



Cutting Edge: Aerospace and Defence

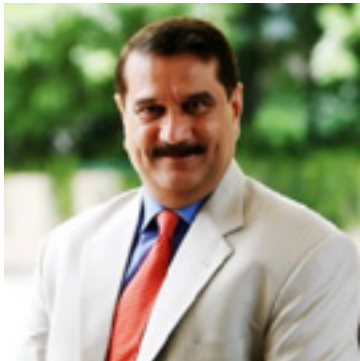


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Editorial



Dhiraj Mathur
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Aerospace and Defence

Dear readers,

Greetings for the second quarter of 2017–18! It gives me immense pleasure to present the 33rd edition of ‘Cutting Edge’, PwC India’s Aerospace and Defence newsletter. With this edition, we aim to update all our valued clients on the latest developments in the A&D sector in India. The last few months have been eventful for the Indian defence sector, with major policy changes such as the launch of the SP policy, abolition of the FIPB, changes in licensing regulations and changes to the SCOMET list. The aviation sector also saw the announcement of the much-awaited decision on the privatisation of its national carrier, Air India.

The SP policy was designed to facilitate investments in defence manufacturing by Indian companies to build a dynamic and efficient defence industrial base

in India. The policy was a move towards strengthening the Indian government’s ‘Make in India’ initiative, thus allowing private firms to enter into agreements as SPs with a foreign OEM and to jointly manufacture fighter jets, helicopters, submarines and armoured vehicles. While not perfect, in our view, the SP model will encourage domestic investments and help in achieving the goal of self-reliance in defence production over the long term because it addresses a key concern of the domestic industry—getting orders from the government. Defence is a capital-intensive monopsony market: The government is the sole buyer and regulator and goes by the L1 principle. The private industry needed assurance that it would receive orders after making investments. This policy provides that assurance. In order to succeed, the model must ensure a ‘win-win’

situation for all concerned while addressing the genuine concerns of OEMs, particularly those with regard to the requirement for government approval on ToT and issues regarding ownership and control of a JV.

Further, changes were introduced in the licensing regulations. The powers and functions to grant a manufacturing licence for defence items were earlier vested with the MHA. They have now been transferred to the DIPP, which will now issue the licence to manufacture defence items. However, it will follow the provisions outlined under the Arms Act and the Arms Rules, 2016. This is a positive decision, as applications for grant of manufacturing licences in the defence sector, which were previously in limbo, will now be processed faster with the notification of the Arms Rules, 2016.

Editorial

The SCOMET list, which is a list of controlled items whose export is regulated, was recently revised. Category 6, which is the munition category, has been included in this list for the first time. From the defence industry's point of view, Category 6 is the most relevant as the export of any item listed under it will be controlled as per the new guidelines. The munition items list is in line with the munition items covered in the WA.

The formulation of the SP policy and the many changes in regulations have led to the signing of major deals at the Paris Air Show, which was held between 23 June and 25 June 2017. Some of the major deals signed were:

1. TASL and Lockheed Martin signed a deal to produce, operate and export F-16 fighters in India.
2. RDL and Thales formed a JV to execute part of the 4.4 billion

USD offset obligations for the 36 Rafale fighter jets India has contracted from France.

3. RDL signed an MoU with Daher Aerospace, France, to jointly explore opportunities in the design and manufacture of composite parts, aerostructure components, integrated logistics, airframes and assemblies.
4. SpiceJet placed a firm order of 25 Q400 aircraft (worth 805 million USD) with Bombardier to serve its plan of expanding its regional footprint. In addition, SpiceJet obtained the purchase rights for 25 additional Q400 aircraft. It has also announced plans to buy 20 B737 MAX 10 from Boeing for a consideration of 4.7 billion USD.

We have been arguing for the privatisation of Air India for many years. It is a very sensible decision by the government. There is no

justification for a state-owned carrier. Moreover, it is a huge burden on the exchequer. The key challenges include dealing with the huge debt of 50,000 crore INR. While 20,000 crore INR can be passed on to the prospective buyer as an aircraft loan and another 6,000 to 7,000 crore INR as a working capital loan, the overdue payments and interest will have to be taken off its books. The buyer must also have full management control and authority to restructure operations as well as rationalise the 25,000 strong workforce. There are likely to be limited synergies with a private airline because Air India has been state-owned and is a full-service airline. That said, it is an excellent acquisition target for an existing Indian airline wishing to expand domestically and internationally, or for a new entrant seeking entry into the Indian market. It has a very

large asset base—120 aircraft, with replacement orders for 43 already placed. Most importantly, it has the largest number of routes and slots and an approximately 15% domestic and more than 17% international market share. Finally, the Maharajah is an iconic brand mascot and the government must insist that the buyer of the airline retains it.

The Indian government took a historic decision on 30 June 2017 and launched the biggest tax reform in 70 years of independence. GST is a single tax that has completely overhauled the entire indirect tax regime and replaced multiple taxes and levies, including central excise duty, service tax, additional customs duty, surcharges, state-level VAT and octroi. GST is applied on the supply of goods and services—right from the manufacturer to the consumer—and is expected to make India a unified common market. There are two components

of GST—namely CGST and SGST. GST is expected to benefit business and industry by improving their competitiveness and to help them in reducing transaction costs for doing business. Under GST, goods and services are taxed at 0%, 5%, 12%, 18% and 28%. GST will simplify the supply chain planning process, as the new tax regime is expected to improve lead times by 30–40% due to the seamless movement of goods at state borders. As regards the A&D sector, there is no change from the VAT/excise tax guidelines except for the MRO) sector. MRO services undertaken outside India were not liable to service tax, and this will continue in the GST regime. Tools and toolkits imported for MRO services were exempted from basic custom duty, but post GST, they will be liable to 5% IGST. Also, service tax applicable to MRO services undertaken in India has increased from 15–18%, and is applicable

to airlines rendering their MRO services through an external party.

Having presented these highlights, I invite you to review our newsletter dedicated to A&D.

I thank all our esteemed clients for their continued support and trust in PwC. Your feedback, trust and support are important and we look forward to the same.

Sincerely,

Dhiraj Mathur

Partner and Leader
Aerospace and Defence



Select news items

Lockheed signs pact with Tata at Paris airshow to make F-16 planes in India

Tata Group and American aerospace giant Lockheed Martin signed an “unprecedented” deal to produce, operate and export the combat-proven F-16 fighters in India, boosting Prime Minister Narendra Modi’s ‘Make in India’ plan. Under the deal, Lockheed will shift its Fort Worth, Texas plant to India without directly affecting American jobs, a campaign pledge of Trump who has vowed to put “America First”.

