

FOREIGN DIRECT INVESTMENT IN INDIA'S AIR CARRIERS: A NEW CASE FOR EFFICIENCY?

By Sundeep Dudeja and Vaibhav Kakkar

The Opening in the Clouds

Cash and capital must be “checked-in” before an aviation player can take off. Aircraft, aviation fuel, employees, training, airport charges and maintenance are only some of the many factors that swell costs, while delaying difficult-to-earn returns for airlines the world over. India is no different. The recent debt burden of domestic airlines in India stands at U.S. \$14.5 billion. The finances of the airline sector have been reeling. Financial and private equity investors have shown minimal interest in this sector in the past given that India’s regulatory framework did not even permit strategic investment.

Foreign airlines were not allowed to hold an equity stake in an Indian air transport undertaking engaged in operating scheduled and non-scheduled air transport services, except cargo airlines. Foreign Direct Investment (FDI) up to 49% was allowed under the “Automatic Route” (i.e., without obtaining prior approval from the Foreign Investment Promotion Board, Ministry of Finance [FIPB]) in scheduled air

transport service/domestic scheduled passenger airlines. In the non-scheduled air transport service, FDI up to 74% was allowed (under the Automatic Route up to 49% and with prior FIPB approval for FDI above 49%).

All this changed on September 20, 2012, when the Department of Industrial Policy & Promotion (DIPP) of the Ministry of Commerce and Industry issued new regulations. DIPP’s “Press Note 6” changed business for good. It allowed foreign airlines to hold capital in Indian companies operating scheduled and non-scheduled air transport services up to 49% of their paid up capital under the Approval Route (i.e., with prior FIPB approval). The Press Note infused fresh breath in the Indian airline space and raised the hopes of domestic carriers that the policy change would revive their sector.

The Government had long delayed this step because of security concerns as well as the fear of acquisition of small players by foreign airlines.

continued on [page 6](#)

ABOUT THIS ISSUE

The Indian civil aviation sector continues to face a paradox. While on the one hand Indian carriers continue to lose large amounts of money and are under tremendous pressure to improve their yields, there have been positive developments in the recent past with the Jet Airways-Etihad Airways deal, the Air Asia-Tata venture and the Tata-Singapore Airlines venture, all looking for the opportune time to start operations.

In the environment that the Indian carriers find themselves, a continuous re-examination of the regulatory and tax regimes has become imperative. The regulatory and tax regime needs to keep changing by carrying out a balancing act between the stakeholder interest and the profitability of the carriers.

The legal fraternity in India and those who have been closely associated with the aviation sector have consistently assisted industry in analysing various implications of the regulatory and tax regime and suggesting ways of improving the regulatory environment for encouraging growth of the industry.

In this background, this issue of the India Law News of the India Committee of the American Bar Association's Section of International Law assumes greater significance. India Law News in this issue has been fortunate to have valuable contributions from expert lawyers practicing in the field of foreign direct investment (FDI), mergers and acquisitions, private equity, tax, civil aviation, and infrastructure, who discuss many of the aspects pertaining to the regulatory and tax regime. Sundeep Dudeja and Vaibhav Kakkar of Luthra & Luthra Law Offices give their perspective on the FDI norms which enable foreign airlines to hold capital in Indian companies operating scheduled and non-scheduled air transport services. Keeping the recent Jet-Etihad deal in mind, Vikas Kumar of DH Law Associates, Advocates and Solicitors, analyses FDI norms applicable to foreign investments and the government policy pertaining to "bilateral air service agreements." Pawan Khatter and Jayanta Kalita, of EY India and Vikas Srivastava and Sanjeev Sachdeva of Luthra & Luthra Law Offices provide their respective views on the indirect and direct tax issues impacting the aviation industry. Aseem Chawla, Anuj Mathur, and Shashank Goel of MPC Legal touch upon certain direct and indirect tax aspects of cross border leasing and highlight deliberation between the stakeholders of this industry and the tax authorities. Co-Guest Editor, Robert S. Metzger, of Rogers Joseph O'Donnell, P.C., makes the case for a national program to develop a next generation turboprop aircraft to meet India's regional transport needs. He suggests such a program can be used to address India's national technology and manufacturing objectives.

We hope you find the above articles interesting and useful.

Atul Sharma and Robert S. Metzger

Guest Editors, Winter Issue 2014

Atul Sharma is the Managing Partner of Link Legal India Law Services, a full service law firm. He has over 30 years of experience in civil and commercial litigation and arbitration in various sectors, including aviation, infrastructure,

CONTENTS

OVERVIEW

- 2 *About This Issue*
- 4 *Co-Chairs' Column*



COMMITTEE NEWS

- 34 *Submission Requests*
- 35 *Join the India Committee*



SPECIAL FOCUS

- 1 *Foreign Direct Investment in India's Air Carriers: A New Case For Efficiency?*
- 11 *Foreign Direct Investment Issues In The Backdrop Of The Jet Airways – Etihad Airways Strategic Acquisition*
- 15 *The Impact of Direct and Indirect Taxes on Foreign Carriers Operating in India*
- 19 *Tax Turbulence for Indian Aviation*
- 25 *Cross-Border Aircraft Leasing: An Indian Tax Perspective*
- 29 *A Next Generation Regional Turboprop Transport: A National Aerospace Project For India*



- 36 [Threading the Needle in U.S./India Deals: Safe Passage through Formidable Legal Risk](#)

real estate, telecom and banking. He has wide experience in dispute resolution procedures and domestic and international arbitration. Atul has advised and represented clients in shareholder disputes arising out of the acquisition and sale of companies, as well as contentious regulatory matters, insolvency proceedings, and real estate and tender-related disputes. He also specializes in the infrastructure sector and has advised developers and contractors. In the last five years, Atul has advised on projects at airports in Istanbul, Turkey, Male, Maldives, and on four major airports in India - Delhi, Mumbai, Bangalore and Hyderabad, in addition to other infrastructure projects like ports, transportation, power and water. Atul can be reached at atul@linklegal.in

Robert S. Metzger is a shareholder at the law firm of Rogers Joseph O'Donnell, P.C., and is based in Washington, D.C. Mr. Metzger counsels leading U.S. and international companies in aviation and defense matters. He is a member of the Defense Executive Committee of the U.S.-India Business Council and has published several articles in international journals on the subject of the U.S.-India aerospace and defense industrial relationship. Mr. Metzger was a Research Fellow at the Center for Science & International Affairs, Harvard University Kennedy School of government, and is a member of the International Institute of Strategic Studies(London). He can be reached at rmetzger@rjo.com.

CO-CHAIR'S COLUMN

On behalf of the India Committee we wish all our readers a very Happy New Year.

India's general election takes place between March and April 2014. Once the elections are over, whichever party or combination of parties prevails, it is expected that the new government will focus on taking effective measures to get India's struggling economy back on track. An anemic 4.6 percent annualized growth rate in GDP in the middle of 2013 shows the extent to which the Planning Commission's ambitious annual target of 8 percent has been derailed.

We can expect that after the elections India is likely to explore all growth options, including putting major infrastructure projects back on track. Some steps have already been taken. For example, a Cabinet Committee on Investment has been created to find ways to streamline regulatory clearance of major projects. The new government will also need to explore ways to address supply-side constraints, double digit inflation—caused in large part by higher food and energy prices—an increasing current account deficit, fall in aggregate investment, and a decrease in collection of tax and non-tax revenues with the consequent risk of higher fiscal deficits.

The India Committee, through its programs and this newsletter will continue to endeavor to keep our readers, members and program participants informed of significant legislative, regulatory and judicial developments in India in the coming months particularly to the extent that such developments may affect investor and business confidence.

This issue of the India Law News continues from our previous issue with a special focus on civil aviation. The articles, written by distinguished legal practitioners, explain the reasons behind India's slow start in laying the foundation for what is potentially one of the largest civil aviation markets in the world. This issue of India Law News, along with the previous one, gives insight into India's revenue, regulatory, environmental and social policy spheres that often have overlapping jurisdictions and different perspectives. This can make it hard for the aviation industry to plan for growth, especially when conflicting decisions by regulatory bodies inevitably leads to litigation. Our special thanks go to co-Guest Editors, Atul Sharma and Robert Metzger for putting together both parts of our two-part series on civil aviation in India. We have been particularly fortunate in having as authors for these two editions among the best legal and tax practitioners in India to guide us through the complexities of the Indian civil aviation industry today. As always we wish to express our gratitude to our editorial board for producing another timely issue on an important topic and to LawQuest for providing desktop publishing for the India Law News.

The India Committee has also chosen this critical time to discuss foreign investment and trade, especially between India and the U.S., at a conference in New Delhi from February 13 to 15, 2014. The India



EDITORIAL BOARD (2013-2014)

Editor-in-Chief

[Bhalinder L. Rikhye](#)

Bartlett, McDonough & Monaghan, LLP, New York, NY

Co-Editors

[Poorvi Chothani](#)

LawQuest, Mumbai, India

[Aseem Chawla](#)

Mohinder, Puri & Company, New Delhi, India

[Antonia Giuliana](#)

Kelley Drye & Warren LLP, New York, NY

[Julia Luyster](#)

Bogert & Rembold, PL, Coral Gables, FL

[Sylvana Q. Sinha](#)

[Desktop Publishing](#)

LawQuest, Mumbai, India

India Law News is published quarterly by the India Committee of the American Bar Association's Section of International Law, 740 15th Street, N.W., Washington, DC 20005. No part of this publication may be reproduced, stored in a retrieval system (except a copy may be stored for your limited personal use), or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of the publisher. To request permission, contact the Co-Chairs of the India Committee.

India Law News endeavors to provide information concerning current, important developments pertaining to law in India, Committee news, and other information of professional interest to its readers. Articles reflect the views of the individuals who prepared them and do not necessarily represent the position of the American Bar Association, the Section of International Law, the India Committee, or the editors of *India Law News*. Unless stated otherwise, views and opinions are those of the authors and not of the organizations with which they are affiliated. This newsletter is intended to provide only general information and should not be relied upon in the absence of advice from competent local counsel.

SUBMISSION DEADLINES

Fall Issue	August 1st
Winter Issue	November 1st
Spring Issue	February 1st
Summer Issue	May 1st

Potential authors should review the [Author Guidelines](#) and send manuscripts via email to the [Editorial Board](#).

© 2014 American Bar Association

All rights reserved

Produced by India Committee

Committee has been extremely fortunate to have as conference organizing partners the Society of Indian Law Firms (SILF) and the Indian Services Export Promotion Council, and other supporters including the U.S India Business Council, for the presentation of this three-day program in New Delhi on trade and investment between the U.S. and India, entitled “Threading the Needle in U.S./India Deals: Safe Passage through Formidable Legal Risk.”

With senior lawyers from India and the U.S. expected to present and attend, this conference promises to be a thought-provoking event and an invaluable networking opportunity. Registration is open and fast filling up, at <http://www.events.iceindia.in/threadingtheneedle/registration.html>. We hope you will register for this event at the Hyatt Regency Hotel, New Delhi, from February 13 through 15, 2014. The panels will cover topics such as India’s new Companies Act, 2013, the mergers and acquisitions regime under the new Companies Act, including cross-border mergers, the ever evolving Indian tax landscape affecting cross border transactions, the compelling logic behind corporate governance, ethical behavior and effective corporate compliance, how India has enabled class action lawsuits, and the lessons India can learn from the U.S., the legal requirement of corporate investment in corporate social responsibility and industry’s response, navigating India’s defense procurement policy, civil aviation, issues related to cross-border franchising, key legal aspects of listing Indian companies in the U.S., the future of international arbitration in India, immigration issues especially as they relate to the conduct of India-U.S. business, a look at U.S. and Indian trade regulations, dealing with cyber attacks that disrupt the nation’s power grid for months, the evolving intellectual property rights regime in India and U.S., moving wealth between India and the U.S. and back, in the context of tax and legal structures affecting persons and families with ties to both India and the U.S., and increasing opportunities for young lawyers in India.

