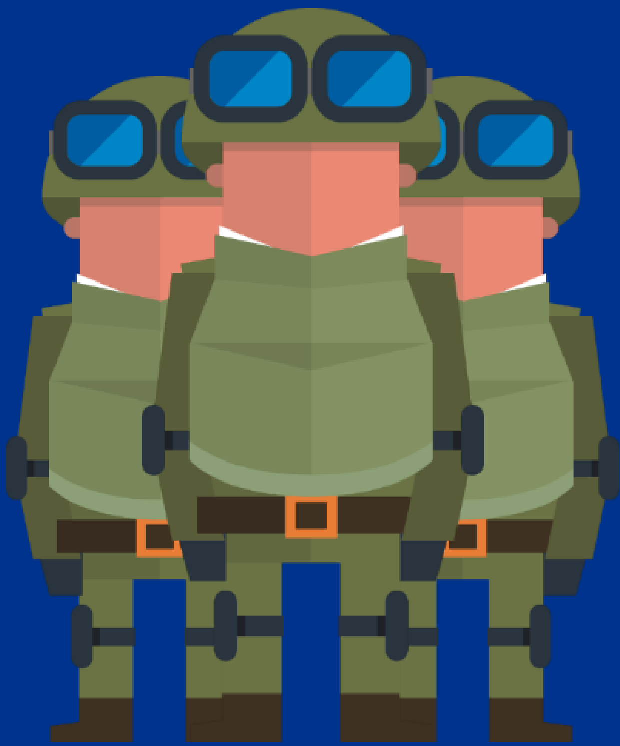
Defence and Aerospace

Union Budget 2016

Post-Budget sectoral point of view



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Context

Where we are

India is located centrally in the Indian Ocean, and shares its border with seven countries. This strategic location exposes India to threats from sea and land. A precarious neighbourhood owing to cross-border unrest, infiltration and increasing domestic disturbances in the form of Naxalism are key concern areas requiring the government's immediate attention. India also desires to assert its presence as a major regional player.

India needs to build a strong, technologically-advanced armed forces. Being one of the world's largest defence spenders with an estimated spend of over 2 per cent share of its GDP, India is yet completely secure due to the following reasons:

- It is majorly dependent on imported defence equipment and has a very nascent domestic manufacturing base. Approximately 70 per cent of its defence equipment is imported, making it the world's largest importer[1]
- Of the total defence equipment held by the Indian armed forces, a meagre 15 per cent can be described as state-of-the-art while nearly 50 per cent has become obsolete, raising serious questions about India's war-preparedness
- While sincere efforts have been made by Defence Public Sector Undertaking (DPSU) to boost indigenous Research and Development (R&D), India has unfortunately not been able to keep pace with global standards
- Low investment by the Indian private sector in R&D and manufacturing.

Given the above facts, the Indian defence sector needs radical reforms to move forward.

Key issues/challenges

- Shortfall of investment in technology innovation and upgradation.
- A complex policy environment coupled with bureaucratic delays in procurement.
- Lack of tax incentives and monetary support for defence manufacturing which suffers from lumpy investments, limited order size and a prolonged gestation period.
- Lack of supporting infrastructure and robust supply chain including availability of raw materials adhering to military specifications/standards.

Government's stance

- Thrust on indigenous manufacturing and creating a robust defence industrial base under 'Make in India' initiative
- Promoting export of high end defence technologies
- Facilitating global defence players to invest in India
- Equipping our armed forces with quality modern equipment

Expectations (policy/fiscal/tax)[2]

- Increase FDI to 74 per cent without any conditions
- Accord infrastructure status for the sector to facilitate tax concessions/benefits for manufacturers and availability of capital liquidity to fund such high capital intensive projects
- Formulate focused and harmonised plans for development and upgradation of the defence manufacturing industry and encourage participation of private industrial houses in the defence manufacturing space
- Revamp Defence Procurement Procedure (DPP) including the policy and mechanism of defence offsets, setting the context for a clear, shorter and simpler DPP
- Develop a clear road map for enhancing efficiency and effectiveness of DPSUs leveraging on the vast infrastructure possessed by them
- Create explicit tax incentives/tax holidays so as to incentivise in-country manufacturing of aerospace and defence components and sub-systems.
- Reduce tax on Aviation Turbine Fuel (ATF) should be reduced
- Create a level playing field for indigenously manufactured defence suppliers vis-à-vis the imported suppliers