Source: <http://www.thehindu.com/news/international/lockheed-signs-pact-with-tata-to-make-f-16-planes-in-india/article19103597.ece>

French firm Thales and Reliance Defence Ltd seal deal for JV

French defence firm Thales and Reliance Defence Limited sealed a deal in Paris Air show, for setting up a joint venture (JV) with a shareholding of 49% and 51% respectively. The JV is being set up to develop Indian capabilities to integrate and maintain radars and manufacture high performance airborne electronics, leveraging Thales’ offset commitment as part of the deal for the supply of 36 Rafale fighter aircraft to Indian Air Force. Thales is a leading supplier of radars, electronic warfare solutions and software to Dassault Aviation that manufactures Rafale jets.

Source: <http://www.livemint.com/Companies/JeEKGcX9wnCg6c0IPUgiwM/Reliance-Defence-French-firm-Thales-seal-deal-for-JV.html>

US clears \$2 Billion, 22 Guardian drones deal

The United States approved the sale of 22 predator Guardian drones sale to Indian Navy. The two countries resolved to expand their maritime security cooperation and announced their intention to build on the implementation of their “White Shipping” data sharing arrangement, which enhances collaboration on maritime domain awareness.

Source: <http://economictimes.indiatimes.com/news/defence/us-clears-sale-of-2-billion-guardian-drones-to-india-modi-trump-meet/articleshow/59331536.cms>



Select news items

Reliance Infra Defence unit inks one more deal with Daher Aerospace to help with Rafale work

Reliance Defence, the defence-focused subsidiary of Reliance Infrastructure has tied up with Daher Aerospace, France, a supplier of integrated systems for aeroplanes. Daher Aerospace is tier one manufacturer in Aerostructures segment comprising Fuselage Sections and Fairings made of composites as well as conventional metals for Dassault Aviation and other leading global aircraft manufacturers.

Source: <http://www.indiandefensenews.in/2017/06/reliance-infra-defence-unit-inks-one.html>

Reliance Defence inks partnership with Serbia's Yugoimport; to manufacture ammunition in India

Reliance Defence Ammunition has entered a strategic partnership with Serbia's state-run defence major Yugoimport to manufacture ammunition in India and target business opportunities of Rs 20,000 crore over the next 10 years.

Source: <http://www.defencenews.in/article/Reliance-Defence-inks-partnership-with-Serbia%E2%80%99s-Yugoimport;-to-manufacture-ammunition-in-India-262718>

India, Russia finalise deal on Frigates, S-400 Missile System & Kamov Helicopters

The two sides have taken forward their defence partnership to concretise deals on frigates, S-400 air defence missile system and Kamov helicopters. Both sides drafted a roadmap for the development of military cooperation, which will become the basic document for planning bilateral defence engagements. India and Russia discussed the final shape of defence deals that include S-400 Triumph air defence missile systems, four Krivak class stealth frigates and Kamov 226T helicopters.

Source: <http://economictimes.indiatimes.com/news/defence/india-russia-finalise-deal-on-frigates-s-400-missile-system-kamov-helicopters/articleshow/59291809.cms>



Select news items

Ka-226T helicopter JV Registered in India

Russian Helicopters and Hindustan Aeronautics Limited (HAL) registered a joint venture (JV) for the production of Ka-226T light helicopters in India. Under the agreement, up to 200 equipments will be produced in India. The newly registered JV will perform final assembly and repair of helicopters, as well as act as an integrator of the Indian supplier chain. It is expected that up to 35 Ka-226T helicopters will be produced every year with the possibility to increase production volumes.

Source: <https://www.shephardmedia.com/news/rotorhub/ka-226t-helicopter-jv-registered-india/>

Boost for defence! Indian Army begins field trials of M777 Howitzer guns

Indian Army has started field trials of the M777 Howitzer guns that it is acquiring from BAE Systems. The Indian Army has begun the field trials at the Pokhran range of Rajasthan's Jaisalmer district. The M777 Howitzer guns will be a formidable addition to the Indian Army's arsenal. The M777 howitzers would be deployed along the India-China border. It would be used by the new mountain strike corps being raised in Panagarh, West Bengal.

Source: <https://defenceaviationpost.com/boost-defence-indian-army-begins-field-trials-m777-howitzer-guns/>

Defence Ministry scraps Rs 6,500 crore Navy helicopter deal, bargains hard on price

The Defence Ministry has scrapped a Rs 6,500 crore deal for buying 16 multirole helicopters for the Navy from America, as the government is bargaining hard on price with foreign vendors and promoting Make in India in the military sector for reducing imports. The final decision on the matter was taken by the ministry after the Contracts Negotiation Committee (CNC) headed by the Joint Secretary and Acquisition Manager (Maritime Systems) recommended the retraction of the tender.

Source: <http://indiatoday.intoday.in/story/defence-ministry-scraps-rs-6-500-crore-helicopter-deal/1/979059.html>



Select news items

India, Russia 5th Generation Fighter jet deal is 'Lost'

India and Russia have hit another hurdle in moving forward with one of their most prestigious joint defense projects, the co-development and production of the Sukhoi/HAL Fifth Generation Fighter Aircraft (FGFA), known in India as the Perspective Multirole Fighter (PMF). According to the official, Moscow is allegedly demanding \$7 billion from India as part of its share in the development of the fifth generation fighter jet, given that a work-sharing agreement currently under negotiation includes the transfer of sensitive Russian defense technology. The transfer of sensitive defense technology from Russia to India has been one of the most contentious issues between the two sides right from the start.

Source: <http://thediplomat.com/2017/05/india-russia-5th-generation-fighter-jet-deal-is-lost/>

Army to induct 18 Dhanush artillery guns this year

The first regiment of 18 Dhanush artillery guns, the indigenously upgraded variant of the Swedish Bofors guns, is scheduled to be inducted into the Army by the end of 2017. In continuation, 36 guns would be inducted in 2018 and 60 guns in 2019, completing the initial order. Dhanush has undergone extensive trials in various conditions, and is now in the final leg of battery trials. The Army has placed an initial order for 114 guns. It is a medium gun with a maximum range of 40 km, and has a high angle of attack. So it can be deployed in both deserts and mountains.

Source: <http://www.thehindu.com/news/national/army-to-induct-18-dhanush-artillery-guns-this-year/article18709318.ece>

Reliance Infrastructure gets go-ahead for \$1-Billion Aerospace Park

Reliance Infrastructure has received government approvals for its planned \$1-billion greenfield aerospace park near Nagpur. The board of approval for special economic zones (SEZs) in the ministry of commerce has given its approval to the proposed aerospace park spread across 289 acres at Mihan near Nagpur.

