

Direct Tax Code : Uncoded*

12 August, 2009

General

The Direct Tax Code has shifted the basis of taxability to financial year and it will come into effect from financial year 2010-11.

Tax Rates

- Tax rates for individuals are proposed to be revised as follows :-

| Old Income slab (INR) | New Income slab (INR) | Tax Rate |
|-----------------------|-----------------------|----------|
| Upto 160,000* | Upto 160,000* | Nil |
| 160,001 – 300,000 | 160,001 – 1,000,000 | 10% |
| 300,001 – 500,000 | 1,000,001 – 2,500,000 | 20% |
| Above 500,000 | Above 2,500,000 | 30% |

[*Basic exemption for resident women to be INR 190,000 and INR 240,000 for resident senior citizens]

- Partnership firms, associations of persons and bodies of individuals will be taxed separately as an “unincorporated body” at a maximum marginal rate of 30% without any threshold exemption limit
- Tax rate for companies (both domestic and foreign) is proposed to be reduced to 25%
- Domestic companies will continue to be liable to dividend distribution tax at 15%
- Foreign companies will be subject to branch profits tax of 15%

Minimum Alternative Tax (“MAT”)

- Base for computing MAT is proposed to be shifted from ‘book profits’ to ‘gross assets’
- Value of ‘gross assets’ will be the value of gross fixed assets *less* accumulated depreciation on fixed assets, value of capital work-in-progress and book value of all other assets excluding debit balance of profit and loss account

- The rate of MAT is proposed to be 2% on all companies (except for banking companies for which it is proposed to be 0.25%)
- MAT will be a final tax and it will not be available as tax credit in subsequent years

Wealth Tax

- Wealth tax is proposed to be only on individuals, hindu undivided family (“HUF”) and private discretionary trusts
- Wealth tax for companies is proposed to be removed
- Threshold exemption limit of wealth tax of individuals and HUF is proposed to be increased and the wealth tax rate is reduced i.e. net wealth of only in excess of Rs.500 million will be subject to wealth tax at the rate of 0.25%
- Definition of ‘assets’ subject to wealth tax is proposed to be widened

International Taxation - Companies

Summary

The Code provides for the reduction of tax rates for non-resident companies to bring them at par with domestic companies. It further provides for the provisions of the Treaty or the Code, whichever is later in time, to prevail. The income accruing from direct / indirect transfer of capital assets situated in India, has also been sought to be brought within the Indian tax net. General Anti Avoidance Rules (“GAAR”) are proposed to be introduced, in order to discourage tax avoidance. Lastly, the definitions of fees for technical services (“FTS”) and royalty income have been significantly enlarged.

Applicable Tax rates for non-residents

- Royalty and Fee for technical services rates proposed to be increased to 20% on gross basis
- Capital gains taxable at 30%
- Corporate tax rate reduced to 25%

Residency rules

- Foreign companies to be treated as resident in India, if the place of control and management is situated either wholly, or even partly in India, at any time during the year

Definitions of key terms to be enlarged

- Fees for Technical Services to include development and transfer of design, drawing, plan and software or similar services
- Royalty to include the consideration for use / right to use of transmission by satellite, cable, optic fibre, ship or aircraft and live coverage of any event
- Income would be deemed to accrue in India regardless of whether payments are made outside India, or the services are being rendered outside India, or income has otherwise not accrued in India

- Terms not defined in Code or Double Tax Avoidance Agreement (“DTAA”) will have meanings assigned in notifications issued by the Government

New Scheme of taxation

- Concept of branch profits tax introduced, and profits of Indian branches of foreign companies would be additionally subjected to branch profits tax at 15 per cent

General Anti-Avoidance Rule

- The Code seeks to introduce GAAR empowering the Commissioner of Income-tax (“CIT”) to declare an arrangement as impermissible if the same has been entered into with the objective of obtaining tax benefit and which lacks commercial substance.
- The tax payer to establish that obtaining a tax benefit, was not the main purpose of the arrangement.
- On invoking the GAAR, the CIT may determine the tax consequences by amending, disregarding or re-characterising the arrangement.
- GAAR to override the applicable DTAA, and directions of CIT would be binding on the Assessing Officer
- The arrangements covered by GAAR to include round trip financing, lifting of corporate veil, etc.