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1. 'SIPRI Yearbook 2015 – Armaments, Disarmament and International Security', Stockholm International Peace Research Institute
2. Source: KPMG in India analysis, 2016; industry discussions

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Key policies/fiscal and tax proposals

Key announcements[1]

Policy

- Proposed allocation for the defence sector for financial year 2016-17 is INR2,49,099 crore (approximately USD38.32 billion), an increase of less than 1 per cent (in INR terms) over the last year's allocation of INR2,46,727 crore (approximately USD 37.96 billion)
- There has been a year on year decline (in INR terms) in capital expenditure from INR94,588 crore (approximately USD14.55 billion) to INR86,340 crore (approximately USD13.28 billion)*
- Foreign Direct Investment (FDI) up to 49 per cent in the defence sector has been allowed under the automatic route beyond which a government approval is required. The conditions linked to FDI have been rationalised
- Validity of industrial licences has been increased from seven years to fifteen years (further extendable upto three years)
- The government has undertaken measures towards export liberalisation and rationalisation by providing easy finance, incentives and a thrust for exports through the defence offset policy
- The government has made significant changes to the offset policy. Services have been reinstated as an eligible avenue to offset discharge under the defence offset policy. Further, a simplified mechanism to change offset partners, components, dollar commitments has been introduced to catalyse the stalled offset investment.

Direct tax

- Corporate tax rate for companies remains the same which is 30 per cent (plus applicable surcharge and education cess) other than:
  - Corporates having turnover of less than INR5 crore in FY2014-15 to be taxed at the rate of 29 per cent
  - New manufacturing companies incorporated on or after 1 March, 2016 to be taxed at the rate of 25 per cent provided they do not avail the benefit of profit linked or investment linked deductions, investment allowance and accelerated depreciation
- Tax holiday provided to start-ups established before 1 April 2019 for a period of three consecutive years out of a period of five years. Such start-ups are to be subject to MAT provisions
- Patents developed and registered in India to be taxed at the rate of 10 per cent on income earned through its worldwide exploitation
- This Finance Bill has initiated the process of phasing out of certain exemptions.
  - Tax holiday to SEZ under section 10AA available if activities are commenced up to 31 March 2020
  - Weighted deduction in skill investment for skill development available up to 1 April 2020
  - Weighted deduction for scientific research available at the rate of 150 per cent from 1 April 2017 and at the rate of100 per cent from 1 April 2020
- 100 per cent deduction of profits for three out of five years for start up set up during April 2016 to March 2019
- Tax residency of foreign company based on Place Of Effective Management (POEM) deferred by one year
- General Anti Avoidance Rules (GAAR) to be applicable from 1 April, 2017
- A three-tiered documentation and reporting structure has been brought under the Base Erosion and Profit Shifting (BEPS) action plan

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1. Union Budget 2016-17, http://indiabudget.nic.in/glance.asp, 29 February 2016

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Indirect tax

- Government to ensure passage of constitutional amendments to implement Goods and Service Tax (GST)
- General basic custom duty rates remain unchanged. Thus, the general effective customs duty rate continues to be 26.43 per cent (capital goods)/29.44 per cent (other goods)
- 'Krishi Kalyan' cess levied on all the taxable services at the rate of 0.5 per cent, with effect from 1 June 2016
- No change in excise duty rates
- Customs duty exempted on tools and tool-kits when imported for maintenance, repair, and overhauling (MRO) of aircraft (with effect from 1 March 2016). Further the procedure for availing customs duty exemption on parts, testing equipment, tools and tool-kits for MRO of aircraft has been simplified as under:
  - — The actual user condition for various category of importers such as Aero Club, Airports Authority of India, etc., has been omitted and the exemption is now available to a unit registered with the Directorate General of Civil Aviation subject to specified conditions
  - — Restriction of one year for utilisation of duty free parts for MRO of aircraft done away with
  - — Relaxed the existing conditions of stay (up to 60 days), so as to provide for stay up to six months of the foreign aircraft for MRO and provide for further extension of such period by DGCA as deemed fit.
- Customs duty exemption on direct imports of specified goods (goods required for construction of, or fitment to, ships of Indian Navy or Coast Guard; aircrafts, aircraft parts, aircraft engines, aircraft engine parts, etc.) by government of India or state governments withdrawn (with effect from 1 April 2016)
- Basic custom duty exemption on imports of specified goods (goods required for construction of, or fitment to, ships of Indian Navy or Coast Guard; aircrafts, aircraft parts, aircraft engines and aircraft engine parts, etc.) by contractors/authorised persons of the Government of India, PSUs or sub-contractors of PSUs withdrawn (with effect from 1 April 2016)
- Excise duty exempted on tools and tool-kits manufactured for MRO of aircraft. The procedure for availing excise duty exemption on parts, testing equipment, tools and tool-kits manufactured for MRO of aircraft is simplified based on records (with effect from from 1 March 2016)
- Excise duty on ATF other than for supply to Scheduled Commuter Airlines (SCA) from the Regional Connectivity Scheme airports increased from 8 per cent to 14 per cent (with effect from 1 March 2016)
- Service tax exemption on construction, erection, commissioning or installation of a new airport/port restored for contracts entered into prior to 1 March, 2015 (with effect from 1 March 2016)
- Indirect Tax Dispute Resolution Scheme, 2016 introduced with effect from 1 June 2016.