Source: <http://economictimes.indiatimes.com/industry/indl-goods/svs/construction/reliance-infrastructure-gets-go-ahead-for-1-billion-aerospace-park/articleshow/59531737.cms>



Select news items

India Army RFI for High Calibre Rifles Receives Response From 20 Manufacturers

Indian is speeding up procurement plan for over 185,000 high calibre guns of 7.62×51 mm to replace locally made INSAS rifles. The move follows weeks after the Army rejected a locally made assault rifle, Indian Express reported Sunday. Already nearly 20 gun manufacturers including a number of foreign entities have responded to the request for information (RFI) for the assault guns. The army particularly sought immediate procurement of at least 65,000 rifles to enhance its fire power in border areas and in counter-terror operations.

Source: <http://www.indiandefensenews.in/2017/07/india-army-rfi-for-high-calibre-rifles.html>

Proposal cleared for modernisation of Army's armoured vehicles

The Defence Ministry today cleared a Rs 2,400 crore proposal for upgrading the Army's armoured fighting vehicles to make them capable of undertaking night operations. The decision to give a go-ahead to the project was taken at a meeting of the Defence Acquisition Council (DAC). The modernisation of the armoured vehicles will enhance their overall performance besides enabling them to fully operate at night.

Source: <http://timesofindia.indiatimes.com/india/proposal-cleared-for-modernisation-of-armys-armoured-vehicles/articleshow/59505829.cms>

Indian Military gets connected aircraft demo from Honeywell

Honeywell's "Connected Aircraft" demonstrator reached India last week, after appearing at the Paris Air Show and heading east via Copenhagen, Moscow and Dubai. And while most of the company's briefings in and around the Boeing 757 test bed have stressed the advantages to be gained from real-time connectivity by commercial operators, and their passengers, the technology has clear military applications. Honeywell invited a large number of senior officials from the Indian Air Force (IAF) and Indian Navy (IN) on a flight from Delhi on July 4. But the IAF and IN are experiencing high AOG rates with their mixed fleets of Western and Russian aircraft, and both are interested in predictive maintenance techniques as pushed by Honeywell in these demonstrations.

Source: <https://www.ainonline.com/aviation-news/defense/2017-07-10/indian-military-gets-connected-aircraft-demo-honeywell>



Select news items

India clears plan for \$3.1 billion second airport for Delhi

To meet explosive growth in passenger traffic, India plans to build second international airport near its capital city in the next four to five years, costing an estimated \$3.10 billion. The Noida International Airport near New Delhi will be built from scratch in phases and is expected to cater to 30-50 million passengers per year (MPPA) over the next 10-15 years. Air travel in India, one of the world's fastest-growing aviation markets, has boomed in the last decade as it opened up to competition, ticket prices were slashed and the number of people wealthy enough to travel swelled.

Source: <http://news.abs-cbn.com/business/06/24/17/india-clears-plan-for-31-b-second-airport-for-delhi>

Air Costa shuts down operations after DGCA cancels flying licence

Vijayawada-based airline Air Costa has stopped its operations after aviation regulator the Directorate General of Civil Aviation (DGCA) suspended its flying licence. The airline had reported a Rs 130 crore loss on revenue of Rs 327 crore for fiscal 2015-16. The lack of service hangars for their Embraer E-190 and E-170 aircraft in India was the main reason for unsustainable costs which forced the airline to shut down operations.

Source: <http://www.moneycontrol.com/news/business/companies/air-costa-shuts-down-operations-after-dgca-cancels-flying-licence-2308211.html>

SpiceJet to buy more planes from Bombardier for shorter routes

Budget airline SpiceJet Ltd plans to buy more Bombardier-made Q400 regional planes. The airline signed a Letter of Intent (LoI) with Bombardier at the Paris Air Show to buy as many as 50 Q400 turboprop planes, which include 25 Q400 turboprops along with purchase rights for the rest. Airlines typically do not pay when they sign a letter of intent, but have to make a small payment of up to 5% of cost of the plane for firming up the order.

Source: <http://www.livemint.com/Companies/F1bcCZMx60rCJiQpCEihLJ/SpiceJet-to-buy-more-planesfrom-Bombardier-forshorterrout.html>

DGCA suspends flying licence of Air Carnival

Aviation regulator DGCA has suspended the flying licence of Coimbatore-based carrier Air Carnival which has not operated a single flight since early April. With this, Air Carnival has become the third regional carrier, after Air. However, before cancelling or suspending the flying permit of an operator, the regulator issued a show-cause notice with a two-weeks time to respond.

Source: <http://indiatoday.intoday.in/story/dgca-suspends-flying-licence-of-air-carnival/1/981442.html>

Select news items

NSDC signs MoU with BIRD ACADEMY for skilling of unemployed youth in the aviation and aerospace sector

An MoU was signed between National Skill Development Corporation (NSDC) and Bird Academy with regards to skilling of unemployed youth in the aviation and aerospace Sector. With the signing of the MoU NSDC has agreed to enter into an arrangement with Bird Academy to train, skill & empower more than 30,000 unemployed youth across various states including North Eastern states with special focus to train and empower minimum 5,000 women & tribal youths from the underprivileged sections of the society and assist states in capacity building over the next six years. The two organizations will work together to set up training centres and centre of excellence in India with the aim of increasing employability of youth aspiring to work in the aerospace and aviation sector under the guidance of Aerospace and Aviation sector skill council.

Source: <http://pib.nic.in/newsite/PrintRelease.aspx?relid=163370>

Jet Airways in Talks to Buy 75 Aircraft

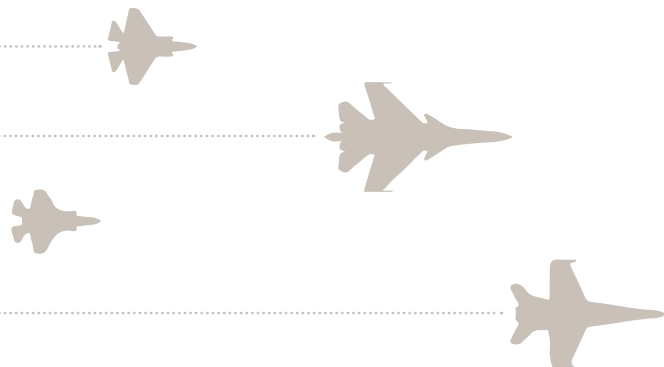
Jet Airways Ltd, India's biggest full service carrier by market share, is in talks to buy 75 single aisle aircraft with an option to purchase another 75. Jet Airways, part owned by Abu Dhabi's Etihad Airways, is likely to consider placing an order for either Boeing's 737 MAX planes or aircraft from Airbus SE's A320neo family. The airline continuously reviews the composition and deployment of its fleet in response to demand trends as well as other economic and market forces, Jet Airways said in an emailed statement.