In December 2013, the India Committee also ran a teleconference, “The Elephant Trots Again: Further Liberalizations and Initiatives Boost Investments in India.” The panel addressed India’s recent Companies Act, 2013, the improvement in credit growth, the Cabinet Committee on Investments, the easing of regulations on financing through equity and debt offerings, reforms in the companies law, land acquisition and foreign investment policy, developments in taxation, and contract enforcement. More teleconferences are planned for 2014.

We hope you enjoy this issue of India Law News, and hope to see you at the Hyatt Regency in New Delhi between February 13 and 15, 2014!

We hope you find the above articles interesting and useful.

Sajai Singh
Sanjay Tailor
Richa Naujoks



FOREIGN DIRECT INVESTMENT IN INDIA'S AIR CARRIERS: A NEW CASE FOR EFFICIENCY?

By Sundeep Dudeja and Vaibhav Kakkar

continued from [page 1](#)

The present government's dependence on support of allied political parties may also have been a factor. While long overdue, this was a welcome move because as strategic alliances were required for achieving consolidation, efficiency and reduction of costs. Such alliances were seen as helping to usher expertise and global practices and standards into India.

The decision paved the way for airlines such as GoAir, SpiceJet, Jet and Kingfisher to explore recapitalisation, restructuring and partnerships with global operators. Further, this bold move, along with the opening of multi-brand retail trade for FDI, helped bolster investor confidence. Before September 2012, the term "policy paralysis" was being associated with the Government. Even Prime Minister Manmohan Singh himself had come under criticism. The new rules cheered global airlines as new opportunities opened up in what they began seeing as India's huge market.

Some of the important conditions for acquisition of a stake by foreign airlines in Indian carriers, was that a "scheduled operator's permit can be granted only to a company (i) that is registered and has its principal place of business within India, (ii) whose Chairman and at least two-thirds of the directors are citizens of India and (iii) the substantial ownership and effective control of which is vested in Indian nationals." The revised policy was not made applicable to Air India which is still owned by the government.

Air Asia Flies Into Turbulent Weather

After Press Note 6 was issued, Malaysia-based budget carrier AirAsia was the first airline to announce a collaboration with the Tatas and Telstra Group to

launch a new low-fare airline in India. AirAsia was to have a 49% stake in AirAsia India, and the Tatas and Telstra 30% and 21% respectively. The FIPB gave its approval to the venture in March 2013; but the proposal almost immediately hit turbulence when the Ministry for Civil Aviation pointed out that the language of Press Note 6 only allowed foreign airlines to acquire a stake in existing carriers, not in greenfield airline projects such as AirAsia India. DIPP at the Ministry of Commerce and Industry, however took the position that the policy change envisaged stakes in greenfield projects as well as existing carriers.

According to paragraph 2.1 of Press Note 6 the "Government of India has reviewed the position in this regard and decided to also permit foreign airlines to invest, in the capital of Indian companies, operating scheduled and non-scheduled air transport services, up to the limit of 49% of their paid-up capital." The FIPB's interpretation that the rule applied to Greenfield projects was based on the comma placed after the word "companies," arguing that there is no distinction made in the said language between existing and newly created companies. The Ministry of Civil Aviation, however, insisted on clarification of the language of the Press Note. The differing viewpoints of these two government departments were widely reported.

The issue could have been avoided by constructive dialogue between government departments prior to the meeting of the FIPB in which AirAsia's proposal was considered. While ultimately, it did not have a bearing on the approval of the proposal by the FIPB, the disagreement showed an inefficient and confusing lack of co-ordination between Government departments and jeopardized investor confidence. Technically, the

DIPP is the policy formulator and its view should have settled the issue.

In support of the argument that Press Note 6 did not permit foreign airlines to invest in greenfield carriers, senior BJP politician Subramanian Swamy filed a public interest litigation (PIL) against the deal before the High Court of Delhi. The case is presently being litigated. However, a fundamental aspect which should not be lost sight of here is that under the settled principles of Indian administrative law, Government policy and its interpretation are the executive's prerogative, which limits judicial review of policy matters. In the context of FDI policy itself, in the judicial decisions of *Federation of Associations of Maharashtra v. Union of India* ([2005] 63 SCL 77 (Delhi)) and *Radio House and Ors. v. Union of India* (2008 (2) KarLJ 695), it has been held that the Government decides and interprets the implications of policy. Therefore, it is unlikely that the Delhi High Court will grant Mr. Swamy's petition given that the FIPB has already cleared the AirAsia India investment, and the DIPP has stated that Press Note 6 is not restricted to investment in existing carriers only.

Jet Airways & Etihad Airways – The Not-So-Smooth Runway for The Big Players

Another deal which lit up the Indian sky in 2013 was Abu Dhabi-based Etihad Airways' 24% investment in Naresh Goyal - owned Jet Airways for approximately \$350 million. The investment deal was huge and the first in an existing domestic airline, amongst the existing Indian operators and was at the same time as India and UAE had signed a memorandum of understanding (MoU) on air services for enhancing seat capacity. The deal in whole could lead Jet Airways being able to reduce its debt burden from \$2.1 billion to \$1.5 billion.

Allegations were made by several politicians, including Subramanian Swamy, that the Government unduly influenced the deal. This transaction, too, is *sub-judice* on a plea filed by him to the Supreme Court of India. The MoU entered into between India and UAE

for an increase in the number of seats per week for their airlines, was alleged to have been formulated to specifically facilitate the Jet-Etihad deal. The MoU has been said to impact domestic carriers (other than Jet) and domestic airports, as it would lead to Abu Dhabi becoming a hub for in-bound and out-bound India flights. Nevertheless, the MoU was given ex post facto clearance by the Cabinet in September, 2013.

The Matter of “Effective Control”

While Press Note 6 mentions that a scheduled operator's permit may be granted only when the company's “effective control” is vested in Indian nationals, it does not define “effective control.” The prevalent FDI policy outlined “control” as the power to appoint a majority of directors. Control as stipulated by the Securities and Exchange Board of India (SEBI) Takeover Code includes the right to appoint a majority of directors or to control management or policy decisions, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

As soon as the Etihad investment in Jet was first announced in April 2013, the proposed structure faced scrutiny of the FIPB, SEBI, the Competition Commission of India (CCI) and the Ministry of Corporate Affairs, on the grounds that the proposed documentation appeared to show a shift in effective control of the airline into Etihad's hands. The regulatory authorities perceived that Etihad was attaining much more than the law permitted, even though the stake proposed to be acquired was a minority 24%. As initially proposed, Etihad was to get three directors on the board, while Jet was to have four, with seven directors being independent. The deal envisaged, among other things, that Etihad could source candidates for senior management positions, network and revenue management functions could be shifted to Abu Dhabi, and the nominations committee could exclusively recommend appointment/removal of independent directors and chief executive officers.

The then existing FDI Policy defined control as simply the power to appoint majority of directors, which was a narrower definition than the definition of control under the SEBI Takeover Code. Practically, however, in the context of FDI also, the Government was applying similar parameters as those envisaged under the SEBI Takeover Code for assessment of control of an entity. FIPB's assessment of the investment in Tata Sky Ltd. is an example of where various governance rights proposed in the transaction documents were directed to be reduced.

Further, the deal was facing examination by SEBI under the requirements of the Takeover Code itself, which mandates that if an acquisition leads to change in control of an entity listed on any stock exchange—Jet is a listed entity—an open offer is required to be made by the acquirer to the public shareholders of the entity for tendering their shares to the acquirer. SEBI was apprehensive that certain clauses in the proposed structure would give control to Etihad over Jet. SEBI's concerns, when echoed in the media and other platforms, led, for the first time, to the FIPB seeking specific comments from SEBI and the Ministry of Corporate Affairs on the deal structure before approving it.

These various regulators worked closely among themselves as well as with Jet-Etihad, to identify those clauses of the proposed shareholders' agreement, commercial cooperation agreement, etc., that could be interpreted as handing control to Etihad. When finally FIPB cleared the deal in July it did so conditionally. Jet Airways Chairman, Naresh Goyal, was to remain executive chairman with a casting vote. Any future changes in the shareholding pattern or shareholders agreement were made subject to prior Government approval. Most importantly, Etihad agreed to two board seats, as opposed to three discussed earlier, with six seats for independent directors. Under the revised terms of the agreement Etihad could only recommend appointments to management. Also, Etihad would not have the right to appoint independent members on the nomination and audit committees and such members

could be appointed only if nominated by the board of directors.

The proposal for shifting of revenue management and the network operations office to Abu Dhabi was also dropped. (Source: <http://m.financialexpress.com/news/jet-flight-plan-gets-green-signal-after-control-shift/1148298/>). Importantly, however, SEBI stated in its assessment that if any other regulator differed in its analysis of the change in Jet Airways' control, SEBI reserved the option of re-examining the issue of open offers to be made to public shareholders.

The clearance of the investment by the FIPB and subsequently by Cabinet Committee on Economic Affairs was a bright spot, even though it took over six months. There were many authorities involved and the deal can be seen as an example of constructive and productive dialogue between a willing investor and Indian regulators, who are usually perceived by the global community as stringent and reluctant to approve these kinds of complex transactions.

The Jet-Etihad transaction also glided through the scrutiny of the Competition Commission of India which did not see the combination as having an appreciable adverse effect on competition in India. However, in its order of November, 2013, based on its assessment of the investment agreement, the shareholders agreement and commercial co-operation agreement, the Commission concluded that Etihad would be in joint control over Jet under the deal. Given this, SEBI has recently been mulling re-examining the deal to determine whether it is indeed a change of control, which could trigger an open offer. Therefore, the last word on this issue is yet to be heard.

Controlling The "Control"

Around the same time that the Jet-Etihad deal was under consideration, the DIPP revised the FDI policy (in August 2013) to bring the definition of "control" in line with that prevalent under the SEBI Takeover Code. The (Indian) Companies Act, 2013, which has been

recently enacted to replace the half-a-century old company law embodied in the (Indian) Companies Act, 1956, also encapsulates a new definition of control which conforms to the one contained in the SEBI Takeover Code.

This is a positive development in the sense that different regulations/guidelines now do not carry contrasting definitions of control. However, certain aspects still remain unresolved. The definition of control under the SEBI Takeover Code has itself been a subject of intense judicial debate and varying interpretation historically, as the same has been interpreted in light of the particular facts of individual cases. As the FDI Policy (post amendment) now carries more or less the same definition of control as in the SEBI Takeover Code, the remaining uncertainty and fluctuations travel here as well.

For instance, in the order in *Subhkam Ventures v. SEBI*, dated January 15, 2010, of the Securities Appellate Tribunal, it was held that control has to be positive control. Certain rights to prevent a company from taking certain actions (such as affirmative/protective right of the investor), however, would not amount to control. However, later, the Supreme Court ruled that this order cannot be treated as a precedent, thus leaving open the contours of the definition of control. Another aspect of this issue is that since the definition of control is now similar in the FDI Policy, the SEBI Takeover Code and the Companies Act, 2013, the interpretation given by regulatory and judicial authorities to “control” under one framework, will necessarily affect the interpretation to be given in another.

Better co-ordination among various Government and regulatory wings will be required. Entrusting one agency with the responsibility of assessment of control in a transaction and the determination made by such agency serving as a parameter for other Government departments, would enhance consistency and clarity.

