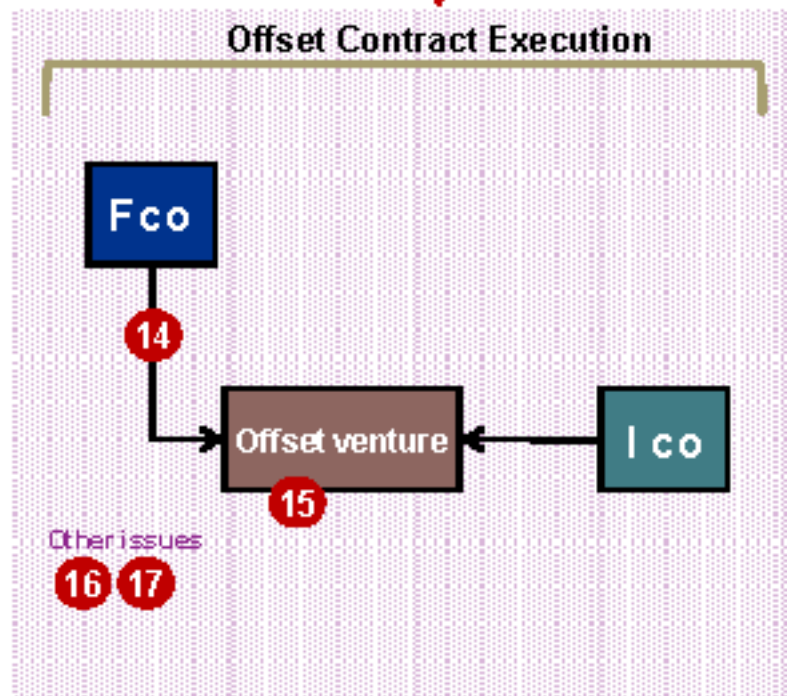
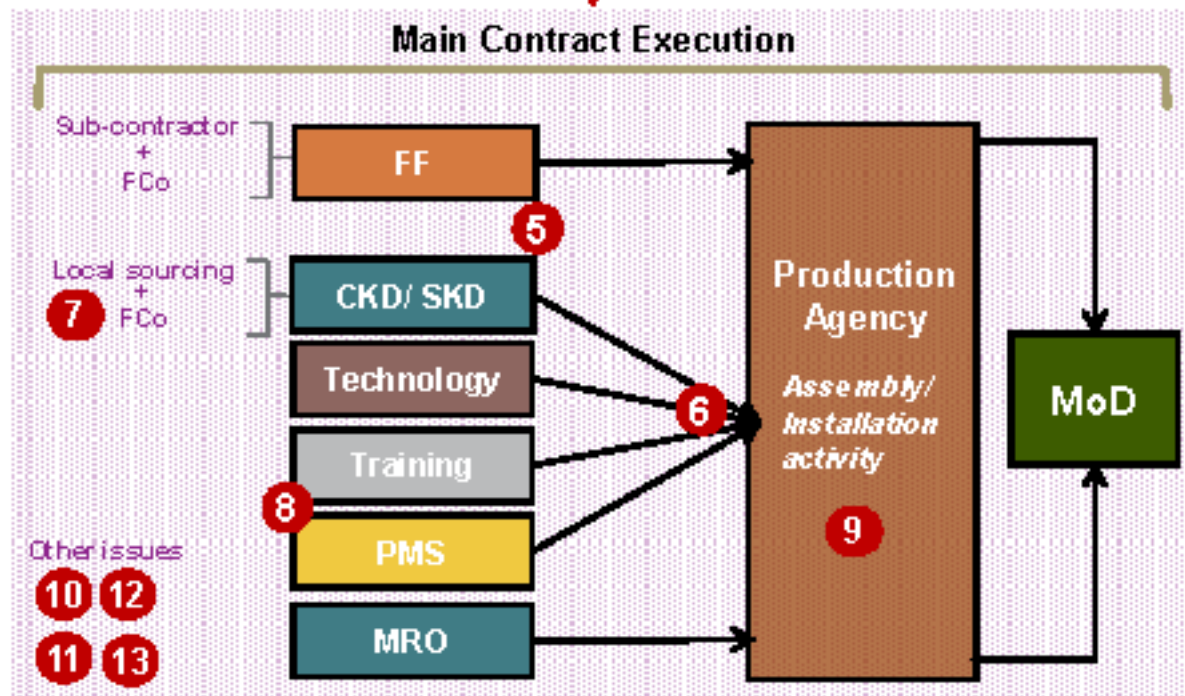
Contract execution

