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Decoding defence

Indian Defence Procurement

Opportunities for investments and offsets.

Introduction

Big Opportunity

- USD 50 Bn in 5 years
- Largely import dependent procurement
- Liberalised offset policy
- First ever Defence Production Policy
- Annual revision of DPP

Investing in the booming Indian defence market

Invest in the Indian Defence Market

The Indian market presents a significant opportunity for the defence businesses. With the third largest armed force in the world, India's defence spending is 1.96% of its GDP. For FY 2011-12, the budget outlays for defence have increased by 11.58% to $36 billion. Strategic compulsions have prompted the Government to launch a $50 billion five year capital procurement plan in 2007.

To fully exploit this opportunity and fulfil offset obligations, original equipment manufacturers and their suppliers should leverage Indian's competitive advantages in manufacturing and information technology by setting up units in India. A large number of Indian private companies and public funded research laboratories are looking for international partners. India has emerged as a global R&D hub with 150 of the Fortune 500 setting up R&D labs in India. A liberal Special Economic Zone policy provides a competitive eco-system for exports through attractive fiscal incentives. Such a strategy would allow companies to fully participate in the Indian market as well as use India's competitive advantages to create a low cost regional/ global manufacturing hub, as has been done successfully in the auto sector.

Changing landscape of India's defence sector

Domestic and Foreign Investment

Historically, India's defence sector had been exclusively reserved for the Government. In May 2001, the Government liberalised the manufacture of defence equipment in India, permitting 100% investment by the domestic private sector and up to 26% Foreign Direct Investment (FDI). This was subject to the Indian company obtaining an Industrial License from the Department of Industrial Policy and Promotion (DIPP) and with prior permission of the Government of India. The licensing conditions require, inter alia, that the management of the applicant company/partnership should be in Indian hands with majority representation and the Chief Executive being resident Indians. There is also a three-year lock-in-period for foreign equity.

To provide a further impetus to domestic manufacturing, the Government in its Defence Offset Policy (introduced through the Defence Procurement Procedure 2006) mandated a minimum 30% plough back of foreign outflows from defence procurement into the Indian defence industry. These funds were to be used for manufacturing, research and development (R&D) in the Defence sector. The offset policy includes purchase of products and services related to defence, homeland security and aerospace (both civil and military) sectors.

This is to encourage technology transfers and setting up of production units in the country. The policy allows foreign suppliers to choose their Indian offset partner – in either the private or the public sector – in discharging their offset obligations.

In 2011, the Government released its first ever defence production policy. The policy was released with the a stated objective to achieve self reliance in the development of defence products by encouraging private sector participation and broadening defence R&D in the country.

Decoding the procurement policy: DPP 2011

Defence procurement is governed by the Defence Procurement Procedure (DPP). First enumerated in 2006, the latest policy on defence procurement (DPP 2011) was released on 6 January, 2011. The government has decided to revise the DPP every year.

Key features of DPP 2011 include:

- Categories of defence procurement:
    - Buy: (Global) outright purchase of equipment from a foreign vendor (Indian) outright purchase of equipment from Indian vendor with minimum local content of 30%
    - Buy and Make: purchase from a foreign vendor followed by licensed domestic manufacture through transfer of technology
    - Buy and Make: (Indian) purchase form an Indian company/Indian JV with minimum local content of 50%
    - Make: indigenous design , development and production of equipment
- Naval ship building procedure has been divided into two different streams
    - acquisition by nomination to DPSUs
    - acquisition on a global competitive basis
- Offset policy includes purchase of products and services related to defence, homeland security and civil aviation sectors
- Fast track procedure:
    - formulated to ensure quick procurement during crisis situations
    - requirement should originate from the concerned service chief
    - exempt from offset obligations
- All details of trail methodology are disclosed in respective Request for Proposals (RFPs)
- Single stage two bid system is followed and technical and commercial proposals are submitted separately with a validity for 18 months
- Offset offers are submitted 3 months after the submission of main bids
- Field trails are conducted on no cost no commitment basis
- Broad time frame for planning purposes from issuing RFP to contract finalisation which is approximately two and a half years in duration.

DPP 2011 – Amendments

- Offsets in internal security and civil aircraft now allowed
- Training included as a service in offsets
- Performance bank guarantee bonds and warranty bonds have been clubbed
- Base rate of Reserve Bank of India (RBI) has replaced the prime lending rate
- Validity of Acceptance of Necessity (AON) after retraction of RFP has been extended by one year
- Exchange Rate Variation clause has been made applicable to all Indian vendors

Key Concerns

- Definition of Indian Industry.
- Increase in banking time limit.
- Open ended penalty clause.