Press Note 6 was a bold step forward. In barely a year, the civil aviation sector has seen three major

ventures: Jet-Etihad, Air Asia India and Singapore Airlines-Tata. Clearly, long-overdue policy changes have provided these companies broad avenues and possibilities for structuring and consolidation. The obligation is on the Government now to keep up the liberalization process, eliminate inconsistencies and simplify procedures. This will allow domestic airlines in India to receive a much needed impetus to recover and flourish. Ultimately, the impact of the reforms, if applied consistently and in a coordinated manner will benefit airlines in terms of increased capitalization, and passengers in terms of competitive fares, more routes and a greater choice of airline.

Sundeep Dudeja is a Partner in the Corporate and Regulatory Practices Team of Luthra & Luthra Law Offices, New Delhi. Sundeep specializes in foreign investment/exchange laws, securities laws and general corporate laws. He has extensive experience in structuring transactions and advising clients on corporate, regulatory and contractual matters including, cross border mergers & acquisitions, joint ventures and private equity. Sundeep has advised clients from across industry sectors such as infrastructure, pharma and health, retail, real estate, oil and gas, financial services, insurance, information technology, e-commerce, broad casting and telecom. He has also advised various reputed multinational clients on significant and complex corporate matters including setting up their presence in India. Sundeep is a qualified Chartered Accountant and Company Secretary. He also has various notable publications in several leading journals. Sundeep can be reached at sdudeja@luthra.com

Vaibhav Kakkar is a Partner in the Corporate and Regulatory Practices Team of Luthra & Luthra Law Offices, New Delhi. Having more than seven years of experience, he has a unique mix of extensive regulatory and transactional expertise, and specializes in structuring transactions, and advising on foreign investment/exchange laws, company law and securities laws. He has advised several global

corporates on appropriate strategies in relation to investments in India and domestic and multinational clients on significant and complex corporate matters including cross border mergers & acquisitions, joint ventures, private equity. He has in-depth experience with industry-specific legal and regulatory issues in sectors including retail, real estate, telecommunications, gaming, hospitals, pharma, education mutual funds, education and the financial sector (banking and non-banking). He has various notable publications in several leading journals and newspapers. Vaibhav can be reached at vkakkar@luthra.com.



FOREIGN DIRECT INVESTMENT ISSUES IN THE BACKDROP OF THE JET AIRWAYS – ETIHAD AIRWAYS STRATEGIC ACQUISITION

By *Vikas Kumar*

If the Wright brothers were alive today Wilbur would have to fire Orville to reduce costs.

- Herb Kelleher, CEO, Southwest Airlines

India's regime for foreign direct investment (FDI) in the civil aviation sector has been progressively liberalized. This article examines the new FDI regime applicable to air transport services and passenger airlines ("Indian Carriers") in the context of the recent partial strategic acquisition of India's Jet Airways by the Abu Dhabi based Etihad Airways.

The fetter of the civil aviation industry is a good barometer of the prevailing economic mood in India. The airlines segment is a disproportionately visible subset of the civil aviation sector due to its glamour which makes it a source of national pride. However, the flight path of the Indian civil aviation industry has mostly been turbulent and marked with intense air-pockets.

Plotting the trajectory of India's airline industry from 2006 tells the whole story. Deccan Airlines had barely managed its initial public offering when it was swiftly folded into Kingfisher Airlines in 2008. Kingfisher Airlines itself, along with its chairman Vijay Mallya, the "King of Good Times," soon thereafter unglamorously collapsed in tough conditions. Air India had its tryst with mounting losses. Sahara merged with Jet Airways. And finally Jet Airways has found itself in a blockbuster foreign direct investment (FDI) deal with Abu Dhabi's Etihad Airways that continues to attract immense scrutiny. India's civil aviation industry rarely engenders a dull moment!

Notwithstanding its reputation as an industry that can only incur losses and destroy wealth, the airline carrier segment has witnessed extraordinary growth in India over the last decade and has the potential to become one of the largest aviation markets in the world. Examples of this potential include Wilbur Ross's profitable exit from SpiceJet after a short two-year term and late entrant IndiGo Airlines' confident glide to a fifth straight year of profits.

The fortunes of Indian carriers ride with those of the external business environment. But they are also greatly impacted by government policy. Overall policy directives notifying changes in foreign direct investment (FDI) regulations, generally also affect the civil aviation industry. The Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry heralds policy changes, and then, in deference to DIPP's policy, the Directorate General of Civil Aviation (DGCA) of the Ministry of Civil Aviation amends its foreign equity participation guidelines for airlines.

In June 2008, FDI upto 49% was allowed under the automatic route (i.e. no prior approval from the Reserve Bank of India is required) subject to some very significant restrictions. Only foreign financial institutions are permitted to invest in Indian Carriers. Foreign airlines are expressly prohibited from having –

- (i) any direct or indirect shareholding interest, financial or commercial tie-up with, or having any interest, in management of Indian Carriers; and
- (ii) loan arrangements, lease-finance and similar tie-ups with Indian Carriers, except for marketing arrangements such as ground handling and code-sharing etc.

Predictably, financial investors with the expertise and finesse in distressed assets investment have taken a chance on Indian carriers. Also not surprisingly, lately there has been a significant surge of interest among international carriers in acquiring strategic stakes in Indian Carriers. Here we get introduced to another game changer – bilateral “Air Services Agreements” (ASAs) that two nations sign to allow international commercial air transport services between their territories. The Ministry of Civil Aviation negotiates ASAs with its bilateral counterpart. Since ASAs dramatically influence volume of air services between two nations, they have an exponential impact on strategic collaborations between airlines. ASAs also overtly signify warming of bilateral trade relations between two nations. Hence, the overall policy impact purportedly travels much beyond the civil aviation sector.

The Jet-Etihad deal makes an interesting case study in the backdrop of the new FDI regulations and ASAs. On September 2, 2012 the DIPP allowed foreign airlines to acquire up to 49% in Indian Carriers under the approval route (Government’s approval is required) and subject to security clearances. The turnstile of events thereafter has attracted a lot of debate, as well as media and judicial scrutiny. Thereafter, on March 1, 2013 the DGCA issued its operational guidelines for FDI in the airline sector. Thus the earlier policy obstacles preventing foreign airlines from acquiring strategic ownership interest in Indian carriers were conclusively removed.

Thereafter, on April 24, 2013, the Ministry of Civil Aviation announced its revised ASA with the United Arab Emirates (UAE) that enhanced seat capacity nearly threefold to 36,670 seats per week, and code-share facilities between designated airlines of both nations spread over 3 years. The Ministry of Civil Aviation has stated that the objective of the revised ASA is to allow carriers of both nations to plan future operations and promote Indian and international connectivity.

Curiously enough, on the same date as when the bar against ownership by foreign airlines was removed, Jet Airways and Etihad Airways jointly announced their ambitious strategic deal whereby Jet Airways would issue 24% of its paid-up equity to Etihad for US\$ 380 million. Coincidentally, the 24% acquisition stake also ensured that the deal fell below the Securities and Exchange Board of India’s 25% threshold for public offers. Other highlights of the Jet-Etihad deal included – (i) a US\$ 150 million investment by Etihad in Jet’s frequent flyer program; (ii) a US\$ 70 million purchase of Jet’s three slots at Heathrow under ‘sale and lease-back’ agreement; and (iii) co-operation on purchasing opportunities for fuel, spare parts, training and maintenance of aircraft.

The policy changes, which seemed to have been synchronized with what appeared to be an overnight Jet-Etihad strategic deal, predictably invited allegations that India’s national interest was being compromised in order to benefit a particular Indian carrier—in this case, Jet Airways. Given the airline industry’s almost oligopolistic nature, such insinuations are often presumed to be true. The presumption appeared all the more convincing since Etihad agreed to pay a 32% premium over the market-quoted price of Jet’s shares. Questions were raised as to why Etihad would buy into a debt-ridden company in the struggling Indian aviation sector? An inference was drawn that the Government might have engineered or set the stage for the Jet-Etihad deal by agreeing to policy changes beforehand in the form of ASA sweeteners. Given the incumbent Government unenviable record of facing multiple allegations of irregularities in ministerial policy making, the presumption of the government changing the regulations to pave the way for the Jet-Etihad deal got added to its rather bad report card. Since the Jet-Etihad strategic deal was in any case under the “approval route,” the entire proposal invariably had to come up before the Foreign Investment Promotion Board (FIPB) and the Cabinet Committee on Economic Affairs (CCEA) for approval.

In July 2013, FIPB approved the deal subject to certain conditions – (i) Jet shall seek FIPB’s approval

before making any changes in the Shareholders' Agreement with Etihad; (ii) all shareholder disputes under the Shareholders' Agreement shall be adjudicated under Indian laws; (iii) Jet Airways' Articles of Association shall be submitted for approval before the CCEA. It was also reported that prior to submission before the FIPB – (i) Etihad's representation on Jet's Board of Directors was to be reduced from three to two; and (ii) Mr. Naresh Goyal, Jet's chairman would have the right to deliver the "casting vote on any matter;" and (iii) an earlier proposal of shifting revenue management to Abu Dhabi was also dropped. This was purportedly done in deference to FIPB's wishes that it required details on who would control the management of Jet before arriving at any decision.

In October 2013, after studying the revised structure, SEBI also conveyed its *prima-facie* opinion that the deal would not trigger "change in control" provisions which absolved Etihad from making an open offer to public shareholders of Jet. However, SEBI has left it open to the Government to construe the implications of the revised Commercial Co-operation Agreement proposed by Jet and Etihad. It is notable that SEBI also advised Mr. Goyal to divest a 6% stake before allotting shares to Etihad, in the interest of corporate governance and to ensure well-dispersed public shareholding.

On October 4, 2013 the CCEA approved the Jet-Etihad deal, expressing satisfaction that Jet and Etihad had complied with regulations relating to "ownership and effective control" issues. On November 12, 2013, the Competition Commission of India (CCI) also approved the Jet-Etihad deal, albeit with a minority dissenting order, stating that the proposed combination was not likely to have appreciable adverse effect on competition in India. The CCI though made a significant observation that the governance structure envisaged in the Commercial Co-operation Agreement did establish "joint control" over Jet's operations and assets.

Meanwhile, simultaneously with the deal lurching forward before market regulators, the Supreme Court

also admitted a public interest litigation (PIL) and began hearings. The PIL was on alleged grounds that the ASA with the UAE was devised to facilitate only this deal and that it would put the national carrier, Air India to disadvantage. In October 2013, though the Supreme Court refused to grant an interim stay on the deal, it continued its hearings and issued notices to the Government and regulatory agencies.

It has been reported that recently the CCI has rejected Jet-Etihad's plea to rectify that part of CCI's order which observed that (i) with a 24% stake and right to nominate 2 directors, Etihad has "significant" ability to participate in management of Jet Airways; and (ii) Etihad has effective "joint control" over Jet. It is pertinent to note that such observations of the CCI appear at variance with SEBI's observations on "change in control." As a consequence, SEBI has also clarified its stance stating that if any other regulator (i.e., CCI) raises an issue on the deal, SEBI may also re-consider its order. Based on recent news reports, SEBI has already started its preliminary work for reopening the matter. The next roll of the turnstile took place as recently as December 2013, when the CCI imposed a monetary fine on Etihad for "consummating parts of the deal without CCI's approval." This relates to Jet's landing slots at Heathrow for US\$ 70 million under the sale and lease-back agreement.

While the Jet-Etihad saga continues, and time will tell how it influences the course of strategic tie-ups between international and Indian Carriers, the blemish on FDI reforms cannot be denied. The overnight opening of the India-UAE ASA just hours before the Jet-Etihad deal was announced, lends itself to a negative perception of how the aviation sector is managed in India.