Source: <http://in.reuters.com/article/jet-airways-aircraft-idINKBN18W1F>

India, Russia Strengthen Bilateral Cooperation in Aviation

India and Russia agreed to strengthen bilateral cooperation in the aviation sector by setting up joint ventures in the field of aviation manufacturing, as India is set to become the third largest global aviation market by 2020. The move is aimed to cater to increasing exports and demands of India's regional air connectivity scheme. The Civil Aviation Policy, 2016, too, provides incentives for made-in-India aircraft and encourages global OEMs for establishing aircraft assembly plant in India, including fast-tracking clearances.

Source: <http://www.newindianexpress.com/world/2017/jun/01/india-russia-strengthen-bilateral-cooperation-in-aviation-1611758.html>



SP policy

The MoD promulgated the much-awaited Chapter-VII of the DPP 2016, ‘strategic partnership policy’, on 31 May 2017. The broad policy objectives are:

1. The government has brought in the SPM with the aim of institutionalising a transparent, objective and functional mechanism to encourage broader participation of the private sector, in addition to the capacities of DPSUs/OFB, in the manufacturing of major defence platforms so as to reduce current dependence on imports.
2. The SPM is expected to enhance competition, increase efficiencies, facilitate faster and more significant absorption of technology, create a tiered industrial ecosystem, ensure development of a wider skill base, trigger innovation, and

promote participation in global value chains as well as exports.

3. Under this policy, a private sector partner will be selected by the government to associate with an OEM to make long-term investments in manufacturing infrastructure, an ecosystem of suppliers, skilled human resources and R&D for modernisation.



Role of SPs and their selection process:

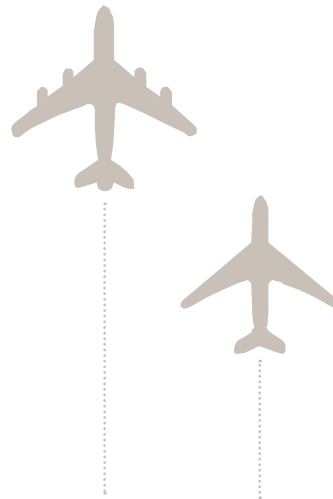
1. The SP will play the role of a system integrator by building an extensive ecosystem comprising development partners, specialised vendors and suppliers, in particular, those from the MSME sector.

2. SPs will be selected based on the broad parameters of financial strength, technical capability and capacity/infrastructure. Potential SPs will be identified primarily based on their experience and competence in the integration of a multidisciplinary functional system of engineering and manufacturing.
3. In the initial phase, SPs will be selected in four segments:
 - a. Fighter aircraft;
 - b. Helicopters;
 - c. Submarines; and
 - d. AFVs/MBTs.
4. SPs will tie up with foreign OEMs for manufacturing, ToT, assistance in training skilled human resources and other support.

Role of OEMs and their selection process:

1. The process of shortlisting of OEMs will be done separately and simultaneously with the process of identifying potential SPs.
2. ToT is one of the main factors in the selection of OEMs; the quantum and scope of technology being offered for transfer by the OEM will be a primary consideration in the selection procedure, besides compliance to SQRs. Towards this, the shortlisting of OEMs will, inter alia, take into consideration the following factors:
 - a. Range, depth and scope of technology transfer offered in identified areas;
 - b. Extent of indigenous content proposed;

- c. Extent of ecosystem of Indian vendors/manufacturers proposed;
- d. Measures to support SPs in establishing a system for integration of platforms;
- e. Plans to train skilled manpower; and
- f. Extent of future R&D planned in India.



Abolition of the FIPB

The Union Cabinet of India, chaired by Prime Minister Shri Narendra Modi, on 24 May 2017 approved the proposal to phase out the FIPB, the inter-ministerial body for processing FDI proposals and making recommendations to the government thereof for its approval. Cases that required government approval were first evaluated by the FIPB that was serviced by the DEA, which is a part of the Ministry of Finance.

The FIPB was established by the Government of India pursuant to the Statement of Industrial Policy, on 24 July 1991. In recent years, there has been a significant decline in the number of proposals that were brought before the FIPB for its approval owing to the liberalisation of the FDI regime across various sectors. Currently, more than 90%

of the total FDI inflow in India is under the automatic route. So, for this purpose, the government has recently decided to abolish the FIPB and delegate its powers and functions to the concerned AM. The concerned AMs will be responsible for monitoring the compliances/conditions imposed under FDI approval, including past cases approved by the FIPB, and seeking the approval of the minister-in-charge/CCEA, as the case may be, as per the extant FDI policy. The DEA issued an Office Memorandum (F.No.01/01/FC on 5th June, 2017)

listing the concerned AM for 11 notified sectors/activities requiring government approval under the FDI policy.

While the erstwhile FIPB has been abolished, the DIPP, under the Ministry of Commerce and Industry, will be in charge of its successor mechanism. This will include the old FIPB portal that has now been placed under the DIPP under a new name, the Foreign Investment Facilitation Portal. The portal will be the main interface used by investors to apply for bringing in FDI into the country. While the dissolution of

the FIPB is aimed at ease of doing business in the country, it will be important for the MoD to adhere to specific timelines within which all applications would be disposed; this will assist in attracting more foreign investments in the sector.

The DIPP, in consultation with AMs/ departments/sector regulators, has prescribed detailed SOPs for processing FDI proposals on 29 June 2017. As far as defence equipment is concerned, the AM will be the DDP in the MoD. For defence items requiring an IL under the Industries (Development & Regulation) Act, 1951, and/or Arms Act, 1959, for which the powers have been delegated by the MHA to the DIPP, the Department of Defence Production, MOD, will be the AM for providing approval for FDI. Also, investments in the defence sector will require clearance from the MHA.



Export controls in line with international standards

The DGFT, vide Notification No. 5 dated 24 April 2017, has notified an amendment to the SCOMET list under the foreign trade policy. The revised list of items is part of India's larger commitment to non-proliferation as enshrined in various laws, particularly the Weapons of Mass Destruction and their Delivery Systems (Prohibition of Unlawful Activities) Act, 2005, and the Foreign Trade (Development and Regulation) Amendment Act, 2010. The revised list is also part of India's efforts to harmonise its list of controlled items with those of the four multilateral export control regimes: the MTCR, SG, WA and the Australia Group.