The contractee needs to abide by the clauses of the contract and execute the delivery of the equipment within the stipulated time. Foreign OEMs can be the prime contractors under "Buy – Global" contract i.e. outright purchase of defence equipment by MoD or "Buy and make with TOT – Global" contract entailing initial purchase of a few equipment followed by supply of CSD/SKD kits and the requisite technology for subsequent indigenous manufacture

Offset execution

A minimum 30% offset obligation is leviable on all capital acquisition programmes under "Buy Global" and "Buy and Make with ToT" contracts by the MoD valuing over \$65 million (approx). The offset obligation can be discharged either by export of defined products and services; foreign direct investment towards producing of defined products and services; or undertaking R&D activity in specified domain. Offset contracts are to be fulfilled co-terminus to the main contract.

Typical defence contract execution – key tax and regulatory issues



- | | | | | | |
|--|---|---|--|---|--|
| 1 Tax cost determination for Commercial offer | 4 Requirement of a split vs. composite contract | 7 Exchange control implications- local sourcing v imports | 10 PE mitigation- offshore supply /service and onshore supply/ service | 13 Withholding tax implications | 16 DOFA clearance |
| 2 Negotiation and validation of contract terms | 5 Taxability of offshore supply | 8 Secondment of employees for training and PMS activity | 11 Requirement of presence in India LO v PO v Company | 14 Entry Strategy – jurisdictional analysis and funding options | 17 MRO/ Software/civil aviation/ HLS – FD100% v 26%? |
| 3 Tax inefficiencies arising from consolidated contracts | 6 Taxability of technology transfer/training/ PMS | 9 AOP exposure – FCO and PA | 12 Availability of defence specific tax exemptions | 15 Industrial licensing and FIPB approval | |

Key aspects of consideration : *Contract structuring*

Efficient contract structuring options need to be analyzed to optimize taxes in light of the significant tax inefficiencies arising from composite contracts for lump sum price

Optimization of taxes

- minimization of taxes
- ensure availability of all concessions/ exemptions

Certainty in tax impact

- definite taxable base
- responsibility to pay tax
- factor 'change in law'

Ease of Implementation

- minimizing exposures
- avoiding litigation

Commercial imperatives not to be compromised

Key aspects of consideration : *Entity/ JV structuring*

Regulatory considerations

- o Determination of regulatory implications arising from the proposed investments in the Indian defence, homeland security and civil aviation sector.
- o Seeking necessary clarifications/ approvals in relation to making foreign investment to undertake the proposed activities
- o Compliance with prescribed pricing mechanism (currently DCF) for valuation of shares/ investment as per Indian Exchange control guidelines

Inbound Investment Structuring

- o Jurisdiction analysis to evaluate a suitable intermediately holding company jurisdiction (e.g. Singapore, Netherlands, Mauritius, Cyprus, etc) for routing the investments into the proposed Indian JV with the perspective to build in tax efficiencies.
- o Devising strategies around investment structuring in order to increase the stake in the JV as the policy environment liberalizes (i.e. increasing stake beyond 26% in defence sector)
- o Analyzing the proposed investment structure in light of the provisions of the proposed DTC (such as GAAR) expected to be effective from April 1, 2012.

Key aspects of consideration : *Entity/ JV structuring (...cont)*

Repatriation strategy

- o Evaluation of possible funding options for investment into the Indian entity(equity, quasi-equity, debt) from the perspective of :
 - Tax efficient repatriations and exits (e.g. Royalty/ FTS, Management Fees, Share Buy-Back, Sale of shares, etc)
 - Control and management considerations
 - Return requirements
 - Regulatory considerations/ implications

Due Diligence

- o Due diligence on the identified Indian JV partner, if any.
- o Review of the financial/ business model
- o Review of shareholders agreements.