Treaty provisions

- Furnishing of tax residency certificate mandatory for claiming relief under the applicable DTAA
- Provisions of the Treaty or the Code, whichever is later in time, shall prevail

Deduction of expenses

- Net basis of taxation in respect of royalty income / FTS earned by non residents is sought to be done away with
- Head office expenditure to be allowed to the extent of 0.5 per cent of total sales, turnover or gross receipts, as against deduction of 5 per cent of the adjusted total income presently available

Advance Rulings

- Income-tax authorities [including Income-tax Appellate Tribunal (“ITAT”)] not to adjudicate appeals filed by non-residents on issues pending before the AAR. Earlier, the above restriction applied to applications filed by resident tax payers only

Others

- Income accrued from direct / indirect transfer of any capital asset situated in India would also be construed as income ‘deemed to accrue’ in India
- Tax arrears due from non-residents may be recovered from any assets of the non-residents, wherever located

Corporate Tax

Summary

The Code proposes reduction in the corporate tax rate to 25% and also provides for unlimited carry forward of business losses. In an attempt to rationalise and simplify tax computation, the Code proposes amendment in the basis of computation of business income from the current “business profits with specified adjustments” to an “income expense model” prevalent in certain developed and other Asean countries. Largely, the Code also provides a status quo on Dividend Distribution Tax (“DDT”) levy at 15% on the dividend actually distributed. Thus, the effective rate of corporate tax works out to 34.78%.

Computation

- Business income computed based on the income-expense model as under:

| | | |
|-----------------------------------|-----|-----|
| Gross Earnings (section 31) | XXX | |
| <u>Less: Business Expenditure</u> | | |
| Operating Expenditure | XXX | |
| Permitted Finance Charges | XXX | |
| Capital Allowances | XXX | XXX |
| Taxable Income from Business | | XXX |

- Income from each business to be computed separately;
- Eventually, income from each business to be aggregated (profit / loss) to work out the income taxable under the head Business Income
 - Business Assets to be distinguished from Investment Assets; Business Assets further classified as Business Trading Assets and Business Capital Assets

Gross Earnings – Computation thereof

- Gross earnings would be the aggregate of:
 - Amount of any accrual or receipt from, or in connection with, the business

- Value of any benefit or perquisite from, or in connection with, the business
- Value of closing inventory
- Gross earnings whether from business trading assets or from business capital assets to be included.
- Gross earnings shall not include certain items which are to be taxed under other heads of income

Operating Expenditure

- Operating expenditure includes specified expenditure laid out or expended wholly and exclusively for the purposes of the business
- Operating expenditure does not, indicatively, include:
 - Personal expenses
 - Capital expenditure
 - Dividend declared or distributed
- Allowability on payment basis of expenditure in nature of tax, duty, cess, royalty or fee, bonus, commission, leave encashment, gratuity, contribution to approved funds retained
- Disallowance of expenditure on account of non-compliance with TDS provision extended in respect of all expenses subject to TDS. Further, such expenditure would be allowable in subsequent years only if the TDS is paid within 2 years

Permitted Finance Charges

- Besides normal interest charges, permitted finance charges also includes proportionate amount of discount or premium payable on bond or debenture, to be computed in the prescribed manner
- Amount of incidental financial charges for issue of debentures, bonds or share capital are not allowable as finance charges

Capital Allowances

- Capital allowances consist of,
 - Depreciation
 - Initial depreciation (*akin* to additional depreciation)
 - Terminal allowance
 - Scientific research and development allowance
- Specified Deferred Revenue Expenditure eligible for capital allowance as under:

| Block of Asset | Depreciation Rate (%) |
|--|-----------------------|
| Non-compete fees | 25 |
| Premium for obtaining any asset on lease or rent | 25 |
| Voluntary retirement scheme expenditure | 25 |
| Business Reorganisation expenditure | 25 |
| Expenditure relating to prospecting of mineral or development of mine / other natural deposit of any mineral | 15 |