Category 6 of the SCOMET list has been populated as the munitions

list, which includes the munitions list of the WA. The notification also mentions that the export of items specified in Category 6, except those covered under Notes 2 and 3 of the CIN of the SCOMET, will be governed by the extant SOP issued by the DDP. Unless prohibited, export may be permitted against an authorisation issued by the DDP. Subsequently, the MoD has also issued a notification to align its own SOPs with the above change. In comparison to the previous SCOMET list which had eight categories, the revised list has nine broad categories, with each category containing an exhaustive list of items:

- **Category 0:** Nuclear material, nuclear-related other materials, equipment and technology
- **Category 1:** Toxic chemical agent and other chemicals

- **Category 2:** Micro-organism, toxins
- **Category 3:** Material, materials processing equipment and related technologies
- **Category 4:** Nuclear-related other equipment, assemblies and components; test and production equipment; and related technology, not controlled under category 0
- **Category 5:** Aerospace systems, equipment including production and test equipment, related technology and specially designed components and accessories thereof
- **Category 6:** Munitions List
- **Category 7:** Electronics, computers, and information technology including information security

- **Category 8:** Special materials and related equipment, material processing, electronics, computers, telecommunications, information security, sensors and lasers, navigation and avionics, marine, aerospace and propulsion

The alignment of Indian export controls with the WA will facilitate exports and provide opportunities for Indian companies to participate in the global supply chain of OEMs.



Licensing regulations simplified

Prior to July 2016, companies engaged in manufacturing defence equipment were required to obtain IL under the IDR Act, 1951, from the DIPP. Post July 2016, in exercise of the powers conferred by the Arms Act, 1959, and in supersession of the Arms Rules, 1962, the MHA, the Government of India notified the Arms Rules, 2016, vide G.S.R. 701(E) dated 15 July 2016, and power to issue ILs was given to the MHA.

The government reconsidered the procedure and after inter-ministerial discussions, vide Notification S.O. 1636 (E) dated 19 May 2017, has notified that the powers and functions to grant manufacturing licence for defence items would once again vest with the DIPP. Accordingly, the DIPP will now issue



the licences to manufacture defence items but will follow the provisions outlined under the Arms Act and the Arms Rules, 2016.

All interested entrepreneurs/ industries/companies are requested to apply in Form A-6 of Arms Rules, 2016, in 15 copies along with details and enclosures as mentioned in the Arms Rules, 2016, to the Senior Development Officer (Industrial Licence), DIPP, Industrial Licensing Section, Udyog Bhawan, New Delhi. A copy of the Arms Rules, 2016, is available on the websites of the DIPP (www.dipp.gov.in) and MHA.

Applications for grant of manufacturing licenses in the sector, which were being processed slowly since the notification of the Arms Rules, 2016, will now be processed faster. However, there exists a gap where the Arms Act and Arms Rules need to be aligned with FDI and licensing policies.

Disinvestment of Air India

Air India operates an ageing fleet of 140 planes, has more than 21,000 employees, flies to nearly 41 international and 72 domestic destinations and is the largest international carrier from India. Till the 1990s, the Maharaja dominated the market. With the entry of private players, Air India has been continuously battling tough market conditions and stiff competition. Its domestic market share has steadily reduced to 14%. Despite receipt of almost 24,000 crore INR equity, its debt stands at 52,000 crore INR and it continues to bleed, though operating losses have marginally reduced to 3,587 crore INR in 2015–16, against 5,859 crore INR in the previous year. So, the reality is a bloated, ageing airline with past burdens weighing it down and

preventing a turnaround under the status quo. The government had decided to trim the excess baggage of the Maharaja and is planning to consider hiving off Air India's assets and a portion of its non-aircraft debt to a SPV as a first step toward clearing up its balance sheet. The sale of Air India's prime real estate assets will meet some of the liabilities, and the government may also separately go for strategic disinvestment of Air India's three profit-making subsidiaries, i.e. its MRO unit, Air India Engineering Services Limited; the ground handling arm, Air India Transport Services Limited; and Air India Charters Limited.

Air India is a government-owned company and will never be able to compete with private airlines in this highly competitive service industry,

where margins are razor thin and survival depends on being nimble and agile. Air India has to comply with the corporate governance principles of the government. These include following elaborate rules and regulations that slow down decision making and the diktats of the government that include flying on uneconomical routes to fulfil social objectives at the cost of commercial viability. The government has no business to be in the service industry, which calls for a level of responsiveness that it is completely incapable of.

The government has now taken a sensible decision to privatise the airline. A strategic investor, preferably one who understands the Indian aviation market, would be best placed. It is important to note that Air India is a full-service airline

and the dynamics of running a full-service and low-cost airline are completely different. Moreover, Air India being a state-owned airline, the culture, etc., will be completely different from that of any private airline and synergies will be very few. Thus, integration will be a challenge. While the aircraft-related debt can be passed on, other dues, etc., will need to be resolved.

Having said that, Air India is an excellent target. It has vast assets, a tremendous brand name and, most importantly, more routes and slots than any other Indian airline. It has an approximately 15% domestic and a higher than 17% international market share. It is an excellent choice for a new entrant or for an existing airline seeking to expand domestically and internationally.

Race circuit used for organising a motor racing event in India held to be a fixed place PE of the non-resident

Facts of the case

The taxpayer, a UK tax resident company, was the CRH in respect of the motor racing WC. As a result of it being the CRH, the taxpayer was the exclusive nominating body at whose instance organisers/promoters were added to the official motor racing calendar.

Agreements entered into between various parties:

- An agreement was entered between the Federation responsible for regulating the Championship and another group company, whereby the Federation transferred the commercial rights with respect to the Championship in favour

of that company. The group company in turn entered into an agreement with the taxpayer, transferring the commercial rights in favour of the taxpayer for a period of 100 years.

- The taxpayer also entered into a concorde agreement with the participants of the race. Such an agreement laid down the parameters and conditions in respect of the race and prize money, etc.
- An RPC (first RPC – entered in 2007) was entered into between the taxpayer and the Indian Company, by which the Indian Company was only given the right to promote the motor racing

event in India. The same was superseded by way of another RPC (second RPC – entered in 2011) that granted the Indian Company the rights to host, stage and promote the event. Another agreement was entered into between the taxpayer and the Indian Company, as per which the Indian Company was permitted to use certain marks and intellectual property belonging to the taxpayer.

- An OA was entered into between the Federation and the Indian Company, wherein the Indian Company was given the responsibility to organise the event.

- On the day of entering into the second RPC, agreements were signed between the Indian Company and three affiliates of the taxpayer, as per which two of the affiliates were separately granted the circuit rights, mainly media and title sponsorship and paddock rights. Another affiliate was engaged to generate TV feed.
- An SA was also entered into by the taxpayer with another one of its affiliates on the race day for provision of various services such as liaison and supervision of other parties at the event, travel, transport and data support services.

After entering into the aforesaid arrangement for hosting the WC event in India, both the taxpayer and the Indian Company approached the AAR, seeking its advance ruling on the following questions:

1. Whether the consideration receivable by the taxpayer from the Indian Company in terms of the RPC was in the nature of royalty as per Article 13 of the DTAA (tax treaty) between India and the UK.
2. Whether the taxpayer had a PE in India in terms of Article 5 of the tax treaty.
3. Whether any part of the consideration received/receivable by the taxpayer from the Indian Company was subject to withholding tax in terms of the provisions of the Income-tax Act, 1961 (the Act).