Herb Kelleher's quote aptly describes the dilemma of the airlines industry. It is an industry that is intensely competitive, needs massive capital injections to survive because of excessively high elasticity with respect to fuel prices and the external business environment. Survival in India also means dealing with competitors who are seen as being able to benefit

from sovereign pacts that are concluded with high opacity to facilitate strategic tie-ups.

Vikas Kumar is a Partner with DH Law Associates, Advocates and Solicitors and advises clients on M&A, private equity and FDI issues. He can be reached at vikas@dhlawassociates.com



THE IMPACT OF DIRECT AND INDIRECT TAXES ON FOREIGN CARRIERS OPERATING IN INDIA

By Pawan Khatter and Jayanta Kalita

With increasing globalization and expanding markets, it is now common for domestic airlines in India to tie-up with international airlines. India is becoming an attractive aviation industry destination, given increasing domestic and international traffic, a rising addressable market and robust projected economic growth. The recent opening of this sector by allowing foreign airlines foreign direct investment (FDI) of upto 49% in Indian airlines has resulted in a considerable increase in activity in this space. Businesses world over are making long-term plans of investing and doing business in the India. The same is true of the Indian aviation industry.

According to the latest statistics released by Airport Authorities of India for fiscal year 2013, India is currently the ninth largest civil aviation market, handling 121 million domestic and 41 million international passengers. Today, more than 85 international airlines operate to India and five Indian carriers connect to over 40 countries. The Indian civil aviation market has only a tenth of the passenger traffic of United States even though only one per cent of the Indian population has so far opted for the skies as a medium of transportation.

A special report released by the International Air Transport Association in October 2012 states that if Indians begin to travel with the same frequency as Americans, the years ahead could see the Indian market boom beyond the two billion passengers per year mark. The growth potential of the Indian civil aviation market is clearly enormous.

However, the industry faces various challenges; foremost among them is the impact of taxes. There are several types of taxes (both direct and indirect) applicable on the aviation industry.

Taxes on Profits

The domestic tax laws of India provide for a deemed basis of taxation (as opposed to actual basis) where 5% of the amount received by a foreign carrier from passenger fares and freight receipts by way of air transport from any place in India shall be deemed income of such foreign carrier. International transportation has been regulated by agreements as a matter of international co-operation between countries permitting aircraft of other countries to fly in their respective jurisdictions on a basis of mutuality.

The Indian government has entered into double taxation avoidance agreements (DTAA) with various countries to provide bilateral relief to taxpayers between the country of residence and country of source of income. Where a specific provision has been made in a DTAA entered into by the Government of India with the Government of a foreign state, that provision shall prevail over the general provisions made in the domestic tax law. Article 8 of a typical DTAA provides for taxation of profit from the operation of aircraft in international traffic and grants the taxing rights to the country in which place of effective management of airline is situated i.e. the place of residence.

Ancillary Revenue

Foreign carriers earn revenues in relation to their international air traffic to and from India derived from ticket sales and cargo traffic. Also, a few foreign airlines, having significant international traffic to and from India have, over the years, established appropriate infrastructure in India for maintenance and repair of its aircraft. These airlines make certain recoveries from other international airlines that, from time to time, use the infrastructure facilities in India,

either because these airlines do not have similar resources or to augment their existing facilities.

These facilities are generally related to ground handling and engineering services (repairs, maintenance etc.) provided in pursuance of a reciprocal pooling arrangement envisaged by the International Airlines Technical Pool (IATP) which has been entered into by most airlines worldwide. These activities are ancillary, incidental and supplemental to the airline business of operating aircraft in international traffic to and from India. As member of the IATP, any foreign airline providing ancillary services in India to other IATP member airlines receives similar services from other airlines worldwide.

The issue arises, whether all income from operation of aircraft in international traffic, including income from ancillary, incidental and supplemental services such as provision of engineering and ground handling services under a pooling arrangement to IATP members are exempt from tax in India under Article 8 of the DTAA. This issue is unfortunately a subject matter of long standing dispute with the Indian revenue authorities, with contradictory decisions of tax courts in India. The matter is currently pending adjudication by the High Court of Delhi and has not yet reached finality.

Profits covered under Article 8 should consist in the first place of profits directly arising from transportation of passengers or cargo by airlines in international traffic. However, as international transport has evolved, air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic operations. The article also covers profits from activities which are not directly connected with the operation of the enterprise's aircraft in international traffic as long as they are ancillary to such operation.

Contemporary tax treaty interpretation is to include ancillary, auxiliary, closely related, supplementary and incidental activities, which is applied by taxing authorities in general.

VAT on Sale of Ticket – Taxation of Ticket Sales on International Travel

An *ad valorem* (fixed percentage on value) tax on sale of tickets for air travel of passengers is levied on the airline operator. Such a tax is internationally known as a ticket tax. Such taxes may be levied either as a VAT (Value Added Tax, which works on the principle of tax on value added in the supply chain) or GST (Goods & Service Tax, a comprehensive tax on supply of goods or services).

In India, a tax by the name of Service Tax is levied on airline operators providing services of passenger travel. Service Tax was initially levied in May 2006 on international air travel of passengers on an *ad valorem* basis (rates varying between 10% - 12% since 2006). This was later extended to domestic travel from July 2010, albeit at nominal fixed value rate per ticket. To date both international and domestic civil aviation attract Service Tax at an abated rate.

Levy of GST/VAT on international passenger travel is converse from that of India. Globally, the majority of the countries (including European nations, Australia and Canada) either exempt or levy VAT/GST on international passenger travel at zero rates. Many emerging markets like Argentina, China, Korea, South Africa etc. also do not levy VAT/GST on international travel. Thus, many countries have recognized the potential of civil aviation and taxing international air travel as zero rated so as to also avoid tax cascading (a cascading tax is a turnover tax applied at every stage in the supply chain without any deduction for the tax paid at earlier stages).

In 2012, the Ministry of Civil Aviation in India made a proposal to the Ministry of Finance for removal of Service Tax on air tickets on the ground that the policy change would result in economic benefits of ten times the revenue generated by the exchequer. The proposal has been considered to the extent that abatements have been granted to airline operators thus reducing the effective rate of Service Tax. However, the

need is for a complete waiver as was envisaged by the International Civil Aviation Organization (ICAO) so as not to tax international air transport services given that such services are provided outside the boundaries of any tax authority.

The Tax-On-Tax Conundrum

Levy of tax on a *ad valorem* basis creates issues regarding the valuation of services. A Service Tax has been sought to be levied by the revenue authorities on the total fare i.e., basic fare, surcharge as well as taxes and the fees component of the ticket. The Indian revenue authorities have been aggressively litigating with carriers demanding Service Tax on the taxes and fees portion of the ticket fare (i.e., departure and other trip charges) which are levied by the governments, government departments and airport authorities of other countries, clearly transcending jurisdictional boundaries. For example, the Indian revenue authorities are seeking to subject to service tax the Customs User Fee levied on arrival of passengers in the United States.

The airlines are contending that they have been designated by government authorities to collect such taxes and fees from the passengers for administrative convenience only. Such taxes and fees do not form part of the revenue of the airlines. Hence, levy of tax on such amounts is preposterous to say the least.

Tax-on-tax is technically known as the cascading effect which defeats the principle of value added basis of taxation. Moreover, the demand of Service Tax on tax-on-tax is *post facto* which literally means that the airline would not be in a position to collect it from the passengers and which, in all probability, may not have been accounted as a cost at the time of budgeting ticket fares.

Significant Taxes on Aviation Turbine Fuel (ATF)

Aviation fuel constitutes a staggering 50-60 per cent of the total operating cost of airlines in India. The Association of European Airlines (AEA) members

indicate that their fuel constitutes 33 per cent of operating cost.

The pricing and tax regime of the Union and State Governments in India have made ATF significantly more expensive compared to international standards. The pricing of ATF in India is based on international import parity prices. Excise duty is levied by the Central Government on such prices at 8 per cent. In addition, VAT is levied by State Governments which can range anywhere between 4-30 per cent (depending upon the State from where ATF is sold). The resultant incidence of tax on ATF could be in the range of 30 per cent (assuming a VAT rate of approximately 20 per cent). Thus, the price of ATF in India works out to be 60-70 per cent higher than international benchmarks.

The Government has accorded a lower rate of VAT of 5 per cent on the sale of ATF, but that is only applicable on ATF sold to aircraft having a maximum take-off mass of less than 40 tonnes. In effect, this concession is only available to smaller aircraft and turbo-props. The industry has been lobbying with the Ministry of Finance for extending this concessional rate of tax on supply of ATF to all aircraft, but has so far been unsuccessful.

Given that the India lacks a comprehensive indirect tax regime (the move towards a comprehensive GST regime has been sluggish), airlines do not have the ability to set off VAT on ATF against their service tax liability.

Even on international travel, the levy of certain taxes is clearly contradictory to the resolutions agreed under the Chicago Convention of 1944 (to which India is a signatory) which requires the signatories to exempt taxes/duties applicable on fuel and lubricants used in the aircraft of other signatory nations. Though the Ministry of Civil Aviation has issued notifications providing for such exemptions, we understand that taxes such as ATF are still levied by many States even on aircraft for international travel.

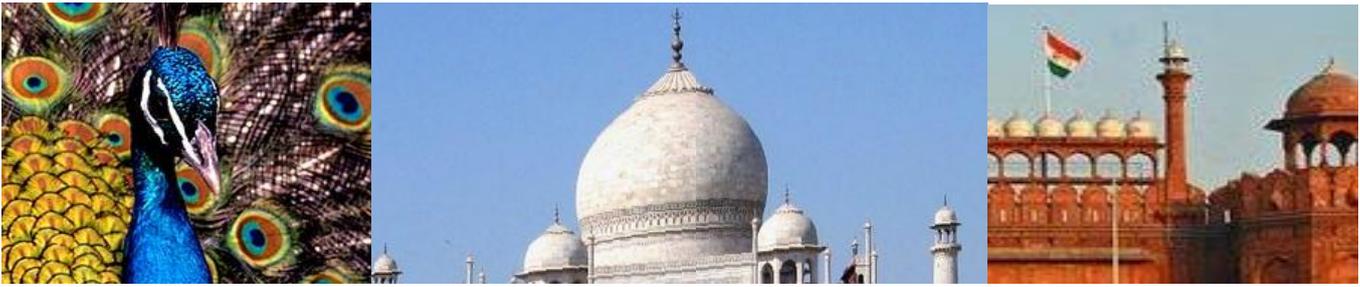
Other Tax Issues

There are various other tax issues plaguing the aviation industry. Some of these issues include application of a service tax on excess baggage charges and import cargo, and application of VAT or service tax on on-board sale of food and other goods.

Taxes are levied on virtually all facets of the aviation sector. Given the growth potential of the

Indian aviation market, particularly international travel, the Government should view this sector as a revenue generator and rationalize the tax regime to provide a much needed impetus to this industry.

Pawan Khatter and Jayanta Kalita are Senior Tax Professionals at EY India. They can be reached at atpawan.khatter@in.ey.com and jayanta.kalita@in.ey.com.



TAX TURBULENCE FOR INDIAN AVIATION

By Vikas Srivastava and Sanjeev Sachdeva

The aviation and aircraft maintenance industry encapsulates the overall operation, management and upkeep of aircraft. Globally, there has been a gradual shift in the industry, with airlines acquiring and leasing aircraft, and outsource Maintenance, Repair and Overhaul (MRO) services to third-parties. In India, due to liberalisation policies of the Government over the last two decades, tremendous growth has been observed in the civil aviation sector. Many private airlines and corporations in India today are operating with high operating revenues. Given this, the sheer numbers and players involved result in magnification of the impact of even small changes in tax laws, which can change at a rate of more than once year!