- 150% Weighted deduction for in-house scientific R&D expenditure extended to all industries
- Loss on sale of business capital assets (where no assets remain in a particular block of asset) will continue to be eligible for depreciation and will not be allowable as a business loss

- In the case of a finance lease, the lessee would be eligible to claim capital allowance

Minimum Alternative Tax – Tax on Gross Assets

- Payable by every company on value of gross assets instead of book profits, if tax on chargeable income is less than tax on value of gross assets
- Tax Rate
 - Banking company – 0.25% of the value of gross assets
 - Other company – 2% of the value of gross assets
- Computation of value of gross assets
 - Aggregate of the following (as at close of the financial year)
 - Value of gross block of fixed assets less accumulated depreciation on fixed assets
 - Value of capital work in progress
 - Book value of all other assets excluding debit balance of Profit and Loss Account
- Amounts as reported in the accounts drawn as per Schedule VI of the Companies Act, 1956, to be considered for the above purpose
- No tax credit / set off allowed in subsequent years

Dividend Distribution Tax

- Status quo on DDT rate at 15%
- Single tier exemption for holding companies continued
- Dividend to following category of shareholders exempt from DDT (being pass through entities)
 - New Pension System Trust
 - Mutual Fund which includes Venture Capital Vehicles

- Approved Provident and Superannuation fund
- Life Insurance Company
- DDT exemption for SEZ developer to be discontinued
- DDT also extended to payments (by way of advance or loan) made by closely held companies which are deemed as dividend

Exemptions, Deductions and New Schemes

Summary

Profit-based tax incentives are sought to be discontinued and an expenditure / investment-based incentive scheme introduced. Large infrastructure projects including development of Special Economic Zones will be covered under the new Scheme. For individuals, the focus is to move towards the Exempt-Exempt-Taxable model. Continued emphasis on deductions based on social tax expenditure

Corporate

- Export based incentives such as section 10A, 10AA, 10B, 10BA to be eliminated
- Area / profit-based incentives to be discontinued without affecting the tax payers currently enjoying such incentives, which will be grandfathered
- Under the new Scheme, a person would be allowed deduction of revenue as well as capital expenditure to determine the taxable profit. Loss, if any, will be allowed to be carried forward indefinitely. The period consumed in recovering such capital and revenue expenditure will be the period of tax holiday. The new Scheme will apply to the following businesses:
 - Generation, transmission or distribution of power
 - Developing or operating and maintaining Infrastructure facility (as defined)
 - Operating and maintaining a hospital in specified areas
 - Processing, preservation and packaging of fruits and vegetables

- Laying and operating cross country natural gas / crude / petroleum / pipeline distribution network including storage facilities
- Setting-up and operating a cold chain facility
- Setting-up and operating agricultural warehouse facility
- Exploration and production of mineral oil or natural gas
- Developing a Special Economic Zone

Others

- The exemptions available under Chapter III of the current Act would largely be retained
- Individuals / HUFs
 - Scheme of Exempt-Exempt-Taxable promoted
 - Accumulated balances in approved PF upto 31 March, 2011 not includible in total income on withdrawal
 - Aggregate deduction for specified savings / investment and children education proposed to be increased from INR 100,000 to INR 300,000 in a financial year

Mergers and Acquisitions

Summary

Paradigm shift in taxation of capital gains is proposed under the Draft Code. All Capital gains would be taxable at normal rates of tax, removing the benefits of lower rates. However, fair market value substitution date is shifted to 1 April, 2000. Gains on transfer of Business capital assets as well as slump sale are now taxable under the head Business Income. Cost of acquisition is deemed to be nil for all self generated assets and where cost of assets can not be determined. With the proposed abolition of Securities Transaction Tax, exemption / lower tax for capital gains tax on sale of shares on stock exchange is withdrawn. Provisions for carry forward of losses of transferor entities in amalgamation liberalised but in case of demerger made more stringent.