Decision of the AAR

The AAR answered the first question holding that the consideration paid/payable by the Indian Company to the taxpayer would amount to royalty under the tax treaty. The second question was answered in favour of the taxpayer, holding that it did not have a PE in India. With respect to the third question, it was held that since the amount received/receivable by the taxpayer was income in the nature of royalty, the Indian Company was liable to withhold taxes on the same.

The taxpayer and the Indian Company challenged the AAR ruling on the aspect of royalty by way of a writ petition before the Delhi HC. The Department of Revenue too filed a writ petition before the Delhi HC, challenging the ruling of the AAR on the aspect of PE.

Decision of the Delhi HC

The Delhi HC reversed the findings of the AAR on both the issues and held that though the amount paid/payable by the Indian Company would not be treated as royalty, it would be taxable in India as business income as the taxpayer has a fixed place PE in India in the

form of a motor racing circuit. The Indian Company would be liable to withhold taxes from the payments to be made to the taxpayer under the provisions of the Act.

The judgement of the Delhi HC was then challenged by the taxpayer, the Indian Company and Revenue before the SC.



Decision of the SC

- It was held that the motor racing circuit was undeniably a fixed place from which different races were conducted. Accordingly, the core questions to be looked at were whether the place was at the disposal of the taxpayer and whether this was a fixed place of business of the taxpayer. For determining whether the motor racing circuit was at the disposal of the taxpayer and whether it had carried out its business therefrom, it was held that the

various agreements could not be read in isolation. This was essential to determine who was having a real and dominant control over the event.

- On the basis of various agreements entered into between the taxpayer and its affiliates, it was clear that the physical control of the circuit was with the taxpayer and its affiliates from the inception of the WC event till its conclusion. The entire situation led to the conclusion that the taxpayer had made its

earnings in India through the said track over which it had complete control during the period of the race.

- With respect to the argument of the taxpayer that the race was only held for three days in a year and such a short duration would not constitute a PE, the SC, relying on the various commentaries and international precedents, upheld that where the business was carried out for a limited number of days, and where the taxpayer had complete

control and access for the entire duration, such duration was enough to constitute a PE. Accordingly, the SC upheld the constitution of fixed place PE of the taxpayer in India.

- Accordingly, the payments made by the Indian company to the taxpayer under the RPC were the business income of the taxpayer's PE in the form of a motor racing circuit and the Indian Company was required to withhold taxes therefrom.



Formula One World Championship Ltd. Vs. Commissioner of Income Tax, (International Taxation) – 3, Delhi [2017] 80 taxmann.com 347 (SC)

Fees for availing of technical know-how to bring a new business into existence treated as a capital expenditure

Facts of the case

The assessee is an Indian company incorporated pursuant to a JV between an Indian company and a foreign company. The assessee company entered into a TCA with the foreign company for availing of technical know-how and technical information for a lump-sum consideration to be paid from the third year of commercial production and royalty at an agreed percentage on its sales. The assessee, while filing its return of income, claimed the above expenditure as revenue expenditure.

The assessee simultaneously entered into certain other agreements with the foreign

company for providing technicians and engineers for necessary guidance for setting up of a plant, supply of parts for manufacture of products and supply of manufacturing facilities. The assessee treated the payments under these agreements as capital expenditure.

The AO, in the re-assessment proceedings, disallowed the amount paid towards technical know-how and royalty under the terms of the TCA as capital expenditure. The matter reached the SC for determining whether the amount paid under the TCA for availing of technical know-how and information is revenue or capital expenditure.



Assessee's contention

The technical know-how and technical information was availed of to manufacture products in India and not for the formation of a plant to manufacture such products. The assessee was not authorised to transfer the ownership rights in know-how to any other person as such rights continued with the foreign company. Also, the Delhi HC, in the assessee's own case on a similar issue, held that payment for know-how fee and royalty was in the nature of revenue expenditure.

Revenue's contention

The technical know-how and technical information were provided for the formation of a new manufacturing facility for the manufacturing of a product which is of enduring nature and hence qualify as capital expenditure.

SC's ruling

The SC held as under:

- Where there is transfer of ownership in the intellectual property rights or in licenses, it would clearly be capital expenditure. Where no such rights have been transferred but the arrangement facilitates grant of licence to use those rights for limited purpose, it would be in the nature of revenue expenditure as no enduring benefit is acquired.
- The purpose of entering into a JV agreement was to set up a JV company with the aim of establishing a manufacturing unit. As a result of the JV agreement, the assessee was incorporated and entered into a TCA for technical collaboration.
- The said technical collaboration included not only the transfer of technical information, but also complete assistance, actual, factual and on the spot, for the establishment of plant

and machinery, etc., to create a manufacturing unit for the products. Thus, a new business was set up with the technical know-how provided by the foreign company.

- In case of the termination of the TCA, the JV itself would end and there would not be any further manufacturing using the technical know-how of the foreign collaborator.

The court held that in the given case, the TCA was crucial for setting up the plant for manufacturing of products and was not for improvising the existing know-how by borrowing the technical know-how from foreign company. Accordingly, the expenditure in the form of technical know-how and royalty is in the nature of capital expenditure.



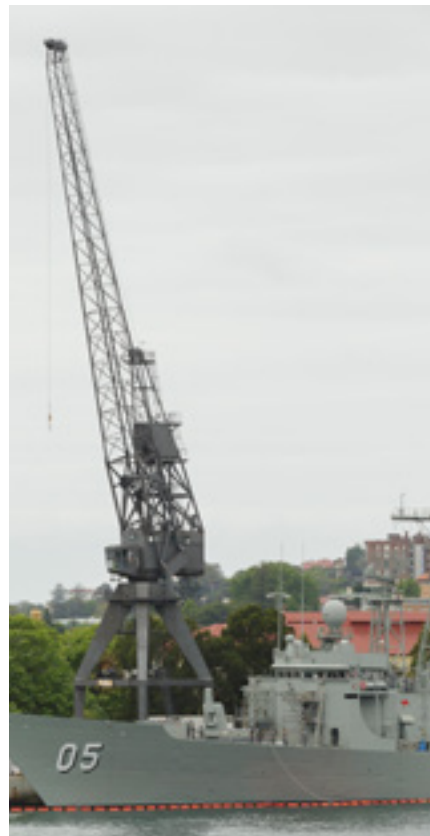
Honda Siel Cars India Ltd (Supreme Court) 82 taxmann.com 212

Expatriation of employees under seconded agreement without ToT would not fall under the term ‘make available’ as per Article 13(4)(c) of the Indo-UK DTAA

Facts of the case

The assessee is a JV between UK Company (UK Co) and Indian Company. The assessee entered into an agreement with UK Co whereby the assessee was provided personnel to carry out functions in the areas of management, setting up of business, property selection and retail operation, product and merchandise selection, and setting up a merchandise team.