The Impact of the Indirect Tax Regime on Civil Aviation

The indirect tax regime in India is characterised by multiple levies, which are administered by governmental agencies at three levels (central, state and local). Principal indirect taxes include service tax on provision of services, customs duty on import of goods, excise duty on manufacture of goods, and Value Added Tax (VAT)/Central Sales Tax (CST) on sale of goods. Service tax, customs duty and excise duty are administered by the Central Government, while VAT and CST are administered by the State Governments. A Research & Development (R&D) cess (tax) is levied on import of technology under foreign collaboration agreements.

The aviation industry encompasses a whole gamut of activities carried out by airlines, airports and agents. The main activities carried out by airlines in India—which include passenger and goods transportation by

air, ground handling services, repair and maintenance services—are primarily subject to service tax.

The aviation sector in India comprises two broad segments, namely, civil aviation and defence. Customs duty exemptions are available for goods imported in relation to defence, subject to certain conditions. As regards civil aviation, indirect tax incentives are available for R&D, and for entities located in Special Economic Zones (SEZ). (There are currently over 140 SEZs in India with another 630 approved for future development.) The tax incentives for SEZ units have the potential to make India a preferred destination for outsourcing manufacturing and services, particularly since there is no attendant export obligation. The only obligation is to achieve a positive net foreign exchange inflow over a cumulative period of five years. Thus, there is great potential for development of aerospace and MRO units in SEZs.

Prior to July 2012, the service tax regime in India was based on a “positive list” of specified services, which attracted service tax. Since July 2012, the service tax regime has been based on a “negative list,” under which all services attract service tax, other than those which are specified in a “negative list” and those which are specifically exempted from the levy. With respect to services provided by a service provider located outside India, the service recipient in India is liable to pay service tax to the government, under the “reverse charge” mechanism.

Thus, all services provided by airlines for a consideration are now subject to service tax in India, except services covered under the negative list or exempted under an exemption notification. Goods transportation services provided by air from outside India are covered in the negative list of services, and are hence not liable to service tax. In the case of

passenger air transportation services (domestic and international routes), service tax is presently applicable at the rate of 12.36 percent of the consideration. An abatement of 60 percent is provided for, subject to the condition that no input tax credit is taken on inputs and capital goods.

Tax Issues Relating to Aviation Turbine Fuel

One major problem is in terms of input tax credits, since cross-utilization of credits between service tax and VAT is not permitted. As a result, VAT on goods procured by the airline industry is a cost which is often a dead loss, since it cannot be offset against service tax payable by the airlines on their output services. Another long-standing complaint of the aviation sector is the non-admissibility of input tax credit (Central VAT [CENVAT] credit) on Aviation Turbine Fuel (ATF).

Airlines in India incur high costs on domestic procurement of ATF (40-to-50 percent of operating costs, by some estimates). The cost of ATF for domestic operators is 60-to-70 percent higher than international benchmarks. ATF is subject to multiple taxes, including customs duties (basic duty, as well as additional duty equivalent to excise duty leviable on domestic manufacture) and VAT, and other levies such as throughput fees charged by airport operators and marketing margins charged by oil marketing companies (OMCs) which are typically owned by the Central Government. The rate of VAT levied on ATF for domestic air carriers is quite high, averaging 23 percent across States according to the Federation of Indian Airlines. The high rate of VAT levied by most States on ATF results in escalating the overall procurement costs of airlines, the burden of which has to be passed on to passengers. An added complication is the fact that VAT rates on ATF vary between States, ranging from 20 percent to as high as 30 percent on the one hand, and from 5 to 12 percent on the other hand. As a fall-out of varying VAT rates, airplanes often have to carry extra fuel, which results in additional costs by way of increased fuel consumption.

The aviation industry has been trying for many years to persuade the government to grant the status of “declared goods” to ATF, which would ensure a uniform VAT rate of 4 percent across the country. Some States have recently reduced the rate of VAT on ATF, as an incentive to bring down the burden of VAT on airlines and to encourage them to frequently fly to that State for refuelling, thereby increasing air connectivity. Earlier, only certain OMCs were allowed to import ATF. The Central Government has recently allowed Indian carriers to directly import ATF as actual users, which would enable them to avoid the burden of VAT on the domestic sale of ATF by OMCs to the carriers. However, to take advantage of this benefit carriers will need to incur investment and operational costs in terms of storage and logistics infrastructure. To reduce the burden of taxes on ATF, the Central Government has also reduced the effective customs duty chargeable on import of ATF.

Taxability of MRO Services

The surge in demand for aviation services in recent years has also fuelled demand for support services, including ground-handling, and MRO services. These services play a critical role in contributing to the efficiency standards of the sector. The Government has recognised the potential for India to establish itself as a hub for MRO services, which would reduce operating costs for domestic carriers and enable other carriers in the vicinity to fly to India for MRO of aircrafts. India has certain advantages for establishment of MRO services, in terms of expertise in design and development, and availability of a low-cost pool of trained engineers and technical personnel. To incentivise MRO operations in India, customs duty exemption has been provided on import of aircraft parts and testing equipment for maintenance, repair and overhauling of aircraft used for operating scheduled and non-scheduled passenger air transport services, scheduled air cargo services, and charter services. However, the customs duty exemption is not available on parts and testing equipment imported for use on aircraft which do not operate in India i.e. “non-India operators.” Further, the exemption is not

available for import of consumables such as lubricants, oils, grease and similar goods.

The competitiveness of the MRO sector in India is adversely impacted by service tax, which is levied on the provision of services. The Indian aviation sector contends that neighbouring countries (including Middle Eastern and South East Asian countries and Sri Lanka) do not levy service tax on similar services. Another complaint is the lack of clarity regarding “export of services,” as MRO services provided to overseas carriers are not considered by the tax authorities as “exported” from India given that these are performed in India.

Goods and Services Tax

In many countries, international passenger travel is exempt from levy of Goods and Services Tax (GST) / VAT, while domestic travel is taxed. However, in India service tax is levied on international as well as domestic routes, thereby making airlines a highly taxed means of transportation. The aviation sector has been petitioning for reduction of indirect tax rates, rationalisation of the indirect tax structure, relief in the service tax burden, and the smooth flow of input tax credits across all indirect taxes, to catalyse growth of the aviation sector. Industry bodies often point out that the indirect tax structure acts as a disincentive for final assembly in India.

The proposed introduction of GST in India presents a great opportunity to undo the inequitable and onerous burden on taxation on the airline industry. Under the GST regime, it is proposed that there will be a single levy on goods and services, consisting of a Central and a State component. It is hoped that appropriate provisions are made for allowing GST paid on goods to be set-off against GST applicable on provision of services, and vice versa. The cross-utilization of credits across the principal indirect taxes will present an opportunity to airlines to mitigate the effects of cascading of taxes. If the government chooses to follow international GST practices, international passenger transportation would be zero-rated. This

would mean zero-rating of any passenger transportation service that begins or ends at a point outside India, including round-trip international transportation services. Such a move would directly benefit passengers and the airline industry, and will generate indirect benefits for the economy.

Direct Tax Regime

Unlike indirect taxes, income-taxes are levied based on the residential status of the taxpayer. Companies resident in India, whether owned by Indians or by non-residents, are taxed on their worldwide income. Non-resident companies, on the other hand, are taxed only on the Indian-sourced income. A company is deemed to be resident in India if it is incorporated in India or if its control and management is wholly situated in India.

If there is a double taxation avoidance agreement (tax treaty) between India and the country of residence of the taxpayer, the provisions of the domestic tax law or the tax treaty, whichever is more beneficial will apply. In order to be eligible for tax treaty benefits, the non-resident taxpayer will be required to obtain a valid tax residency certificate (TRC) with prescribed particulars issued by the Revenue authorities of the country of residence of the non-resident taxpayer.

While resident companies are subject to a basic corporate tax rate of 30 percent, non-resident companies are subject to a basic corporate tax rate of 40 percent. In addition, a surcharge and education cess applies to the basic corporate tax rate taking the effective corporate tax rate to 43.26 percent for foreign companies and 33.99 percent for Indian companies.

India is in the process of implementing anti-avoidance measures called General Anti-Avoidance Rules (GAAR). GAAR provisions were earlier introduced in the domestic tax law in 2012 to deal with aggressive tax planning and to codify the doctrine of “substance over form;” however, its implementation date was postponed absent sufficient clarity and these are now made effective from April 1, 2015.

India is also in the process of revamping the existing tax legislation with a more reformed Direct Tax Code. However, there is no clarity as yet on the date of its enactment.

Foreign Airlines Operating in India

Non-resident entities engaged in the business of operation of aircraft in India are taxed on a presumptive basis. A specified tax rate of 5 percent is applied to (a) amounts received by non-residents (whether in India or outside) for the carriage of passengers, livestock, mail or goods from any place in India; and (b) amounts received in India by non-residents for carriage of passengers, livestock, mail or goods from any place outside India.

Most tax treaties provide that profits derived by an entity from the operation of aircraft in international traffic are taxable only in the country in which the place of effective management of the enterprise is situated. Given this and based on the provisions contained in the applicable tax treaty, profits derived by foreign airline companies from operating aircraft in India would not be taxable in India, provided the effective place of management of such airlines is located outside India. Depending upon the facts and the circumstances of each case, foreign airline companies may approach the Indian Revenue authorities to seek a specific dispensation to claim this exemption. Such dispensation may also be utilized by the foreign airline companies for receiving payments without a withholding tax.

Aircraft Lease

In the current tough times for the Indian airline industry, with increasing fuel costs, buying an aircraft may not necessarily be a preferable option considering the huge cash outlays, delivery time involved and rapid technological improvements. Leasing an aircraft therefore has emerged as a viable solution as it helps increase the fleet size to fulfill growing demand and is less capital intensive.

Generally, there are two types of aircraft lease: (a) Dry Lease, and (b) Wet Lease. A Dry Lease entails a plain vanilla aircraft lease, without any additional service components; whereas a Wet Lease means leasing the aircraft along with insurance, crew, maintenance, etc. The Dry Lease appears to be the preferred lease method in India.

Tax considerations vary depending upon the type of lease. The majority of lease contracts with foreign airlines are "net of tax" arrangements, which means that withholding tax (if any) on lease payments is to be borne by the Indian company taking the aircraft on lease. Given this, the tax consideration and the attached costs assume significant importance.

The domestic tax law used to provide tax exemption to foreign companies on lease payments made by Indian companies. The exemption applied to agreements entered into on or before March 31, 2007, subject to obtaining approval of the Central Government. Payments under any lease agreement entered into after March 31, 2007, are not eligible for such exemption under the domestic tax law. Absent tax exemption, payment of such lease rental by an Indian company to foreign company may qualify as "royalty" as payment for use of or the right to use any industrial, commercial or scientific equipment. Such royalty income is taxable at the current tax rate of 27.0375 percent (inclusive of applicable surcharge and education cess) on a gross basis; this higher rate is made effective from April 1, 2013. In a situation where the lease agreement provides that the tax is to be borne by the Indian company, this could significantly increase the cost for the Indian company leasing the aircraft. The tax rate could however be lowered depending upon the rate prescribed in the relevant tax treaty (if any) where the foreign company is resident.

Where the relevant tax treaty does not contain a clause dealing with "royalty" income or does not cover lease of aircraft within the scope of royalty income, taxability would need to be examined based on whether such income could qualify as "Business

Income” or “other income” under the respective tax treaty.

Typically, Business Income of a foreign entity can be taxed in India, if the foreign company is construed to have a Permanent Establishment (PE) in India.