Capital Gains

- It includes the following :
 - Gains on transfer between holding / subsidiary company will be taxable if :
 - Holding-subsidiary relationship cease to exist at any time. The limitation period of 8 years under existing provisions is removed
 - Existing provisions taxing exempt income in the year of original transfer is removed. Therefore, the gain would be taxable in the year of happening of the above event.
 - Investment asset is converted into or treated as business trading asset
 - Transitional provisions for existing transactions not provided

- Transfer of business capital assets will be taxed under the head business income
- New concept of contribution of asset by way of capital or otherwise to a company introduced and,
 - will be taxable in the year in which such contribution is made
 - amount recorded in the books of the company will be taken as consideration
- Transfers not to be treated as capital gains
 - Condition pertaining to continuity of 25% and 75% respectively of the shareholders on amalgamation or demerger of two foreign companies removed
- Exemption in respect of the following transfers to be withdrawn
 - Transfer of membership rights of a recognised stock exchange
 - Transfer of capital asset in a transaction of reverse mortgage
- Set-off of losses
 - Unabsorbed capital loss allowed to be carried forward indefinitely
- Securities Transaction tax to be abolished and gains from transfer of shares would be taxable
- Cost of acquisition / improvement
 - General provision – if cost of acquisition is not determinable – deemed “Nil”
- Transfer
 - includes retirement from unincorporated body and
 - therefore, gain on above transfers will now be taxable

- full value of consideration will be Fair Market Value (“FMV”) of assets received
- Substitution of cost by fair market value
 - base date shifted from 1-4-1981 to 1-4-2000

Amalgamation

- In case of Companies - to be in accordance with provisions of Companies Act, 1956
- Mergers of Co-operative Societies also covered
- Includes amalgamation of unincorporated bodies with companies
- Certain losses other than business losses also allowed to be carried forward.
- Conditions of owning of industrial undertaking for allowing carry forward of losses of transferor company is removed

Slump sale

- Entire sales consideration will be liable to tax under the head business income
- The acquirer of a business may not be able to claim enhanced tax base for the assets acquired on the basis of consideration paid.

Carry forward and set-off of losses

- Losses of unlisted public companies not to lapse even on change in shareholding of 50% or more

Business reorganisation

- Defined to mean reorganisation of business of two or more residents involving an amalgamation, demerger, and merger under a scheme sanctioned by the Central Government under the Banking Regulation Act, 1949

Filing of Return / Assessment / Appeal TDS / Penalty and Prosecution

Summary

The scope of Dispute Resolution Panel has been extended to all assessee's where the Assessing Officer determines a variation to the returned income in excess of the limit prescribed. Apart from the above the Code seeks to introduce series of small changes.

Return and Assessment

- Scheme for taxation of unincorporated bodies i.e Partnership firm, AOP, and BOI has been introduced
- The new Code reiterates that any direction/ instruction / order / circular issued by the Board shall be binding on the Income Tax Authorities
- Two due dates for filing of tax returns - 30 June for non-business and non-corporate assessee's and 31 August for others
- Selection of cases for scrutiny to be made in accordance with Risk Management Strategy to be formulated by the CBDT, not to be revealed
- The Assessing Officer is required to forward a draft of the proposed order of assessment in case the variation to the returned income is in excess of prescribed limit
- The notice for reassessment to be issued only after approval by the CCIT or CIT and to contain reasons for reopening
- Application for rectification deemed to be rejected if no order passed within six months from the date of application. Assessee can file an appeal

- Reorganisation involving a foreign company may not get covered
- It will be tax neutral in the hands of a shareholder
- Proportionate depreciation in case of business reorganisation in the hands of predecessor and successor in case the same takes place during the financial year
- The adjusted value of block of assets in the hands of successor acquired in a business reorganisation to be the same as if no business reorganisation has taken place
- In case of business reorganisation, unabsorbed current loss from ordinary / special sources in the hands of successor to be the same as in the hands of the predecessor
 - The successor to satisfy the test of continuity of business i.e. the successor should:
 - hold atleast 3/4th of the book value of fixed assets acquired for a period of 5 years
 - continue the business of predecessor for a period of 5 years
 - comply with such other conditions as may be prescribed for revival of the business of the predecessor / business reorganisation is for genuine business purpose
 - The above conditions were applicable only to amalgamation, now it will be applicable in case of demerger also.
- Predecessor to be assessed from the beginning of the financial year till the date of the business reorganisation
- The successor to be assessed from the date of business reorganisation till the end of the financial year