The AO held that the aforesaid services are within the ambit of FTS and thus, tax was required to be deducted by the assessee while making payment to UK Co. On appeal, the CIT (A) ruled in favour of the assessee and Revenue filed an appeal before the ITAT.



Assessee’s contentions

- The amount paid was less than the actual salary payment to the personnel after negotiations and mere reimbursement was made without markup.
- As no technical knowledge know-how, etc., was made available, the payment does not fall within Article 13(4) of the Indo-UK DTAA. Also, as UK Co had no PE in India, no income can be attributed in India.
- The assessee placed reliance on the ITAT ruling in the case of Raymonds Ltd vs DCIT [86 ITD 791] and the Special Bench ruling in Mahindra and Mahindra Ltd vs DCIT [122 ITD 216] wherein the ITAT held that ‘merely providing the employees

or assisting the assessee in the business and in the area of consultancy, management etc. would not constitute make available of the services of any technical or consultancy in nature...’. Thus, expatriation of employee under seconded agreement without ToT would not fall under the term made available as per the article 13(4)(c) of Indo-UK DTAA. The HC upheld the ITAT’s order in the case of Mahindra and ruled in favour of the taxpayer.



Revenue's contentions

The services were in the area of management, selection of property and retail operations, which were in the nature of business strategies and advisory and therefore taxable as FTS. Once the payment is taxable as FTS, the theory of reimbursement of expenses had no application.

As the personnel remained employees of the payee, there is no question of reimbursement of expenses. Since the assessee made payment on the basis of invoice raised by UK Co, it was under obligation to deduct tax at source.

ITAT ruling

- The impugned payment was not FTS since the technology was not 'made available' to the assessee and the payment was reimbursement of expenses by the assessee in the absence of

profit. The ITAT also confirmed the above rulings cited by the assessee.

- Even under the Act, if the payment is only for reimbursement of expenses, the same cannot be regarded as income in the hand of the payee/recipient.

- The ITAT further observed that the entire amount of salary of the personnel was taxed in India at the highest average rate of tax and thus, no default could be attributed on the part of the assessee.
- Aggrieved by the order of the ITAT, Revenue preferred an appeal before the Bombay HC.

HC ruling

The HC upheld the order of the ITAT holding that since the said payment to the employees is already subject to tax in India, there is no question of treating the assessee as assessee in default.



Director of Income-tax (International Taxation) vs. Marks & Spencer Reliance India Pvt Ltd (Bombay HC) (ITA Appeal no. 893 of 2014)

Payment made for 'SOP' taxable as 'royalty' under the India-Germany tax treaty

Facts of the case

The assessee, an Indian company, entered into an agreement with a German entity for sharing the SOPs developed by the German entity and for harmonising all required software systems, policies and processes. Under the subject agreement, the assessee made payment to the German entity without deducting any tax at source. As per the agreement, the German entity allowed the assessee to use its name, brand, logo and website without any costs or financial liability. The SOPs were non-transferable and the assessee was not allowed to make any changes to them.

Assessee's contention

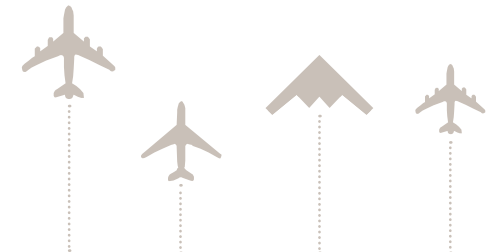
The assessee was of the view that such payments were only for the purpose of sharing SOPs, access to database, email server, hardware and software and were to be treated as business receipts of the German entity. Accordingly, the payments were not taxable in India in the absence of PE of the German entity in India.

Revenue's contention

The AO contended that the payments made by the assessee were for the use of name, goodwill and market reputation of the German entity and therefore taxable as 'royalty' u/s 9(1)(vi) of the Act as well as the India-Germany tax treaty. Accordingly, the AO raised

the demand on the assessee under section 201 read with section 195 of the Act.

On further appeal before CIT (A), the order of the AO was upheld.



ITAT ruling

The ITAT observed that since, as per the agreement, the German entity allowed the assessee to use its name, brand, logo and website without any costs or financial liability, any part of the payment cannot be for the purpose of use of name, brand, logo and website. The ITAT observed that the consideration was towards SOPs and allied activities like harmonisation of software systems, policy and process are only incidental.

The ITAT held that since the SOPs are non-transferable and the assessee is not allowed to make any changes to them, it is only sharing of information about scientific experience by the German entity, and the payments made by the assessee to the German entity would fall within the definition of royalty as payments for ‘information concerning industrial, commercial

or scientific experience’ as per the provisions of Article 13(3) of the India-Germany DTAA.

The ITAT further held that the existence of a PE is essential only for the taxation of business profits, but that the foreign entity not having a PE in India does not come in the way of taxation of royalties.



Oncology Services India (P.) Ltd. v/s ADIT (Int. Taxation) (82 taxmann.com 42) (ITAT Ahmedabad Bench)

CBDT clarifies that remittance of PSF by an airline to the airport operator shall not be construed as rent for the purposes of tax withholding under section 194-I of the Act.

Airline operators collect PSF from embarking passengers, which is remitted to the concerned airport operator/authority.

In case of certain airline operators, a dispute arose on the applicability of the provisions of section 194-I of the Act on payment of PSF by an airline to an airport operator.

The Bombay HC, in the case of CIT (TDS) v. Jet Airways (India) Limited [ITA No. 1181 of 2014], based on the SC ruling in the case of Japan Airlines Co. Limited v. CIT [CA No. 9875 of 2013 CA No. 9876-9881 of 2013], has interpreted the provisions of section 194-I of the Act and held that the characterisation of payment as being in the nature

of rent primarily requires the use of land or building and mere incidental/minor/insignificant use of the same while providing other facilities and services would not fall within the ambit of rent as per section 194-I of the Act.

The CBDT, vide Circular no. 21/2017 dated 12 June 2017, has recognised the view propounded by the Bombay HC as being the final view on the matter and clarified that the provisions of section 194-I of the Act will not apply on PSF.

It has also instructed that appeals may not be filed by the tax department on this ground and those already filed may be withdrawn/not pressed.



Customs

- The central government has issued a notification wherein exemption has been given to the goods falling under the First Schedule of the Customs Tariff Act, 1975 (51 of 1975), when imported into India by or along with a unit of the Army, the Navy, the Air Force or the Central Paramilitary Forces on the occasion of its return to India after a tour of service abroad, from the whole of the basic customs duty and from the whole of the additional duty of customs leviable thereon under section 3 of the said Customs Tariff Act.