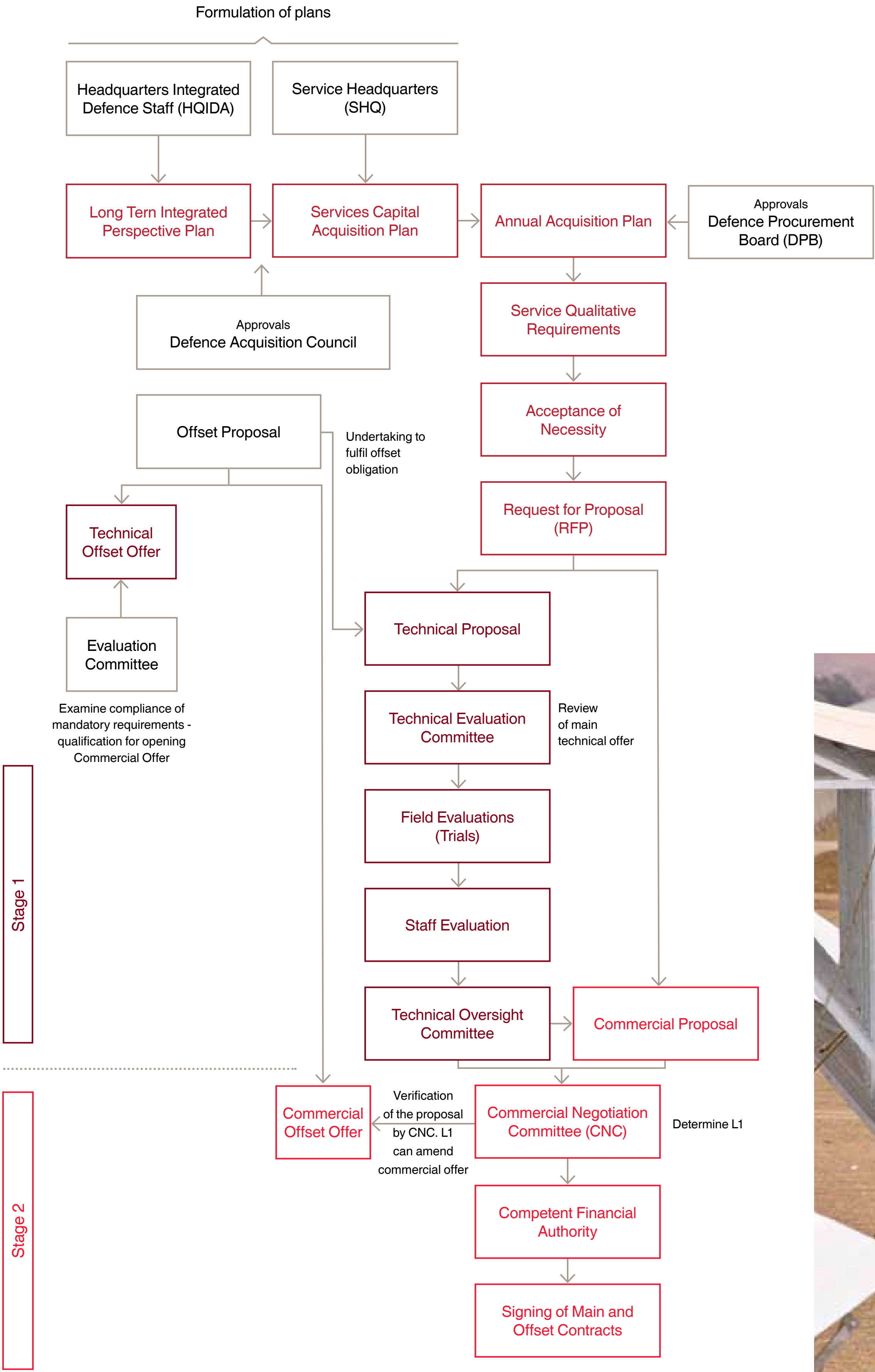
Simplifying the offset policy

- Mandatory offset requirement of a minimum of 30% for procurement of defence equipment in excess of INR 3 billion.
- Categories of schemes in which offsets are applicable:
  - 'Buy (Global)/Buy Indian
  - 'Buy and Make' with transfer of technology
- Banked offset credits are allowed to be discharged against RFPs , which are issued within two years of the approval of banked offset credits
- Transfer of technology not counted towards offset calculation
- Offset obligations can be discharged by any combination of the following methods:
  - Direct purchase of/or, executing export orders for eligible products and components manufactured by, or services provided by Indian industries
  - Direct foreign investment in Indian industries for industrial infrastructure, services, co-development, joint ventures and co-production of eligible products
  - Direct foreign investment in Indian organisations engaged in research and development as certified by Defence Offset Facilitation Agency (DOFA)
  - Discharge of banked offset credits
- List of products eligible for discharge of offset obligations include defence, internal security and civil aerospace products
- Vendor is free to choose Indian offset partner.
- Indian offset partner to comply with licensing requirements/guidelines issued by DIPP
- Offset obligation to be fulfilled co-terminus within period of main contract
- Quarterly submission of reports during implementation stage
- Penalty for default