Technology / Brand transfer

- o Analysis of direct and indirect tax implications on license fee/ trademarks.
- o Applicability of service tax on royalty payments.
- o Transfer pricing implications and determination of arms length price.

Typical Tax Issues

Typical Direct Tax Issues

Taxability of offshore activities
[including equipment supply]

Requirement of a split contract –
onshore vs. offshore

Exchange control implications

PE exposure and consequent
attribution in India

Gross Vs Net basis of taxation

Seeking defence specific tax
exemptions

Typical Indirect Tax Issues

Project specific customs and excise
duty exemptions

Taxability of goods and service
procured from within India

No exemption of VAT, CST, service tax

Structuring of contract (change in law,
supporting the tax positions)

Valuation issues in case of supply of
goods and services

Compliances in case of indirect tax
obligations

Offshore Supply

Fully assembled stock
CKD/SKD/IM Kits
Tools and spares
Components for assembled units
Designs and drawings

IMPORTS

Place of transfer
of title

Arms length
sale

Need
for
Transaction
Structuring

Place of receipt
of consideration

Place of
execution of contract

DIRECT TAX ISSUES

- Determination of taxability based on the terms of supply of equipment/ parts with respect to transfer of title/risk viz. FOB, CIF, etc.
- Exposure of taxability of offshore supply in India on account of activities performed by Indian office/ agent such as order facilitation.
- In case PE is constituted whether any profits attributable to supply of offshore sale of equipments shall be attributed to the PE?
- Evaluating need for split in 'supply' and 'services' scope
- Determining whether any component of the following activities can be apportioned towards supply of offshore equipment:
 - Transfer of design, drawing and documentation
 - MRO activities
 - Training

Fully assembled stock
CKD/SKD/IM Kits
Tools and spares
Components for assembled units
Designs and drawings

IMPORTS

Place of transfer
of title

Arms length
sale

Need
for
Transaction
Structuring

Place of receipt
of consideration

Place of
execution of contract

INDIRECT TAX ISSUES

- Applicability of Customs exemption notifications
- Apportionment of consideration for offshore supplies vis-à-vis other components (onshore, MRO, Training, design, drawings)
- Structuring of transaction to maintain nexus of import and supply (in case of supply through intermediary)
- Applicability of service tax on import of services
- Valuation issues under Customs on supply of:
 - Transfer of design, drawing and documentation
 - MRO activities
 - Training



DIRECT TAX ISSUES

- Whether offshore training activity would attract taxes in India
- Analyzing the need for a split contract from a tax efficiency standpoint –
 - i) offshore and onshore split
 - ii) Split based on nature of training – operation v maintenance v assembly
- Analyzing the PE exposure arising from travel/movement of employees to India for providing training.

INDIRECT TAX ISSUES

- Applicability of service tax
- Analyzing the need for separate contract vis-à-vis single contract for supply and training (where customs duty exemption is available)



DIRECT TAX ISSUES

- Analyzing whether MRO services qualify as 'work' or 'service' to determine their taxability
- In case they qualify as 'work' to determine whether offshore MRO activities would be rendered tax free?
- Analyzing the PE exposure arising from
 - Movement of employees to India
 - Maintaining stock of spares
 - Owning / renting premises/warehouse in India for maintenance of stock of equipment/spares
 - Premises of sub-contractor

INDIRECT TAX ISSUES

- Applicability of VAT and Service tax
- Choice of scheme in case of composite contracts
- Compliances e.g. VAT deduction of tax at source in case of local sub-contracted activity

Transfer of Licenses, Design, Drawings and Documentation



DIRECT TAX ISSUES

- To determine taxability of revenue streams as
 - Business profit;
 - Fees for Services; or
 - Royalty
- In case of constitution of PE (due to MRO service/training/sub-contractor, etc.), to determine whether attributable to PE
- Analyzing the need for a split contract from other supplies/ services from a tax efficiency standpoint