Notification no. 17/2017 dated 21 April 2017

- The central government has levied 4% Special Additional Duty on import of aviation turbine fuel.

Notification no. 52/2017 dated 30 June 2017

- The central government, by way of notification, has exempted engines and parts of aircraft when re-imported into India after having been exported from whole of duty of customs and IGST leviable thereon as in excess of custom duty payable on cost of repair in specific cases prescribed.

Notification no. 38/2017 dated 30 June 2017



GST – supply of service

The following exemptions in the service tax law continue under GST:

- Services by way of transportation by rail/vessel from one place in India to another of defence or military equipment
- Services provided by goods transport agency, by way of transport in a goods carriage of defence or military equipment
- Service by way of transportation of goods by an aircraft from a place outside India up to the custom station of clearance in India



GST updates

- The central government introduced GST from 1 July 2017. Further, a five-tier (0%, 5%, 12%, 18% and 28%) rate structure, along with the relevant rules, have been notified.
- All the importers and exporters will now be required to mention their GSTIN and PAN on documents, namely bill of entry, shipping bills, etc., to avail of benefits under the custom laws and foreign trade policy.
- The government has reopened the GST registration window from 25 June 2017 till 30 September 2017.
- The central government has also released final rules, return formats, payment rules, refund rules and registration rules, etc.
- Under GST, a bond/LUT has to be submitted before the jurisdictional Deputy/Assistant

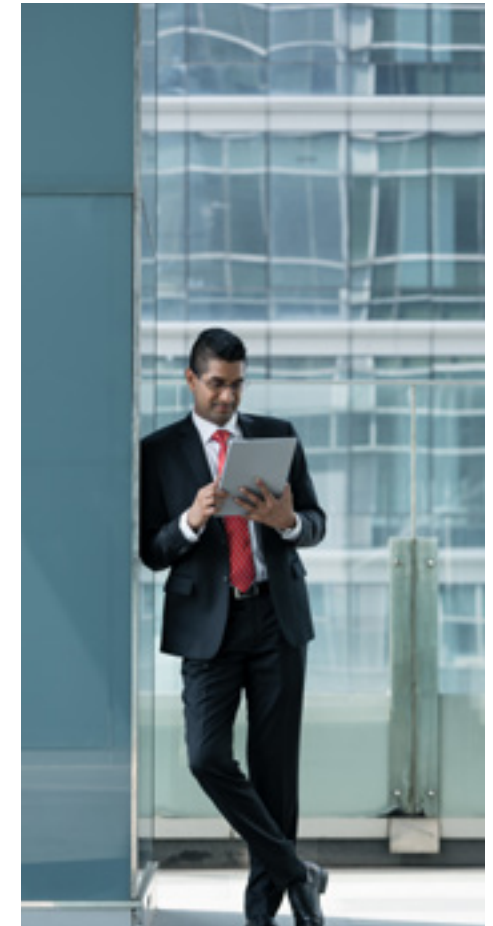
Commissioner prior to making export of goods or services. The bond/LUT has to be submitted in the format specified in Form RFD-11 and can be done manually till the time the module of Form RFD-11 is not available on the common portal.

Circular no. 2/2/2017-GST dated 4 July 2017

- Under the previous law, both VAT and service tax were applicable on maintenance activities undertaken in India (referred to as a 'works contract'), which resulted in a higher tax burden for MRO. The GST law specifies that in the case of a composite supply comprising two or more activities, the supply shall be deemed to be the supply of dominant aspect.
- The GST Council has notified the final rates applicable on goods

and services, according to which 5% IGST is to be levied on tools and toolkits imported for the MRO of aircraft and 18% GST is to be levied on MRO services of an aircraft undertaken in India. Also, services rendered by overseas MRO companies shall attract GST in the hands of the domestic recipient under reverse charge.

- The custom duty exemptions on the import of specified goods like aircraft for defence purposes were removed for imports done by the Government of India or state governments, government contractors, PSUs or subcontractors of PSUs w.e.f. 1 April 2016. Post the release of the final rates applicable on goods, no exemptions are provided and such imports continue to remain liable to tax.



Glossary

A&D	Aerospace and defence
AAR	Authority for Advance Ruling
AFV	Armoured fighting vehicles
AM	Administrative Ministry
CCEA	Cabinet Committee on Economic Affairs
CIN	Commodity Identification Note
CIT (A)	Commissioner of Income Tax (Appeals)
CNC	Contracts Negotiation Committee
CGST	Central Goods and Services Tax
CRH	Commercial rights holder
DCIT	Commissioner of Income Tax
DDP	Department of Defence Production
DGCA	Directorate General of Civil Aviation
DGFT	Directorate General of Foreign Trade

DIPP	Department of Industrial Policy and Promotion
DPP	Defence Procurement Procedure
DPSU	Defence Public Sector Undertakings
FDI	Foreign direct investment
FGFA	Fifth-generation fighter aircraft
FIPB	Foreign Investment Promotion Board
FTS	Fees for Technical Services
GST	Goods and Services Tax
HAL	Hindustan Aeronautics Limited
HC	High Court
IDR	Industries Development and Regulation Act
IL	Industrial licence
IGST	Integrated Goods and Services Tax
ITAT	Income Tax Appellate Tribunal

Glossary

JV	Joint venture
LoI	Letter of intent
LUT	Letter of undertaking
MBT	Main battle tanks
MHA	Ministry of Home Affairs
MOD	Ministry of Defence
MoU	Memorandum of understanding
MPPA	Million passengers per year
MRO	Maintenance, repair and overhaul
MTCR	Missile Technology Control Regime
NSDC	National Skill Development Corporation
NSG	Nuclear Suppliers Group
OA	Organisation agreement
OEM	Original equipment manufacturer

OFB	Ordnance Factory Board
PAN	Permanent Account Number
PE	Permanent establishment
PMF	Perspective Multirole Fighter
PSF	Passenger service fees
PSU	Public sector undertaking
R&D	Research and development
RCS	Regional Connectivity Scheme
RDL	Reliance Defence Limited
RPC	Race Promotion Contract
SP	Strategic partner
SA	Service agreement
SC	Supreme Court
SCOMET	Special Chemicals, Organisms, Materials, Equipment and Technologies

Glossary

SGST	State Goods and Services Tax
SOP	Standard operating procedure
SPM	Strategic Partner Model
SPV	Special purpose vehicle
SQR	Service quality requirements
TASL	Tata Advanced Systems Limited
TCA	Technical collaboration agreement
ToT	Transfer of technology
VAT	Value-added tax
WA	Wassenaar Arrangement
WC	World championship



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