Appeals

- No appeal shall lie to the ITAT against an order passed by the CIT directing revision of assessment.
- National Tax Tribunal, once established, will exercise the power of the High Court except the power granted under Article 226 of the Constitution of India
- The ITAT cannot condone the delay in filing of the appeal, if such delay exceeds one year

Penal Provisions

- The Code envisages creation of a modern Tax Payer's Information System to ensure deterrence against non-compliance
- Penalty to be imposed for wilful under-reporting of tax base based on the concept of *mens rea*. Maximum penalty imposable for such a default can be 200% of tax payable
- No income tax authority shall have the power to waive penalties
- Levy of penalty and initiation of prosecution to be independent of each other

Others

- Rates of tax withholding included in the Schedules to the Code and provisions relating to recovery to be streamlined
- Right to Information Act to be amended to prohibit disclosure of information relating to any assessee to be disclosed to any 3rd party except in the circumstances provided in the Code

Transfer Pricing

Summary

The Code seeks to bring about certain far reaching changes within the Indian transfer pricing regime. Some of these are retention of Safe Harbour provisions, introduction of Advance Pricing Agreement (“APAs”) and the introduction of Thin Capitalisation measures

Advance Pricing Agreement

- The Code seeks to introduce the concept of APA.
- APA is an agreement between the taxpayer and the tax authorities for the upfront determination of the arm’s length pricing / pricing methodology of an international transaction.
- The features of an APA will be as follows :
 - Pricing under an APA to be the arm’s length price as prescribed under the Code, subject to necessary / expedient adjustments made by the Board;
 - APA validity shall not exceed five consecutive years; and
 - APA not to be binding in case of change in the law on the basis of which it was entered into.

Anti-avoidance measures

- The Code seeks to introduce certain anti-avoidance measures whereby certain arrangements, the main purpose of which is to obtain tax benefits and which depart from the arm’s length principle, would be considered as “Impermissible Avoidance Arrangements”.
- Such arrangements may be amended (wholly or in part), disregarded or re-characterised by the Revenue.

- Arrangements include, in certain circumstances, disregarding a particular type of debt arrangement and for re-characterisation of interest as dividend
- Arrangements shall be presumed to have been entered into for the purpose of obtaining a tax benefit, and the onus of proving the genuineness of the transaction has been shifted from revenue to the taxpayer

Associated Enterprises

- Various threshold limits prescribed under the Act for considering two enterprises as ‘Associated Enterprises’ are proposed to be amended as follows:

| Criteria | Current threshold limit | Proposed threshold limit |
|--|---|---|
| Shareholding, directly or indirectly, held by one enterprise in the other enterprise, or by the same person(s) in both the enterprises | Shares carrying 26% or more of voting power | Shares carrying 10% or more of voting power |
| Loan by one enterprise, as a percentage of book value of total assets of the other enterprise | 51% or more | 26% or more |
| Certain number of directors or members of the governing board of one enterprise are appointed by the other enterprise, or by the same person(s) in both the enterprises | More than half | More than one-third |
| Raw materials required for manufacture by one enterprise, are supplied by other enterprise/ other designated enterprise, and the terms thereof are influenced by such other enterprise | 90% or more of the raw material value | Two-third or more of the raw material value |

Transfer Pricing Assessments

- Transfer Pricing Officer (“TPO”) to select cases for scrutiny in accordance with the risk management strategy to be framed by the Central Board Of Direct Tax (“CBDT”)
- No information relating to risk management strategy shall be revealed.