Understanding the Offset bid evaluation process

- Separate Technical and commercial offset proposals to be filed
- Technical offset offer to contain details of the products, services and investment proposals indicating relative percentages and proposed Indian partners for the offset investment. In addition, details of banked offset credits as discharged offset obligations are also required.
- Technical offset offers to be scrutinised by a technical offset evaluation committee comprising of the Acquisition wing
- DOFA to help the committee by providing information on the technical feasibility of the offset offer, in terms of the capability of the Indian offset partner. The committee will examine compliance with mandatory requirements for meeting the offset obligations
- Commercial offset offer to specify the absolute amount of the offset with a break-up of the details, phasing, name(s) of the Indian partner(s) and banked credits as discharged obligations
- Commercial Offset offer to be opened along with the main commercial offer.
- Contract Negotiating Committee (CNC) to verity that the offer meets the stipulated offset obligations. Lowest vendor (L1) can amend the commercial offset offer at this stage.
- Commercial offset offer to have no bearing on determination of L1 vendor
- For "Buy (Global)" category, offset not applicable if an Indian firm, including a JV, is offering an indigenously developed product with local content to exceed 50%

Summary of bidding process



Defence Production policy

The Ministry of Defence released the first ever Defence Production Policy on 13 January 2011. The objectives of the policy are to:

- achieve substantive self reliance in the design, development and production of equipment/weapon systems/platforms required for defence in as quickly as possible;
- to create conditions conducive for the private industry to take an active role in this endeavour;
- to enhance potential of SMEs in indigenization, and
- to broaden the defence R&D base of the country.

Key features of Defence Production Policy include:

- Preference will be given to indigenous design, development and manufacture of defence equipment. Wherever the required arms, ammunition and equipment is possible to be manufactured by the Indian industry within the required time frame, the procurement will be made from indigenous sources.
- Futuristic weapon systems required in the next ten years would be specified and developed within the country. Sub-systems not economically viable to be manufactured within the country will be imported.
- Synergy between academia, R&D institutions, technical and scientific institutions, consortia and PPP will be achieved, to produce state of art equipment within stipulated price and timelines.
- A separate fund will be provided for R&D to public/private sector/ academic and scientific institutions.
- The 'Make' procedure will be simplified.
- The Qualitative Requirements (QR)s will be kept flexible and practical.
- Option of 'Buy' will be followed incase indigenous production gets delayed.
- Upgrades will be carried out by the Indian industry as far as possible.

'Make (High-tech)' Procedure

HQ IDS obtains approval of DAC with Acceptance of Necessity & Quantity Vetting

Integrated Project Management Team (IPMT), constituted by Acquisition Wing and headed by service officer, evolves Project Definition Document headed by service officer, evolves Project Definition Document

IPMT seeks EoI from companies recommended by Department of Defence Production

IPMT analyses responses, assesses capabilities and sends names of short-listed companies to Defence Production Board (through Acquisition Wing) which selects two companies

Both submit Detailed Project Report (DPR) including role of foreign technology provider, if any

IPMT analyses DPR and forwards to Acquisition Wing for approval, especially the exit criterion. Acquisition Wing obtains sanction of the competent financial authority

IPMT monitors progress and reports to Defence Production Board through Acquisition Wing

User trials and staff evaluation of prototypes carried out under Service HQ. MoD accepts staff evaluation. Commercial evaluation and contract negotiation done by Acquisition Wing as per normal 'Buy' procedure

Tax Framework in India – An Overview

India has a federal set up of tax administration under which the Central Government levies taxes on income, custom duties, central excise and service tax, whereas the State Government levies taxes like value added tax, central sales tax, works contract tax.

Corporate Income-tax

- Permitted Business presence in India for a foreign company (FC): Project Office, Branch Office, Liaison Office; Subsidiary/Joint Venture company.
- Effective corporate tax rate for domestic companies is 33.22%; for foreign companies 42.23% .
- While dividend income received from domestic company is exempt in the hands of the shareholder, Dividend Distribution Tax (DDT) at 16.61% is levied on the companies declaring dividends.
- Minimum Alternate Tax (MAT) applicable at 19.93% of book profits when tax liability under normal tax provisions of the Income Tax Act, 1961 is less than 18% of book profits.
- FTS and Royalty taxable in India on source basis.
- India has withholding tax regime. The payer is required to withhold tax on payments to non-resident/residents which are subject to tax in India.
- Direct Taxes Code proposing to change the legislation substantially is under consideration and may be introduced by 1 April 2012.