The existence of a PE of the foreign lessor in India would largely depend on the nature of activities carried out by such foreign companies in India. Typically in a Dry Lease scenario, where the lessee in India will remain responsible for all aspects of operation, maintenance, insurance and inspection of the aircrafts, mere leasing of the aircraft should not create any PE exposure to the foreign lessor companies. This issue has been tested in the Indian courts, where the Tax Tribunal and Courts have held that the mere presence of equipment (aircraft) in India should not create PE of the foreign company in India. However, certain tax treaties that India has entered into even provide that the presence of substantial equipment itself can be translated into a PE of the foreign lessor in India.

On the other hand, in a Wet Lease scenario, where along with aircraft, the foreign lessor also takes responsibility of insurance, crew, maintenance, etc., there may be a potential PE exposure in India for the foreign lessor company, in which case income would be taxed as Business Income, taxable at the rate of 43.26 percent on a net basis.

While the decision to lease an aircraft is purely commercial, the attached tax cost needs to be considered when leasing from a foreign jurisdiction. An unplanned transaction can result in increased tax cost.

Maintenance, Repair and Operations Services

Costs incurred by airline companies for MRO services being rendered by MRO operators in India, either by stand-alone foreign companies or even joint ventures (JVs) involving big foreign companies, also forms a significant chunk of the overall cost base. Any withholding tax on payment for such MRO services not

only increases the burden of compliance but could potentially create cash flow constraints for the operators working on thin margins against stiff competition.

It is currently debatable whether the payment for MRO services qualifies as “Fees for Technical Services” (FTS) subject to a withholding tax. Characterization of such payment would significantly depend on the nature of the services and the definition contained in the applicable tax treaty where the MRO operator is a foreign company.

Indian courts have generally treated payment for basic services as not qualifying as FTS, while payment for special technical services forming part of MRO services do qualify for FTS, and hence are subject to withholding tax obligations.

Landing and Parking Charges

Also unsettled is the questions of whether charges paid by foreign airlines on landing and parking charges to the Airport Authorities of India represent “rent” payments subject to a withholding tax. The present rate for Indian tax residents is 10 percent.

The Airports Authority provides various facilities to aircraft for a fee. The services provided typically include charges for landing and take-off facilities, taxiways with necessary draining and fencing of airport, parking route, navigation and terminal navigation. These charges are based on a weight formula and maximum permissible take-off weight and length of the stay of the aircraft.

The airlines contend that such payments, being contractual payments, should, at best, be subject to a withholding tax at the rate of 2 percent. The Indian Revenue authorities, however, have taken the view that such payment are not mere contractual payments but “rent” and should be subject to a withholding tax at the rate of 10 percent.

There are contradictory rulings on this point from different courts—the Madras High Court, in an action brought by Singapore Airlines, has ruled landing and parking fees to be a contractual payment, while the Delhi High Court, in a case brought by United Airlines has held it to be rent. The issue should attain finality in a much followed case brought by Japan Airlines pending before the Supreme Court of India.

Withholding Tax

The domestic tax law prescribes that any payment to non-residents, which is chargeable to tax in India, should be subject to a withholding tax at appropriate rates. Certain prescribed payments to residents, are also required to be subject to a withholding tax. Payment streams between foreign and Indian companies, such as for lease of aircraft, MRO services, ground handling charges, etc, need to be thoroughly examined to determine appropriate withholding tax.

The withholding tax obligations under the domestic law of India is quite onerous, and failure to withhold appropriate tax attracts various penal consequences, such as disallowance of expenses, penal interest at the prescribed rate payable until the taxes are ultimately deposited, and penalty equivalent to the amount of tax required to be withheld. Considering this, the payor typically adopts a conservative approach and applies withholding tax, unless the tax position is very clear that the underlying payment is not chargeable to tax.

The Need for Clarity

Aviation and aircraft maintenance is a burgeoning industry in India, and holds great promise for growth. The most prominent example in this regard is the MRO sector, which the Indian Government has been attempting to incentivize. However, the airline industry continues to be saddled with many issues, particularly from a tax perspective, which are inhibiting its development and adversely impacting its competitiveness.

Greater clarity and certainty surrounding tax issues and relief from multiple levies of taxes will provide adequate impetus to the aviation industry to realize its true potential.

Vikas Srivastava is a Senior Partner at Luthra&Luthra Law Offices. He heads the Direct Tax Practice of the Firm, and has over 29 years of experience in Corporate Taxation, both domestic as well as international tax. He specializes in international taxation and transfer pricing. Vikas has represented several large multinationals and corporates before the tax authorities and courts for complex corporate tax and transfer pricing matters. He has advised several multinationals on their cross border group structuring and entry/exit strategies. He has particular expertise in the impact of tax treaties, inbound & outbound investments, transfer pricing regulations, corporate and expatriate taxation. Clients have been from diverse fields including auto components, aviation, banking, consumer goods, construction, defence, food, hospitality, information technology, infrastructure, insurance, luxury goods, media, oil and gas, pharmaceuticals, power, private equity, real estate, retail, steel, telecom and travel. He also has significant experience and expertise in the various facets of conceptualization, structuring, constitution and formulation of entry and exit strategies for private equity funds and venture capital funds. Vikas can be reached at vsrivastava@luthra.com.

Sanjeev Sachdeva is a Partner at Luthra & Luthra Law Offices. He specializes in Indirect Taxes, Foreign Trade Laws and the Foreign Exchange Management Act and has over 30 years of relevant experience. He has been a member of the Indian Revenue Service, and was conferred with the Presidential Award of Appreciation Certificate for "Specially Distinguished Record of Service" on the occasion of Republic Day, 1999. Sanjeev has extensive experience in advising clients across industry sectors ranging from hospitality and hospitals to airlines, infra-structure, oil & gas, retail and BPO. He also regularly appears before departmental adjudicating authorities, the Customs, Excise and Service Tax Appellate Tribunal (CESTAT), FEMA authorities, Settlement Commission and the Authority on Advance Rulings. Sanjeev can be reached at ssachdeva@luthra.com.



CROSS-BORDER AIRCRAFT LEASING: AN INDIAN TAX PERSPECTIVE

By Aseem Chawla

When the Government of India opened India's skies by deregulating the aviation sector, India was widely expected to become a dominant global player in aviation by 2020. This sector, however, which was once considered a sunrise industry, is now viewed with circumspection because of continuing inadequate infrastructure, escalating fuel prices and uncertain tax policies.

As an alternative to outright purchase of aircraft (which has the potential of adversely affecting a balance sheet), leasing has emerged as a preferred mode of meeting the requirements of increasing fleet size. The option of leasing not only leverages on operational efficiency, but also saves considerable amounts of outflows for the cash-strapped aviation sector.

The aviation industry usually adopts two mechanisms of leasing, i.e. the wet lease and the dry lease. Under a wet lease the aircraft is provided on lease along with complete crew, maintenance and insurance. Under a dry lease (also known as a "bareboat arrangement"), aircraft are leased without any accompaniments.

Taxation of cross border leasing of civil aircraft, from a direct as well as indirect tax perspective has been a contentious affair and has multi-fold implications. This article touches upon certain indirect tax and direct tax aspects of cross border leasing and highlights matters currently being deliberated between industry stakeholders and the tax authorities.

Value Added Tax Considerations

India has not yet adopted the Goods & Service Tax Model, which is otherwise prevalent across the globe.

India's indirect tax regime is based on a Federal system wherein, goods are subject to a state levy that is Value Added Tax (VAT) is levied on transactions involving sale of goods. Services are subject to service tax which is a Central (Federal) levy. Due to the existing federal tax system, equipment leasing in India has been extremely litigious because it has been subject to double taxation in the form of VAT and service tax.

An equipment leasing transaction is considered as a sale of goods under the VAT laws and Constitution of India, if the right to use the equipment has been transferred to the lessee. However, case law and amendments of service tax laws carve out an exception under which a transaction is characterised as a "service" subject to service tax if the right to use has been transferred without control, custody and possession of the equipment.

The tax structure in India also provides that movement of goods from one state to another, pursuant to a contract of sale, or the transfer of the right to use of goods (i.e., a lease), are not subject to states' sales tax laws and shall be taxable only under the Central Sales Tax Act, 1956, which is a federal statute.

Therefore, when the right to use an aircraft is transferred from one state to another it is characterised as an inter-state transaction. On the other hand, when there is a transfer of the right to use an aircraft outside the taxable territories of India, or vice versa, the transaction is characterised as an import/export. Given, however that Article 286(1) of the Constitution of India prohibits imposition of Central Sales Tax (CST) on the import and export of goods, it can be argued that airline leases to or from parties in another country fall outside the ambit of the CST. There is a school of thought that holds that leases qualify as import/export

only if the agreement for transfer of right to use has been executed outside India. In the absence of any authoritative judicial decisions on this aspect and given high taxes and litigation costs, the aviation industry has adopted a practice of executing such contracts outside India, as a matter of abundant caution.

Service Tax Considerations

At the outset, imposition of service tax may occur where aircraft are leased without transfer of the corresponding right to use, i.e., where aircraft are leased without transfer of effective control, custody and possession.

Under the new service tax regime effective July 2012, service transactions are exigible (leviable) to service tax only if the place of provision of services is in India. In cases of service transactions, where the duration of the lease of an aircraft to be used as a means of transport does not exceed a month, the location of the service provider is considered to be the "place of provision of service." Conversely, where the duration of the lease of an aircraft to be used as a means of transport exceeds a month, or where the aircraft is not used as a means of transport, the location of the recipient of the service shall be regarded as the "place of provision of service."

To illustrate this legal proposition, where the lessor of an aircraft situated outside India provides the aircraft on lease to the lessee located in India for a period less than one month, for the purpose of use as means of transport, the place of lessor i.e., a country outside India, is regarded as the "place of provision" and accordingly, imposition of service tax would not arise. However, where the aircraft is being leased for a period more than one month or is being leased for purpose other than a means of transport, then the place of provision of service would be the location of lessee, i.e., India, and hence the provisions of the service tax law would be applicable.

Customs Laws

Broadly speaking, import of aircraft is subject to customs duty at the applicable rate. However, exemptions in the applicable rate of tax have been

issued from time to time by the Central Board of Excise and Customs (India's highest indirect tax administrative body [CBEC]), in certain specified situations, such as:

- (i) where the aircraft is imported by an operator or on behalf of an operator, for operating scheduled air transport service or scheduled air cargo service; or
- (ii) where the aircraft is imported by the Aero Club of India, New Delhi or a flying training institute approved by the competent authority, for imparting training; or
- (iii) where the aircraft is imported by an operator who has been granted approval by the competent authority in the Ministry of Civil Aviation to import aircraft for providing non-scheduled (passenger) services or non-scheduled (charter) services.

Under these scenarios there is an exemption from differential customs duty or a complete exemption depending upon the applicable scenario. Despite this, the procedural aspects and clearance formalities for aircraft are rather elaborate. The importer is required to seek various approvals from Ministry of Civil Aviation, thereby, protracting the entire process of customs clearance.

Direct Tax Considerations

Cross border leasing of aircraft also enjoys a special exemption under Section 10(15A) of the Income Tax Act, 1961 (ITA). However, a sunset clause was introduced by the Finance Act, 2005, to provide that the exemption shall not be available for agreements entered after April 1, 2007.

In the aftermath of the withdrawal of the exemption, direct tax is largely governed by the ITA or bilateral tax treaties entered into by India and various countries. The extent to which a direct tax liability arises depends on the nature of the lease agreement. The foremost consideration is whether a non-resident lessor has a taxable presence in India by way of a Permanent Establishment (PE) as defined by Article 5 of those tax treaties. Where a PE is found to exist under Article 5, the profits that are attributable to such PE are chargeable to tax in India as defined in Article 7 (business profits).