Penalty

| Particulars | Current | Proposed |
|--|--|------------------------------------|
| TP adjustment | 100% to 300% of tax on such adjustment | 100% to 200% of tax on adjustments |
| Failure to maintain documentation | 2% of value of transactions | INR 50,000 to INR 200,000 |
| Failure to furnish documentation | 2% of value of transactions | INR 5,000 to INR 100,000 |
| Failure to furnish Accountants’ Report | INR 100,000 | INR 50,000 to INR 200,000 |

Individual tax

Summary

A major change in the area of individual taxation is to introduce EET based taxation. The residency definition has also been changed. In addition, changes are proposed with respect to computation of income from house property

Residency rules and taxability

- The separate category of resident but non ordinarily resident is proposed to be done away with. resident individuals would enjoy exemption on income sourced outside India for 2 consecutive financial years i.e. in the financial year the individual becomes a resident and in the immediately succeeding financial year if the individual was a non resident for nine years immediately preceding the financial year in which he becomes a resident
- Income received outside India on behalf of a resident included within the ambit of taxation
- Income accruing outside India or received outside India by the resident by himself or by any one on his behalf to be included in the total income irrespective of whether the income have been subjected to tax outside India or whatever the method be for granting of relief for the avoidance of any double taxation under any agreement entered by India

Income from Employment

- Income under the head Income from Employment shall be Gross salary less aggregate amount of specified deductions
- The deductions to be reduced from Gross Salary include inter alia any amount received directly or indirectly from the employer on account of Voluntary Retirement Scheme or Voluntary Termination Scheme, amount received on account

of Gratuity, amount received on Commutation of Pension

- Such deductions will be allowed only if the above amounts are paid or deposited in a Retirement Benefits Account (RBA). Such RBA could be an approved provident fund, superannuation fund, life insurer or New Pension System Trust
- Subsequent withdrawal from RBA will be taxed in the year of withdrawal / receipt at the appropriate personal marginal rate

Income from House property

- Income from House Property shall be Gross Rent /less deductions as specified. Gross Rent will be higher of the amount of Contractual Rent or Presumptive Rent
- Presumptive Rent shall be 6% of rateable value fixed by any local authority in respect of the property or in cases where no such value has been fixed, cost of construction or acquisition of the property
- Advance rent will be taxed only in the financial year to which it relates
- Deduction for repairs and maintenance of property to be allowed at 20% of Gross Rent (currently 30% of annual value)
- In case of self occupied property, no deduction to be allowed on interest paid on capital borrowed for the purpose of acquiring, constructing, repairing, renewing or reconstructing the property

Financial Services

Summary

The Direct Tax Code has rationalised the taxation in respect of financial intermediaries and other investment vehicles.

Financial intermediaries

- Financial intermediaries like mutual fund, venture capital fund, pension funds, superannuation funds, provident funds and life insurance companies are treated as pass through entities, irrespective of the sectors in which they invest.
- As per the explanation to the Code, the investor will be liable to tax on income which accrues from such pass-through entities.

Banking companies

- Rate of tax for banking companies, higher of 25% on total income or 0.25% of the gross assets.
- Foreign bank branches liable to tax at the normal rates as above plus a branch profits tax at 15%. Head office expenditure allowable to the extent of 0.5% of turnover.
- Provision for bad and doubtful debts allowable to the extent of 1% of aggregate average advances.
- Interest on sticky loans to be taxed based on credit or receipt whichever is earlier.

Insurance companies

- Profits in shareholder's account prepared in accordance with the Insurance Act, 1938, treated as profits from life insurance business taxable in hands of shareholders subject to certain specified adjustments.

- Profits of other insurance business shall be the profits disclosed in annual accounts furnished under the Insurance Act, subject to certain prescribed adjustments.

Foreign Institutional Investors ("FIIs")

- No separate tax regime for FIIs. To be treated on par with other non-residents.
- Interest paid by FIIs on offshore leverage for investment in India could become taxable in India, subject to availability of Treaty benefits.

Trust taxation

- Trust taxation provisions simplified. Differential and complex tax regime for determinate and in-determinate trusts removed.
- Pass through status for trust taxation to continue.

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