INDIRECT TAX ISSUES

- Applicability of VAT and Service tax
- Mode of supply electronic, physical media, embedded
- Analyzing the need for separate contract vis-à-vis single contract for supply and training (where customs duty exemption is available)

Assembly, Installation and Testing



DIRECT TAX ISSUES

- To determine classification of testing fees as work or service
- Supervision if included in scope shall entail evaluation of PE risk and taxability as 'work' or 'technical service'
- Analyzing the PE exposure in case of :
 - Subcontractor premises
 - Premises of production agency
 - Supervision activity, if any
 - Movement/travel of employees to India
- Exchange control implications on undertaking part of manufacturing activities through third parties vide sub-contract/ job work basis.

INDIRECT TAX ISSUES

- Excise duty tax implications on assembling/ integration
- Service tax implications on testing, support services

Exemption from Duties/ Taxes



DIRECT TAX ISSUES

- Administrative hurdles in seeking exemption from tax on income from royalty or FTS to a notified foreign company in pursuance of an agreement entered into with the government of India in projects connected with security of India

INDIRECT TAX ISSUES

- Currently exemption from Customs duty/ Excise duty is available to DPSUs and their contractors for specified projects
- No exemption available from VAT and Service tax
- Analyzing impact of duty/ tax cost on supply of equipment
- Evaluating possibility of optimizing tax/ duty incidence

Association of Persons (AOP) exposure

Key factors (AOP)

- Common objective
- Common scope of work
- Common stream of payments
- Joint and several liability
- Sharing of risks and rewards

DIRECT TAX ISSUES

- Exposure of taxability of entire contractual revenues, including income earned overseas
- Issues regarding deductibility of expenses incurred separately by the consortium members
- Possible denial of treaty benefits to AOP
- Issue regarding availability of tax credit to the members in their home country

The exposure of being taxed as an AOP may be mitigated through:

- Building safeguards in Consortium / Joint Venture/ Sub-contract Agreements
- Review of invoicing systems and other documentation

KPMG - Our end-to-end assistance

Strategy stage

- Market assessment
- Product portfolio analysis
- Business planning/ financial modeling

Deal stage

- Bid advisory / contract negotiation
- Partner search
- Transaction support
- Enterprise valuation
- Commercial and financial due diligence

Operational stage

- Operational/ financial planning
- Organization design
- Post-transaction business integration
- Business process design
- IT strategy and implementation
- Sustainability strategy and implementation
- Supply chain management

- Seeking regulatory clarifications
- Forms of presence in India
- Tax advisory including offset advisory

- Bid related tax advise/ contract structuring
- Tax due diligence
- Inbound investment structuring
- Seeking approvals from regulators
- Compliance check of offset structures
- JV formation/ entity incorporation

- Direct and indirect tax compliances
- Approvals for tax exemptions
- Tax advisory including
 - Corporate tax
 - Expatriate tax
 - Transfer pricing
 - International Taxation
 - Indirect Tax
- Transition to DTC and GST *

Annexure 2

Glossary



| | |
|-------------|--|
| AOP | Association of Persons |
| DCF | Discounted Cash Flow |
| DIPP | Department of Industrial Policy and Promotion |
| DIN | Director's Identification Number |
| DOFA | Defence Offset Facilitation Agency |
| DPP | Defence Procurement Procedure |
| DTC | Direct Tax Code |
| DTAA | Double Taxation Avoidance Agreement |
| DSC | Digital Signature Certificate |
| FDI | Foreign Direct Investment |
| FIPB | Foreign Investment Promotion Board |
| FTS | Fee for Technical Services |

Glossary



| | |
|-------------|---|
| GAAR | General Anti Avoidance Regulations |
| GST | Goods and Service Tax |
| JV | Joint Venture |
| NOC | No Objection Certificates |
| MoD | Ministry of Defence |
| MRO | Maintenance, Repair and Overhaul |
| PAN | Permanent Account Number |
| PE | Permanent Establishment |
| PF | Provident Fund |
| RBI | Reserve Bank of India |
| ROC | Registrar of Companies |
| TAN | Tax Deduction Account Number |
| TP | Transfer Pricing |