Generally speaking, mere leasing of an aircraft which is located in India ought not to result in finding the existence of a PE. The Organisation for Economic Development and Cooperation has expressly stated that where an enterprise leases equipment in another contracting state without maintaining a fixed place of business in that other state, the leased equipment shall not constitute a PE in that other state. This should also be so where the lessor supplies personnel to operate the equipment, as long as its responsibility is limited solely to the operation and maintenance of the equipment under the direction, control and responsibility of the lessee.

A departure from this general principle is contained in the India-Australia tax treaty, the peculiar provisions of which stipulate that presence of equipment in the other state may lead to a finding of the existence of a PE in that other state. A detailed examination of the facts of each case is essential to evaluate whether a PE will be found to exist on the basis of leasing activities.

There are other considerations regarding the characterisation of lease income. Depending on the nature of the lease arrangement, i.e., whether the lease is an operating lease or finance lease, the lease rentals accruing to the lessor may also be characterised as “royalty” or “interest.”

The definition of royalty under the ITA and certain tax treaties, includes consideration for the use or right to use any commercial, scientific and industrial equipment. Aircraft do arguably fall within this category of equipment (although the equally opposite argument is also made) and therefore, the corresponding lease rentals may be characterised as royalty. However, certain tax treaties which India has, notably with Ireland and Singapore, have explicitly excluded aircraft from the scope of this provision. While under the ITA royalty attracts a withholding tax rate of 25 percent (subject to surcharges where income exceeds INR 10 million to INR 1 billion), the tax payer may be entitled to the beneficial provisions of the tax treaty which requires a tax ranging from 10-to-20 percent.

The characterisation of lease rentals as royalty may be appropriate only where the lease arrangement is of the nature of an operating lease. Moreover, it is essential that the lessor be in “control” and “possession” of the aircraft, which is usual for a dry lease.

In contrast, a finance lease arrangement has certain characteristics of a loan for purchase of an asset, rather than mere use of an asset. The consideration in a finance lease comprises the selling price along with an embedded interest component. Under the ITA, this interest element is taxable at the rate of 20 percent (subject to the same surcharge as a royalty). However, the tax treaties entered into by India do prescribe a beneficial rate of tax for interest, which ranges from 10-to-15 percent.

Most of the tax treaties entered into by India incorporate a separate provision (Article 8) on profits from shipping and air transport. Although, in broader terms, this Article deals with allocation of taxing rights on profits from operations of ships and aircraft in international traffic, certain tax treaties, also include within the ambit of this provision, rental of ships and aircraft. For instance, under the tax treaty with Ireland, profits derived by an enterprise of a contracting state from rentals of aircraft are taxable “only” in such country.

Another aspect is the entitlement tax depreciation on leased aircrafts. The issue of eligibility of tax depreciation is often contentious, especially with finance lease arrangements. However, the Supreme Court of India has held that the claim of depreciation in the case of a finance lease lies with the lessor, because the lessor fulfils the twin test of “ownership” and “usage for the purpose of business.”

The debate is far from settled. First, the Direct Tax Code, 2010 (which will replace the ITA but whose effective date has not yet been announced), grants tax depreciation to the lessee, rather than the lessor. Second, the Central Board of Direct Taxes— the apex direct tax administrative body—recently rolled out draft “Tax Accounting Standards” (TAS) and invited public comment. Among other things the draft TAS provides that in a finance lease transaction, the lessor shall be eligible to receive the benefit of tax

depreciation. It remains to be seen whether these draft provisions will withstand future judicial scrutiny. Transactions involving the sale and lease of fixed assets have always been viewed with circumspection.

Lease Versus Purchase

In light of the prevailing legal, tax and regulatory environment in India and the recent headwinds being faced by the aviation industry, the efficacy of importing aircraft is a matter of doubt. This is especially due to the fact that outright importing of aircraft does have a considerable impact on the financial position and liquidity of an enterprise. However, given the lack of clarity surrounding the tax treatment of transactions involving cross border leasing of aircraft—including consequential tax and litigation costs—the cost/benefit of a leasing transaction has to some extent withered away.

Aseem Chawla is the founding partner of MPC Legal in New Delhi and leads the firm's tax practice group. He is currently Vice Chair of India Committee of ABA Section of International Law & is Co-editor of India Law News. He can be reached at aseem.chawla@mpclegal.in. The author wishes to acknowledge the contributions of Anuj Mathur and Shashank Goel, senior associates in the tax practice group at MPC Legal.



A NEXT GENERATION REGIONAL TURBOPROP TRANSPORT: A NATIONAL AEROSPACE PROJECT FOR INDIA

By Robert S. Metzger

A third "U.S.-India Aviation Summit" was held in October 2013 in Washington, D.C. India sent a distinguished delegation, led by Ajit Singh, Minister of Civil Aviation, Arun Mishra, Director General of Civil Aviation, Y.S. Bave, Chairman of the Airports Economic Regulatory Authority of India and V.P. Agrawal, Chairman of the Airports Authority of India. The U.S. responded with Cabinet officers from the Departments of Transportation and of Commerce, and the heads of the Federal Aviation Administration and the Transportation Security Administration.

This impressive gathering spoke to the enormous promise as well as the daunting challenges of civil aviation in India. India is seen as a huge untapped market for both domestic and international air travel, as well as for cargo and private aviation. Many forecasts anticipate continued growth in civil air traffic and expected demand for many hundreds of new aircraft worth tens of billions of dollars. Also recognized are the serious restraints on India's aviation infrastructure. There are not enough airports and not enough carrier capacity to service growing demand for air travel to non-metro, "Tier II" and "Tier III" cities.

Even if one submits to optimism, and postulates the achievement of new airports and improved infrastructure, how are domestic carriers to add necessary capacity tailored for these emerging markets? How can India participate in the supply of the hundreds of new airplanes and in maintenance and support of its growing domestic fleet?

Today there is neither a coherent nor a realistic national program to answer either of these multi-billion dollar questions. Yet there is so much at stake. A commercially viable domestic aviation industry can offer long-term technical and manufacturing

employment for thousands. If India can contribute to the supply chain for the new aircraft its carriers will acquire in coming years, it will help India to manage balance of trade and current account deficit risks and promote national economic growth.

Viewing Government pronouncements over recent years, many airplane initiatives have been touted. Few have made real progress. Among this field, however, one prospect shines with opportunity.

A decade ago, Government sources announced intent to develop the "RTA-70," a Regional Transport Aircraft. Then, it was to be powered by turboprop engines, designed by the National Aerospace Laboratory with Hindustan Aeronautics Limited (HAL) envisioned for the production role. As of now, it is only a "paper airplane."

In December 2006, HAL announced a \$700 million joint venture with a Russian company to manufacture a Multi-Role Transport Aircraft (MRTA). Intended primarily for military purposes, the MRTA was to be jet-powered, carry 18-20 tons of payload or 100+ soldiers, and have a range approaching 3,000 miles. A "framework" agreement reportedly was signed in October 2012 between HAL and the Russian partner. Supposedly, 150 designers are working on the plane's design. A first flight in 2017 has been promised. But seasoned observers of aerospace in India know to limit trust to what is verified by observation and demonstration. Evidence of actual progress on the MRTA is scant. In any case, it never was realistic to propose to develop a "heavy" military transport aircraft, using advanced technology, for \$700 million. Embraer is reported to expect to spend nearly \$2.5 billion to complete development of its KC-390 military transport. Moreover, if the MRTA aircraft somehow were brought to market, it would compete against

established alternatives, such as the Lockheed Martin C-130J, the Airbus A-400M and Embraer's KC-390.

Another collaboration with Russia also figures into the equation. India has announced a partnership with Russia to share design, development and production of a Fifth Generation Fighter Aircraft (FGFA). If this project proceeds, its forecast cost of \$35 billion, for 200 fighters, would be much greater than the \$15+ billion that has been publicly identified as the price India has agreed to pay Dassault to buy 126 Rafale fourth generation "medium" fighters.

India announced the award to Dassault in January 2012 but the parties have yet to agree upon the commercial terms of the deal. The problems may be more than contractual. One question is whether India has sufficient funds, given the slowing economy and adverse effects of the rupee's decline in value. Another is the present sufficiency of India's aerospace industrial base. India has demanded that Dassault satisfy a huge "offset" requirement set at 50% of the Rafale's purchase value. Questions have been raised whether there is enough relevant and competent indigenous industrial capacity for Dassault to meet this obligation. Reportedly, Dassault and HAL have been unable to reach an understanding on "workshare" division.

Last summer, the Ministry of Defence put out a \$3 billion tender to replace 56 aging Avro transport aircraft, inviting eight foreign airframe makers to propose partnerships with the Indian private sector. The first 16 aircraft would be purchased off-the-shelf, while the remaining 40 would be manufactured in India.

But this solicitation has proven controversial. The invited foreign sources may decline to participate because the quantities are too small and co-production in India, on the terms required, may not be realistic. Moreover, Minister of Heavy Industry Praful Patel has openly questioned the exclusion of the PSUs, suggesting a political push to move the project to HAL. While it is only public sector unit possessing the relevant competencies, other Government officials have conceded HAL's order book is full. As a matter of history, HAL has had trouble finishing and fielding aircraft. Not until late December 2013 was the Indian Air Force able to induct the Tejas Light Combat Aircraft

into operational service – nearly 30 years after program inception.

In July 2012, the Prime Minister's office announced a commitment of \$2 billion for the development of a new Regional Transport Aircraft (RTA), to be designed and built in India. It would carry 70-90 passengers. Should the RTA proceed as a jet-powered aircraft, it will find itself squarely in a very crowded market in which competition is presented by Bombardier (Canada), Embraer (Brazil), Comac (China), Mitsubishi (Japan), and Sukhoi (Russia). As a jet, the RTA will have no commercial credibility, if only because of the surfeit of competition. For India's specific needs, it has limited utility, since a jet is most unlikely to be capable of operation from short runways as needed to work routes to India's under-served cities.

Yet – if properly executed – the RTA holds great promise. As a national initiative, India should champion a long-term program to design, develop, build and support a civil aircraft focused on India's particular transport needs. Such an aircraft need not fly fast, but it must be able to operate economically on routes under 1,000 km and from unimproved airfields with short runways. This points to a next generation turboprop-powered transport aircraft.

Turboprops are undergoing something of a renaissance elsewhere in the world, largely as a function of continuing high prices for aviation fuel that reward the lower cost of operation (versus a jet) of a turboprop. Indian carriers, the bulk of whom are "low cost carriers" operating with thin margins, no doubt share the motivation to employ next generation aircraft that are miserly in fuel use, as India has among the highest jet fuel costs in the world. Today, the fuel used for turboprops enjoys a favorable advantage under national and State tax regimes. And turboprops are comparatively miserly in the use of fuel.

But the dominant reason to look to a next generation turboprop is to answer the infrastructure problem. However positive the Government's intentions, it will take many years to add airports and improve infrastructure. And the costs will be great. India has announced a national imperative to improve air service beyond the key metro areas to provide more connectivity to Tier II and Tier III cities. A modern

turboprop does a better job to answer this demand than conventional jet transports. With a suitably optimized design, this aircraft type can operate from shorter runways with less improved ground infrastructure, and can handle high altitude destinations well. This comports with the Government's new plans to expand airport connectivity by emphasizing, initially, new airports for lesser served communities that have runways too short for typical jets. The lower operating costs and potentially reduced maintenance demands for turboprops also can translate into economies that will translate into lower ticket prices as budget carriers will seek to introduce air travel to more passengers.

Today, the Government is contemplating various regulatory and subsidy schemes to compel or encourage domestic air carriers to increase service to the Tier II and III cities. These have their place, but are not long-term solutions, because such policies do not answer airport infrastructure constraints. A national program to develop a new airplane optimized for India may prove the right answer to India's need to offer air carriage to more of its population – and to improve the balance sheets of domestic carriers.