As per the proposed DTC, the SEZ developers and units will continue to enjoy the tax benefits subject to certain conditions however there will be no exemption from Dividend Distribution Tax (DDT) and Minimum Alternative Tax (MAT)

Tax Incentives

- 100% tax holiday for ten years for developers of Special Economic Zone (SEZ).
- 100% tax holiday on profits on exports for five years and 50% tax holiday for the next ten years for units set up in a SEZ (subject to specified conditions).
- 100% tax holiday available to undertakings manufacturing specified goods located in North Eastern States (up to March 2017).
- Tax holiday available to undertaking manufacturing specified goods located in Himachal Pradesh and Uttaranchal (up to March 2012) - 100% of profits for first five assessment year and 30% for the next five years.
- Deduction of 150% of scientific research expenditure incurred by a company on in-house R&D facility for specified activities, including manufacture/production of aircraft, helicopters, electronic equipment (up to 31 March 2012). Subject to specified conditions, deduction is available of 125% of payments made for research activities to an approved Indian company in scientific R&D.

General Tax Implications

- International transactions with associated companies need to be at arm's length price and subject to transfer pricing regulations.
- Taxpayers can up-front approach the Authority for Advance Ruling to determine income-tax implications of any proposed or current transactions.
- India has entered into comprehensive treaties for avoidance of double taxation with over 70 countries

Indirect Tax Implications for Defence Sector

- Effective customs duty rate on import of goods is 24.42 % based on peak rate of customs. Exemption available for defence supplies subject to conditions.
- Effective excise duty rate on manufacturing activity is 8.24 % (inclusive of education cess and secondary & higher education cess). Exemption available for defence supplies subject to conditions.
- While inter-State sale of goods is subject to levy of CST, intra-State sale of goods are subject to levy of VAT. CST rate is 2% against submission of statutory forms by the purchaser else VAT rate of the originating State would apply. For most of the goods, VAT rate is either 4% or 12.5%. No general exemptions/concessions available on sale of goods made to defence – each State VAT legislation should be examined.
- Specified services are subject to service tax and liability to pay the same is on the service provider. For a few specified services including imported services, liability to pay service tax shifts to the service recipient. Service tax rate is 10.30% (inclusive of education cess and secondary & higher education cess). Presently, no specific exemptions available for services rendered to defence related activities.
- The States are also authorised to levy other local taxes such as entry tax.
- Furthermore, local authorities and municipal corporations impose local taxes.
- Research and Development cess at 5% applicable on import of technology into India by an industrial concern under a foreign collaboration. However, the cess paid can be adjusted against service tax liability accruing under certain service categories.
- Indirect tax incentives available to SEZ units for their authorised operations.

About Aerospace and Defence team

We are a team of professionals with diverse background and experience cutting integrated across all our lines of service. Our people and culture, promoting constant sharing of knowledge and best practices, has been our greatest strengths. This can be gauged from our strong global Aerospace and Defence practice that serves most of the leading global Aerospace and Defence companies. Further, our deep understanding of Government regulations and industry issues helps us understand clients needs better and deliver greater value.

To provide high quality service, our partners and consultants invest considerable time in developing of our industry expertise. Our team maintains strong yet independent relationships with the Government and constantly shares knowledge with players in the defence sector and Government. We also conduct research, arrange workshops and conferences to deliberate upon important issues for the development of the industry.

Your requirements	Our Service offerings
Regulatory Advice/ Approvals/Legal support	• Advice on strategy for necessary regulatory approvals – Industrial License, FIPB, RBI • Assistance in obtaining clarifications/approvals/licenses from the relevant regulatory authorities • Assistance in making representations to the regulatory authorities • Offset related assistance - structuring offset and banking proposals, review of bids.
Tax and Regulatory Structuring	• Advice on evolving a tax efficient business and capital holding mind regulatory restrictions relating to level of returns, repatriation, exchange control and other related issues under the Indian Companies Act and also implementation assistance. • Tax advice in relation to various transaction taxes, corporate tax, transfer pricing, tax incentives and special dispensations. • Suggesting an appropriate business and entity structure, joint venture, contract manufacturing, consortium arrangements etc. to undertake the proposed operations. • Agreement reviews–assist in review of transaction documents, joint venture agreements from a tax and regulatory perspective. • International assignment tax services for expatriates, both consulting and compliance, covering structuring of assignments including review of employment contracts, tax equalization policies, employees stock plans, fringe benefit tax, Indian Social Security applicable to International Workers.
Advisory Services	• Joint Venture partner search : financial/strategic • Joint venture partner due diligence • Transaction support including structuring, valuation, negotiations, fund mobilisation and shareholders agreements. • Supply Chain Management • Performance Improvement • Risk Management • Market entry and growth strategy - Market size, scope and mission identification, Buying behaviour and market accessibility, Gauge competition, Outline strategy.

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