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Impact

The decline in allocation for capital expenditure is a dampener for the sector*. With no major announcements for the sector, the expectations have clearly not been met. With the introduction of a sunset clause on major tax holidays, specially under the SEZ scheme, it is likely that companies may expedite their investment plans in India.

A level playing field has been provided on indigenously manufactured supplies vis-à-vis imported supplies by removing customs duty exemptions available to the government on imports. Widening the scope of excise and customs duty exemptions to MROs would help the sector.

The government needs to understand or analyse certain ground level issues and address them in an appropriate and timely manner so as to ensure the development of a strong indigenous manufacturing base. These include issues like FDI limit enhancement, improvement in the quality of manufacturing infrastructure and the pace of the defence procurement process.

Our point of view

As far as the taxation regime is concerned, the Budget seems to have fallen short of providing adequate incentives/benefits to the sector from both a direct as well as an indirect tax perspective. It could have introduced more tax incentives in aerospace and defence manufacturing by according 'infrastructure' status to the sector.

The Budget has overall not met the expectations of the industry in every aspect – allocation, roadmap, incentives, policy reforms, etc.

* There is an increase of approximately 11 per cent while comparing revised estimate for FY 2015-16 to that of FY 2016-17 for the defence sector

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Unfinished agenda

What remains

- Facilitation of a conducive and pro-investment policy environment should be another focal point for the government, taking into account the best interests of various stakeholders. Currently, the sector is subject to numerous regulations and stringent monitoring, which makes functioning for companies in this space quite difficult. To overcome such challenges, the government must work towards harmonisation of the policy environment including the FDI policy, licencing regime, offset policy, tax laws, etc.
- The government must channelise its efforts towards streamlining procurement processes, making them time effective and unambiguous. Similarly, the offset policy, which has the potential to stimulate indigenous defence manufacturing should be strengthened and made effective. Currently, these policies lack consistency and precision
- A relook at the operating mechanism of the public sector undertakings i.e. DPSUs, Defence Research and Development Organisation (DRDO) and Ordnance Factory Board (OFB) should be undertaken from the standpoint of productiveness, innovation, efficiency and utilisation. The government should analyse the gaps and take corrective action for their redressal
- Additional investment should be made towards technological upgradation. Institutions like DRDO should be strengthened to produce leading edge technology
- The government should consider according 'infrastructure' status to the A&D industry and providing various concessions/benefits in the form of tax incentives to A&D manufacturers, both from direct and indirect tax perspectives, so as to augment domestic defence production
- While the government has significantly enhanced the FDI cap on the defence sector (from the erstwhile 26 per cent to 49 per cent), such policy initiatives have not yielded the desired results. The government could reconsider enhancing the FDI cap to 74 per cent.

What is expected going forward

With defence remaining within the government's high priority focus area and in view of the government's commitment towards fine-tuning of policy and regulations, the sector may see a significant growth trajectory.

As a nation, we are certainly not lacking in terms of capability and resources. With an abundance of qualified manpower, skill intensive manufacturing capabilities, a booming auto industry and a leading IT base, it is quite evident that India possesses the essential ingredients to create a strong domestic defence manufacturing base.

What is lacking is the inflow of sophisticated technology. With further enhancement of the FDI limit, critical technology may flow in. The government should provide a level playing field for private players.

Today, the Indian industry is more confident about making significant investments in the defence sector. This has to be encouraged to enhance competition and improve the procurement options for the government.

The government must ensure creation of a conducive policy environment with minimum red tapism, less intrusive monitoring and attractive incentives to promote domestic defence manufacturing . With a little more impetus from the government's end, India could well become a major defence and aerospace manufacturing hub in the 15-20 years.

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