Many considerations figure into the optimum aircraft. Ability to operate from short runways at high altitude airports is critical. This will present a design challenge since a high lift wing can produce higher drag that works against range and fuel efficiency. But low cost of operation and high fuel efficiency are a must, as is reliability and ease of support and maintenance. Emissions should be minimized. Also important is the number of passengers that can be carried, comfortably and safely, and passenger flight experience must appeal to the public (including those new to air travel). Cargo handling is another key consideration. These factors suggest that a regional aircraft best suited for India will be one that can hold more than 75 passengers. It should be planned for growth versions that can carry 100 passengers, or more. India should pursue a new "clean sheet" aircraft rather than a derivative of some existing design. The aircraft should employ new generation gas turbine engines to achieve double digit reductions in fuel utilization, produce greater power and improve on emissions. These goals appear achievable, based on various announcements of the world's leading engine suppliers – but they will require a new powerplant (a

"centerline" program, in the parlance of the industry) rather than a derivation of an existing engine.

There are existing turboprops in the market. Bombardier's Q-400 and the ATR 72 both carry about 75 passengers and are optimized for short-haul routes. But neither employs "next generation" advances in materials, propulsion, aerodynamics and flight controls. Both are at the practical limits of their existing design. There is room in the market for a new turboprop that can carry more passengers and operate efficiently from small airports over regional routes. Powerful advances have occurred in many areas of aviation design over the past decade, but few have been realized in turboprop-powered aircraft, thus far.

If it pursues a "clean sheet" advanced turboprop regional aircraft as a national project, rather than accept an existing design and accommodate its limitations, India can design to its unique requirements and the business needs of its carriers. This may mean that the program takes a decade to reach fruition – but that is par for the course, considering the experience of China and Brazil, for example. And India can "aim high." The long-term objective is to build hundreds of airplanes that will be relied upon by Indian flag carriers for hundreds of domestic routes. The Government can encourage domestic adoption by tax benefits or other subsidy or preference.

Outside of India, a next generation regional turboprop can find markets in other countries, such as the Philippines or the Indonesian archipelago, with similar tension between growing demand for domestic air travel and infrastructure limitations. These markets similarly will favor airplanes that are inexpensive to operate and relatively easy to service.

India cannot achieve this promise by going it alone. Nor will it get done by reliance upon the DPSUs. Rather, to succeed such a project virtually "demands" the active commitment of foreign airframe and engine prime contractors. To get that commitment, with all that it implies as to transfer of technology and sharing of IP and know-how, India must end its pattern of active and passive frustration of foreign investment and ownership in aerospace industries.

In fact, this national aerospace project would be a great vehicle for India to “pilot” reforms which, once demonstrated, could be employed in other areas where national industrial base growth is sought and foreign assistance is needed. India could create a specially-chartered national agency to champion this airplane project. Suitably empowered, this agency would resolve permits and licenses, clarify disputes among agencies and serve as a “single window” for permits. Corruption risks could be greatly reduced by concentrating the decision making authority in a few officials and using modern information systems that assure high transparency and efficient decision-making. It would act as the accountable national authority to oversee the private sector partners who manage the design, development, test and production of the aircraft.

For such a project, India must involve its leading private sector industrial firms and resist the political demands of the DPSUs to dominate the project. India also must welcome new foreign investment and actively encourage the participation of existing foreign-owned companies already doing business in India. In addition, participation should be open to Indian companies whose products are “dual use,” suitable for military or civil application. Offset obligations, owed by foreign sellers of military equipment, can be leveraged by awarding “multipliers” on credits earned through investments or technology transferred to the new national aerospace program.

The national aerospace program must be commercially viable. That presents some hard decisions up-front. The development expense likely will be several billion dollars. The market is too uncertain for private companies to shoulder that expense and risk. Accordingly, the Government must be prepared to underwrite the development and perhaps initial production as well. This may mean abbreviation or early termination of other projects, such as several cited above, that are not producing results sufficient to justify their costs. The national benefits of a successful advanced regional turboprop aircraft project are enormous. The Government’s investment can be recouped in a number of ways, such as manufacturer payment of license fees or use of debt financing for later project stages.

Of fundamental importance, a national aerospace project to field an Indian advanced regional turboprop aircraft would be a civil project intended for commercial application. This will greatly reduce the development cost and time to flight, and will focus design and development attention on the low operating costs and passenger safety and comfort that are key to profitable operation by commercial air carriers. Foreign participation will be facilitated as technology release and export are much less problematic when the product is civil in character. It is fine to anticipate military derivatives, and the design should recognize eventual military applications, but the project should not be driven by military requirements. The market is too small, the costs are too high and a military program will take too long. Moreover, for near-term military airlift needs, India has many choices, as evidenced by the recent decision to purchase additional C-130J aircraft from Lockheed Martin.

A national aerospace project, as here described, requires a long-term vision, an investment mentality and a business-like approach. These may be different from the norm of Government-sponsored projects in India, but they can be accomplished with the will and the necessary organizational and financial commitment. As the project proceeds, even before a first aircraft taxis out to test, it will help India to develop an indigenous aerospace industrial base. As that base matures, its benefits to India’s economy are self-evident. It also will assist India in realizing the long-held national goals of achieving genuine, world-class indigenous aerospace and defence capabilities. More Indian companies can occupy roles as trusted suppliers in the global aerospace supply chain. A successful advanced turboprop aircraft, once certified under international standards, could position India to exploit international markets with a product that is distinguished from other rivals. India can become, at last, an aerospace leader and aviation exporter.

Robert S. Metzger is a lawyer with Rogers Joseph O'Donnell, P.C., based in Washington, D.C. He advises U.S. and international companies on aerospace and defense matters, and has written frequently about the U.S.-India defense industrial relationship and aviation matters. He is a member of the International Institute of Strategic Studies (London) and was a Research Fellow at the

Harvard Kennedy School Center for Science & International Affairs. He can be reached at RMetzger@rjo.com.

An earlier and shorter version of this article was previously published in the Economic Times on November 13, 2013.

SUBMISSION REQUESTS

Annual Year-in-Review

Each year, ABA International requests each of its committees to submit an overview of significant legal developments of that year within each committee's jurisdiction. These submissions are then compiled as respective committee's *Year-in-Review* articles and typically published in the Spring Issue of the Section's award-winning quarterly scholarly journal, *The International Lawyer*. Submissions are typically due in the first week of November with final manuscripts due at the end of November. Potential authors may submit articles and case notes for the India Committee's Year-in-Review by emailing the [Co-Chairs](#) and requesting submission guidelines.

India Law News

India Law News is looking for articles and recent Indian case notes on significant legal or business developments in India that would be of interest to international practitioners. The Spring 2014 issue will have a special focus on the Companies Act, 2013. Please read the Author Guidelines available on the [India Committee website](#). The deadline for submissions has been extended to March 15, 2014. Note that, *India Law News* does not publish any footnotes, bibliographies or lengthy citations. Submissions will be accepted and published at the sole discretion of the [Editorial Board](#).

INDIA COMMITTEE

The [India Committee](#) is a forum for ABA International members who have an interest in Indian legal, regulatory and policy matters, both in the private and public international law spheres. The Committee facilitates information sharing, analysis, and review on these matters, with a focus on the evolving Indo-U.S. relationship. Key objectives include facilitation of trade and investment in the private domain, while concurrently supporting democratic institutions in the public domain. The Committee believes in creating links and understanding between the legal fraternity and law students in India and the U.S., as well as other countries, in an effort to support the global Rule of Law.

BECOME A MEMBER!

Membership in the India Committee is free to all members of ABA International. If you are not an ABA International member, you may become one by signing up on the [ABA website](#). We encourage active participation in the Committee's activities and welcome your interest in joining the Steering Committee. If you are interested, please send an email to the Co-Chairs. You may also participate by volunteering for any of the Committee's projects, including editing a future issue of the *India Law News*.

Membership in the India Committee will enable you to participate in an online "members only" listserv to exchange news, views or comments regarding any legal or business developments in or concerning India that may be of interest to Committee members.

We hope you will consider joining the India Committee!

UPCOMING SECTION EVENTS (India Committee)

Conference

[Threading the Needle in U.S./India Deals:
Safe Passage through Formidable Legal Risk](#)

Hyatt Regency Hotel, New Delhi
February 13 - 15, 2014

LEADERSHIP (2013-2014)

Senior Advisors

Aaron Schildhaus
Law Offices of Aaron Schildhaus, Washington, D.C.

Erik B. Wulff
DLA Piper, Washington DC

Immediate Past Co-Chairs

Priti Suri
PSA Legal Counsellors, New Delhi, India

Co-Chairs

Sajai Singh
J Sagar Associates, Bangalore, India

Hon. Sanjay T. Tailor
Circuit Court of Cook County, Illinois

Richa Naujoks
Nixon Peabody LLP, New York, NY

Vice Chairs

Aseem Chawla
Mobinder, Puri & Company, New Delhi, India

Bhalinder L. Rikhye
Bartlett, McDonough & Monaghan, LLP, New York, NY

Douglas Ochs Adler
Vedder Price, Washington, DC

Hanishi Thanawalla Ali
Mithras Law Group, Woodville, MA

Kavita Mohan
*Grinfeld, Desiderio, Lebowitz, Silverman, & Klestadt,
Washington, DC*

Kaviraj Singh
Trustman & Co, New Delhi, India

Vishal Gandhi
Gandhi & Associates, Mumbai, India

Vijaya Sampath
*Lakshmi Kumaran & Sridharan Attorneys, New Delhi,
India*

Shikhil Suri
Suri & Suri, New Delhi, India





**THREADING THE NEEDLE IN U.S. INDIA DEALS:
SAFE PASSAGE THROUGH FORMIDABLE LEGAL RISK**

Presented by
American Bar Association
Society of Indian Law Firms
Services Export Promotion Council

Hyatt Regency
February 13-15, 2014
Bhikaji Cama Place, Ring Road, New Delhi 110607, India

CONFERENCE CONVENORS



Dr. Lalit Bhasin
President SILF



James P. Duffy, III
Berg and Duffy



Erik B. Wulff
DLA Piper

SUPPORTING ORGANIZATIONS

Indian National Bar Association

International Section of the New York State Bar Association

South Asian Bar Association of North America

US-India Business Council

New York City Bar

Bar & Bench

THE FOLLOWING ABA SECTION OF INTERNATIONAL LAW COMMITTEES

Asia Pacific Committee

Middle East Committee
International Energy and Natural Resources Committee
International M&A and JV Committee
Aerospace & Defense Industries Committee
Privacy, E-Commerce & Data Security Committee
Export Controls & Economic Sanctions Committee
Young Lawyer's Interest Network
International Arbitration Committee
CSR Committee
Immigration & Naturalization Committee
International Employment Committee
International Legal Education and Specialist Certification Committee

ABA SECTION OF INTERNATIONAL LAW, INDIA COMMITTEE CO-CHAIRS

Richa Naujoks	Sajai Singh	Hon. Sanjay T. Tailor
---------------	-------------	-----------------------

CONFERENCE STEERING COMMITTEE

Priti Suri, Rajiv Luthra, and Sajai Singh, Co-chairs		
Hanishi Ali	Richa Naujoks	Kaviraj Singh
Aseem Chawla	Ashish Jejurkar	Shikhil Suri
Poorvi Chothani	Robert Metzger	Roland Trope
Vishal Gandhi	Kavita Mohan	Ramesh Vaidyanathan
Shubha Ghosh	JLN Murthy	Vikas Varma
	Bhali Rikhye	